CITY OF Los Angeles
DEFERRED COMPENSATION PLAN (DCP)

Plan Governance & Administrative Issues Committee (Committee)
Report 19-01

Committee Members
John R. Mumma *Chairperson*
Joshua Geller
Wendy Macy
Thomas Moutes

Date: February 5, 2019

To: Committee

From: Staff

Subject: 2019 DCP Resources Review

Recommendation:
That the Committee (a) receive and file report regarding the 2019 DCP resource review; and (b) recommend to the Board that the Board revise budgetary assumptions regarding long-term net participation from 2% to 3% and indirect salary reimbursement rates from 100% to 115%.

Discussion
At its March 20, 2018 meeting, the Board adopted staff's recommendation to convene the Committee on an annual basis in order to conduct a DCP resource review. This review includes a review of the assumptions for key variables which are used in forecasting the long-term (ten-year) projections of DCP reserve fund balances.

To assist the Committee in its review, staff has developed a supplementary report summarizing the status of key variables used to forecast the long-term projections of Plan reserve fund balances compared to the Plan's adopted target reserve (**Attachment A**). During the Committee meeting staff will also project a spreadsheet forecasting tool so that the Committee may model additional scenarios for consideration.

A. Reserve Fund Target and Forecasting Assumptions

All of the City's internal administrative costs are required to be paid by participant fees. Two accounts are used to pay expenses: a fund held with the Third-Party Administrator (TPA) which acts as a repository for participant fees and from which most Plan expenses are paid; and a fund held within the City, from which travel and equipment purchases are made. In order to maintain stability within the fee structure, the DCP maintains a reserve balance. The target reserve amount is 50% of annual Plan operating expenses. As of September 30, 2018, the surplus was $3.4 million versus the target reserve of $1.4 million.

The Committee and Board conducted a DCP resource review in 2018. At the Board's March 20, 2018 meeting, following a Committee review which took place February 2, 2018, the Board approved the Committee's recommendations to reduce the participant asset-based administrative fee from 0.10% to 0.09% as well as reduce the administrative fee cap from $125 to $115. The Board further adopted certain assumptions used in the projection of future DCP Reserve Fund Balances. The 2018 analysis indicated a stable projected outlook for the Plan's long-term reserve fund balance target including the approved fee reductions.

Following is a summary of the current adopted long-term assumptions for key variables relating to management of the DCP Reserve Fund:

Variable	Current
Plan Assets Growth Rate	6.5%
Net Enrollment Growth Rate	2.0%
Annual Expenses Increase Factor	2.0%
Special Rates Increase Factor: Personnel	100.0%
Special Rates Increase Factor: City Attorney	100.0%
Stable Value Interest Rate	2.0%
Participant Fees: Basis Point Charge	0.09%
Participants Fees: Annual Dollar Cap	$115.00

B. TPA Fees

As noted in the 2018 DCP Resources review, the change in the DCP's Third-Party Administrator (TPA) to Voya, which occurred in October 2017, has resulted in significant cost reductions, including the following:

- The annual per-participant TPA account management fee was reduced from $36.97 to $32, a 13.4% reduction saving approximately $220,000 annually
- Rollover fees were eliminated saving approximately $75,000 annually
- Hardship processing fees were eliminated saving approximately $100,000 annually
- Asset Allocation Fund recordkeeping fees were eliminated saving approximately $72,000 annually
- Investment fund share class changes produced savings of approximately $572,000 annually

Cost reductions contributed to the Board's ability to reduce participant fees in 2018.

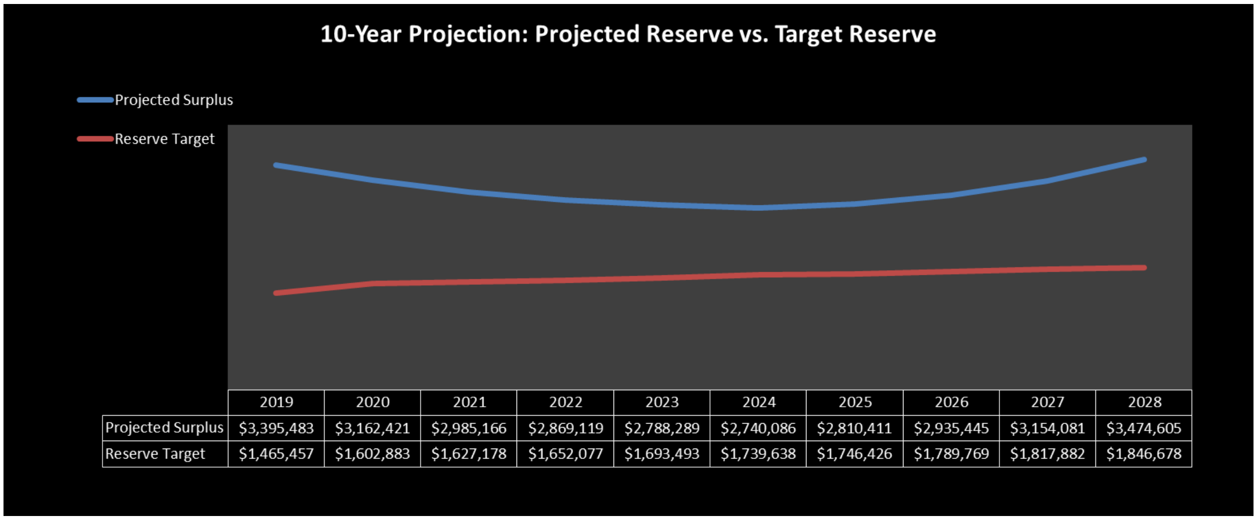
C. Plan Asset Growth

Over the past year, Plan assets rose 2%, which is lower than historical averages. The five-year average growth rate is 7.6%. The ten-year average growth rate is 9.6%. Growth rates incorporate both participant contributions as well as investment gains.

D. Reserve Fund Ten-Year Projection: Baseline Scenario

Staff has updated its ten-year forecast incorporating DCP data as of September 30, 2018, current expense information, and the Board's adopted assumptions for all of the variables used in generating projections. The projected ten-year reserve of $3.5 million is above the ten-year target reserve of $1.8 million. Projected reserves are projected to incrementally decline through 2024 before gradually increasing between 2025-2028. For the purpose of comparison to other scenarios in this report, this projection will be referred to as the "*Baseline Scenario*."

Baseline Scenario



	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Projected Surplus	$3,395,483	$3,162,421	$2,985,166	$2,869,119	$2,788,289	$2,740,086	$2,810,411	$2,935,445	$3,154,081	$3,474,605
Reserve Target	$1,465,457	$1,602,883	$1,627,178	$1,652,077	$1,693,493	$1,739,638	$1,746,426	$1,789,769	$1,817,882	$1,846,678

Following analysis, staff recommends the following with respect to the current adopted assumptions related to **Asset Growth, Net Participation, Administrative Expense Inflation**, **Indirect Salary Cost,** and **Stable Value Fund Interest**:

- **Asset Growth (recommendation: no change)** - Notwithstanding last year's below-average growth in DCP assets, both the historical averages as well as the assumed long-term overall DCP investment rate of return provided by Mercer Investment Consulting (Mercer) support the 6.5% assumed growth rate assumption.
- **Net Participation (recommendation: increase assumed annual growth from 2% to 3%)** – Net participation rose by 6% in 2018 and over the past five years has increased by over 3% annually. If the economy and the City's financial position remain stable, further City hiring, as well as the potential expansion of the DCP Auto Enrollment Program (AEP), may support continued strong growth in the number of participant accounts. Countering this trend will be employee retirements and other separations from service, but if the DCP is successful in its goal to limit full account liquidations, retirements may not mean the closing of as many participant accounts.

- **Administrative Expense Inflation (recommendation: no change)** – Given that new ongoing expenses (including the costs of an annual DCP audit and outside tax counsel services) are included in base costs, staff finds that the 2% annual increase in overall costs (e.g., for direct salary costs) is reasonable.
- **Indirect Salary Costs (recommendation: increase assumed ten-year average rate to 115%)** – Special rates provided by the City Controller for calculation of indirect costs for the Personnel Department and City Attorney are presently 102.3% and 104.7%, respectively. As indirect salary costs tend to trend higher, staff recommends the assumption for indirect cost special rates be increased to 115%.
- **Stable Value Fund Interest (recommendation: no change)** – Longer-term rates of return will largely be driven by economic growth. As the current economic expansion continues to be one of the longest on record, staff's finding is that the risks of a decline in interest rates, perhaps a protracted decline, argue for maintaining an assumed 2% average rate.

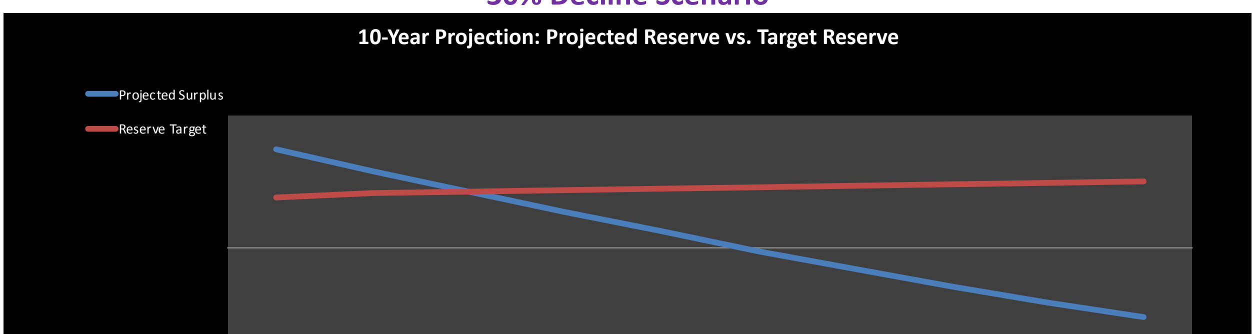
E. Reserve Fund Ten-Year Projection: 30% Decline Scenario

Asset values can fluctuate significantly in either direction based on market returns. Since 2008, the DCP and its participants have benefited from a long-running bull market in equities and a stable bond market, which more than offset declines in returns for the DCP's interest-bearing investment options (the Stable Value and FDIC-Insured funds). Assets have also been buttressed significantly in recent years by the growth in participant accounts and contributions.

The DCP has experienced market-related annual asset declines, however, with the worst being in 2008 (28% decline). As was the case in the Committee's 2018 review, staff has provided an illustration of the impact of a sharp reduction in DCP assets on par with the 2008 decline.

The following chart illustrates a scenario involving a 30% decline in assets incorporating all of the modified assumptions noted in Section D of this report. In this scenario, the projected reserve would become negative beginning in 2024 (meaning participant fees would need to be increased in order for the DCP to fulfill its expense obligations).

30% Decline Scenario



	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Projected Surplus	$3,001,474	$2,341,776	$1,705,528	$1,096,011	$484,975	$(132,574)	$(673,297)	$(1,203,734)	$(1,687,893)	$(2,120,573)
Reserve Target	$1,511,475	$1,659,850	$1,694,400	$1,730,033	$1,782,679	$1,840,569	$1,859,635	$1,915,811	$1,957,329	$2,000,125

F. Reserve Fund Ten-Year Projection: Impact of Participant Fee Reductions

Should the Committee wish to consider options available to reduce participant fees, as was the case in the 2018 DCP resource review, staff has provided illustrations of three primary options for a broad-based fee reduction:

(1) **Basis Point Reduction Scenario** - Reducing the nine basis point asset-based fee presently assessed on all participant account balances to 0.085%, up to the present $115 fee cap;

(2) **Fee Cap Reduction Scenario** – Maintaining the current .09% asset-based fee but reducing the $115 fee cap to $110, which applies on a more limited basis to the approximately 14,800 participants (2% of total) who presently have balances above the fee cap threshold; and

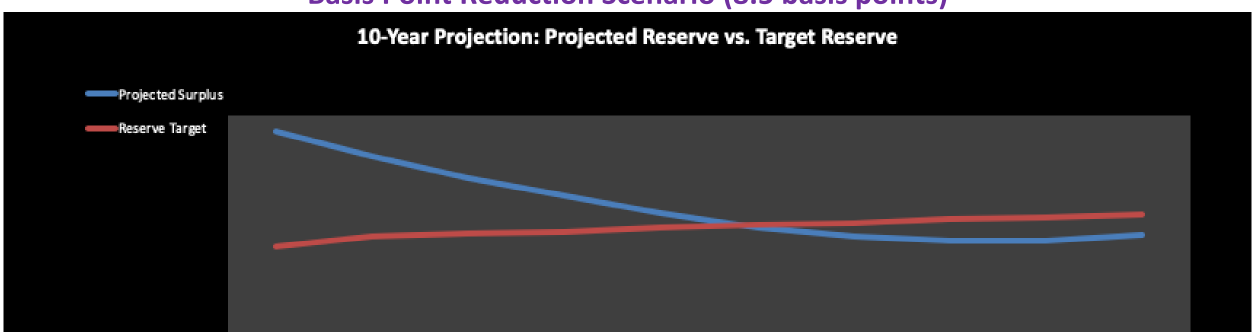
(3) **Combined Scenario** - A combined scenario where both the administrative fee and fee cap are reduced by the amounts included in the prior two scenarios.

Other scenarios can be modeled via the spreadsheet projection at the Committee meeting.

(1) Basis Point Reduction Scenario

As indicated in the following chart, based on current assets and updated assumptions, reducing participant fees by one-half basis point (0.005%), from .09% to .085%, results in the projected reserve falling below target in 2024 and continuing to gradually decline through 2026 before reversing the trend.

Basis Point Reduction Scenario (8.5 basis points)

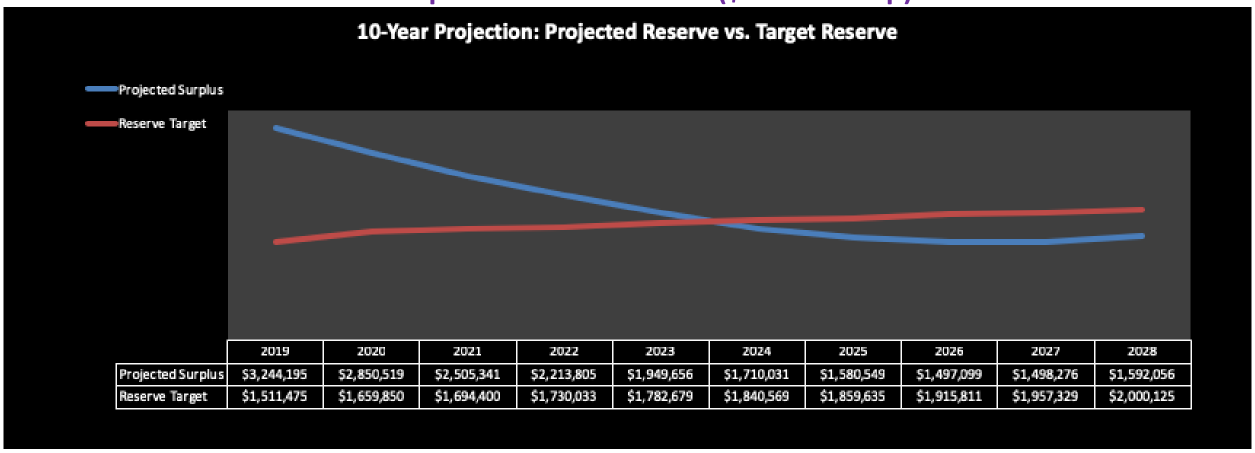


	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Projected Surplus	$3,261,406	$2,883,735	$2,553,149	$2,274,569	$2,021,499	$1,790,810	$1,667,834	$1,588,151	$1,590,017	$1,681,044
Reserve Target	$1,511,475	$1,659,850	$1,694,400	$1,730,033	$1,782,679	$1,840,569	$1,859,635	$1,915,811	$1,957,329	$2,000,125

(2) Fee Cap Reduction Scenario

As indicated in the following chart, based on current assets and updated assumptions, reducing the current fee cap from $115 to $110 results in the projected reserve falling below target in 2024 and continuing to gradually decline through 2027 before reversing the trend in 2028.

Fee Cap Reduction Scenario ($110 Fee Cap)

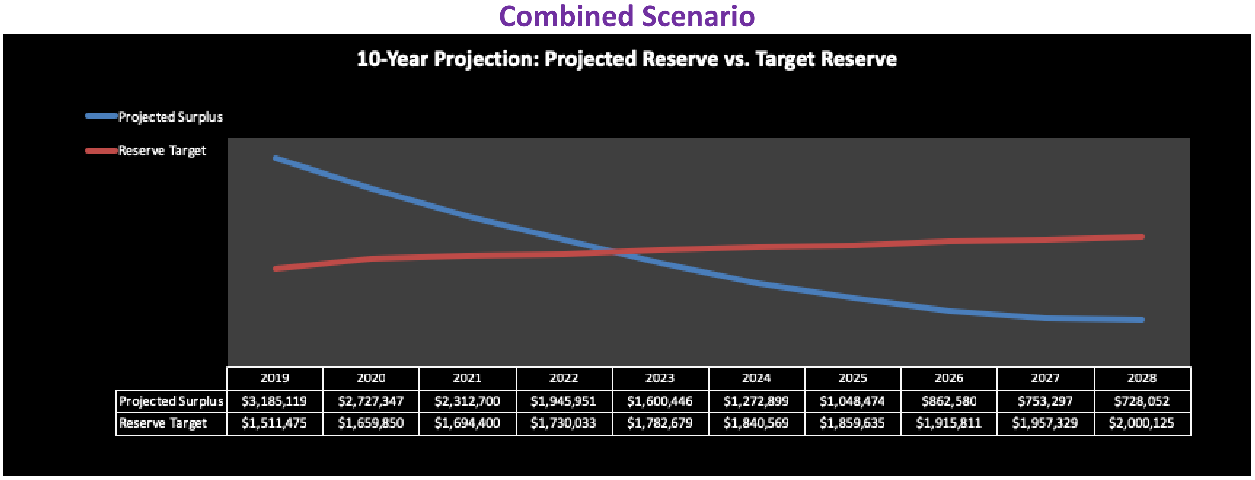


	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Projected Surplus	$3,244,195	$2,850,519	$2,505,341	$2,213,805	$1,949,656	$1,710,031	$1,580,549	$1,497,099	$1,498,276	$1,592,056
Reserve Target	$1,511,475	$1,659,850	$1,694,400	$1,730,033	$1,782,679	$1,840,569	$1,859,635	$1,915,811	$1,957,329	$2,000,125

(3) Combined Scenario

As indicated in the following chart, based on current assets and updated assumptions, reducing the asset-based fee to 0.085% and the fee cap to $110 results in the projected reserve falling below target in 2023 and continuing to gradually decline through 2028, with no reversal in trend.

Combined Scenario



	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Projected Surplus	$3,185,119	$2,727,347	$2,312,700	$1,945,951	$1,600,446	$1,272,899	$1,048,474	$862,580	$753,297	$728,052
Reserve Target	$1,511,475	$1,659,850	$1,694,400	$1,730,033	$1,782,679	$1,840,569	$1,859,635	$1,915,811	$1,957,329	$2,000,125

Summary:

Staff does not recommend reductions to asset-based fees and/or the fee cap based on this year's review. Even modest reductions in either result in the projected reserve falling below target. A significant and/or extended decline in the investment markets should be considered a real risk over the next ten years. Staff's finding is that maintaining the current fee structure is appropriate based on current data.

However, staff recommends that the Committee recommend to the Board that it revise budgetary assumptions regarding long-term net participation from 2% to 3% and indirect salary reimbursement rates from 100% to 115%. Once the Committee makes its findings and recommendations, staff will prepare a report for the Board for consideration at its February 19, 2019 meeting. That report will also include a proposed annual budget for 2019.

Submitted by: __________________________
Matthew Vong

Reviewed by: ____________________________
Isaias Cantú

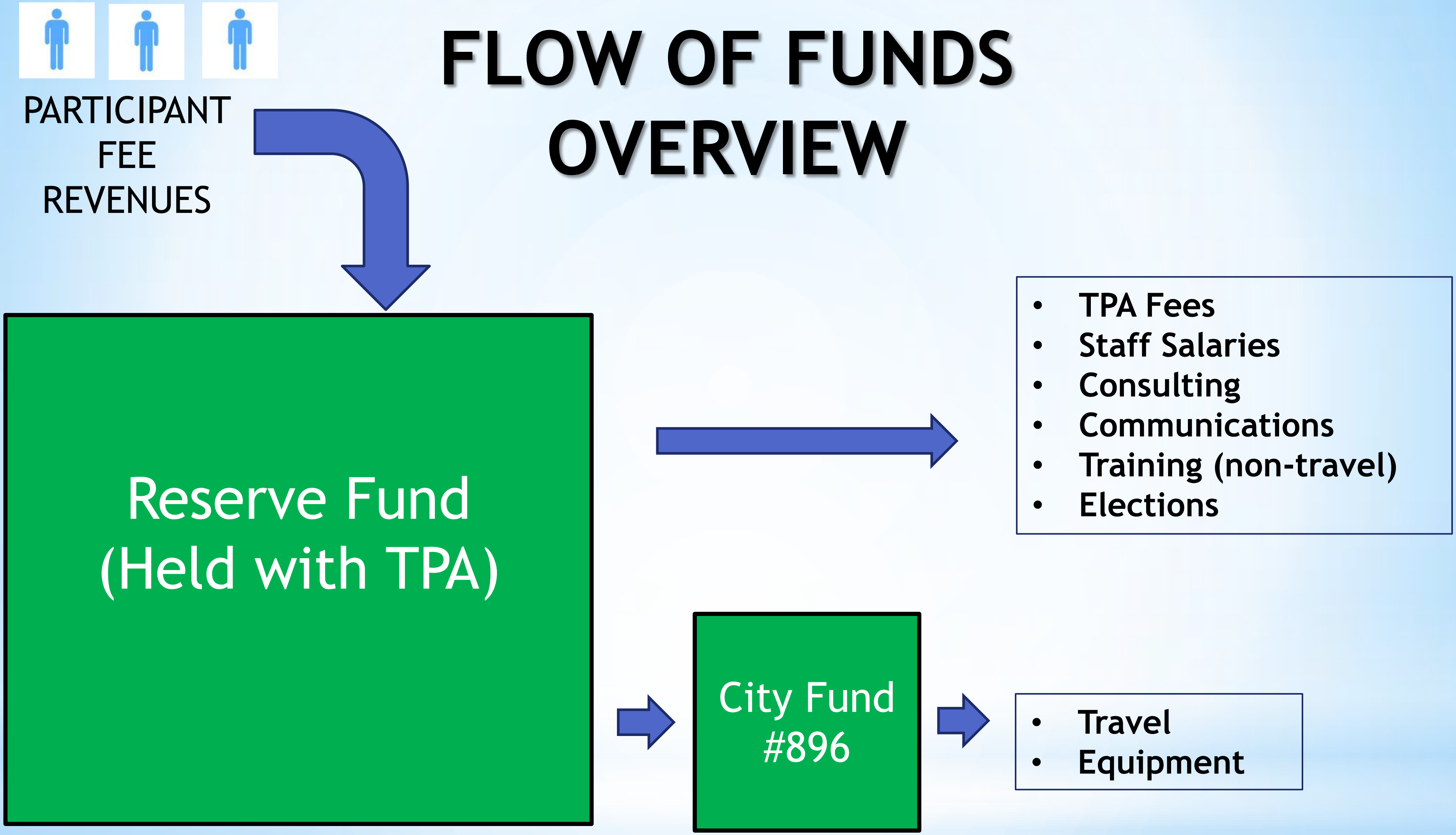
Approved by: ____________________________
Steven Montagna

CITY OF Los Angeles
DEFERRED COMPENSATION PLAN

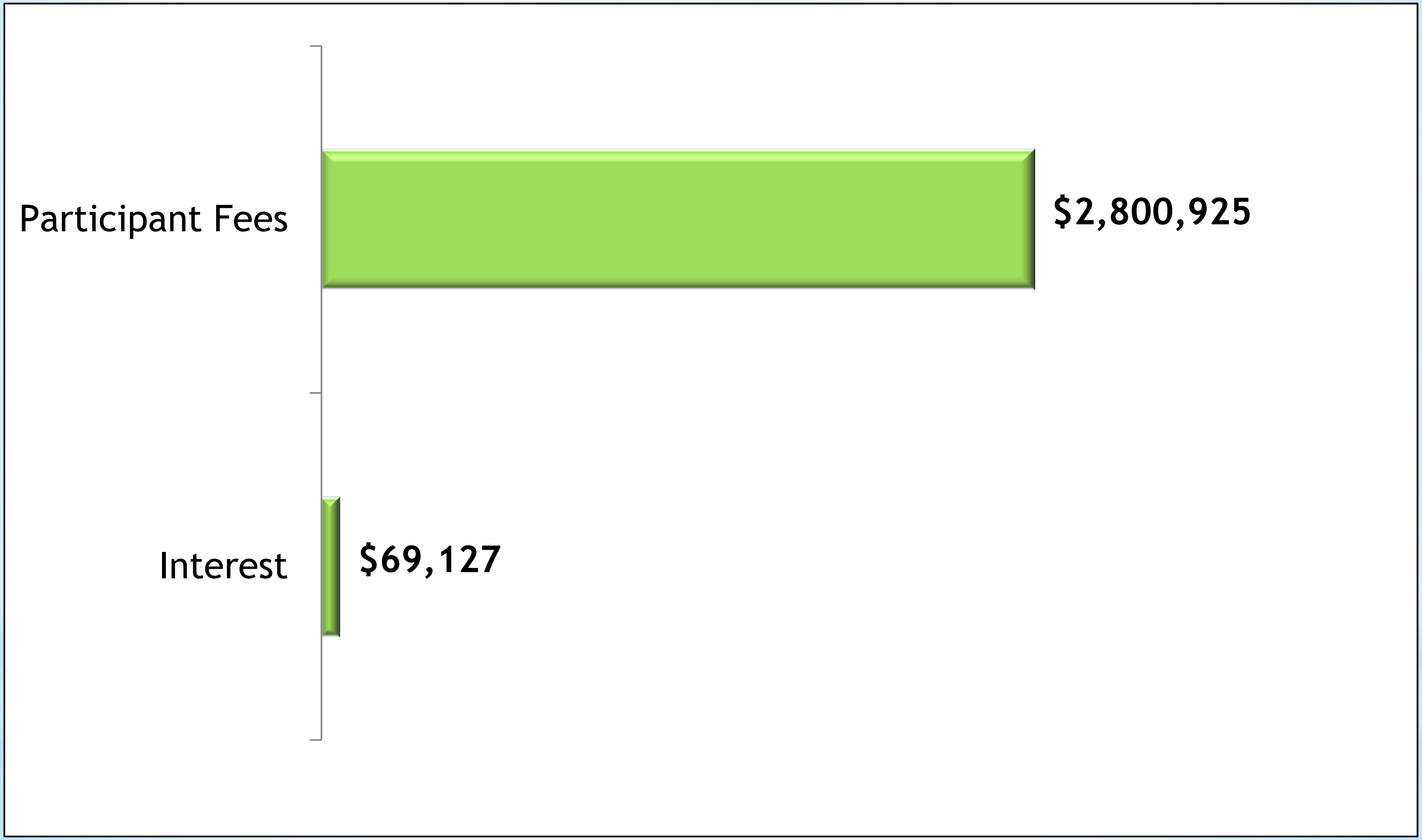
PLAN BUDGET & RESOURCES REVIEW

February 5, 2019

FLOW OF FUNDS OVERVIEW

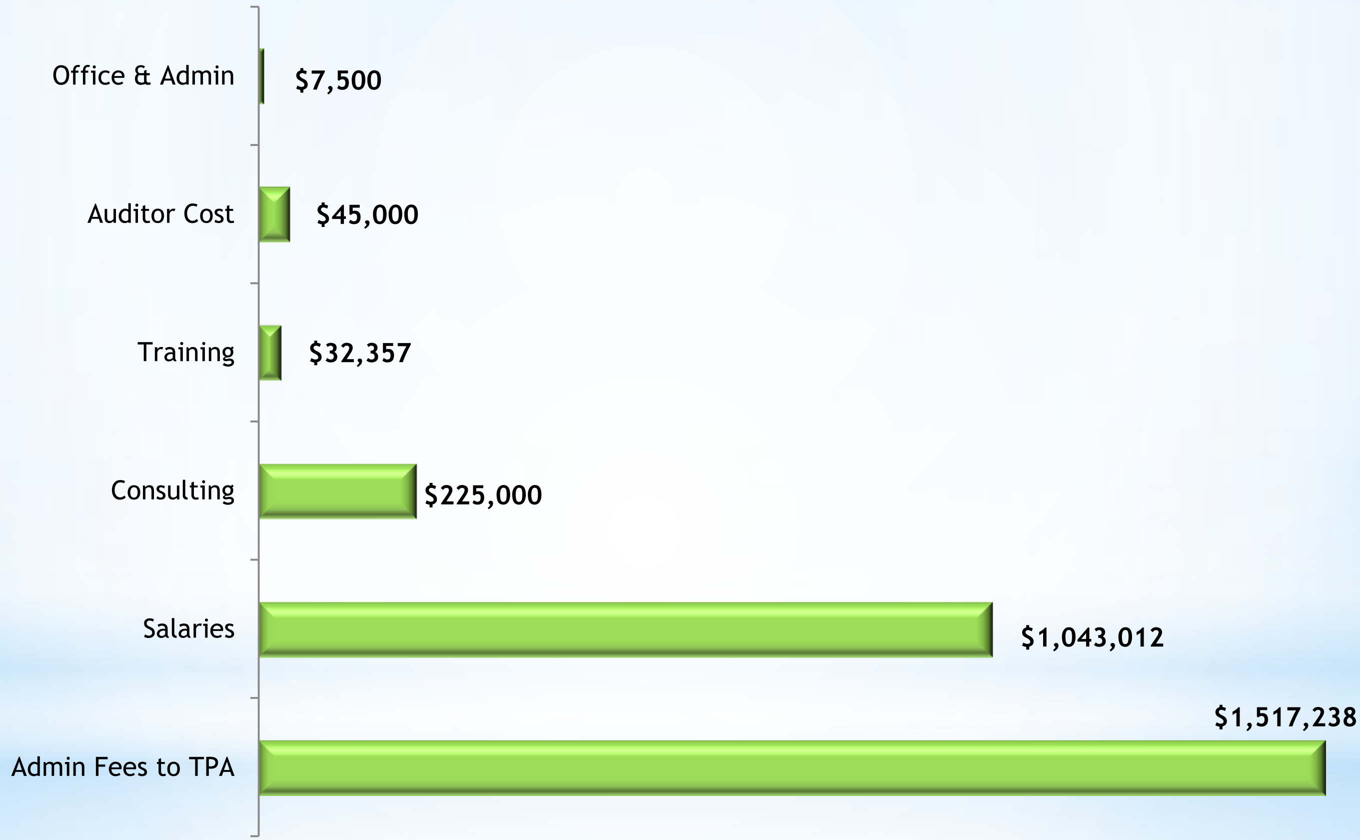


Projected 2019 REVENUES



Annual Total - **$2.87 million**

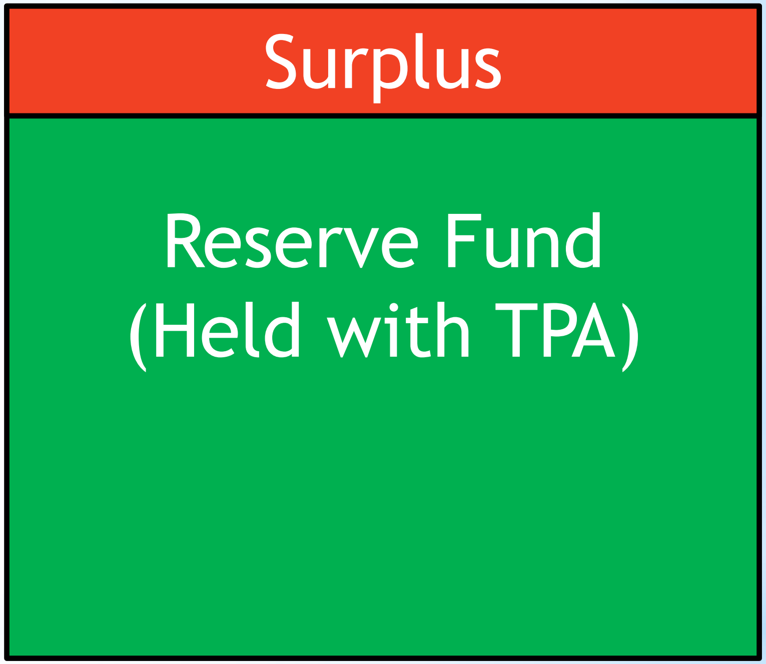
PROJECTED 2019 EXPENDITURES



Annual Total - **$2.87 million**

SURPLUS TARGET

- Adopted Reserve Fund surplus target is 50% of annual operating expenses (approximately $1.4 million in 2019)
- Historical surplus has been maintained above that target
- Board previously established a “structural deficit” in relationship of revenues to expenses to gradually reduce surplus
- As of 09/30/18, surplus was **$3.5 million**



RESERVE FUND KEY ASSUMPTIONS

Current

→

Expenses Inflation Adjustment Factor	*Enrollment Adjustment Factor*	*Asset Growth Adjustment Factor*	*Stable Value Funds Interest Assumption*	*Basis Points Charged Against Participant Accounts*	*Fee Cap*
2.0%	**2.0%**	**6.5%**	**2.0%**	**0.09%**	**$115**

Current

→

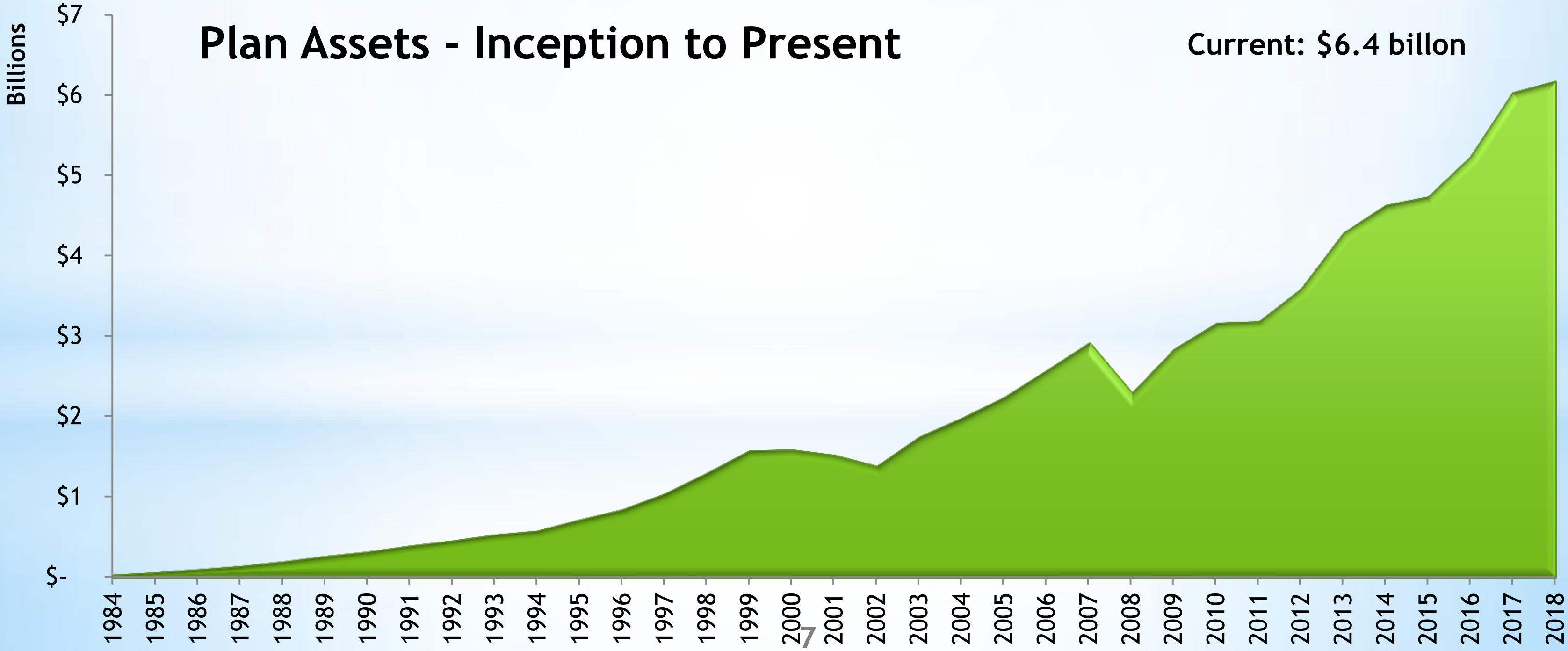
Personnel Avg. Special Rate	*City Attorney Avg. Special Rate*
100%	**100%**

These assumptions were last updated by the Board on March 20, 2018.

KEY ASSUMPTIONS
Plan Asset Growth
Current: **6.5%**

Where Applied: Growth rate for Plan assets

Considerations: Recent growth higher than current assumption, but bond/equity bull markets aging



KEY ASSUMPTIONS

Plan Asset Growth

Year	Assets	% Change
1984	$ 17,990,298	N/A
1985	$ 48,584,697	170%
1986	$ 84,762,277	43%
1987	$ 126,921,243	33%
1988	$ 180,395,336	30%
1989	$ 249,105,465	28%
1990	$ 303,691,355	18%
1991	$ 378,018,448	20%
1992	$ 441,306,161	14%
1993	$ 516,401,147	15%
1994	$ 564,392,235	9%
1995	$ 702,779,928	20%
1996	$ 831,689,383	15%
1997	$ 1,029,129,147	19%
1998	$ 1,285,271,264	20%
1999	$ 1,564,440,301	18%
2000	$ 1,578,565,882	1%
2001	$ 1,508,545,448	-5%
2002	$ 1,373,444,396	-10%
2003	$ 1,737,260,679	21%
2004	$ 1,973,665,625	12%
2005	$ 2,230,031,810	11%
2006	$ 2,566,734,158	13%
2007	$ 2,909,282,960	12%
2008	$ 2,279,918,897	-28%
2009	$ 2,828,435,629	19%
2010	$ 3,154,860,910	10%
2011	$ 3,174,274,111	1%
2012	$ 3,578,684,906	11%
2013	$ 4,277,754,120	16%
2014	$ 4,622,493,622	7%
2015	$ 4,726,682,745	2%
2016	$ 5,221,905,502	10%
2017	$ 6,027,047,083	15%
2018	$ 6,167,288,137	2%

2018 Plan Asset totals as of 12/31/2018

Potential Growth Rate Scenarios	
Last 15 years average-->	**7.8%**
Last 10 years average-->	**9.6%**
Last 5 years average-->	**7.6%**
Actuarial Potential Growth Rate -->	**6.7%**

Projected Growth Rate Including ROR		
Current Assets (as of 12/31/2018)	$	6,167,288,137
Net Annual Contributions	$	44,059,058
Projected ROR (per Mercer)*		5.82%
Earnings Growth	$	358,936,170
Projected Ending Balance	$	6,581,208,964
Projected Annual Growth Rate		**7.6%**

*The rate of return (ROR) was provided by Mercer in January of 2019. This value is projected over a 20-year horizon.

KEY ASSUMPTIONS
Net Participation

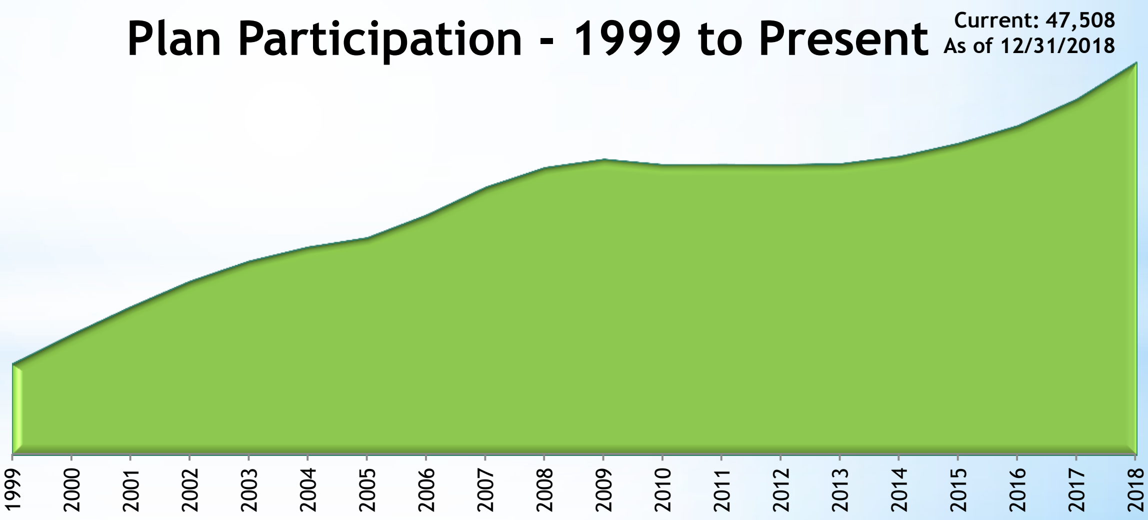
Current: 2%

Where Applied: Estimated growth in participant accounts

Considerations: Net growth is rising; 2018 increase highest since 2002

Year Ending	Participants	Percent Change
1999	26,319	
2000	28,382	8%
2001	30,315	7%
2002	32,109	6%
2003	33,528	4%
2004	34,528	3%
2005	35,182	2%
2006	36,784	5%
2007	38,733	5%
2008	40,106	4%
2009	40,702	1%
2010	40,316	-1%
2011	40,348	0%
2012	40,325	0%
2013	40,389	0%
2014	40,906	1%
2015	41,818	2%
2016	43,076	3%
2017	44,938	4%
2018	47,508	6%

Participant totals As of 12/31/2018



KEY ASSUMPTIONS
Administrative Expense Inflation

Current: 2%

Where Applied: Salary costs, Training costs, and Office/Admin costs

Considerations:
- Cost of living increases may be below this rate over near and mid-term
- Positions often filled at lower level than position authority
- Training costs/admin costs generally lower than budgeted amount

KEY ASSUMPTIONS
Indirect Salary Costs

FY 17-18 #40 Special Rates (Final):
- Personnel – 102.34%
- City Attorney – 104.67%

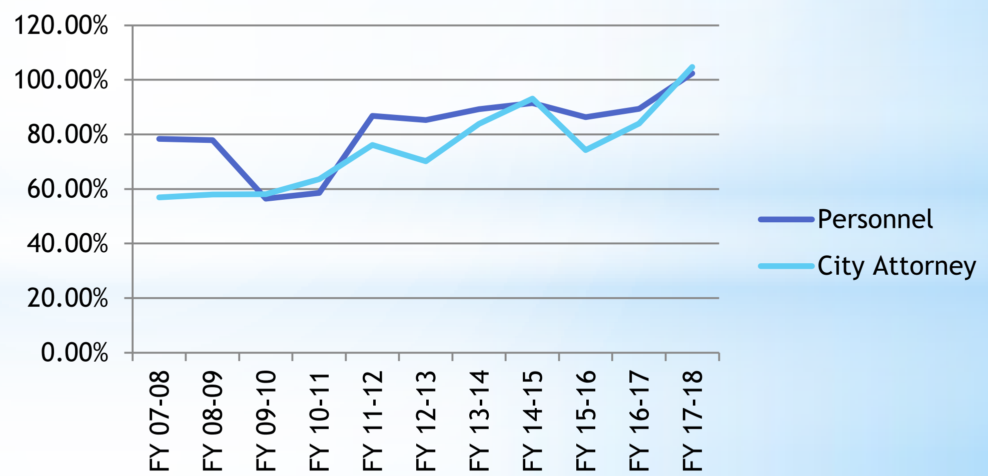
5-Year Average:
- Personnel – **91.76%**
- City Attorney – **87.98%**

Current Assumptions:
- Personnel – **100%**
- City Attorney – **100%**

As Applied: Indirect salary costs

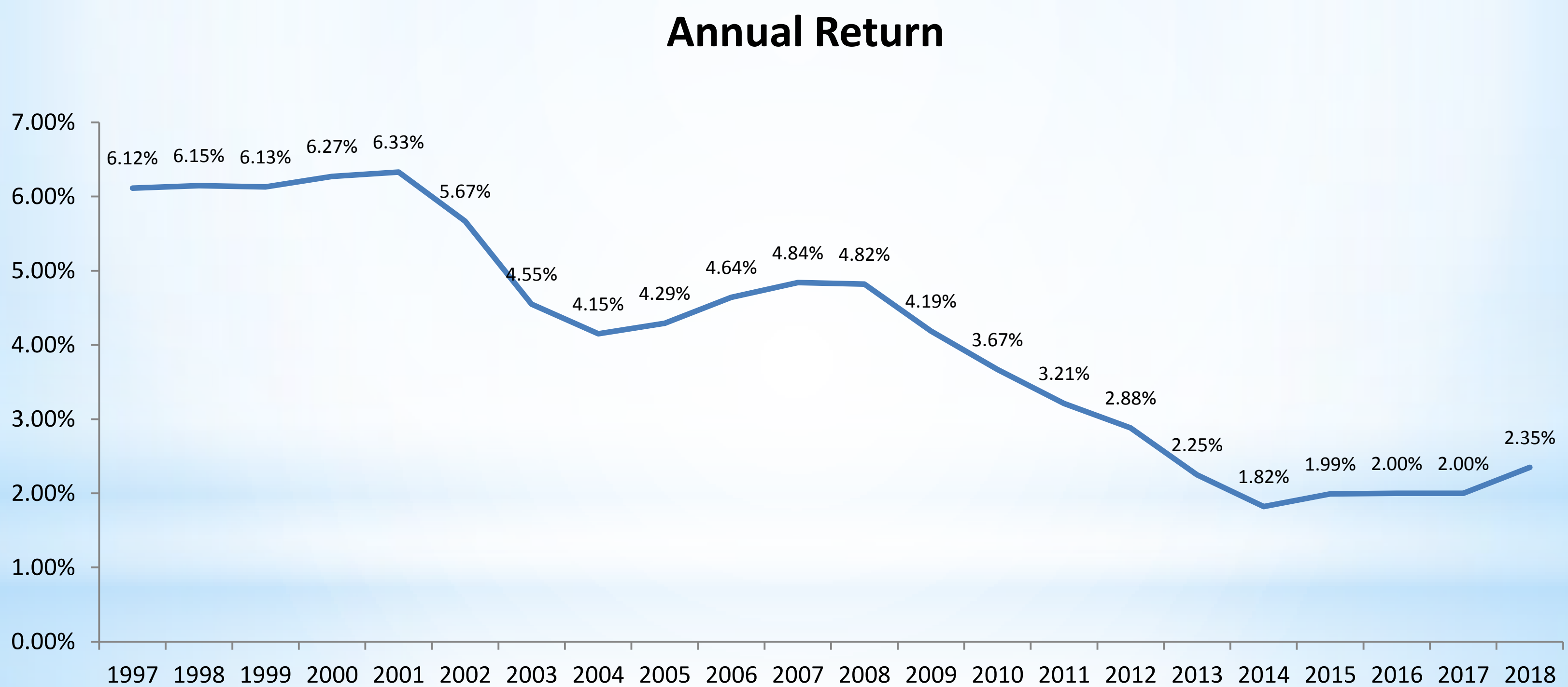
Considerations: Rates can be volatile and have large impact on costs

Fiscal Year	Personnel	City Attorney
FY 07-08	78.30%	56.91%
FY 08-09	77.94%	57.96%
FY 09-10	56.43%	58.03%
FY 10-11	58.56%	63.59%
FY 11-12	86.77%	76.17%
FY 12-13	85.23%	70.19%
FY 13-14	89.30%	83.83%
FY 14-15	91.51%	93.09%
FY 15-16	86.28%	74.25%
FY 16-17	89.37%	84.04%
FY 17-18	102.34%	104.67%
All Avg	**82.00%**	**74.79%**
5-Yr Avg	**91.76%**	**87.98%**



KEY ASSUMPTIONS
Stable Value Fund Interest

Current: **2%**



KEY ASSUMPTIONS
Participant Fees

Current:

Basis Points: **0.09%**/Fee Cap: **$115**

Where Applied: Fees assessed against participant accounts, up to fee cap

Considerations:

- Changes to Third-Party Administrator fee structure have created structural long-term savings
- Risk lies in a protracted market downturn that does not resolve in a short (few years) period of time