Plan Governance & Administrative Issues Committee Report 22-01

Committee Members
Joshua Geller *Chairperson*
Thomas Moutes
Baldemar J. Sandoval

Date: August 29, 2022

To: Plan Governance & Administrative Issues Committee

From: Staff

Subject: 2023 DCP Resource Review

Recommendation:

That the Plan Governance & Administrative Issues Committee (Committee) recommend that the Board of Deferred Compensation Administration (Board) adopt the following assumptions for use in projecting future Deferred Compensation Plan (DCP) Reserve Fund balances:

(1) DCP Assets Growth Rate - **5.5%**
(2) Net Participation Growth Rate - **3%**
(3) Annual Administrative Expenses Growth Rate - **3%**
(4) Special Rates Increase Factor: Personnel - **91%**
(5) Special Rates Increase Factor: City Attorney - **93%**
(6) Stable Value Fund Average Rate of Return - **2%**
(7) Participant Fees: Annual Basis Point Charge - **0.09%**
(8) Participant Fees: Annual Dollar Cap - **$115**

Discussion:

At its March 20, 2018 meeting, the Board adopted staff's recommendation to convene the Committee on an annual basis to conduct a DCP resource review. This evaluation includes a review of the key assumptions used in forecasting the ten-year projection of the DCP Reserve Fund balance and additional considerations related to long-term resource planning for the DCP.

To assist the Committee in its review of recommendations related to key assumptions, staff has developed a supplementary report (**Attachment A**) summarizing the status of key variables used to forecast the long-term projection of the DCP Reserve Fund balance compared to the DCP target Reserve Fund balance.

A. Background

All of the DCP's administrative costs are required to be paid by participant fees. Two accounts are used to pay expenses: a fund held with the DCP Third-Party Administrator (TPA) which acts as a repository for participant fees and from which most DCP expenses are paid; and a fund held within the City, from which travel expenses and equipment purchases are paid.

To maintain stability within the fee structure, the DCP maintains a Reserve Fund balance. The target Reserve Fund balance is 50% of annual DCP operating expenses. As of June 30, 2022, the target Reserve Fund balance was $1.6 million compared to the actual balance of about $4.7 million.

The Committee last conducted a DCP resource review in November 2021. Over the past year, the Board has actions relating to the Reserve Fund:

- At its **December 21, 2021** meeting, the Board adopted staff's recommendation to (a) approve the Committee's recommendations to adopt key assumptions used in forecasting the long-term (ten-year) projection of the DCP Reserve Fund balance; (b) request that staff draft a proposed budget policy for adoption of the Board to address roles and responsibilities of the DC Plan Manager and the Board and including a timetable for conducting DCP resource reviews, developing annual budget requests to the Mayor and City Council, and engaging with stakeholders in support of its resource objectives; and (c) postpone further review of offering platform-based investment advice pending successful completion of City and DWP payroll system conversions.
- At its **April 19, 2021** meeting, the Board adopted revisions to its Governance Policies/Bylaws. "Fiscal Administration Policy."

B. Annual Review of Reserve Account Assumptions

1) <u>2022 Reserve Fund Assumptions</u>

Following is a summary of the key assumptions adopted by the Board at its December 21, 2021 meeting. These assumptions are used in forecasting a ten-year projection of the DCP Reserve Fund balance:

Variable Description	Assumption
DCP Assets Growth Rate	6.0%
Net Enrollment Growth Rate	3.0%
Annual Expenses Increase Factor	3.0%
Special Rates Increase Factor: Personnel	91.0%
Special Rates Increase Factor: City Attorney	93.0%
Stable Value Interest Rate	2.0%
Participant Fees: Basis Point Charge	0.09%
Participants Fees: Annual Dollar Cap	$115.00

2) <u>Proposed 2023 Reserve Account Assumptions</u>

Recommended actions for 2023 Reserve Account assumptions are discussed as follows:

- **DCP Assets Growth Rate**
  2023 Recommendation: 5.5%

  The projected DCP assets growth rate incorporates both investment gains <u>and</u> participant contributions/rollovers. This projection incorporates future value formulas combining net new contributions and assumed rates of return. The following table provides average gross growth rates over various time periods, inclusive of both contribution and investment gains. Over the past 20 years, increases have ranged from 9.5% to 12.4% over various time bands. This 20-year history includes three significant equity market downturns (2000, 2009 and early 2020) and has produced an average annual DCP growth rate of 10.1%.

Average Growth Rates	
Average (Inception to Present)	**21.0%**
Last 20 years average→	**10.1%**
Last 15 years average→	**9.5%**
Last 10 years average→	**11.5%**
Last 5 years average→	**12.4%**

  Following a period of strong equity performance in the previous decade years, market performance in 2022 year-to-date indicates a trend toward lower returns in the near future. Using current assets and participant allocations, the Board's investments consultant has updated its long-term projected investment rate of return for the DCP, which is now 5.52%. Staff has combined that with a future value projection incorporating an assumption regarding average net cash inflows. The resulting forward-looking projection is 5.9%. This projection has marginally decreased year-over-year in previous DCP Resource reviews. Therefore, staff recommends adopting a conservative assumed **5.5%** average annual DCP assets growth over the next ten years, instead of the previously adopted 6% assumption.

- **Net Enrollment Growth Rate**
  2023 Recommendation: 3%

  Net annual enrollment growth in the DCP has averaged 3.4% over the last five years, a period which includes both significant expansion and contraction in the City's workforce. Therefore this number appears to be a reasonable predictor of average future long-term growth. Staff recommends maintaining an assumed **3%** average net participation growth rate over the next ten years.

- **Annual Administrative Expenses Growth Rate**
  2023 Recommendation: 3%

  Administrative expenses are primarily driven by staffing costs. This factor considers increases in staffing costs due to wage increases as well as periods in which positions are vacant. Staff's recommendation is to maintain the previously adopted **3%** growth rate assumption.

- **Special Rates Increase Factor**
  2023 Recommendation: 91% (Personnel Department); 93% (City Attorney)

  Special Rates provided by the City Controller for calculation of indirect costs for the Personnel Department and City Attorney are presently 79.97% and 82.05%, respectively. Staff utilized a projection tool which inflates the indirect cost rate by 2% annually and produces a projected average ten-year rate of 91% and 93% for Personnel and City Attorney staff, respectively. Based on that methodology, staff recommends maintaining assumed **91%** and **93%** average Special Rates increases for Personnel Department and City Attorney staffing costs, respectively.

- **Stable Value Fund Average Rate of Return**
  2023 Recommendation: 2%

  The Reserve Fund is primarily held within a special account in the DCP Stable Value Fund. The average rate of return for the Stable Value Fund over the past five years has been 2.23%. Future rates of return will be affected by economic growth. Although the U.S. Federal Reserve Board is expected to announce further interest rate increases through the end of 2022, staff recommends maintaining a conservative assumption of **2%**.

- **Participant Fees**
  2023 Recommendation: 0.09% Participant Fees; Annual Dollar Cap $115

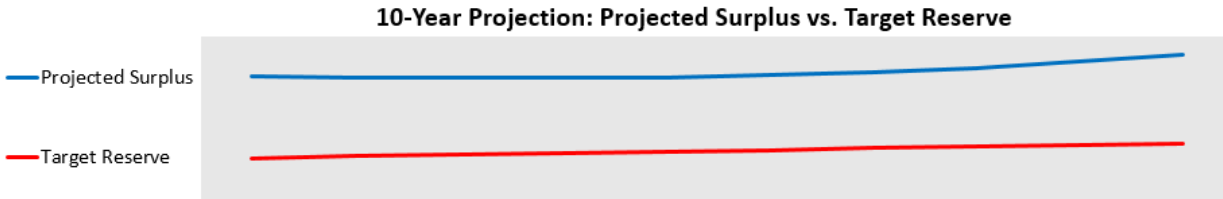
  In line with staff's recommendation in the previous Resource Review, staff is not recommending any actions targeted at reducing the projected surplus in the Reserve Fund at this time. As a consequence, no changes are being recommended to decreasing participant fees.

C. DCP Reserve Fund Ten-Year Projection

1) <u>Baseline Scenario</u>

Staff has updated its ten-year forecast incorporating DCP data as of June 30, 2022, current expense information, and the proposed key variable assumptions for 2023 as previously discussed. The projected Reserve Fund balance is consistently above the target Reserve Fund balance over the ten-year period. This projection is referred to as the "**Baseline Scenario**."

Baseline Scenario



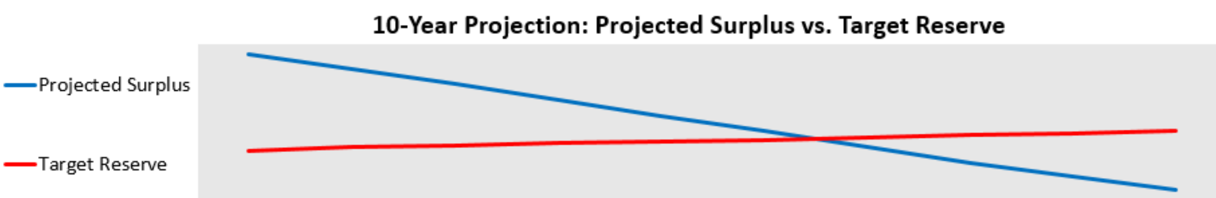
	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Projected Surplus	$4,583,358	$4,525,254	$4,522,566	$4,506,860	$4,534,498	$4,627,142	$4,717,076	$4,861,424	$5,082,661	$5,355,933
Target Reserve	$1,609,324	$1,706,875	$1,742,631	$1,815,910	$1,863,757	$1,904,220	$1,982,347	$2,035,187	$2,080,793	$2,143,216

2) <u>30% Market Decline Scenario</u>

Asset values can fluctuate significantly based on market returns. After a long-running bull market in equities and stable bond market, market returns in 2022 year-to-date are down from previous years as both inflation rates and recession fears are on the rise. The most significant market decline occurred in 2008, at a 22% year-over-year decline.

The following chart illustrates a "**30% Market Decline Scenario**" which incorporates the proposed 2023 variables and a worst-case scenario of a 30% year-over-year decline in DCP assets. In this scenario, the projected reserve would steadily decline, falling below the target reserve over a five-year period.

30% Market Decline Scenario



	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Projected Surplus	$4,240,170	$3,813,139	$3,414,232	$2,973,375	$2,545,193	$2,149,518	$1,716,697	$1,301,809	$925,168	$559,638
Target Reserve	$1,609,324	$1,706,875	$1,742,631	$1,815,910	$1,863,757	$1,904,220	$1,982,347	$2,035,187	$2,080,793	$2,143,216

As staff is not recommending any actions relative to the projected surplus additional projected scenarios are not provided as they have been in some previous years. However, staff can provide additional scenario illustrations to the Committee if so desires.

D. DCP Future Resource Considerations

Overall, the projected ten-year reserve remains above the target. As with the 2022 Resource Review, staff remains cautious of actions to reduce the surplus in the immediate future. As an organization, the DCP may face new resource demands may arise in the future, including the following:

(1) **Staffing –** The DCP is in the process of filling vacancies for the newly created DC Plan Manager and recently allocated Senior Benefits Analyst II positions. Additional resources were brought in through DCP's relationship with Voya, including an intern position and a Voya position dedicated on a full-time basis, to utilizing data to develop goals and implement strategies to drive improved participant outcomes. In the future, it is possible that additional staffing resources will be required to support the continued growth of the DCP over the next ten years. Additionally, due to challenges with filling the DC Plan Manager vacancy, the Board may elect to procure the services of an executive recruitment firm, which would incur additional costs.

(2) **Facilities –** Although DCP and contracted staff are currently working primarily remotely, the DCP continues to consider the potential costs for facilities, including office space for the incoming DC Plan manager and a potential future move away from staff's current location in City Hall.

(3) **Program Services and Features –** Adding new DCP programs and services may result in higher ongoing program costs in the future. Review of additional services such as investment advance are currently paused until after the City and Department of Water and Power (DWP) payroll system conversions are completed and post-conversion issues have been resolved. Nevertheless, whether it is investment advice or some other future potential program feature, new services represent another potential resource cost over the next ten years.

E. Summary and Recommendations

Staff recommends that the Committee recommend that the Board adopt the following assumptions for use in projecting future DCP Reserve Fund balances as outlined below:

Variable Description	Assumption	Proposed
DCP Assets Growth Rate	6.0%	**5.5%**
Net Enrollment Growth Rate	3.0%	**3.0%**
Annual Expenses Increase Factor	3.0%	**3.0%**
Special Rates Increase Factor: Personnel	91.0%	**91.0%**
Special Rates Increase Factor: City Attorney	93.0%	**93.0%**
Stable Value Interest Rate	2.0%	**2.0%**
Participant Fees: Basis Point Charge	0.09%	**0.09%**
Participants Fees: Annual Dollar Cap	$115.00	**$115.00**

Submitted by: ____

Mindy Lam, Benefits Analyst

Submitted by: ____

Daniel Powell, Senior Personnel Analyst II

Attachment A

CITY OF Los Angeles
DEFERRED COMPENSATION PLAN

DCP BUDGET & RESOURCE REVIEW

August 29, 2022

FLOW OF FUNDS OVERVIEW

PARTICIPANT FEE REVENUES

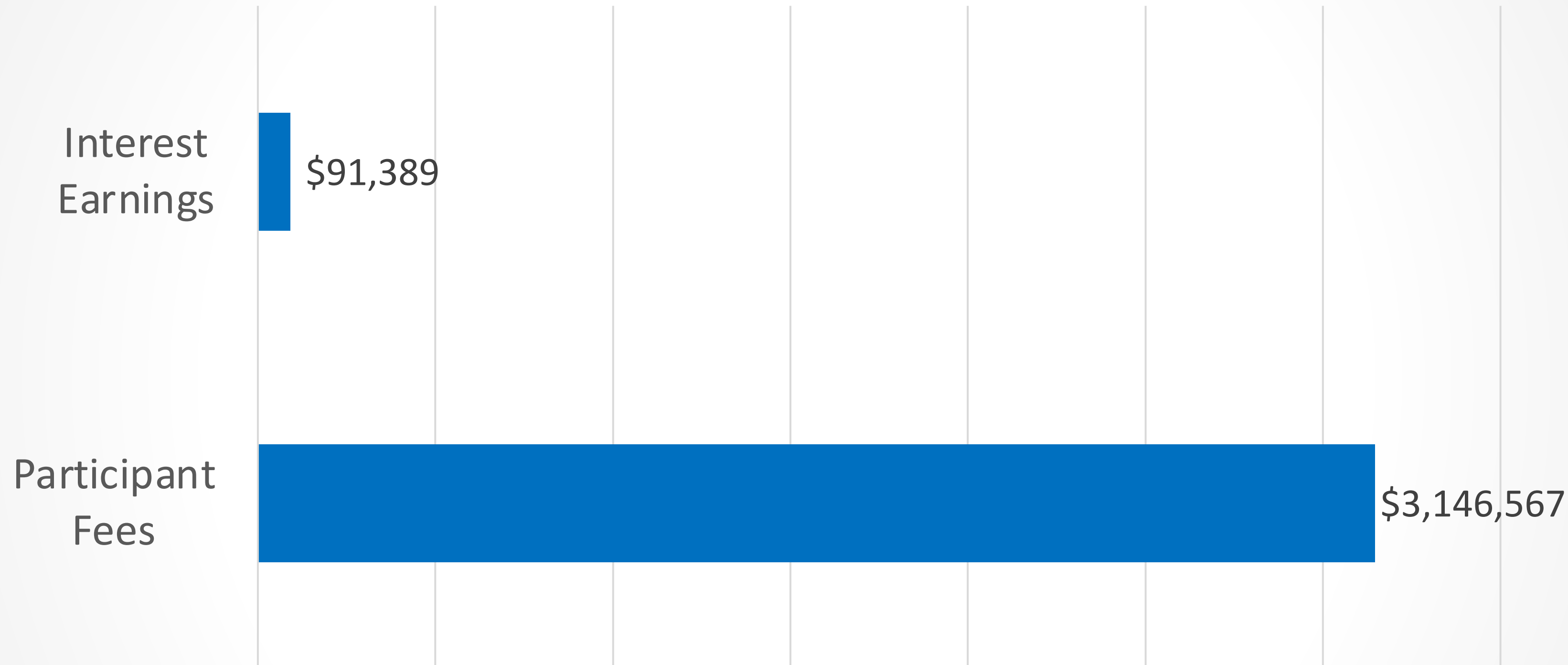
Reserve Fund (Held with DCP Third-Party Administrator (TPA))

- **TPA Admin. Fees**
- **Staff Salaries**
- **Consulting**
- **Communications**
- **Auditing**
- **Training (non-travel)**
- **Office & Administrative**
- **Elections**

City Fund #896

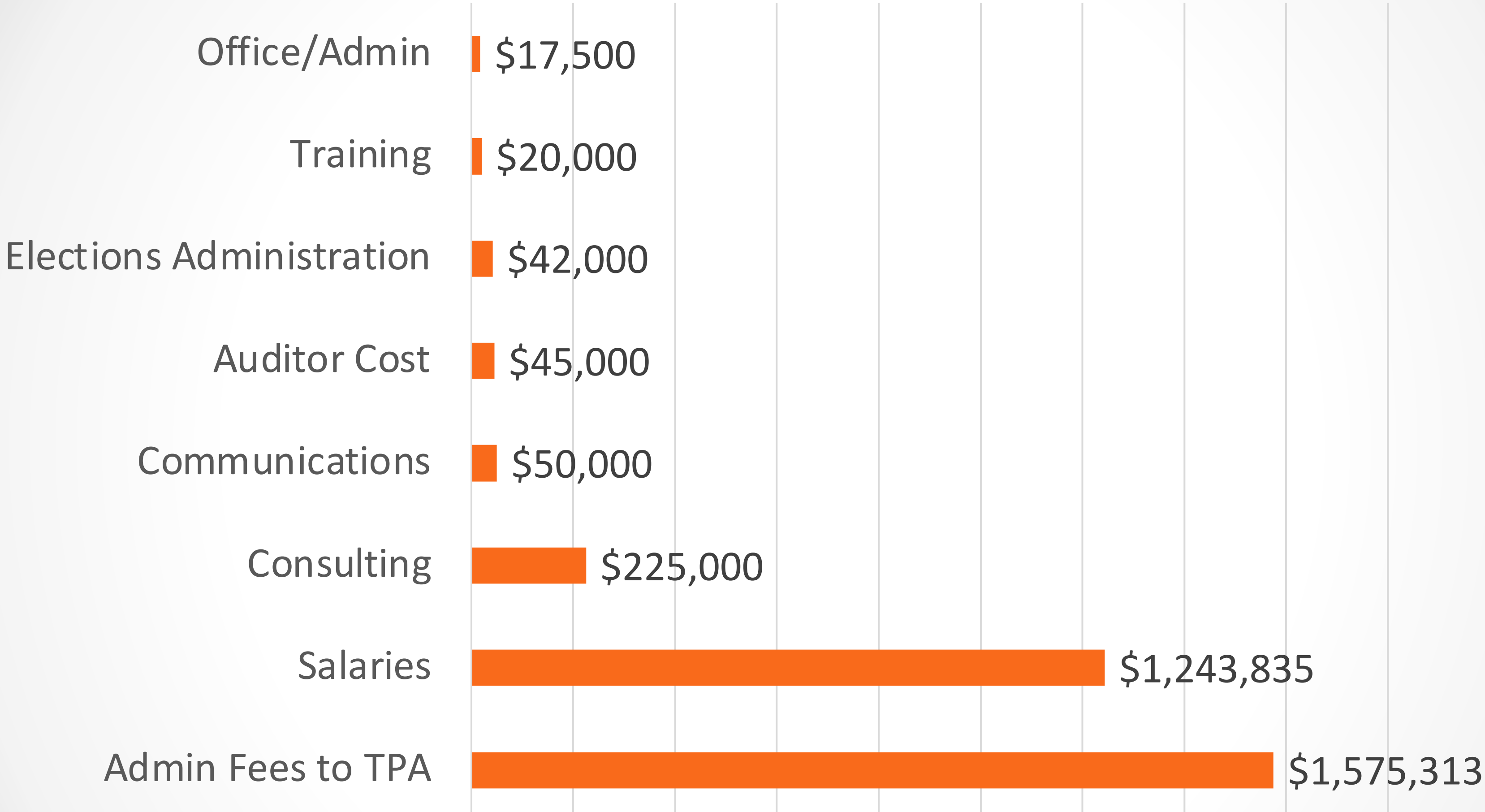
- **Travel**
- **Equipment**

PROJECTED 2023 REVENUES



Projected Annual Total - $3.2 million

PROJECTED 2023 EXPENDITURES



Projected Annual Total - $3.2 million

TARGET RESERVE FUND BALANCE

- The adopted target Reserve Fund balance is 50% of annual operating expenses (projected to be **$1.6 million** in 2023).
- The Board previously established a “structural deficit” in relationship of revenues to expenses to gradually reduce the Reserve Fund balance.
- As of 6/30/22, the Reserve Fund balance was about **$4.7 million**.
- Projected Revenues and Expenses are based on Key Assumptions adopted by the Board at its December 21, 2021 meeting.

Reserve Fund Balance

Reserve Fund
(Held with TPA)
+
City Fund #896

Target Reserve Fund Balance

50% of Annual
Operating Expenses

RESERVE FUND KEY ASSUMPTIONS

Current

→

Expenses Inflation Adjustment Factor	*Net Enrollment Adjustment Factor*	*Plan Asset Growth Adjustment Factor*	*Stable Value Fund Interest Rate Assumption*	*Basis Points Charged Against Participant Accounts*	*Fee Cap*
3.0%	**3.0%**	**6.0%**	**2.0%**	**0.09%**	**$115**

Current

→

Personnel Avg. Special Rate	*City Attorney Avg. Special Rate*
91 %	**93%**

These assumptions were last approved by the Board on December 21, 2021.

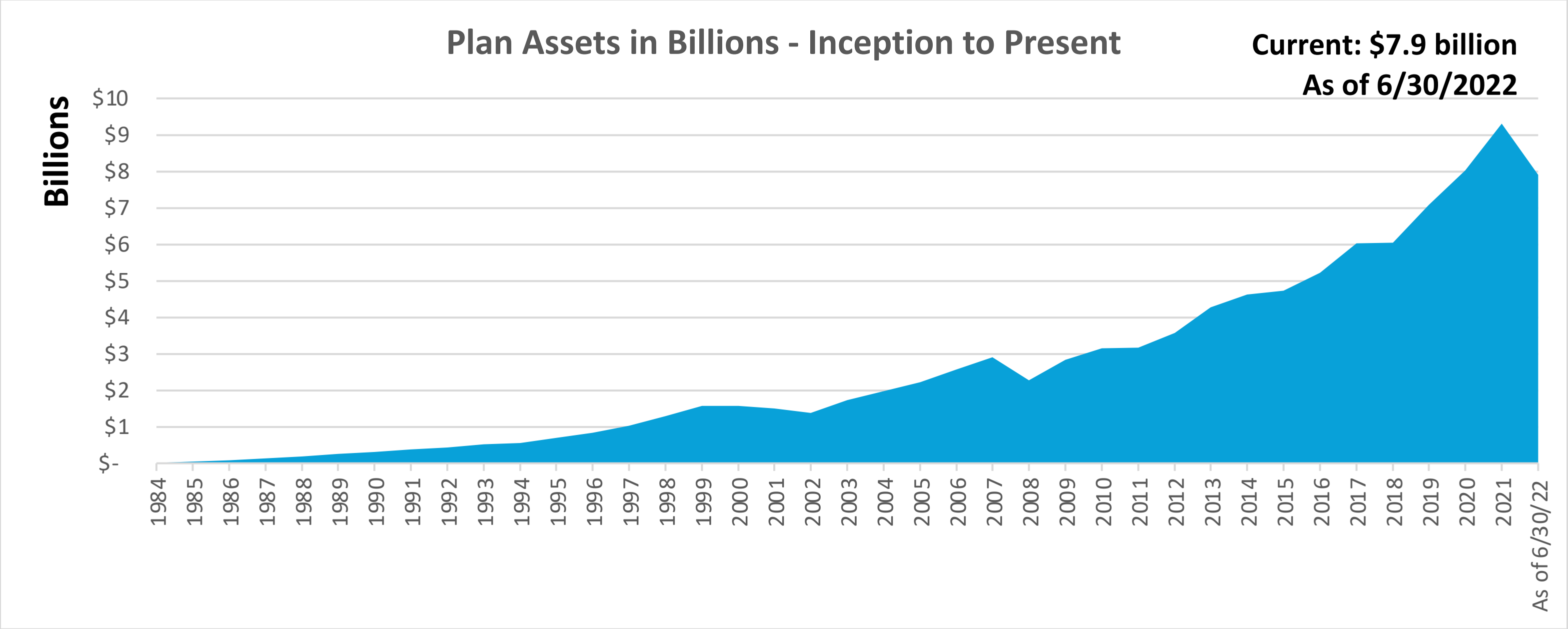
KEY ASSUMPTIONS

Plan Assets Growth

Current: **6.0%**

Where Applied: Total overall growth rate for DCP assets

Considerations: 5, 10, 15, and 20-year growth trends higher than assumption
Market volatility in 2022 does not necessarily indicate future performance in remainder of 2022 and beyond.



KEY ASSUMPTIONS

Plan Assets Growth

Historical Plan Assets Inception to Present

Year	Assets	% Change
1984	$17,990,298	N/A
1985	$48,584,697	170%
1986	$84,762,277	74%
1987	$126,921,243	50%
1988	$180,395,336	42%
1989	$249,105,465	38%
1990	$303,691,355	22%
1991	$378,018,448	24%
1992	$441,306,161	17%
1993	$516,401,147	17%
1994	$564,392,235	9%
1995	$702,779,928	25%
1996	$831,689,383	18%
1997	$1,029,129,147	24%
1998	$1,285,271,264	25%
1999	$1,564,440,301	22%
2000	$1,578,565,882	1%
2001	$1,508,545,448	-4%
2002	$1,373,444,396	-9%
2003	$1,737,260,679	26%
2004	$1,973,665,625	14%
2005	$2,230,031,810	13%
2006	$2,566,734,158	15%
2007	$2,909,282,960	13%
2008	$2,279,918,897	-22%
2009	$2,828,435,629	24%
2010	$3,154,860,910	12%
2011	$3,174,274,111	1%
2012	$3,578,684,906	13%
2013	$4,277,754,120	20%
2014	$4,622,493,622	8%
2015	$4,726,682,745	2%
2016	$5,221,905,502	10%
2017	$6,027,047,090	15%
2018	$6,037,310,346	0%
2019	$7,087,584,205	17%
2020	$8,035,190,777	13%
2021	$9,307,962,971	16%
As of 6/30/22	$7,906,363,478	-15% CYTD

Historical and Projected Growth Rates*

Last 15 years average-->	**9.5%**
Last 10 years average-->	**11.5%**
Last 5 years average-->	**12.4%**
Projected Investment-Only Rate of Return (Mercer)	**5.5%**
Projected Total (Investments + Contributions) Annual Growth Rate -->	**5.9%**

*Historical averages through previous year end (12/31/21)

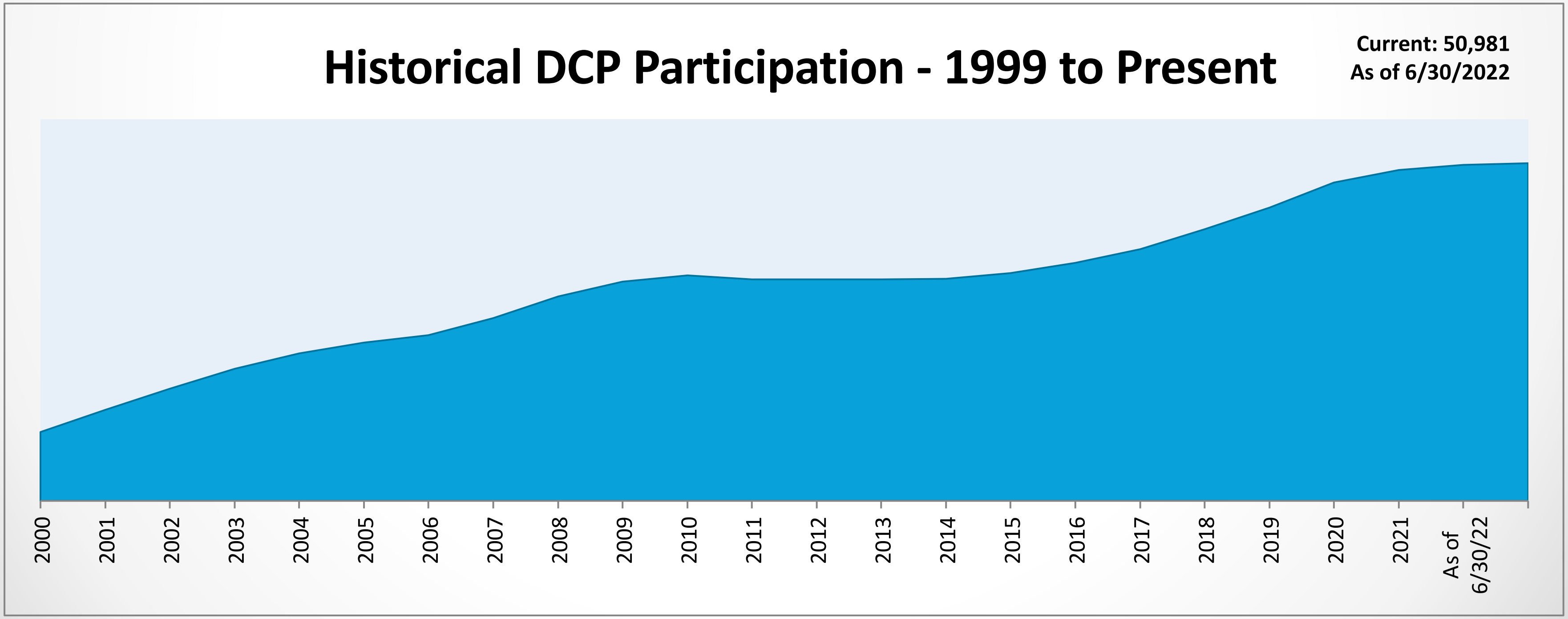
KEY ASSUMPTIONS

Net Enrollment

Current: **3%**

Where Applied: Estimated growth in participant accounts

Considerations: Slowed hiring and increase of retirements and other separations from 2020 through 2022



KEY ASSUMPTIONS

Net Enrollment

HISTORICAL NET ENROLLMENT		
Year	**Participants**	**% 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	46,904	4%
2019	49,209	5%
2020	50,377	2.4%
2021	50,814	0.9%
As of 6/30/2022	50,981	0.3%

Historical Growth Rates*	
Last 20 years average-->	2.6%
Last 15 years average-->	2.2%
Last 10 years average-->	2.3%
Last 5 years average-->	3.4%

*Historical averages through previous year end (12/31/21)

KEY ASSUMPTIONS
Administrative Expenses Inflation

Current: **3%**

Where Applied: Salary, consulting, communications, training, auditing, and office and administrative costs

Considerations:
- Cost of living increases may be below this rate over near and mid-term
- Positions often filled at lower level than budgeted position authority
- Communications, training, and office and administrative costs often lower than budgeted amount

KEY ASSUMPTIONS

Indirect Salary Costs

Current: Personnel – **91%**, City Attorney – **93%**

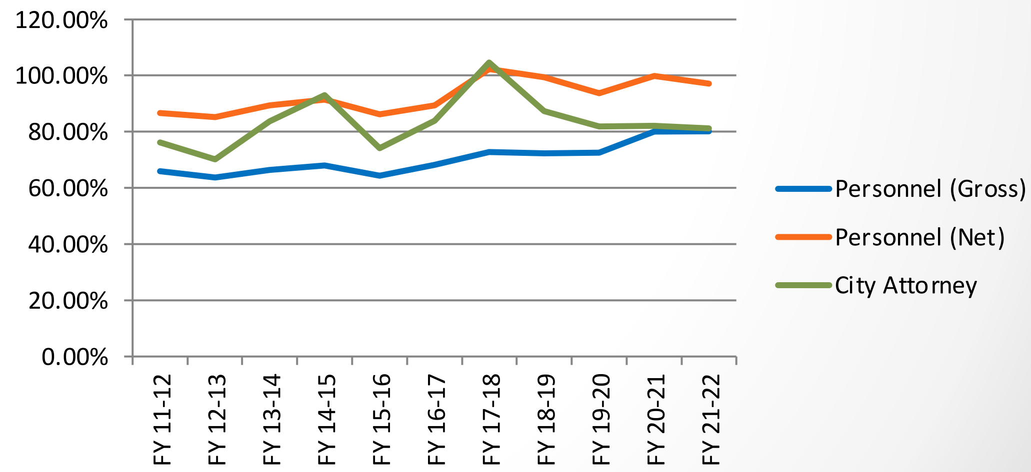
Where Applied: Indirect salary costs

Considerations: Rates fluctuate from year-to-year. Reimbursement methodology for personnel staff salaries is based on reimbursement method for 100% dedicated staff

Historical Indirect Salary Rates*

Fiscal Year	Personnel (Gross)	Personnel (Net)	City Attorney
FY 11-12	65.86%	86.77%	76.17%
FY 12-13	63.73%	85.23%	70.19%
FY 13-14	66.48%	89.30%	83.83%
FY 14-15	67.91%	91.51%	93.09%
FY 15-16	64.39%	86.28%	74.25%
FY 16-17	68.29%	89.37%	84.04%
FY 17-18	72.75%	102.34%	104.67%
FY 18-19	72.24%	99.39%	87.45%
FY 19-20	72.57%	93.71%	81.99%
FY 20-21	79.97%	99.86%	82.05%
FY 21-22	80.18%	97.09%	81.26%
10-Yr Avg	**70.85%**	**93.41%**	**84.28%**
5-Yr Avg	**75.54%**	**98.48%**	**87.48%**

Indirect Salary Rates* FY 11-12 to Present



*Indirect salary rates are determined by the Office of the Controller each fiscal year. The latest published Rate is **Special Rate 44** for FY 21-22.

KEY ASSUMPTIONS

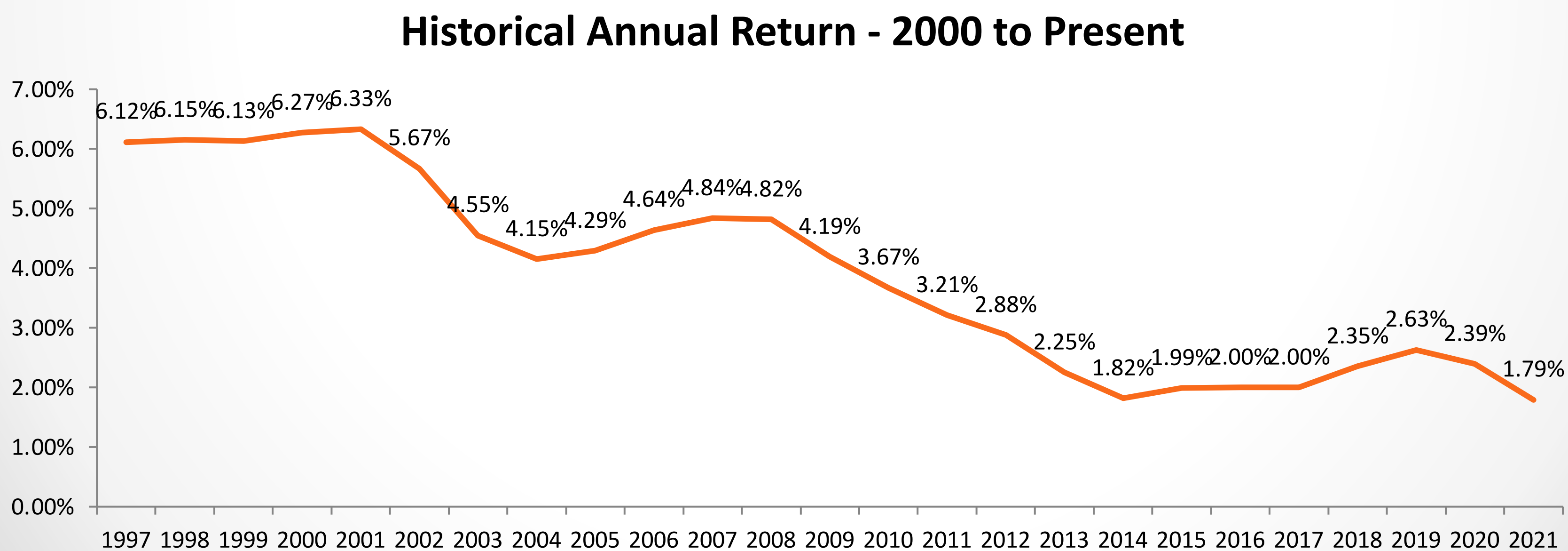
Stable Value Fund Interest Rate

Current: **2%**

<u>Where Applied</u>: Estimated interest earnings

<u>Considerations</u>: Annual return over last five years averaged 2.23%

U.S. Federal Reserve Board may increase interest rates



KEY ASSUMPTIONS

Participant Fees

Current:

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

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

Considerations:

- Reductions to Third-Party Administrator (TPA) fees have created structural long-term savings (reductions to TPA administrative fee effective in 2017 and 2022)