CITY OF *Los Angeles*
DEFERRED COMPENSATION PLAN

Plan Governance & Administrative Issues Committee (Committee)
Report 21-03

Date: November 18, 2021

To: Committee

From: Staff

Subject: 2022 DCP Resource Review

Recommendation:

That the Committee recommend that the Board of Deferred Compensation Administration (Board):

(a) Adopt the following Deferred Compensation Plan (DCP) Growth and Expense variable and Fee variable assumptions for use in projecting future DCP Reserve Fund balances:

(1) DCP Assets Growth Rate - 6%
(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

(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;

(c) Request that staff finalize the Annual Report by the March meeting for submission by public hearing to the City Council; and

(d) Postpone further review of offering platform-based investment advice pending successful completion of City and DWP payroll system conversions.

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 long-term (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, 2021, the target Reserve Fund balance was $1.6 million compared to the actual balance of about $4.5 million.

The Committee last conducted a DCP resource review in November 2020. Over the past year, the Board has taken several actions which may impact the Reserve Fund balance:

- At its **December 15, 2020** 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) find the cost of investment advice services could be reasonably funded under the existing fee structure; and (c) defer further action with respect to reducing the long-term projected Reserve Fund Balance until the Board has completed its assessment of investment advice services.
- At its **April 20, 2021** meeting, staff provided a status update to the Board regarding the development of a Board presentation from a respondent to the City's Request for Information (RFI) for investment advice services; the Board adopted staff's recommendation requesting the Committee further review investment advice and financial education services with staff and Segal Consulting and provide recommendations to the Board for further action.

B. Annual Review of Reserve Account Assumptions

1) <u>2021 Reserve Fund Assumptions</u>

Following is a summary of the key assumptions adopted by the Board at its December 15, 2020 meeting. These assumptions are used in forecasting the long-term (ten-year) projection of the DCP Reserve Fund balance:

Variable Description	Assumption
DCP Assets Growth Rate	7.0%
Net Enrollment Growth Rate	3.0%
Annual Expenses Increase Factor	2.0%
Special Rates Increase Factor: Personnel	115.0%
Special Rates Increase Factor: City Attorney	115.0%
Stable Value Interest Rate	2.0%
Participant Fees: Basis Point Charge	0.09%
Participants Fees: Annual Dollar Cap	$115.00

2) <u>Proposed 2022 Reserve Account Assumptions</u>

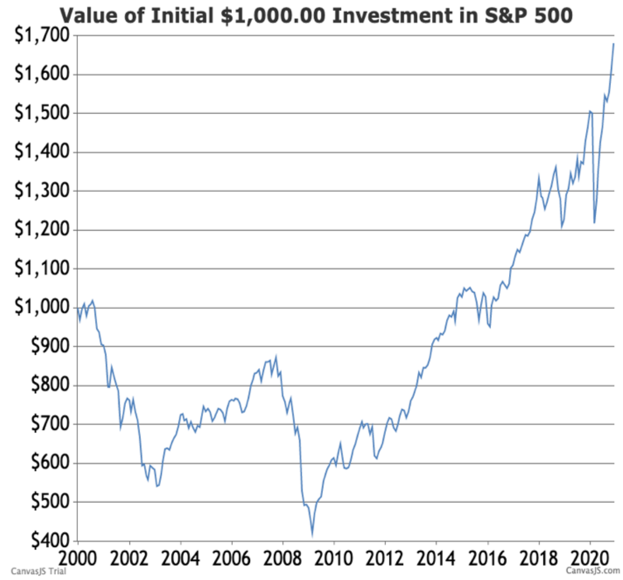
Recommended actions for 2022 Reserve Account assumptions are discussed as follows:

- **DCP Assets Growth Rate**
  2022 Recommendation: 6%

  The projected DCP assets growth rate incorporates both investment gains <u>and</u> participant contributions/rollovers. Projections must therefore incorporate future value formulas combining net new contributions and assumed rates of return. Looking retrospectively, the following table provides average gross growth rates over various time periods inclusive of both contribution and investment sources of gains. Earlier years for the DCP produced much larger growth rates than later years. Over the past 20 years, increases have ranged from 9.5% to 12.3% over various time bands. This 20 year history includes three significant equity market downturns (2000, 2009 and 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-->	**12.3%**

Given the strong recent equity performance of recent years (see chart right of 20-year chart of the S&P 500), future equity market returns may tend to be lower than returns over the past decade. 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 5.12%. Staff has combined that with a future value projection incorporating an assumption regarding average net cash inflows. The resulting forward-looking projection is 6%. Based on that projection, staff recommends adoption of an assumed 6% average annual DCP assets growth rate over the next ten years, reduced slightly from the 7% adopted last year by the Board.



- **Net Enrollment Growth Rate**
  2022 Recommendation: 3%

  Net annual enrollment growth in the DCP over the last five years has averaged 3.3%. This period of time includes periods of both significant expansion and contraction in the City's workforce, and thus appears to be a reasonable predictor of average future long-term growth. Staff therefore recommends adoption of an assumed 3% average net participation growth rate over the next ten years.

- **Annual Administrative Expenses Growth Rate**
  2022 Recommendation: 3%

  Administrative expenses are primarily driven by staffing costs. The annual expense growth rate factor reflects two often countervailing influences – increases in staffing costs due to wage increases vs. periods in which positions are vacant. Looking forward, recent steps taken by the Board and Personnel Department to support greater staffing stability (creating or upgrading positions, reallocating to new classifications, and taking a more direct role in communications to stakeholders about resources) should result in fewer and shorter vacancies in staff positions and thus a steadier upward trend in administrative costs. Staff's recommendation is to increase the previously adopted 2% increase factor to 3% based on a projection that salary cost increases will be less offset by periods during which positions are vacant.

- **Special Rates Increase Factor**
  2022 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. The current adopted assumption of 115% appears too high, as much of the volatility associated with indirect cost rates appears to have moderated since the Board moved from CAP Rates to Special Rates. Staff created a new 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 adoption of assumed 91% and 93% average Special Rates increases for Personnel Department and City Attorney staffing costs, respectively.

- **Stable Value Fund Average Rate of Return**
  2022 Recommendation: 2%

  Reserve Fund dollars are primarily held within a special account within the DCP Stable Value Fund. The average rate of return for the Stable Value Fund over the past five years has been 2.39%. Future rates of return will largely be driven by economic growth. Although the average of recent rates for the SVF has been closer to 2.5%, staff recommends utilizing a more conservative assumption of 2%.

- **Participant Fees**
  2022 Recommendation: 0.09% Participant Fees; Annual Dollar Cap $115

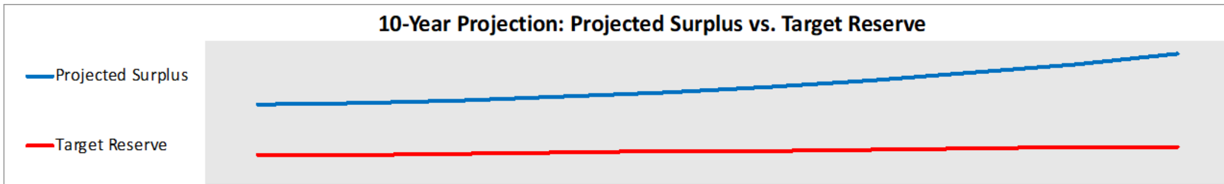
  As will be discussed in the subsequent sections of this report, staff is not recommending any actions targeted at reducing the projected surplus in the Reserve Fund at this time. As a consequence, no changes are being recommended to decreasing participant fees.

C. DCP Reserve Fund Ten-Year Projection

1) Baseline Scenario

Staff has updated its ten-year forecast incorporating DCP data as of June 30, 2021, current expense information, and the proposed key variable assumptions for 2022 as previously discussed. The projected Reserve Fund balance is above the target Reserve Fund balance over the ten-year period. This projection is referred to as the "**Baseline Scenario**."

Baseline Scenario



	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
Projected Surplus	$4,478,567	$4,575,286	$4,722,825	$4,943,433	$5,170,026	$5,460,419	$5,837,837	$6,236,238	$6,714,550	$7,297,182
Target Reserve	$1,611,426	$1,682,279	$1,726,117	$1,762,450	$1,836,324	$1,884,784	$1,925,877	$2,004,653	$2,058,163	$2,104,458

As staff is not recommending any actions relative to the projected surplus (for reasons set forth in the next section of this report), additional projected scenarios are not provided as they have been in years past. However, staff can provide additional scenario illustrations to the Committee if so desired.

D. DCP Future Resource Considerations

Although the projected ten-year surplus appears significant, staff believes caution is warranted prior to taking any immediate action relative to reducing the longer-term apparent balances. Potential new resource demands may emerge in three areas: staffing, facilities, and program services/features, which staff will review next.

(1) Staffing

From a staffing perspective, the DCP is in a particularly unusual moment in its history, with several significant upcoming staffing changes:

- A new DC Plan Manager position has been created but not filled; this position will provide the DCP with its first full-time, exclusively dedicated leadership role.
- The Board is requesting a step-level review for the purpose of elevating the DCP's vacant Senior Benefits Analyst I position to Senior Benefits Analyst II, with the present vacancy in this position needing to be filled.
- The DCP is bringing in new resources through its relationship with Voya, including a new Voya position dedicated on a full-time basis to utilizing data to develop goals and implement strategies to drive improved participant outcomes.

These new resources are anticipated to "go live" in the second quarter of 2022, pending successful hiring of the new DC Plan Manager and approval in the FY 2022-23 budget for elevating the Senior Benefits Analyst position. Given that the DCP has never been resourced to this level, and given that it has been exceedingly rare for the DCP to have all of its positions filled for any sustained duration, these resources should be given some period of time to establish themselves and their capabilities before longer-term resource questions are addressed.

However, in considering resource needs over a period as long as ten years, it is likely that additional staffing resources will be required at some point. The complexity, demands, and expectations for the DCP have historically grown over time, and there is no reason to think the trend will not continue. The regulatory landscape as well as industry product and service offerings are always evolving; administrative responsibilities and technological complexity inevitably increase over time; innovation can and should generate new initiatives to reach new heights of program success; and as the scope of work expands, it also tends to produce greater instances of periodic disorder because there are more opportunities for systems and processes to misfire. The human resources dedicated to the DCP will need to keep pace with these growth curves.

The costs of adding additional human resources are significant. As an illustration, staff prepared a ten-year projection of the direct/indirect costs of adding either a Benefits Analyst or Senior Benefits Analyst I to the DCP – those ten-year costs are $2.3 and $2.7 million, respectively, representing roughly half of the apparent amount above target in the Baseline Scenario. Adding higher-level positions (e.g. an Investment Officer I, II, or III) would be even more costly. The Board may well determine, however, that one or more of these resources would be desirable to add to the DCP over the next ten years.

(2) Facilities

Staff has recently been considering the potential that costs for facilities (principally office space but potentially other related costs, such as equipment and technology infrastructure) may require more DCP resources in the not too distant future. Pre-COVID the Employee Benefits Division had begun looking into options for moving some or all of its staff from its current location in City Hall #867 because the trajectory of City and contractor staff working onsite was creating space concerns. The COVID-inspired rethinking of telework has delayed the need to address that issue for some period of time, but not permanently. More immediately, staff will need to identify an office space arrangement for the incoming DC Plan Manager, but in a future state environment the ideal arrangement may involve moving all of the City and TPA staff into a single location that would provide the same level of centrality and convenience presently provided to DCP participants in City Hall #867. That may incur additional administrative costs which are not presently budgeted.

(3) Program Services and Features

Adding new DCP programs and services may result in higher ongoing program costs in the future. Prior to COVID, staff and the Board had been studying investment advice services utilizing a platform-driven approach. Staff now believes that further review of this should be postponed indefinitely. Offering any kind of platform-based resource will not be tenable until 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. Recommendations

Although staff is not recommending taking any action at this time in terms of the projected Reserve Fund surplus, there are steps that staff believes would strengthen processes related to future consideration of DCP resource needs:

(1) Change to Scheduling of Resource Reviews - The more active role being taken by the Board in communicating directly with the Mayor and City Council regarding DCP resource needs requires that deliberations and analysis take place in sufficient time to generate budget requests, which typically must be finalized in September/October. As a result, staff believes the following timetable, to occur on a recurring schedule annually, should be followed to allow sufficient time for key communications to occur optimally:

Time of Year	Process Step
June	DC Plan Manager Development of Annual Resource Review/Analysis
July	Plan Governance & Administrative Issues Committee Review of Analysis
August	Draft Budget Requests for Subsequent Fiscal Year
September	Submit Budget Requests for Board Approval
October	Provide Budget Requests to Personnel on Behalf of and as Approved by the Board for Transmittal to the Mayor
January-March	Execute Follow-Up Engagement Strategy (written communications, meeting with elected officials or CAO, etc.) in Support of Budget Initiatives

(2) Establish a Budget Policy – Staff believes it would be helpful to establish a separate budget policy for the Board that would include process details such as those indicated in the above table, as well as define roles and responsibilities for the DC Plan Manager and the Board.

(3) Submit DCP Annual Report to City Council for Public Hearing – Historically the DCP Annual Report has been submitted to the elected officials as an informational item but not through a public hearing process. Staff believes that finalizing this report slightly earlier (e.g. March) and submitting it for City Council consideration and approval would provide a valuable additional opportunity for the Board to raise the public profile of the DCP and its resource needs at an ideal time, as budget review and adoption is occurring in May-June.

If the Committee concurs, staff recommends that the Committee recommend to the Board that it (a) 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 (b) request that staff finalize the Annual Report by the March meeting for submission by public hearing to the City Council. In addition, as the matter of investment advice is still outstanding with the Committee, staff further recommends that the Committee recommend that the Board postpone further review of offering platform-based investment advice pending successful completion of City and DWP payroll system conversions.

Submitted by: ______________________________

Mindy Lam, Personnel Analyst

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Steven Montagna, Chief Personnel Analyst

Attachment A

CITY OF Los Angeles
DEFERRED COMPENSATION PLAN

DCP BUDGET & RESOURCE REVIEW

November 18, 2021

FLOW OF FUNDS OVERVIEW

PARTICIPANT FEE REVENUES

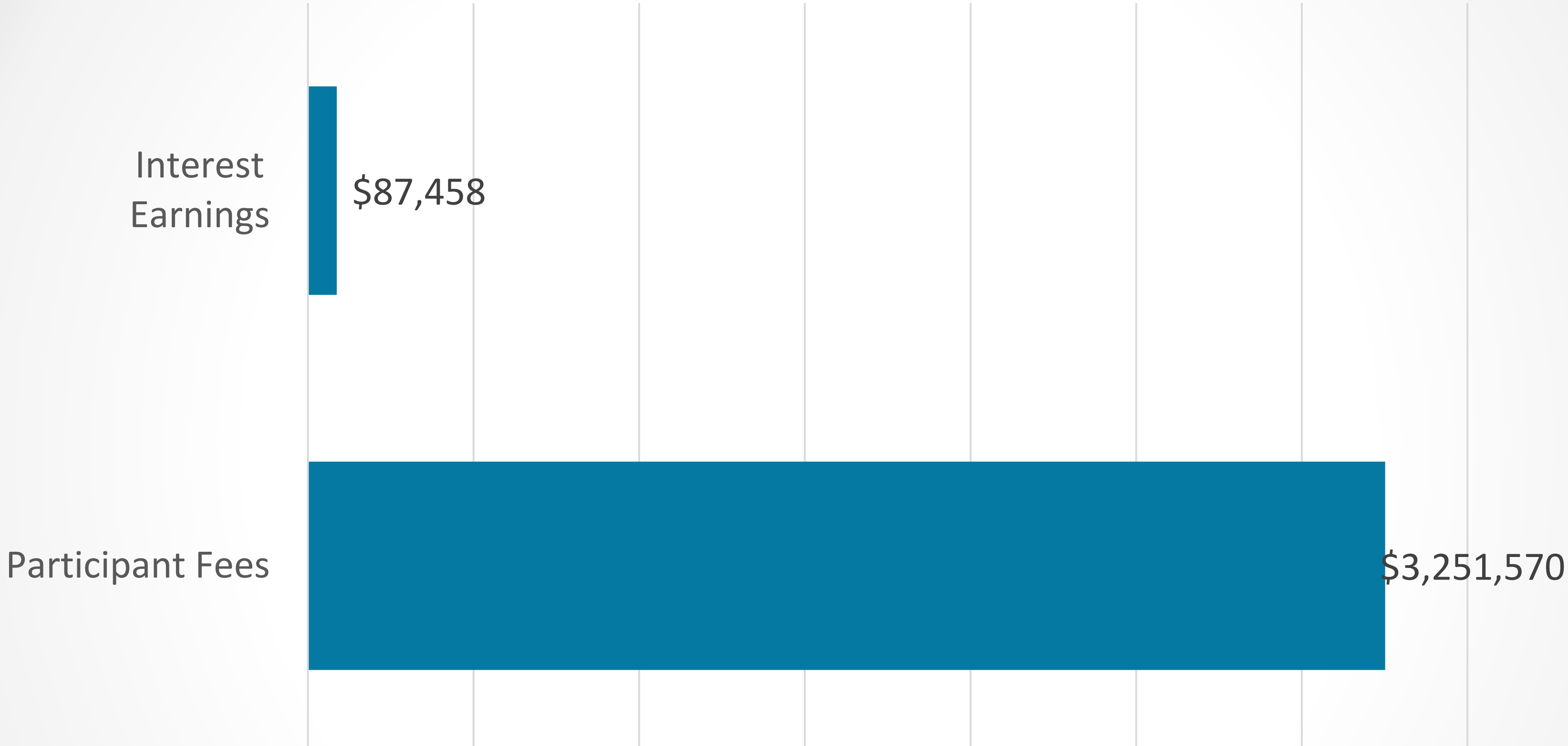
Reserve Fund (Held with DCP Third-Party Administrator (TPA))

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

City Fund #896

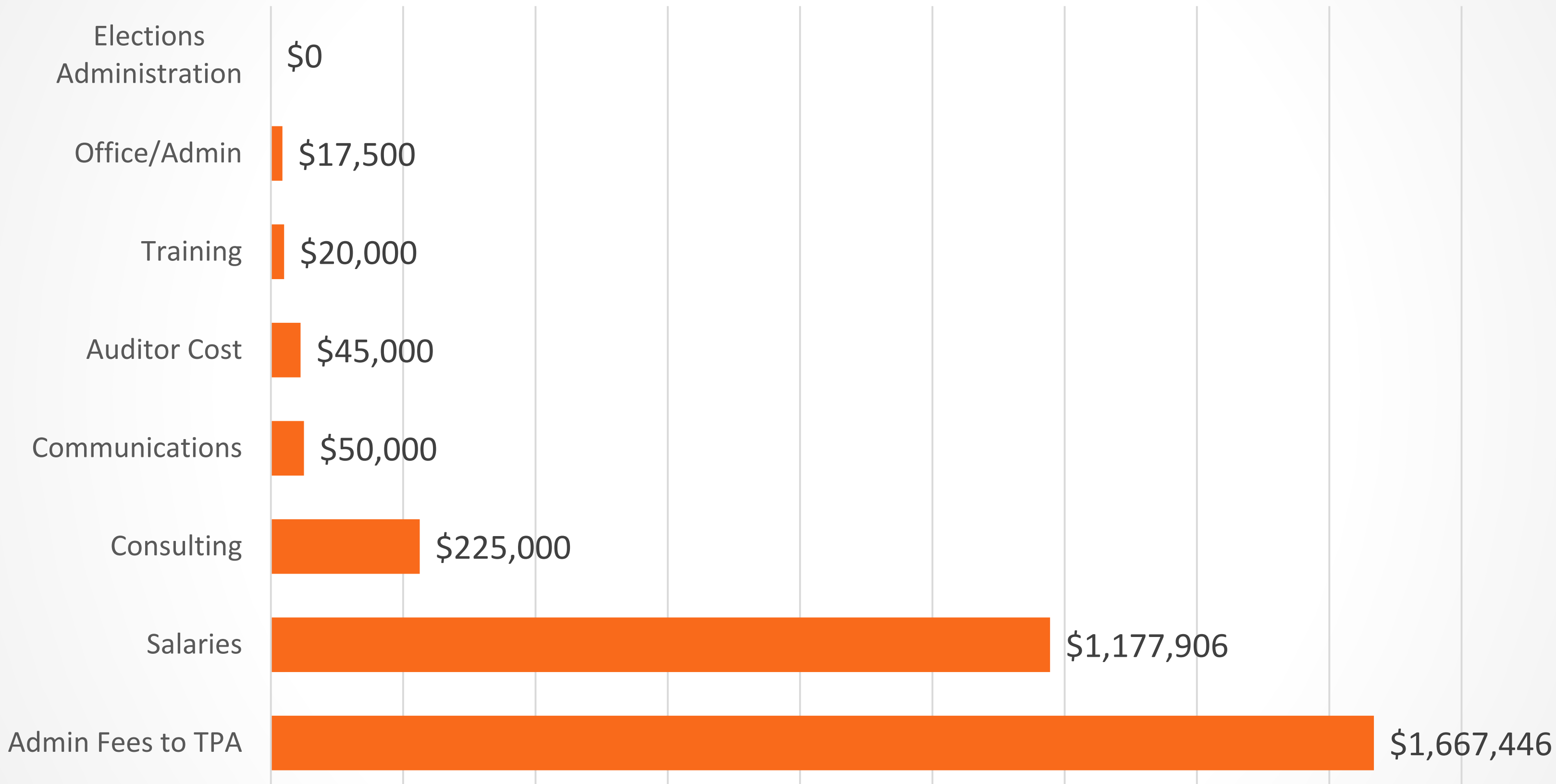
- **Travel**
- **Equipment**

PROJECTED 2022 REVENUES



Projected Annual Total - $3.3 million

PROJECTED 2022 EXPENDITURES



Projected Annual Total - $3.2 million

TARGET RESERVE FUND BALANCE

- The adopted target Reserve Fund balance is 50% of annual operating expenses (approximately **$1.6 million** in 2022).
- The historical Reserve Fund balance has been maintained above that target.
- The Board previously established a "structural deficit" in relationship of revenues to expenses to gradually reduce the Reserve Fund balance. However, ongoing revenues and expenses have tended to roughly balance out, due primarily to staffing vacancies.
- As of 6/30/21, the Reserve Fund balance was approximately **$4.5 million**.

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*
2.0%	**3.0%**	**7.0%**	**2.0%**	**0.09%**	**$115**

Current

→

Personnel Avg. Special Rate	*City Attorney Avg. Special Rate*
115 %	**115%**

These assumptions were last approved by the Board on December 15, 2020.

KEY ASSUMPTIONS

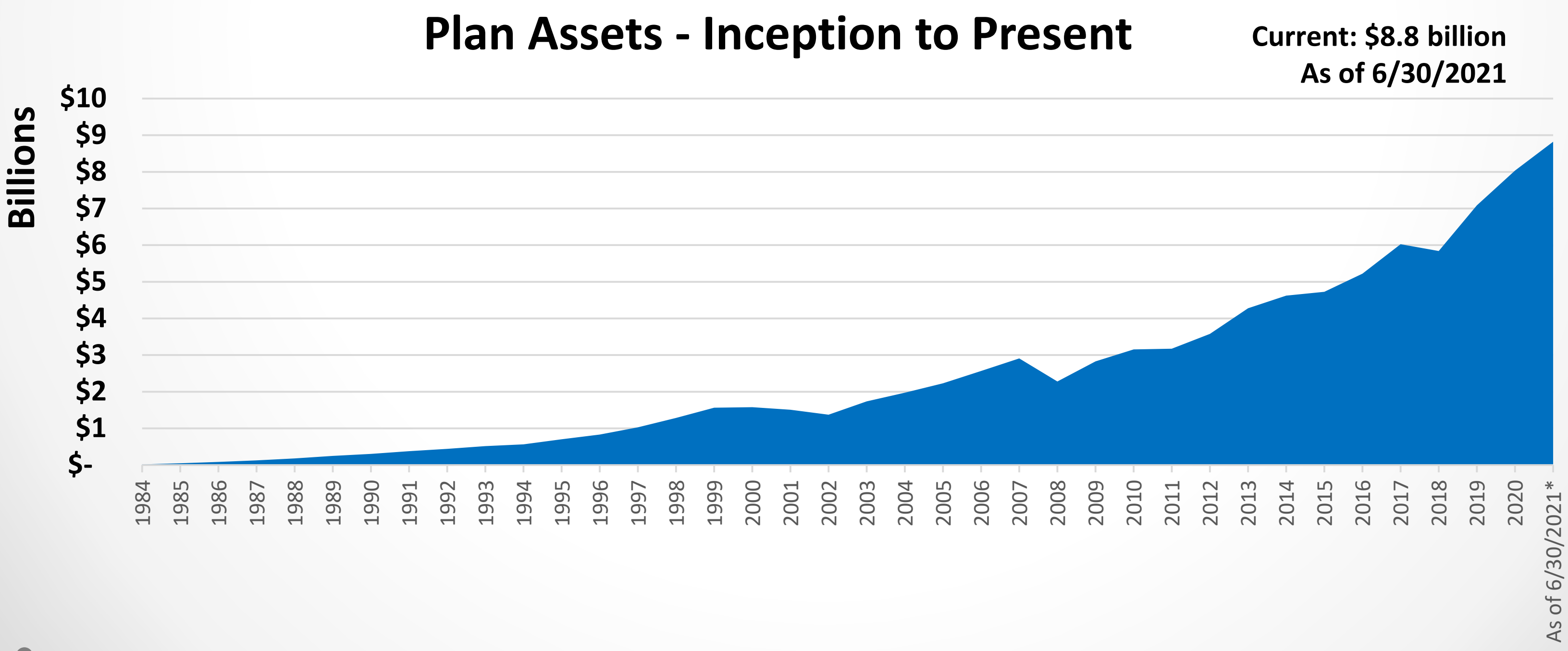
Plan Assets Growth

Recommended: **6.0%**

<u>Where Applied</u>: Total overall growth rate for DCP assets.

<u>Considerations</u>:

- Historically 5, 10, 15, and 20-year growth trends are higher than assumption, but consultant's projection is 6%; given strong equity returns since 2009, lower future equity returns a strong possibility.



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	$6,025,581,565	15%
2018	$5,839,909,114	-3%
2019	$7,085,845,898	21%
2020	$8,034,763,128	13%
As of 6/30/2021*	$8,821,660,305	10%

Historical and Projected Growth Rates

Last 15 years average-->	**9.5%**
Last 10 years average-->	**11.5%**
Last 5 years average-->	**12.3%**
Projected Investment-Only Rate of Return (Mercer)	**5.12%**
Projected Total (Investments + Contributions) Annual Growth Rate -->	**6%**

KEY ASSUMPTIONS

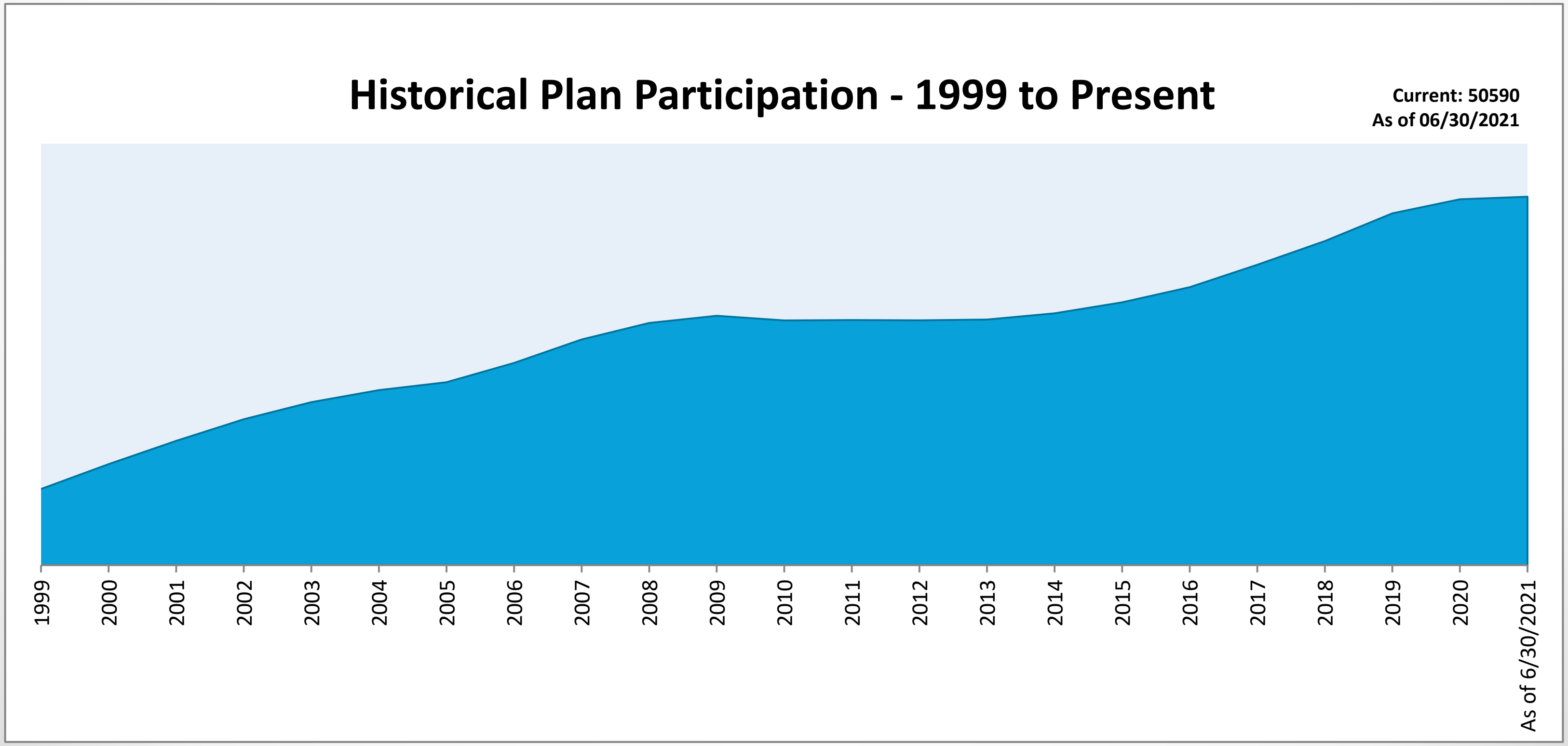
Net Enrollment

Recommended: **3%**

Where Applied: Estimated growth in participant accounts.

Considerations:

- Budget challenges slowed hiring over past 1.5 years, but new hiring points to increased growth.



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%
As of 6/30/2021	50,590	0.4%

Average Growth Rates	
Last 20 years average-->	2.6%
Last 15 years average-->	2.2%
Last 10 years average-->	2.3%
Last 5 years average-->	3.3%

KEY ASSUMPTIONS

Administrative Expenses Inflation

Recommended: **3%**

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

Considerations:

- Staffing costs are the largest component of administrative costs.
- Historically the assumption has been 2%, but potential new stability in staffing suggests that step and cost-of-living increases will accelerate administration expense inflation.

KEY ASSUMPTIONS

Indirect Salary Costs

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

<u>Where Applied</u>: Indirect salary costs.

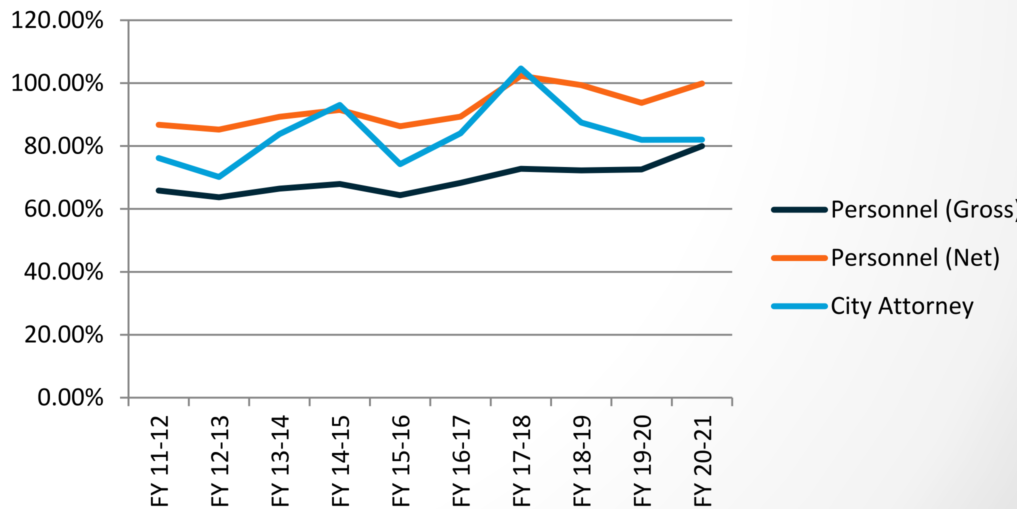
<u>Considerations</u>:

- Rates have historically been lower than previously adopted assumption.
- Updated reimbursement methodology reduces assumed rates.

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%
10-Yr Avg	**69.42%**	**92.38%**	**83.77%**
5-Yr Avg	**73.16%**	**96.93%**	**88.04%**

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 43** for FY 20-21.

KEY ASSUMPTIONS

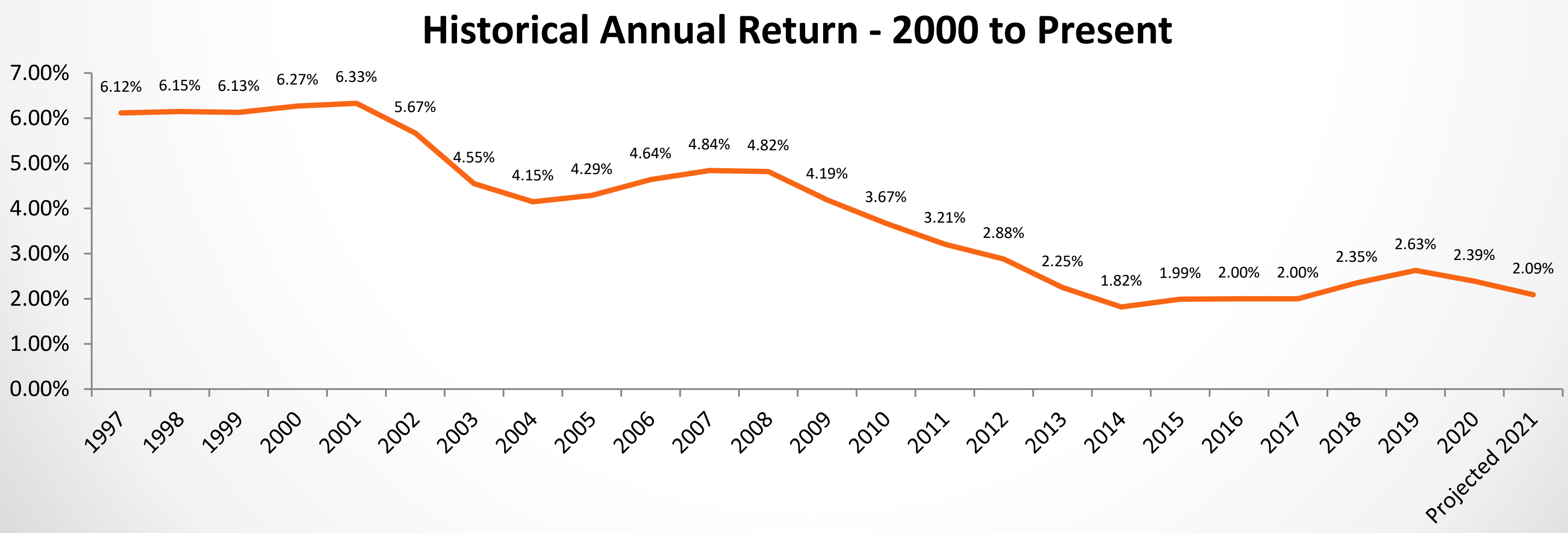
Stable Value Fund Interest Rate

Recommended: **2%**

Where Applied: Estimated interest earnings.

Considerations:

- Annual return over last five years averaged 2.29%.



KEY ASSUMPTIONS

Participant Fees

Recommended:

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).