COUNCIL AGENDA: 06-5-2007
ITEM: 3.9

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

# Memorandum

**TO:** HONORABLE MAYOR AND CITY COUNCIL

**FROM:** Mark Danaj

**SUBJECT:** SEE BELOW

**DATE:** 05-14-07

Approved Deanna Santana  Date 5/17/07

**COUNCIL DISTRICT:** N/A
**SNI AREA:** N/A

**SUBJECT: AMENDMENT TO THE CITY OF SAN JOSÉ DEFERRED COMPENSATION PLAN TO PERMIT PARTICIPANT LOANS**

## RECOMMENDATION

Approve an ordinance amending Chapter 3.48 of Title 3 of the San José Municipal Code by adding section 3.48.140 to permit loans to participants from the City of San José Deferred Compensation Plan.

## OUTCOME

This amendment will enable the City of San José's Deferred Compensation Plan to implement a loan program administered by the plan provider. The program will allow participants to take out loans against their interests in the plan. If approved, staff expects implementation to be completed by early Fall 2007.

## BACKGROUND

The Internal Revenue Code of 1986, Section 72(p)(2), provides that qualified retirement plans – including 457(b), governmental deferred compensation plans – may allow participants to take out loans against their interests in the plan when certain IRS requirements are satisfied. The City of San José Deferred Compensation Plan needs to be amended to provide this option for participants.

In October 2006, the City transitioned from having two deferred compensation plan investment providers to having one investment provider, ING. The efficiencies gained by this change have made implementing a loan program administratively feasible.

At the February 22, 2007, Deferred Compensation Advisory Committee (DCAC) meeting, the Committee approved the recommended loan provisions included in this draft ordinance. On April 26, 2007, the DCAC approved the draft ordinance for City Council approval.

## ANALYSIS

In recommending the loan provisions outlined in this ordinance, the DCAC addressed its decision points with several objectives in mind:

- Meet the requirements of the Internal Revenue Code
- Provide flexibility to Plan participants
- Adopt provisions that are easily understood and relatively simple to administer

At a minimum, the DCAC is recommending provisions based on a number of loan program conditions required by the Internal Revenue Code (IRC) and Treasury Department Regulations:

1. Loans are only available for employees who are voluntary plan participants.
2. Loans are permitted as long as the participant's total outstanding loan balances at any one time do not exceed the lesser of (i) $50,000; or, (ii) one-half of the participant's vested account balance.
3. Participant loans must be made pursuant to an enforceable agreement with adequate security and with an interest rate and repayment terms that are commercially reasonable.
4. The repayment period must be no longer than 5 years except where the participant certifies that the loan is for the purchase of a principal residence.
5. Loan repayments must be calculated on a level amortization schedule, with payments made no less frequently than quarterly.
6. The outstanding balances on defaulted loans are to be treated as taxable distributions from the plan. Exceptions to this requirement are provided for delayed payments due to unpaid leave of absence or active military leave, as provided by IRC Section 414(u).

The proposed ordinance includes all of these requirements.

In addition to these basic requirements, the DCAC had discretion in defining other provisions of the program. Attachment A lists the loan provisions that were used to define the program and summarizes what the IRS allows, the Committee's recommendations, and the deciding factors that led to the recommendation for each provision. The ordinance either specifically identifies these discretionary provisions or sets out the DCAC's authority in administering the loan program. In some cases, specific loan terms adopted by the DCAC are left unstated for administrative flexibility.

For example, the ordinance allows a loan fee to be deducted from the participant's account, but it does not specify the amount of the fee currently charged by ING ($25). Similarly, the ordinance requires that there be a reasonable rate of interest approved by the DCAC, but it doesn't require a specific rate. (The DCAC has determined that for now, Moody's Long Term Corporate Bond Rate is one of the least costly, commercially reasonable rates to assign and intends to use this rate if the ordinance is approved).

## PUBLIC OUTREACH/INTEREST

- ☐ **Criterion 1**: Requires Council action on the use of public funds equal to $1 million or greater. **(Required: Website Posting)**
- ☐ **Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- ☐ **Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

Although this item does not meet any of the criteria above, this memorandum is posted on the City's website for the June 5, 2007, City Council meeting.

In addition, staff reviewed the DCAC's recommendations with the City Labor Alliance (CLA) on March 28, 2007, to solicit comment from stakeholders. Feedback was positive and required no change to the recommendations.

Following the April 26, 2007, DCAC meeting in which the Committee approved the draft ordinance for City Council approval, the Office of Employee Relations e-mailed the draft ordinance to all bargaining unit representatives for review. No comments were received.

## COORDINATION

This memorandum was coordinated with the City Attorney's Office and the Office of Employee Relations. This recommendation to amend the Municipal Code was approved by the Deferred Compensation Advisory Committee at its meeting of April 26, 2007.

## COST SUMMARY/IMPLICATIONS

There are no City costs associated with this recommendation.

## CEQA

Not a project.

Mark Danaj

MARK DANAJ
Secretary, Deferred Compensation
Advisory Committee

For questions please contact David DeLong, Acting Benefits Manager, at (408) 975-1428.

# Attachment A

## Summary of DCAC Loan Provision Recommendations

| Loan Provisions | IRS Allows | DCAC Recommendation | Deciding Factors |
|---|---|---|---|
| **Type(s) of Loans** | Residential (principle residence) and/or General Purpose | Allow Residential and General Purpose Loans | Maximum flexibility for participants |
| **Number of Outstanding Loans to Allow at One Time** | Does not specify | 1 Residential<br>1 General Purpose | ING statistics show that loan default rates increase with an increase in the number of outstanding loans available.<br><br>Unforeseen Emergency withdrawals are still available for hardships when needed. |
| **Minimum Loan Amount** | As specified by Plan administrator or $1,000 (ERISA plans only) | $1,000 | Chosen for simplicity and benefit to participants. |
| **Loan Interest Rate** | The Plan must provide a commercially feasible rate of interest; otherwise, the loan risks being considered a taxable disbursement by the IRS. | Moody's U.S. Long-Term Corporate Bond Rate (5.97% as of Feb 2007) | Lowest commercially feasible rate for participants.<br><br>Historically, the Moody's rate is lower than the Wall Street Journal Prime Rate (8.25% as of Feb 2007). |
| **Maximum Repayment Period(s)** | <u>Residential:</u><br>A reasonable time determined at time of the loan<br><br><u>General Purpose:</u><br>5 years (60 Months) | <u>Residential:</u><br>240 Months<br><br><u>General Purpose:</u><br>60 Months | Adopt typical repayment periods for both types of loans.<br><br>Concern about loans extending beyond a participant's career. |
| **Loan Repayment Frequency** | Not less frequently than quarterly | Bi-weekly payments. | Administratively feasible and works with the City's current method of transmitting 457 deferral information via electronic payroll interface. |
| **Grace Period for Missed Payments (When the Loan is Considered to be in Default)** | Defined by the Plan, but may not continue beyond the last day of the calendar quarter following the calendar quarter in which the required installment payment is due. | Loan is considered in default if the missed payment is not received on or before the last day of the calendar quarter following the calendar quarter in which the required installment payment is due. | Maximum flexibility for participants. |

## Attachment A, Cont'd…

## Summary of DCAC Loan Provision Recommendations

| Loan Provision Decision Point | IRS Allows | DCAC Decision | Deciding Factors |
|---|---|---|---|
| **Money Source Withdrawal Sequence** | Not addressed | Funding of the loan from participant accounts will take place in the following order:<br>1. Employees' elective 457 deferrals;<br>2. 457 Rollovers from other plans;<br>3. Rollovers from non-457 Plans (i.e., 401 or 403(b) plans). | Non-457 rollovers could be penalized for early withdrawal (10% if participant is less than age 59.5 years). |
| **Spousal Consent Required for Loan Approval?** | Not addressed | Yes | Domestic Relations Order (DRO) issues. |
| **Loan Authorization – Plan Provider or Plan Sponsor?** | Plan administrator (Plan Provider or the Plan Sponsor) | ING | Administratively easy and simple for Plan participants. |
| **Loan Request Notification to the Plan?** | Not addressed | Yes. ING will notify the City as loans are approved. | Notification required to setup participant repayment deductions in PeopleSoft. |
| **Loan Monitoring – Plan Provider or Plan Sponsor?** | Not addressed | ING will provide quarterly reports to the DCAC. | Administratively easy.<br><br>Grace Period: The end of the calendar year quarter that follows the quarter in which the participant misses a payment. |
| **$25 Loan Origination Fee – Paid by Participant or Plan Sponsor?** | Not addressed | Paid by the participant. | The origination fee ($25) is treated like other admin. fees – deducted at time of application. |