Deferred Compensation Plan
BOARD REPORT 12-04

Date: January 5, 2012

To: Board of Deferred Compensation Administration

From: Staff

Subject: Proposed Investment Policy Amendment: Bank Deposit Savings Account

Recommendation:

That the Board of Deferred Compensation Administration:

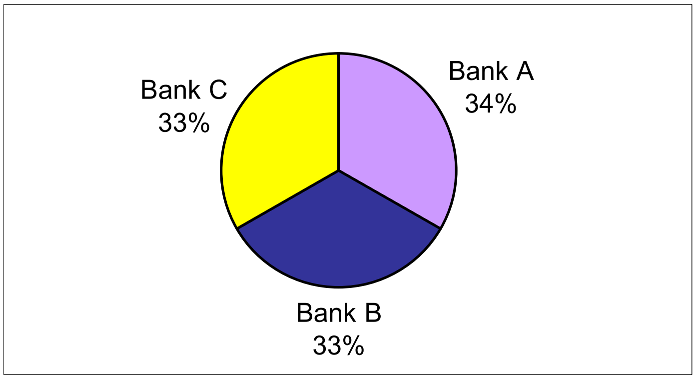
(a) Approve staff/Mercer recommended revisions to the Deferred Compensation Plan Investment Policy Statement in order to incorporate recommended changes to the Bank Deposit Savings Account (FDIC Option);

(b) Direct staff to enter into negotiations with Bank of the West for the purpose of drafting an amendment to the City's contract with Bank of the West incorporating a reduction in the interest rate floor, and return to the Board with the draft amendment; and

(c) Approve staff/Mercer's recommendation to direct Great-West to allocate 50% of FDIC option assets to Bank of the West and split the remaining balance equally among the remaining providers by approximately April, 2012.

Discussion:

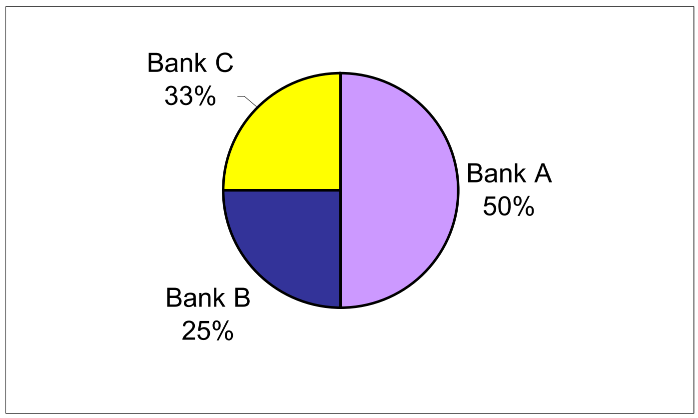
Investment Policy Change: Bank Deposit Account - At the Board's November 15, 2011 meeting, the Board approved in concept staff's proposal for a modification to the structure of the Plan's FDIC-Insured Bank Deposit Account, and instructed staff to return with recommended language to modify the Deferred Compensation Plan Investment Policy accordingly, as well as an analysis of whether to apply the new structure to the current set of providers. In a report prepared for the Board for that meeting, staff had indicated that this option currently utilizes three underlying banking institutions to create a blended option. Staff indicated that the benefit of this structure is that it provides expanded FDIC coverage to Plan participants while at the same time giving the Board flexibility to shift assets between providers in the event a potential insolvency or other problem occurs with one of the institutions.



Staff indicated that the current structure provides for an equal weight allocation policy of 34%/33%/33% divided among the three providers, and that this offers Plan participants FDIC insurance coverage of up to $750,000. Staff indicated that it was recommending creating flexibility within the Investment Policy for shifting these allocations in order to create a higher yield for Plan participants, but without compromising the strength or reliability of the investment option.

Staff further indicated that this consideration had arisen as a result of a large interest rate differential between the three providers. Specifically, the current contract with one of the providers, Bank of the West, provides for a highly favorable interest rate floor of 1%, compared to the contracts with Bank of America and City National Bank, which do not provide such a floor rate. Staff indicated that Bank of the West had previously represented that it could apply its 1.0% floor rate for any and all additional assets that are currently being held with Bank of America and City National Bank, should the City elect to shift those assets to Bank of the West.

As a result, staff began working with Mercer to review the current allocation model and whether it was possible to redesign the model to better balance the rate of return objectives of the Fund with the objectives of maintaining a stable investment option for Plan participants. Staff's and Mercer recommended that the Board establish a policy providing flexibility to adjust the allocation percentages from the current 33%/33%/33% present model to a 50%/25%/25% model if a given set of conditions were met and the Board determined that the adjustment was reasonable. This would result in 50% of FDIC assets being allocated to the highest yielding bank.



The conditions would involve having the highest yielding bank offering a rate at least 0.25% higher than the next highest rate. In addition, the banking institution would need to continue to meet the stability and viability requirements as established in the Board's Investment Policy.

Staff noted that if such an adjustment was made, the maximum amount of FDIC protection would be reduced from $750,000 to $500,000, but that a minimal number of participants (at present, approximately 18 out of 10,102) would be impacted by this change, and that the value of the reduction in FDIC insurance coverage for these individuals would be more than outweighed by the increased return for the overwhelming majority of participants in this option.

Staff and Mercer have worked together to draft a proposed modification to the Plan's Investment Policy Statement (IPS) to incorporate the policy change addressing the Bank Deposit Account option (Attachment A). In addition, staff/Mercer have included language which further formalizes that the Board may also elect to shift the asset allocation percentages for this option in the event material concerns arise regarding the institutional viability of any of the underlying providers.

Bank of the West – Following the Board's November meeting, staff was contacted by Bank of the West's relationship manager, Lily Ng. Ms. Ng indicated that the Bank had reviewed the contract with the City of Los Angeles with senior management and was no longer able to accommodate a greater share of this option's assets at the 1% interest rate floor, and in fact wished to request a reduction in that interest rate floor to 0.75%. Staff, and Mercer in a subsequent conversation, expressed concerns to Bank of the West regarding the change in their position on this issue. Ms. Ng was advised that Bank of the West should formalize its position in writing so the matter could be considered by the Board. Bank of the West did so and has provided the attached correspondence.

Staff and Mercer have jointly reviewed this matter. Bank of the West's inconsistency on its position regarding the interest rate floor is certainly troubling, given that both staff and Mercer had discussed this matter with the firm on multiple occasions, and the firm has had ample prior opportunity to reconsider and/or clarify its position prior to this date.

However, it is also clear that the 1% floor is, by all indications, significantly out of alignment with interest rates being offered by other banking institutions in the current interest rate environment. The savings rates offered by Bank of America and City National Bank are 0.04% and 0.15%, respectively, and Mercer indicates that the predominant rate quotes currently being offered by other institutions are within this range. Even at 0.75%, the rate being offered by Bank of the West would be significantly above this range. **(Note: staff became aware of the new Bank of America rate of 0.04% at the time this report was being finalized – staff will work with Mercer to report back to the Board with a bank rate survey and potential action items).**

Further, in the event the City does not accept this proposal, there is risk that Bank of the West may discontinue its relationship with the City. Although the 1% rate floor is part of the City's contract with Bank of the West, and although the firm has not indicated it would exit the contract, it has the ability to terminate the contract without cause with sixty days notice.

Given this, staff recommends that the Board direct staff to enter into negotiations with Bank of the West for the purpose of drafting an amendment to the contract incorporating a reduction in the interest rate floor. Staff would then return to the Board with a proposed amendment.

Fund Reallocation – Assuming a revised Bank of the West interest rate floor of 0.75%, this rate is still approximately 60 basis points higher than the rates offered by both Bank of America and City National Bank. The change would add approximately two basis points of yield, which on the asset base as a whole ($291 million) equates to approximately $540,000 on an annual basis. Assuming Board adoption of the proposed change to the IPS concerning the Bank Deposit Account, Mercer has prepared a review/analysis (Attachment B) recommending that the Board direct Great-West to allocate 50% of FDIC option assets to Bank of the West and split the remaining balance equally among the remaining bank accounts. If adopted by the Board, this change would become effective approximately April, 2012.

Submitted by: ______________________________
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Approved by: ______________________________
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