Deferred Compensation Plan
BOARD REPORT 15-21

Date: April 10, 2015

To: Board of Deferred Compensation

From: Staff

Subject: Correction to Crediting Rate for FDIC-Insured Savings Option

Recommendation:

That the Board of Deferred Compensation Administration receive and file the following information regarding a correction made to the crediting rate for the Deferred Compensation Plan FDIC-Insured Savings Account option.

Discussion:

In early April the Board's consultant, Mercer Investment Consulting, notified staff of an apparent discrepancy with respect to the crediting rate for the Deferred Compensation Plan's FDIC-Insured Savings Account option. Mercer indicated that first quarter performance for this option as reported by Empower Retirement was showing a negative return. As of 12/31/2014, the FDIC-Insured Savings Account option held approximately $294.3 million in participant assets, representing approximately 6.4% of total Plan assets.

Staff researched with Empower and determined that:

(a) An error had occurred with Empower's application of the crediting rate beginning October 1, 2014, and continuing through January 5, 2015.

(b) The error involved applying an expired annualized rate of 0.75% which in fact had been reduced to 0.25%; **this resulted in an over-crediting of interest to 9,193 participant accounts** in the amount of approximately $180,000 for the period October 1, 2014 through January 5, 2015.

(c) Empower corrected this over-crediting through a one-time negative adjustment on January 6, 2015 but did not inform staff of its action.

(d) By correcting the fourth quarter 2014 over-crediting of interest through a first quarter 2015 negative adjustment, the FDIC-Insured Savings option was indicating a negative return of -0.03% for the 3-months ending March 31, 2015.

Staff then worked with and provided direction to Empower as to how this matter should be addressed. Specifically, it was determined that the following corrective actions should occur:

- Impacted participants will be issued a corrected fourth quarter 2014 statement reflecting the correct amount of interest that should have been applied, as well as an explanation of why the error occurred, and noting that the corrected statement replaces the prior version.

- Following the issuance of the corrected fourth quarter 2014 statement, first quarter 2015 statements will be issued applying the correct amount of interest that should have been applied beginning January 1, 2015.

Empower's discussion and review of this matter is provided in the attached correspondence.

Of particular concern to staff was that Empower did not communicate the error or how Empower intended to correct it at the time the error occurred. Plan staff should have been immediately apprised of the situation and potential ramifications, and a plan for rectifying it should have been developed jointly by Empower and the City. The Board's Investment Consultant, by identifying the negative rate to staff on April 2nd, provided City staff with the notification that allowed staff to identify an appropriate plan of action in sufficient time to avoid what would otherwise have been even more challenging corrective and communication measures. Staff has reviewed with Empower the communications and procedural changes that should be instituted to ensure that similar errors of this type do not recur.

Submitted by: ______________________________

Steven Montagna

April 10, 2015

City of Los Angeles
Steven Montagna
200 N. Spring Street #867
Los Angeles, CA 90012

SUBJECT: City of Los Angeles Blended FDIC Option

Dear Steven:

The City's Deferred Compensation Plan offers an FDIC-Insured Savings Account as an investment option, composed of underlying bank providers. Effective October 1, 2014, there was a change in the structure of the bank providers as follows:

	Allocation prior to 10/1/14	Allocation effective 10/1/14
Bank of the West	50%	50%
Bank of America	25%	0%
City National Bank	25%	0%
East West Bank	0%	50%

In order to blend the rates of each bank based on the weighting above, a blended unit value is created.

At the same time that the change in bank providers occurred, Bank of the West—the bank that was retained under the new structure—also changed their interest rate methodology. Their methodology was changed to the following: The rate set each quarter is based on an average 3-month LIBOR for the 10 business days preceding the quarter plus 0.10%, with a cap of the Fed Funds Target rate, whichever is lower. This interest rate is reset at the end of each quarter. Interest is accrued daily and paid monthly at month end. Prior to this time, the Bank of the West interest rate had been set annually.

On October 1, 2014, Bank of the West sent the new quarterly rate of .25% to Empower's product team. The product team was used to looking for an annual rate and did not look for a quarterly rate email. The account manager was not copied on the rate email and therefore did not realize that the rate had been sent. The existing annual rate of .75% remained on the system and was used in the blended unit value calculation for fourth quarter 2014.

In early January 2015, Bank of the West sent the 1Q2015 rate of .25%. The products team was expecting a rate on this date since it was the beginning of the year. However, when the rate came in, it looked much lower than what had been received in previous years and therefore the rate was

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questioned. At this point it was discovered that the rate was a quarterly rate and that the 4Q14 rate had not been updated.   The variance from October 1, 2014 to January 5, 2015 was calculated and came to approximately $180,000. Since tax years had been crossed and the amount of the adjustment was minimal, a current day correction was made to correct the unit value. What was not anticipated was the effect that the current day correction would have on the performance and it created a negative return for the FDIC investment option.

In order to correct the issue, Empower will:

- Correct the unit values from October 1, 2014 – January 5, 2015.
- Re-calculate performance as of 12/31/14 for the FDIC option; the YTD performance was originally reported as .44%. The corrected performance is 0.38%.
- Re-run 4Q14 participant statements for those individuals in the FDIC option. Included with the statements will be a narrative on the statement, a letter further explaining the situation, and a corrected performance document. There are 9,193 participants who are affected and will be receiving the mailing.
- Include a narrative on the 1Q15 statement to all participants letting them know that 12/31/14 performance for the FDIC option has been corrected and an updated performance document can be found on the website.
- Post a web banner with a link to the corrected performance document.
- Prepare the call center and local office for participant inquiries.

Participants that took a withdrawal during the correction period from October 1, 2014 – January 5, 2015 and had received the overstated FDIC fund balance will not be corrected since it was a benefit to the participant.

The revised 4Q14 statements are expected to mail near the end of the week of April 13, 2015 and the 1Q15 statements are expected to mail near the end of the week of April 20, 2015.

In order to prevent this type of situation from happening again, we will be implementing several new measures as follows:

1) **Enhanced controls regarding contract and interest rate changes**
   The Client Service team will work with the Product team to ensure that all changes are understood and applied.

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2) **More rigorous oversight for funds not regulated by Investment Company Act of 1940**
The Investment Company Act of 1940 places responsibilities and limitations on pooled investment vehicles such as mutual funds and unit investment trust that offer investment products to the public. These types of funds are referred to as "40 Act Funds." Non-pooled, or private, investments are referred to as "Non 40 Act Funds" as they are not subject to the legislation. A bank fund is an example of a Non 40 Act Fund.

   In addressing unit value corrections, Empower presently uses industry standards based on the Investment Company Act and applies them to both 40 Act and Non 40 Act funds. However, as a result of the situation occurring with the City's FDIC-Insured Savings option, we are exploring developing more rigorous standards to Non 40 Act Funds, specifically those that are interest rate sensitive. This would result in greater levels of review and analysis prior to a unit value correction being processed.

3) **Define reconciliation thresholds and proper escalation protocol for out of balances between the bank statement and internal record keeping system**
The monthly reconciliation between the bank statement and the internal recordkeeping system is usually completed between the 15th and 20th business day of the month. The reconciliation is reviewed by the Manager and then the Asst Vice President of Financial Control. Any variance of .003% or more of the account balance will be escalated to the Client Account Manager and additional research will be completed.

We deeply regret this crediting error and any confusion that it caused to the City's participants. We believe that our new measures will help in preventing this type of situation from occurring again.

Please do not hesitate to call me at 303-737-5159 should you have additional questions.

Sincerely,

Lisa K. Tilley

Lisa K. Tilley
Director
National Accounts-Government Markets