DEFERRED COMPENSATION PLAN
BOARD REPORT 06-02

EMPLOYEE BENEFITS DIVISION

Date: January 9, 2006

To: Board of Deferred Compensation Administration

From: Staff

Subject: Request for Proposal for Plan Administration

Recommendation:

That the Board of Deferred Compensation Administration adopt staff's recommendations to

(a) Draft the next Request for Proposal for Deferred Compensation Plan Administration with the following general guidelines:
   1. Define minimum core local staffing requirements as detailed in this report;
   2. Omit questions concerning investment advice or managed account services pending an evaluation of the investment advice question by the Board;
   3. Omit any request for quoting of an asset-based fee; and
   4. With the concurrence of the General Manager Personnel Department, include a separate questionnaire within the RFP for Pension Savings Plan administration;

(b) Approve establishment of an RFP review committee as defined in this report, and direct staff to draft a specific proposal for an outside rater;

(c) Adopt staff's proposal for consensus scoring of RFP responses and not including vendor interviews as part of the evaluation process; and

(d) Return to the Board at its February meeting with a draft Request for Proposal for Plan Administration.

Discussion:

Prior to presenting a draft RFP for review by the Board, staff believes it would be helpful to consider certain key issues which will help shape the final document. Staff will first review some of the basic data from the recent participant survey, which will frame many of the issues discussed in this report. Next, staff will review the issues and concerns identified in the 2004 City Administrative Office (CAO) report concerning the prior RFP process for Plan Administration (Attachment I). Staff's primary goal is to create an improved RFP by incorporating participant survey feedback and addressing the recommendations from the CAO.

A. Survey Results

Mercer's detailed report regarding all survey results will not be available until the Board's February meeting. However, in the interest of expediting progress on this RFP, staff has obtained some of the raw survey data for the purpose of addressing some of the key recommendations included in this report.

Staff identified three key themes arising out of the survey results:

- Broad general satisfaction with the current Plan design and Plan services;
- An overwhelming preference for keeping plan costs low if the alternative is a higher cost for additional services; and
- No demonstration of majority interest in potential new services such as investment advice or managed accounts.

Survey results indicate that 81% of Plan participants are satisfied or very satisfied with the Plan overall, with 72% satisfied with the investment options. When asked specifically about Plan services, a smaller number, 54%, expressed satisfaction, but only 11% expressed dissatisfaction – the balance of respondents were neutral on the question.

Regarding costs vs. services, by 90% to 10%, respondents indicated that keeping costs lower was preferable to adding more services. None of the questions concerning investment advice and managed account services generated majority interest – the highest level of support was for automated investment advice, with 34% expressing an interest, and the lowest level of support was for managed accounts, with just 16% expressing an interest.

Although there clearly will be further details to explore once Mercer presents its final report, for the purpose of this RFP staff believes that the data strongly supports the proposition that the next vendor search should (a) seek a provider that can maintain the current service level, (b) attempt to avoid an increase in fees above current levels, and (c) avoid seeking new services for which broad participant interest has not yet been established.

B. CAO Report

Background - The Board initiated an RFP for Plan Administration in January 2004 which resulted in a vote on August 17, 2004 vote to select Nationwide Retirement Solutions as a new provider. Following concerns expressed by many Plan participants regarding this decision, the City Council requested that the CAO review the Board's selection process.

As a result of that review, the CAO developed a report identifying a number of flaws and recommendations for improvement. On October 5, 2004, Council vetoed the Board's selection of Nationwide and recommended that the Board cancel its current RFP for Plan third-party-administrative services, conduct a participant survey prior to releasing a new RFP, and revise its contract selection process to conform to best practices. The Board subsequently canceled the prior RFP on March 15, 2005.

Staff will address the following issues discussed in the CAO report:
- Local Staffing Services
- Investment Advice
- Review & Evaluation Process

In addition, staff will address related issues regarding:
- Fee Proposal Structure; and
- Pension Savings Plan administration.

1. Local Staffing Services

CAO Finding - The CAO report indicated that, given the maturity of the Plan in terms of participation/assets, and given staff experience with respect to staffing needs, the RFP should have more clearly defined its staffing expectations. The CAO recommended that in a revised RFP vendors be allowed to offer additional staff they believe are appropriate, but that they be required to specify the measurable benefit to the City for those staff and to provide a separate cost breakdown. Finally, the CAO recommended that the Board explore the feasibility of having some of the non-technical contract activities performed by an additional full-time Personnel Department staff person if it could help defray a portion of the contract costs.

RFP Recommendation – In developing this RFP, staff has undertaken a critical review of Plan staffing needs at the local level. Staff's Board Report 05-34 regarding Personnel Department staffing, adopted by the Board December 20, 2005, has already addressed the issue regarding the City's internal staffing needs. With respect to local staffing provided by the Plan Administrator, it would be helpful to begin by reviewing the current staffing provided by Great-West. The present contract with Great-West provides for the following positions:

- 1 Account Manager
- 2 investment counselors/enrollers
- 1 administrative support

Great-West has modified this somewhat in practice because it operates a local office providing similar services to other clients in the Southern California region. Presently the Account Manager position is dedicated to the City's Plan approximately half-time while a third counselor/enroller has been added. In addition, the administrative support position is part of a pool of administrative support positions utilized by Great-West locally, so other staff who perform those functions are sometimes shared with the City.

Staff believes that the following objectives are important to meeting the City's core local staffing needs:

- Administrator management-level oversight should be present to ensure accountability for local services, serve as a face-to-face contact and liaison with headquarter operations, and manage higher-level functions such as new communications initiatives, enrollment efforts, etc.;

- Sufficient counselor staffing should be available for group enrollment and educational meetings, face-to-face participant counseling, and staffing expectations at the City Hall walk-in service center and other City facilities/locations;
- Administrative support should be sufficient to answer participant questions regarding City-specific functions and to handle distribution of specialized forms/materials.

The basic current staffing levels have, in staff's experience, proven to be adequate for the need. New enrollments and participation have steadily risen over the last 5½ years, group meeting obligations have been met, and a wide range of policy and communications issues have been effectively addressed at the local level. In addition, staff has not received participant complaints indicating deficiencies in local staffing resources (e.g. lack of counselor availability, phone calls not returned, forms not received, etc.). As a result, staff recommends that the RFP define core local staffing as follows:

> "The *equivalent* of one full-time local account manager; 2.5 local counselors/enrollers; and 1.5 administrative support positions."

This represents a modest expansion of core local staffing to five full-time positions from the four technically provided for under the Great-West contract, although in current practice that number is closer to 4.5 positions. Staff believes that a marginal staffing increase is justified given the Plan's recent growth and expected continued growth over the next contract cycle. However, given the increase in local staffing approved by the Board last month, more substantial staffing increases are not required.

The emphasis on "equivalent" means that proposers should be given the latitude to offer variations which can effectively provide the service even if not in the precise position-model the RFP describes. However, the RFP would make clear that any staffing proposal which substantially exceeds the core level must include separate pricing for those additional staff and justification as to why the vendor believes those additional staff are needed.

2. <u>Investment Advice Services</u>

CAO Finding - The CAO report faulted the prior RFP for not being clear on the question of whether or how investment advice services would be offered by the Plan. The result was confusion in the vendor responses, in which two proposers included investment advice in their proposals but did not separately delineate the costs. The CAO report noted that "industry sources indicate that between 10% and 15% of participants use investment advice services, even when the service is offered at no additional charge." In other words, some of the vendor proposals included a service, the cost of which would have to be borne by all Plan participants, but the interest for which had not been established by the Plan.

RFP Recommendation – The participant survey results did not indicate strong general interest in investment advice and/or managed account services. As a result, staff believes that questions regarding the ability of vendors to offer these types of services should not be included in the RFP unless and until a full evaluation has been made by the Board regarding the appropriateness of including these services in the Plan. The question of whether such services will be offered by the Plan does not need to be answered in the context of this RFP.

However, if the Board is interested in resolving this issue in advance of issuing the RFP, staff can work with the Plan consultant to prepare a report for the Board's February meeting.

3. Review/Evaluation Process

CAO Finding - The CAO report discussed the finalist interviews conducted by the Board, noting that standard questions and rating forms should have been used by Board members. The report further observed that it was more typical for staff to be delegated responsibility to both evaluate the written proposals and conduct interviews. The report made reference to the City Controller contracted audit of Department of Airports contracting practices, which included among its observations that participation by Board members in the contract selection process is contrary to best business practices, and that the evaluation committee should include the Contract Administrator and at least two additional members that are selected based on "their understanding of the technical requirements of the proposal as well as their ability to provide an impartial evaluation." The CAO report suggested that the Board "consider the alternative contract selection process of delegating to staff the evaluation of written proposals and interviews."

RFP Recommendation: Review Committee - Consistent with the CAO recommendation, staff believes that the optimal structure of a review committee should include members who (a) might bring different expertise or perspectives to the evaluation process but who (b) are true subject matter experts in administration of governmental 457 plans. Staff has identified three such potential sources for participation on a review committee that meet both of these criteria:

(a) Personnel Department staff, who offer the unique perspective of their familiarity with, and are subject matter experts on, the particular policy, procedural and operational needs of the City's Plan;
(b) The Plan consultant, who provides the broad perspective on administrative services to 457 plans and is a subject matter expert on the technical support features offered by various service providers; and
(c) A retired state or local government employee with experience in the administration of a large 457 plan, state or local, who can bring an impartial outsider's perspective to the City's Plan while still having direct experience in the specifics of 457 plan administration.

With respect to the latter, Mercer has advised that they can help identify potential candidates to fill this role. Staff could contact various candidates to see if they would be willing to serve in this capacity as an independent contractor. Potential costs for using an outside rater would include a fee for their time spent in reviewing vendor responses, as well as possibly travel costs if it is determined that face-to-face discussions or vendor interviews would be helpful in the review process. The source of funding for these payments would be Plan operating funds.

RFP Recommendation: Consensus Scoring - Staff further proposes that the three potential review committee members identified above utilize an evaluation process, which Mercer advises has been used by some of its other governmental plan sponsor clients, called “consensus scoring.” Although this was not noted by the CAO, staff believes that another aspect of the prior RFP review process that could be improved upon was having the two reviewers (staff and the consultant) both conduct completely independent scoring of all the review categories. On some of the more technical categories, staff’s scoring was effectively neutral based on the concern that staff did not have the technical expertise to make as effective an evaluation as the consultant. Conversely, there may have been some areas wherein staff’s review might have been better informed than the consultant based on its working knowledge of the City’s Plan.

As a result, staff believes that the optimal approach involves having the review committee generate a single “consensus” score based on review and discussion. In this model, committee members would review and discuss the proposals together. In developing scoring, the consultant would likely be given deference in certain technical areas, and staff might receive deference in areas connected with unique operational needs of the City’s Plan. On issues where there is debate or it might be more difficult to develop consensus, one of the benefits of an outside rater is that he or she can pose questions, encourage the debate and help in consensus-building.

RFP Recommendation: Vendor Interviews – The CAO report alluded to some of the complications of the vendor interview process used in the last TPA RFP process. Principally, the CAO was concerned that the Board participated in those interviews without clear accountability for how those interviews factored into each Board member’s final decision. The CAO recommended (a) that the interview process be delegated to staff, and (b) that it include rating factors and rating forms so as to provide accountability.

Staff concurs with the CAO recommendation to not have the Board participate in vendor interviews. Going a step further, however, staff also finds that “vendor” or “finalist” interviews are an inherently problematic tool to use in the evaluation process. First, it has been well established by the City Attorney that in any Request for Proposal the rating and decision-making for a given RFP should be strictly limited to the written proposals submitted by vendors (exclusive of any type of “performance test,” which would not be part of this type of contract). Vendor interviews have been justified in the past on the premise that they provide an opportunity for firms to “clarify” responses provided in their written proposals or to highlight certain aspects of capabilities detailed in their proposals that might be difficult to evaluate in the form of the written word.

However, the interview process also presents a substantial risk – that the decision-making process ends up being influenced by how well a vendor conducted itself in an interview rather than the information contained in the written proposal. Certain rating factors (e.g. Communications, which might represent 5-10% of the formal rating criteria) can end up mushrooming into more highly-weighted factors in the evaluator’s mind because they are the focus of the interview process, while other less visible rating factors (e.g. Recordkeeping and Systems, which might represent 25% of the evaluation criteria) might end up effectively carrying no weight at all because they are left out of the interview. To be used appropriately, the interview process must be tightly controlled and the evaluator must be exceedingly disciplined in how any information gained from that process influences his or her decision-making. Even when that is done, however, there can be further complications if only "finalists" are interviewed – firms not established as finalists may argue that they were not given an equal opportunity to "clarify" their written proposals.

As a result, staff's recommendation is that vendor interviews not be part of the Review Committee's evaluation process. Staff believes that this will help ensure that the evaluation process strictly adheres to the fundamental obligation of the RFP – that vendors be evaluated exclusively on the relative strength of their written proposals and not on any other factor.

4. Fees

One of the most controversial and confusing elements of the prior RFP process concerned vendor fee proposals. To understand how it became confusing, it may be helpful to begin with some background on the basics of how fees are presently charged/paid within the City's Plan.

Contractually, the City pays a flat annual "per-participant" fee to Great-West of $37.65 per participant plus a $382,000 annual recordkeeping fee. Below is an example of a hypothetical annual contract payment based on the current participant count:

Annual Per-Participant Charge		Number of Participants		Annual Recordkeeping Fee		Amount Contractually Owed to Great-West
$ 37.65	x	35,123	+	$ 382,000	=	**$ 1,704,381**

However, how fees are paid to Great-West is different than the way that the Plan collects fees from participant accounts. To collect its revenue, the Plan assesses an "asset-based" fee of .11% (eleven "basis points") on all participant accounts. The Plan pays what is owed to Great-West out of the asset-based fee. Any excess goes to the Plan's Administrative Fee Reserve Fund. Below is an example of what might be collected as an annual fee based on current Plan assets:

Asset-Based Fee		Plan Assets		Revenue Collected		Less Great-West Fee Obligation from Prior Example = Surplus Revenue
0.11%	x	$ 2,197,190,069	=	**$ 2,416,909**		$ 712,528

Some defined contribution plans (particularly smaller ones) charge a "pure" asset based fee in which the vendor providing services essentially carries the risk of Plan assets going up and down. As an example, let us say that Vendor X determines that in order to administer a given Plan at a profit it can charge an asset based fee of 0.10%, expecting average assets over the contract term of $100 million. However, let us say that assets actually average $80 million - in this case, the vendor operates at a loss. Conversely, if assets average $120 million, the vendor experiences a much larger profit.

The prior RFP invited vendors to bid both a "per-participant" charge as well as a pure "asset-based" fee. In the controversy that followed, there was a great deal of understandable confusion regarding the fees, in part because each vendor essentially had two fee proposals on the table. As a result, quite often "apples were being compared to oranges."

One of the ways that the fee issue can be simplified for this RFP is by limiting vendors to proposing only a per-participant charge. Staff believes there is justification for this. In separate research (see Attachment II) Mercer has previously noted that:

> *"Many unbundled plan sponsors pay their service providers on a per-participant fee basis because this type of fee is most closely related to the actual TPA cost drivers, and the cost to the plan does not increase simply because of favorable investment returns."*

Mercer goes on to state:

> *"An asset-based fee (determined as a percentage of plan assets) is a common fee methodology and is almost always used in alliance or bundled service arrangements when the provider offers both services and investment options. It is less common in unbundled situations because, as stated above, a TPA's internal cost to provide services is not related to assets."*

In other words, per-participant charges are a more accurate reflection of actual cost because participation levels tend to be more stable than Plan assets, which can fluctuate substantially. The question for the Plan essentially is whether allowing vendors to quote an asset-based fee provides any benefit. Mercer advises that using an asset-based fee may be an "advantage" to the Plan if a vendor *overestimates* Plan assets in its proposal, the plan sponsor accepts the proposal and assets ultimately decline or do not grow as projected. The plan sponsor essentially capitalizes on the vendor's mistake by paying a lower fee than the actual cost to the vendor to provide the services. The converse risk, of course, is that the plan sponsor effectively *underestimates* its asset growth and the vendor reaps a "windfall" of surplus fee revenue greatly exceeding what would otherwise have been paid had Plan fees been keyed off the more stable per-participant charge.

In either scenario, staff believes there are arguments for not requesting asset-based fee quotes in the first place. First, it is highly doubtful that a large, unbundled plan like the City's would or should be willing to take on the risk of substantial fee overpayment by switching to a pure asset-based approach. Even if, as Mercer suggests, a vendor quotes a price that reflects a poor projection of future Plan assets, it is reasonable to ask whether the City's interests are served by entering into a long-term contract with a vendor that effectively runs a large program like the City's at a loss. In other Employee Benefits Division contracts in which this type of scenario has unfolded, the under-pricing of fees during the initial contract phase has been shown to lead to a counter-balancing overpricing in the next bid cycle as the incumbent attempts to recover its previous shortfall. Other vendors aware of the situation might perhaps feel safer in bidding a higher fee than they otherwise might because they realize the incumbent will need to raise prices. In short, staff believes that both the vendor and the City have an interest in utilizing a stable fee structure that is highly correlated to the actual costs of administering the program.

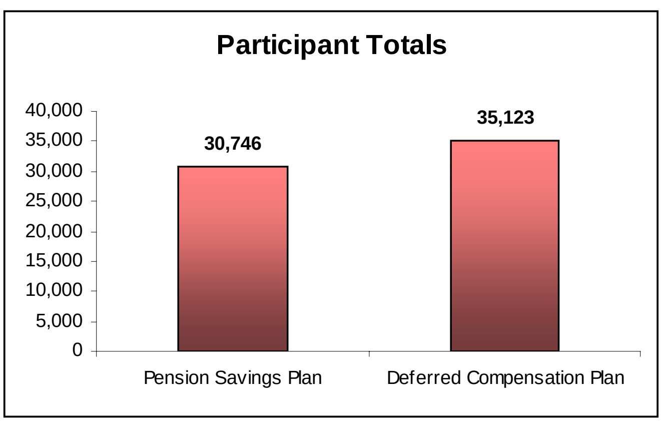
The Plan's fee structure will always be complex. However, one additional benefit of limiting fee quotes to a per-participant charge only is that it helps to eliminate potential confusion at the end of the process if and when fees must be explained to Board members, City officials and Plan participants.

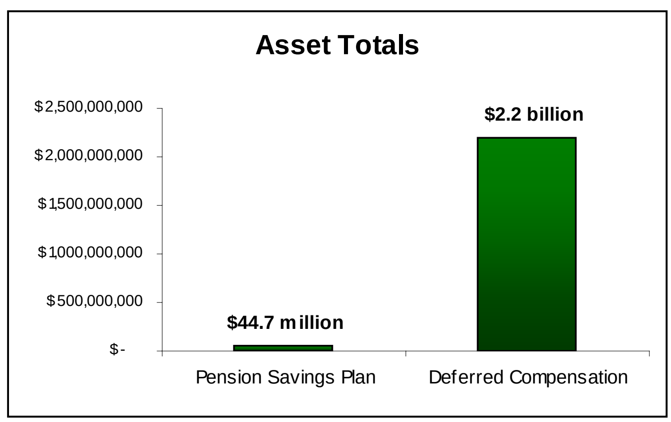
5. Pension Savings Plan Administration

The Pension Savings Plan (PSP) is the City's retirement program for part-time, temporary and seasonal employees. The Plan is administered by the Personnel Department. The Personnel Department General Manager is the contracting authority. For this program, the Board functions in an advisory role only. Currently Great-West provides administrative services for the Pension Savings Plan.

Issues related to PSP administration were not part of the CAO recommendations but have come up for discussion as a result of initial work performed in developing the RFP that is the subject of this report. Mercer has suggested that there may be certain advantages to combining administration of both programs into a single RFP.

Governmental retirement programs for part-time, temporary and seasonal employees are not particularly attractive to administrative service providers for defined contribution plans. The programs appear to be unattractive to administer because they have large numbers of participant accounts relative to the overall size of the program and perhaps do not always fit well with the vendor's business model. In the City's case, the participant count is comparable for both the Deferred Compensation and Pension Savings Plans, but the assets in the former dwarf those in the latter (see following charts):





There are several reasons why it makes sense to combine the services of both programs into a single RFP. First, vendors who might otherwise decline to submit a proposal for the PSP might be willing to do so if their administration of the smaller plan was connected to their administration of the larger plan. Second, there are certain benefits to Plan participants in both programs in having a single administrator provide all services. The high volume of rollover transfers from the part-time to full-time plan are made vastly easier with a single administrator. This benefits the many sworn employees (who are PSP members during their training phase), and part-time employees moving from part-time to full-time, who benefit from moving the funds they have accumulated in the PSP into the Deferred Compensation Plan.

Moreover, staff is concerned about the potential consequences of not renewing the incumbent administrator contract for the Deferred Compensation Plan. Great-West has indicated to the City that they may no longer wish to service the Pension Savings Plan should they not continue to be the provider for the full-time Plan. If this happens, and if Great-West exits the PSP on a separate contract cycle, it might be difficult to find a willing provider in a new bid process. Combining both programs in the RFP would signal the marketplace that the City has an interest in finding a single administrator for both programs.

Nevertheless, there are negatives associated with this approach as well. Each program has a separate contracting authority. There is no obligation on the part of the General Manager Personnel Department to select the same vendor for the Pension Savings Plan that the Board has selected for the Deferred Compensation Plan, or vice versa.

Unfortunately there are no perfect solutions. However, after careful consideration of these issues, staff believes that the most prudent course of action is to pose questions regarding the PSP in this RFP under the following conditions:

- PSP services would be included as a separate questionnaire;
- Potential bidders would be informed that they may, but are not required to, submit proposals for both programs, and further that a proposal for the PSP may be made conditional upon being awarded the contract for the Deferred Compensation Plan;
- Potential bidders would further be informed that the City may, but is not obligated to, award contracts for both programs;
- Any dual proposals would be evaluated and scored separately, so that the Board's evaluation of Deferred Compensation Plan services would not include PSP services;
- In the event the Board and General Manager Personnel Department reach similar conclusions with respect to potential providers, both programs may be awarded to a single provider;
- In the event dissimilar conclusions are reached, the Board would proceed with its appointment and the General Manager Personnel Department would address the PSP issue separately.

In short, this approach should preserve the widest range of options going forward without creating any specific obligations on the part of the Board or the General Manager Personnel Department. While it signals the City's interest, in the best of all possible worlds, in having a single provider, it will also make clear that this interest will not be subordinated to what is in the unique interests of participants in both programs, nor to the discrete contracting authority of the Board and General Manager Personnel Department.

Conclusion

Once the Board reaches its broad policy directives regarding the RFP, staff will work to finalize a draft for review at the Board's February 21st meeting. The Board will have the opportunity to review specific proposed RFP questions and rating factor weightings in the context of more specific and detailed information from the consultant regarding survey results. This ensures that the final version of the RFP will continue to build on the input received from Plan participants.

Submitted by: ______________________________
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Approved by: ______________________________
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