BOARD REPORT 09-27

Date: May 1, 2009

To: Board of Deferred Compensation Administration

From: Staff

Subject:: Hartford General Account and Stable Value Fund Consolidation

Recommendation:
That the Board of Deferred Compensation Administration approve the option of a Lump-Sum Payment/Liquidation of assets from the Hartford General Account, and instruct staff to provide immediate notification of same to Hartford Life Insurance.

Discussion:
At Board meeting of April 21, 2009, staff indicated that the transfer of assets from the Hartford General Account to the Galliard Stable Value Fund was scheduled to occur on June 1, 2009. This targeted transfer date was based on a telephonic conference meeting involving Galliard Capital Management, Hartford Life Insurance, Great-West Retirement Services, Mercer Investment Consulting and staff on April 1, 2009. At this meeting staff indicated to all parties that it appeared to be optimal to move Hartford assets sooner rather than later, and Hartford appeared to be in agreement with, and did not voice objections to, an approach in which the payout would occur on June 1.

Subsequent to that meeting staff was contacted by a Hartford relationship manager, Eric Judge, who transmitted correspondence from Hartford (see attached) indicating that the General Account assets would not be transferred as of June 1, 2009. Moreover, Mr. Judge indicated that Hartford would be relying on the terms of the City's contract with Hartford with respect to discontinuance of the General Account. This was despite a series of verbal representations made by Hartford to staff and to the consultant over the past 12-18 months to the contrary, in which Hartford had indicated both its willingness to transfer assets earlier than the contract termination date and its flexibility in doing so.

This abrupt change in Hartford's position and willingness to be cooperative is deeply concerning to staff and does not reflect well on the firm. Nevertheless, the terms of the contract are fairly clear and the City's Plan must address its options accordingly. Staff has been in communication with Mercer Investment Consulting (Phil Suess and Susan Dalton); the Plan Administrator, Great-West (Rick Kramer and Tom Pfeifle); the future Stable Value Fund manager for the entire asset pool, Galliard Capital Management (Michael Norman); and the City Attorney's Office (Steven Hong). As a result of those discussions, staff is prepared to make a recommendation as to how the Board should proceed.

1. **Consolidation Objectives** – As a beginning point, it would be helpful to reiterate the original objectives of consolidating the General Account assets into a new Stable Value Structure:

   (a) To improve the safety of those assets (by removing the risk of maintaining a pool of $446 million as an asset of a single insurance company);
   (b) To improve upon the yield and reduce fees (by moving to a structure where both the underlying holdings as well as the costs of managing the portfolio are fully transparent, and where the investment objectives are established by the Plan and not the provider); and
   (c) To improve liquidity (by reducing the scope of the broader equity wash limitations that apply to the General Account as compared to the more limited equity wash limitations of the Stable Value Fund).
   (d) To remove from the Plan the liquidity risk of not being able to access the Plan's assets in the event of default by the General Account product provider.

2. **Transition Objective** – The objective of transferring the assets is to do so in a manner which maximizes the combined yield of the entire asset pool (which includes both Galliard assets, presently valued at $167 million, as well as Hartford assets, presently valued at $446 million) and which is consistent with the previously communicated crediting rates to Plan participants.

3. **Contract Termination Options** – The Hartford contract provides for three options for removing assets from the General Account, outlined as follows:

   (a) *Five-Year Payment* – Six equal installments paid annually over a period of five years subject to a minimum crediting rate of 3%;
   (b) *12-Month Payment* – Payout of the balance at discontinuance subject to Hartford's ability to defer payment, at its option, for a period of up to twelve months, with the rate applied to the assets at 3% over that one-year period; and
   (c) *Lump-Sum Payment* – payment of the balance at discontinuance, subject to any required market value adjustment, and requiring a 90-day advance notice.

It is the finding of staff and the consultant that the first option is not viable given the length of time over which the payment is required to be made, which would delay implementation of all of the previously identified Consolidation Objectives. This leaves the 12-Month Payment and the Lump-Sum Payment as the remaining viable options.

As a point of reference, a "market value adjustment" means that the apparent balance of the account can be discounted if some of the underlying holdings of the account must be sold at less than book value. Book value means the nominal value of the holding. For example, a bond which has a face value of $100 but has a current market value of $90 would suggest a market value adjustment of $10 because it must be cashed out at less than its book value.

The advantage of the 12-Month Payment option is that no market value adjustment applies to the liquidation. The disadvantage is that assets maintained with Hartford over the 12-month payout would be earning only 3% (vs. the 4% currently being earned).

The advantage of the Lump-Sum Payment is that the assets would transition immediately. The potential disadvantage is the risk of a market value adjustment which might result in some of those assets being cashed out at less than book value.

Based on the current interest rate environment as well as Hartford's representations, Mercer advises that if the account could be cashed out today there would be no market value adjustment. It is further the view of Mercer as well as Galliard that even if a market value adjustment were to apply, the impact on the combined rate of return for all assets would likely be less than if the Hartford portion of the assets were subject to a 3% rate of return for up to one year. As a result, it is the joint recommendation of staff and the consultant that the Board approve the lump-sum payment option.

There is of course risk of an unanticipated significant change in the interest rate environment over the next 90 days, specifically a dramatic increase in treasury bond yields. This would likely require significant positive developments in expectations for the economy. Given current structural economic weakness, however, this appears unlikely.

At the time of writing this report Mercer and staff are awaiting data from Hartford on the General Account holdings which would allow Mercer to conduct a more precise analysis of the degree of cushion which currently exists to protect these assets against a market value adjustment. However, in talking with Mr. Suess on this matter, he indicates that under the provisions of the contract, it is likely that the Plan will be able to re-invest its assets at a yield exceeding the discount rate utilized by Hartford to determine the discontinuance payment. Hartford's discount rate is 75 basis points above the current yield of a zero coupon treasury bond having the same maturity date of the Hartford payments under discontinuance option a. For example the current yields on AA/corporate bonds provide a 154 to 167 basis point yield premium above treasury yields of comparable maturity.

Mercer is developing a supplementary report which will provide further background and the results of its review of Hartford's data. This report will be distributed either electronically to Board members prior to the Board meeting or at the meeting. However, given current information, staff is recommending that the Board approve the option of a Lump-Sum Payment/Liquidation of assets out of the Hartford General Account, and instruct staff to provide immediate notification of same to Hartford Life Insurance. The target for the payout would be approximately August 3-4, 2009.

Submitted by: ____________________________
Steven Montagna

Approved by: ____________________________
Alejandrina Basquez