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DEFERRED COMPENSATION PLAN BOARD REPORT 08-30



Date: August 5, 2008
To: Board of Deferred Compensation Administration
From: Staff
Subject: Plan Savings Options

Recommendation:

That the Board of Deferred Compensation Administration:

- (a) Reaffirm the Plan's commitment to including an FDIC-insured option or options as part of its core investment menu;
- (b) Approve expansion of trading options under the Plan's brokerage window to include Certificates of Deposit to be effective at such point in time that Charles Schwab can offer that as a stand-alone trading option;
- (c) Direct staff to draft a Request for Proposal for Plan savings (FDIC-insured) options; and
- (d) Approve the attached draft Request for Proposal for a Plan Stable Value Fund provider.

Discussion:

With recent stresses to the world's financial markets, and in particular to banks and other lending institutions, concerns have been raised about risks to investors in the event a financial institution fails. Staff has also received inquiries from participants regarding the safety of their assets and what steps can be taken to provide broader protection.

At the Board's May 20, 2008 meeting, investment provider Washington Mutual Bank provided its annual presentation regarding its Liquid Account and Certificates of Deposit. Staff indicated at that meeting that it was working with the Board's consultant, Mercer Investment Consulting, to review the Plan's savings options and generate a report to the Board. As a result of that review, staff is now prepared to make several recommendations regarding these options.

FDIC Insurance & LASP Coverage – The Plan contains two FDIC-insured options:

- Washington Mutual Liquid Account
- Washington Mutual Certificates of Deposit

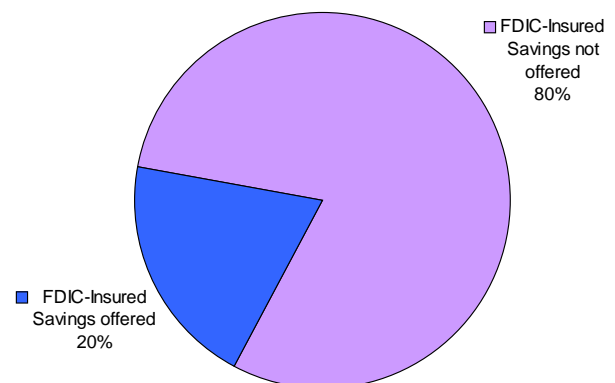
Both Washington Mutual options are insured by the Federal Deposit Insurance Corporation (FDIC) up to \$250,000 per participant within the Plan. So, for example, if a participant had \$200,000 in the Liquid Account and \$50,000 in CDs, the combined \$250,000 would be fully insured in the event of the bank’s insolvency.

Washington Mutual also participates in California’s Local Agency Security Program (LASP). LASP is administered by the State of California Department of Financial Institutions. LASP member entities are required to place as collateral with the State a minimum of 110% of deposit balances that exceed the FDIC limit, in the form of either AAA-rated Municipal Securities or U.S. Treasury obligations.

For any individual depositor accounts in excess of \$250,000, in the event a member institution becomes insolvent LASP would take assets from the pledged collateral to make depositors whole. Member banks are required to maintain the 110% collateral or face fines. Washington Mutual indicates that they maintain an extra margin of assets in the program due to the large volume of business they have in California. Over the last five years they have maintained, on average, 123.73% of deposit balances vs. the required 110%, which represents approximately \$26 million in average holdings over and above the collateral minimum.

Maintaining a Bank FDIC-Insured Savings Option

- It is important to begin by observing that inclusion of an FDIC-Insured option is atypical in the public sector defined contribution world. Mercer and Great-West have long indicated that inclusion of FDIC-Insured products is rare within public sector plans. Staff conducted independent research in July 2008 by surveying NAGDCA member organizations on use of FDIC-insured options. Out of 45 respondents (which we would consider a fully representative sample for state/local plans), 80% of plans did not offer an FDIC-insured savings option as part of their core investment menu (see attachment). The more common offering is a stable value fund or money market account, neither of which have FDIC protection.



Over the years staff has considered arguments from peers and advisors in the governmental arena regarding eliminating the bank savings options in favor of a single cash-equivalent product such as a stable value or money market fund. Staff has consistently resisted this plan design concept for two reasons:

- Savings accounts may provide superior rates of return relative to other cash equivalent products in certain market cycles; and
- FDIC Insurance provides a unique benefit that represents a significant value to some participants.

In the past two years, both of these propositions have proven their application and value. First, although last year's inverted interest rate cycle has clearly now ended, there was nevertheless an extended period of time in which Plan participants were able to find superior rates of return in the Washington Mutual Liquid Account compared to the Plan's other savings options.

Second, the subsequent recent tumult in the nation's lending institutions, including the failures of some high-profile corporate entities (e.g. IndyMac), has fairly dramatically highlighted the value of FDIC insurance. Like other types of insurance, its value is often under-appreciated until it is needed. In staff's view, the value of FDIC insurance is not simply because it provides participants peace of mind, but also because it provides real protection in the event of disastrous outcomes, as rare as those might be. Far worse than a bank failure requiring use of FDIC insurance would be failure of a money market account for which no such insurance was available.

Given this, staff's first observation is that the Board should reaffirm its commitment to offering an FDIC-insured option as part of the City's Plan's core investment menu. This will provide valuable guidance to the Board's Investments Committee as they consider options for restructuring that menu.

Multiple FDIC-Insured Products - One of the questions received from a number of Plan participants as news spread regarding IndyMac's failure was whether the Plan could offer savings options from multiple providers in order to obtain broader FDIC coverage. Although at first glance this might appear to be a reasonable concept, staff believes it may not be the optimal policy response for the following reasons:

- Adding saving options conflicts with an emerging policy approach of eliminating redundancy in the Plan's core investment menu and streamlining options to help participants make better asset allocation decisions;
- The State's Local Agency Security Program (LASP) already provides protection for amounts above the FDIC-insured limit;
- It is questionable how much additional security would really be provided by having more than one provider during an extreme market event which is creating systemic failures; and
- Providing access to multiple savings products could more effectively be addressed through expansion of the brokerage window.

With respect to this last point, Charles Schwab has indicated through Great-West that they are developing functionality, with an approximate start date of September 2008, to allow purchases of Certificates of Deposit as a stand-alone trading option through the

brokerage window. Presently, making those Certificates of Deposit available would require providing access to the full menu of stocks and bonds. While Schwab could offer CDs, it could not offer additional savings account options, so participants would be limited on that basis. However, staff believes that this represents a balanced policy response. FDIC insurance coverage could be expanded without subverting the policy goal of a streamlined core investment menu. As a result, staff recommends that the Board approve this additional trading category for implementation as soon as it becomes available.

Strengthening LASP Coverage – Mercer has reviewed the application of LASP requirements to Washington Mutual’s products and is recommending a reporting change in order to help strengthen that coverage. Banks participating in LASP are required to provide weekly updates of assets which are subject to LASP requirements. Presently, however, Great West updates that information to Washington Mutual monthly. Mercer advises that ideally more frequent updates would occur in order to address the potential for significant fluctuations in cash flows. Staff concurs with this finding and is presently working with Great-West to determine the feasibility of instituting more frequent reporting.

Testing the Market – Given the recent upheaval in the banking sector staff believes that now is an appropriate time to “test the market” of potential savings product providers. The consultant could review not only performance information but more importantly the relative stability of various firms that might be interested in securing the City’s business. The last time the Plan conducted a search process for potential bank product providers was in 1999. As a result, staff is recommending that the Board direct staff to work with the consultant to draft a Request for Proposal for bank savings options

Certificates of Deposit – As previously mentioned, it is possible to allow purchases of Certificates of Deposit through the Plan’s brokerage window provider, Charles Schwab. Staff believes that, pending final decisions on what products will be offered through the Plan’s brokerage window, the Board should consider the possibility that the Plan’s certificates of deposit be eliminated from the Plan’s core menu and that these options be made available through the brokerage window only. This concept is one that could be reviewed in greater detail by the Plan’s Investments Committee as part of the discussion to streamline the Plan’s investments menu.

Non-FDIC Insured Accounts - The Hartford General Account and Galliard Stable Value Fund are not FDIC insured. Pursuant to Board action, both products are undergoing a transition with respect to how the underlying assets are held. In the past both accounts have been part of collective pools in which the City’s Plan participated along with other plans/investors. Both are now transitioning to separate account stable value structures, where City Plan assets will be singly and uniquely held. The assets of each provider are backed by the underlying, broadly diversified holdings of each account.

In connection with decisions made by the Board to first transition and then subsequently competitively bid this pool of assets, staff has worked with Mercer to develop the attached Request for Proposal for a Stable Value Fund manager for the City's Deferred Compensation Plan. The contracts with the incumbent managers of the City's "fixed account" savings options, the Hartford General Account and the Galliard Stable Value Fund, expire on June 30, 2009. Although this might appear to be some distance away, in fact Mercer advises that ideally a decision regarding the future manager should be made by the end of this calendar year to provide ample time for transition issues and contract execution.

The format of the RFP is identical to that used for the recently issued RFP for Russell 2000 and mid-cap index fund managers. The specific questions were developed by Mercer's Phil Suess, a Principal with the firm and an individual who has advised the Plan for many years regarding its fixed account options.

Conclusion:

Like all market events, the current crisis in the financial services industry will pass. These events, however, provide opportunities for plan administrators to review their programs to determine how well prepared they were for the crisis and how they can be better prepared for the future. In the City's Plan, the inclusion of FDIC-insured options implies that the Plan was better prepared than the majority of its government market peers. Nevertheless, there are several areas where we can be proactive by improving reporting, expanding availability of FDIC-insured vehicles, and testing the market of savings product providers.

Submitted by: _____
Steven Montagna

Approved by: _____
Maryanne Keehn

NAGDCA SURVEY: FDIC-INSURED SAVINGS OPTIONS

Entity	FDIC offered
Anne Arundel County, MD	No
Bay Area Rapid Transit District	No
Cal Pers	No
City and County of San Francisco	No
City of Dallas	No
City of New York	No
City of Portland, OR ⁵	No
City of Torrance	No
City of Tucson, AZ	No
Clark County, WA	No
County of Los Angeles	Yes
County of Sacramento	Yes
County of Santa Clara ³	Yes
County of Sonoma	Yes
County of Ventura	No
Gwinnett County	No
Humboldt County, CA ¹	No
Kentucky Public Employees' DC Auth.	No
L.A. County Sanitation District	No
Los Angeles Unified School District	No
Maine Pers	No
Metropolitan Transportation Authority	No
Multnomah County, OR ⁵	No
Nassau County, NY	No
Nevada Public Employees' DC Program	No
New Jersey City	No
NYS Deferred Compensation Plan	No
Orange County Transportation Authority	No
Sheriff's Office of Orange County, FL	No
South Carolina Retirement Systems	No
South Coast Air Quality Management District in Diamond Bar	No
State of California (including CSU system) ⁴	Yes
State of Delaware	No
State of Florida ²	Yes

State of Georgia	Yes
State of Indiana	No
State of Kentucky	No
State of Michigan	No
State of Tennessee	Yes
State of Texas	No
State of Wisconsin	Yes
State Universities Retirement System of Illinois	No
Teachers' Retirement System of Oklahoma	No
Utah Retirement Systems	No
Virginia Retirement System	No