Deferred Compensation Plan
BOARD REPORT 11-70

Date: November 2, 2011

To: Board of Deferred Compensation Administration

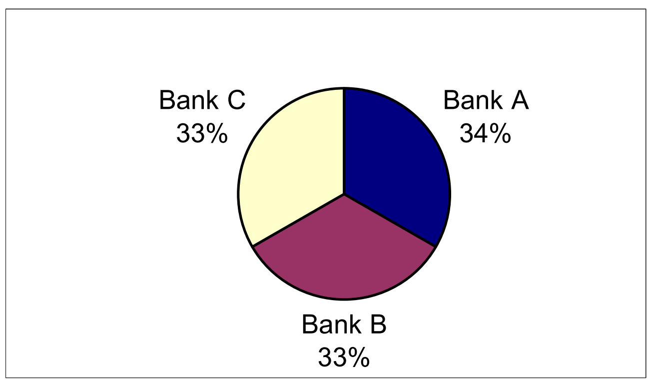
From: Staff

Subject: FDIC-Insured Bank Deposit Account - Provider Allocations

Recommendation:
That the Board of Deferred Compensation Administration approve in concept staff's proposal for a modification to the structure of the Plan's FDIC-Insured Bank Deposit Account, and instruct 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.

Background:
Currently the City's Deferred Compensation Plan offers a Bank Deposit Savings option. This product provides Plan participants with the opportunity to invest in an interest-bearing account which is insured by the Federal Deposit Insurance Corporation (FDIC).

The City's Plan has offered a similar option since its inception in 1983. From 1983 to 2009 the option was offered by a single provider. The original provider in 1983 was Great Western Bank. Great Western Bank was acquired by Washington Mutual Bank in 1994. In 2008, as Washington Mutual was nearing insolvency, the FDIC brokered a takeover/acquisition by JP Morgan Chase.



Shortly after the acquisition, JP Morgan Chase informed the City that it would not be willing to administer the product on an ongoing basis. In January 2009 the City's Plan began a search process for a successor through a Request for Proposal (RFP). In order to reduce the risks of holding assets with a single provider, and to expand the amount of FDIC insurance available to participants, the City indicated that it intended to create a blended option comprised of three underlying providers, each with an equal weighting (33.3%) of the total assets in the Fund (see illustration above).

In March 2009 the RFP was canceled because an insufficient number of firms submitted responses. With the assistance of its consultant, the Board then identified three banks (**Bank**

of the West, **Bank of America**, and **City National Bank**) willing to participate in the blended option. The new blended option was introduced into the Plan in October 2009.

Discussion:
The current equal weight allocation policy provides Plan participants with FDIC insurance coverage of up to $750,000. In addition, having three providers provides the Board with the flexibility to shift assets between providers in the event a potential insolvency or other problem occurs with one of the institutions. However, Bank of the West has offered the City's Plan an opportunity to receive a higher rate of return on a larger share of the assets.

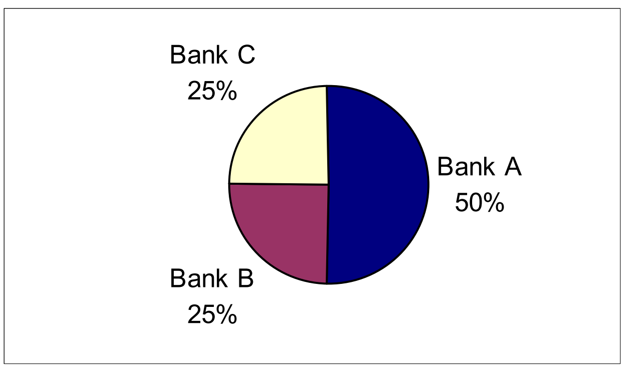
Earlier this year staff met with Bank of the West relationship managers to discuss collateral reporting and their process for interest credited to Deferred Compensation Plan accounts. Staff and Bank of the West also discussed interest rate pricing.

The current contract with Bank of the West provides for a highly favorable interest rate floor of 1%. Specifically, the contract language provides that the interest rate paid on the account will be based on the 91-Day T-Bill rate with a floor rate of 1.0%, until the 91-day T-Bill reaches 1% or above – following this, the rate each month would be based on the last 91-day T-Bill rate announced in the preceding calendar month. Since implementation, the 91-day T-Bill has not reached 1%.

In today's interest rate environment, a 1% floor is extremely favorable for Plan participants. The Bank of America and City National Bank contracts do not provide such a floor rate. The Bank of America contract provides that the interest rate is based on the prior month's average Federal Funds effective rate plus 0.10%, less FDIC insurance fees. The current rate is 0.13%. The City National Bank contract states that the interest rate is based on the greater of 0.15% or 3-month LIBOR as of previous quarter end, less 0.50%. The current rate is 0.15%. **The approximate blended rate of the three institutions is presently 0.43%.**

In the meeting with Bank of the West, staff inquired about the possibility of providing additional assets to Bank of the West in order to receive a higher overall rate of return for Plan participants. Bank of the West indicated 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.

Staff then 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. At staff's request, Mercer prepared the attached report with an analysis of staff's inquiry.



Staff's and Mercer's finding is that establishing a policy which provides the Board with the ability to adjust the allocations in this option within a specified range would benefit participants in this Fund while still meeting the objectives of safety of principal. Specifically, staff is recommending that the Board establish a policy which would provide the 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. If so, 50% of FDIC assets would then be allocated to the highest yielding bank.

The conditions would essentially 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.

If such an adjustment was made, the maximum amount of FDIC protection would be reduced from $750,000 to $500,000. However, staff and Mercer reviewed the number of participants that would be adversely affected by such a change and the number was minimal. Only eighteen participants have more than $500,000 invested in the FDIC option. In staff's view, the value of the reduction in FDIC insurance coverage for these individuals would be more than outweighed by the increased return for all participants in the option. In addition, any participant who wishes to obtain FDIC insurance for more than $500,000 in assets can accomplish this by directing some of their assets into the Self-Directed Brokerage Option (SDBO).

In addition, over time, staff's expectation is that adopting this policy may create some incentives for current or future providers to adjust rates slightly, on the margins, in order to avoid the risk of losing assets. For example, if the highest-rate provider's interest rate was 0.30% higher than the next lowest, then that lower-rate provider might be motivated to increase its rate of return by 0.06% in order to maintain its asset base. This, of course, would still be to the benefit of Plan participants by creating incentives, where possible, for higher rates.

Staff therefore recommends that the Board approve this proposed change in concept and instruct staff to work with Mercer to draft the appropriate modification to the Plan's Investment Policy. Staff would then return to the Board with a recommendation to modify the investment policy as well as a recommendation as to whether to apply this change to the current providers.

Submitted by: ______________________________
Natasha Gameroz

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Steven Montagna

Approved by: ______________________________
Alejandrina Basquez