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Memo

To: Board of Deferred Compensation Administration, City of Los Angeles Deferred Compensation Plan

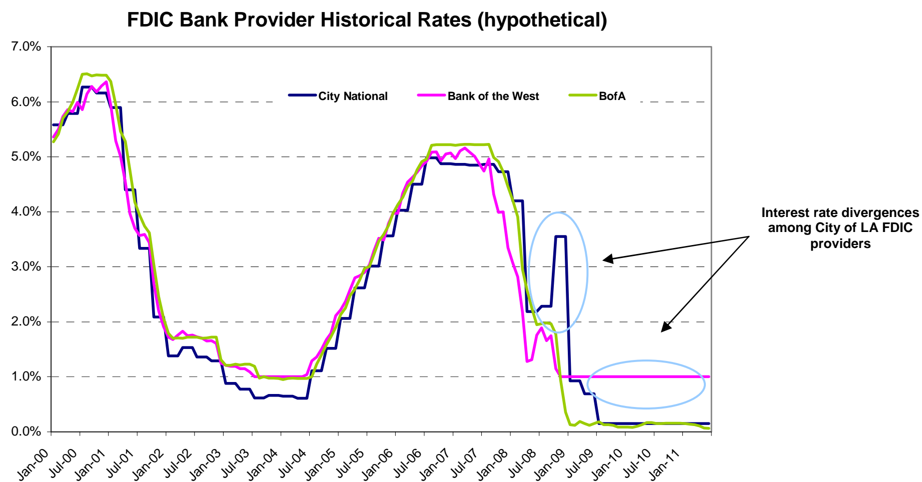
Date: November 1, 2011

From: Devon Muir, CFA and Eileen Kwei, CFA

Subject: FDIC-insured option provider allocations

Copy: Staff

The Deferred Compensation Plan's FDIC-insured option comprises savings accounts from three banks, Bank of the West, City National, and Bank of America, with each offering FDIC protection up to the maximum allowable threshold of $250,000 per participant ($750,000 in total when combining protection offered by all three providers). While over time each provider pays interest on a relatively similar scale, there can be meaningful divergences in rates offered in the short term due to the use of difference interest conventions.



This memo aims to review these differences and identify ways to increase the expected yield of the FDIC option should the Board wish to pursue higher returns at the cost of reducing the maximum FDIC coverage cap.

Interest rate methodologies by bank

The Plan's FDIC providers credit interest to the FDIC insured accounts according to the following short-term reference interest rates which were established in their respective agreements with the Plan.

FDIC Account Reference Interest Rates

- ***Bank of the West: Greater of 1.00%[1] or 91-day t-bill rate from the following month***
- ***City National: Greater of 0.15% or 3-month LIBOR as of previous quarter end less 0.50%***
- ***Bank of America: Prior month's average Federal Funds effective rate plus 0.10% less FDIC insurance fees (0.13% currently)***

Over time, performance that investors would have experienced under any one of these interest rate scenarios is relatively similar, but over shorter periods, there are yield discrepancies due to the fact that one bank's reference rate or minimum floor may prevail over the others at certain points (perhaps best illustrated in recent months by Bank of the West's 1.0% floor substantially exceeding the current yields of the other accounts). Moreover, significant differences in the providers' reference rates are fairly common, with the average range between the highest and the next highest interest rate in any given month since 2000 being 0.41%.[2]

Geometric returns of FDIC rates compounded monthly (hypothetical) to 6/30/2011

Period	City National	Bank of the West	Bank of America
1-year	0.15%	1.00%	0.13%
3-year	0.72%	1.07%	0.36%
5-year	2.23%	2.30%	2.06%
7-year	2.40%	2.53%	2.34%
10-year	2.06%	2.24%	2.13%
Since 1/1/2000	2.55%	2.69%	2.63%

The reasons for the rate differentials are both economic (i.e., substantive differences between Treasury bill, Fed Funds Effective, and LIBOR rates) and artificial (e.g., Bank of the West's 1.0% floor was devised as an introductory rate but due to unprecedented market conditions has persisted). Regardless of the root of these differences, however, the opportunity to enhance the blended yield offered by the Plan's FDIC investment option exists.

Reviewing the Plan's allocation approach relative to an alternative approach

The Plan currently implements an equal weight allocation policy of 33.3% to each provider[3] irrespective of the expected future interest for each account. While this approach is convenient and a reasonable means to achieving diversification by institution, on a historical basis, altering allocation weights would have led to superior performance. Doing so, however, would reduce the maximum FDIC insurance coverage threshold from $750,000, which would affect the handful[4] of high-balance FDIC participants in the plan. The extent to which FDIC coverage is reduced is a function of how large an allocation is given to a single provider (i.e., the larger the allocation, the lower amount of total FDIC coverage distributed among the other providers). It should be noted that balances held in excess of $250,000 of FDIC coverage per provider would be fully collateralized by the provider in accordance with California Government Code.[5]

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[1] Offered to the City of LA Deferred Compensation Plan for the term of the contract
[2] Figure represents the average of subtracting the second highest monthly rate from the highest rate
[3] Great-West, upon standing direction from the Board, allocates to each of the providers in accordance with this policy and creates a unitized, blended option in which participants ultimately invest
[4] As of early June, there were 18 participants with assets in excess of $500,000 in the FDIC option compared to 9,996 with balances below this amount
[5] Collateral in the form of bonds, notes, or other obligations of the US; local public agency or public housing agency; bonds of this state (CA), or of any county, city, town, metropolitan, municipality; and certain other public securities

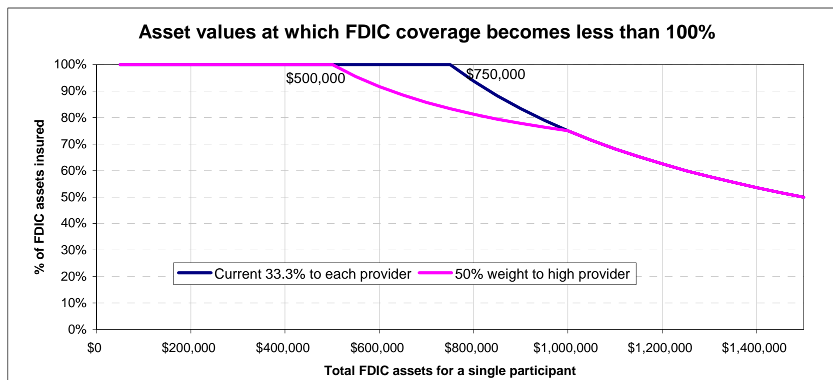
For the purposes of this study, we focused on a methodology of allocating 50% of FDIC assets to the highest yielding bank if its rate at the end of the calendar year was at least 0.25% higher than the next highest rate; meanwhile, the remaining assets would be split equally among the remaining banks. The illustration below shows hypothetical performance that a participant would have experienced under this approach as well as under the current allocation methodology. Not surprisingly, over all trailing periods examined, increased weight to the highest yielding account led to enhanced performance.

Historical performance of different allocation methods (hypothetical)

Period	Current (equal weight)	50% allocation to highest yielding account
1-year	0.43%	0.57%
3-year	0.72%	0.87%
5-year	2.20%	2.31%
7-year	2.43%	2.50%
10-year	2.15%	2.20%
Since 1/1/2000	2.62%	2.67%

Reduction in FDIC protection

Despite superior performance, a natural question in changing allocations is to what degree FDIC coverage would decrease by moving from the current targets. As depicted in the following illustration, at a 50% weight to the highest yielding strategy, FDIC protection is reduced from a $750,000 to $500,000 cap (a level which currently 99.8% of FDIC participants do not surpass currently).



Relating the preceding graphic to the Plan's participant base, the following breakdown provides context on the amount of FDIC participants by asset levels. As can be seen, the overwhelming majority of participants investing in the FDIC option have below $200,000 currently. Absent dramatic asset movement into the option, it appears very few participants would be affected from reduced FDIC coverage due to a change in the current portfolio structure.

Range	Participant Count	Cumulative Total
0 - $100K	9,219	91.26%
$100K - $200K	601	97.21%
$200K - $300K	196	99.15%
$300K - $400K	57	99.71%
$400K - $500K	11	99.82%
$500K - $600K	8	99.90%
$600K - $700K	4	99.94%
$700K - $750K	4	99.98%
$750K - $1 MM	1	99.99%
$1,000,000+	1	100.00%
Total	10,102	

Forward looking perspective of different allocation methodology

As highlighted earlier, Bank of the West's current 1.00% minimum rate floor is significantly in excess of the other two providers.[6] As a consequence of this, increasing allocations to Bank of the West leads to return enhancements in this very low yield environment. Nevertheless, when compounded, these incremental return expectations could become material to investors.

Return expectations of current and proposed allocation

Period	Current (equal weight)	50% allocation to highest yielding account
Expected Return	0.40%	0.55%
Incremental growth of $100,000 when compounded over 10 years at expected new return relative to current allocation return	N/A	$1,561

Note: Assumes constant compounding at current rates over 10 years at current interest rate levels for each allocation.

Policy and Implementation

If the Board is interested in pursuing incremental expected yield for the FDIC option at the cost of reducing FDIC coverage, we recommend the following approach.

Step 1: At an annual date to be determined, Board and staff will direct the investment consultant to analyze current rates offered by each of the FDIC option providers to determine if any rate dominates the others by more than 0.25%. In addition, the consultant will conduct an informal survey of major banks' then current demand deposit rates to understand if better investment opportunities may exist.[7]

Step 2: If no extraordinary rate exists, the consultant will provide written notice of this to the Board and an equal weight allocation methodology will be implemented. If the 0.25% threshold is exceeded,

[6] It should be noted that Bank of the West's long-term bond ratings, like the other two FDIC providers, continue to be rated as upper medium investment grade or better by the three major ratings firms as of 6/30/2011. In addition, as of the same date all of the current providers meet the Office of the Comptroller of the Currency's standard of "Well Capitalized" as defined by the Prompt Corrective Action section (Section 38) of the Federal Deposit Insurance Act.

[7] Mercer conducted such an exercise in August and found that no major banks were offering rates substantially different from what City National and Bank of America currently offer. Our findings are that Bank of the West's current 1.0% rate is an outlier case.

however, the consultant, if it deems prudent under circumstances then present, will provide written correspondence to the Board recommending that it direct the third-party administrator (TPA) to allocate 50% of FDIC option assets to the high interest bearing account and split the remaining balance equally among the other two bank accounts.

Step 3: The Board will review this recommendation, and if it deems prudent under circumstances then current, will delegate Staff to issue such a directive to the TPA.

Step 4: The TPA will implement the Board's directive and take necessary steps from an administrative perspective to ensure a seamless transition.

Conclusion

Should the Board approve moving to this FDIC option rebalancing policy, we will work with Staff to formalize it in the Plan's Investment Policy Statement. In addition, Staff and Mercer will work with Great-West to ensure that appropriate communication is crafted and other administrative details are in order for an orderly transition.