Deferred Compensation Plan
BOARD REPORT 16-13

Date: March 8, 2016

To: Board of Deferred Compensation Administration

From: Staff

Subject: Approval of Third Provider for the FDIC Insured Savings Account Option

Recommendation:
That the Board of Deferred Compensation Administration:

a) Approve the addition of a third underlying bank provider to the FDIC Insured Savings Account Option;

b) Approve the selection of Union Bank as the third provider for the FDIC Insured Savings Account Option; and

c) Instruct staff to draft a proposed contract for Union Bank and authorize the Board Chairperson to execute the contract, subject to agreement between the City and the provider as to all applicable terms and conditions.

Background:
The FDIC-Insured Savings Account is an option offered in the Deferred Compensation Plan's core investment menu. The foremost objective for this option is capital preservation, which is achieved by FDIC insurance coverage provided by multiple underlying banking institutions. Any amounts not covered under FDIC are required to be collateralized by the banking institutions.

As indicated in the Plan's Investment Policy Statement (IPS), this option is ideally intended to have three underlying providers with an equal allocation of assets to each provider (unless the Board chooses to adjust such allocation based on institutional viability and/or significant interest rate differentials). Currently, however, the option's providers and respective allocations are as shown below:

1) Bank of the West (50%)
2) East West Bank (50%)

As of December 31, 2015, assets in the FDIC-Insured Savings Account totaled $302,681,706, meaning approximately $151 million is on deposit with each bank.

On April 8, 2014, the Board issued a Request for Proposal (RFP) for provider services for this option. Two responses were received, from East West Bank and Bank of the West. At its July 2014 meeting, the Board approved the selection of these two providers. As there were no other respondents to the RFP, the Plan was not able to select a third provider.

As previously communicated to the Board, the lack of interest from the provider community in competing for this contract was likely related, as it was in 2009 with a previous similar procurement, to the unusual set of credit, monetary policy, and interest rate conditions following the recession. Savings deposits of this nature were viewed by some institutions as representing liabilities or not in alignment with the institution's strategic interests. Additionally, subsequent to 2008, financial regulations became more stringent for banking institutions, which likely increased the administrative complexity (and reluctance) of providing such services to the Plan.

Subsequently, the Board approved conducting an independent search for a third provider. It had used a similar approach in 2009 when the response to the RFP had also been lacking. The Plan's investment consultant, Mercer Investment Consulting, was tasked with conducting a provider review and outreach process to gauge interest and viability. Union Bank expressed interest but also indicated certain questions related to the City's contracting requirements and also securing its internal administrative authority to move forward. The review and discussion process with Union Bank has progressed to a point where staff is now prepared to recommend that they be selected as a third provider for the FDIC-Insured Savings Option. Mercer has provided an analysis regarding the merits of adding a third provider and Union Bank specifically as a provider (see attached).

Discussion:

I. THIRD PROVIDER FOR THE FDIC-INSURED SAVINGS ACCOUNT

The Board has the option to retain the current dual-provider structure or to add a third provider. Staff and Mercer's rationale for adding a third provider is based on a review of the following factors:

- Added flexibility and stability for the FDIC-Insured Savings Account
- Increase to FDIC insurance coverage levels
- No apparent significant adverse impact to crediting rates

Multiple Underlying Banking Institutions

The FDIC-Insurance Savings Account product was created subsequent to the financial upheaval of 2008. The Plan had at that time administered a similar product, but with only one banking institution holding all deposits. The banking institution subsequently filed for bankruptcy and was acquired by another bank, which required that the Plan immediately find an alternative option.

In order to provide better protection for assets held within this option, the FDIC-Insured Savings Account was redesigned to include multiple underlying banking institutions in order to allow flexibility for the Plan to be able to move assets in a similar emergency situation. Should the viability of any underlying banking institution come into question or require the immediate liquidation of Plan participant assets, the Plan has a built in safety mechanism allowing it to move assets to another underlying institution. Adding a third provider will allow the Plan broader flexibility in situations such as this.

In addition, relative to Union Bank specifically as a candidate provider, its size and strength add an additional layer of resource depth and stability. Union Bank's organizational viability is discussed further in Mercer's attached review.

FDIC-Insurance Coverage

The FDIC-Insured Savings Account option provides an alternative to individuals who are seeking principal stability and protection. One unique layer of protection offered in this type of investment is FDIC Insurance. Adding a third provider increases the level of FDIC insurance coverage provided to participants.

Each participant's assets in the FDIC-Insured Savings Account are divided among the underlying banks for the purpose of providing FDIC insured coverage amounts. Each banking institution will provide FDIC insurance coverage on balances up to $250,000 (and will further be required to collateralize amounts above this limit not covered by FDIC). Currently, 100% of balances up to **$500,000** are covered. Introducing a third bank will increase this to 100% of balances up to **$750,000**. The following charts help depict how the FDIC coverage is applied.

CURRENT FDIC COVERAGE - SAMPLE

		Hypothetical Participant Account Balance					
		$ 500,000		**$ 750,000**		**$1,000,000**	
Current Bank Allocations		*Amount Deposited*	*Amount FDIC Insured*	*Amount Deposited*	*Amount FDIC Insured*	*Amount Deposited*	*Amount FDIC Insured*
Bank of the West	50%	$ 250,000	$ 250,000	$ 375,000	$250,000	$ 500,000	$ 250,000
East West Bank	50%	$ 250,000	$ 250,000	$ 375,000	$250,000	$ 500,000	$ 250,000
		100% of balance insured		*67% of balance insured*		*50% of balance insured*	

PROPOSED FDIC COVERAGE WITH THIRD PROVIDER- SAMPLE

		Hypothetical Participant Account Balance			
		$ 750,000		**$1,000,000**	
Current Bank Allocations		*Amount Deposited*	*Amount FDIC Insured*	*Amount Deposited*	*Amount FDIC Insured*
Bank of the West	33%	$ 250,000	$ 250,000	$ 333,333	$ 250,000
East West Bank	33%	$ 250,000	$ 250,000	$ 333,333	$ 250,000
Union Bank	33%	$ 250,000	$ 250,000	$ 333,333	$ 250,000
		100% of balance insured		*75% of balance insured*	

PARTICIPANTS WITH FDIC BALANCES, AS OF MARCH 4, 2016

	Participant Count	Total Assets	% of Total Account Assets
Up to $500,000	15,281	$295,360,384.67	96.5%
Over $500,000 and up to $750,000	16	$8,924,160.35	2.9%
From $750,000 and under $1,000,000	2	$1,744,187.80	0.6%
$1,000,000 and over	-	-	-
TOTAL	**15,299**	**$306,028,732.82**	**100%**

Adding a third provider will allow 99.4% of participants in this option to have 100% of their balance covered by FDIC insurance.

FDIC-Insured Savings Account Interest Rates

Each underlying provider has a different formula from which their interest rate is derived. That rate is applied to their portion of the account's deposits.

- **East West Bank:** 3-month LIBOR rate less .03% (3 basis points).
- **Bank of the West:** Average 3-month LIBOR for the 10 business days preceding the quarter plus 0.10%, with a cap to the Fed Funds Target rate, whichever is lower.

The following tables compare the blended rates for the current and proposed revised provider structures:

QTR	YEAR	EAST WEST	BANK OF THE WEST	BLENDED RATE
1Q	2015	0.24%	0.25%	0.25%
2Q	2015	0.24%	0.25%	0.25%
3Q	2015	0.25%	0.25%	0.25%
4Q	2015	0.30%	0.25%	0.28%
1Q	2016	0.58%	0.51%	**0.54%**

Union Bank is proposing a 3-month LIBOR rate less 0.10% (10 basis points). Following is the hypothetical rate if Union Bank was added:

QTR	YEAR	EAST WEST	BANK OF THE WEST	UNION BANK	BLENDED RATE
1Q	2016	0.58%	0.51%	0.51%	**0.53%**

The potential rate that would have applied in the first quarter has a difference of 0.01% if Union Bank had been added to the allocation. This is a minor reduction and, in Mercer's and staff's analysis, not significant enough to outweigh the benefits of adding a third provider.

Staff further recommends that the Board maintain the allocation of the even one-third split given that there are no significant rate differentials between the banks. Under the Investment Policy Statement, the Board has the option to allow a larger allocation to a provider that may be offering a rate that is substantially higher than the other providers (if the rate is more than 0.25%). In this instance, staff's finding is that there is no sufficient differential to justify a higher allocation to one bank.

II. UNION BANK – VIABILITY AS PROVIDER

Mercer has reviewed Union Bank's proposed services and institutional viability. Mercer indicates Union Bank is a large bank provider with strong financial health ratios. Mercer further indicates that Union Bank already provides a similar service to the California Savings Plus 401(k) and 457 Plans. Additional information related to Union Bank's organizational capabilities are included in the Mercer attachment.

Empower Retirement, the Plan's recordkeeper, has also indicated that there will be no issues operationally with integrating Union Bank as a third provider.

Should the Board approve Union Bank as the third provider, staff will continue with a contract negotiation process to ensure Union Bank is in compliance with all City contracting requirements.

III. IMPLEMENTATION PLAN

Should the Board approve these recommendations, staff will target a tentative implementation date of September 1, 2016. This will provide sufficient time to:

- Negotiate and execute a contract with Union Bank.
- Communicate the change and provide advance notice to Plan participants in the second quarter 2016 newsletter, which would mail at the end of July, and update all related Plan communication materials related to this option.
- Schedule the change in coordination with the Plan's Third-Party-Administrator (TPA) and the required transfer of assets from the two incumbent providers (each of which would need to transfer out approximately $50 million in Plan assets to the new provider).

Based on these findings, staff recommends that the Board approve the addition of a third underlying bank provider to the FDIC Insured Savings Account Option; approve the selection of Union Bank as the third provider for the FDIC Insured Savings Account Option; and instruct staff to draft a proposed contract for Union Bank and authorize the Board Chairperson to execute the contract, subject to agreement between the City and the provider as to all applicable terms and conditions.

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