BALTIMORE COUNTY PUBLIC SCHOOLS

DATE: March 26, 2002

TO: BOARD OF EDUCATION

FROM: Dr. Joe A. Hairston, Superintendent

SUBJECT: Tax Sheltered Annuity Plan – 403(b)(7)

ORIGINATOR: J. Robert Haines, Deputy Superintendent, Business Services

RESOURCE PERSON(S): Randy Grimsley, Executive Director, Human Resources
Barbara Burnopp, Executive Director, Fiscal Services
Edward Dieffenbach, Payroll Administrator
Rick Gay, Manager, Purchasing

RECOMMENDATION

That the Board of Education approve the revised list of 403b/b7 companies approved to sell annuities and/or mutual funds that will offer the best value to our employees.

* *

Summary of Recommendation:

In Fall 2001, BCPS issued a RFP for its 403b Plan. Bolton Offutt Donovan Investment Consulting Group (Consultant) evaluated all of the vendor responses to the Baltimore County Public Schools Request for Proposal (RFP) # 2-281-02. Each vendor's responses were quantitatively screened for accuracy and completeness based upon screening criteria established by the BCPS. The criteria for the evaluation included:

1. 403(b) experience
2. IRS compliance
3. credit ratings
4. investment performance
5. professional fee schedule
6. contractual provisions
7. quality of field representative
8. investment universe depth
9. investment due diligence review

In addition to reviewing each vendor's ability to conduct all necessary compliance tests, the consultant also reviewed several qualitative attributes of the RFP responses. When available, the consultant reviewed the financial condition of each vendor based upon independent credit ratings as well as investment performance. Each vendor's product features (such as fees, death benefit, declining surrender charges) were reviewed. The consultant identified each vendor's Errors & Omissions coverage and investigated each vendor's experience in the Tax Sheltered Annuity/403 (b) market but did not evaluate any vendor's training program. With exception of Ferris, Baker & Watts (Safeco), all incumbent vendors submitted a proposal. There were 8 incumbent responses and 7 non-incumbent responses. Two respondents, MONY/Edward Jones and Nationwide submitted incomplete proposals and were determined to be non-responsive.

Based on the knowledge gained from the evaluation of an independent consultant we feel it is our responsibility to recommend to the Board of Education companies that ***provide the best value to our employees***. We therefore recommend that the Board of Education approve contract modification for the 403(b)(7) companies as follows:

1. Add TIAA-CREF as an approved company;

2. Eliminate Ferris Baker Watts as an approved company for failure to respond to the RFP;

3. Retain American Century, CitiStreet, Legg Mason, T. Rowe Price, and American General Financial Group (VALIC) as approved companies; and

4. Freeze enrollment in Lincoln Financial Advisors, MetLife, Security Benefit (NEA Valuebuilder). This means that they will be allowed to continue receiving deferrals from active participants but would be prohibited from soliciting new accounts based on the following rationale:

Lincoln Financial Advisors: Lincoln's credit ratings were below average compared with the responses of other vendors. Lincoln's contractual provisions include above average contract-based surrender charges (10 years) and no real death benefit (account value less withdrawals). Furthermore, while many vendors have kept their investment universes competitive by eliminating under performing managers, Lincoln has not taken steps to remove any under performing options from their available investment universe.

While many variable annuity vendors require an annual meeting with their clients to review their objectives and review their portfolios, Lincoln has no requirement. Variable annuity products have higher internal fees to pay for higher levels of personal service. Based on the assessment from our consultant we are concerned that participants may not be receiving timely advice when compared to their peers. For example, the absence of a requirement to meet with participants may affect participants' asset allocations with Lincoln. As a result, over 50% of Lincoln's participants assets are invested in a fixed account. The consultant felt that based on their evaluation there were other products available that provided a better value to our employees.

Security Benefit (NEA ValueBuilder): Security Benefit's failure to provide net investment was a major reason for their exclusion. Despite a two-week extension and multiple attempts to follow-up, our consultant never received the requested information. Security Benefit also reported below average credit ratings and did not remove under performing investment managers from its available investment universe.

Additionally, Security Benefit's contractual provisions includes an above average deferred sales charge schedule on redemptions (nine years for each deposit into the annuity) and no real death benefit (account value less withdrawals). Based on the consultant's evaluation of NEA ValueBuilder's proposal and their lack of response to requests for information there were other products available that provided better value to our employees.

Met Life: Met Life's contractual provisions included an eight-year deposit-based deferred sales charge schedule. Additionally, investment performance for the available investment universe was below average (only four investment options were in the top half of their peer group over a three-year measurement period and only 6 were in the top-half over a five year measurement period). Despite this poor performance, Met Life reported that it did not remove any under performing investment options over the past five years. Such a move may have reduced the likelihood of its participants investing in poor performing options. After careful consideration of the evaluation criteria and Met Life's proposal the consultant felt there were other products that offered a better value to our employees.

Nature of the Issue:

Recent litigation has shown that employers may have a certain responsibility towards their employees when offering 403 (b) plans. On January 25, 2002, the College Life Insurance Company of America and other plaintiffs settled a class action suit brought by a Laredo schoolteacher. The settlement was for $10.8 million for a class of 130,000 policy holders who had been sold misleading "Tax-sheltered life" plans inside their 403 (b) plans, largely because no agency or school district did anything to protect the teachers. This suit lead the State of Texas to pass legislation creating sweeping changes in 403 (b) plans. The new Texas law increased disclosure and required contribution savings plans not to be burdened by excessive fees. Based on providing the best value to our employees, a Consultant was hired to review the proposals.

History of the Issue:

In 1997, BCPS hired Bolton Offutt Donovan Investment Consulting Group (Consultant) to review and summarize vendor responses to a "Request for Proposal (RFP) for 403b Providers" bid. Using the criteria developed by BCPS, the consultant's analysis focused upon the: overall competitiveness of the proposals, including the credentials of the vendors; pricing of the proposed products; and communication support offered. The consultant did not evaluate the investment performance or financial condition of the vendors. The consultant reviewed 15 RFPs and 9 companies were selected. The Board approved staff's recommendation that these 9 companies be approved to market annuities and mutual funds to BCPS through payroll deduction. BCPS signed 2-year contacts with each of the 9 companies in June 1998.

The contracts provided for two 1-year extensions. The current contracts expire June 30, 2002. Currently there are 6,200 accounts with an estimated value of $24 million annually.

2002 Analysis Criteria Used by the Consultant:

The consultant investigated the different compensation structures of the vendors. The goal of this analysis was to identify any programs where a representative received higher compensation for placing assets in a fixed account rather than a variable account. Most vendors pay commissions to its sales force in the initial contract year and subsequent years. All vendors have a fidelity bond to cover their clients in the case of employee theft. Most vendors are not involved in any pending lawsuits. After following up with the vendors that responded "yes" to any pending lawsuits, it appears that these lawsuits are parts of the usual course of business and would not materially affect the firm's ongoing business. The consultant investigated each vendor's professional liability insurance. In the case where a vendor would make an error in its compliance calculations, this professional liability insurance, often known as Errors and Omissions Coverage, would be the recourse used to help compensate BCPS in case of vendor error. Most vendors required its representatives to have some type of errors and omissions coverage.

Finally, the consultant asked vendors to provide a copy of their most recent SAS 70 report. The SAS 70 report is an opinion rendered by an independent auditing firm regarding the worthiness of the Policies and Procedures in place to test the effectiveness relating to its accounting services of defined contribution accounts. All firms provided the consultant with a copy of their SAS 70 opinion except Legg Mason, Horace Mann and Nationwide.

An analysis of each vendor's credit ratings was performed. The credit evaluation is important when reviewing the financial health of a vendor, as well as its ability to meet obligations to participants. In addition to credit reviews, an analysis of fixed interest crediting rates was also performed. When comparing interest rate differentials among fixed accounts, there were no significant disparities between the proposed programs. In fact, interest rates of higher-rated companies are competitive with lower-rated vendors. Since it is somewhat difficult to evaluate credit ratings, the consultant utilized an industry standard model to calculate the Average Public Rating Numeric Equivalent.

In an attempt to gauge investment performance among the different providers, the consultant implemented a scoring system to evaluate each vendor's investment universe. This system compares the vendor's investment universe to a universe of peers as defined by the Morningstar Principia database. Simply comparing the performance of the various funds to one another does not provide valuable insight since it is very difficult to understand what is going on with each fund. Therefore, a comparison of each fund to a comparable universe is used to quantify how competitive the provider's performance has been relative to the total available universe of funds over the past three and five year time periods.

In an attempt to help differentiate total fees assessed by the various vendors, the consultant reviewed the Morningstar Principia Variable Annuity database to determine the average highest and lowest variable annuity fee structure. The contractual fee in each vendor's program was also reviewed. Additional investment management fees will vary. Based on each vendor's fee structure, the consultant categorized each vendor into an average, low, or high cost program. T. Rowe Price and TIAA-CREF are the only true low cost programs. The incumbent BCPS Annuity vendors fall into the average cost category. Many vendors assess annual administrative fees. In some cases, these fees are waived if the account balance exceeds a certain threshold. The consultant listed whether the sales charges are assessed on each deposit or upon the initiation of the contract. It is important to remember that these charges apply to amounts withdrawn above the free withdrawal corridor.

The goal of this project was to identify potential areas of non-compliance as well review several qualitative aspects of these programs themselves. After a thorough review of the existing program, the consultant divided our recommendations into four categories: Add, Retain, Do Not Retain, Additional Review and Terminate. BCPS eliminated any vendor that failed to respond to the RFP, since these vendors have not received a due diligence review. Second, vendors with low participation or vendors that assess above-average fees should be evaluated further. Since BCPS has current information on all vendors, questionable vendors and products are candidates for termination. Finally, all approved vendors should offer competitive programs as well demonstrate strong credit ratings (if available).