UNIVERSITY OF CALIFORNIA, ACADEMIC SENATE

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Chair of the Assembly of the Academic Senate
Faculty Representative to the Regents
University of California
1111 Franklin Street, 12th Floor
Oakland, California 94607-5200

June 4, 2014

NATHAN BROSTROM
EXECUTIVE VICE PRESIDENT, BUSINESS OPERATIONS

Re: Recommendation to Borrow to Fund UCRP

Dear Nathan:

At its May 28 meeting, the Academic Council voted unanimously to endorse and forward to you the attached proposal and "Resolution on Borrowing to Reduce the Unfunded Liability in the University of California Retirement Plan," authored by the University Committee on Faculty Welfare (UCFW) and its Task Force on Investment and Retirement (TFIR). I am also including a separate letter from the University Committee on Planning and Budget (UCPB) supporting the proposal.

In May, Council was pleased to learn that the administration is now preparing its own UCRP borrowing plan proposal that is similar in concept to the TFIR proposal. While the administration's plan is a bit more limited in scope – it would borrow $1.3 billion over two years, meet "Modified ARC," and achieve a 95% funded ratio for UCRP by 2040 compared to TFIR's plan, which would borrow $1.7 billion, meet the full ARC, and achieve a 100% funding ratio by 2040 – we appreciate the administration's movement on this issue and support the plan presented to us. We look forward to working with you to ensure this plan for addressing UCRP's unfunded liability and the long-term health of the retirement system moves forward and is approved by the Regents.

Please do not hesitate to contact me if we can help and if you have further questions.

Sincerely,

Bill Jacob

Encl. (2)

Cc: President Napolitano
Academic Council
Executive Director Winnacker

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UNIVERSITY COMMITTEE ON FACULTY WELFARE (UCFW)
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April 24, 2014

WILLIAM JACOB, CHAIR
ACADEMIC COUNCIL

RE: UCRP Funding

Dear Bill,

The UC Systemwide Committee on Faculty Welfare (UCFW) and its Task Force on Investment and Retirement (TFIR) carefully follows the status of UC's retirement plan. The committee and task force were supportive of the decisions made by the Regents at the end of 2010 to restore the health of the plan through increased contributions by both the employer and the employee, and other changes made at that time. Separately, UCFW continues to emphasize that salary increases are needed to compensate for the resulting reduction in total remuneration due to increased employee contributions.

The Regents adopted a funding plan to gradually ramp up contributions until, in 2018, the amount contributed would cover 1) the "normal" costs of the plan, 2) the interest on the unfunded liability, and 3) a payment of principal on the liability to eliminate it in 30 years. These three components comprise the "Annual Required Contribution," or "ARC." For the last two years, however, UCFW and TFIR have become concerned that the Regents' plan may not be followed. Regental action is needed to move to higher contributions over time, and the Senate has been informed that there are no plans to increase employer contributions beyond the 14% rate to become effective July 1, 2014.

There are two sources of funds for UCRP: asset earnings and employee/employer contributions. Our main concern is that employer contributions will be held too low in the early years to reduce the unfunded liability. The result is contributions higher than necessary for decades to come. Two funding scenarios are shown in Figure 1 using data provided to UCFW and TFIR by The Segal Company, the Regents' actuary, who provide annual summaries of the status of UCRP to the Regents.

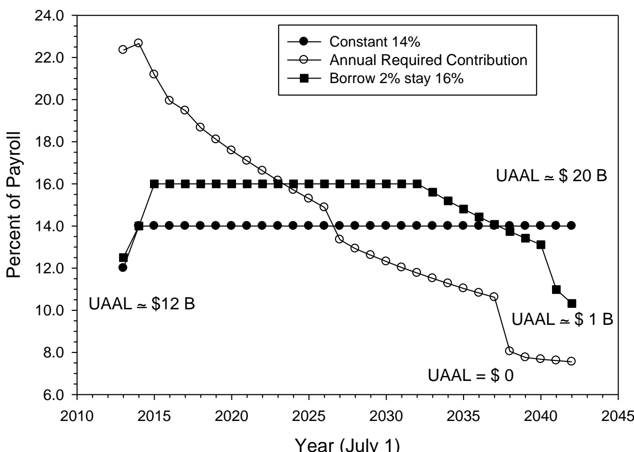

Figure 1. Annual employer contribution rate to UCRP under a constant 14% rate (filled circles) the rates needed to meet the TFIR proposal (filled squares) or a variable rate needed to meet each year's Annual Required Contribution (open circles) from July 1, 2013 through July 1, 2042. UAAL = unfunded actuarial accrued liability.

The Annual Required Contribution (ARC) defines a path for contributions that will amortize the unfunded liability and achieve 100% funding. The contributions necessary to meet ARC are extremely high in the first years. But if these are made, and the plan earns its expected rate of return of 7.5%, two good things happen. First, the unfunded liability declines, just like the principal part of a home loan. Second, UC will have stopped digging a deeper hole because we won't be foregoing the interest on the unfunded portion of the liability. The required contributions come down fairly rapidly and the unfunded liability is eliminated.

The filled circles show the employer contribution rising to 14% next July and then staying there. Even assuming that the plan still earns its expected rate of return of 7.5%, the constant 14% employer contribution doesn't pay down the liability but actually causes it to *increase* at an initial rate of about $2.5 M per day, from about $12 B reaching about $20 B by 2042.

The details of the growth of plan assets and of the unfunded liability under different scenarios are shown in Figure 2. For the constant 14% scenario, the normal cost of the plan amounts to 18% of payroll, so payroll deductions of 18% are needed just to cover the normal costs. Starting in 2014, the sum of employer and employee contributions will reach 22%, but that additional 4% of payroll is not enough to start paying down the $12 B unfunded liability. This is because UCRP is expected to achieve an annual investment return of 7.5% when it is 100% funded; the Plan isn't earning 7.5% on the 24% of current pension liabilities that are unfunded. As a result, the 4% of payroll contributed above normal cost doesn't even offset the foregone earnings of 7.5% of the $12B liability.

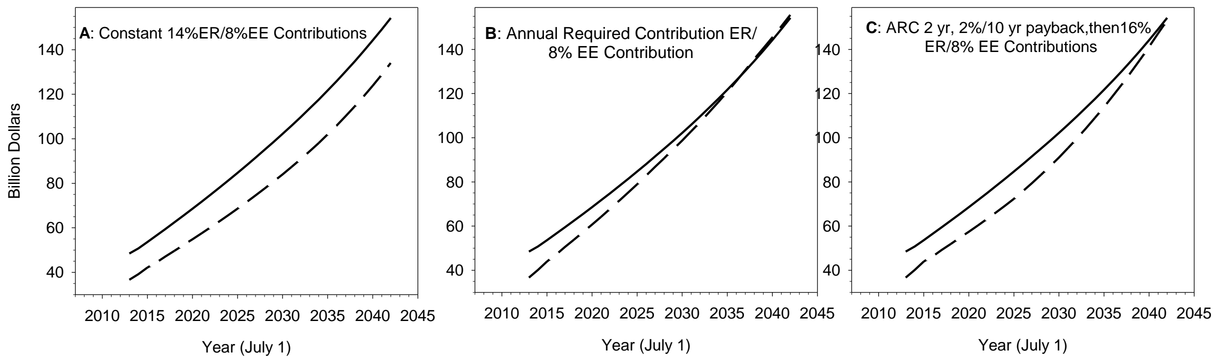

Figure 2 A - C. Growth of the Actuarial Accrued Liability (solid line)and the Actuarial Value of Assets (dashed line) from July 1, 2013 through July 1, 2042. The Actuarial Accrued Liability (AAL) is the amount of funding needed to cover the cost of meeting all future pension obligations based on past service credit and on the assumption that these assets will earn 7.5% annual returns. Equivalently, it is the present value of all future pension UC anticipates providing, based upon employees' service to date and an actuarial analysis of retirement and mortality experience of the UC population, using a 7.5% discount rate. The Actuarial Value of Assets (AVA) is the current value of assets in the plan (based on five-year smoothing of returns; this analysis could also be done with the Market Value of Assets (MVA)). The unfunded liability is calculated as AAL – AVA, and the funding ratio is calculated and expressed as a percentage as (AVA/AAL) * 100. Because Segal's projections are based on earning 7.5% each year, after a few years, there is no difference between using AVA and MVA in projections. A: The projections assume employer and employee contribution rates of 14% and 8% of payroll. B: employer contribution is adjusted to meet the Annual Required Contribution whereas the employee contribution is fixed at 8% of payroll. C: Employee contribution fixed at 8% of payroll, with the employer contribution set at 14% plus a 2% surcharge to pay off a $1.7 B loan in 10 years and set at 16% thereafter, until the plan's assets permit reductions in the employer contribution.

Figure 2A also shows why the funding ratio is not a good measure of the health of UCRP. In 2013, the Actuarial Accrued Liability (AAL) was $48.4 B, whereas the Actuarial value of Assets (AVA) was $36.7 B, leaving a $11.7 B shortfall and a funding ratio of 75.8%. In 2042, the projected AVA will be $154 B whereas the AAL is projected to be $134 B leaving a larger shortfall of $20 B but a funding ratio of 87%. Consequently, Figure 2A shows that an increasing funding ratio does not equate to a reduction in the unfunded liability. Although the funding ratio becomes more favorable, this is not because the liability is being reduced. It is only because both the numerator and the denominator of the ratio increase at different rates over time while their difference also continues to increase.

Figure 2B shows the growth of plan assets and the unfunded liability if UC were to make the Annual Required Contribution, instead of fixing the employer contribution at 14% of payroll. The unfunded liability is eliminated, and the plan is projected to generate a small surplus, which could be fixed by reducing the employer contribution in the out-years even more than shown in Figure 1.

The plan to contribute ARC each year is the least expensive way overall to eliminate the unfunded liability and remains the favored approach of UCFW and TFIR. It also is the Regents Funding Policy starting in FY 2018. The campuses have objected because of the pressure on their operating budgets. The TFIR resolution is a pragmatic compromise between the current policy of maintaining a funding policy that allows the unfunded liability to grow while being the most expensive funding plan overall, and meeting ARC. In brief, the resolution calls for internal borrowing by UC of the amounts necessary to meet ARC over the next two years and paying off that loan in ten years with a 2% surcharge on the employer contribution rate. Effectively, this

raises the employer contribution rate to 16%. After ten years we recommend that the employer contribution rate remain at 16%, although such a decision does not need to be made at this time.

The effects of the TFIR proposal on contribution rates over time and the unfunded liability are shown in Figures 1 and 2C. We are grateful to UCOP for having given the opportunity to TFIR to work with the consultants from Segal to model this proposal in detail. First, the proposal allows ARC to be met, through borrowing, for the next two years. Second, it leverages the next expected increase in the employer contribution rate to 16%, thus increasing the return on the investment of those funds at the expected 7.5% rate of growth. Third, assuming that the employer contribution rate remains at 16% after 2025, when the 10-year loan is paid off, then the required employer contribution rate is projected to drop in 2032 and the unfunded liability will be nearly paid off in 2042 (filled squares in Figure 1).

UCFW expects our administrators to say that UC "cannot afford" any higher contribution rate than 14%, or that the "opportunity costs" of adopting the TFIR proposal are too high. The concept of opportunity cost is useful before committing to a specific policy, spending plan, or in this case, a pension benefit. UC employees have already earned the pension benefits reflected in the unfunded liability; whether to pay for them is simply not a choice. As the Senate has consistently emphasized, the only option is to act responsibility to deal with it now, or pay more in the future, to provide exactly the same benefits. Taking a longer-term view, UCFW believes that UC cannot afford *not* to adopt the TFIR proposal. Figure 3 shows how much lower the total contribution percentage could be if UC substituted returns of 7.5% on the unfunded liability for the funding provided by contributions. The interest income that UC foregoes by not being fully funded represents a substantial portion of employer contributions and represents roughly a third of the University's annual state funding. Those contributions, reduced then eliminated under the TFIR proposal, could be allocated to other priorities of the University, including undergraduate education, research, scholarships and financial aid, graduate student support, competitive salaries, *etc*. Think of how much more UC could accomplish if it could shed the burden of employer contributions that must still go to UCRP as a consequence of not making modestly larger contributions now. In the opinion of UCFW, the real opportunity cost is the cost of failing to adopt the TFIR proposal now in exchange for vastly improved economic opportunities in the future.

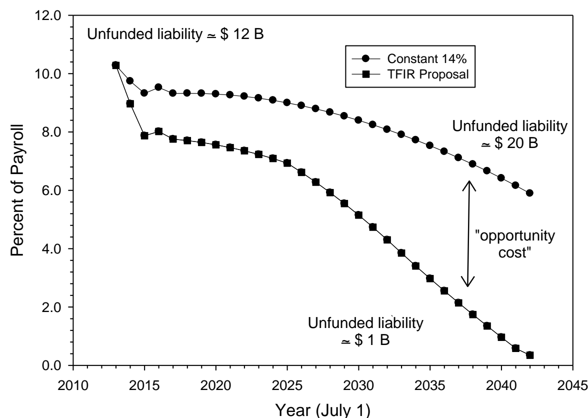

Figure 3. Foregone earnings at 7.5% as a percentage of payroll if employer contributions are frozen at 14% (filled circles) or if the TFIR proposal is followed (filled squares). The difference between the lines is the cost of not replacing employer contributions with earnings from UCRP and represents the long-term "opportunity cost" of not adopting the TFIR proposal.

UCFW and TFIR find the results of the projections to provide compelling support for the TFIR proposal for both financial and political reasons. The proposal provides a viable, long-term solution to UCRP's unfunded liability that should be noted by ratings agencies, sooner or later. Moreover, the projections also show that UC can indeed manage UCRP effectively. Finally, all of this can be accomplished with only a modest increase in employer contributions, provided the UC leadership has the fortitude and discipline to stick to the plan.

UCFW therefore endorses the resolution from TFIR and asks that it be adopted by the Academic Council as Senate Policy. We then ask that the policy statement be conveyed to the President for implementation.

Sincerely,

J. David Hare

J. Daniel Hare, UCFW Chair

Enclosure

Copy: UCFW
Mary Gilly, Vice Chair, Academic Council
Martha Winnacker, Executive Director, Academic Senate

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UNIVERSITY COMMITTEE ON FACULTY WELFARE (UCFW)
TASK FORCE ON INVESTMENT AND RETIREMENT (TFIR)
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April 22, 2014

J. DANIEL HARE, CHAIR
UNIVERSITY COMMITTEE ON FACULTY WELFARE

RE: TFIR Recommendation to Borrow to Fund UCRP

On behalf of UCFW's Task Force on Investments and Retirement (TFIR), I am pleased to submit the attached resolution for UCFW's review, with the request that the committee endorse the resolution and refer it to the Academic Council for adoption as Academic Senate policy.

Specifically, TFIR asks that UCFW and the Academic Council

(i) reiterate past support for the goal of making contributions to UCRP that are at least as large as the Annual Required Contribution (ARC);

(ii) support borrowing from STIP or other appropriate sources, to meet the level of contributions called for in following the Regents Funding Policy to contribute ARC;

(iii) support repayment of the loan from an additional employer contribution of approximately 2% (for ten years), as was done in 2009-10;

(iv) support a plan to reconsider appropriate level for the employer contribution after the loan is repaid.

The full statement follows as an attachment. Its roots will be quite familiar to UCFW and can be found in the numerous statements that the Senate has endorsed, over the last decade,[1] concerning the University of California Retirement Plan (UCRP). The Senate has consistently warned of the need to restore the Plan's funded status, specifically advocating a more aggressive "ramp-up" of contributions to restore the Plan to 100% funded status. This resolution recommends that the University use borrowing from either internal or external funds to meet its obligations to fund UCRP. The recommendation builds upon the Senate's previous support for borrowing from the Short-Term Interest Pool (STIP) to fund the Annual Required Contribution (ARC) in 2009-10, and is consistent with the funding policy adopted by The Regents in December, 2010.[2] It would permit the University to continue its "ramp-up" of contributions to levels needed to reduce the Plan's unfunded liability.

[1] http://senate.universityofcalifornia.edu/reports/.
[2] http://regents.universityofcalifornia.edu/regmeet/dec10/j1.pdf

TFIR is concerned that, while the University has made much progress toward restoring the Plan to health, there is apparently a belief that we have done enough. TFIR's analysis of projections prepared by the Segal Company, the consulting actuarial firm of The Regents, reveals that this belief is mistaken. The University is exposed to a serious fiscal risk as long as the Plan remains under-funded, as well as a political risk that the large unfunded liability will be cited in calls for reform of pension benefits. As UCFW knows, UC has already enacted a series of reforms to reduce the cost of providing pension and other post-employment benefits, but the unfunded liability represents a serious fiscal problem, first and foremost. Moreover, critics of public-sector pensions can cite figures such as the large unfunded liability as evidence that further reforms and limits are needed, which means that the University is taking on an unnecessary political risk. Limits on the benefits that UC can offer would seriously compromise our ability to recruit the best faculty and staff. *The main message of our resolution should therefore be understood to be that TFIR believes very strongly that the University can manage its pension plan without outside intervention, but it needs to take action, to demonstrate that fact.*

TFIR recognizes that the current plan to move to 14% employer contributions put significant pressure on operating budgets. TFIR's view is that increased contributions for debt service now will have a less adverse impact than permanently higher contributions later. Put simply, the more of the funds in the Plan that come from asset earnings, the less are needed from employee and employer contributions. That is why the cost of remaining below fully funded status seems so wasteful and so staggering; using the actuarial rate of return of 7.5%, the foregone annual earnings due to the unfunded liability of nearly $12B are nearly $900M in the current year alone.

The borrowing plan called for in the resolution reduces the maximum employer contributions required in the future, without any increase in employee contributions. Over the long term, this brings relief to all funding sources and frees sorely needed resources to provide funding for all aspects of the University's mission. The reductions in employer contributions over time would represent a highly visible demonstration that UC is capable of managing its benefits programs efficiently, bolstering the argument for preserving the Plan and for the full restoration of state support.

As UCFW knows, the contributions required to provide pension benefits that accrue to each year of service by employees are based on calculations that assume that the plan will be fully funded and earn an actuarial rate of return equal to 7.5%. To the extent that the Plan is underfunded, UC is foregoing earnings on the assets that should have been in the plan—using the actuarial rate of return of 7.5%, that represents foregone earnings of nearly $900M in the current year alone. Pension benefits that are not funded from earnings on assets invested in the plan must be paid for with a combination of employee and employer contributions.

The recent downgrading of UC's credit rating provides a clear demonstration of the effects of inaction, and of the need for the University to deal with the large unfunded liability in UCRP. The Senate has long been out in front on these funding issues, and this plan is more fiscally responsible than what the administration seems to be advocating. We hope that the Senate's support and encouragement toward greater fiscal responsibility would move the administration toward our position. It would certainly represent adopting a more responsible fiscal plan.

In short, TFIR acknowledges the argument that increasing contributions is painful. The ongoing accumulation of reserves by the campuses suggests that the pain would not be too great.

TFIR looks forward to providing any additional analysis or further recommendations, to support UCFW's deliberations.

Best regards,

James A. Chalfant, Chair
UCFW-TFIR

Enclosure

Copy: UCFW
UCFW-TFIR
Martha Winnacker, Executive Director, Academic Senate

Proposed Academic Senate Resolution on Borrowing to Reduce the Unfunded Liability in the University of California Retirement Plan (UCRP)

Whereas:

Retirement benefits are an important component of total remuneration for all UC employees;

Employees benefit from being able to plan on a secure, stable retirement;

The University benefits from maintaining a defined-benefit pension plan that helps recruit and retain top faculty and staff and also helps to encourage retirement at a targeted age, bringing regular renewal of the workforce;

Benefits accrued to date within UCRP cannot be reduced, and the University must therefore eliminate the unfunded liability within UCRP over time;

There are only two sources of funding for UCRP: asset earnings and employee/employer contributions in the form of assessments on covered compensation;

The June 30, 2013 report on the plan's funded status indicated an unfunded liability of $11.7 billion;

The Regents have approved a plan to increase the employee contribution to 8%, reducing employees' take-home pay and further eroding the competitiveness of UC's total remuneration;

Employer contributions of 14% and higher represent a drain on the operating budget. The result is that

- contracts and grants involve higher costs than at comparison institutions, due to the higher annual benefits costs associated with salaries paid from these funding sources;
- the clinical enterprise is less competitive due to higher benefits costs for employees whose salaries are funded from clinical revenues;
- employer contributions associated with employees whose salaries are state-funded reduce the funds available for other priorities, such as graduate-student support or reducing class sizes.

These high costs are not due to the benefits being excessively generous; instead, they are due to the inefficient funding of the benefit that relies too much on future contributions and not enough on asset earnings;

Approximately two-thirds of UC's total covered compensation is from sources other than state-funding. Increasing contributions made by all funding sources therefore leverages state funding, by requiring equivalent contribution levels for covered compensation paid

by non-state sources. Each dollar contributed using state general funds brings two dollars of funding from outside sources;

The Regents have authorized the President to use borrowing from either internal or external sources to provide funding necessary to follow the Regents Funding Policy and contribute the full Annual Required Contribution (ARC);

Projections show that a loan in the amount necessary to fund the full ARC for 2013-14 and 2014-15 could be repaid without unsustainable cost. For instance, internal or external debt payable over ten years with a 3% interest rate would require repayments equivalent to roughly 2% of covered compensation;

Be it Therefore Resolved that:

- The Academic Council reiterates its past support for the goal of making contributions to UCRP that are at least as large as the Annual Required Contribution;
- The Academic Council supports borrowing from STIP or other appropriate sources, to meet the level of contributions called for by the Regents Funding Policy to contribute ARC;
- The President should authorize borrowing from either internal or external sources to contribute ARC for 2013-14 and for 2014-15, with repayment to be funded using a payroll assessment---paid by all funding sources---equalling approximately 2% of payroll, to be added to the employer contribution percentage of 14% beginning July 1, 2014.

    a) The minimum amount of borrowing should be the amount necessary to contribute the full ARC for all state-funded covered compensation and all other covered compensation (i.e., non-state-funded covered compensation), or approximately $1.7B, based upon the most recent actuarial report to The Regents;[1]
    b) The loan should be repaid using an employer contribution, expressed as a percentage of payroll sufficient for repayment in no more than ten years, with all funding sources assessed the same percentage to fund the repayment of the initial loan;
    c) There should be a reconsideration of the appropriate level for the employer contribution after the loan is repaid.

[1] http://regents.universityofcalifornia.edu/regmeet/nov13/f10.pdf.

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UNIVERSITY COMMITTEE ON PLANNING AND BUDGET (UCPB)
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April 24, 2014

WILLIAM JACOB, CHAIR
ACADEMIC COUNCIL

Re: Investing in UCRP

Dear Bill,

One of the UC's most important assets in faculty recruitment and retention is its defined benefit pension plan, UCRP. For the past many years, during which total faculty salaries have lagged our peer institutions, the benefits offered by this plan have played a critical role in total remuneration enabling UC to maintain a world-class faculty. The defined nature of the benefits plays a major role in retention of faculty who have been at UC for 15 or 20 years and are at the peak of their productivity. At the same time, the defined benefits from UCRP also induce faculty to retire without the financial concerns of other types of retirement plans, creating openings for timely renewal of the faculty via new hires. In recognition of its critical role in supporting the world-class strength of its faculty it must be one of the university's highest priorities to maintain the health of this pension fund.

UCRP is in a precarious financial position. UCRP currently has an unfunded liability (actuarial cost of earned benefits in excess of the fund balance) of approximately $12B. This liability is a historical legacy stemming from the last several years of an 18-year contribution holiday (1992-2010) that coincided with investment losses resulting from a severe economic downturn beginning in late 2007. In response, the Regents approved a policy that requires full funding of new obligations (referred to as the Normal Cost) and amortization of the unfunded liability over a 30 year period (the total is referred to as the Annual Required Contribution or ARC), but offering some leeway in how to achieve this in the early years. Though several years behind target already, UC has ramped up both employee and employer contributions, with the latter planned to increase by 2% annual increments until it reaches a maximum of 18%. This rate would be required until approximately 2030 according to projections by the UC's pension consultant, Segal & Associates, before it would begin to decrease towards the rate necessary to fund new obligations alone.

Many University officials have raised significant objections to following the modified funding policy up to an employer contribution of 18% due to concerns about the effect on the UC operating budget. However, if the UC were to cap its employer contribution rate at 14% (the July 1, 2014 rate) as has been suggested, the unfunded liability would continue to grow to approximately $20b

by 2042 while the funded ratio for UCRP would level off in the 80-85% range. Some university officials, both at OP and on campuses, have suggested that such a low funding ratio is acceptable, or even that full funding is irresponsible.

The University Committee on Planning & Budget (UCPB) disagrees with this view and considers a goal of less than full funding to be imprudent. First, such a scenario will require a continuation of high contribution rates for many decades in order to make up with contributions (that come from operating funds) for investment returns that are not earned on the unfunded liability. Second, this would expose the future operations of the university to substantial unjustified risk in the (almost inevitable) event of another major economic down-turn sometime during the next several decades. In responding to a question from Regent Makarechian at the April Regents meeting CFO Peter Taylor characterized this as the greatest risk to the long term financial stability of the university.

UCPB supports the proposal, coming from the University Committee on Faculty Welfare (UCFW) and its Task Force on Investment & Retirement (TFIR) to increment the employer contribution by an additional 2% in 2015 with this additional contribution used to fund the debt service on a loan of approximately $1.8b to UCRP to immediately lower the unfunded liability to approximately $10b.

UCPB has analyzed projections from Segal & Associates that were generated in response to a request from the UCFW according to specifications outlined by TFIR. These model the effect of borrowing funds in the next two years to make up the difference between the current contribution rate and the rate that would be necessary according to ARC, thereby reducing the unfunded liability through one-time infusions of cash. It is clear from the Segal analysis that there is tremendous leverage and a major advantage to the UCFW borrowing plan. Borrowed funds could come from internal or external sources, such as bond sales, state general fund infusions, or internal borrowing from capital reserves. The University conducted such transactions in 2011 and 2012, each time adding $1B to the UCRP trust to lower the unfunded liability.

Today, the case for borrowing remains compelling:

<u>Regardless of the source of the funds, the case for borrowing to address the unfunded liability is very strong.</u> Borrowing to fund UCRP is actually beneficial, independent of the amount borrowed and independent of the source, as long as there is a significant difference between the cost of borrowed funds and a conservative assumption of long-term yield for the UCRP trust fund (the actuarial projections assume a 7.5% yield). The modeling from Segal makes it clear that in the current climate, using the next 2% contribution increment to pay debt service for $1.8b in borrowed funds would have a much greater impact on both the reduction of the unfunded liability, and on the time before future contributions can be decreased towards the normal cost of benefits, than if that same 2% increment was used as an additional regular contribution. While borrowing from STIP/TRIP is an attractive source of funds, the conclusion that borrowing is attractive does not rely on this as the funding source.

<u>UC has capital on hand that can be used for this purpose.</u> The current amount of working capital (reserves) on hand and their near doubling over past five years - from $7.3b on Jun 30, 2008 to $13.8b on Jun 30, 2013, reflecting an average annual growth of $1.3b - lead to several conclusions. First, these funds are not currently being employed in an optimal manner to address the missions of the university. Second, the rapid increase in these fund balances, especially during a period when state funding allocations have decreased represents a serious political liability. Third, these funds

can provide substantial working capital (at least $2b according to the most recent analysis of the CFO, dated Mar 2014) that could be invested in UCRP with no disruption to the operation of STIP/TRIP and no impact on the availability of funds compared to current investment strategies for these funds.

Investing in UCRP does not represent a shift in investment allocation practices, available capital, or decision-making processes. The decision to invest in UCRP could helpfully be framed as a decision to include an intermediate-term UCOP "bond" in TRIP as a component of its fixed income investment portfolio. Opposition to this approach has apparently been raised by the ten campus chancellors. UCPB understands the chancellors' interest in the management of these funds. However, it is UCPB's view that the decision to loan these funds is fundamentally an investment decision that should be made on a systemwide basis by the CIO, just as all other investment decisions for TRIP are made by the CIO. The obligation to the chancellors is that STIP and TRIP meet their investment objectives, e.g., target returns for both, immediate demand of depositor funds from STIP, and operate within the constraints of design asset allocation and risk exposure for TRIP. The requirement for liquidity of working capital is in the purview of the CFO. UCOP needs to take a stronger hand both in the investment decision and in insisting that available working capital be deployed to address fundamental institutional goals. This is important not only in the present context, but is also a more general concern, due to the potential political liability, of having a very large depository of "unused" rainy day funds in STIP/TRIP.

Borrowing now protects the future operating budget of the University. In the short to intermediate term, borrowing decreases the employer contribution necessary to comply with the Regents policy, e.g., to meet ARC by 2018. Over the longer run, borrowing leads to a significant decrease in the time period before contributions can be returned to the Normal Cost level needed for new obligations, thus benefiting the university's operational budget, while simultaneously decreasing the exposure of this budget to future market volatility. Given a substantial unfunded liability and a funded ratio that would remain well below 100% for the next several decades, the almost inevitable market downturn has the potential to cripple UC's financial health, as acknowledged by CFO Taylor's expressed concerns. Such a scenario has the potential to greatly reduce the university's operations, or to force a reduction in post employment benefits and with it the competitive position of the university for faculty, or both. Either has the potential to result in dramatic and long-term damage to the quality of the UC.

UCPB is also mindful of additional external considerations. UCPB certainly agrees with the UC's position that funding UCRP is a state obligation, consistent with all other state pension funds. However, while there has been progress in convincing the state to accept responsibility for Normal Cost, this is not a likely or timely source to address the current unfunded liability. UCPB has discussed with the office of the CFO the potential impacts of borrowing to fund UCRP on debt capacity, bond ratings and the cost of borrowed capital. While the effects are a bit difficult to predict, since both additional debt and the unfunded liability show up as liabilities on UC's balance sheet, it is possible that additional borrowing for UCRP would force some reprioritizing of other UC capital needs. The importance of a well-funded plan to the UC and the risk the unfunded liability poses to the long-term financial stability of the institution, justify such reprioritizing.

In conclusion, UCPB recommends strongly that the Regents policy for funding UCRP be followed and that the next incremental increase in employer contributions be used to service the debt on a loan.

Sincerely,

Donald Felt Senear

Donald Senear
UCPB Chair

cc: UCPB
Martha Winnacker, Senate Executive Director