Market Turmoil and the UCRP Lump Sum Cashout

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There has been considerable concern among UC employees and retirees about the effect of the current turmoil in financial markets on UCRP pension benefits and the restart of employee contributions. Some have suggested that people should choose the lump sum cashout option at retirement, instead of lifetime monthly benefits. Some have even suggested that active employees nearing retirement should retire immediately and elect the lump sum cashout. Neither of these suggestions is appropriate as a response to market turmoil. While the Academic Senate cannot provide legal or investment advice, employees who are covered by UCRP should be aware of the following factors if they consider taking a lump sum cashout, and should obtain legal and investment advice as appropriate.

1. *UC has a legal obligation to provide funding for UCRP*. The terms of UCRP define the retirement benefit promised to eligible employees. The funding provisions require UC to make contributions in an amount sufficient to maintain the plan at an actuarially sound level, taking into account contributions from the active members. Courts have consistently found that, under the US and California constitutions, public entities like UC cannot renege on those promises. Thus, UC employees and retirees have much more security than participants in private-sector pension plans, whose accrued benefits can be reduced in the event the employer goes bankrupt.
    a. *Employer contributions are needed to restore UCRP's funding status*. As of June 30, 2008, UCRP was approximately 100% funded, based both on Market Value of Assets (MVA) and smoothed Actuarial Value of Assets (AVA). This means that UCRP had enough money to fund the cost of accrued service as of June 30, 2008, assuming that the actuarial assumptions on employee longevity, salary growth, investment returns and other factors proved correct. However, each year, employees accrue additional benefits due to their additional year of service, and it has been clear for several years now that contributions would need to be restarted in order to cover "normal cost," the cost of this additional accrued service; see the Academic Senate's 2007 statement: http://www.universityofcalifornia.edu/senate/committees/council/ac.ucrp.0707.pdf.
    b. *The market turmoil has made the need for employer contributions more urgent*. As a result of the market turmoil, UCRP is currently significantly less than 100% funded by MVA. Barring a dramatic increase in securities prices between now and June 30, 2009, UCRP will be less than 100% funded by the smoothed AVA on that date. However, UCRP remains significantly better funded than most public pension plans, including CalPERS. Contributions will be needed to begin amortizing the shortfall in UCRP funding, in addition to covering normal cost.
    c. *UC's obligation to UCRP is not affected by market turmoil.* The employer contributions that will be required pose a major challenge to UC's budget, but the funding shortfall does not affect UC's obligation to ensure that UCRP remains adequately funded to provide the promised benefits.

2. *While the lump sum cashout may be appropriate for some retirees, it is a bad choice for most retirees*.
    a. If a retiree takes the lump sum cashout, s/he forfeits retiree health benefits. The value of retiree health benefits to the employee is large, but neither this value nor UC's cost to provide retiree health coverage is factored into the calculation of the amount of the lump sum cashout.
    b. If a retiree who has a qualifying spouse or domestic partner at the time of retirement chooses monthly retirement income, and the retiree dies before the spouse or domestic partner, the spouse or domestic partner automatically receives a partial survivor benefit. This survivor benefit is not taken into account in computing the amount of the lump sum cashout.
    c. Staff employees with accrued sick leave can convert the sick leave to service credit if they elect monthly benefits, but not if they elect a lump sum cashout.
    d. Retirees electing monthly benefits receive cost-of-living adjustments (COLAs). These COLAs are only partially taken into account in computing the amount of the lump sum cashout.
    e. UCRP monthly benefits are paid for the lifetime of the retiree, and can continue also for the lifetime of a contingent annuitant, such as a spouse or domestic partner. One of the biggest risks facing retirees is the risk of outliving their retirement assets. The lump sum cashout is a fixed sum of money, and retirees could exhaust it while still alive, resulting in a dramatic reduction in retirement income. A retiree could instead use the lump sum cashout to purchase a commercial annuity which would provide lifetime benefits; however, because the interest rate on commercial annuities is well below the 7.5% actuarial rate of return assumed in computing the lump sum cashout for UCRP, the commercial annuity would yield a much smaller monthly benefit than the employee would receive by electing monthly retirement income from UCRP.
    f. If a retiree elects a lump sum cashout, s/he assumes the responsibility for investing the proceeds and the risk that the investments will decline in value. S/he could choose assets with little volatility, but then would have to accept a low rate of return. Alternatively, s/he could choose assets with higher volatility, in the hope of achieving a higher rate of return, but at the risk that the assets will significantly decline in value. In short, an employee who elects the lump sum cashout assumes substantial investment risk.
3. *Retiring earlier than age 60 significantly reduces pension benefits.* The monthly retirement benefits, as well as the amount of the lump sum cashout, increase between ages 50 and 60 for non-safety members, and it is generally financially attractive to wait to age 60 before retiring.
4. *If other employees elect the lump sum cashout, it will not mean there is less left for you when you retire.* When a retiree takes a lump sum cashout, UCRP assets decrease, but UCRP's liabilities decrease by a slightly larger amount. There is no adverse effect on the

UCRP surplus or deficit.[1] It is true that some private-sector pension plans have experienced "bank runs." These have occurred in cases in which the plan was underfunded and, in addition, the employer was financially distressed. In bankruptcy, financially distressed private-sector employers can shed their pension obligations; under these circumstances, a "bank run" on the pension plan can be damaging to the other plan participants. Consistent court decisions have held that, under the US and California constitutions, a public entity like UC cannot renege on its accrued pension obligations.

[1] Because of several features of the lump sum cashout calculation (no survivor income provisions, only partial COLAs, different liability measures), a lump sum cashout decreases UCRP's funding liabilities slightly more than it decreases the assets, so it slightly reduces any UCRP funding deficit (and would slightly increases a UCRP funding surplus). In addition, payments for retiree health benefits (which do not come out of UCRP funds) are reduced when an employee elects a lump sum cashout. Thus, lump sum cashouts provide a slight benefit to UCRP funding and a larger benefit to UC's operating budget, by reducing the retiree health payments.