

AN EXPLANATORY GLOSSARY OF POST EMPLOYMENT BENEFITS  
AND DESIGN OPTIONS  
FOR DISCUSSION WITHIN THE ACADEMIC SENATE

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April 16, 2010

This paper, in the form of an explanatory glossary, attempts to address a number of terms used in considering the nature of post-employment benefits in the University of California. The President's Task Force on Post-Employment benefits is considering recommendations to the President regarding changes in retirement and health benefits. The charge to the task force included directives to make recommendations to the President that will allow the Regents to meet their fiduciary obligations in the management of UCRP and their educational responsibilities. The task force is directed to analyze market competitiveness, work force behavior, employee and labor relations, legal implications and risks, current and long-term PEB funding options, and the impact of UCRP on UC's financial integrity. Along the way, a primary effort of the task force has become the reduction in the cost of post-employment benefits. Agencies of the Academic Senate are beginning a review of options before the task force. To date, no recommendations have been made. Options for re-designing post employment benefits are evolving as the task force workgroups continue to meet.

As a preface to understanding benefits, it is useful to separate total remuneration to UC employees into three broad components—cash compensation, current health and welfare benefits (such as health plans or dental/vision care), and retirement benefits (including retiree health coverage and pensions). The recent total remuneration study describes the methodology that has been used to model UC's competitiveness in total remuneration, and includes dollar values of benefits. Three broad conclusions from this study confirm expectations with respect to faculty that: (1) UC's cash compensation lags that of competitors; (2) benefits make up a significant portion of the gap, but even considering benefits UC's total remuneration is below that of the competition;<sup>1</sup> (3) UC's benefits represent a substantial share of total remuneration. Hence, any changes in retirement benefits have important implications not only for current retirees, but for the welfare and behavior of the current workforce. It is important, therefore, that there be comprehensive, easily understood information available to Academic Senate faculty engaged in evaluating and advising on alternative options.

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\* Vice-Chair of the University of California Academic Senate. Many of the financial descriptions in this paper are from the Senate Task Force on Investment and Retirement (TFIR) Recommendations to Assure Adequate Funding for UCRP, updated to 1/20/10, from which this paper lifts large sections of material. An earlier version of the TFIR paper is available on the Academic Senate website at <http://www.universityofcalifornia.edu/senate/reports/mctoyudof.ucrpfunding.june09.pdf>. Thus, much of the content of this paper is deeply indebted to the work of Professor Robert Anderson, the chair of TFIR, along with the members of TFIR. **Any positions reflected in this paper are solely the views of its author and do not represent any positions endorsed by the UC Academic Senate or any of its agencies, nor do they represent the views of the University of California.**

<sup>1</sup> With respect to some employee groups, particularly represented staff, UC benefits exceed comparison groups.

## RETIREMENT INCOME BENEFITS

**Defined Contribution Plan.** In a defined contribution plan, employer and employee contributions are set aside in a separate account for each employee. The account grows with both future contributions and investment income. In a defined contribution plan, the amount of money available for retirement income is subject to market fluctuations. The benefit of gain and the risk of loss falls on the employee. In addition, defined contribution plans are portable, in the sense that the employee does not lose the value of the account by changing employment.

The Deferred Contribution Plan (DCP) into which UC employees have been contributing approximately two percent of covered compensation<sup>2</sup> (until April 15, 2010) is a defined contribution plan. Although many DC plans feature contributions by the employer, sometimes on a matching basis, only employee contributions go into the University DCP. Employees may elect to make voluntary contributions above the current mandatory contribution. Starting April 15, the mandatory employee contributions will be redirected into UCRP, rather than into the DCP.<sup>3</sup> The two other voluntary plans that are available to UC employees, the § 403(b) and § 457 plans (which are similar to a § 401(k) plan), also are defined contribution plans funded by employee contributions.

Defined contributions plans offer the ability to save for retirement by investing pre-tax income and employer contributions without paying income taxes on the contributions. Amounts withdrawn from a retirement account are included in income subject to tax upon withdrawal, but not sooner. Thus, employees can accrue gain on the full amount in the fund and defer tax on contributions and investment gain, representing a significant advantage over investments of after-tax dollars.

**Defined Benefit Plan.** In a defined benefit plan, benefits are established by formula, usually based on a combination of age, years of service, and pre-retirement compensation. The employer invests employer and employee contributions in a trust and bears the investment risk. Unlike a defined contribution plan, the amount payable to an employee on retirement is defined under the plan and does not vary as a result of market fluctuations. Stated differently, the benefit of market gain and the risk of market loss falls on the employer as it affects the amount required to be contributed in order to maintain promised benefits. The employer may, however, require a higher level of employee contributions to maintain an underfunded plan, or reduce contributions in the event of overfunding.<sup>4</sup> In addition, once vested, *accrued* benefits promised under a defined benefit plan become a contractual property right of the employee and cannot be reduced.<sup>5</sup>

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<sup>22</sup> The employee contribution is 2% of each employee's UCRP covered compensation, up to the Social Security wage base (\$106,800 in 2010) and 4% above the Social Security wage base, less \$19 per month.

<sup>3</sup> The redirection of the DCP employee contribution is subject to collective bargaining. Most, but not all unions that represent UC employees have agreed to the redirection as of now, so some exclusively represented employees will continue to make their contributions into their individual DCP accounts.

<sup>4</sup> This is what happened in the case of UCRP in the early 1990's. The funding level of UCRS was such that contributions were halted.

<sup>5</sup> See the entry for "vesting" below.

Retirement income under a defined benefit plan increases as an employee accumulates years of service with an employer. Most defined benefits plans are structured so that benefits increase as the employee approaches a specified retirement age. Benefits are dramatically less if an employee retires before reaching a targeted age. For example, under the current UCRP (UC's primary defined benefit plan), for employees retiring at age 50 the monthly pension benefit is approximately an age factor of 1.1 percent times highest average monthly compensation times years of service. The percentage age factor increases each year until, at age 60, the benefit increases to 2.5 percent of highest average compensation (times years of service). After age 60, employees continue to accrue service credit, but the age factor remains at 2.5 percent. Unlike a defined contribution plan, benefits of a defined benefit plan are not portable.<sup>6</sup> Defined benefit plans reward long-term service with the employer. Each year an employee remains with the University, up to age 60 the age factor increases, and even after age 60 the employee earns additional service credit increasing the employee's future pension benefit. Each year the employee's annual economic benefit from employment increases by an economic benefit that is not reflected in current compensation, and the value of this benefit increases each year as retirement age approaches. Due to the fact that the pension benefit increases dramatically with service years between ages 50 and 60, it becomes economically more difficult for employees to leave the University in mid-career, roughly age 45-60. In addition, and one of the principal reasons that the University adopted a defined benefit plan in 1962, the defined benefit plan permits employees with long service to the University to retire with a relatively secure income level when the time is right. The retirement of senior faculty provides for renewal of the University faculty when young faculty members are hired to replace retired faculty.

**Retirement Age Factor.** The "age factor" is the percentage figure referenced in the previous paragraph. The age factor is multiplied by years of service to determine the percentage of monthly income that is available as a retirement payment. The age factor increases from the date of eligibility for retirement. The age factor begins at 0.0111 at age 50 and increases by approximately 0.0001 for each month retirement is delayed, topping out at age 60 as follows:

<u>Age</u>	<u>Factor</u>
50	0.0110
51	0.0124
52	0.0138
53	0.0152
54	0.0166
55	0.0180
56	0.0194
57	0.0208
58	0.0222
59	0.0236
60+	0.0250

**Years of Service.** The retirement age factor is applied for each year of service credit, which is a measure of time that a member has received covered compensation from the plan. A year of

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<sup>6</sup> If a vested employee leaves UC prior to retirement, he or she becomes a vested terminated member, and is eligible to receive a pension benefit.

service credit is earned for a year of full-time work. Faculty on nine-month appointments earn one year of service credit for each full-time academic year appointment; faculty do not earn service credit for summer research or teaching appointments.

At or after age 60, with an age factor of 0.025, it takes 40 years of service credits to achieve a retirement income of 100 percent of highest average plan compensation, 32 years to achieve a retirement income of 80 percent, and 30 years to achieve retirement income of 75 percent. If the age factor were 0.018, it would take 44.4 years to achieve a retirement benefit of 80 percent.

**Highest Average Plan Compensation (HAPC).** HAPC is the highest average monthly compensation earned over the 36 highest continuous months preceding retirement. Retirement benefits are a function of this compensation base.<sup>7</sup>

**Basic Retirement Benefits** for employees coordinated with Social Security are calculated as:  
$$\text{HAPC less } \$133 \text{ per month} \times \text{Service Credit} \times \text{Age Factor},$$

For employees coordinated with Social Security, the plan also provides a benefit of 25 percent of the retirement benefit to a surviving spouse or domestic partner. Higher levels of this continuation benefit can be provided to a survivor under options that require a reduction the principal employee benefit.

**Lump Sum Cashout.** In lieu of a monthly benefit for life (an annuity), a retiring employee can elect to receive the present value of the annuity as a lump sum. The lump-sum value of the annuity is calculated using a 7.5 percent discount rate.<sup>8</sup> Electing a lump-sum payout means that the retiree is not eligible for retiree health care.<sup>9</sup>

**Vesting.** An employee's rights to the benefits provided in the plan vest and become nonforfeitable after five years of service credit. An employee who leaves the University prior to vesting will receive a distribution of accumulations of employee contributions plus some interest, but nothing from the employer's contributions. Accrued benefits for past service are vested and cannot be changed. The plan language contains a provision in which the Regents assert the right to change benefits associated with the future service of current employees. Whether the Regents can actually revise benefits allocable to future service of current employees raises legal questions that have not been tested and about which knowledgeable people have different views. There is also strong opposition within the Senate to any change to retirement benefits of current employees.

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<sup>7</sup> For employees integrated with social security HAPC is reduced by \$133 per month.

<sup>8</sup> The discount rate is the interest rate that is used to determine the present value of the annuity paid to a retiree over the annuitant's life expectancy. The present value of the future benefits represents the amount that would have to be set aside on a particular date, earning 7.5% return annually, to provide for monthly payments over the annuitant's expected lifetime. The 7.5% discount rate is the rate at which the future payments are "discounted" to present value.

<sup>9</sup> For a discussion of the lump sum cash out see the UCFW paper, *Market Turmoil and the UCRP Lump Sum Cashout* (1/20/09) on the Academic Senate website at <http://www.universityofcalifornia.edu/senate/reports/Lump%20Sum%20Cashouts%2022JAN09%20Final.pdf>.

**Cost of Living Adjustment (COLA).** COLAs are meant to adjust dollar values for inflation. The purchasing power of a pension erodes over time, with inflation, and COLAs are used to increase the pension to restore purchasing power. UCRP provides a COLA that is 100 percent of the first 2 percent of inflation, zero on the next 2 percent of inflation, then 75 percent of inflation amounts over 4 percent of inflation. The maximum COLA is 6 percent per year (which would correspond to a rate of inflation of just over 9%). In addition, the Regents have periodically provided an ad hoc COLA, in order to maintain a retiree's purchasing power at 75 percent of purchasing power on the date of retirement.

**Inactive COLA.** The HAPC of a person who has left UC employment is adjusted for inflation from the date of separation until benefits are paid at retirement. The inactive COLA is the annual adjustment to HAPC of such "inactive members of UCRP", calculated every July 1. The inactive COLA is capped at 2 percent per year.

**Normal Cost.** Normal cost represents the present value (cost) of future benefits that accrue to plan members each year, expressed as a percentage of covered compensation. Thus, normal cost is the percentage of covered compensation that must be invested each year (i.e., contributed to the plan) to fund the benefits that accrue to active employees for that year's service. Normal cost is a function of assumptions about retirement age, years of service, compensation levels and the rate of return on plan assets. It also varies with the mortality experience of the population of plan members. The Regents employ an actuarial consulting firm to update these assumptions as needed. In different terms, normal cost is the annual increase in the portion of the liabilities of UCRS to fund the retirement benefits generated by that year's service. Normal cost of the current benefit structure is 17.5 percent of covered compensation.

**Assumed Rate of Return on Plan Assets.** Based on its current asset allocation (the percentage of the assets invested in each of the different asset classes) and the historic rate of return of each asset class over a period of decades, the Regents assume that UCRP assets will earn on average 7.5 percent per year, but with substantial variations in return from year to year. The amount of the future liability, and thus the amount of required contributions each year, is determined based on this rate of return. Assuming a lower rate of return would require a larger annual contribution to fund the required amount, i.e. a lower rate of return increases the present cost of future UCRP benefits.

Note also that in any year that the full amount of the annual required contribution is not made into the fund, not only does the fund lose the required contribution, the fund also loses the assumed rate of return on that contribution. For example, if the University and employees contributed only 7.5 percent of covered compensation, on an annualized basis the shortfall is not only 10 percent of the required annual contribution of normal cost, the fund loses an additional 0.75 percent representing 7.5% of the 10 percent shortfall. In different terms, if the contributions are only 7.5 percent of covered compensation, the fund's unfunded liability grows by 10.75 percent, not just the 10 percent that was not contributed.<sup>10</sup>

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<sup>10</sup> Actually, since the contributions are made on a twelve month basis, the annual shortfall is less.

**Unfunded Actuarial Accrued Liability (UAAL).** UCRP's Actuarial Accrued Liability (AAL) is the present discounted value of all of the accrued benefits due to employees on retirement. The amount of this liability is based on assumptions adopted by the Regents on the advice of the Regents' actuarial consultants about retirement age, growth in compensation, the assumed rate of return, and the actual accumulated years of service to date. In other words, the present value of the accumulated liability is a function of the sum of the present value of benefits earned by all employees who are members of the plan. The plan is underfunded to the extent that AAL exceeds the value of plan assets.

**Value of Assets.** The value of assets in the plan is measured in two different ways: by Market Value of Assets (MVA) and Actuarial Value of Assets (AVA). MVA is the amount of money that could be realized by selling all the assets in the market on a given day. AVA is a smoothed version of MVA, in which investment gains and losses are incorporated over a period of time, five years in the case of UCRP. Thus, the calculation of AVA of UCRP as of 6/30/09 takes into account only one-fifth of the investment loss incurred during the market turmoil of 2008-09. As of 6/30/09, MVA was approximately 71 percent of the actuarial accrued liability and AVA was approximately 95 percent of actuarial accrued liability; by both measures, the plan had an unfunded liability.

**Amortization.** Amortization refers to spreading an amount over a set period of time. In the context of UCRP's unfunded liability, the question is how to amortize contributions to the fund over a period such as 15 or 30 years, in order to reach an appropriate funding level. There are several issues here; what is the appropriate funding ratio, over how many years should the unfunded liability be restored, and how much can the University afford to contribute to UCRP to meet the unfunded liability. The current Regents' policy provides for 15 year amortization of any actuarial deficit, and 30 year amortization of any actuarial surplus. Recognize again that to the extent UCRP is not fully funded, the unfunded liability grows by 7.5 percent of the unfunded amount due to the loss of return on assets that are not present in the fund.

**Annual Required Contribution (ARC).** The Annual Required Contribution is the annual amount required each year to fund normal cost plus amortization of unfunded liability, less amortization of any overfunding. For each year of service, each employee earns the right to future benefits based on years of service, age at retirement, and HAPC. Each year the fund thereby incurs a liability for the future benefit (normal cost). On average, under current assumptions adopted by the Regents with respect to the plan, the normal cost (present value of the additional future benefits earned during the year) of the future benefit is 17.5 percent of covered compensation. This means that to fund the trust, the University is required to set aside an amount equivalent to 17.5 percent of all compensation paid to employees that is eligible to be taken into account in calculating future benefits. In addition, full funding of the trust requires a contribution to amortize any unfunded liability. Regents' policy is to amortize unfunded actuarial liability over fifteen years.

**Funding Ratio.** The ratio of the current value of assets in the trust to the accumulated liability is the plan's funding ratio. There are two funding ratios, determined by market value of assets (MVA) and actuarial value of assets (AVA); the first is the ratio of MVA over actuarial accrued liability (AAL), and the second is the ratio of AVA over AAL. Under Regents' policy, the

impact of market gains and losses is spread into the value of the fund's assets with a five year smoothing convention. Under this methodology, the market losses of 2008-2009 (19% plus failure to earn a positive 7.5%) will be reflected in the actuarial valuation of the fund over a five year period. With this smoothing taken into account, as of June 30, 2009, UCRP was 95 percent funded. Taking the actual fair market value of assets on that date into account, UCRP was 71 percent funded.

The unfunded liability has two significant impacts on the trust. First, the assets in the trust currently are not sufficient to meet all of its liabilities. All benefits that are currently due are being paid because the fund has sufficient assets to meet its current liability for payment to retired annuitants. However, over time, if the underfunding persists, the fund could conceivably run out of assets, in which case the Regents are liable for payments of accrued benefits to retired employees from other sources. Second, and more significant, to the extent that UCRP is underfunded, it loses the return on its assets in the amount of 7.5 percent of the underfunding. This in turn increases the amount of the unfunded liability. The unfunded liability thereby grows each year by an amount that is the sum of any shortfall in the required annual contribution (17.5 percent of covered compensation plus amortization of UAAL) plus 7.5 percent of the amount of the unfunded liability.

**Funding Policy.** Post employment benefits are funded by a combination of employer and employee contributions. For twenty years, there have been no employer<sup>11</sup> and no employee contributions to UCRP. AAL grew each year, but the assets in the plan as of 1990, and the subsequent earnings, were sufficient to keep UCRP more than 100 percent funded by both MVA and AVA. In September 2008 the Regents adopted a funding policy that called for contributions to UCRP that would consist of the annual required contribution (ARC; normal cost plus an amortization charge for any unfunded actuarial accrued liability (UAAL) less an amortization charged based on any funding surplus). Based on the amortization policy with respect to unfunded liabilities and the then existing surplus,<sup>12</sup> UCRP's actuary (the Segal Company) recommended a total contribution beginning July 1, 2009, of 11.5 percent of covered compensation, with an expectation that the University would contribute 9.5 percent of salary and the employees would contribute 2 percent of salary up to the Social Security wage base and 4 percent above the Social Security wage base.<sup>13</sup> The Academic Senate recommended support of this funding policy. In November 2008, the Regents adopted a reduced University contribution level of 4 percent of covered compensation plus employee contributions of 2 percent of salary up to the Social Security wage base and 4 percent above the Social Security wage base. This contribution level was premised on a \$20 million State augmentation, which was ultimately not

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<sup>11</sup> The Department of Energy has been making contributions to UCRP to amortize the unfunded liability with respect to retirees from Los Alamos National Laboratory (LANL) and Lawrence Livermore National Laboratory (LLNL). There are no active UCRP members remaining at LANL and LLNL.

<sup>12</sup> The surplus as of the effective date of the policy was to be amortized over a period of three to five years.

<sup>13</sup> The employee contribution shifts required employee contributions to a defined contribution plan (DCP) in the same amount to UCRP. While an individual employee's take-home pay will not be reduced by this change, there is a reduction in the employee's total compensation as the contribution is shifted from an account that grows for the employee to benefits that are already guaranteed.

included in the budget.<sup>14</sup> As a consequence, the Regents deferred employer and employee contributions to April 15, 2010, which remains the scheduled start date for contributions.<sup>15</sup>

The proposed budget for 2010-2011, adopted by the Regents in November 2009, includes \$108.9 million to continue a 4 percent employer contribution to UCRP. The Governor's January 2010 budget proposal does not contain state funds for this purpose. Thus, UC's contribution will have to be made from UC general funds.

**Slow Ramp Up.** One plan, not adopted by the Regents, envisions increasing employee contributions by 1 percent per year until they reach 5 percent of covered compensation; and increasing employer contributions by 2 percent per year beginning in July 1, 2011, until the combined employer and employee contributions reach the ARC. In a paper endorsed by the UC Academic Senate's University Committee on Faculty Welfare and the Academic Council, and transmitted to President Yudof on June 3, 2009, (hereinafter referred to as the TFIR paper) the Senate Task Force on Investment and Retirement (TFIR) asserted that the slow ramp up inherent in this policy is inadequate to meet the needs of UCRP, and indeed, will lead to unmanageable shortfalls in funding the plan.<sup>16</sup>

The Regents' September 2008 Funding plan would require contributions sufficient to meet UCRP's 17.5 percent normal cost plus amortization of the unfunded liability generated by the failure to initiate contributions several years ago, plus the 2008-09 market decline in UCRP assets. For 2010-2011, the Regents' funding policy requires contributions of 20.4 percent of covered compensation.<sup>17</sup> The actuarial consultant estimated that annual required contributions will rise to approximately 37 percent of covered compensation by July 1, 2014, then slowly decline provided that the full amount of the ARC is contributed each year. Over time, any deferral of the required annual contributions exacerbates the amount of required future contributions, in part because of the loss of investment earnings on required contributions. Thus, the UCRP actuary estimates that, if employer contributions increase only by the 2 percent per year ramp-up, the required funding contributions will exceed 50 percent of covered compensation by 2022, while the proposed slow ramp up would only provide for contributions of 35 percent of covered compensation (30% employer, 5% employee).

The shortfall in UCRP funding, plus accrued liability for retiree health care is shown in the following table:

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<sup>14</sup> The legislature inserted language into the Education Code indicating an intent not to provide incremental funding to UC to support UCRP contributions.

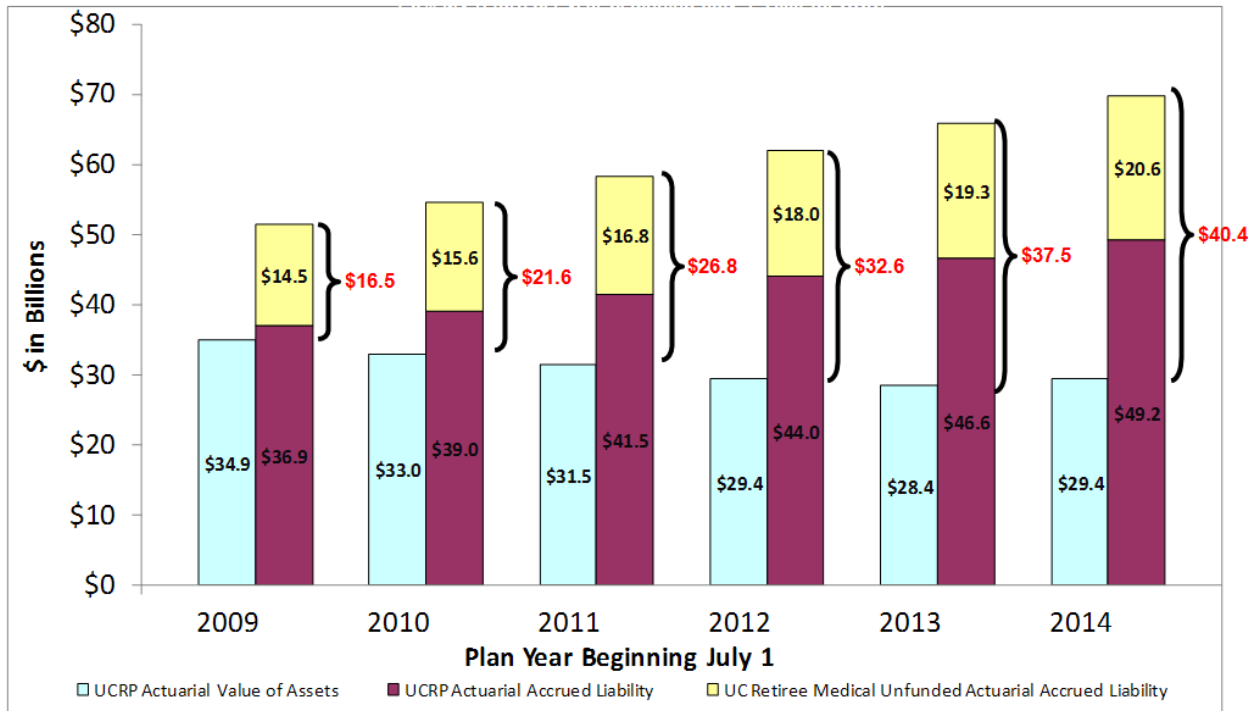
<sup>15</sup> Contributions from represented employees are subject to collective bargaining. As of the date of this paper, all but two unions have agreed to the redirection of employee contributions from the DCP to UCRP.

<sup>16</sup> Senate Task Force on Investment and Retirement (TFIR) Recommendations to Assure Adequate Funding for UCRP (5/13/09), <http://www.universityofcalifornia.edu/senate/reports/mctoyudof.ucrpfunding.june09.pdf>.

<sup>17</sup> UC Regents, Committee on Finance, Item F 5, November 18, 2009.



## Overview of Employee PEB Assets / Liabilities / Shortfall



In addition, as the TFIR paper points out:

Further increasing the urgency of making contributions is that fact that less than a third of UC salaries are paid by state funds, with federal grants and contracts and self-supporting entities, such as the clinical enterprises, making up the other two-thirds. The employer contribution on behalf of each employee is charged to the fund source which provides the employee's salary. These other fund sources will not make employer contributions larger than those made on behalf of state-funded employees, but they will contribute at the same rate. Thus, each dollar of contributions on behalf of state-funded employees results in over two dollars in contributions from other sources. Each dollar of contributions on behalf of state-funded employees that is deferred results in the loss of an additional two dollars of contributions from non-state sources. The slow ramp-up therefore means that UC is continuing to price its benefits far below cost, effectively giving a discount to outside funding sources; this policy is not sustainable because UC cannot obtain a binding commitment from these fund sources to make up the shortfall through future contributions.<sup>18</sup>

<sup>18</sup> The statement in this report that state supported compensation represents only one-third of total covered compensation may not be completely accurate. Analysis undertaken subsequent to the date of the TFIR report

The unmanageable unfunded liability attributable to the absence of contributions funding normal cost, plus the loss of earnings on those contributions, could destroy the University. Obviously the University cannot afford to contribute fifty percent of covered compensation to retirement benefits. Grant agencies are not likely to provide grants to UC based on pension costs at that level. However, the University's obligation to pay accrued benefits to current employees is absolute. Failure to fund these benefits on a current basis will impose an impossible burden on the University's operating budget if contributions at a level of 30 percent of compensation or higher. For this reason, the Academic Senate has endorsed current funding of normal cost plus amortization of the unfunded liability.

**Pension Obligation Bonds.** At its February 24, 2010, meeting the Academic Council endorsed a TFIR recommendation that contributions be made as provided under the Funding Policy.<sup>19</sup> Recognizing the competing stresses on the current UC operating budget, and the fact that the State is not likely to provide supplemental funding to meet obligations under UCRP, TFIR recommended that the University issue pension obligation bonds in an amount sufficient to meet the University's contribution under the Funding Policy with respect to State funded employees. The proceeds from pension obligation bonds would be contributed to UCRP. Alternatively, the University might contribute an interest bearing IOU, or seek an IOU from the State, to UCRP to fund the University's contribution. The principal advantage of either approach is that contribution levels would be established for compensation funded from non-State sources, particularly federal contracts and grants and the UC medical centers. Recognizing that higher contribution levels will also strain medical center budgets and the health care compensation plan, TFIR notes that the medical centers themselves could fund contributions with pension obligation bonds.

The issue of pension obligation bonds would create an indebtedness for the University that would have to be repaid from operating funds. As TFIR points out, the bonds might be issued at

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suggests that the proportion of covered compensation funded by Federal contracts and grants is less than originally anticipated. Thus, state covered compensation appears to be greater than one-third. In addition, subsequent to the date of this report, TFIR has pointed out that under OMB Circular A-21 pension costs chargeable to a federal grant must be equitable across all activities and must be paid within six-months of the end of the fiscal year. This means that federal grants cannot be charged for past unfunded liability accrued as a result of contributing less than the full ARC; unfunded liability arising from investment returns less than the actuarial assumption of 7.5%, and from changes in demographics of the UC workforce and retirees, can be recovered. This increases the pressure to provide contributions to UCRP that reflect the total ARC. TFIR estimated that approximately \$58 million of pension contributions that could have been recovered from federal contracts and grants in 2009-10 will be irrevocably lost. For 2010-11 the amount will be \$83 million. It is higher than that because Circular A-21 limits the amount of smoothing by a collar rule that AVA can't be more than 120% of AVA, so ARC is roughly 27.5% of covered compensation, rather than 20.5% of covered compensation. The lost funds are exacerbated by the loss of the 7.5% assumed return on the contributions.

<sup>19</sup> The letter to the President from Academic Council Chair Henry Powell, dated March 3, 2010, and the accompanying TFIR report is on the UC Academic Senate web site at [http://www.universityofcalifornia.edu/senate/reports/HP2MGY\\_UCRPfunding\\_030310.pdf](http://www.universityofcalifornia.edu/senate/reports/HP2MGY_UCRPfunding_030310.pdf).

interest rates lower than the assumed rate applied to UCRP assets.<sup>20</sup> A significant advantage of proceeding in this fashion is that each dollar of contribution from the University will be matched by contributions with respect to UC employee compensation funded from sources other than the State budgeted core funds. POBs would smooth out the University's cash flow, and could be repaid once the Funding Policy contribution starts to decline in about 5 years.

**Options to reduce Normal Cost.** Several options are under consideration by the President's Task Force on Post Employment Benefits in an effort to reduce the normal cost of the defined benefit plan. Reducing plan benefits will not affect the unfunded accrued liability, but would reduce required annual contributions by the reduction in normal cost in future years. Possible options are to raise the retirement age, reduce the retirement age factor (as an example, from 2.5 percent for each year of service to ranges such as 1.8 percent, or perhaps lower), and/or limit the maximum retirement benefits to 80 percent of HAPC. One proposed plan would recognize the availability Social Security so that the combined retirement income at all salary levels would reflect a combination of Social Security and UCRP benefits with variable age factors phased in at retirement ages between 55 and 65.

As of the date of this document, the PEB Task Force has not reached its conclusions about which of a range of options the Task Force will endorse. Nor has the Academic Senate endorsed specific options, although the UC Committees on Faculty Welfare, Planning and Budget, and the Academic Council have discussed specific proposals, which have also been discussed by welfare, budget, and executive committees within the Divisional Senates. It is, premature to describe potential options in a paper that will be made available for wide distribution.

At the present time, plan revisions under discussion are to be applicable to persons hired after the date that plan changes are enacted. There is, nonetheless, consideration being given to the possibility that the reduction in benefits contemplated under a plan revision might be applied to the future service of current employees. Current employees rights to vested and accrued benefits cannot be modified. However, the Regents assert in the UCRP plan documents the right to change the value of benefits that accrue for future service. The Regents ability to change the value of future accruals for service by current employees has not been tested in the courts and individual employees and employee groups may file legal action to challenge any such revision. The UC committee on Faculty Welfare, its Task Force on Investment and Retirement, and the Committee on Planning and Budget have all taken the position that there should be no change in the benefits provided to future service of current employees.

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<sup>20</sup> Any bonds issued to fund investment in UCRP would not be tax exempt. Internal Revenue Code §§ 103(b)(2) and 148 deny tax exemption to any bond issue where the proceeds are invested in higher yielding instruments, "arbitrage bonds".

## RETIREE HEALTH BENEFITS

**Current Health Coverage.** The University offers health benefits to retired employees who receive annuity payments from UCRP and who have accumulated at least 10 years of service credit prior to retirement.<sup>21</sup> For eligible retired employees, UC contributes to medical and dental coverage. For employees who entered UCRP before January 1, 1990, UC will pay 100 percent of UC's contribution level to individuals who retire before age 55 with at least ten years of service, or individuals who retire after age 55 with at least five years of service. For employees who entered UCRP after January 1, 1990, UC will pay a variable percentage of UC's contribution towards medical and dental monthly premiums depending on age at retirement and years of service. If a person's age and years of service equal at least 75, UC will pay 50 percent of the premium. For persons who retire at age 50 or later with ten years of service, UC will pay 50 percent of its contribution level. After ten years of service, the percentage increases by 5 percent each year until the contribution level reaches 100 percent of the UC contribution after 20 years of service. Thus, an employee who retires after age 50 with twenty years of service is eligible to receive 100 percent of UC's contribution to retiree health plans. For 2010-2011 UC's contribution will be 89 percent of a blended premium for health care coverage.

**Blended Premiums.** UC's current contribution for retiree health is based on insurance premiums calculated by taking into account UC's entire employee pool and those retirees who are not eligible for Medicare because they are not yet 65 years old—a blended premium. This means that the cost of retiree health coverage is determined by spreading the risk (the cost of medical care) across a population of employees that includes both younger and healthier employees as well as older employees and retirees who tend to be less healthy and accordingly require more medical care. In this sense, the insurance premium is based on insurance that spreads the risk of medical care over a larger population with a significant variation in health care requirements.

**Unblended Premiums.** Determining the cost of retiree health coverage based on an unblended population only including retirees who are not yet eligible for Medicare requires higher premiums. The coverage group is narrowed to include an older population that is more likely to require more medical services and more expensive health care. An unblended premium for this group will be substantially higher. Removing retirees from the insurance pool for purposes of calculating premiums also results in a lower health insurance premium for current employees.

**Medicare.** Retired employees who are eligible for the Federal Medicare program are required to enroll in Medicare Part A (hospital insurance) and Medicare Part B (medical insurance) in order to receive retiree health benefits from UC.

**Pay-as-you-go Policy:** Historically UC has covered its obligation for retiree health by paying the cost on an annual basis. Unlike UCRP, UC does not maintain a trust into which UC has contributed an amount sufficient to fund the present cost of the future unfunded liability.<sup>22</sup> For

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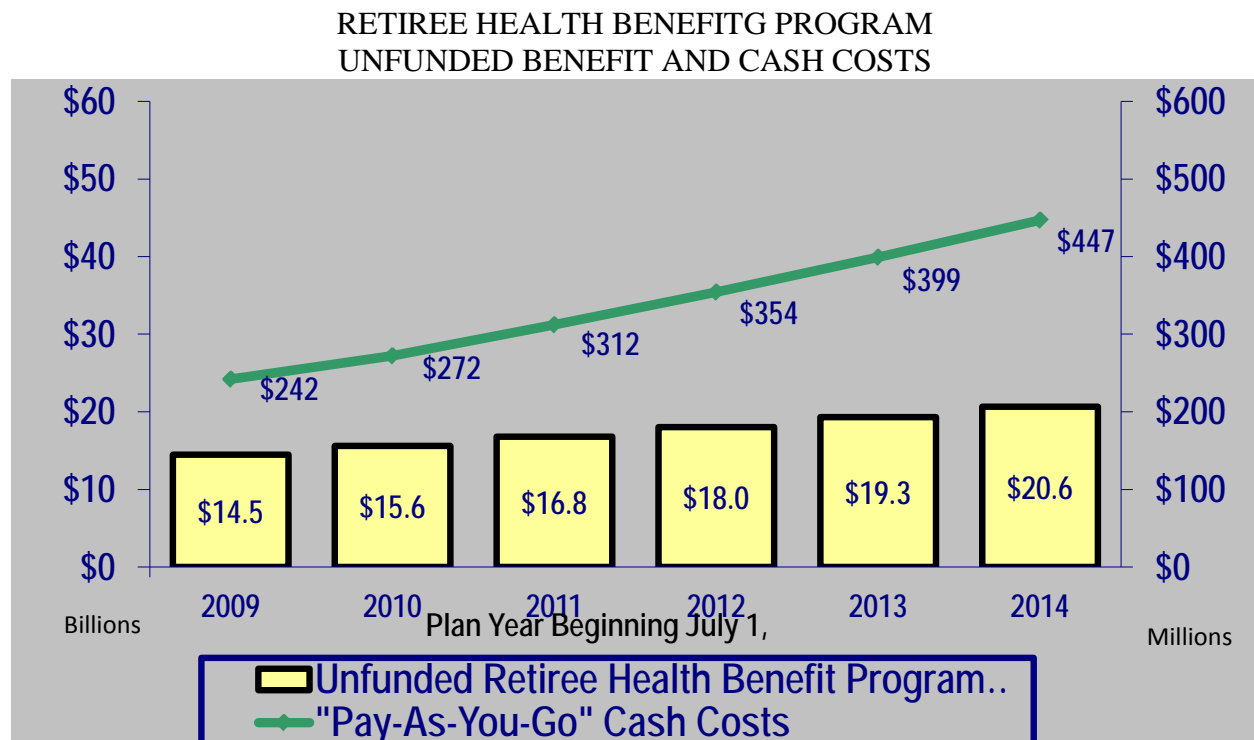
<sup>21</sup> Health benefits are not available to former employees who have taken a lump sum payment from UCRP.

<sup>22</sup> UC has established a retiree health trust but to date the trust has only a small amount of assets representing less than one percent of the retiree health AAL.

fiscal year 2010 the annual pay-as-you-go cost of UC's contribution to retiree health care will be \$242 million. The cost is projected to grow to \$666 million by 2019.

**Government Accounting Standards Board (GASB).** The GASB has recently required public entities to adopt accounting standards similar to those of the private sector that require a public entity to more directly report on its financial statements the annual required contribution for retiree health benefits. The full unfunded liability is shown in a footnote, but amortization of this liability increases the annual required contribution shown as a liability on the balance sheet. Although these requirements do not require the University to actually fund its unfunded liability for retiree health benefits (unlike the requirements for funding retirement income), this reporting requirement has required public entities to stare at this liability in the face.

**Actuarial Accrued Liability for Retiree Health (Unfunded Liability).** The unfunded liability for retiree health is the present discounted value of the cost of future benefits promised to retired employees. Currently, the liability is computed using a 5.5 percent discount rate. Funding the full ARC each year would permit the University to use a 7.5 percent discount rate (the assumed return on invested assets), which would lower the unfunded liability. The University's unfunded liability grows each year as shown on the following table:



Note that the accrued liability represents the present value of the present and growing total liability for the health care costs of all future retirees, which is why the figure is so much greater than the current annual University contribution for the premiums of current retirees.

**Normal Cost.** The normal cost of providing retiree health benefits under the current program is estimated to be 7.9 percent of average covered compensation.<sup>23</sup>

**Options to Lower Normal Cost.** As is the case with retirement income benefits, the Presidential Task Force on Post-Employment Benefits is examining options that would lower the cost of retiree health benefits. Again, as of the date of this paper, no recommendations have been finalized. Nor have recommendations been endorsed by the Academic Senate, although agencies of the Senate are reviewing specific options.

Options include lowering the percentage of UC's contribution to retiree health coverage and increasing the contribution required of retirees, basing the contribution on unblended premiums, raising the age at which employees become eligible for contributions to retiree health, increasing the vesting period and expanding the number of years of service over which the percentage contribution increases.

**Grandfathering.** The eligibility of current employees in terms of age and years of service may be based on current eligibility rules. Grandfathering affects eligibility age and graduated eligibility only. Grandfathered employees will have to pay higher medical care premiums as UC reduces its maximum contribution as a percentage of premiums. In addition, retirees who elected in 1976 not to participate in Social Security may be treated as active employees for purposes of health benefit contributions with blended premiums and subject to pay bands, but perhaps with lower contribution rates from the University.

## SUMMARY

The TFIR recommendations point out that reducing UCRP benefits will not solve the funding problem. The big issue is the growing unfunded liability that attaches to existing vested benefits of current employees—benefits that are not subject to reduction. The unfunded liability can in part be mitigated by replacing the “soft” growing liability of the University to UCRP with a hard liability in the form of pension obligation bonds. The issue of pension obligation bonds will, nonetheless, impose burdens on the University operating budget. The cost of funding UCRP and the cost of pension obligation bonds must be weighed against competing claims for competitive current salary and maintaining the funding level of existing programs. In addition, the University administration is committed to reducing the normal cost of future retirement benefits. In doing so, the University must carefully consider the level of retirement benefits that are required both to provide incentives to long-term employment at the University and assure an adequate level of retirement income security so that long-term employees are not required to maintain active status beyond their capacity to do so effectively. Adequate funding for retiree health benefits is an important part of this equation. Retiree health coverage is an important part of total remuneration. The level of both benefits must be adequate to assure income security in retirement but at the same time be affordable to the University.

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<sup>23</sup> Normal cost has a slightly different application in the case of health care as compared to the pension program because the value of health benefits does not vary with the beneficiaries' income. Thus, normal cost does not vary by assumptions about compensation at the time of retirement.

Finally, total remuneration consists of current cash compensation and current health and welfare benefits, plus deferred benefits such as retirement income and retiree health. To the extent that employer contributions to future benefits are reduced, or current employee contributions are increased, the total remuneration of faculty declines. Total remuneration of UC faculty is already behind the compensation at the agreed comparison eight institutions. The future of the University of California depends on the retention and recruitment of its faculty. The issues surrounding the funding and nature of post-employment benefits must be addressed in the context of total remuneration.