UCRP Primer:
A Brief Documentary History for UCFW Members

UNIVERSITY OF CALIFORNIA ACADEMIC SENATE

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November 13, 2006
REVISED

PRESIDENT ROBERT C. DYNES

RE: Academic Council Analysis and Recommendation on Total Remuneration and the 2007-08 Budget

Dear Bob,

At its October 25, 2006, meeting, the Academic Council unanimously endorsed the enclosed document, *Total Remuneration and the 2007-08 Budget: An Academic Council Analysis and Recommendation*.

As you will see from the enclosed analysis, in order for the University to avoid losing ground against its competitors in total compensation in 2007-2008, the University must provide a range adjustment (COLA) to faculty of seven percent up to the Social Security wage base, and ten percent above that base. Therefore, the Academic Council offers the following recommendation:

> The Academic Council urges the President and The Regents to seek sufficient funds in the 2007-2008 budget to provide a range adjustment (COLA) for faculty (in addition to funding for merits) that will fully compensate for the reduction in compensation caused by the restart of contributions to UCRP in addition to matching the anticipated increase in faculty salaries at competing institutions.

On behalf of the Academic Council, I respectfully request a response from the appropriate UCOP division concerning this analysis and recommendation, and that this letter be transmitted forthwith to The Regents.

Sincerely,

John B. Oakley, Chair
Academic Council

Encl: 1
Copy: Academic Council
Executive Director Bertero-Barceló

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Total Remuneration and the 2007-2008 Budget: An Academic Council Analysis and Recommendation

Endorsed by the Academic Council October 25, 2006
As proposed by the University Committee on Faculty Welfare (UCFW)

Conclusion: To avoid losing ground against its competitors in total compensation in 2007-2008, UC must provide a range adjustment (COLA) to faculty of:

- **7% up to the Social Security wage base and**
- **10% above that base.**

Background and Analysis

The Board of Regents adopted RE-61 in November, 2005, which commits the University to "increase salaries to achieve market comparability for all groups of employees over the ten-year period from 2006-2007 through 2015-2016." The key philosophy behind RE-61 is:

> "The quality of our academic, management and staff personnel is essential to maintain the excellence of the University of California and its ability to contribute to the health and vitality of the State of California. Our strategy is to attract and retain the highest quality academic, managerial, and staff talent by offering competitive total remuneration."

RE-61 anticipated that the value of health and welfare and retirement and retiree medical benefits would be "reduced significantly" over the next few years due to rapidly increasing healthcare costs and the resumption of employee contributions to UCRP. To achieve the goal of market comparability, RE-61 recognized that cash compensation must be increased and provided that the following action would be taken:

> "The University will actively pursue obtaining additional funds from State and all other resources."

In January, 2006, the University Committee on Faculty Welfare (UCFW) adopted the position—which it believes is critically important to the health of the University—that **any reduction in the value of UC benefits must be *simultaneously* accompanied by an increase in cash salaries sufficient to ensure there is no deterioration in UC's competitive position in total remuneration**. The Academic Council adopted the same position at its February 22, 2006, meeting.

The Academic Council has strongly supported the gradual restart of contributions to UCRP beginning July 1, 2007.[1] Restarting at a low level with a gradual rise, rather than deferring to a later date, will be much less painful than having to restart contributions at the higher level deferral would require. The Academic Council strongly supports efforts by UCOP to obtain funding from the state and other funding sources to meet the required employer contributions.

[1] Contributions are needed to ensure that the plan remains fully funded and capable of paying the benefits that have been promised and continue to be earned.

As explained below, to prevent the restart of UCRP contributions from reducing total faculty remuneration, it will be necessary to increase cash compensation by a COLA of at least 3% up to the Social Security wage base, and 6% above the wage base. In addition, to avoid increasing the gap between UC and its comparator institutions, salaries must be increased by an additional 4%. The Academic Council is alarmed at reports that UCOP's 2007-2008 budget will propose only a 3% COLA plus 2% funding for merits for faculty. Such a budget will seriously diminish UC's competitive position in total faculty remuneration.

Faculty compensation at UC is in a state of crisis, and the long-run future of academic excellence at UC is at stake. Increasing the gap between UC faculty's total remuneration and that of its competitors next year would be contrary to the policy adopted by the Regents in RE-61 and a very serious mistake for the University.

Calculation of COLA Required to Maintain UC's Current Competitive Position in Faculty Salaries in 2007-2008

Prepared for UCFW by Robert M. Anderson, Chair of the UCFW Task Force on Investment and Retirement, October 20, 2006

1. A 4% COLA will be needed to match salary increases at comparator institutions

UC and the California Postsecondary Education Commission (CPEC) project each year that faculty salaries at the Comparison 8 institutions will increase by the geometric average of the increases of the previous five years. Using this methodology, they projected that Comparison 8 full Professor salaries would rise by 4.09% from 2005-06 to 2006-07. The data needed to make projections for 2007-08 are not yet available, but it seems very unlikely that faculty salaries at competing institutions will rise by less than 4%. Thus, in the absence of any change in the value of benefits, UC would need to provide a 4% COLA to retain its current competitive position.

2. An additional COLA of 3% of covered compensation up to the Social Security wage base[2] and of 6% above the base will be needed to offset redirection of the DC plan contribution into UCRP

The Regents are contemplating a major reduction in the value of benefits by restarting contributions to UCRP. Currently, employees make a compulsory contribution (2% of covered salary up to the Social Security wage base, plus 4% of covered salary above the Social Security wage, less $19 per month) to personal Defined Contribution (DC) plan accounts; when an employee retires, the DC plan balance provides retirement income over and above the UCRP Defined Benefit plan. When contributions to UCRP are restarted, the compulsory employee contribution will no longer go into personal DC plan accounts, and thus will not generate additional retirement income. Mercer's methodology for computing the value to employees of UC's benefits takes into account tax-deferral benefits. Thus, the Mercer methodology values the DC plan as being equivalent to roughly 3% of covered compensation up to the Social Security wage base, and 6% of covered compensation above the wage base. Compensating employees for the restart of UCRP contributions will require an increment of 3% up to the Social Security wage base, and 6% above the wage base.

[2] The Social Security wage base for 2007 is $97,500, up from $94,200 for 2006, and $90,000 for 2005. See http://www.ssa.gov/OACT/COLA/cbb.html for the method of calculating increases to the base.

3. A total COLA of 7% of covered compensation up to the Social Security wage base and of 10% above the base will be required

In order to maintain UC's competitive position in total remuneration, one needs to increase salaries to compensate for the loss of the DC plan accumulation, and to match the anticipated salary increase by competing institutions. Thus, one needs an increase of 7% (4% + 3%) in covered compensation up to the Social Security wage base, and 10% (4% + 6%) above the Social Security wage base to simply keep UC where it currently stands in terms of total remuneration.

The 2% proposed for merit increases for faculty does not alter this calculation. The merit system does not, in a steady state, result in any change in the distribution of faculty salaries, as senior faculty at high salaries retire and are replaced by new faculty at lower points on the salary scale. Net funding for merits is needed only because the UC salary scale has fallen egregiously behind the salaries of our competitors, and a large part of the merit money is, in fact, used to retain faculty who have received outside offers that vastly exceed the UC scale.[3] We need to adjust the *scale* to compensate for the increase in competitors' salaries and for the restart of UCRP contributions. A COLA is the only way to increase the scale, so a COLA of 7% of salary up to the Social Security wage base, and 10% of salary above the wage base, is needed to maintain UC's competitive position in total remuneration.

Recommendation

The Academic Council urges the President and The Regents to seek sufficient funds in the 2007-2008 budget to provide a range adjustment (COLA) for faculty (in addition to funding for merits) that will fully compensate for the reduction in compensation caused by the restart of contributions to UCRP in addition to matching the anticipated increase in faculty salaries at competing institutions.

[3] For an example, when a faculty member is promoted from Associate Professor to Professor, the increase in salary is charged to the merit pool, but in fact the promotion *lowers* both the average UC full Professor salary and the average UC Associate Professor salary, worsening our competitive position using the CPEC methodology.

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August 10, 2007

ROBERT C. DYNES
PRESIDENT

Re: Academic Council Statement on the University of California Retirement Plan (UCRP)

Dear Bob,

I am pleased to present you with the enclosed *Academic Council Statement on UCRP* that the Council adopted unanimously on July 25, 2007. Based on a draft conceived and authored by the University Committee on Faculty Welfare (UCFW) and the Task Force on Investment and Retirement (TFIR), the statement provides information to concerned members of the University community about the management and investment performance of UCRP.

On behalf of the Academic Council, I respectfully request your assistance in distributing the *Academic Council Statement on UCRP* to University administrators and officials, the campuses, University employees, members of the general University community, and such other interested parties as you may deem suitable recipients.

Sincerely,

John B. Oakley, Chair
Academic Council

Copy: Academic Council
María Bertero-Barceló, Executive Director

Enclosure: 1

JO/MAR

ACADEMIC COUNCIL STATEMENT ON UCRP

July 25, 2007

There has been considerable criticism in the press, and by employee groups, of the management of University of California Retirement Plan (UCRP) assets. The criticism is unfounded. UCRP is well managed by The Regents, who set investment policy but do not choose individual investments, and the Office of the Treasurer, which chooses individual investments following the policy set by The Regents. Consistent with the Academic Senate's role in the shared governance of the University, faculty on two Senate committees—the University Committee on Faculty Welfare (UCFW) and its Task Force on Investments and Retirement (TFIR)—carefully monitor UCRP investment policy and returns. The Senate also nominates two faculty to serve on the University of California Retirement System (UCRS) Advisory Board.

It is truly extraordinary that we have been able to maintain a fully funded plan without contributions for the last sixteen years; this attests to the overall soundness of UCRP's management. Contributions will eventually be needed to UCRP—not because of poor management, but because UCRP's liabilities increase each year as UC employees earn additional service credit. Each additional year of service credit earned by an employee increases the pension benefits that UCRP will be required to pay. The large surplus that was built up as a result of the strong performance of the stock market in the period 1982-2000 has slowly been eroded by the annual growth of liabilities, which were not offset by annual contributions.

Understandably, faculty and other UC employee groups are concerned about the proposed restart of contributions—especially because UC salaries significantly lag the market—and about the safety of their pensions. These concerns, amplified by allegations reported in the press and elsewhere that poor management and conflicts of interest have produced investment returns that are too low, have created considerable anxiety among UC employees. They have also created the impression that the restart of contributions to UCRP is necessary because of this alleged poor performance. The Academic Senate is convinced that these concerns are unfounded.

Concerns about UCRP have also led to demands for changes in the governance structure, to some form of joint governance. The Academic Senate believes that some change in the role of the UCRS Advisory Board would be advisable, but that ultimate authority over UCRP investment and policy decisions should be left with The Regents.

The purpose of this document is to provide a statement of current Academic Senate policies concerning UCRP, and to provide information to the UC community about UCRP and the Senate's role in its management and oversight. The document is based on an independent analysis by TFIR. It explains the current governance structure of UCRP, how UCRP liabilities are calculated, and why it is important to maintain UCRP at fully funded status. It also explains the changes in UCRP investment policy made in 2002 and why those changes enhanced the long-run security of UC employee pensions. The document also gives a brief account of what determines investment returns and how investment performance should be measured, and then compares UCRP investment returns with those of CalPERS and CalSTRS, the main pension plans for state employees and teachers, over the last ten years. The document also states current Academic Senate policies with respect to UCRP and the restart of contributions. Finally, it concludes with a recommendation for change in the UCRS Advisory Board.

1. How UCRP's Funding Ratio Is Calculated:

The funded status of a defined benefit pension plan like UCRP is computed in the following way. The first step is to compute the actuarial accrued liability (AAL) of the plan. This is the present discounted value of the pension benefits that will be paid in the future, based on the service credit earned to date. As an example, consider a 50-year-old employee with 20 years of service credit who plans to retire ten years from now, at age 60, when this individual's service credit will have grown to 30 years. At retirement, this individual will be entitled to a pension of 75% (30 years of service credit times an age factor of 2.5%) of their highest average plan compensation (HAPC), the highest average covered compensation earned over a period of thirty-six consecutive months. The computation of AAL as of today takes into account the twenty years of service credit that have already been earned, and thus calculates an accrued pension benefit equal to 50% (20 years of service credit times 2.5%) of an estimate of this individual's eventual HAPC. (Future salary growth is assumed and factored into the calculation, as is the increase in the age factor that occurs from age 50 to age 60, but service credits from future years of employment are not included in current liability.) This stream of pension payments is discounted back to its present value today at the actuarial assumed rate of return (7.5% per annum) on the UCRP assets. The second step is to compute the Market Value of Assets (MVA). The funding ratio is simply MVA divided by AAL.[1]

A 100% funding ratio means that, if the plan's actuarial assumptions about investment returns, salary increases, mortality, and so on, actually happened and no further service credit was earned, the current assets would be exactly sufficient to pay

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[1] The UCRP actuary also computes the so-called Actuarial Value of Assets (AVA), which smooths out volatility in market returns by spreading out each year's market performance over 5 years. For simplicity in this discussion, we will focus on MVA.

off all the pension benefits earned to date. However, nothing would be left to pay off the pension benefits that will be earned in the future, i.e., in the example above, the benefits arising from the additional ten years of service credit. Thus, with a 100% funding ratio, contributions are required each year to cover the normal cost of the plan, which is essentially the increment to AAL resulting from the service credit earned in the year. Virtually all defined benefit pension plans require contributions each year to cover the additional service credit earned.

The assumption of a 7.5% rate of return is a reasonable, and slightly conservative, estimate of the expected long-run investment return on the portfolio, given an acceptable level of volatility for a pension portfolio. In practice, investment returns will vary tremendously from year to year; over the past ten fiscal years, returns have ranged from +21.82% in 1997-98, as the stock market bubble inflated, to -9.20% in 2001-02, as the bubble deflated. Even over long periods, the investment return could be significantly above or below the assumed rate. A shortfall in investment returns would be very painful, requiring large contributions to fund the benefits owed to present and future retirees. Thus, it is appropriate to make the assumption slightly conservative, since this reduces the chances of a painful shortfall.

For simplicity, the above discussion is based on the payment of a certain stream of UCRP benefits to retirees. In reality, the stream of pension benefits actually paid to a retiree depends on the number of years that employee spends in retirement, *i.e.*, how long he/she lives; assumptions must also be made concerning payments to survivors. In calculating the AAL, an average present discounted value is used for the expected payments, based on weighting various potential streams of payments by associated probabilities of particular retirement dates, mortality, etc. The averages are based on actual experience with UC's population of retirees. Periodically, The Regents commission the UCRP actuary, The Segal Company, to conduct experience studies and recommend appropriate changes in assumptions about mortality and other parameters. The most recent experience study was presented to The Regents in May 2007.

2. Why UCRP's Funding Ratio Should Not Be Allowed to Fall Below 100%:

The AAL is the present value of UC's legal liability to pay future pension benefits; these pension benefits must be paid. Therefore, if the funding ratio falls below 100%, then the excess liability has to be offset by even larger contributions. Assuming that UCRP investments earn the actuarially assumed 7.5% rate of return, 16% of UC's payroll must be paid into the plan each year to cover the additional pension obligations incurred in that year. This is called the "normal cost" of maintaining UCRP at a fully funded status. What happens if a plan is allowed to fall below fully funded status is illustrated by CalPERS. If it were fully funded, its normal cost would be about the same as that of UCRP—16%. However, its funding was allowed to fall below 100% so at present, 20.9% of payroll is being contributed, a burden which is shared by employers and employees. Deferring contributions to a pension plan substantially increases the total amount that must be contributed, due to the foregone returns that would have been earned on the deferred contributions.

Beyond the risk that employer and employees will, in the future, have to contribute more than 16% of payroll to UCRP, allowing funding levels to fall below 100% also threatens the future well-being of retirees. Basic UCRP pension benefits and partial COLAs (cost of living increases) are legally guaranteed by the University and would have to be paid regardless of the funding status. However, the legally required COLAs are not sufficient to keep up with a rate of inflation above 2%. As a result, The Regents have also authorized occasional ad hoc COLAs to retirees. These ad hoc COLAs are valuable to all retirees, and are critically important for retirees who live into their eighties and nineties, who historically have depended on the ad hoc COLAs to prevent substantial erosion of the purchasing power of their pensions. If UCRP funding falls below 100%, these ad hoc COLAs may well be at risk.

3. Plans for Restarting Contributions:

As of June 30, 2006, the funding ratio of UCRP was approximately 107.5%. Assuming that investment returns would just equal the assumed 7.5% rate, the funding ratio would have dropped below 100% in the 2008-09 fiscal year. As a result, The Regents voted to restart contributions at a low level, effective July 1, 2007, intending that they be slowly raised over several years to an 11% employer contribution and a 5% employee contribution, which would be sufficient to sustain UCRP in the long run. This split between employer and employee contributions mirrors the split that CalPERS would have if it were 100% funded. Universities which compete with UC for faculty typically make an employer contribution of about 10% of salary to a defined contribution pension plan; this gives the faculty member the choice between contributing approximately 6% of salary and having roughly the same expected pension benefit provided by UCRP, or contributing less and having a lower expected pension benefit. Because the Governor and Legislature declined to provide funding for the restart of employer contributions at this time, however, the restart of employee contributions to UCRP has also been postponed.

The markets did very well in 2006-07, and we anticipate that the funding ratio of UCRP, as of June 30, 2007, will be approximately 115%. This is very fortunate, but it is unreasonable to expect the market to continue to provide this kind of performance year after year. The one-time windfall in 2006-07 provides us with some breathing room, and contributions can probably be postponed for another two or three years. However, unless we achieve truly extraordinary investment returns going forward, contributions will eventually need to be restarted. The only question is when. The Academic Senate strongly supports restarting employer and employee contributions when needed to maintain UCRP's funding ratio above 100%.

4. Effect of Employee Contributions on Total Remuneration:

The restart of employee contributions will mean a substantial reduction in total employee remuneration at a time when UC faculty and staff salaries are already seriously uncompetitive. The Academic Senate's position is that the restart of employee contributions must not reduce UC's competitiveness in total remuneration. Hence, the Academic Senate's position is that the restart of contributions must be accompanied by substantial salary increases, both to compensate for the restart of contributions and to move cash compensation quickly toward competitive levels.

5. UCRP Investment Policy and Returns:

UCRP assets have been well managed over the years. The annual return over the ten-year period ending June 30, 2006, was 9.04%, a period that included the deflation of the stock market bubble in 2000-2002. This is 1.54% above the rate of return assumed in the actuarial calculation of the funding ratio. In the 2006-07 fiscal year through May 31, the return was 19.70%.

There have been allegations in the press and by employee organizations that we should have done better. The arguments advanced for this position have included the following:

- CalPERS and CalSTRS have had higher investment returns than UCRP in some recent years, and consequently UCRP must be doing something wrong.
- The Regents forced the resignation of former Treasurer Patricia Small in 2000 and "outsourced" the management of the funds; had Ms. Small continued as Treasurer, we would have had higher returns.
- UCRP's investment returns have been reduced as a result of serious conflicts of interest.

None of these arguments has merit.

The primary determinant of investment return and investment risk in a portfolio is the allocation of investment dollars among the various classes of assets: domestic stocks, foreign stocks, bonds, private equity, real estate, absolute return, and so on. The asset allocation is set by The Regents, based on advice from the Treasurer and an outside consultant. The outside consultant, Richards & Tierney, advises on the asset allocation but plays no role in choosing individual investments and receives no commissions or fees in relation to the holding or trade of individual investments. Those who do receive fees for managing assets receive a flat fee, plus, in some cases, incentive payments based on the returns they achieve. This structure is consistent with the practices of other well-managed public pension funds, and notably avoids conflicts of interest that could arise if the consultant received fees for trading.[2]

The investment risk of the portfolio is determined in part by the risk of the individual asset classes and the amounts allocated to them. It is also determined, to a substantial extent, by the *correlations* between asset classes (the extent to which they rise and fall together). For example, although foreign stocks are somewhat more volatile than domestic stocks, the inclusion of foreign stocks in the portfolio provides diversification. This diversification can reduce the overall volatility of the portfolio because the factors affecting the value of foreign stocks are, to some extent, different from those affecting the value of domestic stocks.

The outside consultant and The Regents choose the asset allocation that, in their judgment, maximizes expected return, subject to the level of volatility they are willing to tolerate. If they were willing to tolerate higher volatility, they could obtain the possibility of higher returns, but at the cost of a higher probability of investment losses. Since the UCRP portfolio is a pension fund, The Regents have appropriately chosen an asset allocation with lower volatility than the asset allocation used in the UC General Endowment Pool.

Asset returns are volatile and unpredictable. In any given year, the actual return on an asset class consists of the predictable expected return on that asset class plus a random return outcome which cannot be predicted in advance. It is important to note that, for most asset classes, the random, unpredictable component is larger than the predictable expected return. Thus, two portfolios with prudent but different asset allocations are likely, in any given year, to produce very different returns; the portfolios could have identical expected returns and overall volatility, with the difference in one year's results attributable to the unpredictable portion of returns. Simply comparing realized returns does not provide a sound basis for judging the quality of investment managers.

The asset allocation of UCRP is different from that of CalPERS. Because the asset classes that are heavily weighted in the CalPERS portfolio have done well in a few recent years, the overall return on the CalPERS portfolio in those years has been higher than that of UCRP. In other years, however, that same asset allocation would not have

[2] The Regents, the Office of the Treasurer, and consultants act in accordance with State and University policies governing conflict of interest and ethical conduct.

fared as well. Over the ten-year period ending June 30, 2006, CalPERS reports its annual return was 9%, which just matches UCRP's performance.

The main difference between UCRP and CalPERS is that CalPERS is less than 100% funded and currently requires a combined employer/employee contribution of 20.9% of salary; UCRP is slightly over 100% funded, despite having had no contributions for 16 years.

It is very important that the asset allocation of a portfolio remain stable over time, with adjustments made infrequently and based on careful analysis. Research has shown that frequent reallocation of assets within a portfolio, or "market timing"—a strategy in which the investor tries to guess which asset class will do best in a given month or year—has a poor track record compared to a strategy of maintaining a stable asset allocation over extended periods of time. It is certainly correct that investing more funds in the asset classes that performed relatively well in recent years would have led to higher returns for UCRP. But this outcome was not predictable and cannot be expected to occur in the future. Those who criticize the investment performance by comparing UCRP to CalPERS or other pension funds over a period of just a few years are implicitly asking that we adopt market timing as our investment strategy; that would be a very bad idea.

In addition to asset allocation, diversification within each of the asset classes is very important to reduce risk without a resulting reduction in expected return. The current Chief Investment Officer and Acting Treasurer, Marie Berggren, and her predecessor, David Russ, have established a disciplined and effective policy of diversification. A large part of the equity portfolio is invested in index funds, which will track very closely the average performance of the asset class because of their diversification, and which involve very low expenses. By essentially buying "the market", the riskiness of holding large shares of the portfolio in individual stocks is avoided. Part of the equity portfolio is actively managed by outside managers. Each outside manager controls only a small portion of the portfolio, so the actively managed portfolio is much better diversified than it would be if it were managed by a single manager, whether internal or external. Russ and Berggren have carefully measured the performance of the external managers and the internal staff who monitor them, and have replaced managers when warranted by a shortfall in their investments' return compared to the appropriate benchmark.

The best way to judge the quality of management is to compare the return of each asset class within the portfolio to an appropriate benchmark for that class, usually a broad index of all the assets within the class. For example, the benchmark for domestic equity is the Russell 3000 index, which represents approximately 98% of the market value of U.S. publicly traded securities. Every three months, The Treasurer publishes a detailed breakdown of the return of each asset class, in comparison to the return on the benchmark for that class. If the return on domestic equity matches its benchmark in a given quarter, it means that the return on domestic equity just equaled that of the Russell 3000 for that quarter. The overall benchmark for the UCRP portfolio is an average of the benchmarks for the individual asset classes, weighted by UCRP's asset allocation. The current investment policy was put into effect in November, 2002, so only the last four full fiscal years 2003-04 through 2006-07 reflect the current policies established by The Regents, Russ, and Berggren. In each of those years[3], investment returns in each asset class closely track the benchmark for the class, and the overall return is slightly above the overall benchmark.

Prior to 2002-03, the equity portion of the UCRP portfolio was managed internally. The treasurers in this period did not practice the type of risk management that is expected in a pension portfolio of this size. The portfolio was concentrated in a relatively small number of large-capitalization stocks that the internal managers hoped would outperform the market. As a consequence, the portfolio was poorly diversified. This increased the volatility of the portfolio without producing a compensating increase in the expected rate of return. Investment returns varied substantially from the benchmarks, being well above the benchmarks in some years and well below in others. Investment returns were on average near the benchmark in this period; we attribute this fact to a combination of low investment expenses and good luck, rather than to any inherent advantages of the strategy that was followed.

We have seen other instances in which California public portfolio managers obtained attractive results for a period of time, but then suffered substantial losses because they had not put adequate risk management measures in place, and we were very concerned by the potential for a substantial loss. We were greatly relieved when The Regents, and Treasurers Russ and Berggren, put in place appropriate risk management measures to safeguard the UCRP portfolio. We are convinced that UC and its employees and retirees have been, and continue to be, well served by those changes.

Much has been made of the fact that in the 2005-06 fiscal year, UCRP paid $32 million in fees to outside managers. This amounts to about 0.075% of the UCRP assets. The total expenses, including internal costs and fees to outside managers, amount to 17 basis points: 17/100ths of 1 percent. As a comparison, CREF, which offers retirement plans for many competing universities, has expense ratios at least twice as high for all their funds, including their index funds. UCRP uses a mix of active and passive management of its funds allocated to domestic, publicly-traded, securities. The jury is

[3] Results for 2006-07 are through May 31, 2007.

still out on whether the returns produced by these active managers justify the additional fees for active management, but these fees are very modest in proportion to the size of the portfolio.

The specific allegations of conflict of interest seem either far-fetched or inconsequential. More important, we see no evidence whatsoever that the alleged conflicts of interest have had any adverse impact on UCRP investment returns.

6. <u>UCRP Governance</u>:

Currently, The Regents have the responsibility for managing UCRP. They have the fiduciary responsibility to see that the promised benefits are paid. They set investment policy, but delegate the implementation of that policy to the Treasurer's Office.

Some employee groups have called for joint governance of UCRP. While the exact definition of joint governance is unclear, they appear to want The Regents to delegate all or a substantial part of the fiduciary responsibility for UCRP to a new board, which would be equally divided between appointees of UC's management and representatives elected by employees.

Much of the impetus for the call for joint governance appears to arise from the erroneous perception that UCRP investment performance has been substandard, and that is the reason we will need eventually to restart contributions. The need to restart contributions was not caused by the current UCRP governance structure, and it cannot be avoided by changing that structure.

Depending on how it is implemented, joint governance might carry some significant dangers:

- It is unclear whether faculty and staff would run in separate elections, or faculty and staff would compete in an at-large election; since staff vastly outnumber faculty, an at-large election might result in the election of no faculty to the new board. Currently, the Academic Senate has substantial input into UCRP policies, so joint governance could decrease, rather than increase, the influence of faculty. The Senate policy remains that faculty have a special role to play, given the Senate's shared governance of the University established under the Standing Orders of The Regents and the California Constitution.

- A number of those calling for joint governance have expressed the view that it would be better to defer restarting contributions until the funding ratio of UCRP declines to 80-85%. For the reasons explained above, this would not be in the interests of UC, its employees, or retirees.

- A number of those calling for joint governance have argued that we should return to the investment policies practiced prior to 2002. For the reasons explained above, this would not be in the interests of UC, its employees, or retirees.

UCRP currently has a very weak form of joint governance structure, the UC Retirement System Advisory Board (UCRS Board). This board is composed of five representatives of UC management, two faculty chosen by the Academic Senate, and two representatives elected by staff. At one time, the UCRS Board had considerable influence over UCRP policies and practices. However, for the last several years, the Board's actions have been severely limited by the Office of the General Counsel, over concerns that its operation might violate the "direct dealing" provisions of the California Higher Education Employee Relations Act (HEERA), the labor law governing UC, its employees, and unions. These provisions prevent UC from "dealing directly" with employees, rather than the unions that represent them, over the terms and conditions of employment. According to court precedents, the direct dealing provisions prevent the UCRS Board from making recommendations to The Regents. The Senate believes that the University should respond to the calls for joint governance by asking the Legislature to amend HEERA to exempt the UCRS Board from the HEERA "direct dealing" provisions, to restore the ability of the UCRS Board to function effectively in providing employee input into the management of UCRP. If HEERA is amended, The Regents should establish procedures to ensure that the UCRS Board's recommendations must be considered by The Regents before The Regents enact any changes in UCRP. However, in the Senate's view, the ultimate authority over UCRP should be retained by The Regents.

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Oakland, California 94607-5200

July 2, 2008

PRESIDENT MARK G. YUDOF
UNIVERSITY OF CALIFORNIA

Re: UCRP Funding Policy

Dear Mark:

At its June 25, 2008 meeting, the Academic Council, acting on behalf of the Assembly of the Academic Senate, evaluated the proposed UC Retirement Program (UCRP) funding policy, which we understand that The Regents may consider at their July meeting. With the understanding that the proposed policy will not lead to or be associated with reductions in total compensation to UC employees, and on the recommendation of University Committee on Faculty Welfare (UCFW) and its Task Force on Investments and Retirement (TFIR), the Council unanimously supports the proposal. In our view, the proposed funding policy is a transparent and prudent method of establishing recommended levels of contributions to UCRP each year, which should help in securing the state funding needed to keep the plan fully funded.

In making this endorsement, the Academic Council would like to amplify its caveat that there be no "reductions in total compensation," given existing Senate policy in this area:

1. To avoid further erosion in the competitiveness of cash compensation, employee salaries must increase by *at least* the increase in salaries in the appropriate market comparison group. For faculty, this means salaries must rise by approximately 4%, the anticipated increase in faculty salaries among the Comparison 8 institutions.
2. In addition, employee salaries must be increased by *at least* the amount of the required employee contribution, to avoid a reduction in UC's competitive position in total remuneration.
3. Significant increases in premiums paid to health insurers are anticipated in 2009. Either the employer share of those premiums needs to be raised to cover those increases, or employee salaries need to be raised to cover any increase in employee premiums, to avoid a reduction in UC's competitive position in total remuneration.
4. The Senate recognizes that employer contributions require that the University obtain additional funding. The Senate opposes resuming employee contributions before employer contributions have begun. Moreover, employee contributions shall never exceed the amount of the employer contribution.

For your convenience and reference, I have also enclosed the UCFW and TFIR recommendations of this proposal. If you have any questions about Council's comments, please let me know.

Sincerely,

Michael T. Brown, Chair
Academic Council

Copy: Provost Wyatt R. Hume
EVP Katherine N. Lapp
AVP Judith W. Boyette
Martha Winnacker, Executive Director
Academic Council

Encl. 2

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UNIVERSITY COMMITTEE ON FACULTY WELFARE (UCFW)
James A. Chalfant, Chair
jim@primal.ucdavis.edu

Assembly of the Academic Senate
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June 16, 2008

CONFIDENTIAL

MICHAEL T. BROWN, CHAIR
ACADEMIC COUNCIL

RE: UCRP Funding Policy

Dear Michael,

At its June 13, 2008 meeting, the University Committee on Faculty Welfare (UCFW) reviewed a confidential draft item concerning funding policy for the UC Retirement Plan (UCRP) that is tentatively scheduled for discussion at the July Regents meeting. The attached statement summarizes our committee's views concerning this item and also the broader topic of resumption of contributions to UCRP framed within the rubric of UC employees' total remuneration. The statement reiterates and expands upon existing Academic Senate policy, and we send it to you for endorsement by the Academic Council.

The Regents' draft item proposes a policy concerning funding that specifies how any surplus in the Plan is to be amortized, and how annual contributions would be affected. UCFW has referred this item to its Task Force on Investments and Retirement (TFIR), and I anticipate that TFIR's recommendations concerning the numerous technical details in the proposal will soon be available for the Academic Council's consideration. Because this item came to us only very recently, it was not possible for TFIR to evaluate those details prior to UCFW's discussion of this item at its June meeting.

In addition to requesting TFIR's views, I have asked Human Resources and Benefits Executive Director for Policy and Program Design, Randy Scott, to approve the distribution of the Regents' confidential draft item to members of the Academic Council. That item is essential for either the UCFW statement or any statement coming from TFIR to be understood. I hope that it will be possible to circulate both TFIR's statement and the Regents' item before the Council's meeting next week.

I know you join me in conveying UCFW's strong support for taking actions that preserve the fully-funded status of UCRP, while also reiterating past Senate policy that employee contributions should not resume unless accompanied by salary increases sufficient to keep total remuneration from declining any further below comparison institutions. I look forward to discussing this item with the Council.

Thank you very much.

James A Chalfant

James A. Chalfant, Chair
UCFW

Encl.

cc: UCFW
Maria Bertero-Barcelo, Executive Director, Systemwide Academic Senate

UCFW Statement on Restart of UCRP Contributions

June 2008

It is truly extraordinary that UC has been able to maintain a fully funded defined benefit pension plan without contributions for the last seventeen years. However, contributions will eventually be needed because UCRP's liabilities increase each year as UC employees earn additional service credit. Each additional year of service credit earned by an employee increases the pension benefits that UCRP will be required to pay. The large surplus that was built up as a result of the strong performance of the stock market in the period 1982-2000 has slowly been eroded by the annual growth of liabilities, which were not offset by annual contributions.

In retrospect, it was a mistake to stop contributions entirely for the last seventeen years. Contributions may be reduced in the face of a funding surplus, and contributions need to be increased in the face of an unfunded liability, but the contribution level should be adjusted gradually from year to year. The recommendation by the UCRP actuary, Segal and Company, sets forth a good procedure to determine, each year, a recommended contribution amount. If this procedure had been in place in the past, contributions to UCRP would have been reduced to a very low level as the surplus grew, but would have been gradually increased as the surplus shrank. If that procedure had been followed, we would still have a comfortable surplus in the plan, and only relatively modest employer and employee contributions would be needed.

UCFW supports the proposed procedure for determining the recommended contribution, and urges The Regents to seek funding from the Legislature and the Governor for this purpose. In this regard, we note that the longer contributions are put off, the larger the amount that will have to be contributed. The opportunity for a very gradual restart has passed, and delaying contributions much longer means resuming them at or even above the normal cost of the plan. In addition, we note that approximately two-thirds of any employer contribution will be paid by sources other than state funds, such as the federal government and the clinical enterprises. Each year without contributions represents a year of additional pension benefit liability that these funding sources do not have to fund. Deferring the restart of contributions will therefore mean that UC and the state will continue to accrue a liability for the pension benefits of employees that could be funded by non-state sources, without collecting any contributions from those funding sources. UC can expect non-state funding sources to contribute funds to meet the obligation for service credit that accrues each year, but there is no guarantee that these funding sources will provide extra contributions to cover shortfalls from pension benefits earned in the past. Obtaining contributions now on behalf of all employees will thus help protect UC and the state from the risk of having to fund this liability. The Academic Senate is therefore strongly in favor of resuming contributions to UCRP, subject to the conditions outlined below.

It is important to remember that employee contributions to UCRP represent a reduction in an employee's total remuneration. UC remains seriously uncompetitive in total remuneration for both faculty and staff, and Senate policy remains that there be no reduction in UC's competitive position. The restart of employee contributions, if it were limited to redirecting the current 2%/4% of salary currently contributed to employee-owned DC plans to UCRP, would not result in a reduction in take-home pay, but it would result in a reduction in total remuneration, because the employee would no longer be accumulating assets in his or her DC plan account. Furthermore, if the employee contribution to UCRP were higher, as is anticipated to occur eventually, it would represent both a reduction in take-home pay and a reduction in total remuneration. Thus, in keeping with longstanding Senate policy, the Senate's support of an actual restart of employee contributions effective 7/1/09 is dependent on the following conditions:

1. To avoid further erosion in the competitiveness of cash compensation, employee salaries must increase by *at least* the increase in salaries in the appropriate market comparison group. For faculty, this means salaries must rise by approximately 4%, the anticipated increase in faculty salaries among the Comparison 8 institutions.

2. In addition, employee salaries must be increased by *at least* the amount of the required employee contribution, to avoid a reduction in UC's competitive position in total remuneration.

3. Significant increases in premiums paid to health insurers are anticipated in 2009. Either the employer share of those premiums needs to be raised to cover those increases, or employee salaries need to be raised to cover any increase in employee premiums, to avoid a reduction in UC's competitive position in total remuneration.

4. The Senate recognizes that employer contributions require that the University obtain additional funding. The Senate opposes resuming employee contributions before employer contributions have begun. Moreover, employee contributions shall never exceed the amount of the employer contribution.

   Furthermore, equal percentage contributions need to be made on behalf of all employees, since all employees are earning future pension benefits as an equal percentage of covered compensation, times years of service credit. The Senate recognizes that the relative contribution made by the employer and employee is, in some instances, the subject of collective bargaining; if a given union succeeds in negotiating a lower percentage employee contribution, UC must make up the difference with an additional employer contribution, so as not to place the burden on other employees.

5. Nonetheless, employee contributions shall never exceed 5% of UCRP covered compensation.

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June 24, 2008

Jim Chalfant, Chair
University Committee on Faculty Welfare
University of California

Dear Jim:

TFIR and UCFW had previously supported in principle the Segal Company's "Recommended New Funding Policy for UCRP," which is intended for discussion at the July Regents meeting, subject to the caveats in your letter of behalf of UCFW to Senate Chair Michael Brown.

Since the details of the proposal became available only a few days before UCFW's last meeting on June 13, TFIR met on June 24 to examine the details, including the amortization periods for surpluses and deficits, the layering structure in which different sources of surplus/deficit would be tracked and amortized separately, the asset smoothing method, and the choice of level dollar versus level percent of pay amortization. TFIR agreed unanimously that the choices recommended by Segal on each of these issues are appropriate. Thus TFIR endorses the proposal, subject to the caveats in UCFW's letter.

If the new policy were adopted, it would have the following consequences:

- The small current surplus would be amortized over a period of three to seven years (the exact period is still to be determined), resulting in a recommendation for resumption of contributions effective 7/1/09 at a level below normal cost, and ramping up to normal cost over time. TFIR would be comfortable with any choice of amortization period for the initial surplus within the three-to-seven year range. The choice of three years would result in the lowest recommended contribution level as of 7/1/09.
- Future deficits would be amortized as a level dollar amount over fifteen years. Future surpluses would be amortized as a level dollar amount over thirty years. As a consequence, recommended contributions would adjust gradually from year to year, rather than changing abruptly when the plan moved from surplus to deficit. Recommended contributions would be above normal cost while a deficit was being amortized, and below normal cost while a surplus was being amortized. Recommended contributions would cease entirely only if the plan became approximately 200% funded, so it is unlikely we will have another contribution holiday in the foreseeable future; however, if the plan were to return to a substantial surplus condition, the contributions would become relatively small.

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- The funding plan provides a recommended contribution level for each future year, based on the experience of the plan in the interim. It is important to stress that this would be the *recommended* level of contributions. Each year, The Regents would have to set the actual contribution level, taking into account the availability of funds, the impact of employee contributions on the competitiveness of UC's total remuneration package, and collective bargaining. Setting a recommended level will help UC press the case for state funding to the Governor and Legislature.

Sincerely,

Robert M. Anderson, Chair
Task Force on Investment and Retirement

ASSEMBLY HIGHER EDUCATION COMMITTEE
CHAIR – ASSEMBLYMEMBER ANTHONY PORTANTINO

Tuesday, June 24, 2008

Testimony by
James A. Chalfant
Professor of Agricultural and Resource Economics
University of California, Davis
And
Chair, University Committee on Faculty Welfare (UCFW)

- I thank Chairman Portantino, Vice Chair Horton, and committee members and staff for this opportunity to speak with you today.

- My name is Jim Chalfant and I am a faculty member at UC Davis. I chair the Academic Senate's system-wide Committee on Faculty Welfare (UCFW). Our committee monitors and advises on all aspects of the conditions of employment for faculty, including salaries and benefits. Members of UCFW and especially its two task forces (on health care and investments and retirement) are chosen for their expertise on these issues. My comments today are based on Academic Senate policy, reflecting the Senate's role in shared governance of the University.

- The Academic Senate prepared a very comprehensive policy statement in July 2007, as a response to SCR 52. That policy states our firm support for the Regents' continued management of UC's retirement benefits. SCR 52 pertained to UC's defined-benefit pension plan, UCRP, and ACA 5 refers to the broader set of University of California Retirement System (UCRS) retirement benefits.

- UCRP has been well managed by the Regents. The fund's investment policies have produced a truly remarkable and unmatched seventeen-year period of self-funding that has avoided the need for either employee or state contributions. UC's retirement benefits are a significant part of compensation for all UC employees and these benefits are vital for recruitment, retention, and a secure retirement for all who devote their careers to public higher education.

- The Senate supports giving employees a stronger advisory role in the maintenance of UCRS. We proposed last year that the UCRS Advisory Board be strengthened. We advocated amendments to the Higher Education Employee Relations Act (HEERA), to exempt the existing UCRS Advisory Board from the "direct dealing" provision.

  In July 2007, we wrote that "[i]f HEERA is amended, The Regents should establish procedures to ensure that the UCRS Board's recommendations must be considered by The Regents before The Regents enact any changes in UCRP." This remains our view, it should have happened by now, and we continue to believe that this is an appropriate avenue for employee input that preserves the fiduciary role of The Regents and achieves the goals expressed by advocates of both SCR 52 and ACA 5. A constitutional amendment to divest the Regents of their responsibility for the management of UCRS, conversely, would unravel a highly successful and well-funded pension system at a potentially great cost to the State of California and to UC employees.

- Three reasons have been given for changing the governance structure for UCRP:

  1. The performance of the UCRP portfolio.

  Over the ten-year period ending in 2006, returns for CalPERS and UCRP were essentially identical; both earned approximately 9% per year. If UCRP has a great year or a poor year, the defined pension benefit that faculty and staff earn does not change---it is a legal liability of The Regents and it has to be paid. But UCRP has performed well and there is no indication that changing its governance would improve its performance.

  2. Conflict of interest

  A strengthened UCRS Advisory Board monitoring every aspect of UCRP policy and management, including policy concerning conflict of interest, will protect the interests of UC employees and provide a vehicle for all employee groups to make their views known to the Regents, and it will ensure accountability.

3. The resumption of contributions to UCRP.

It is not surprising that employee groups want to have a vote over the resumption of employee contributions to UCRP. It is also not surprising that, since it was effective management that made the contribution holiday possible, employees might ask if management is now to blame for restarting contributions.

Contributions to UCRP are needed, but not because of the performance of the portfolio or its governance structure. Every year, all UC employees earn an additional pension benefit as they accumulate service credit. Contributions are needed to fund the additional benefits that are earned year by year, just as the state is making contributions to CalPERS and CalSTRS. It is not different governance structures that determine the need for contributions.

There is another difference between UCRP and CalPERS. If contributions were to resume, approximately two-thirds of the funding would be tied to salaries paid by grants and other outside sources. In the absence of contributions, UC is accumulating a legal liability for the pension benefit those employees accrue, but is not receiving any funding from those sources to cover that liability. If a motivation for ACA 5 is to delay the resumption of contributions, this policy seems short-sighted and harmful to all Californians.

For these reasons, it is the policy of the Academic Senate to support the resumption of contributions to UCRP, and it is also our policy that salaries must increase first by enough to offset these contributions and to begin to close the gap with respect to our competitors. Unless salaries are increased by more, the restart of contributions represents a reduction in total compensation, at a time when UC's salaries are far from competitive.

Changing the governance of UCRP might delay contributions that soon will be urgently needed, but it won't bring about the salary increases that are needed alongside them. It is here that this committee can best help UC employees.

- ACA 5 does not solve any of these problems, but it does introduce politics into the management of UCRP, and it does create a conflict of interest. Unlike CalPERS, employees and retirees would comprise a *majority* on the proposed Board. As members of UCRP, they could vote to increase benefits, without the approval of either The Regents or the Legislature, completely divorced from the discipline of raising the necessary revenue.

- ACA 5 also expands the scope of the proposed Board of Trustees beyond UCRP to UC's defined contribution plan, its 403(b) and 457 Retirement Savings plans, and even the retiree health, vision, and dental benefits. The Academic Senate has not taken a formal position on this aspect of the proposed amendment, but we have heard no reason for altering the governance of these benefits. In the case of the savings plans, employees already determine how their funds are invested. In the case of health benefits, UC would retain responsibility for these plans for active employees, yet retiree health benefits would be managed by a new Board; this has the potential to greatly increase the out-of-pocket premiums paid by retirees, since currently their health costs and premiums are pooled with those of active employees. The benefits from UC's bargaining power will be reduced for our retirees by ACA 5.

Conclusions

- The Academic Senate supports employee input into the decision-making process and a UCRS Advisory Board that has significant influence, including providing its views on every topic relating to UCRP that comes before the Regents.
- But the Senate strongly opposes any erosion of the Regents' role as fiduciaries for UCRS. Under the Regents' leadership, UC employees have enjoyed a significant benefit and a contribution holiday. Fiduciary control over retirement and benefits policy should remain with The Regents, operating under the framework that has served UC, its employees, and all of California well for many years. None of the issues cited by proponents of this amendment were brought about by any shortcomings in the Regents' management, and there are no problems that will be solved by replacing The Regents with the proposed Board of Trustees.

- The best thing the legislature can do for UC, its employees, and its retirees is to restore UC's budget so that all employee groups can look forward to both competitive compensation and a secure retirement. This takes money, not alternative forms of governance.
- Thank you very much.

Attachments

The University of California Retirement Plan (UCRP), Academic Council Statement on, memo to President Dynes from Academic Council (08/07)

http://www.universityofcalifornia.edu/senate/committees/council/ac.ucrp.0707.pdf

Total Remuneration and the 2007-2008 Budget: An Academic Council Analysis and Recommendation, memo to President Dynes (11/06)

http://www.universityofcalifornia.edu/senate/reports/ac.FacultySalaries.2007-08%20Budget11.06.pdf

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Chair of the Assembly and the Academic Council
Faculty Representative to the Board of Regents
University of California
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September 26, 2008

PRESIDENT MARK G. YUDOF
ASSOCIATE VICE PRESIDENT JUDITH BOYETTE

Re: RFP for Outsourcing UCRP Benefits Administration

Dear Mark and Judy:

At its September 24, 2008 meeting, the Academic Council considered a report from the University Committee on Faculty Welfare (UCFW) on the RFP for outsourcing UCRP benefits administration. The Academic Council voted unanimously to endorse UCFW's recommendations not to proceed with the current RFP process and to begin a new RFP process to update existing in-house technological infrastructure for UCRP.

In making these recommendations, Council would like to emphasize five principles that it endorsed in former Council Chair Brown's July 15, 2008 letter to Executive Vice President Lapp. These principles outline the terms under which outsourcing UC's benefits administration should be considered. They include justification, the quality of services provided, security of confidential information, costs, and control of benefit design. The Academic Council agrees with UCFW that outsourcing UCRP cannot be justified on the basis of these principles. Outsourcing would provide neither a significant improvement in the quality of services, nor a reduction in costs. Moreover, such a radical change as outsourcing UCRP administration may be viewed by some UCRP members as a first step toward reducing and diminishing the University's health, welfare, and retirement benefits, particularly in the context of the resumption of contributions to UCRP and recent struggles over its governance (i.e., ACA 5). Such a perception, whether accurate or not, would inevitably undercut the University's ability to recruit and retain faculty at this time when UC salaries are not competitive. In addition, the Academic Council expressed grave concerns regarding outsourcing under the current climate of instability and corporate buy-outs.

Process

As the Senate committee most closely involved with issues involving the UC Retirement System, UCFW and its ad hoc subcommittee participated in several steps of the outsourcing initiative, which included reviewing a draft of the RFP in March, and attending the bidders' conference in April and vendor presentations in August. At its July meeting, UCFW heard a presentation by UCOP/Deloitte on the results of the UC Pension Administration Review Team self-assessment. The subcommittee's analysis of the information garnered throughout this process, along with UCFW's recommendation regarding UCRP administration, were conveyed to the Academic Council for consideration at its September 24 meeting. UCFW's report to the Academic Council notes that the purpose of the RFP process was described as solely an information-gathering exercise and that UCFW approached it in this spirit. In making its recommendations, UCFW also relied on the principles noted above. Since the RFP was first proposed, Council has emphasized that the current level of service provided to UCRP members and member satisfaction are very high, and that a decision to outsource would need to be explicitly justified by lower costs or improved quality.

UCFW's Assessment
The main points of UCFW's report to Council are as follows:

1. Throughout the process, no singular advantage for outsourcing UCRP administration has been demonstrated. At no time during the process was there any assertion that UCRP does not offer excellent service. The information gathered during the process, including the vendor presentations, revealed no evidence that outsourcing would likely decrease the cost of UCRP administration or increase customer service above that provided by an in-house solution of improved UCRP IT infrastructure. UCRP's current IT capabilities are sustainable for 2-3 years, providing ample time to complete an upgrade.

2. While vendors currently exceed the University's capability to monitor performance by quantitative measures such as first contact resolution and call center wait time, this monitoring technology would be available to UC in a "co-sourcing solution" - acquiring improved technology to support the existing in-house UCRP administration. It is not at all certain that UC expertise and culture can be successfully transferred to a vendor, and the price in our members' satisfaction would be very high if the transfer were not completely successful. Furthermore, it is likely that a number of current UCRS employees would depart in the face of the imminent disappearance of their jobs rather than remain to assist with the transfer.

3. After close review of vendor data, UCFW concluded that while outsourcing costs may look comparable to an enhanced in-house model now, those costs are very likely to increase as contractual details are worked out. In addition, since removing UCRP administration from UC will be essentially irreversible, the University will have little negotiation leverage over either costs or service quality in future contracts with either the first generation provider or a potential successor. Thus, over time it is likely that outsourcing will prove substantially more expensive than retaining UCRP administration in-house.

As noted above, Council strongly opposes proceeding with the outsourcing project. Instead, Council urges the University to investigate potential improvements to in-house technology through a new RFP with the goal of completing an upgrade in three years.

Please do not hesitate to contact me if you have any questions regarding Council's comments.

Sincerely,

Mary Croughan

Mary Croughan, Chair
Academic Council

Copy: Executive Vice President Katherine Lapp
Academic Council
Martha Winnacker, Academic Senate Executive Director

Encl. 2

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UNIVERSITY COMMITTEE ON FACULTY WELFARE (UCFW)
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September 14, 2008

MARY CROUGHAN, CHAIR
ACADEMIC SENATE

RE: Proposed UCRP Administrative Outsourcing

Time line of the UCRP Outsourcing Undertaking

Dec 6, 2007:	TFIR first informed of coming outsourcing RFP
March, 2008:	UCFW and UCPB reviewed a draft of the RFP
Apr 30:	Bidders Conference
Jul 17/18:	UCOP/Deloitte Presentation of Vendor Bidding Results
Aug 18/19	Presentation of UC PAR Self-Assessment and Vendor Presentations
Sep 9- (?):	Vendor Site Visits

<u>Vendor Presentations: General Comments</u>

We began the two-day session with a presentation of the Self-Assessment prepared by the UC Pension Administration Review (PAR) Team. While anecdotal evidence suggests a high degree of satisfaction with customer service provided by UCOP, qualitative assessments in this presentation indicated that currently the UC administration of UCRP is somewhat weaker than the industry standard in being able to carry out systematic measurement of customer service quality according to industry standards and that some calculations (e.g. disability eligibility and benefits) are not done in a timely fashion. It is generally agreed that the UCOP information-technology infrastructure, although likely adequate for the next 2-3 years, will need updating in the near future. Comparison of cost, on a per member basis, did not vary significantly between vendors or between vendors as given in their proposals and UC (as based on our actual costs). Costs for an "enhanced" UC administrative system were also within this range.

With regard to the outside vendors, there were originally three models in the RFP. Model 2, where the responses were concentrated, involves outsourcing everything and transferring all electronic records, with UC retaining all non-electronic records. Model 1 adds the handling of archival, non-electronic records to vendor responsibilities; UCOP/Deloitte felt the vendors had substantially underestimated costs for this model, and there is agreement that it is both cheaper and equally effective for UC to maintain these older records, providing specific information to a vendor as needed. We support the removal of Model 1 from consideration. Model 3 retains the customer service function within UC, with the vendor responsible for maintaining the database and supplying the information technology. There is no interest in Model 3 on the part of vendors. The remainder of this report concerns Model 2.

We approached the vendor presentations with the view that although we had serious concerns about outsourcing UCRP administration, we needed listen to the presentations with an open mind and gather further information about the implications of UCRP outsourcing. Throughout the presentations we looked for an answer to the question "What problem does outsourcing solve?". We did not receive a compelling answer to this question from any vendor or from UCOP/Deloitte.

Based on what we saw and heard, our concerns remain and have become somewhat more concentrated on particular aspects of outsourcing. The privatization that the outsourcing model would represent does not reduce costs and does not substantially improve members' experience with UCRP. Any minor improvements that could be identified (for instance, the ability to process rollovers from outside plans) could be implemented in-house with the co-sourcing model we are advocating. This model would retain the data-stewardship and customer-service functions within UC, but would make use of a vendor's software and would be equivalent to the Service Center model outlined in the Roles Report. One of the vendors expressed considerable interest in this model, and another potential bidder had indicated interest in this model, but declined to submit a bid because this model was not included in the RFP. We see this approach as one that reflects the Senate's principles. It would be broadly competitive with external vendors in terms of cost, possibly superior in terms of customer service, and would avoid the many serious risks from outsourcing.

Since it is our legacy IT framework, not our customer service, that represents some of the impetus for change, we are very much in favor of abandoning this RFP and pursuing a co-sourcing model, in which the vendor supplies to us the technology/software, necessary for us to manage the administration of UCRP. This view was reinforced by the UCOP/Deloitte presentations concerning what we've previously referred to, in our requests for such information, as the "enhanced status quo" model, in which UC would invest more in the "in-sourced" model we now have, focusing in particular on the IT side. We learned from our discussions with UCOP that our technology gap extends to additional technology to monitor customer service quality, and saw merit in such an investment.

Academic Council Principles

In analyzing the specific features and costs presented by the vendors, we determined the extent to which these met the Principles articulated by the Academic Council (excerpted in bold below; also enclosed) in former Academic Senate Chair Michael Brown's July 15th letter to Executive Vice President Katie Lapp.

This concern has led Council to adopt the following principles, which it respectfully requests the Administration use as guidelines in deciding whether to outsource benefits administration:

- **Justification: Based on information we have received to date, outsourcing benefits seems unjustified on the basis of either efficiency or effectiveness; outsourcing of UC benefits administration should be explicitly justified on the basis of costs, efficiency, and/or effectiveness.**

It is clear to us that the outsourced alternative will not be less costly than our current system or an "enhanced status quo". Even if outsourcing proceeded under the current RFP, UC would continue to have is own HR expenses (estimated at $5.5M, lower than the current estimated $18.9M spent in this area) for benefits counseling, coordination with the new vendor, management oversight, etc. The tentative pricing that we saw from the interviewed vendors made the overall costs similar to or higher than current costs – and those vendor estimates were without detailed contracting which easily could increase the vendor contract price.

Both Deloitte and UCOP participants indicated their view that the current UCOP technology is sustainable for 2-3 years. A justification cited for concern beyond that time-period is the possibility that UC might want to adopt different benefits for different groups, or perhaps a "hybrid" (reduced DB benefit + DC plan) for new hires. The current IT infrastructure could not accommodate that. Nothing about poor customer service quality from UC HR&B was involved in any justification, beyond discussions of capabilities such as the automated monitoring of the percentage of first-calls that are answered. The outside vendors have better capabilities for monitoring quality control; we don't perceive that we have a quality control problem, but we also do not oppose adding such a capability.

Peak load is an issue for UCOP, but expansion of our customer service can be done in increments of one more person and one more phone line. The economies of scale outside vendors bring involve adding customer service reps from other clients to a dedicated UC team during peak times such as Open Enrollment. Even with the vendor who emphasized cross-training with other teams, so that added reps would not be completely unfamiliar with UC, such individuals would not be fully dedicated to UC most of the year.

We see much potential in a "co-sourcing" model, or an enhanced "in-sourced solution" that involves purchasing just a "systems solution" outside (i.e., we pay the outside vendor to help us take their better IT solution and apply it to our setting, retaining our customer service and other functions in-house, albeit with IT and training costs). One firm that elected not to bid was at one point interested in offering only this service, and this is descriptive of what CalPERS is currently investigating, having apparently found no external vendor to be a good alternative. One firm in the presentations mentioned other clients who have taken this approach. We think that waiting to make a decision is prudent because it allows us to see what CalPERS develops, and to consider issuing a new RFP focused solely on technology.

We also note that perhaps we are not looking at the right part of the technology problem. A theme in the interviews is that the vendor would have to accommodate numerous different UC payroll systems. UCOP's difficulties in responding to the *Chronicle* during Comp-gate were largely due to not having a modern payroll system. It may be that retooling the business side of UC should be focused there instead of or in addition to UCRP administration. Better, more coordinated UC IT capabilities might serve a number of problems related to reporting within and without the University, audit and compliance, etc., and might facilitate HR management as well.

- **Quality of services provided: Current quality provided to employees is very high and there should be no diminution of that quality.**

There would need to be a substantial transfer of expertise and information to the third-party vendor. Even then, each vendor being considered is geographically removed from California, so the familiarity with such details as "where is Santa Rosa?" will surely be lacking. A call concerning a health-care problem in a particular region in California will make less sense to customer service reps in another state. As one UCOP administrator noted, "all health-care problems are local".

All vendors seemed eager to "learn UC's culture", from where our retirees live and seek health care to how Californians are likely to feel about diversity or same-sex marriage. In sales mode, they are of course going to assure us that their representatives would receive training pertaining to the diversity and culture of UC. We don't need to teach UC people this culture and the necessity for this training of vendor employees adds to the risk inherent in outsourcing.

Most of the vendors' statements in regard to customer service related to quality-control monitoring or else consisted of "tell us what you want and we can do that". Furthermore, we perceive that external vendors make a profit by encouraging members to use "self service", web-based solutions as much as possible. Some of our retirees may not be happy with that.

UC HR&B administrators had some clear discomfort about features of our current in-house service. HR&B retirement has little ability to monitor the quality of responses to employees, poor ability to track queries, etc. While HR&B perceives that there is great overall satisfaction with their services, they are concerned that their capabilities are stretched, and do not lend themselves to quality assurance monitoring and control. There inevitably would be some costs involved to improve these features of our current "in-sourced" model. We recommend that such capabilities be considered as part of the new RFP we propose.

- **Security of confidential information: Providing employee information to a third party could increase the risk of security breaches and unauthorized disclosure of confidential information; there should not be any increased risks to security or confidentiality of personal information associated with the possible outsourcing of benefits administration.**

We do not see specific cause for concern, and the security of each site should be a focus of a site visit, but discomfort on the part of UCRP members in this regard will remain a reason to keep things in-house, and that is especially pertinent if we do not see an offsetting benefit.

- **Costs: Benefit services are funded out of the plan itself; there should be no cost increases associated with outsourcing such services.**

We think increased costs are inevitable. It seems to be the nature of the business that the current proposed fee structure is based on a plain-vanilla outsourcing model, and each time we ask for their framework to be tailored to meet a new UC need, a new fee must be negotiated.

Moreover, this step is irreversible. We anticipate that, in five years, it would be essentially impossible to bring things back inside UCOP. Our choice at that point would be to remain with the first-generation external vendor or switch to a second. Given that vendors know that such a switch would be costly, our bargaining power would be rather constrained as we negotiate with our first-generation vendor, even if we are happy with service quality. So, we would have to anticipate costs rising relative to the current bids that get them in the door.

- **Benefits design: Outsourcing should in no way affect UC's role in the design of benefits plans.**

We are satisfied here, though we also see the potential for the cost of departing from what is easiest for the vendor to implement becoming a factor in any future discussions of our menu of benefits. UC would not transfer the decision-making to the vendor, but what is cheapest for the vendor to implement would surely affect UC's incentives.

<u>Summary and Recommendation</u>

It is important to recall that the purpose of the exercise of formulating the RFP to outsource UCRP administration and analyzing the responses to it has been "to learn what's out there", and that there was not to be a pre-determined outcome. We have indeed learned a lot, and it has shaped our thinking. The vendors acknowledge that UC has done an excellent job with UCRP administration, particularly in customer service, and they demonstrated that they can do what we want, rather than showing us that they already do better. Thus, there seems to be wide agreement among the UCOP and Deloitte participants that there will not be significant cost reductions; that our current capabilities are sustainable for 2-3 years; that an enhanced UCOP solution is feasible; and that if we were to announce a transition to an external vendor, there would be a chaotic situation in which the employees needed to transfer tremendous amounts of information to an external vendor would also know that they are about to lose their jobs, and presumably would not wait around until the vendor's "go live" date to look for another job.

Our core concerns with the outsourcing of UCRP can be summarized as follows:

1. ***No cogent justification for outsourcing UCRP administration has been given by UCOP or Deloitte at any time during this process.***

2. ***Transferring UC expertise and culture to a vendor is fraught with uncertainty of success, with a large price to pay in terms of our members' satisfaction if it is not completely successful.***

3. ***While outsourcing costs may look comparable (to an in-house model), we now think it quite likely that outsourcing will prove substantially more expensive over time.***

<u>We recommend that the Senate advocates strongly and vigorously against any of the three models in the current RFP.</u> Instead, the Senate should recommend a new RFP that seeks only improved in-house technology. This is the model that CalPERS is following. We may find that a gradual increase in our reliance on the private sector is worthwhile over time, but in the current environment, there is not enough offered to make it worth the risk and the costs of complete outsourcing. Our proposal takes into account not only our excellent customer service but the irreversibility and substantial cost associated with a radical, wholesale abandonment of our current capabilities.

Sincerely yours,

Helen L Henry

Helen Henry, UCFW Chair

Encl.

Copy: UCFW
Martha Winnacker, Executive Director, Academic Senate

Michael T. Brown
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Chair of the Assembly and the Academic Council
Faculty Representative to the Board of Regents
University of California
1111 Franklin Street, 12th Floor
Oakland, California 94607-5200

July 15, 2008

KATHERINE N. LAPP
EXECUTIVE VICE PRESIDENT

Re: Outsourcing of Benefits Administration

Dear Katie:

At its June meeting, Academic Council requested that I convey Council's concerns related to the current consideration of outsourcing the University's benefits administration, including the Request for Proposals (RFP). At the start, let me emphasize Council's appreciation for consulting with us. We also appreciate having a role in vetting the RFP and evaluating the responses to it over the next few months, as well as your willingness to schedule the RFP process to permit the Senate's Committee on Faculty Welfare (UCFW) to present a recommendation to Council in time to convey recommendations to the Administration before a final decision is made.

Notwithstanding, Council is concerned that outsourcing may adversely affect benefits administration, an area in which the Office of the President is perceived as offering superb service. This concern has led Council to adopt the following principles, which it respectfully requests the Administration use as guidelines in deciding whether to outsource benefits administration:

- Justification: Based on information we have received to date, outsourcing benefits seems unjustified on the basis of either efficiency or effectiveness; outsourcing of UC benefits administration should be explicitly justified on the basis of costs, efficiency, and/or effectiveness.
- Quality of services provided: Current quality provided to employees is very high and there should be no diminution of that quality.
- Security of confidential information: Providing employee information to a third party could increase the risk of security breaches and unauthorized disclosure of confidential information; there should not be any increased risks to security or confidentiality of personal information associated with the possible outsourcing of benefits administration.
- Costs: Benefit services are funded out of the plan itself; there should be no cost increases associated with outsourcing such services.
- Benefits design: Outsourcing should in no way affect UC's role in the design of benefits plans.

I am happy to discuss these principles with you, at your convenience.

Thank you for considering this advice.

Sincerely,

Michael

Michael T. Brown, Chair
Academic Council

Copy: President Mark G. Yudof
Provost Wyatt R. Hume
Academic Council
Martha Winnacker, Senate Director

Pension Primer Glossary

AAL – Accrued Actuarial Liability: The amount of money needed now to meet the portion of a pension plan's future obligations that have been accrued to date, as determined by special actuarial procedures that incorporate plan member life expectancies, current incomes , anticipated future salary increases, and service credit.

Actuary/Actuarial: A professional with training in mathematics and statistics who focuses on annuity/pension premiums, reserves, and dividends; specialized statistics focusing on life expectancy.

Age factors: An increasing percentage by which older plan participants get a greater portion of their active employee salary paid to them in retirement.

For UCRP: Current age factors begin at 1.1% for those who retire at age 50 and increase by .14% per year, capping at 2.5% for those who retire at age 60 or later. This figure is multiplied by years of service to generate the percentage of HAPC a pensioner can expect in post-retirement income. (Note: safety personnel have different age factors.)

Amortize: To pay off an obligation over time.

Arbitrage: To buy and sell assets in different markets at nearly simultaneous times in order to take advantage of price discrepancies between the markets.

Assumed Rate of Return: An actuarial calculation of anticipated future investment returns.

For UCRP: the assumed rate of return is 7.5%; this is based on the long-term historical returns in varying assets classes, and the allocation of the UCRP portfolio among those asset classes.

AVA – Actuarial Value of Assets: The value of assets in a pension plan, as determined by smoothing volatile investment returns over a period of years.

For UCRP: AVA is amortized over five years. In a given year, if the return on assets is X%, then the difference between the actual return and the assumed return is X – 7.5%; (X – 7.5%)/5 is incorporated into AVA in each of the following five years.

Covered Compensation: The portion of an employee's pay that is counted in determining UCRP HAPC. Summer salary, staff overtime, external consulting fees, and the Y and Z portions of Health Sciences faculty salary, for example, are not covered compensation.

DB plan – Defined Benefit plan: A plan in which the benefits are determined by a formula based on age at retirement, years of service, and HAPC. Most defined benefit plan benefits are paid out as monthly retirement income over the lifetime of the retiree, and/or the joint lifetime of a retiree and his/her spouse/domestic partner; DB plan benefits do not depend on investment performance.

In UCRP: Retirees may take a lump sum cashout, the actuarial equivalent of the monthly retirement income, as a single cash payment in lieu of monthly retirement income (taking this option also forecloses retiree health benefits).

DC plan – Defined Contribution plan: A plan in which the number and size of payouts are determined by the total value of assets accrued by the individual. Poor investment performance will lower the amount of money available to be drawn out. Once the fund is empty, no more support from the plan can be realized, regardless of how much longer the participant may live.

GASB – Governmental Accounting Standards Board: The agency which sets accounting rules for government agencies, including UC.

HAPC – Highest Average Plan Contribution: In UCRP, the average of a participant's 36 consecutive months of highest covered compensation is used to determine the monthly payout after retirement. A participant's specific monthly payout is calculated by multiplying the (average of 36 highest consecutive months of covered compensation at the full-time rate) by [(age factor) times (years of service)]. (See sample calculation below.)

MVA – Market Value of Assets: The cash value of a plan's investments as determined by the current cash value of the stocks and bonds which make up the investment portfolio.

Normal Cost: The annual amount of money that needs to be put into a plan so that it can meet its future obligations and maintain its current funded status.

For UCRP: The normal cost is currently equal to 17.5% of covered compensation.

OMB Circular A-21 – Office of Management and Budget: The document which contains the rules by which universities recover costs, including pension costs, from federal grants and contracts.

POB – Pension Obligation Bond: A bond that would be issued by the plan fiduciaries and whose proceeds would be used to make employer contributions to a pension plan. The bond would be repaid from future operating budgets. Typically, POBs carry an interest rate lower than the Assumed Rate of Return.

For UCRP: The Regents are the plan fiduciaries and would issue the bonds.

Social Security coordination: Neither UCRP nor Social Security alone is designed to replace 100% of a worker's income after retirement. Social Security replaces a large fraction of final income for lower-income workers, but a much smaller fraction of final income for higher-income workers. In a pension plan that is coordinated with Social Security, the provisions of Social Security are taken into account when determining the benefits paid by the pension plan. Coordination can be used to provide roughly the same replacement of final income across different income groups.

UAAL – Unfunded Accrued Actuarial Liability: The portion of the future obligations accrued to date that have not yet been paid for. This is determined separately for AVA and MVA:

By MVA, UAAL is AAL – MVA, provided AAL is greater than MVA.

By AVA, UAAL is AAL – AVA, provided AAL is greater than AVA

Vested Rights: Benefits that cannot legally be removed or changed.

Years of Service: The number of years a full-time participant has been in a plan. (Employees who work less than 100% time in a given year earn service credit in proportion to the percent of time worked.)

Sample calculation: If I retire at 50 (age factor 1.1) with 15 years of service, this yields a replacement income of 16.5% of my HAPC. Thus, if my HAPC is $50K, I multiply the monthly amount ($4166) by 16.5% to arrive at $687 monthly income from UCRP. If I retire at age 60 with 15 years of service and still have an HAPC of $50K, my monthly pension income raises to 37.5%, or $1562, due to an age factor of 2.5% with the same number of years of service.[1]

[1] There are other factors to determining actual UCRP income, but for this simplified exercise, the additional factors are omitted.

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

Daniel L. Simmons[*]
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;[1] (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.

[*] 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.**

[1] 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[2] (until April 15, 2010) is a defined contribution plan. Although may 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.[3] 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.[4] In addition, once vested, *accrued* benefits promised under a defined benefit plan become a contractual property right of the employee and cannot be reduced.[5]

[22] 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.
[3] 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.
[4] 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.
[5] 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.[6] 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 0.0001for each month retirement is delayed, topping out at age 60 as follows:

Age	Factor
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

[6] 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. [7]

Basic Retirement Benefits for employees coordinated with Social Security are calculated as:

HAPC less $133 per month x Service Credit x 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.[8] Electing a lump-sum payout means that the retiree is not eligible for retiree health care.[9]

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.

[7] For employees integrated with social security HAPC is reduced by $133 per month.

[8] 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.

[9] 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.[10]

[10] 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 meets 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 under funded, it losses 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[11] 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,[12] 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.[13] 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

[11] 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..

[12] The surplus as of the effective date of the policy was to be amortized over a period of three to five years.

[13] 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.[14] As a consequence, the Regents deferred employer and employee contributions to April 15, 2010, which remains the scheduled start date for contributions.[15]

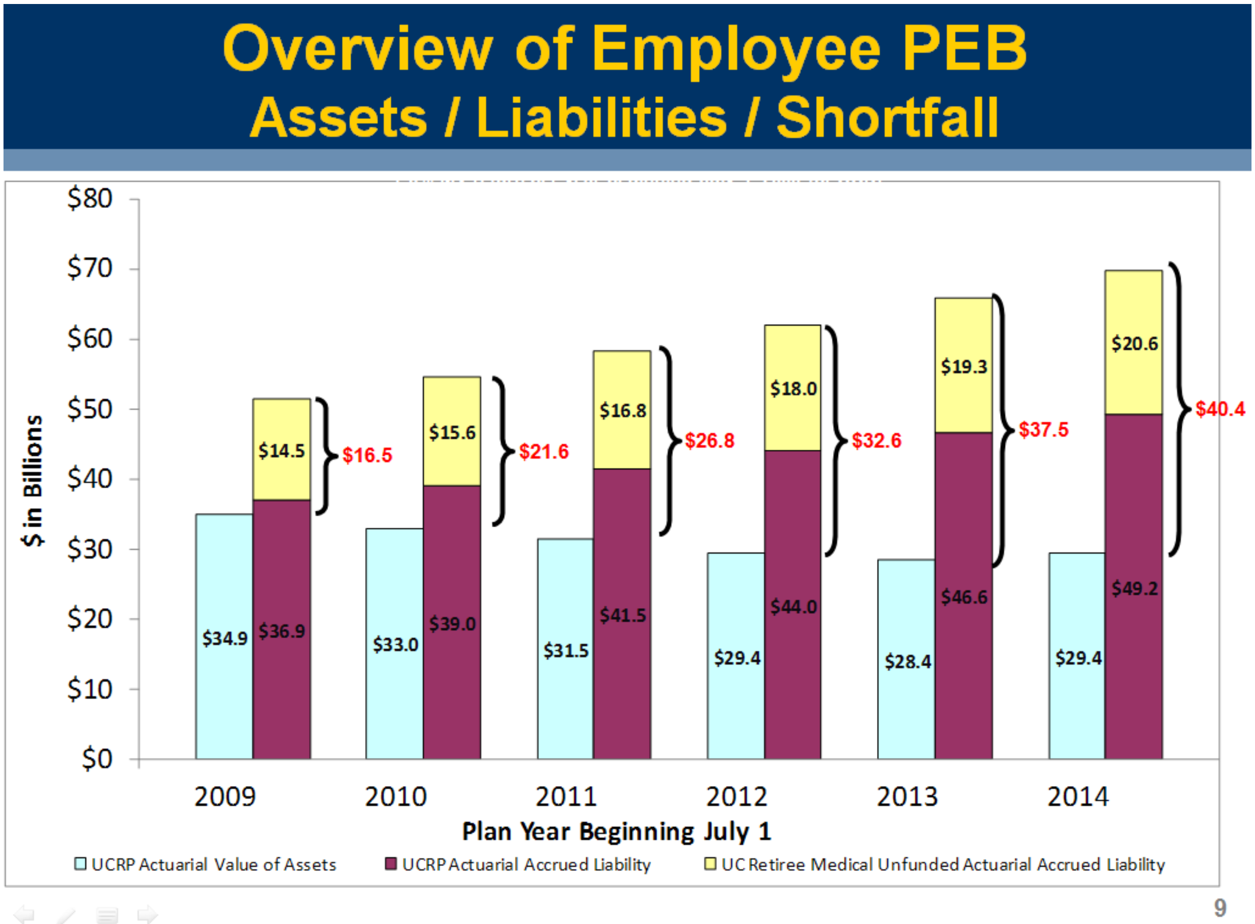
The proposed budget for 2010-2011, adopted by the Regents in November 2009, includes $108.9 million to continue a 4 percent employer contribution to UCRP. The Governor's January 2010 budget proposal does not contain state funds for this purpose. Thus, UC's contribution will have to be made from UC general 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.[16]

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.[17] 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:

[14] The legislature inserted language into the Education Code indicating an intent not to provide incremental funding to UC to support UCRP contributions.
[15] 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.
[16] 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.
[17] UC Regents, Committee on Finance, Item F 5, November 18, 2009.



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.[18]

[18] 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.[19] 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

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.

[19] 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.

interest rates lower than the assumed rate applied to UCRP assets.[20] 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 possibilty 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.

[20] 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.[21] 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.[22] For

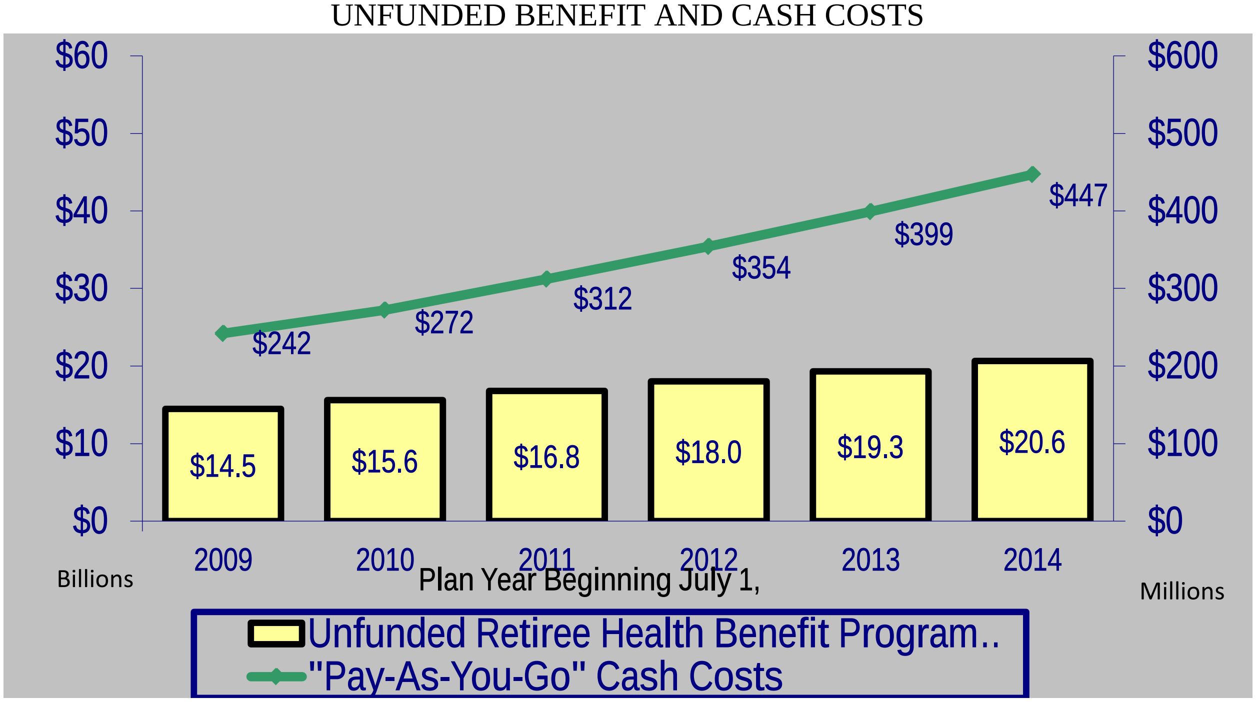
[21] Health benefits are not available to former employees who have taken a lump sum payment from UCRP.
[22] UC has established a retiree health trust but to date the trust has only a small amount of assets representing less than one percent of the retiree health AAL.

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:

RETIREE HEALTH BENEFITG PROGRAM
UNFUNDED BENEFIT AND CASH COSTS



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.[23]

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.

[23] 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.