UCRS Advisory Board

Prof. Shane N White
Chair, UC Retirement System Advisory Board
June 20, 2014

President Janet Napolitano
Office of the President
University of California

Dear President Napolitano:

The University of California Retirement System Advisory Board is a representative body, established by the standing orders of the Regents, focused on the University of California Retirement System, including the University of California Retirement Plan (UCRP) and voluntary and compulsory defined contribution plans [403(b), 457(b), DC plan, CAP]. The Board is constituted of: your nominees, senior administrators; the Chief Investment Officer; the Chair of the Council of UC Emeriti Associations; the Chair of the Council of UC Retiree Associations; non-Senate employee-elected representatives; and Academic Senate representatives. The Board does not issue recommendations, but may communicate information directly to you.

The Board has focused significant attention on the condition of UCRP fund and is pleased to note that significant progress has been made over the last five years, a period of time marked by tremendous fiscal uncertainty. From a zero contribution, the contribution level is now reaching 22%. We continue to closely monitor funding and are pleased to see that there seems to be a confluence of direction and alignment. As always, the Board recognizes the inherent tensions and trades-off.

The Board wishes to bring the following matters to your attention. The UCRP trust fund is in deficit by approximately $11.7 billion, approximately 24% of required funding on an actuarial basis, or 21% on market value. At current contribution levels, the dollar deficit is projected to grow substantially in the coming decade. The University is currently in debt to UCRP by this amount, in effect, and borrowing at 7.5% to finance that debt. This liability is inescapable, and it grows at 7.5% per year, due to foregone earnings, and more when contributions lag. Closing UCRP today would not solve or decrease the deficit; the liability would still exist. This unfunded liability means that UCRP is currently forgoing annual earnings of $900 million, more as the liability continues to grow and compound. This represents an enormous long-term drain on University resources. The deficit was largely created by a 20-year contribution holiday. Although current Regental Funding Policy intends the full Annual Required Contribution (ARC) to be made to UCRP every year (*see link below*), this has not yet occurred.
(http://regents.universityofcalifornia.edu/governance/policies/5601.html)

Actuarial projections presented to the Board show that two additional years of contributions at ARC levels, now, would dramatically reduce UCRP's unfunded liability (*see the attachment to agenda item E in the following link*). (http://ucnet.universityofcalifornia.edu/compensation-and-benefits/retirement-benefits/ucrsab/docs/20140228-agenda-items.pdf). The Board notes that borrowing to undertake these contributions does not represent an increase in University indebtedness, but rearranges it from a deficit in UCRP to an obligation to the lending source (which may be internal to the University). Avoiding delay in contributions significantly reduces future UCRP deficits as contributions earn compound returns, and reduces future required contributions from UC general funds.

Following consideration of the 2010 Post-Employment Benefits Task Force Report, the Regents authorized a plan to return to full funding, aiming to reach a modified ARC by 2011, and full ARC by 2018, and full funding in 30 years (*see link below*). (http://regents.universityofcalifornia.edu/minutes/2010/joint12.pdf). That plan was designed to balance the competing needs of current campus operations and long-term fiscal rectitude. That plan included 2 components. The first was a ramp up in employee contributions to 8% of payroll and a ramp up in employer contributions to 18% of payroll. The second component authorized use of internal or external borrowing at the discretion of the President. To date, modified ARC has been contributed only in 2 out of 4 years since the plan was approved; those when internal borrowing from the Short Term Investment Pool (STIP) was utilized. The unfunded liability has continued to grow and compound.

Raising contribution levels to meet modified and full ARC on the established Regental timeline may impact the University in the following dimensions:

(1) Increases in general fund contributions are, in effect, matched two-for-one by ancillary funding contributions, because contributions to UCRP come approximately 34% from University general funds and 66% from ancillary funding (Medical Centers, Housing and Food Services, Contracts and Grants) at the same proportions of payroll. UCRP claims on general funds are thereby reduced.

(2) Reduction in the unfunded liability can improve the University's credit rating, to increase its debt capacity, and to decrease the cost of borrowing for other purposes including capital projects.

(3) Delay in the ramp up will cause the dollar amount of the unfunded liability to grow considerably over coming decades (*see the attachment to agenda item E in the link below*). (http://ucnet.universityofcalifornia.edu/compensation-and-benefits/retirement-benefits/ucrsab/docs/20140228-agenda-items.pdf).This exposes the University to both substantial financial and political risk.

(4) The time value of contributions means that delay in returning to ARC, by foregoing the investment return on contributions, substantially increases the University's long-term operating costs for decades to come, diverting funds from supporting students and the core mission, to paying sustained high levels of employer contributions. The reason for this is that there are only two sources of funding for pensions: either contributions or the earnings on those contributions. Foregoing earnings now means contributing much more in the future.

The ramp-up in employee contributions has decreased employee total remuneration at a time when some employee groups already lagged their peer comparators. Moreover, the ramp-up in employer contributions has placed tremendous pressure on campus operating budgets at a time of diminished levels of state funding. These pressures may be even more acute in areas that are essentially self-funded, such as the hospitals or those funded by external contracts and grants. Proposals to borrow to fund UCRP have been made by the Academic Senate (*see link below*) (http://senate.universityofcalifornia.edu/reports/BJ2NB_UCRPFunding.pdf) and by the EVP for Business Operations; the latter proposal will be presented at the upcoming July Regents' meeting. These proposals seek to ensure the fiscal stability of UCRP and may provide relief for campus operating budgets.

Thank you for reviewing this material. This correspondence was circulated to Board Members prior to the Board's June 20, 2014 meeting and discussed at the meeting; it reflects the consensus view of the Members. I would be more than happy to discuss the contents of this letter with you, at your convenience.

Yours truly,

Shane N White, Chair of UCRSAB

Cc: **UCRS Advisory Board Members (listed below)**
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