The Regents of the University of California

COMMITTEE ON FINANCE
July 16, 2014

The Committee on Finance met on the above date at UCSF–Mission Bay Conference Center, San Francisco.

Members present: Regents Gould, Island, Kieffer, Lozano, Makarechian, Reiss, Ruiz, and Saifuddin; Ex officio members Napolitano and Varner; Advisory member Jacob; Staff Advisors Acker and Coyne

In attendance: Regents De La Peña, Engelhorn, Lansing, Sherman, Wachter, and Zettel, Regents-designate Davis, Gorman, and Oved, Faculty Representative Gilly, Interim Secretary and Chief of Staff Shaw, General Counsel Robinson, Chief Compliance and Audit Officer Vacca, Chief Investment Officer Bachher, Provost Dorr, Executive Vice President and Interim Chief Financial Officer Brostrom, Senior Vice Presidents Dooley and Stobo, Vice Presidents Allen-Diaz, Andriola, Brown, Budil, Duckett, Lenz, and Sakaki, Chancellors Block, Blumenthal, Dirks, Katehi, Khosla, Leland, Wilcox, and Yang, Interim Chancellors Gillman and Hawgood, and Recording Secretary Johns

The meeting convened at 11:55 a.m. with Committee Chair Ruiz presiding.

1. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

   Upon motion duly made and seconded, the minutes of the meeting of May 15, 2014 were approved.

2. **AUTHORIZATION FOR EXTERNAL FINANCING FOR UCPATH PROJECT**

   The President of the University recommended that she be authorized to approve and obtain external financing for the UCPath project in an amount of $220.5 million. The President shall require that:

   A. As long as the debt is outstanding, the Systemwide Assessment (excluding funds from tuition and State operating appropriations) attributed to the UCPath project shall be maintained in amounts sufficient to pay the debt service and to meet the related requirements of the authorized financing.

   B. The general credit of the Regents shall not be pledged.

   C. The President be authorized to execute all documents necessary in connection with the above.

[Background material was provided to Regents in advance of the meeting, and a copy is on file in the Office of the Secretary and Chief of Staff.]

Executive Vice President and Interim Chief Financial Officer Brostrom recalled that to date, the University had funded the UCPath project through the CapEquip program, a no-interest loan program run by the Office of the President with a maximum repayment period of seven years. The current item proposed that the UCPath project be shifted from short-term to long-term financing. Financing with a commercial paper program would last through four UCPath pilot deployment projects at the Office of the President, UC Santa Cruz, UC Merced, and UCLA. The administration would evaluate progress and, at a future meeting, present a proposal for amortization. The proposed action would provide a longer repayment period than is now available and additional structuring flexibility.

Regent Makarechian asked what kind of bond would be issued. Mr. Brostrom responded that if UC issued a bond, it would be a bond for general credit of the Regents. The repayment source would be a payroll assessment to every campus and the Office of the President.

Upon motion duly made and seconded, the Committee approved the President's recommendation and voted to present it to the Board.

3. **AUTHORIZATION TO FUND UNIVERSITY OF CALIFORNIA RETIREMENT PLAN MODIFIED ANNUAL REQUIRED CONTRIBUTION WITH CONTRIBUTION FROM SHORT TERM INVESTMENT POOL**

The President of the University recommended that the Regents amend the *Amendment of Authorization to Make Additional Contributions toward University of California Retirement Plan's Annual Required Contribution from One or More Multiple Sources*, as shown below.

Additions shown by underscoring; deletions shown by strikethrough

The President be delegated authority and discretion to make contributions to the University of California Retirement Plan (UCRP) to supplement scheduled employer and employee contributions beginning FY 2010-11. The amount and timing of the contributions will be guided by the goal of putting the Plan on a path toward fully funded status, with consideration of the projected budgetary impact to the University. The President may utilize borrowing from the Short Term Investment Pool (STIP), restructuring of University debt, and other internal or external sources to make these contributions to UCRP, ~~fund the gap between scheduled pension contribution from the University and employees, and the required funding amount described above,~~ as follows:

...

F. Transfer funds from STIP to UCRP in FY 2014-15 in an amount equal to the difference between the approved total employer and employee contribution to

UCRP and modified ARC for FY 2013-14. This transfer shall satisfy the requirements below and will not exceed a total of $700,000,000:

(1) The creation of an internal note receivable ("STIP Note") for the amount above, owned by STIP participants.

(2) The ability to set the repayment terms on the STIP Note, not to exceed a maximum of a 30-year amortization period.

(3) Adoption of a waiver to the STIP investment guideline's maximum of five and a half years on investments to accommodate the terms of this STIP Note.

(4) Assessment of all University fund sources making UCRP payments to include an additional amount for principal and interest payments on the STIP Note, divided proportionally based on covered compensation.

(5) For funding sources, such as federal contracts and grants, where interest payments for the STIP Note are not billable as direct program costs, campuses will be required to pay these charges using non-federal sources. These fund sources may also be excluded from the STIP loan repayment if they pre-pay their portion of the modified ARC assessment in FY 2014-15.

[Background material was provided to Regents in advance of the meeting, and a copy is on file in the Office of the Secretary and Chief of Staff.]

Executive Vice President and Interim Chief Financial Officer Brostrom explained that this action, an amendment of a prior December 2012 action, proposed borrowing from the Short Term Investment Pool (STIP) and transferring the funds to the UC Retirement Plan (UCRP). The reason for the action was to cap employer contributions at 14 percent while achieving a funded level around 95 percent for the UCRP. As of July 2013, UCRP was 76 percent funded on an actuarial basis. New actuarial estimates would be provided in November. Preliminary estimates project a strong return on investment, over 17 percent. As of July 1, 2014, the employer contribution had risen to 14 percent; the employee contribution had risen to eight percent. If the University continued on this trajectory, the UCRP would reach 91 percent funded status by 2042. The administration was proposing that UC borrow the Annual Required Contribution, or $700 million, from STIP into UCRP. This would bring the funded level from 91 percent to 95 percent by 2042 and enable UC to cap the employer contribution at 14 percent. The employer contribution had been a significant burden on campus and medical center operating budgets. Mr. Brostrom recalled that the University had taken similar action before, borrowing $2 billion, $1 billion from STIP and $1 billion from commercial paper. The previous year the STIP return had been 1.7 percent. The University projects a 7.5 percent return on the UCRP; the previous year the return had been 17 percent. The additional 15 percent went to support the UCRP. He expressed his preference for avoiding external pension obligation borrowing. This proposed action would essentially be the University borrowing from itself. Sufficient liquidity is an important concern for the University as well as for the rating agencies. The STIP holdings are currently $6.1 billion, enough to address any day-to-day or month-to-month needs UC might have, but the University is a $25 billion enterprise. The medical centers seek to have 180 days cash on hand. This matter needs to be considered on a regular basis. He concluded that the proposed action would shore up the UCRP.

Regent Makarechian expressed misgivings about borrowing to cover obligations owed by the State, and depleting UC assets. He asked about the reason for the STIP borrowing at this particular time and why UC, under this proposal, would not put even more money in the UCRP, where it would earn higher returns. Mr. Brostrom responded that the University was moving aggressively because in addition to money UC has transferred from STIP to UCRP, it has also moved funds to the Total Return Investment Pool (TRIP), and the campuses were seeking to move more funds to TRIP. This would be a further demand on STIP. The University could move more funds and would continue to consider doing so. There is constant discussion with rating agencies about how much liquidity UC needs. The reason for borrowing at this moment was to make it clear for the purposes of long-term campus planning that the employer contribution to UCRP would not rise above 14 percent.

Regent Makarechian observed that the 76 percent funded level of the UCRP was based on a seven percent return. The returns could improve, and the resumption of contributions was having a significant impact. The actuaries had calculated shortfalls based on an assumption of a seven percent return, when in fact the UCRP was earning much more. He again questioned transferring cash from UC's operating funds to the UCRP. Mr. Brostrom responded that the UCRP return had been high for one year, but low a few years previously. The University should use the 7.5 percent return assumption over the long term.

Regent Makarechian argued that the proposed action should be postponed; there was no urgent need for it at this point. He expressed concern about the effects of any cash shortfall. Mr. Brostrom responded that the rating agencies have made it clear that this action would not affect the University's external debt capacity. This would essentially be an internal loan. It would not affect borrowing for capital projects or deferred maintenance. The rating agencies take a positive view of this approach. The single reason for the downgrade of UC credit was the UCRP.

Regent Makarechian expressed disagreement with Mr. Brostrom. He stated that, according to the rating agencies, the UCRP was underfunded, although the agencies knew that UC had liquidity. The University was borrowing more rather than pursuing the State's obligation to the UCRP, and the rating agencies gave UC a negative outlook. Mr. Brostrom responded that this action would not reduce the imperative for the State to honor its obligation. The University is stating that a 14 percent contribution is the amount owed by the State. If UC did not take the proposed action, it would have to raise the contribution to 16 percent or higher, and the State would be obligated to pay more.

Through this measure, UC was reducing the amount to come out of campus operating budgets. Regent Makarechian expressed his view that a transfer from STIP was not appropriate at this time.

Regent Gould stated that he was comfortable with the proposed action, as were the rating agencies. He suggested that when the Board examines the University's long-term debt capacity, it might be helpful to have representatives of the rating agencies present, to explain their perspective. He recalled that there had been anxiety on the part of the medical centers and the campuses about the increase in the employer contribution; the fact that it can be limited to 14 percent would provide relief. This would not preclude the Regents from taking a hard look at future obligations and UC's future steps. While UCRP returns had been very positive in the current year, earlier returns had been less favorable, and the long-term return assumptions should not be adjusted.

Regent De La Peña expressed agreement with Regent Makarechian. He stressed the medical centers' need for liquidity, noting that UC might have to borrow money for their operations. This money could not be returned from the UCRP. Mr. Brostrom reiterated that STIP holdings were currently $6.1 billion, and added that UC had nearly $1 billion in outside lines of credit. He stated his view that the University has substantial liquidity both for daily operations and for rare, hard-to-predict events that have great impact, so-called "black swan" events.

Faculty Representative Jacob remarked that the Academic Senate had been following this issue for some time. The Academic Senate supported the resumption of contributions to the UCRP and it supported this proposed borrowing. Unfunded liability is a great political risk. If UC failed to meet the modified Annual Required Contribution, potential opportunity costs in the future could be significant.

Regent Reiss observed that limiting the employer contribution paid by the campuses to 14 percent would be very important to avoid cuts to campus programs. She asked for how long a period this limit was projected, and what assumptions it was based on. Mr. Brostrom responded that the assumptions were made by the Segal Company. The contribution would remain at 14 percent through 2026, then gradually be reduced so that by 2040 it would just cover the normal cost, about nine percent.

Regent Reiss asked if the reason for not investing more in the UCRP was due to a need for liquidity, and if UC would examine this question further. Mr. Brostrom responded that UC would examine its overall liquidity and assets. The administration might propose an additional borrowing in a year, especially if it enabled UC to reduce the employer contribution sooner. He recalled that this was a $1.3 billion expense that UC did not have five years earlier, with an enormous impact on the campuses and medical centers. He stated that anything the University can do to use its balance sheet to reduce operating costs is beneficial.

Regent Reiss observed that this action was not a statement that it was acceptable for the State to avoid its obligations to the UCRP; the University continues advocating in the strongest terms. This action would allow UC to generate more returns on investment and avoid cuts that would hurt the institution.

Regent Wachter stated that the proposed action was responsible. The STIP funds would provide better returns in the UCRP or the TRIP over the long term. The underfunding of the UCRP is calculated over long periods of time, and the returns of one year would not have a great impact on this calculation. The 76 percent funded level was to be taken seriously. Mr. Brostrom confirmed that the unfunded liability is measured over 30 years, but anticipated that there would be an impact on the liability in the current year due to the size of the current return and that five-year actuarial smoothing would mitigate the bad results of 2008, now that five years had passed.

Committee Chair Ruiz emphasized the need for caution in maintaining sustainable revenues to cover the University's expenses, given yearly changes in the market. Managing this situation effectively requires discipline on the part of the University. UC should also spend more time advocating for funding from the State.

Upon motion duly made and seconded, the Committee approved the President's recommendation and voted to present it to the Board.

4. **UPDATE ON THE UNIVERSITY'S 2014-15 BUDGET**

[Background material was provided to Regents in advance of the meeting, and a copy is on file in the Office of the Secretary and Chief of Staff.]

Vice President Lenz recalled that at the end of the State budget deliberations, the University achieved a $142.2 million or five percent increase which had been proposed in the Governor's January budget. There was also a so-called "positive trigger" which would have provided the University with $50 million in one-time funding for deferred maintenance and other one-time priorities, to be drawn from the surplus of the 2013-14 property tax. Unfortunately, the University had just been informed that day that this funding would not materialize. UC would benefit from one-time augmentations for the California Blueprint for Research to Advance Innovations in Neuroscience, for UC's labor research centers, and the Statewide Database project at UC Berkeley. UC would also benefit from about $15 million in Proposition 63 funding for Behavioral Health Centers of Excellence at UC Davis and UCLA. The budget also includes a request from the Governor and the Legislature for UC and the California State University (CSU) to develop a three-year plan for financial sustainability.

Outside the budget for UC, the State budget includes $50 million in one-time funding for the Governor's innovation awards, an initiative proposed in January involving UC, CSU, and the community colleges in order to increase graduation rates, reduce time to degree, and improve the transfer function. The State budget includes the first year of funding for the new Middle Class Scholarship program to provide financial assistance for UC and CSU students with family incomes of up to $150,000. The University estimated that its students would receive about $30 million in funding from this program in 2014-15.

Regent Gould requested that Regents receive information on the level of State support for students and the cost to students of a UC education in the context of the Middle Class Scholarship Program. Vice President Lenz stated he would provide this information.

Regent Lozano asked about resources the University is dedicating to student mental health. She requested a summary of UC financing for mental health services, the state of those services, and any gaps that might exist.

Committee Chair Ruiz asked about UC efforts regarding the $50 million in one-time funding for the Governor's innovation awards. President Napolitano responded that applications for these awards were not due until late December or early January 2015. The University was still awaiting guidance on how to proceed and was engaged in discussions with CSU and the community colleges on how to apply for this funding.

Committee Chair Ruiz stated his view that in the past year the University had managed to nudge legislators. These efforts should increase, both in Sacramento and with local legislators. The University should have the tools and resources to be able to communicate its needs very specifically. Mr. Lenz responded that the Regents and the UC community had done more than nudge. The State Assembly and Senate had supported funding over and above the $142.2 million increase the University finally secured, based on May Revision assumptions different from those of the Governor. The Governor maintained his assumptions, and this accounted for the outcome. Nevertheless, Mr. Lenz concluded that the University managed to move the Legislature in recognizing and funding a number of priorities for UC. This was a continuing effort.

Chairman Varner noted that the Regents would be having conversations with the Governor and legislative leaders and presenting specific, focused comments and requests.

The meeting adjourned at 12:40 p.m.

Attest:

Interim Secretary and Chief of Staff