The Regents of the University of California

FINANCE AND CAPITAL STRATEGIES COMMITTEE
May 23, 2018

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

Members present: Regents Anguiano, Lemus, Makarechian, Park, Sherman, and Zettel; Advisory members Anderson and Morimoto; Chancellors Blumenthal, Gillman, Hawgood, and May; Staff Advisor Valdry; Student Advisor Sands

In attendance: Assistant Secretary Lyall, Chief Compliance and Audit Officer Bustamante, Executive Vice President and Chief Financial Officer Brostrom, Executive Vice President and Chief Operating Officer Nava, Executive Vice President Stobo, Vice President Duckett, Deputy General Counsel Woodall, and Recording Secretary Johns

The meeting convened at 2:45 p.m. with Committee Chair Makarechian presiding.

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

Upon motion duly made and seconded, the minutes the meeting of March 14, 2018 were approved.

2. **ESTABLISHMENT OF A COMPENSATION AND PERSONNEL SUBCOMMITTEE**

Chair Kieffer recommended that the Finance and Capital Strategies Committee recommend that the Governance and Compensation Committee establish a Compensation and Personnel Subcommittee of the Finance and Capital Strategies Committee.

[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.]

Committee Chair Makarechian briefly introduced the item. He explained that this action required the approval of the Finance and Capital Strategies Committee because the proposed Compensation and Personnel Subcommittee would be a subcommittee of the Finance and Capital Strategies Committee. This matter would be further discussed later that day in the meeting of the Governance and Compensation Committee.

Upon motion duly made and seconded, the Committee approved the Chair's recommendation and voted to present it to the Governance and Compensation Committee.

3. **CONSENT AGENDA**

A. ***Approval of Preliminary Plans Funding, Triton Pavilion for Student Resources and Community Engagement, San Diego Campus***

The President of the University recommended that the 2017-18 Budget for Capital Improvements and the Capital Improvement Program be amended to include the following project:

San Diego: Triton Pavilion for Student Resources and Community Engagement – preliminary plans – $15.45 million, to be funded from campus funds ($12 million) and UC San Diego Extension reserves ($3.45 million).

B. ***Approval of External Financing Supported by State General Funds, Ridge Walk Academic Complex, San Diego Campus and Northern Regional Library Facility, Systemwide***

The President of the University recommended that:

(1) The President be authorized to obtain external financing not to exceed $80 million plus related interest expense and financing costs for the following projects included in the 2018-19 Budget for State Capital Improvements:

Campus	**Project**	**State General Funds Financed** ($000s)	**2018-19 State Phase**
San Diego	Ridge Walk Academic Complex	$50,000	Construction
Systemwide	Northern Regional Library Facility Phase 4 Expansion	$30,000	Construction Equipment
	TOTAL STATE FUNDS FINANCED	**$80,000**	

(2) The President shall require that:

a. Interest only, based on the amount drawn down, shall be paid on the outstanding balance during the construction period.

b. The primary source of repayment for the external financing of $80 million plus related interest expense and financing costs shall be from State General Fund appropriations, pursuant to the Education Code Section 92493 et seq. Should State General Fund appropriation funds not be available, the President shall have the authority to use any legally available funds to make debt service payments.

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

C. ***Adoption of Endowment Administration Cost Recovery Rate***

The President of the University recommended that the endowment administration cost recovery rate remain at 55 basis points (0.55 percent)[1] and apply to distributions from the General Endowment Pool (GEP) to be made after July 1, 2018, from the eligible assets invested in the GEP. The funds recovered shall be used to defray, in part, the cost of administering and carrying out the terms of endowments on the campuses and at the Office of the President.

D. ***Adoption of Expenditure Rate for the General Endowment Pool***

The President of the University recommended that the expenditure rate per unit of the General Endowment Pool (GEP) for expenditure in the 2018-19 fiscal year remain at 4.75 percent of a 60-month moving average of the market value of a unit invested in the GEP.

[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.]

Committee Chair Makarechian briefly introduced the consent agenda.

Regent Park asked about the recommendation that the endowment administration cost recovery rate remain at 55 basis points. There appeared to be flexibility about activities that could be undertaken with this money. She asked why the University would not increase its fundraising efforts and increase the recovery rate to 65 basis points. Executive Vice President and Chief Financial Officer Brostrom responded that he was in favor of raising the rate. UC had raised the rate dramatically in the past, from 15 basis points in 1998 to the current rate of 55 basis points. The University completes an extensive "workbook" to document the actual costs incurred in administering endowment funds. The most recent issue of the workbook was in 2011. Since 2011, the General Endowment Pool had grown from $6.3 billion to more than $9.8 billion. Administrative costs associated with carrying out the terms of endowment agreements had not increased at the same rate, and the University was concerned that if it were to update the workbook, this would result in a lower cost recovery rate. In addition, the campuses were satisfied with the 55 basis point rate. Mr. Brostrom acknowledged that the more UC could derive from endowment cost recovery, the more fungible money would be available for the campuses.

[1] One basis point is 0.01 percent of yield (i.e., one hundred basis points equals one percent); 55 basis points are the equivalent of $55 on endowment assets with a 60-month average market value of $10,000.

Regent Park asked if this issue is reconsidered every year. Mr. Brostrom responded that the University had not issued a workbook for a number of years; this is related to the University's status as a tax-exempt entity.

Regent Park suggested that there be a discussion at a future meeting to consider raising the endowment administration cost recovery rate.

Regent Zettel asked if maintaining low administration rates for endowment funds and for the campus foundations encourages the campus foundations to turn money over to be invested by the Office of the Chief Investment Officer. Mr. Brostrom clarified that this cost did not cover the administrative costs of the Office of the Chief Investment Officer; this latter cost was a small administrative cost, about three basis points, on all investment returns. This was a very favorable rate for the campuses.

Chancellor Hawgood stressed the importance of recognizing that different campuses have different gift fees, taxes, and operations assessments on gifts. The University must be careful to avoid multiple taxes that may be difficult to explain to donors.

Regent Sherman asked how many donors stipulate in their gift agreements that no administrative charges may be deducted from the earnings on their gifts. Mr. Brostrom responded that the endowment payouts referred to in this item did not have this kind of stipulation. While donors might stipulate that there be no gift tax, this action item concerned the endowment payout, not subject to those kinds of provisions.

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

4. **UPDATE ON GOVERNOR'S MAY REVISION TO THE 2018-19 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.]

Executive Vice President and Chief Financial Officer Brostrom began the discussion by informing the Committee that the University had just issued $1.4 billion in general revenue bonds to support projects on nine campuses. These bonds had 40-year terms and an all-in, true interest cost of 3.91 percent. UC had also issued $800 million in limited project revenue bonds at a 40-year term for housing projects at seven campuses, at a rate of 3.85 percent. The low interest rates on these bond issues would help increase affordability for students.

Regent Makarechian asked why the amounts of the bonds issued were not higher. Mr. Brostrom responded that UC usually issues bonds in the amount of $1 billion each year. The University was concerned about a rising interest rate environment, and Mr. Brostrom's office asked if the campuses wished to move projects forward for financing. Four campuses moved projects forward, and UC issued about $2 billion in bonds this year. The amount was capped due to a three-year spending requirement. For example, UCLA had many upcoming housing projects, but the campus would not have spent all these funds within a three-year period.

Regent Makarechian asked if any of the higher rates could be refinanced and paid down. Mr. Brostrom responded that the University had already refinanced about $300 million in bonds in December 2017, for savings of about ten percent.

Mr. Brostrom then discussed the Governor's May Revision of the State budget. The revenue situation for the State was positive. General Fund revenues in May were about $3.7 billion higher than in January; most of this was attributable to personal income tax and capital gains tax revenues from the 2017 equity markets. This resulted in a projected surplus of $9 billion, compared to the $6 billion forecast in January. Mr. Brostrom noted the degree to which the State budget was dependent upon personal income tax. The previous year, 70 percent of State revenues were derived from personal income and capital gains taxes. The Governor had expressed appropriate caution about the economic outlook and was concerned how long this recovery and bull market would last.

The Governor had provided no more permanent funding to UC in the May Revision. The University's base budget adjustment was maintained at three percent. UC received some welcome one-time appropriations, such as $100 million for deferred maintenance and $55 million to expand psychiatric residency programs, primarily in underserved areas of the state like the San Joaquin Valley and the Inland Empire. The State had stipulated that if UC raised tuition, the State would reduce UC's General Fund appropriation by the amount the State had to increase Cal Grants and the Middle Class Scholarship to cover the increase. If the University were to increase tuition by $70 million, as had been under consideration, this appropriation would be reduced by about $22 million.

Mr. Brostrom outlined the University's funding request made in Sacramento. It included $70 million to buy out an increase in tuition and the Student Services Fee, $25 million to address current unfunded enrollment, and $10 million for 2018-19 enrollment growth, in addition to $15 million UC had already identified through diversion of funds. The University had requested $35 million for deferred maintenance, and the State exceeded this request. UC had also sought a buyout of nonresident undergraduate tuition, and the ability to restore financial aid to nonresident undergraduates.

The Governor had maintained the Office of the President budget as a line item appropriation for this year, and it was reduced by $8.6 million. UC had identified this as an amount that could be directed to enrollment growth. The State kept the appropriation for UCPath at $52 million, the same as the previous year. UCPath costs would grow by about $15 million, because six campuses would implement UCPath in the coming year, including UCLA and UC Santa Barbara in September 2018. The State suggested that UC use a fee-for-service model, by the number of W-2 forms processed per campus, to cover that increase. The University hoped that this would be the first step in allowing UCPath to move to a fee-for-service model for the entire cost.

In the State Senate the previous week, Senate Budget Subcommittee 1 on Education had endorsed all the UC funding requests mentioned by Mr. Brostrom except for the provisions related to nonresident tuition. The Senate endorsed all the May Revision items and approved additional modifications: $25 million in one-time funds for student mental health, $8.5 million in new funds for 2018-19 enrollment growth, instead of redirecting UCOP funds, and annual inflation-based adjustments to UC's General Fund base. The University had always advocated for the last-mentioned adjustment, but it would be difficult to guarantee that the Legislature would provide this in future years. The Senate's endorsements would amount to $118.5 million over the Governor's January budget, which had been $93 million, or $210 million in additional permanent funding for UC, an excellent outcome.

Associate Vice President David Alcocer reported that the State Assembly Budget Subcommittee 2 on Education Finance that day had endorsed all the Governor's May Revision items as a baseline for UC's appropriation in the following year. The Assembly provided $25 million in funding to support enrollment growth of 2,500 students in 2019-20. This was a very important item for the University, above and beyond UC's original request, which was focused on 2018-19 needs. This item would return the State to its historic track record of providing its full share of the marginal cost of enrollment growth, which was $10,000, essentially the cost of enrolling a new student minus tuition and fee revenue paid by that student. The State had provided this level of funding until about 2007-08. Mr. Alcocer emphasized what a welcome and positive change this was.

The Assembly supported nearly full funding for the University's requests. One alteration had been introduced: UC requested $25 million in new State funding for the next year to help address the unfunded over-enrollment of about 2,500 students. The Assembly would provide half that amount as new State General Funds, $12.5 million, with the expectation that UC consider other savings that are achievable, or other resources to make up the remainder. This was not exactly what UC had proposed, but this, combined with full funding for enrollment growth in the following year, would leave UC in a better position than it had initially sought.

The rest of the Assembly's measures, consistent with many of the Governor's proposals, focused on one-time funding, including a $120 million contribution from Proposition 2 funds toward the unfunded liability of the UC Retirement Plan (UCRP), contingent upon UC removing the Defined Contribution Plan as an option for represented employees. Other proposed one-time contributions were $5 million for campus-based activities related to student food and basic needs, $2 million for faculty diversity and Equal Employment Opportunity efforts, $2.8 million for the UC Davis Aggie Square satellite campus project, research funding for a number of priorities for the Legislature, such as Valley fever, opioids, and gun violence, and funding for expanding medical school post-baccalaureate programs. Most of these items were approved unanimously, and Mr. Alcocer described this as a promising development as the University moved into the final stages of the State budget cycle.

Mr. Brostrom concluded by remarking that the next step would be for the full Assembly and the full Senate to pass the budget, which would then move to a conference committee. Many of the University's items had been approved by both houses of the Legislature and would not be taken up by the conference committee. The status of funding for deferred maintenance was still not certain, since the Legislature might have specific projects in mind for funding. The conference committee would resolve differences between the two houses. For unfunded enrollment, the Senate would provide $25 million, and the Assembly $12.5 million. For 2019-20 enrollment, the Senate would provide $5 million, and the Assembly $25 million. Mr. Brostrom emphasized his view that this had been a positive outcome for UC, an outcome that reflected advocacy at a new level with active engagement by students, chancellors, campuses, and the Regents.

Committee Chair Makarechian stated that the activity of students had put pressure on the Governor and Legislature. He requested more details on the unfunded liability of the University's retirement programs. Mr. Brostrom responded that the Governor had provided no funding for this unfunded liability, whereas in past years, UC had received some Proposition 2 funds to address this. The State was now using Proposition 2 funds to pre-fund its retiree health program. The Assembly added a provision that would give UC an additional $120 million toward the unfunded liability, but this was contingent upon UC removing the Defined Contribution Plan as an option for the represented workforce; these employees would be offered only the Defined Benefit Plan.

Committee Chair Makarechian asked if this last condition would represent a financial loss for the University. Mr. Brostrom responded in the negative. UC contributes the same amount to the Defined Benefit Plan as it contributes to the Defined Contribution Plan. He acknowledged that the University's risk for the two plans is different. If the University did not accept this provision, it would not receive funding for the UCRP unfunded liability; but it remained to be seen if this provision would be passed by the conference committee.

Committee Chair Makarechian asked how the University could measure the cost or benefit of accepting this provision. Mr. Brostrom responded that it would be very difficult to calculate this. The systemwide task force on 2016 retirement benefits had had long debates about the value of a defined benefit plan versus a defined contribution plan, and how one determines the value of a risk transfer from a defined contribution plan to a defined benefit plan. This value was certainly less than $120 million. Mr. Brostrom expressed his hope that in future years the State would contribute its share to the unfunded liability. Committee Chair Makarechian observed that the $120 million proposed by the State was one-time funding.

Chancellor Blumenthal requested clarification on two points. With regard to the $25 million for unfunded enrollment proposed by the Senate, or the $12.5 million proposed by the Assembly, he noted that this was to make up for the fact that UC overenrolled at a time when the Legislature had specified that the University had to admit a certain number of students, and would receive no funding if it enrolled one student less than that number. This funding was not to account for the fact that UC did not receive the full $10,000 per student in support for those students for whom the Legislature did provide funding.

Mr. Brostrom confirmed that this was correct. In the two-year period referred to by Chancellor Blumenthal, the University had agreed to increase undergraduate enrollment by 5,000 students the first year, and 2,500 students the second year. It then turned out that UC had enrolled 10,100 additional students systemwide, and the University received no additional funding for these students.

Chancellor Blumenthal stated that UC should be pleased with the overall outcome of the budget process, but while the $100 million for deferred maintenance was not negligible, in terms of State-funded capital, the University's total unfunded deferred maintenance needs amounted to approximately $4 billion. Mr. Brostrom estimated that this amount was greater than $4 billion. The University's Integrated Capital Asset Management Program (ICAMP) was currently analyzing this question and would provide standardized data. Chancellor May stated that the Davis campus' deferred maintenance need was $1.3 billion.

Regent Sherman asked if the funding for student enrollment was one-time or continuous, adding to ongoing funding and the baseline budget. Mr. Brostrom confirmed that this was base-building or permanent funding.

Regent Sherman asked if there is reporting by the University on its spending of these funds, to show that funds have been spent appropriately, for example, on deferred maintenance. Mr. Alcocer responded that UC compiles a list of its deferred maintenance projects and submits the list to the State Department of Finance. The Department of Finance requests periodic updates. There were reporting requirements associated with all one-time funding.

Regent Sherman asked if the State was reimbursing UC for deferred maintenance projects, or if the University first had to finance a project and then seek reimbursement from the State. Mr. Brostrom responded that he believed this might be different for each project; he would provide this information.

Committee Chair Makarechian asked about the criteria used to determine the allocation of deferred maintenance funding to the campuses. Mr. Alcocer responded that the University's approach was to examine objective factors associated with a campus' likely need for deferred maintenance funds, such as a campus' total share of State-supported space, the average age of that space, and the estimated replacement cost of that space. These factors are considered in allocating a certain amount of resources to a campus. It is left to the campus to identify and prioritize the projects for which it will use deferred maintenance funding, based on its own most critical needs and other available fund sources. Mr. Brostrom added that the Office of the President develops the formula in collaboration with the campuses.

Regent Anguiano observed that the question of the defined benefit and defined contribution plans involved not only cost. A well-structured defined benefit plan could have the same cost as a defined contribution plan, and the University was clearly in a better position to take on risk than was an individual. In this instance, a greater concern was the lack of choice for an individual. Defined benefit plans and defined contribution plans can be beneficial for different groups of employees, and Regent Anguiano expressed misgivings about the inability of employees to make a personal choice. Mr. Brostrom responded that the normal cost for the University's Defined Benefit Plan and Defined Contribution Plan was identical, but that risk is borne by different parties. The Defined Contribution Plan option had now been in place for over two-and-a-half years, and about one-third of UC's new employees were choosing the Defined Contribution Plan for various reasons: the plan might be more affordable, or the employee might not intend to stay with UC for more than five years.

Committee Chair Makarechian asked about the increase in nonresident tuition. Mr. Brostrom recalled that the Regents approved a 3.5 percent increase in nonresident tuition at the March 2018 meeting, but asked that the University include in its funding request to the State the request that the State buy out this increase. In a recent budget act, the Legislature had stipulated that the University could not give tuition-based financial aid to nonresident students. UC representatives raised the issue of a nonresident tuition buyout with legislators, but legislators did not even want to consider this.

Staff Advisor Valdry asked if the direct allocation for the UCPath Center was now funded, or if it still remained to be settled in the conference committee. Mr. Brostrom responded that this item had not been taken up by either the Assembly or the Senate, so that it was now funded.

Mr. Valdry asked about the funding model for the UCPath Center, with a portion funded by the State, and a portion paid by campus assessments based on the number of W-2 forms processed. Mr. Brostrom responded that this arrangement was not ideal, and that the University would prefer to fund the UCPath Center entirely through the fee-for-service model.

Mr. Valdry asked about the challenges to the campuses in working with this arrangement. Mr. Brostrom responded that the primary challenge was that chancellors would have to recoup the amount that the medical centers, housing and dining operations, or personnel receiving research grants would have been paying to UCPath, because this was now being paid by the General Fund.

The meeting adjourned at 3:20 p.m.

Attest:

Secretary and Chief of Staff