F11

Office of the President

TO MEMBERS OF THE COMMITTEE ON FINANCE:

ACTION ITEM

For Meeting of July 14, 2011

AUTHORIZATION OR ENDORSEMENT OF CERTAIN ALTERNATE REVENUE STRATEGIES FOR FISCAL YEAR 2011-12

EXECUTIVE SUMMARY

This item requests that the Regents authorize or endorse, as indicated in the Recommendation section, certain alternate revenue strategies to address the portion of 2011-12 budget cuts that are not addressed by the additional tuition increase, as described in the item *Update on 2011-12 Budget and Approval of Additional 2011-12 Tuition Increase* (F10) for the July Regents meeting.

As indicated in the July 2011 Regents' item F10, the revenue generated by revenue enhancements, cost reduction measures and tuition is $10.4 million short of the amount of revenue needed to cover the $650 million reduction imposed by the State in 2011-12. The President plans to address this $10.4 million gap with four alternate revenue strategies, as listed below:

- Transfer an additional $1 billion from the systemwide Short Term Investment Pool (STIP) into the Total Return Investment Pool (TRIP) to increase investment earnings;
- Distribute a two percent extraordinary payout on eligible year-end 2010-11 balances of funds functioning as endowments (FFEs);
- Distribute a two percent extraordinary payout on eligible year-end 2010-11 balances of true endowments; and
- Draw down as needed from the University's employee/retiree healthcare reserve.

In addition to the $10.4 million gap described above, the final State budget package includes a trigger mechanism that could result in an additional budget reduction of $100 million for the University in January 2012 if certain State revenue projections are not achieved. Should that situation occur, the President may also wish to address the additional budget reduction through the strategies listed above.

Furthermore, other alternate revenue strategies are being pursued, about which the Regents should be informed but which the Regents need not approve. These include increasing endowment cost recovery (previously approved by the Regents at the May 2011 meeting), taxing

carry-forwards, implementing a central bank for debt management, and implementing a captive insurance program.

RECOMMENDATION

The President recommends that the Committee on Finance recommend to the Regents that the Regents take the following actions regarding the President's planned alternate revenue strategies:

A. Authorize the President to instruct the Chief Investment Officer to transfer an additional amount not to exceed $1 billion from the systemwide Short Term Investment Pool (STIP) into the Total Return Investment Pool (TRIP) to increase investment earnings.

B. Authorize the President to instruct the Chief Investment Officer to distribute an extraordinary payout not to exceed two percent of eligible year-end 2010-11 balances of funds functioning as endowments (FFEs).

C. Authorize the President to instruct the Chief Investment Officer to distribute an extraordinary payout not to exceed two percent of eligible year-end 2010-11 balances of true endowments.

D. Endorse the President's plan to draw down as needed from the University's employee/retiree healthcare reserve.

BACKGROUND

In an effort to bridge the gap between revenues and expenses over the coming months, after the mitigating effects of both efficiencies and tuition increases have been taken into account, alternate revenue strategies have been identified and proposed. Some of these strategies represent sound fiscal policy for the immediate future of the University, regardless of the need to accommodate additional cuts in 2011-12, and are thus proposed irrespective of the ultimate State budget outcome. Other of these strategies would normally not be pursued under less stressful budgetary conditions, but are specifically being pursued at this time in recognition of the need for one-time and ongoing revenues to bridge to a more stable funding future.

As discussed in item F10 for the July 2011 meeting, the $650 million reduction in the final budget act adopted by the Governor and the Legislature for 2011-12 is being primarily addressed through efficiencies (which will cover almost 74 percent of this reduction) and previously approved and a proposed tuition increase that will generate $265.8 million, net of financial aid. When annualized, the proposed fee increase will generate $150 million. However, because the tuition increase is not being implemented for summer 2011, $10.4 million of the additional cut must be addressed on a one-time basis. In addition, the budget act contains a provision that would call for another $100 million reduction in State support for the University if specified levels of new State revenue are not achieved. Due to this trigger mechanism described in Regents' item F10 of the July 2011 meeting, alternate revenue strategies will be needed for the $10.4 million and may be needed to generate an additional $100 million, if the additional budget reduction is triggered in January 2012 by inadequate revenue at the State level.

It is important to note that the implementation of most of these tools will be done at the campus level. Particular options will be more practical for some campuses than others. Furthermore, all revenues resulting from use of these strategies are expected to stay on the campus.

The following table displays the various alternate revenue strategies according to requested Regents' action and cash flow timing:

	Impacting 2011-12 Cashflow	Impacting 2012-13 Cashflow and Beyond
Seeking Regents' Action to Authorize or Endorse	a) Transfer assets from STIP to TRIP ($40 mm)	a) Transfer assets from STIP to TRIP ($40 mm)
	b) Extraordinary payout on FFEs ($40 mm)	
	c) Extraordinary payout on true endowments ($20 mm)	
	d) Draw down healthcare reserve (up to $97 mm)	
Strategies Underway with No Action Needed	e) Increase endowment cost recovery ($4 mm)	e) Increase endowment cost recovery ($4 mm)
	f) Tax carry-forwards ($70 mm)	
		g) Implement central bank for debt management ($TBD)
		h) Implement captive insurance program ($TBD)

Seeking Regents' Action to Authorize or Endorse:

a) Transfer $1 billion from STIP to TRIP. To increase investment returns available to the campuses, the Office of the President recently shepherded a systemwide target allocation of 70 percent/30 percent between the Short Term Investment Pool and Total Return Investment Pool (STIP/TRIP). Further returns can be generated by moving an additional $1 billion from STIP into TRIP, resulting in a target allocation of 60 percent/40 percent. Approval of this item empowers the President to: (1) direct the Chief Financial Officer and Chief Investment Officer to identify and execute the changes in asset management strategies that are necessary to proceed with this step; and (2) at the President's discretion, move funds at one time, rather than incrementally. The more aggressive allocation will produce incremental returns of **$40 million** (immediately and on an ongoing basis).

b) Distribute two percent extraordinary payout on funds functioning as endowment (FFEs). Most UC endowments are highly restricted, both in terms of payouts and purpose. However, many endowment funds are merely *functioning* as endowments, i.e., they are purpose-restricted, but not *payout*-restricted. Despite these purpose restrictions on FFEs, their payout flexibility provides an opportunity for campuses to manage fungibility of FFE balances through budget operations. Additionally, this strategy is fiscally sound, given that the

distributions will be taken against income only, and the funds have performed well during the past two fiscal years. Nonetheless, each individual FFE will require additional due diligence to ensure its legal eligibility for this purpose. The two percent distribution will produce approximately **$40 million** (on a one-time basis).

c) Distribute two percent extraordinary payout on true endowments. Although generally both purpose- and payout-restricted, true endowments still offer an alternate revenue opportunity in that increased payouts can often be directed towards departmental activity that may have been formerly funded through the State budget. The University should increase temporarily true endowment payouts and apply those funds towards eligible expenses, thus giving campuses a degree of budgetary flexibility during one fiscal year. Examples include covering additional graduate student funding, or faculty/staff salaries as appropriate, from true endowments with the corresponding department receiving fewer *general funds* for these expenses. These freed-up general funds can be used at the campuses' discretion. Like the previous strategy, each individual endowment will require additional due diligence to ensure its legal eligibility for this purpose. The University anticipates excluding endowments that support scholarship and student financial aid. The two percent distribution will produce approximately **$20 million** (on a one-time basis).

d) Draw down up to $97 million from employee/retiree healthcare reserve. The University is expected to end fiscal year 2010-11 with approximately $97 million in its employee/retiree healthcare reserve fund, which is used to provide a hedge against substantial increases in the cost of providing health care to retirees. Retiree health costs are currently budgeted by charging fund sources 3.41 percent of payroll. This rate is scheduled to increase to 3.54 percent in fiscal year 2011-12 (campuses have already budgeted for this increase). Initially, $50 million of this reserve would be made available to the campuses for 2011-12. The President may draw additional amounts from the reserve if needed. Therefore, the draw-down could produce up to **$97 million** (on a one-time basis).

Strategies Under Way with No Action Needed:

e) Increase endowment cost recovery by ten basis points. The University recovers eligible administrative costs associated with *managing* endowments that fund research, teaching, and public service. The University recovers these management costs by means of an endowment cost recovery (ECR) rate that is embedded in the endowment payout rate. In order to fully recover all allowable costs, the Regents approved an increase in the ECR rate from 45 basis points to 55 basis points at the May 2011 Regents meeting. The implementation of this increased payout rate is under way, and it will produce **$4 million** (immediately and on an ongoing basis).

f) Impose two percent tax on carry-forwards. This strategy entails an asset tax on carry-forward balances that could be applied broadly, on both unrestricted balances and "internally restricted" balances such as parking and housing (as opposed to externally restricted balances such as donor funds). Some campuses already do this. This is one strategy for meeting the Office of the President assessment on campuses and medical centers that is associated with the new "Funding Streams" initiative. Although the tax itself will remain in place in future

years, it is anticipated that behavioral changes will cause resulting cash flow to impact primarily the first year (2011-12). Thus, the two percent tax on carry-forwards is expected to produce **$70 million** (on a one-time basis).

g) Implement central bank for debt management. Central bank debt management structures, which are common in the higher education industry, entail central university offices taking on the role of internal lender, thereby decoupling bondholders from campuses. The strategy involves large-scale debt restructuring and interest rate swaps, as well as a decoupling of campuses from bond refundings. Under such a strategy, campuses would receive rate certainty/stability, while the central office significantly mitigates interest costs. The strategy also introduces an opportunity to generate revenue through certain interest rates swap structures. This strategy will be implemented over the next two to five years. Thus, the future revenue it generates is **to be determined**. However, this strategy is expected to produce revenue on an ongoing basis (as opposed to one-time).

h) Implement captive insurance program. The University could establish an alternative risk financing program, including the formation of a captive insurance company that would be legally authorized to extend coverage and other risk services to third parties such as University physicians conducting third-party care. Such a structure not only directly supports UC business operations, it also generates new revenue. This strategy will be implemented over the next two to five years. Thus, the future revenue it generates is **to be determined**. However, this strategy is expected to produce revenue on an ongoing basis (as opposed to one-time).