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Office of the President

TO MEMBERS OF THE COMMITTEE ON FINANCE:

<u>ACTION ITEM</u>

For Meeting of November 19, 2015

AUTHORIZATION TO FUND UNIVERSITY OF CALIFORNIA RETIREMENT PLAN ANNUAL REQUIRED CONTRIBUTIONS FOR FISCAL YEAR 2015-16, FISCAL YEAR 2016-17, AND FISCAL YEAR 2017-18 WITH CONTRIBUTION FROM SHORT TERM INVESTMENT POOL

EXECUTIVE SUMMARY

This item requests authorization for the President of the University to make contributions to the Campus and Medical Centers segment of the University of California Retirement Plan (UCRP or Plan) in Fiscal Year (FY) 2015-16 , FY 2016-17, and FY 2017-18 via asset transfers from the Short Term Investment Pool (STIP). These contributions, along with contributions from the University, active members, and the State of California, will bring the total annual contribution up to the total Annual Required Contribution (ARC)[1] for each of those years. The contribution authorization will be in amounts not to exceed $563,600,000 in FY 2015-16, $481,000,000 in FY 2016-17, and $391,800,000 in FY 2017-18.

RECOMMENDATION

The President of the University recommends that the Committee on Finance recommend that the Regents amend the Regents' July 2014 action, *Authorization to Fund University of California Retirement Plan Modified Annual Required Contribution with Contribution from Short Term Investment Pool*, as follows:

Additions shown by underscoring; deletions shown by strikethrough

The President of the University be delegated authority and discretion to make contributions to 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 of the University 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, as follows:

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[1] ARC is the total funding policy contribution defined in Regents Policy 5601. Modified ARC is the Normal Cost plus interest on the unfunded liability.

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G. Transfer funds from STIP to UCRP in FY 2015-16, FY 2016-17, and FY 2017-18, in amounts equal to the difference between the approved total UCRP contribution and ARC. Should STIP have insufficient funds, funds will be transferred from TRIP to STIP. These transfers shall satisfy the requirements below and will not exceed $563,600,000 in FY 2015-16, $481,000,000 in FY 2016-17, and $391,800,000 in FY 2017-18:

(1) Maintenance of a minimum balance in STIP of $5 billion at all times.

(2) Receipt of State Proposition 2 funds for UCRP of $96,000,000 in FY 2015-16, $170,000,000 in FY 2016-17, and $170,000,000 in FY 2017-18.

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

(4) The ability to set the repayment terms on the STIP Note, which will have a final maturity no later than FY 2041-42.

(5) 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.

(6) 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.

BACKGROUND

As of July 1, 2015, the Campus and Medical Centers segment of UCRP is 80.7 percent funded, with actuarial value of assets (AVA) of $45.5 billion and actuarial accrued liability (AAL) of $56.4 billion.[2] The funded status has improved from last year, when the Campus and Medical Centers segment of UCRP was 79.2 percent funded, with $40.7 billion AVA and $51.4 billion AAL. The increase is a result of an investment gain on the AVA and a $700 million transfer from STIP to UCRP in July 2014, offset to some extent by changes in actuarial assumptions. The July 1, 2015 valuation is based on updated assumptions from a UCRP experience study, which was presented to the Committee on Finance in September 2015. Among the updated assumptions are a decrease in the investment return from 7.5 percent per year to 7.25 percent per year, a decrease in the inflation rate from 3.5 percent per year to three percent per year, and a change in mortality assumptions to reflect longer life expectancies of retirees. The combined impact of the updated assumptions is an increase in AAL, an increase in Normal Cost (NC), and an increase in the total funding policy contribution rate for the Campus and Medical Centers segment. Without the $700 million transfer the funded status of the Campus and Medical Centers segment would have been 79.3 percent funded (1.4 percentage points lower).

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[2] The UCRP actuarial valuation report as of July 1, 2015 is being presented to the Committee on Finance at this meeting.

Since resumption of University and member contributions to UCRP in FY 2010-11, the University has incrementally increased contribution rates, but total contributions still remain below the funding policy contribution level. Since July 1, 2014 employer and member contribution rates have remained at 14 percent and eight percent for most members[3], respectively. In order to improve the Plan's funded status, the University has also funded UCRP with transfers from STIP and external borrowings to meet modified ARC.

<table>
<tr><th>FYE</th><th>2011</th><th>2012</th><th>2015</th><th>Total</th></tr>
<tr><td>Internal (STIP) Borrowing</td><td>$1.1 B</td><td></td><td>$0.7 B</td><td rowspan="2">$2.7 B</td></tr>
<tr><td>External Borrowing</td><td></td><td>$0.9 B</td><td></td></tr>
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The STIP and external borrowings are being paid back through campus assessments on covered payroll.

FINANCIAL ANALYSIS

State Support

The 2015-16 State budget provides $436 million in one-time funds over the next three years in Proposition 2 debt repayment funds for UCRP, including $96 million in 2015-16, $170 million in 2016-17, and $170 million in 2017-18. As specified in the State Constitution, Proposition 2 funds must be supplemental, above Regentally approved contribution rates, and must be used to help pay down the unfunded liability associated with UCRP. This funding is contingent upon Regental approval of a cap on pensionable salary at the same level as the State's Public Employee Pension Reform Act (PEPRA) cap for the defined benefit plan for employees hired on or after July 1, 2016. The President has convened a task force to advise on the design of new retirement options that will include the new pensionable salary cap consistent with PEPRA. The task force will bring its recommendations on the new retirement options to the Regents next year for review and approval. The pension cap now in place is the Internal Revenue Code section 401(a)(17) limit, currently $265,000 for most employees; for employees hired on or after July 1, 2016 pensionable salaries would be capped at the PEPRA cap ($117,020 in 2015-16, indexed with inflation for 2016-17) for those in the defined benefit plan. These changes will only affect new employees hired after the new options are implemented. New employees will have the opportunity to choose a fully defined contribution plan as a retirement option, as an alternative to the PEPRA-capped defined benefit plan. For represented groups, retirement options will be subject to collective bargaining.

STIP Borrowing to Fund ARC

The proposed STIP transfers to UCRP will help fund the unfunded portion of ARC in FY 2015-16, FY 2016-17, and FY 2017-18, or the difference between ARC and total University contributions to UCRP in each year.

[3] Nine percent for Safety members and members represented by certain unions. For members in the 1976 tier and Safety members, member contributions are reduced by $19 per month. Seven percent for 2013 tier members.

When combined with the Proposition 2 contribution from the State, the $563.6 million STIP transfer in FY 2015-16 will bring the total contribution amount for that FY up to full ARC. Similarly, in FY 2016-17 and FY 2017-18, the combination of the STIP transfer with the State contribution will bring the total contribution amount for those FYs up to full ARC.

Campus Assessment

As with the FY 2010-11 and FY 2014-15 STIP borrowings, the proposed STIP transfers will create a STIP Note that will be repaid over the same 25-year period as the previous borrowings. All STIP borrowings will have a final maturity in FY 2042. The first principal and interest payments on the FY 2015-16 borrowing will be in FY 2017. For the FY 2016-17 borrowing, principal and interest payments will begin in FY 2018. For the FY 2017-18 borrowing, principal and interest payments will begin in FY 2019. Campuses and medical centers will be assessed for the repayments as a percentage of covered payroll. The repayment of the loan will be distributed proportionally among the fund sources that pay into UCRP. The interest and principal will pay back STIP Note holders. 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. Principal payments, however, are an allowable cost of federal contracts and grants.

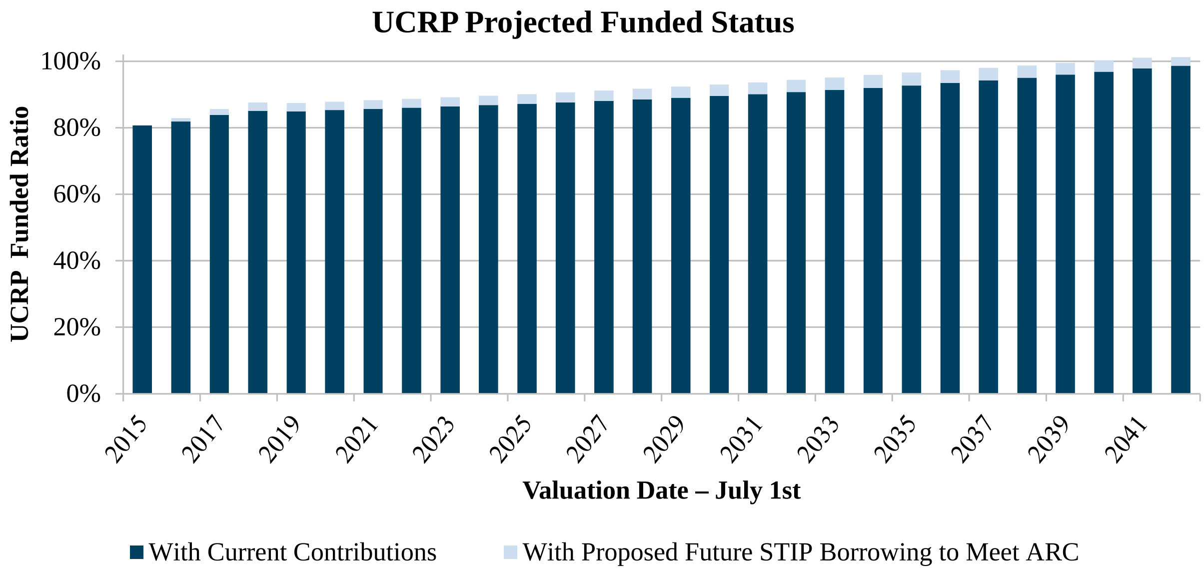
The interest rate for the STIP Notes will be reset every July 1 for the following 12 months, based on the historical STIP rates. While repayment of the STIP Notes will have to be built into the operating budgets of campuses and medical centers, the relatively low rate only slightly increases the assessment rate above the current assessment rate for the previous borrowings. The assessment for the outstanding STIP Notes and external borrowing is 0.6 percent of covered payroll in FY 2015-16, and is projected to range from 0.8 percent to 1.25 percent over the subsequent ten years. An additional $563.6 million STIP borrowing in FY 2015-16 would increase the projected assessment to a minimum of 1.1 percent and a maximum of 1.53 percent each year over the next ten years. A $481.0 million STIP borrowing in FY 2016-17 would increase the projected assessment to a maximum of 1.8 percent over the subsequent ten years. A $391.8 million STIP borrowing in FY 2017-18 would increase the projected assessment to a maximum of 2.04 percent over the subsequent ten years.

Payroll Assessments to Repay Borrowing for UCRP
Next 10 Years (FYE 2017 – 2026)

	With Current Contribution Level	**With Future Borrowing from STIP in:**		
		FY 2015-16 ($563,600,000)	**+ FY 2016-17** ($481,000,000)	**+ FY 2017-18** ($391,800,000)
Minimum	0.80%	1.10%	1.10%	1.10%
Maximum	1.25%	1.53%	1.80%	2.04%

UCRP Projections

Beginning July 1, 2014, employer contributions to UCRP rose to 14 percent and contributions for most members rose to eight percent[4] of covered compensation. If contributions remain at these levels, the Campus and Medical Centers segment of UCRP will not be 100 percent funded even by July 1, 2042, AVA. If the University funds ARC in FY 2015-16, FY 2016-17, and FY 2017-18 as proposed in this recommendation, then by July 1, 2042 the Campus and Medical Centers segment is projected to be 101 percent funded.



Campus and Medical Centers segment
Assumes 7.25 percent UCRP annual returns and 0.7 percent annual active member population growth

STIP and TRIP

As of September 30, 2015, the University's STIP balance is \$6.10 billion[5] and TRIP balance is \$7.55 billion[6].

In July 2015 the Regents approved proposed amendments to the Total Return Investment Pool Investment Policy, which revised the asset allocation within TRIP to better align the portfolio with its objective. The new asset allocation reduces equity, increases fixed income and absolute return, and removes cross asset class exposure. This was part of the first steps to implement a new framework for STIP/TRIP management to emphasize a holistic view of STIP and TRIP,

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[4] Nine percent for Safety members and members represented by certain unions. For members in the 1976 tier and Safety members, member contributions are reduced by \$19 per month. Seven percent for 2013 tier members.
[5] Total includes campus operating funds only. Excludes UCRS, UCRP, Agency, campus foundation, and endowment holdings in STIP; bond and commercial paper proceeds; and MOP loans
[6] Total includes campus operating funds only. Excludes Fiat Lux funds, campus foundation funds, and century bond proceeds

maximize returns, and balance liquidity needs. Subsequently in September, $1.26 billion in excess STIP funds were identified and moved to TRIP.

As part of the new STIP/TRIP framework, the Office of the Chief Investment Officer (OCIO) manages STIP to a minimum balance of $5 billion in order to ensure sufficient liquidity for daily operating cash flow, extraordinary liquidity needs, and some rating agency requirements. As OCIO continues to explore opportunities to maximize liquidity needs across STIP and TRIP, the Office of the Chief Financial Officer will work with OCIO on these proposed moves from STIP to UCRP to ensure there are sufficient funds in STIP. Should there be insufficient funds in STIP for the proposed borrowings, funds will be moved from TRIP to STIP.

The University's strong liquidity position is one of its major financial strengths. The University continues to monitor risks, trade-offs, and possible changes in the University's day-to-day operations.

University staff will also continue to work with faculty on ideas and strategies to address UCRP's unfunded liability and to put it on a path toward fully funded status.

Key to Acronyms

AAL	Actuarial Accrued Liability
ARC	Annual Required Contribution
AVA	Actuarial Value of Assets
CFO	Chief Financial Officer
FY	Fiscal Year
NC	Normal Cost
OCIO	Office of the Chief Investment Officer
STIP	Short Term Investment Pool
TFIR	Task Force on Investments and Retirement
TRIP	Total Return Investment Pool
UCFW	University Committee on Faculty Welfare
UCRP	University of California Retirement Plan

APPENDIX

Previous Actions:

September 2008: The Regents approved a funding policy for the Campus and Medical Centers segment of UCRP.

February 2009: The Regents approved restarting University and member contributions effective on or about April 15, 2010, subject to collective bargaining as applicable.

September 2010: An Overview of University of California Post-Employment Benefits, including UCRP and the Retiree Health Program, was presented to the Regents. The Regents approved employer and member UCRP contribution rates for Plan Years beginning July 1, 2011, and July 1, 2012, subject to collective bargaining as applicable. The Regents approved a revised amortization schedule (30 years instead of 15) for UCRP unfunded liabilities.

December 2010: The Board approved changes to University-sponsored post-employment benefits including a UCRP new hire tier effective July 1, 2013. The Board also delegated to the President the authority to fully fund the UCRP annual required contribution (ARC) as quickly as practical.

March 2011: The Regents authorized the President to make contributions to UCRP in FY 2010-11 and FY 2011-12 in amounts equal to the difference between modified ARC and total University contributions via a combination of an asset transfer from STIP, external borrowing, and/or debt restructuring.

December 2012: The President was authorized by interim action to make contributions to UCRP in FY 2010-11 and FY 2011-12, authorized in March 2011, under a financing structure which would provide as low an interest cost as possible.

July 2014: The Regents authorized the President to make a contribution to UCRP in FY 2014-15 in an amount equal to the difference between the total approved UCRP contribution and modified ARC for FY 2013-14[7] via an asset transfer from STIP.

[7] Since the $700 million was deposited in FY 2014-15, this became an amount to fully-fund ARC for FY 2014-15.