The Regents of the University of California

COMMITTEE ON FINANCE
March 15, 2006

The Committee on Finance met on the above date at Covel Commons, Los Angeles campus.

Members present: Regents Blum, Dynes, Gould, Hopkinson, Juline, Parsky, Preuss, and Wachter; Advisory members Ledesma, Schreiner, and Oakley

In attendance: Regents Island, Johnson, Kozberg, Lansing, Marcus, Moores, Pattiz, Rominger, Rosenthal, Ruiz, and Schilling, Regent-designate Coombs, Secretary Trivette, General Counsel Holst, Interim Treasurer Berggren, Acting Provost Hume, Senior Vice Presidents Darling and Mullinix, Vice Presidents Broome, Gomes, Gurtner, and Hershman, Chancellors Birgeneau, Bishop, Carnesale, Córdova, Denton, Drake, Fox, Tomlinson-Keasey, Vanderhoef, and Yang, Laboratory Director Anastasio, University Auditor Reed, and Recording Secretary Bryan

The meeting convened at 10:50 a.m. with Committee Chair Blum presiding.

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

The minutes of the meeting of January 18, 2006 will be presented at the Committee's meeting in May.

2. **REPORT ON ADMINISTRATIVE EFFICIENCIES, LOS ANGELES CAMPUS**

Senior Vice President Mullinix recalled that during the past year there have been several presentations about campus' efforts to reduce costs by increasing efficiencies and delivery of business and administrative services. The presentations included efforts at the Santa Cruz, Irvine, and San Diego campuses. He introduced Mr. Sam Morabito, Vice Chancellor of Business and Administrative Services at UCLA, who provided an overview of the Los Angeles campus' efforts to reduce costs by streamlining administrative processes, leveraging technology, and pursuing strategic sourcing.

Vice Chancellor Morabito focused on services provided by the Business Administrative Services organization, which is the central unit responsible for providing business services to the campus departments. The challenge, beginning with the budget cuts of the 1990s and over the last three years, when central unit budgets were cut by 15 percent, has been to maintain high-quality services and enhance the capability of business systems while accommodating significant growth at UCLA and responding to an increasingly complex regulatory environment. He reported that UCLA has been leveraging its significant investment in systems and technology by providing a full range of business services to the Office of the President and the Merced campus. UCLA is also providing selected travel services to several campuses. A set of goals and strategies was established consistent with the principles articulated in UC 2010, the New Business Architecture, to address the challenge of managing in an era of diminishing resources. In this regard, the focus has been on eliminating unnecessary steps in work flow processes and on using technology to automate where possible. In addition, in the late 1990s the campus initiated an aggressive strategic sourcing initiative to reduce the costs of goods and services obtained on the campus.

Mr. Morabito recalled that over the past 15 years the challenge has been to do more with less. The campus continues to expand its research portfolio, and auxiliary units particularly in housing and parking continue to grow to respond to contemporary needs, yet central administrative staffing has declined over this time period. He showed slides to illustrate the changes, reporting that over the past 15 years campus expenditures, which are one measure of workload, have increased by over 50 percent in constant dollars. In that same time frame, research activity as measured by contract and grant award dollars has more than doubled; workload as measured by general ledger transactions, invoices, and payroll transactions has also almost doubled, yet over the past 15 years staffing in central units responsible for this workload has declined in real terms by 15 percent. With the aid of technology and automation, productivity as measured by the relationship of transactions to full-time employees has increased almost 200 percent over the period. By any measure, more is being done with less. This challenge has been addressed by using technology and process improvement to absorb workload growth and respond to the demands of an increasingly complex regulatory environment. One example of this is the automation of transaction input into campus financial systems. In 2001, 96 percent of the input was done manually with paper forms that had to be reviewed centrally and key punched. By the end of 2005, 90 percent of the transactions had been converted to on-line web input with embedded business rules and post-audit review, eliminating the need for central office handling. Another example is the conversion of paper student bills to electronic bills. In fall 2002, all student bills were printed and mailed. E-bills were implemented in December 2002, and by fall 2005, 95 percent were done electronically. Annual savings are estimated at about $250,000 on this process alone. Another example of using technology to enhance service and deal with growth is the self-service smart technology being used in UCLA housing to provide customer service to students. Since this technology was implemented in 2005 the number of e-mails and telephone calls per resident has declined; now 75 percent of web-based inquiries from new students are being handled electronically through self-service software. This frees staff to deal with issues that require special handling. This smart technology gives students access to services at any time. This tool allows the campus to serve prospective new students when they need it.

The cost of purchased utilities is a concern at all UC campuses. Through a variety of cost-saving measures and technological improvements, campus energy consumption has decreased 12 percent since 1999 even though campus space has increased a net 2.1 million square feet, or 11 percent. The $16 million in savings over the five-year period was achieved mainly by four technological initiatives, including centralizing building systems, which enabled the campus from a central point to control setbacks for heating and air conditioning during closedown periods; implementing campus-wide lighting retrofit programs with more efficient fixtures; installing a variety of energy-saving equipment; and consolidating campus cooling towers. Even with these initiatives, the UCLA campus is estimating a significant short-fall in its purchased utilities budget for 2005-06, especially given the price of natural gas, and although it has moderated somewhat, it has been a major problem. The campus continually seeks ways to reduce costs and improve services.

UCLA's strategic sourcing initiative was begun in the late 1990s. It was developed to leverage campus spending through implementation of sourcing contracts and e-procurement. The goal has been to lower the total cost of goods and services purchased and to direct campus users to strategic sourcing suppliers through the use of electronic catalogues. Since 1999, this initiative has returned almost $57 million in direct savings and rebates which have accrued to participating departments not only at UCLA but, because it does purchasing for the Office of the President and UC Merced, to those departments at those locations as well. About one-third of campus contracts were developed as part of the systemwide strategic sourcing initiative. There are plans to implement another 60 contracts over the next three years.

In addition to the sourcing initiative, at UCLA there has been put in place a fully automated electronic purchasing system that takes campus purchasers from purchase order through vendor payment all in electronic mode. Another example is a partnership with UC San Diego to implement a business portal, starting with central administrative units. In the central administration, it is planned to replace more than 40 web sites with one site, using common site organization and navigation tools. The business portal will reduce costs and ease access to services for internal and external customers. The web will provide self-paced tutorial training. The portal will assist further in streamlining core business processes. Several of the major service departments have implemented their portions of this portal, and more units will be added over the coming few years.

In 2004, UCLA launched its repositioning IT initiative. While its decentralized IT structure has served the campus well over the past 20 years, new technology, the need to apply common security systems, cross-applications on campus and the constraint on resources require that the campus move toward a consolidation of systems where advantageous. While it may take several years to accomplish the level of consolidation appropriate for the campus, significant process is being made with the consolidation of e-mail and calendar systems in the central administrative units. Other units are waiting to join the centralized e-mail system. When the initiative is completed, there will be savings of $7 million to $10 million annually.

Accountability for performance is an important part of the management process. In the business and administrative services organization, the campus uses a pro forma scorecard system to measure the organization's success in achieving its goals. The system helps to set direction, increase accountability, improve decision-making, and align priorities with the overall strategic direction of the campus. Mr. Morabito discussed an example of how the performance scorecard is used in the administrative information systems group, which is responsible for delivering IT applications. Customer satisfaction, the amount of training provided, and the uptime of all systems are tracked methodically.

For the future, the plan is to continue the expansion of technology, automate processes, and streamline services. It is intended to move forward aggressively in the consolidation of the campus' IT systems and, in partnership with OP, to continue in the strategic sourcing effort, which has paid huge dividends to the Los Angeles campus over the past five years. He emphasized that process improvement is not a single event; rather, it is a continuous effort that must be sustained over a period of years to be successful.

Committee Chair Blum acknowledged the campus' significant progress in strategic sourcing. He asked how the 200 percent productivity figure over 15 years ranks the campus with similar institutions or large organizations. Mr. Morabito responded that most educational institutions across the country have been faced with reduced resources. The data is tracked closely at UCLA; the most savings are found by imbedding the business rules within the automated systems being put in place, which obviates the need for staff checking.

Regent Juline asked about any systemic or cultural problems being encountered. Mr. Morabito responded that in any organization management changes are difficult when they involve asking people to examine processes in a new way, do things differently, and give up control of local systems. He believed that success may be achieved through aggressive campus leadership. At UCLA, the Chancellor has been supportive of the strategic sourcing effort, and the level of cooperation has been high. As a key incentive, any savings are redirected toward the academic enterprise. Regent Juline asked to hear from the campuses that are not achieving the same degree of progress.

Vice President Broome provided an overview of the strategic sourcing initiative, which will leverage UC's buying power through its strong alliances, demonstrate ongoing savings, and develop more efficient and easier procurement processes. The initiative is focused on increasing product quality and service. She reported that Huron Consulting was engaged to do a complex spend diagnostic across the system.

Vice President Broome discussed the progress of the initiative. She reported that Huron worked with materiel managers at the medical centers, laboratories, campuses, and Office of the President. Categorizing the spending and sorting the categories resulted in a determination that between $1.3 billion and $2 billion can be sourced through the University's purchasing units. She noted that the study did not include the Los Alamos National Laboratory, although talks have begun with Bechtel to see if UC could pool its purchasing with some of the other laboratories that Bechtel manages.

Ms. Broome noted that the University must encourage the use of strategic sourcing by communicating its value and ensuring that every campus has the technology to participate in purchasing the goods. Although they will vary, savings on contracts are targeted at about 10 percent. Based upon the diagnostic, a five-year plan was developed, although work was started 18 months ago on getting contracts. Initiatives will take from two to five quarters to complete. The newest effort concerns travel, including on-line bookings and airfares.

Ms. Broome reported that the California State University system has asked to join the University, keeping its own contracts but pooling the spending to gain better prices. The State also hopes to give the University some of its purchasing. The more purchasing that can be leveraged, the better the prices for all.

Ms. Broome reported that the next step is implementation of the plan. A funding model committee was established, comprised of representatives from the budget and planning offices, to examine investment by location in order to develop a template of the optimum investment, determine what will be needed, and measure progress. A methodology must be developed for resources directly involved with implementation to be funded by the savings from the initiative. The plan will continue to be refined.

Regent Hopkinson commended the efforts of the Office of the President and the campuses, noting that the initiative had a difficult start and was not widely embraced.

Regent Juline advised looking systemwide for opportunities to achieve cost savings in construction materials.

Regent Blum noted that the initiative would profit from more support and additional personnel. Vice President Broome reported that the smaller campuses have been particularly constrained and have not been able to dedicate resources for improvements such as e-procurement systems.

Regent Gould was impressed by the progress that has been made. He suggested that the Regents receive an annual report on its status, which Ms. Broome indicated was planned to be provided.

Regent Rosenthal asked whether campuses were having difficulty with town-gown relationships with respect to local vendors and whether an effort was being made to allow them to compete, recognizing that they provide significant support to the campuses. Ms. Broome noted that, while it would be good to support the local small businesses, there has to be a balance between that and getting the best prices for goods and services.

Chairman Parsky suggested that the Regents be briefed on how the funds that are saved are to be spent. He advocated establishing incentives to individual campuses by affording them an opportunity to have more funds available based on what they save.

Regent Marcus expressed concern that the State might try to reorganize the University's budget activities and provide less funding based on its success with strategic sourcing. Vice President Hershman responded that the University's intentions with regard to any savings have been conveyed publicly in budget presentations. The State has never cut the University's budget because of money saved.

3. **NEW FINANCING STRUCTURE FOR UNIVERSITY OF CALIFORNIA ACADEMIC MEDICAL CENTERS**

Senior Vice President Mullinix recalled that a new debt structure plan for the medical centers was part of the continued process with the following objectives: increase debt capacity; reduce cost by enhancing the University's credit ratings; and increase operating flexibility by devising better covenants overall for debt.

Assistant Treasurer Young discussed a financing strategy for the University's medical centers that will result in higher bond ratings and therefore lower interest rates, and increased debt capacity, which will assure access to the financial markets for the medical centers. He reviewed the debt restructuring over the past three years for general campus projects for instruction and research and the expansion of debt capacity in financing housing and parking on a subordinated basis, and sketched out a financing proposal that will provide financing efficiencies for the medical centers similar to those enjoyed by general campus and auxiliaries. He reported that in 2003 a general revenue bond indenture was created that identified a basket of revenues which included student fees and tuition, auxiliary income, indirect cost recovery from federal contracts and grants, unrestricted gifts, and investment income, but not medical center revenues. At the same time, a modernized general revenue bond indenture was created to provide financing flexibility. General revenue bonds are used for new financing for projects related to core instruction and research as well as infrastructure, deferred maintenance, and systems renewal. The current bond rating is AA by both Moody's and S&P, the two most influential bond rating agencies. In 2004, UC's debt capacity was expanded by creating a subordinated financing vehicle for auxiliaries – primarily housing and parking. Unlike general revenue bonds, where pledge revenues are not project specific, limited project revenue bonds pledge to the gross revenues of projects financed. The indenture was modernized to provide the same financing flexibility to auxiliary projects as general revenue bonds provide to core education and research. Limited project revenue bonds, being subordinated bonds, are rated one notch lower than general revenue bonds, in the AA- category. It is believed that UC's debt capacity at the A debt rating level is about $4.4 billion for this fiscal year. Most of that debt capacity is already allocated to campuses for projects they have prioritized over the next three years – projects approved by the Board but not yet financed – and as a precaution as a hedge against the possible failure of voters to approve future State bond initiatives for higher education projects.

As an alternative to using UC debt to build student housing, a financing trust structure was created which provides an option to use taxes and financing for private ownership of housing by nonprofit owners. The Financing Trust Structure pools reserve funds across all projects financed under the structure, thereby reducing the total borrowing required for each project. The FTS was used for the East Campus Phase 2 project at Irvine, for a savings of about $2 million. In addition to the FTS structure, work continues on a true off balance sheet, third-party model for the Davis campus West Village development.

The current financing model for the medical centers treats each medical center as a tub on its own bottom: each medical center's financing stands on its own balance sheet, income statement, and market. The indentures, although updated with each new financing, are carry overs from the very rigid healthcare financing environment of the 1980s and resemble the indentures for community hospitals and not the prestigious academic medical centers of the University. While there is some positive benefit from being under the UC umbrella, the interest rate and other financing costs for a medical center reflect the bond rating of the medical center being financed. Underlying ratings for UC medical centers are in the A category, with San Diego and San Francisco at A+ and Davis and UCLA at A and A-. It is anticipated that Irvine also would be rated in the A category if it had hospital bond financing outstanding. There are $748 million in hospital revenue bonds outstanding for four of the five medical centers, which represents about 12 percent of all UC debt. San Francisco's bonds were issued by the California Hospital Financing Facility Authority when the medical center was part of UCSF-Stanford Health Care and were assumed by UC in 2000.

As the third phase of debt restructuring for the University, a pooled financing structure is recommended for the medical centers. The University Academic Medical Center Pooled Financing Revenue Trust Indenture will combine the net patient revenues of each of the five medical centers for repayment of external financing regardless of the medical center at which financing proceeds are spent. At the same time, the indenture will be modernized along the lines of the general revenue bonds to provide the flexibility the medical centers need to finance future capital projects. It is anticipated that pooling the medical center revenues for repayment will result in a higher bond rating than can be achieved by the medical centers alone, even by the two highest rated ones. Higher bond ratings translate into reduced borrowing rates and issuance costs, broader access to the financing market, and an increase in debt capacity, which is necessary to the creation of debt targets for the medical centers without reducing debt capacity for the general campus and auxiliaries. Preliminary discussions with S&P and Moody's have indicated that rating agencies and bond investors will respond positively to the move. For them, size and overall quality matter. Investing in a new pooled medical center bond offers the investor all five medical centers, with 3,400 beds and almost $4 billion in net patient revenues. Pooling offers market and geographical diversification in five of the largest metropolitan areas in California, each with its own market characteristics. Each medical center offers the highest level of care and complexity of procedures. They include four level one trauma centers, and UCSF operates San Francisco General Hospital, San Francisco's trauma hospital. Looking at 2005 revenues alone, Fortune 500 rankings would have placed the UC pooled academic medical centers as the fifth largest healthcare system in the nation. UC's $15 billion of revenues in 2005, excluding Department of Energy laboratories, would rank UC number 144 in the Fortune 500, displacing AT&T. It is proposed to pool financing for the medical centers for financing purposes only. This financing structure requires no change to the internal management procedures of the medical centers. Each medical center is expected to continue to develop and implement its business and market strategy to enable it to compete effectively in its local market. No medical center will be asked to pay for the operations, debt service, or health system support of any other. Each chancellor will retain the ultimate responsibility for the operations and financial health of his or her medical center, including health system support and the payment of debt service as well as the oversight and approval of the medical center's capital program. No medical center may borrow more than its own debt capacity and internal debt target. The increase in debt capacity created by pooling will be reserved to provide a cushion that assures access to the market. Medical center project financing will continue to be presented to The Regents for financing approval.

Mr. Young reported that the pooled financing proposal has been discussed with medical center administrators, who sought assurance that no individual medical center could borrow another medical center's debt capacity or any of the increased debt capacity created by pooling; that each medical center and its campus would pay for the operations and debt service and support to its own medical school; and that no medical center would be responsible for payment of any other medical center's costs in spite of the indenture pledge. The CEOs of the medical centers and deans of the schools of medicine and the campuses have approved this financing strategy, subject to the continuation of internal management practices. At the May meeting, approval will be sought for this financing strategy and authorization to create the Academic Medical Center Pooled Revenue Bond Indenture. Between now and November, discussions will continue with the medical centers on indenture terms and implementation strategies. The target date for implementation of the pooled medical center financing is November 1.

Committee Chair Blum asked what would happen if one medical center were unable to pay its bills. Senior Vice President Mullinix explained that the process would remain as it is; the campus would be responsible for the default, and if the campus could not handle it, a system liquidity process would begin. Assistant Treasurer Young added that two safety nets are in place: internal procedures require that a campus be responsible for the operations of its medical center, and The Regents' hospital working capital program is available from which a medical center may draw for hospital working capital, which includes the payment of debt service.

Regent Lansing believed that the pooling was an excellent idea. The combined entity will be more powerful but each entity will remain responsible for its fate. She advocated looking for opportunities to use the strategy in other areas of the University.

Regent Rominger asked why, if each medical center or campus still must cover its own debts, the rating services would give the University a better deal. Mr. Young responded that rating agencies give credit to health systems and consider a health system's ratios differently from individual medical centers. The University is taking advantage of that by presenting to the market the pooling of the medical centers that will be looked at at the more favorable ratios than as on a stand-alone basis. Mr. Mullinix added that it is the same idea as issuing each campus debt separately. A campus is not going to be allowed to fail, but if the debt were issued separately, if would cost more.

Regent Ruiz believed the strategy was overdue. He asked whether there would be a cost to restructuring debt. Mr. Young responded that it is planned to implement the pooled financing strategy incrementally with new money projects. Any medical center project that has not been financed yet will go immediately into the indenture; outstanding indentures will be amended so that the indenture terms reflect the same terms as the new indenture, placing all investors and all indentures on an equal footing. A bond would not be refinanced into the Pooled Financing Indenture unless that were economical. Mr. Mullinix noted that the instrument offered will be more attractive to investors. The strategy overall is not just the debt service cost savings but also the modernization of the indenture and the significant increase in debt capacity that is gained by pooling.

Committee Chair Blum noted that the University's debt capacity must be considered. Senior Vice President Mullinix responded that this program has been structured so as to increase the flexibility to issue lower level debt and create a vehicle for issuing third-party debt that all the players have agreed to. Committee Chair Blum acknowledged that the general strategy is to keep housing off the balance sheet where possible.

Regent Gould believed that the idea was sensible, especially considering the individual accountability and that it was likely that the benefit increase would emerge as a more traditional interest rate environment develops. He asked for background on debt which is off the balance sheet. Mr. Young explained that the University is trying to provide opportunities for campuses with housing sites to invite in third parties that will bring in equity and use conventional financing; such an arrangement would be off the balance sheet. He noted that the Davis campus has used third-party off balance sheet financing for years successfully. He agreed to brief Regent Gould individually on further details of the strategy.

4. **THE SAN DIEGO CONSORTIUM FOR REGENERATIVE MEDICINE**

Chancellor Fox recalled that the San Diego campus had announced the intention to join a consortium with three La Jolla based biomedical research institutions to create The San Diego Consortium for Regenerative Medicine (Consortium), a non-profit entity that would expand collaborations among the four in the area of human embryonic stem cell (hESC) research. In addition, the Consortium would plan, finance, build, own (or lease), and operate an hESC research facility. The three institutions are The Burnham Institute for Medical Research, a non-profit public benefit corporation (Burnham); The Salk Institute for Biological Studies, a non-profit public benefit corporation (Salk); and The Scripps Research Institute, a non-profit public benefit corporation (Scripps). The first step in creating the Consortium is the development and execution of a Consortium Agreement that will outline the key objectives of the collaboration.

Vice Chancellor Holmes recalled that in November, 2004, California voters had passed Proposition 71 – the California Stem Cell Research and Cures Initiative. This amendment to the State Constitution established the California Institute for Regenerative Medicine (CIRM) to make grants and loans to fund hESC research and facilities in California. The Initiative authorized issuance of General Obligation bonds of $3 billion for this purpose, subject to an annual limit of $350 million, with up to 10 percent of the total (or $300 million) to be allocated for grants to build scientific and medical research facilities.

Lawsuits challenging the constitutionality of the Initiative have thus far prevented the dissemination of these funds.

Over the past two decades, La Jolla has emerged as an internationally renowned center for biomedical research, in part because interdisciplinary collaborations have flourished within and across the traditional institutional and scientific boundaries of these institutions. Building on these existing relationships, Burnham, Salk, Scripps, and UC San Diego have begun to develop joint research and training collaborations in the hESC field. For example, the training grant proposals that each institution submitted to CIRM last July described opportunities for individual trainees from each institution to participate in activities at all four locations. These four institutions have now reached a consensus to organize more formally, to expand the quality and quantity of hESC research in La Jolla, to realize the extraordinary potential for scientific synergy among these four institutions, and to pursue extramural funding as a joint entity in order to maximize support for their scientific collaborations.

Consequently, the four institutions collaborated on a Consortium Agreement which is not legally binding on issues of substance other than a mutual agreement not to seek funding for separate research facilities while they negotiate definitive terms for the Consortium. The Consortium Agreement, which any of the four parties may terminate at its sole discretion, requires the four institutions to negotiate the details of the Consortium, including governance and organizational structure, the academic and research programs that will take place within the Consortium, and the planning, financing, and development of research space for the Consortium. UC San Diego consulted with the Office of the President and General Counsel on the content of the Consortium Agreement, and secured authorization from them for the campus to sign the Agreement.

UC San Diego will continue to work closely with the Office of the President and General Counsel on the development of the subsequent definitive four-party agreement that will be presented to the four institutions' respective Boards for approval at a future date. In particular, the Agreement is expected to result in a joint proposal to secure CIRM funding for a capital project that would be located on University land and used by the new Consortium, and subleased to the four institutions, subject to the customary campus, presidential, and Regents' review and approval processes.

Regent Preuss recalled that the dream of a common facility of institutions which would make San Diego great has been around for over 20 years. The agreement is a major step for the City and the University and for the nation and its research. He noted that the California Institute of Telecommunications and Information Technology is already working on this research, making it an overreaching collaboration of major proportions.

Regent Lansing commented that scientists working together and sharing information will result in quicker and better research, to the patient's benefit. By reaching out to other institutions, UC is leading the way. She thanked Regent Moores for his leadership and guidance and expressed the hope that other institutions would follow the University's lead.

Chairman Parsky commented that he anticipated receiving future reports on the status of the collaboration.

5. **ADOPTION OF EXPENDITURE RATE FOR THE GENERAL ENDOWMENT POOL**

The President recommended that, with the concurrence of the Committee on Investments, the rate per unit of the General Endowment Pool (GEP) for expenditure in the 2006-07 fiscal year shall be 4.75 percent of a 60-month moving average of the market value of a unit invested in the GEP.

The Committee was informed that the President's recommendation was made in consultation with the Interim Treasurer. The payout will be distributed in August 2006 for expenditure in the 2006-07 fiscal year. This will increase by 10 basis points (0.10 percent)[1] the rate adopted by The Regents in May 2005 for expenditure in the 2005-06 fiscal year. At its February 2006 meeting, the Committee on Investments approved the payout rate of 4.75 percent.

In October 1998, following a study, The Regents adopted a target endowment expenditure rate of 4.75 percent, with a first year payout of 4.35 percent. For all future years, the President and the Treasurer committed to review GEP performance, inflation expectations, and the University's programmatic needs and to recommend to The Regents a rate that would provide appropriate increases in the dollar value of the payout. In the interim years, the payout rate has been increased in stages to 4.65 percent for expenditure in 2005-06.

Also at its February meeting, the Committee on Investments approved a proposal to increase the endowment cost recovery rate by 10 basis points (0.10 percent). Endowment cost recovery is taken from the endowment payout each year and is used to recover a portion of the costs of administering and carrying out the terms of the endowments on the campuses and at the systemwide offices. The funds released by this mechanism will be used by the campuses to help support additional fundraising expenses.

Later in 2006 and in early 2007, the Office of the President, in association with the campuses, will study whether it is advisable to recover a greater percentage of the actual costs of endowment administration, perhaps up to the systemwide aggregate average for the costs of endowment administration. A subsequent recommendation will be brought forward in 2007.

The Treasurer's Office has prepared estimates, in dollar terms and year-to-year percentage change of GEP, for payouts based on a range of assumed GEP investment

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[1] One basis point is 0.01% of yield (i.e., one hundred basis points equals 1 percent); twenty-five basis points are the equivalent of $25 on endowment assets with a 60-month moving market value of $10,000; 15 basis points are the equivalent of $15 on endowment assets with a 60-month moving market value of $10,000.

returns through the end of FY2005-06, the end of the 60-month averaging period. This range of dollar payouts is considered to be an appropriate balance among the following objectives that were discussed with the Regents in October 1998:

- Maximize long-term total return;
- Preserve the real (i.e., after inflation) long-term purchasing power of the endowment portfolio's principal and of its distributions;
- Optimize annual distributions from the endowment portfolio;
- Maximize the stability and predictability of distributions;
- Promote accountability of asset management (disclosures to donors, performance reporting, etc.); and
- Promote the fundraising effort.

In response to a question asked by Regent Juline, Senior Vice President Darling noted that under the law the University is not allowed to put these monies into development. This action merely increases the endowment payout rate. The next item addresses the endowment cost recovery and will have that effect.

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

6. ADOPTION OF ENDOWMENT ADMINISTRATION COST RECOVERY RATE

The President recommended that, with the concurrence of the Committee on Investments, an endowment administration cost recovery rate of 25 basis points (0.25 percent) be approved to apply to the distributions from the General Endowment Pool (GEP) to be made after July 1, 2006, from the eligible assets invested in the GEP to defray, in part, the cost of administering and carrying out the terms of endowments on the campuses and at the systemwide offices.

Senior Vice President Darling recalled that the endowment administration cost recovery rate of 25 basis points (0.25 percent) represents an increase of 10 basis points (0.10 percent) from the existing rate of 15 basis points (0.15 percent) approved at the October 1998 Regents' meeting. The funds so recovered will help to defray the costs on the campuses and at the systemwide offices of administering and carrying out the terms of the endowments. The funds released by this mechanism will be used by the campuses to increase campus fundraising efforts. At its February 2006 meeting, the Committee on Investments recommended a range of between 25 and 30 basis points, with the exact rate to be determined by the Committee on Finance and The Regents, upon recommendation of the President.

Following an analysis of costs to administer and carry out the terms of endowments on the campuses, The Regents, at the October 1998 meeting, adopted an endowment administration cost recovery rate of 15 basis points (0.15 percent) applied to the eligible General Endowment Pool (GEP) distributions made after July 1, 1998. The recommendation was made pursuant to the March 1998 action of The Regents, in which the endowment administration cost recovery policy was adopted, as permitted by California trust law, to allow the recovery from the endowment payout of reasonable and actual administrative costs for gift assets invested in the GEP. Such costs include compliance with gift terms, reporting, and other related activities necessary to carry out the terms of endowments at the campuses and the Office of the President.

The legal justification for the endowment administration cost recovery policy is a December 1996 opinion from the California Attorney General, in which he stated, "...that Probate Code section 15684 specifically authorizes the reimbursement for all costs properly incurred in the administration of (endowment) funds. All such reimbursements must, however, come from income and not from principal (Probate Code section 16312)." In addition, he said, "...that all such expenses must be properly documented and accounted for and reimbursements subjected to independent audits. To the extent the University has pooled funds and incurs expenses on a pooled basis, it may allocate such expenses among the (endowment) on a proportionate basis."

Since the initial endowment cost recovery study in 1998, further analyses have shown that substantially greater costs were incurred in endowment administration. The actual cost to administer endowments, in dollar terms, has been reported by the campuses to be over $36 million, including both Regents and Foundation endowments. Expressed as a percentage of the 60-month average endowment value, it is approximately 57 basis points (0.57 percent); thus, the proposed rate of 25 basis points (0.25 percent) will recover just under one-half of the actual costs at the campuses and the systemwide offices to administer Regents endowments.

The funds recovered in this fashion will provide the campuses with an additional source of funds from which endowment administration costs will be paid and will have the effect of releasing the funds currently used to cover endowment administration expenses. The President and the Chancellors have committed to use the monies released by this fund source for incremental fundraising support to enable campuses to enhance their fundraising activities, not as an offset of existing fundraising expenses. The cost recovery program will be reviewed regularly by the Office of the President, as will the impact of the additional funds released for fundraising activities.

Each campus and the Office of the President would be permitted to recover endowment-related expenses of 25 basis points (0.25 percent) to be taken from the payout. The balance of each year's payout would support the individual endowments' related program activities. Following approval of the related items by the Committee on Finance and The Regents, campuses would be permitted to recover endowment-related administrative costs at the new rate beginning with distributions after June 30, 2006.

Later this calendar year and in early 2007, the Office of the President, in association with the campuses, will study whether it is advisable to recover a greater percentage of the actual costs of endowment administration, perhaps up to the systemwide aggregate average for the costs of endowment administration. Recommendations regarding possible increase in the endowment administration cost recovery rate, paired with an increase in the payout rate, will be brought forward in 2007.

At the request of Regent Hopkinson, Senior Vice President Darling agreed to present at the May meeting a report on the percentage of gifts that is used for general administrative costs.

Mr. Darling reported that, now that the target payout rate has been achieved, over the coming year an assessment will be made as to how the following objectives can be achieved: increase the corpus of the endowment and its rate of growth above the rate of inflation; increase payout to fund holders in terms of dollars above the rate of inflation; and recapture an appropriate share of costs of administering.

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

7. **REPORT OF NEW LITIGATION**

General Counsel Holst presented his **Report of New Litigation**. By this reference, the report is made a part of the official record of the meeting.

The meeting adjourned at 12:25 p.m.

Attest:

Secretary