The Regents of the University of California

COMMITTEE ON FINANCE
COMMITTEE ON COMPLIANCE AND AUDIT
November 18, 2009

The Committees on Finance and Compliance and Audit met jointly on the above date at Covel Commons, Los Angeles campus.

Members present: Representing the Committee on Finance: Regents Bernal, Island, Kozberg, Lozano, Makarechian, Schilling, and Varner; Ex officio members Gould and Yudof; Advisory members DeFreece and Simmons; Staff Advisors Abeyta and Martinez
Representing the Committee on Compliance and Audit: Regents Bernal, De La Peña, Makarechian, Ruiz, Stovitz, Varner and Zettel; Ex officio member Gould; Advisory members Hime and Simmons

In attendance: Regents Kieffer, Lansing, Marcus, Nunn Gorman, Pattiz, and Reiss, Regent-designate Cheng, Faculty Representative Powell, Secretary and Chief of Staff Griffiths, Associate Secretary Shaw, General Counsel Robinson, Chief Investment Officer Berggren, Chief Compliance and Audit Officer Vacca, Interim Provost Pitts, Executive Vice President Taylor, Interim Executive Vice President Brostrom, Senior Vice Presidents Dooley and Stobo, Vice Presidents Beckwith, Duckett, Lenz, and Sakaki, Chancellors Birgeneau, Block, Blumenthal, Desmond-Hellmann, Drake, Fox, Kang, Katehi, White, and Yang, and Recording Secretary Johns

The meeting convened at 10:15 a.m. with Committee on Finance Chair Lozano presiding.

UNIVERSITY OF CALIFORNIA FINANCIAL REPORTS, 2009

The President recommended that the Regents adopt the University of California Annual Financial Report 2008-2009 and the June 30, 2009 audited financial statements for the University of California Retirement Plan, including the PERS-VERIP; the University of California Retirement Savings Program, including the Defined Contribution, 403(b) and 457(b) Plans; and the University of California Health and Welfare Program, including the retiree health benefit trust and the five University of California Medical Centers.

[Background material was mailed to Regents in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

Chief Financial Officer Taylor introduced the University of California annual financial reports, focusing on the University's financial position as of fiscal year end June 30, 2009. He noted that this presentation would illustrate the financial environment in which the University currently finds itself and establish the framework for difficult decisions that confront the University now and will continue to confront it in the coming months.

Assistant Vice President Plotts presented a summary of the Annual Financial Report, which includes financial information for the University of California, the UC Retirement System, the campus foundations, and the Retiree Health Benefit Trust. He began with a summary of the financial position of the University of California as of June 30, 2009. The University’s total assets were $42 billion, an increase of approximately $74 million over the previous year. Total liabilities were somewhat over $22 billion. Liabilities increased by $2.3 billion over the same period. Net assets were slightly under $20 billion and declined by $2.25 billion. Over the last year, liabilities have increased, and equity has decreased.

In operating results, UC experienced a decrease in net assets of $2.25 billion in 2009, compared to a decrease of $234 million in 2008; the decrease in 2009 was greater by about $2 billion.

Mr. Plotts identified four significant factors in the 2009 financial statements. The first is equity markets and the depreciation in the value of UC investments. This depreciation in 2009 was $1.27 billion, compared to a depreciation of $192 million in the previous year, a $1.08 billion year-to-year difference. The second factor is the decline in State educational appropriations. These amounted to $2.41 billion in 2009, $560 million below the previous year’s level. The third factor is the University’s retiree health expense. This year it is $1.5 billion. This is the expense which accrues over the course of the year related to the University’s promise to its retirees. Last year this expense was $1.35 billion; it has increased by $147 million in 2009. The fourth factor is a phenomenon occurring for the first time in over 20 years, a slight pension expense in the UC financial statements. This is due to a decline in the funding status over the last few years. This expense was $69 million this year; there was no expense last year.

Turning to the University’s assets and liabilities, Mr. Plotts noted that UC investments were $13.4 billion, a depreciation of $1.4 billion from the previous year. Capital assets rose by $1.7 billion. Capital spending was about $2.9 billion, offset by $1.2 billion of depreciation expense. Debt, including commercial paper debt, increased by $964 million. Mr. Plotts called attention to the obligations for retiree health and to the UC Retirement Plan (UCRP). The obligation for retiree health, mentioned above, is $1.5 billion; but the University has funded only $279 million of this expense. The difference is recorded on the balance sheet as a liability. Similarly, the obligation to the UCRP was $69 million. There was no employer contribution. This amount is also recorded as a liability. These two line items will increase over the next several years and the expenses, which are greater than the funded amounts, will continue to be of concern to the University.

Mr. Plotts outlined four categories of net assets, which are the difference between assets and liabilities. The category “invested in capital assets, net of related debt” increased by $787 million. Restricted nonexpendable net assets are primarily the corpus of the permanent endowments. Restricted expendable net assets, which are restricted for use by an external party, declined by $1.23 billion. This category has experienced the greatest depreciation in the fair value of investments. The fourth category, unrestricted net assets, not restricted by an external party but committed internally, declined by almost $1.8 billion.

Mr. Taylor referred to a discussion of unrestricted net assets at the September meeting and recalled that the term “unrestricted” is defined by the Governmental Accounting Standards Board (GASB). These assets have sometimes been mistakenly thought of as a free-floating reserve. These funds are allocated in advance to a wide variety of academic and student programs. Mr. Taylor emphasized that, on June 30, 2007, the University’s unrestricted net assets were $6.5 billion; now, two years later, on June 30, 2009, unrestricted reserves were at $3.54 billion, a decline of $3 billion. He projected that, by June 30, 2010, these reserves will be below $1 billion. The University’s balance sheet equity is declining. There is no free-floating reserve that can be applied to UC financial problems.

Mr. Plotts continued by commenting on UC operating results. Operating revenues were $16 billion, compared to about $15.5 billion the previous year.

Mr. Taylor made a distinction between operating revenues and non-operating revenues. Operating revenues include student fee revenues. He noted that there is a fair amount of misinformation about the use of student fees. There have been allegations and a call for an audit on the use of student fees, with the idea that these fees have been used for construction or for debt service on bonds. These allegations are factually inaccurate and misleading. Mr. Taylor emphasized that, while general revenue, including the student Educational Fee, is pledged as security for bonds, none of the Educational Fee revenue is used to pay debt service on construction. Every campus construction project presented to the Board must have a clearly identified internal source of repayment. Of the 489 projects approved by the Board for use in the bond finance program since it was restructured in 2003, not a single one has used the Educational Fee as the identified source of internal repayment. Office of the President staff have examined fund transfers which occurred over the last year to check for errors in this area. Mr. Taylor stressed that the pledge of UC general revenues, including the Educational Fee, in no way necessitates a student fee increase. The pledge of UC general funds is a way of ensuring that the University can keep its financing costs down. UC’s broad general revenue pledge provides greater financing flexibility at a time when State revenues would not allow the University to meet its payroll obligations in a timely manner. If there is any evidence that any campus is misusing the Educational Fee, for example on debt service or construction projects, the administration will investigate immediately. However, without real evidence, the expense of carrying out an audit would not be justified.

Mr. Plotts returned to operating revenues, which have increased by a little over $600 million. Operating expenses increased by about the same amount. The operating loss of $4.77 billion is close to that of the previous year. The University will always show an operating loss, because State educational appropriations are required to be reported as non-operating revenues, which declined by about $1.75 billion this year. The decline in non-operating revenues reflects reduced State educational appropriations and a decline in the fair value of investments. The loss before other changes in net assets is $2.73 billion, compared to $908 million in the previous year. Other changes in net assets, including capital gifts and grants, declined slightly.

President Yudof noted that the unrestricted net assets, which were $6.5 billion two years ago, include bond proceeds for construction projects, fees collected in advance, and hospital reserves.

He asked about the current and projected amount of unrestricted net assets. Mr. Taylor responded that these assets are currently at $3.5 billion and he anticipated that on June 30, 2010, they will be between $600 million and $700 million.

President Yudof observed that the University's problem is not one of hoarding assets. These assets are being exhausted. The campuses do not have a financial cushion to offset current budget cuts.

Regent Kieffer requested clarification on the major categories of net asset reductions. Mr. Taylor responded that the decline in unrestricted net assets is due to a variety of causes. The increasing cost of the retiree health program is probably the largest single factor. Campuses are drawing on different sources of revenue to bridge over difficult financial times, and spending down unexpended plant funds on construction projects. He recalled that the University does not debt finance 100 percent of its construction projects, but requires a campus contribution.

Regent Kieffer requested clarification on the difference between these funds and reserves which are set aside. Mr. Taylor responded that some existing reserves are included in unrestricted net assets. The $3.54 billion in unrestricted net assets includes approximately $800 million in medical center reserves. However, this $800 million amount is before $200 million in transfers to campuses for operational costs. Unrestricted net assets include what might traditionally be considered reserves, but often the assets are restricted funds, monies that cannot be moved.

Regent Kieffer referred to the projected $700 million balance of unrestricted net assets for next year. He asked what proportion of those funds is already committed. Mr. Plotts responded that essentially all unrestricted net assets are committed at the campus level. The University's equity is being exhausted. If UC's retiree health program expense is $1.5 billion and UC funds $300 million of that expense, the difference of $1.2 billion is taken from unrestricted net assets.

Regent Kieffer emphasized that the University is using up its own assets. Referring to the decline in unrestricted net assets from $6 billion to $3 billion to $700 million, which is essentially pledged, he observed that the University is moving toward becoming an institution with no equity.

Committee on Finance Chair Lozano recalled that, precisely because of this concern, the Regents asked Mr. Taylor to present a review of what is included in unrestricted net assets at the last meeting. She stressed that these are designated funds which have not been expended. She concurred with Regent Kieffer's assessment of the effect of the decline in these assets.

Mr. Taylor noted that there are 76,000 individual fund account combinations in unrestricted net assets. He estimated that thousands of them have balances of less than $1,000. Many have been spent down already.

Mr. Plotts then turned to the financial position of the campus foundations. Their assets are at $4.3 billion, a decline of $718 million from last year. Their net assets declined by $641 million to $3.8 billion. This was in large part due to depreciation in the fair value of investments. They experienced an $82 million operating loss as grants to campuses were greater than private gifts received. In non-operating revenues, there was a $743 million net depreciation in fair value of investments. The increase in permanent endowments received by the campuses was far short of the depreciation in fair value of investments, resulting in the $641 million decline.

Mr. Plotts discussed the financial position of the UC Retirement System. The total system assets were $56 billion; they declined by almost $13 billion. The total net assets were $44.8 billion, declining by $11.4 billion, almost entirely as a result of the financial markets. UCRP operating results show an investment income of $1.1 billion and benefit payments of $1.86 billion. The cash flow is not sufficient to cover beneficiary payments, and the need for contributions is evident. In addition, there was a $9 billion depreciation in the fair value of investments. There was a decrease in the net assets of the Defined Contribution Plan of $1.6 billion, driven by a $2.3 billion depreciation in the fair value of investments.

Campuses and medical centers participate in the Retiree Health Benefit Trust; the Lawrence Berkeley National Laboratory does not. The Retiree Health Benefit Trust has $74 million in net assets. The actuarial accrued liability as of July 1, 2008 is $13.3 billion. This liability grew by $1.2 billion in one year. Turning to financial results, Mr. Plotts noted that there were $251 million in contributions; $235 million from UC and $16 million from retirees. The University paid $228 million to insurance companies.

Regent Zettel asked about the kinds of projects for which campus foundation funds are committed, whether capital projects, financial aid, or others. Mr. Taylor estimated that the campus foundation funds are committed up to 98 or 99 percent. Donors direct how they want funds spent. From his own experience as Chair of the UCLA Foundation Board of Directors, he stated that most donors were focused on operating programs, such as endowed chairs and scholarships, rather than on capital projects. He stated that he would provide information on the breakdown between funds for capital and operating programs.

Regent Schilling expressed astonishment at the University's liability for health benefits. She recalled that, three years ago, the estimate for annual liability was $1 billion. The University has now accrued $13 billion in liability. Mr. Plotts responded that, two years previously, the transition liability was about $12.5 billion, due to GASB Statement 45. He clarified that the $1 billion estimate may have referred to the annual cost. However, the accumulated liability at that time was about $12 billion to $12.5 billion.

Regent Schilling expressed concern that this liability could bankrupt the University. Mr. Plotts responded that the University is using up its own equity and growing its liabilities, with respect to both retiree health and pensions. Mr. Taylor added that the President's Task Force on Post-employment Benefits is seriously examining this problem. He emphasized that this problem must be solved.

Committee on Finance Chair Lozano thanked Mr. Taylor and Mr. Plotts for their clarification regarding the use of Educational Fee revenue and for the information on the decline in the University's net assets, which sheds light on the financial pressures the University is experiencing.

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

The meeting adjourned at 10:40 a.m.

Attest:

Secretary and Chief of Staff