The Regents of the University of California

COMPLIANCE AND AUDIT COMMITTEE
November 15, 2017

The Compliance and Audit Committee met on the above date at UCSF–Mission Bay Conference Center, San Francisco.

Members Present: Regents Anguiano, De La Peña, Elliott, Lemus, Makarechian, Newsom, Pérez, Sherman, and Tauscher; Ex officio member Kieffer; Advisory members Anderson, Graves, and White; Chancellors Blumenthal, Gillman, Khosla, and Yang; Expert Financial Advisor Juline; Staff Advisor Valdry

In attendance: Secretary and Chief of Staff Shaw, General Counsel Robinson, Chief Compliance and Audit Officer Bustamante, Provost Brown, Executive Vice President and Chief Financial Officer Brostrom, Executive Vice President and Chief Operating Officer Nava, Vice Presidents Andriola and Budil, and Recording Secretary Johns

The meeting convened at 10:15 a.m. with Committee Vice Chair Elliott presiding.

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

Upon motion duly made and seconded, the minutes of the meeting of September 13, 2017 were approved.

2. **ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES, 2016-17**

[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 Vice Chair Elliott explained that this was an information item, and written materials had been provided to the Regents. Committee members present had no questions on this item.

3. **UPDATE ON SIX-MONTH STATUS REPORT ON IMPLEMENTATION OF RECOMMENDATIONS FROM STATE AUDIT OF UNIVERSITY OF CALIFORNIA OFFICE OF THE PRESIDENT ADMINISTRATIVE EXPENDITURES**

[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 Operating Officer Nava reported that the Office of the President (UCOP) had submitted its six-month status report to the California State Auditor on implementation of recommendations following the State audit of UCOP administrative expenditures.

Systemwide Deputy Audit Officer Matthew Hicks recalled that the State audit report contained 33 recommendations for UCOP. The University had agreed to implement all the recommendations. UC would be required to provide further status reports in the future. As part of its standard follow-up process, the State Auditor would review information provided by UC and make its own determination on the implementation status of each recommendation. This review typically takes one to two months, and results are published on the State Auditor's website. Ten of the 33 recommendations would be due for completion in April 2018. The University believed that it was on track to completing these ten recommendations, and four of the ten were already reported as completed.

Ms. Nava recalled that the 33 implementation tasks had been organized into ten workstreams, five pertaining to staffing, and five associated with budget processes. She outlined results for some of these workstreams. The University had updated its expense reimbursement policies effective October 2017, eliminating the use of car allowances, lowering meal limits and hotel rates during business travel, eliminating the cash relocation allowance, making adjustments to moving reimbursement allowances, and prospectively eliminating contributions to the Senior Management Supplemental Benefit Program. UCOP had also made policy changes regarding employee recognition.

Regarding the cost of hotel stays, Regent Pérez asked about approval processes for UC employees who reportedly cannot find a hotel room at the policy rate and spend above that rate. Ms. Nava responded that the State Auditor's concern appeared to be the level of the University's allowance, 200 percent of the federal per diem, and affirmed that the University has protocols when accommodations cost above the threshold of $275 per night. Regent Pérez asked if these protocols had been changed. Ms. Nava responded in the negative; the protocols were not a concern for the State audit. Regent Pérez disagreed with this, stating his recollection that there had been specific concerns about these protocols. Committee Vice Chair Elliott added that the State Auditor's concern may have been the question of whether these protocols were being followed. Ms. Nava stated that the policy language could be provided and UCOP would follow up on this matter. UC believed that adequate controls were in place.

Ms. Nava then continued her presentation. A second workstream concerned an examination of fund restrictions in UCOP's budget process. UCOP had identified and categorized more than 500 fund sources and was reviewing the types of restrictions on these funds, whether of a legal or regulatory nature, external or internal. In response to a question by Regent Pérez, Ms. Nava explained that in the case of funds with internal, UC-imposed restrictions, UCOP would work with campus stakeholders and others to understand the reasons for the restrictions. The results of the work would be presented to the Regents, who would direct staff on whether the restrictions that had been identified and the recommendations put forward align with the Regents' expectations.

Another workstream was focused on UCOP's reserve policy. UCOP had carried out a considerable amount of benchmarking and analysis of reserve practices at other universities and at non-profit and government organizations of similar size to get a sense of standards in this area. UCOP was currently developing a forecasting model for reserve requirement scenarios based on UCOP's historical experience and revenue volatility.

Regent Pérez observed that there can be different ideas of what an organization of similar size is. Some Regents might feel that UCOP should compare itself to an organization the size of UCOP, while others might find that a comparison with an organization the size of the UC system would be more appropriate. He asked which size of organization the UCOP benchmarking had been based on. Ms. Nava responded that this work was still in the analysis phase, with UCOP analyzing the types of revenue volatility. Regent Pérez emphasized the tremendous difference in scale between UCOP and the entire UC system and urged the University to proceed with caution in determining which institution might be an appropriate comparator.

Regent Makarechian suggested that reserve policies for the campuses should be developed by the campuses, who best know their cash flow requirements. Ms. Nava clarified that the workstream being discussed pertained specifically to UCOP's reserve policy.

Ms. Nava remarked on UCOP efforts devoted to improving the budget presentation and process. This fall, President Napolitano had reconvened the Executive Budget Committee, a group that had existed some years earlier. The group included campus leadership, Academic Senate representatives, and UCOP leadership. The Executive Budget Committee was reviewing the current UCOP budget structure, division by division. UCOP was also beginning to focus on priorities for the 2018-19 budget cycle.

Regent Pérez again raised the issue of identifying an appropriate comparator for UCOP, and asked if UCOP was examining whether it should increase its staff or reduce the number of staff. Ms. Nava responded that it is challenging to develop benchmarks for UCOP. UCOP operates services that other university system offices do not operate, such as a pension system and an investment portfolio. The work of evaluating UCOP's size and structure was ongoing and it would help achieve efficiencies. The outside review by Sjoberg Evashenk Consulting would also help identify any duplication of services by UCOP and the campuses. Regent Pérez expressed concern that the University might be funding unnecessary operations or that some services might be better provided at the campus level than at UCOP.

Regent Makarechian asked about the membership of the Executive Budget Committee and about the source of the data it was analyzing. Ms. Nava responded that the Executive Budget Committee included representatives from each campus – the campus provost, chief financial officer, or vice chancellor for administration; the Chair and former Chair of the Academic Senate; and from UCOP, the Chief Financial Officer, the Chief Operating Officer, and the Provost. The Executive Budget Committee was currently focused on the structure of the UCOP budget. In developing the 2018-19 budget, UCOP would seek input from the campuses about their priorities.

Regent Makarechian asked how decisions for the UCOP budget are made. Ms. Nava responded that the Executive Budget Committee would provide recommendations to

President Napolitano for her review before the UCOP budget is presented to the Regents. If the President were to exclude from the budget an item that the Executive Budget Committee had strongly recommended, this would be brought to the Regents' attention.

Regent-designate Graves asked how alumni, retirees, and students would be involved in the UCOP budget development process. Ms. Nava responded that she would discuss this with Mr. Graves at a later point. She clarified that this work concerned the operating budget for UCOP, not the overall UC system budget.

Ms. Nava then remarked on another workstream focused on systemwide initiatives and programs. UCOP had begun identifying and categorizing these initiatives and programs. She concluded her presentation by outlining the workstream tasks UCOP would have completed by April 2018. In response to a question by Committee Vice Chair Elliott, she clarified that these were recommendations made by the State Auditor. Committee Vice Chair Elliott stated his hope that the State Auditor's response to UC's six-month status report would be available to the Regents at the January meeting.

Staff Advisor Valdry asked about impact on UCOP staff morale, which would ultimately have an impact on the campuses. Ms. Nava responded that UCOP leadership had been engaged in conversations with the UCOP staff assembly, which was examining non-monetary ways to recognize staff. Mr. Valdry asked if the quality of service to the campuses had been affected. Ms. Nava responded that for many UCOP operational units there are service level agreements and benchmarks. Morale is harder to measure without regular input and survey data, but UCOP had mechanisms to receive campus feedback. There had been no significant impact on service levels at the moment; it would be important to continue to monitor this situation.

4. **REPORT ON INDEPENDENT ASSESSMENT OF AUDIT IMPLEMENTATION STATUS**

[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.]

Kurt Sjoberg of Sjoberg Evashenk Consulting recalled that his firm had been engaged to conduct the independent consulting review of the Office of the President's (UCOP) implementation of the State Auditor's recommendations. Sjoberg Evashenk Consulting had visited the ten UCOP working groups to understand the dynamics of the meetings and discussion process. There was a consistency of approach among the ten groups. UCOP was committing significant resources to this process, and Mr. Sjoberg observed that this resource commitment could not continue indefinitely. UCOP was demonstrating that it was dedicated to meeting the State Auditor's deadlines. Sjoberg Evashenk Consulting would continue to monitor the progress of the working groups in areas such as gathering information for determining comparator institutions, meeting deadlines, and involving the campuses and chancellors.

Regent Makarechian noted that according to Sjoberg Evashenk Consulting's report of October 2, 2017 UCOP had selected a preliminary benchmark group of 18 universities, cities, and industry groups for UCOP's reserve policy. He asked how these institutions were selected. Mr. Sjoberg responded that his firm did not intend to create a list on behalf of UCOP. Sjoberg Evashenk Consulting had gathered background information; the working groups were considering a large number of comparator institutions, but the comparator group had not yet been finalized. Marianne Evashenk of Sjoberg Evashenk Consulting added that the firm had integrated the comparators proposed by all the working groups into a general matrix. The results had not yet been shared with UCOP, but there was general consistency in the choice of comparators.

Regent Makarechian recalled that UCOP had identified about 500 restricted fund sources. He asked if this was a normal state of affairs. Mr. Sjoberg responded that some essential questions to be asked about the funds were their purpose; whether the funds were current, being used for active programs; and the fund balance amounts. UCOP was addressing this matter and attempting to winnow down the number of funds.

5. **CYBER RISK PROGRAM UPDATE**

[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 Vice Chair Elliott briefly introduced this information item. Staff Advisor Valdry referred to the background materials provided, which mentioned campaigns across the UC system carried out by the internal audit cybersecurity audit team and the Cyber Risk Coordination Center that simulated phishing, the fraudulent practice of sending emails purporting to be from reputable entities in order to induce individuals to reveal personal information. He asked about the result of these campaigns. Vice President Andriola responded that the simulated phishing campaigns were coordinated with the campuses that wished to participate in them. They were not required. At those campuses that participated, the campaigns were successful in raising awareness of the types of phishing attacks that exist. Mr. Valdry asked if there were statistics on successful simulated phishing attacks. Mr. Andriola responded that these numbers could be provided.

Regent Pérez asked how many UC locations had availed themselves of the opportunity to take part in these campaigns. Mr. Andriola responded that fewer than half of UC locations had done so.

Committee Vice Chair Elliott asked about the cyber incident response process and certain problematic areas identified in the background materials, including inconsistent adherence to the cyber incident escalation protocol; inconsistent understanding about statutory time requirements for reporting; and unclear communication protocols between the UC Health system locations and their designated Cyber Risk Responsible Executives. He asked about UC's progress in addressing these major issues. Mr. Andriola responded that following a major cyber attack at UCLA about two years earlier, the University had carried out a self-assessment of its processes and identified opportunities for improvement. A four-step plan has been established and reviewed with the Cyber Risk Governance Committee. The implementation of steps to address each of the problematic areas that had been identified would begin around January 2018.

6. **ANNUAL REPORT OF EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 2017**

[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.]

Associate Vice President Peggy Arrivas reported that the University's annual audit by its external auditors was completed. Along with the regular reports on financial statements for the University, the medical centers, and the retirement system, this year's audit included an extra report requested by the Compliance and Audit Committee on the Office of the President.

PricewaterhouseCoopers (PwC) representative Michael Schini remarked that the audit process went well and was finished on time. The audit of the University is a large undertaking requiring extensive cooperation by UC management. From the voluminous material presented to the Regents, Mr. Schini drew attention to the Required Communications to the Board of Regents, which included information about the University's adoption of a new accounting standard, Governmental Accounting Standards Board (GASB) Statement No. 75, concerning post-employment benefits. This standard did not cause a liability to exist, but caused a liability of approximately $11.3 billion to be moved onto the University's balance sheet. Financial statements for fiscal year 2016 had also been restated in accordance with this standard. Mr. Schini also noted that during the year, the University had transferred funds to its captive insurance company, Fiat Lux, to build out that entity, a significant transaction on a consolidated basis. There were no unbooked adjustments at the end of the year. There are judgments and estimates inherent in UC's financial statements every year; there had been no changes in the current year to those judgments or to the degree of conservatism of the University's approach.

PwC representative Michael MacBryde referred to the internal control report to the Regents, the so-called Management Letter, which included three comments, two of which arose in the current year, while one related to a prior year. The prior-year comment pertained to a significant deficiency in information technology (IT) access controls. Solutions to IT problems can take some time to implement, and the University had a plan in place and was addressing this matter. One of the current-year comments concerned vacation accruals. This problem had been addressed at the relevant location and Mr. MacBryde did not expect this matter to continue into the next year. The second current-year comment related to third-party payor reserve estimates at the medical centers. PwC recommended that UC management increase controls in this area.

Regent Pérez asked in what year the University's external auditors identified the structural deficit at UC Berkeley and how this was reported in the external audit. He asked what patterns the Regents should look for in the external audit report that might indicate a similar situation at another campus or location. Executive Vice President and Chief Financial

Officer Brostrom responded that this external audit report presented aggregate financial data for all the campuses and would not identify such a pattern at a specific campus. The Financial Accounting office at the Office of the President provides an annual statement of revenues and expenses. It was in this document that the University first identified the structural deficit at the Berkeley campus, in 2015. He recalled that UC has significant unfunded liabilities for retiree health benefit and pension plans, held on the systemwide balance sheet; if these liabilities were shown at the campus level, all the campuses would have structural deficits.

Regent Pérez wondered if the aggregated figures might give the University a false sense of comfort, and asked how the Regents would be made aware of campus-specific concerns. Mr. Brostrom responded that this was a legitimate concern. The Office of the President was considering presenting periodic dashboard reports for each campus.

Regent Tauscher noted that public company boards have "heat maps" identifying issues that need to be targeted. Such maps, on a quarterly or monthly basis, might be appropriate for a large organization like UC, with its many moving parts and diversification. Ms. Arrivas responded that the annual operating cycle of the University is different from that of a public company. UC does not produce quarterly data comparable to its year-end financial statements. Some campuses were considering compiling such data, but Ms. Arrivas stressed that this would be a significant undertaking requiring additional resources.

Regent Tauscher asked about the medical centers, which have a different business cycle. Ms. Arrivas responded that the University produces quarterly reports on the medical centers and provides these reports to the Health Services Committee and to bondholders. Mr. Brostrom identified unfunded liabilities in retiree health and the UC Retirement Plan (UCRP) and capital needs at the campuses as "hot spots" for the UC system, for which the University struggles to find funding sources.

Regent Tauscher asked about the partners in UC's captive insurance company. Mr. Brostrom responded that UC was the sole partner in the captive insurance company Fiat Lux. The University had been approached by a number of other California entities, including the California State University (CSU), about establishing a separate cell within Fiat Lux with no crossover of liability. Fiat Lux has a subsidiary or second cell for medical malpractice in a risk retention group.

Regent Tauscher asked if UC had considered further diversifying Fiat Lux. Mr. Brostrom responded that some of the largest captive insurance companies in the U.S. are for associations of independent colleges; for example, there is a captive insurance company in Wisconsin for 12 different colleges. The University feels that a standalone captive insurance company for UC is appropriate, given the large size of the institution and the diversified risks due to this size. It might be worthwhile for the University to consider a subsidiary for CSU.

Regent Sherman asked what discount rates PwC considered appropriate for the retiree health program and the UCRP, given that these were the two largest liabilities for the University. Mr. Schini responded that the rate for the University's retiree health benefit program is automatically set based on an independent index, while there is room for judgment in setting the discount rate for the UCRP. For the current year, the assumption for the UCRP was kept the same, based on UC's conferral with its independent actuary. PwC had shared this information with its own in-house actuaries and concurred with the rate that had been established, feeling that it was appropriate.

Regent Sherman asked if a range of variation might be possible for this rate, such as lowering the assumption to 6.75 percent. Mr. Schini emphasized that this is a judgment about future events and that some range is possible. The proposed number would have to be based on estimates of future return.

Regent Sherman asked about the range of discount rates for public institutions of higher education. Mr. Schini responded that the UCRP discount rate is within the range of comparable institutions, give or take about 50 basis points.

Regent Pérez requested that the Compliance and Audit Committee receive the quarterly reports on the medical centers. Ms. Arrivas confirmed that it would be possible to provide these reports.

Regent Pérez referred to the unfunded liability of the UCRP as it might develop over time. He asked if the University had evaluated the impact of its decision to move from an approach with a Defined Benefit Plan only to an approach with both a Defined Benefit and a Defined Contribution Plan, with employees choosing between the two. He asked about the future unfunded liability of the Defined Benefit Plan. Mr. Brostrom responded that UC tested the participation rate in the Defined Contribution Plan, which had been expected to be 20 percent, but turned out to be higher, around 32 percent.

Regent Pérez observed that if a higher percentage of employees than expected were choosing the Defined Contribution Plan, this resulted in a smaller number of employees funding the UCRP's unfunded liability. Mr. Brostrom countered that this situation does not arise. When employees select the Defined Contribution Plan, the University is currently required to pay six percent, the portion of the unfunded liability for that individual.

Regent Pérez stated that this contribution by the University represented General Fund monies UC could then not use for other purposes. This funding was being used to offset a gap that was perhaps being exacerbated by the growth of the Defined Contribution Plan. Mr. Brostrom responded that in his view, the employees and the University were covering the normal cost every year. When UC implemented the option for the Defined Contribution Plan, it deliberately established the condition that as long as there is an unfunded liability, the University would pay a portion of the normal cost up to the Annual Required Contribution.

Regent Makarechian asked about the payout from Fiat Lux. Mr. Brostrom responded that Fiat Lux is not intended to be a profit center, but to lower the cost of insurance for the University. The loss portfolio transfer that had been made to Fiat Lux resulted in savings of about $20 million and this would allow for reduced premium. Fiat Lux was able to provide unusual forms of insurance coverage, such as coverage for a UC real estate transaction at 50 percent of the cost of outside insurance. Regent Makarechian requested the dollar amount of savings gained through Fiat Lux.

Regent Makarechian asked about a worst-case scenario for UC's unfunded liabilities. Mr. Brostrom responded that prior to establishing Fiat Lux, the University took risk positions in different insurance lines. Large portions of the University's liability are still insured either in the direct market or the resale market. UC has not changed its retention very much; UC was participating in some insurance towers and specific lines to a greater degree. The question about how much UC was increasing is exposure was relevant.

Regent Makarechian asked if the University had calculated what its real retiree health benefit liabilities would be in a worst-case scenario. Mr. Brostrom responded that retiree health benefits are covered on a pay-as-you-go basis. The cost in the past year had been about $315 million, a small amount relative to UC's total revenues of $32 billion. The retiree health benefit liabilities become inflated on UC's balance sheet because costs grow at the medical trend rate, which may range from five percent to nine percent, while the discount rate reflects the risk-free cost of capital, currently a 20-year general obligation bond rate, of about 3.5 percent. President Napolitano was forming a working group to examine options for retiree health, to determine how to make this important program sustainable over the long term. The working group would begin in January 2018; its work over the following six months would allow it to set rates for 2019.

Regent Makarechian asked about the membership of the working group. Mr. Brostrom responded that the group would reflect a broad spectrum, including representatives of the Academic Senate, staff, and retirees. The group would be led by Ms. Arrivas and Vice President Duckett.

Regent Makarechian asked if the PwC comment on vacation accruals could be solved by the UCPath system. Ms. Arrivas responded in the affirmative. Mr. Brostrom added that the establishment of one common enterprise system would avert problems such as this.

Faculty Representative White noted that the Academic Senate had asked President Napolitano to clarify the charge of the retiree health working group. The Academic Senate believed that this charge should be broad, considering all policy levers and means to develop a sustainable pathway. The Academic Senate asked that the working group have broad representation of all stakeholders, including expertise from the Academic Senate's University Committee on Faculty Welfare (UCFW) Task Force on Investment and Retirement and the UCFW Health Care Task Force. The working group should report directly to the President. The Academic Senate did not yet know the group's charge or membership.

The meeting adjourned at 11:30 a.m.

Attest:

Secretary and Chief of Staff