

Office of the President

TO MEMBERS OF THE FINANCE AND CAPITAL STRATEGIES COMMITTEE:

**ACTION ITEM**

*For Meeting of July 12, 2017*

**AUTHORIZATION TO INCREASE THE UNIVERSITY EMPLOYER CONTRIBUTION RATE, MAKE ADDITIONAL CONTRIBUTIONS TO THE UNIVERSITY OF CALIFORNIA RETIREMENT PLAN, AND ~~RESCIND THE 70 PERCENT FLOOR FOR THE UNIVERSITY'S AGGREGATE ANNUAL CONTRIBUTION TO THE RETIREE HEALTH BENEFIT PROGRAM~~**

**EXECUTIVE SUMMARY**

This item requests authorization for the President of the University to (1) set the University contribution rates to the University of California Retirement Plan (UCRP or Plan) as outlined below, and (2) make contributions to the Campus and Medical Centers (C/MC) segment of the UCRP in fiscal year (FY) 2018-19, FY 2019-20, FY 2020-21, and FY 2021-22 via internal borrowings through transfers from the Short Term Investment Pool (STIP), external financing, or a combination of both. The proposed University contribution rates and transfers from STIP and/or external financing, along with projected contributions from active members, are expected to bring the total annual contribution up to the total Annual Required Contribution (ARC)<sup>1</sup> for each of those years. ~~Additionally, this item requests authorization for the President of the University to rescind the floor of 70 percent for the University's aggregate annual contribution to the Retiree Health Benefit Program, to provide flexibility in managing the University's share of retiree health care costs.~~

**RECOMMENDATION**

The President of the University recommends that the Finance and Capital Strategies Committee recommend that the Regents:

- A. Approve increases in the University contribution rate for the Campus and Medical Centers segment of the University of California Retirement Plan (UCRP), effective July 1, 2018, to 15 percent (from 14 percent) for all member classes other than Tier Two and 7.5 percent (from seven percent) for Tier Two members<sup>2</sup>, and an increase in the employer assessment to seven percent (from six percent) for Savings Choice Participants in the Defined Contribution Plan, to help pay down the UCRP unfunded

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<sup>1</sup> ARC is the total funding policy contribution defined in Regents Policy 5601.

<sup>2</sup> The UCRP member class known as "Tier Two" is a frozen group. As of July 1, 2016, it had six active members.

liability.

- B. Add Sections H, I, J and K to the Regents' November 2015 action, *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 Contributions from Short Term Investment Pool*, as follows:

**Additions shown by underscoring**

- H. Transfer funds from STIP to UCRP in FY 2018-19, FY 2019-20, FY 2020-21, and FY 2021-22 in amounts equal to the difference between the approved total UCRP contribution and the ARC. Should STIP have insufficient funds, funds will be transferred from the Total Return Investment Portfolio (TRIP) to STIP. These transfers shall satisfy the requirements below and will not exceed \$500,000,000 in FY 2018-19, \$500,000,000 in FY 2019-20, \$600,000,000 in FY 2020-21, and \$700,000,000 in FY 2021-22:
- (1) Maintenance of a minimum balance of STIP and TRIP liquidity of \$5 billion at all times. STIP and TRIP liquidity is the sum of STIP and up to \$1 billion of STIP-like investments in TRIP.
  - (2) The creation of an internal note receivable ("STIP Note") for the amounts above, owned by STIP participants.
  - (3) The ability to set the repayment terms on the STIP Note, which will have a final maturity no later than FY 2041-42.
  - (4) 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.
  - (5) For funding sources, such as federal contracts and grants, where interest payments for the STIP Note are not billable as direct program costs, the campuses will be required to pay these charges using non-federal sources.
- I. Obtain external financing not to exceed \$2,300,000,000, plus additional related financing costs in lieu of or in addition to the STIP transfers, for the purpose described above if it is expected that this option could be accomplished at a lower cost or is more practical for the University. The repayment of external financing shall be from the same University fund sources that would be responsible for making payments on the STIP Note as outlined above.
- J. The total amount of the STIP transfers and external financing shall not exceed \$2,300,000,000 plus additional related financing costs.

- K. Take all actions and execute all documents necessary in connection with Sections H through J above.
- ~~C. Rescind the floor of 70 percent for the University's aggregate annual contribution to the Retiree Health Benefit Program, effective immediately.~~

### BACKGROUND

Since resumption of University and member contributions to UCRP in Fiscal Year (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 for the University as employer and eight percent for most members<sup>3</sup>, respectively. In order to improve the Plan's funded status, the University has also funded UCRP with internal borrowings from STIP and external borrowings to meet the ARC or modified ARC. Most recently, in November 2015, the Regents approved internal borrowings from STIP to fund UCRP in FY 2015-16, FY 2016-17, and FY 2017-18, which, along with State Proposition 2 funds<sup>4</sup>, University contributions, and member contributions, was or is expected to bring the total annual contribution to the ARC level in each of those years. The STIP internal borrowings and external borrowings are paid back through campus assessments on covered payroll.

As of July 1, 2016, the C/MC segment of UCRP was 81.4 percent funded, with actuarial value of assets (AVA) of \$48.8 billion and an actuarial accrued liability (AAL) of \$59.9 billion. The funded status improved from the previous year, when the C/MC segment of UCRP was 80.7 percent funded, with \$45.5 billion AVA and \$56.4 billion AAL. The increase was mainly the result of a \$563.5 million transfer from STIP to UCRP in FY 2015-16, which, along with contributions received, resulted in approximately fully funding the total ARC for that year. In FY 2016-17, the University transferred \$481 million from STIP to UCRP. The University plans to transfer \$391.8 million from STIP to UCRP in FY 2017-18. As stated above, the STIP transfers are internal borrowings, which are repaid through campus assessments on covered payroll.

The University has reviewed different options to fund the ARC beyond FY 2017-18, including by increasing University contribution rates, transferring additional funds from STIP and/or external financing to UCRP, and a combination thereof. This item requests authorization for a small increase in University contribution rates and additional internal borrowings from STIP, external financing, or a combination of both over four years beginning in FY 2018-19, expected to bring the total annual contribution to the ARC level in each of those years. ~~Additionally, this item requests that the floor of 70 percent for the University's aggregate annual contribution to the Retiree Health Benefit Program be rescinded to provide flexibility in managing the University's share of retiree health care costs.~~

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<sup>3</sup> 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 and 2016 Tier members.

<sup>4</sup> \$96 million in FY 2015-16, \$171 million in FY 2016-17 and \$169 million in FY 2017-18

**UNIVERSITY OF CALIFORNIA RETIREMENT PLAN**

STIP and External Borrowing

The Regents have approved approximately \$3.2 billion in transfers from STIP to UCRP and approximately \$936.5 million in external borrowing for UCRP to date. Along with the proposed increase in the University’s contribution rate, the proposed STIP transfers to and/or external financing for UCRP will help bring total annual contributions to the ARC in FY 2018-19, FY 2019-20, FY 2020-21, and FY 2021-22.

| <b>STIP and External Borrowing</b> |                         |  |                   |                   |                   |              |
|------------------------------------|-------------------------|--|-------------------|-------------------|-------------------|--------------|
|                                    | <b>Approved to Date</b> | <b>Proposed STIP Transfers and/or External Borrowing</b> |                   |                   |                   | <b>Total</b> |
|                                    |                         | <b>FY 2018-19</b>  | <b>FY 2019-20</b> | <b>FY 2020-21</b> | <b>FY 2021-22</b> |              |
| STIP Internal Borrowing            | \$3.2 B                 | \$0.5 B  | \$0.5 B           | \$0.6 B           | \$0.7 B           | \$6.4 B      |
| External Borrowing                 | \$0.9 B                 |  |                   |                   |                   |              |

Campus Payroll Assessment

As with the prior STIP transfers, the STIP transfers proposed in this item will create a STIP Note that will be repaid over the same period as the previous transfers, with a final maturity in FY 2041-42. The STIP and external borrowing are repaid via campus assessments as a percentage of covered payroll. For funding sources, such as federal contracts and grants, where interest payments for the STIP Note and external financing are not billable as direct program costs, the campuses are 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 Note is reset every July 1 for the following 12 months, based on historical STIP rates. The assessment for the currently outstanding STIP Note, external borrowing, and planned additional STIP transfers in FY 2017-18 is 1.3 percent of covered payroll in FY 2017-18, and is projected to range from 1.3 percent to 2.1 percent over the next ten years. Including current employer contributions to UCRP of 14 percent, the total C/MC contribution rate is expected to range from 15.3 percent to 16.1 percent of covered payroll over the next ten years. The additional proposed STIP transfers of \$500 million in FY 2018-19, \$500 million in FY 2019-20, \$600 million in FY 2020-21, and \$700 million in FY 2021-22 would increase the payroll assessment to approximately 1.7 percent to 3.5 percent over the next ten years. Including the proposed employer contribution of 15 percent, the total C/MC contribution rate is projected to range from 16.7 percent to 18.5 percent over the next ten years.

| <b>Projected UCRP Payroll Assessment including University Contribution and Repayment for STIP and External Borrowing Over Next Ten Years</b> |                            |  |                                       |                                       |                                       |
|--|----------------------------|--|---------------------------------------|---------------------------------------|---------------------------------------|
|  | <b>Current<sup>5</sup></b> | <b>With Proposed Employer Contribution Rate and STIP Transfers</b> |                                       |                                       |                                       |
|  |                            | <b>FY 2018-19<br/>(\$500,000,000)</b>                              | <b>FY 2019-20<br/>(\$500,000,000)</b> | <b>FY 2020-21<br/>(\$600,000,000)</b> | <b>FY 2021-22<br/>(\$700,000,000)</b> |
| Minimum  | 15.30%                     | 16.70%   | 17.10%                                | 17.55%                                | 17.90%                                |
| Maximum  | 16.10%                     | 17.40%   | 17.70%                                | 18.05%                                | 18.50%                                |

The University proposes to utilize external financing in lieu of or in addition to the STIP transfers if it would be cost-effective or more practical for the University. The University may issue taxable debt for working capital purposes and transfer the proceeds to UCRP. The total amount of the STIP transfers and external financing will not exceed \$2.3 billion plus additional related financing costs. As in the case of the proposed STIP internal borrowing, the external financing will be repaid by FY 2041-42. As stated above, the STIP Note and external borrowing are repaid via campus assessments as a percentage of covered payroll.

UCRP Projections

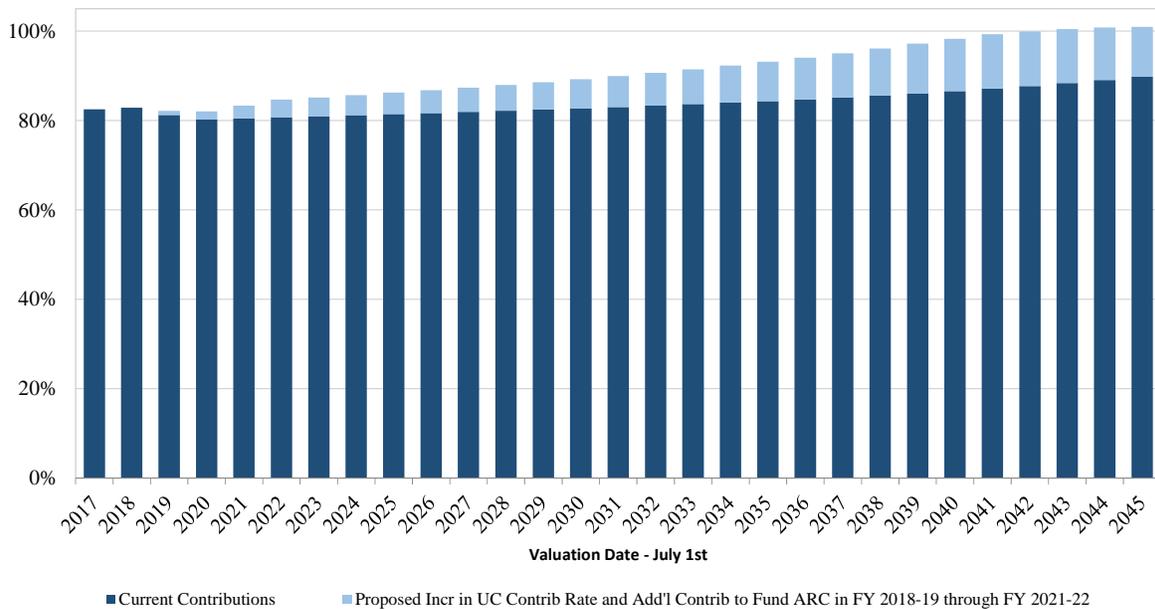
Beginning July 1, 2014, the employer contributions to UCRP rose to 14 percent and contributions for most members rose to eight percent<sup>6</sup> of covered compensation. If contributions remain at these levels and no additional contributions are made to UCRP beyond what has already been approved, including the planned STIP transfers in FY 2017-18, the C/MC segment of UCRP is projected to be 90 percent funded by July 1, 2045. If the University contribution rate increases to 15 percent for most members<sup>7</sup> beginning July 1, 2018, and additional funds are transferred from STIP and/or external financing to UCRP to bring the total annual contribution up to the ARC in FY 2018-19, FY 2019-20, FY 2020-21, and FY 2021-22 as proposed in this item, the C/MC segment is projected to be 90 percent funded by July 1, 2031.

<sup>5</sup> With current University contribution rate and approved STIP transfers through FY 2017-18

<sup>6</sup> 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 and 2016 Tier members.

<sup>7</sup> The proposed University contribution rate is 15 percent for all member classes other than Tier Two, and 7.5 percent for Tier Two members. In addition, there is a seven percent assessment for Savings Choice participants in the Defined Contribution Plan to help pay down the UCRP unfunded liability.

**UCRP Projected Funded Status on an AVA Basis**



■ Current Contributions     ■ Proposed Incr in UC Contrib Rate and Add'l Contrib to Fund ARC in FY 2018-19 through FY 2021-22  
 Campus and Medical Centers segment  
 Assumes 7.25 percent UCRP annual returns, 0.7 percent annual active member population growth, and 2016 Tier with 20 percent assumed Savings Choice election rate

**STIP and TRIP**

The University manages STIP and TRIP holistically to maintain adequate systemwide liquidity while maximizing returns to support the University’s operations. STIP and TRIP are important considerations in the rating agencies’ assessments of the University’s credit and access to liquidity. The University maintains a minimum balance of \$5 billion in STIP and TRIP liquidity to ensure sufficient liquidity for daily operating cash flow, extraordinary liquidity needs, and rating agency requirements in connection with the University’s self-liquidity obligations. STIP and TRIP liquidity includes STIP and up to \$1 billion of STIP-like investments in TRIP. In February 2017, the University implemented internal investment guidelines for TRIP, which place parameters on TRIP fixed income assets to closely mirror STIP investment guidelines, allowing the University the flexibility to count up to \$1 billion of STIP-like investments in TRIP towards the \$5 billion minimum. As of March 31, 2017, the University’s STIP balance was \$5.6 billion and TRIP balance was \$8.9 billion.

The Office of the Chief Financial Officer will work with the Office of the Chief Investment Officer on the proposed transfers from STIP to UCRP to ensure there are sufficient funds in STIP. Should there be insufficient funds in STIP for the proposed transfers, 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 OF CALIFORNIA RETIREE HEALTH BENEFIT PROGRAM**

Retiree health benefits are a valuable tool in the University's recruitment and retention efforts. Access to affordable, high-quality health care coverage in retirement is a priority to the University's employees and retirees alike, especially in light of increasing healthcare costs. Consequently, the University will continue to provide retiree health benefits. In the December 2010 Regents action, *University of California Post-Employment Benefits—An Overview*, the University lowered its maximum aggregate contribution toward the retiree health premiums to a floor of 70 percent, to control retiree health costs. As of January 1, 2017, the University's share of retiree health premiums is at or near the 70 percent floor. Healthcare costs continue to escalate at a pace faster than inflation. Higher healthcare costs along with increases in the number of retirees eligible for retiree healthcare benefits are resulting in escalating pay-as-you-go funding for retiree health care costs.

The cost of the retiree health program is not pre-funded but rather included in the University's operating budget on a pay-as-you-go basis. Retiree health benefits are not paid from the UCRP trust. Program options, benefits, and rates are subject to change or termination each year and are not accrued or vested benefit entitlements. To provide future flexibility in managing the University's share of retiree health care costs, this item proposes rescission of the 70 percent floor for the maximum aggregate contribution toward the retiree health premiums as approved by the Regents in December 2010.

This recommendation would apply to all eligible Retiree Health Benefit Program participants, based on their level of University contributions, which is based on their hire date, years of service credit, and other factors. The administration should reassess the level of the University contribution each year, during the annual health plan renewal process and in the context of overall budget resources, salary adjustments for active employees, and cost-of-living adjustments (COLAs) for retirees.

Key to Acronyms

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|-------|--|
| AAL   | Actuarial Accrued Liability                  |
| ARC   | Annual Required Contribution                 |
| AVA   | Actuarial Value of Assets                    |
| COLA  | Cost-of-Living Adjustment                    |
| C/MC  | Campus and Medical Centers                   |
| FY    | Fiscal Year                                  |
| PEPRA | Public Employees' Pension Reform Act of 2013 |
| STIP  | Short Term Investment Pool                   |
| TRIP  | Total Return Investment Pool                 |
| UCRP  | University of California Retirement Plan     |

APPENDIX

Previous Actions: **September 2008:** The Regents approved a funding policy for the C/MC 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:** *University of California Post-Employment Benefits – An Overview*, 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 Regents approved changes to University-sponsored post-employment benefits, including a UCRP new hire tier effective July 1, 2013 and the lowering of the University's aggregate contribution to the Retiree Health Program to a floor of 70 percent. The Regents also delegated to the President of the University the authority to fully fund the UCRP ARC.

**March 2011:** The Regents authorized the President of the University 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 of the University 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 2013:** The Regents approved increases in University and member contribution rates to UCRP beginning in Plan Year 2014-15.

**July 2014:** The Regents authorized the President of the University 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<sup>8</sup> via an asset transfer from STIP.

**November 2015:** The Regents authorized the President of the University to make contributions to UCRP from STIP in FY 2015-16, FY 2016-17, and

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<sup>8</sup> Since the \$700 million was deposited in FY 2014-15, this became an amount to fully-fund ARC for FY 2014-15.

FY 2017-18 to bring the total annual contribution up to ARC in those years.

**March 2016:** The Regents approved the Retirement Choice Program effective July 1, 2016 for newly hired faculty and staff and certain rehires and newly eligible employees. Pensionable earnings are limited to the Public Employees' Pension Reform Act (PEPRA) limit, which is \$118,775 effective July 1, 2017.