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Office of the President

TO MEMBERS OF THE COMMITTEE ON FINANCE:

ACTION ITEM

For Meeting of March 16, 2011

AUTHORIZATION TO MAKE ADDITIONAL CONTRIBUTIONS TOWARD THE UNIVERSITY OF CALIFORNIA RETIREMENT PLAN'S ANNUAL REQUIRED CONTRIBUTION (ARC) FROM ONE OR MULTIPLE SOURCES

EXECUTIVE SUMMARY

Consistent with the December 13, 2010 Regents' action item regarding post-employment benefits, this item recommends that the Regents provide the President additional flexibility to perform asset transfers to the University of California Retirement Plan ("UCRP" or "Plan") beginning in the current fiscal year (FY2010-11), and includes an additional funding option for consideration.

The goal of these asset transfers would be to pay the unfunded portion of the University's Normal Cost for the pension system, as well as the interest on the unfunded liability in UCRP ("modified ARC"). The funds to be transferred would be obtained by one or a combination of the following options:

1. Transfers from the Short-Term Investment Pool (STIP)
2. Proceeds garnered through the sale of debt as part of a general taxable borrowing, or
3. Restructuring existing debt to allow previously budgeted revenues to be used for partial payment of the modified ARC

On December 13, 2010, the Regents delegated authority to the President to fully fund the UCRP annual required contribution[1] (ARC) as quickly as practical by paying UCRP modified ARC (Normal Cost plus interest only on the Unfunded Actuarial Accrued Liability (UAAL)) from 2011 until 2018, using University resources as appropriate to make up the gap between approved contributions and modified ARC. This item requests authorization to contribute modified ARC beginning in the current fiscal year, FY2010-11. Additionally, option number two above would be a new source of funding.

[1] A measure of needed plan funding used by the Governmental Accounting Standards Board (GASB). The ARC has two parts: the Normal Cost (the cost allocated to each additional year of service credit for all active UCRP members) and the Amortization (the annual amount needed to eliminate the unfunded liability over the Plan's amortization period), which is currently 30 years under the Regents' funding policy (changed from 15 to 30 years at the September 2010 meeting).

Contributing modified ARC to UCRP for FY2010-11 and FY2011-12, in the amount of approximately $2.1 billion over the approved contribution amount levels, will improve the funded status of the Plan, greatly lessen any need to report on the University's balance sheet annual underfunding during those two years, reduce the future growth of UCRP's UAAL and allow the University to lower necessary UCRP **employer** contributions by $3.7 billion[2] over the 19-year period from FY2017-18 to FY2035-36, or approximately 1.4 percent of annual UCRP covered compensation.

Previous Actions: **September 2008**: The Regents approved a funding policy for the campus and medical center segment of UCRP.

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

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

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

RECOMMENDATION

The President recommends that the Committee on Finance recommend that the Regents amend *University of California Post-Employment Benefits Recommendations* recommended by the Committee on Finance and approved by the Board of Regents at the December 13, 2010 meeting as follows:

Additions shown by underscoring; deletions shown by strikethrough

The President be delegated authority and discretion to fully fund the Annual Required Contribution (ARC) for the University of California Retirement Plan (UCRP) in the following two phases. From fiscal year (FY) ~~2011~~ 2010-11 through FY 2018-19, the University would contribute to UCRP, to the extent practical, the "modified" ARC, which would include the

[2] Projected $3.7 billion savings calculated based STIP borrowing at 2.5 percent. The net present value of these savings is $2.5 billon based on a 2.5 percent discount rate. Additional savings accrue past FY2036. Projected retirement costs and payroll data provided by The Segal Company and are based on the July 1, 2010 Actuarial Valuation Report for UCRP.

normal cost plus interest only on the Unfunded Actuarial Accrued Liability (UAAL). Beyond FY 2018-19, the University would contribute the full ARC payment, which would include the normal cost on the pension, interest on the UAAL, and an amount that represents the annual principal contribution of the 30-year amortization of the UAAL. The President may utilize borrowing from the Short Term Investment Pool (STIP), restructuring of University debt, and other internal or external sources to fund the gap between scheduled pension contributions from the University and employees, and the required funding amount~~, as~~ described above, as follows:

A. Transfer funds from STIP to UCRP in FY2010-11 and FY2011-12 for an amount equal to the difference between the approved total UCRP contribution and modified ARC (Normal Cost plus interest only on the UAAL). The STIP transfer shall satisfy the requirements below, and not exceed a total of $2,100,000,000:

   (1) The creation of an internal note receivable (“STIP Note”) for the amount above, owned by STIP participants.

   (2) The ability to set the repayment terms on the STIP Note, not to exceed a maximum of a 30-year amortization period.

   (3) Adoption of a waiver to the STIP investment guideline’s maximum of five and a half years on investments to accommodate the terms of this STIP Note.

   (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, campuses will be required to pay these charges using unrestricted general revenues. These fund sources may also be excluded from the STIP loan repayment if they pre-pay their portion of the modified ARC assessment in FY2010-11 and FY2011-12.

B. Obtain external financing (not to exceed $1,000,000,000) in lieu of the STIP Note if it is expected this option could be accomplished at a lower cost or is more practical for the University. The repayment of this debt shall be from the same University fund sources responsible for making payments as outlined in recommendation number two above.

C. Partially restructure the Regents’ long-term debt portfolio starting in fiscal year 2010-11, in an amount not to exceed $1,000,000,000, of such long-term debt plus additional related refinancing costs.

D. The combination of the STIP transfer, debt restructuring and the portion of external financing intended to make contributions to UCRP shall not exceed $2,100,000,000.

E. To take all necessary actions related to the STIP transfer, external financing, and debt restructuring and to execute and deliver related financing documents.

BACKGROUND

The post-employment benefits the University of California (UC) offers to employees play a vital role in attracting and retaining the caliber of faculty and staff needed to maintain UC as a premier public research university and preserve the quality of the University's service to the public. UC is committed to providing high quality benefit programs. The University's pension benefits are designed to recognize faculty and staff who spend long careers at UC. The University is also committed to focusing its efforts on providing fiscally sustainable post-employment benefits for both current and future retirees. The University faces serious challenges in achieving a fiscal balance between current expenses and long-term obligations. Costs are increasing, UC and its employees are facing increasing contribution levels, and the State has not resumed its funding of the University's pension fund.

An Overview of University of California Post-Employment Benefits, including UCRP and the Retiree Health Program, was presented to the Regents at their meeting on September 16, 2010. (See http://www.universityofcalifornia.edu/regents/regmeet/sept10/j4.pdf.)

The President's final recommendations for changes to the University of California Post-Employment Benefits, including UCRP and the Retiree Health Program, were approved by the Regents on December 13, 2010.
(See http://www.universityofcalifornia.edu/regents/regmeet/dec10/j1.pdf)

FINANCIAL ANALYSIS

The Regents delegated authority to the President to fully fund the UCRP ARC as quickly as practical by paying UCRP modified ARC (Normal Cost plus interest only on the UAAL) from 2011 until 2018 and using other University resources to make up the gap between the total contribution rate and modified ARC. This item also requests authority to pay modified ARC in FY2010-11.

The December 13, 2010 recommendation, approved and authorized by the Regents, involves contributions totaling UCRP Normal Cost plus interest only on the UCRP unfunded liability until 2018 as an interim financing strategy, and then switching to contributions totaling ARC (i.e., Normal Cost with full amortization of UAAL) thereafter. While paying both the principal and interest is the recommended long-term plan, an interest-only payment on UCRP's unfunded liability through June 2018 provides the University with approximately $900 million reduced pension costs out of the annual operating budgets of the campuses and medical centers from July 2011 to June 2018 (as described in the Post-Employment Benefits Task Force report). This interim financing strategy stops UCRP's unfunded liability from growing, achieves temporary budgetary relief and moves the University closer to fully funding ARC.

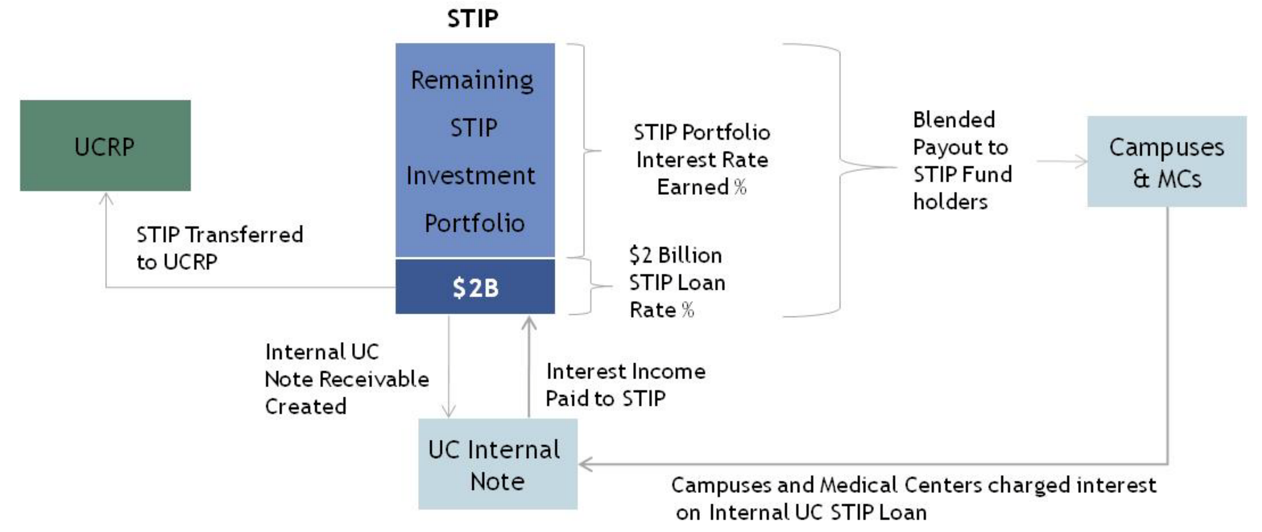
STIP TRANSFER:
The University's practice has been to transfer funds to UCRP equivalent to the amounts that are assessed on campuses and medical centers. The transfers to UCRP are made in advance of the campus assessments. The campus assessment for this fund transfer from STIP to UCRP is to be

spread over a 30-year period (plus interest at an agreed-upon rate) by all University funding sources that are responsible for UCRP benefits costs.

This recommendation would utilize the University's STIP balance by borrowing up to the annual funding gap amount from STIP at an agreed-upon interest rate to be paid back over a 30-year period. The borrowed funds would be used to pay the modified ARC (less the total contribution rate) in fiscal years 2010-11 and 2011-12. The amount borrowed would be limited to the annual funding gap between the Normal Cost plus interest on the UAAL and the scheduled total University and member pension contribution percentage recommended by the President and approved by the Regents. The University's borrowing rate would be reset every May for the following 12 months beginning on July 1st, based upon the historical STIP interest rate for that fiscal year. Currently, this cost is much lower than the cost to issue fixed rate pension obligation bonds, which are another potential source of funding for UCRP contributions. The repayment term is to be set for a period no greater than 30 years, but in an extended period of positive market returns, it is possible that in the future the repayment of STIP could be accelerated. In addition, the total borrowed from STIP would be limited, in an attempt to ascertain an amount that would not adversely affect the University's daily liquidity needs, as determined in partnership with the rating agencies.

While repayment of the Note (principal and interest) would have to be built into the operating budgets of campuses and medical centers, the relatively low borrowing rate limits the amount to between 0.6 percent and 0.8 percent of payroll over the 30-year term of the STIP note. The repayment source for the loan would be equally distributed proportionally among the fund sources that pay into UCRP and there would be an assessment above the approved UCRP contribution for the repayment of the principal and interest payments on the STIP Note. The interest and principal would then be utilized to pay back STIP Note holders and would be part of monthly STIP income. For funding sources, such as federal contracts and grants, where interest payments for the STIP Note are not billable as direct program costs, campuses will be required to pay these charges using unrestricted general revenues. These fund sources may also be excluded from the STIP loan repayment if they pre-pay their portion of the modified ARC assessment in FY2010-11 and FY2011-12. See flow of funds diagram below.

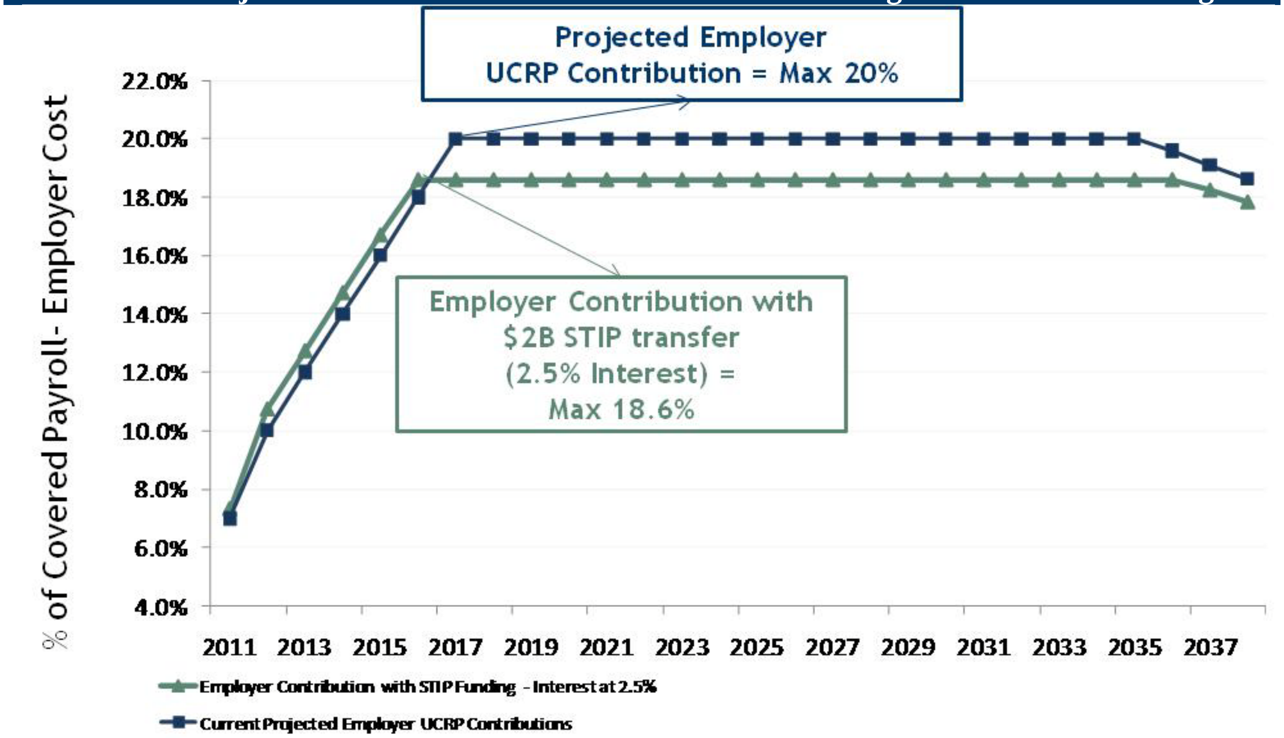
STIP Note Flow of Funds



Under current modeling projections, the University's contribution rate to UCRP increases annually by two percent of covered payroll to reach an imposed limit of 20 percent by FY 2017-18 and plateaus at this cost until FY2035-36, decreasing slowly thereafter in line with the decrease in ARC. Transferring from STIP to UCRP the University's annual funding gap in FY 2010-11 and FY 2011-12 ($1.1 billion and $0.9 billion, respectively) could reduce the University's maximum annual contribution to 18.6 percent of pay from FY 2017-18-FY2035-36 instead of 20 percent, as shown in the graph on the next page. This is a projected decrease in contributions of $3.7 billion over the 19 year period.[3]

[3] Projected $3.7 billion savings calculated based STIP borrowing at 2.5 percent. The net present value of these savings is $2.5 billon based on a 2.5 percent discount rate. Additional savings accrue past FY2036. Projected retirement costs and payroll data provided by the Segal Company and are based on the July 1, 2010 Actuarial Valuation Report for UCRP.

Employer Contribution:
Current Projected Contributions vs. Contributions including some STIP Borrowing



Assumptions:
-Reflects new tier approved on December 13, 2010 by the Regents implemented by FY2013.
-Assumes zero growth in employee population.
-Market value investment returns of 7.5 percent per year beginning July 1, 2010.

As of June 30, 2010, the University had $6.7 billion[4] in STIP. This strong liquidity position is one of the University's major financial strengths and the University remains committed to maintaining adequate liquidity to meet daily operational needs. The University conducted a systemwide liquidity analysis and found that since FY2004-5, 99 percent of the time, STIP's daily cash fluctuates no more than five percent of the total STIP balance. Quarterly fluctuations are larger, with average STIP balance reductions of $1.0 – $1.5 billion. In addition to daily and quarterly fluctuations, cash reserves are also needed for commercial paper payments and Medical Center working capital reserves. Thus, an up to $2 billion STIP transfer would not have a negative effect on the University's daily operational liquidity needs. Any transfers above this amount would require a further analysis of risks, trade-offs and possibly changes in the University's day-to-day operations.

[4] Excludes investments held for third parties, campus foundations, UCRP, unexpended bond proceeds and MOP investments and allocations.

EXTERNAL BORROWING:

As stated above, the University's practice has been to transfer funds to UCRP equivalent to the amounts that are assessed on campuses and medical centers for the Plan.

In this scenario, the University would issue taxable debt as a working capital borrowing and transfer some or all of the proceeds to UCRP to cover the annual modified ARC amount for FY2010-11 and FY2011-12 in advance of the campus and medical center assessment. As in the STIP transfer alternative, the campus assessment for this deposit to UCRP would be spread over a 30-year period (plus interest at an agreed-upon rate) and repaid using the same University funding sources.

This alternative would be executed only in the case where market conditions are such that it is more cost-effective or practical for the University to issue working capital debt than to transfer STIP funds into UCRP. While a traditional fixed rate 30-year pension obligation bond would not be cost-effective (current yields for such debt exceed 6.5 percent), there are other debt structures available that can be issued at the shorter end of the yield curve below the current STIP rate. As the interest rate payout for STIP is currently 2.71 percent[5], any debt with an interest rate below this amount would reduce the UCRP assessment to the campuses and medical centers for the pre-paid FY2010-11 and FY2011-12 modified ARC amounts.

The University is reviewing alternatives, including a fixed rate note with an annual or longer interest reset period and other variable rate options. In order to protect the University from interest rate risk, the University may also consider hedging mechanisms.

Given the short-term nature of these instruments, the cost of this debt can be periodically assessed and compared to the STIP transfer alternative. If the interest rates increase dramatically relative to STIP earnings, the University can and will take out the bonds with STIP funds and continue the campus UCRP assessment in the same manner as in the case of the STIP transfer alternative.

DEBT RESTRUCTURING:

A restructuring of near-term debt service obligations would extend the repayment horizon of existing long-term bonds, matching certain amounts of principal and interest with the useful lives of the assets originally financed, allowing previously budgeted revenues to be used instead for partial payment of pension costs.

As of December 31, 2010, the University had approximately $10.4 billion in debt outstanding (excluding commercial paper).

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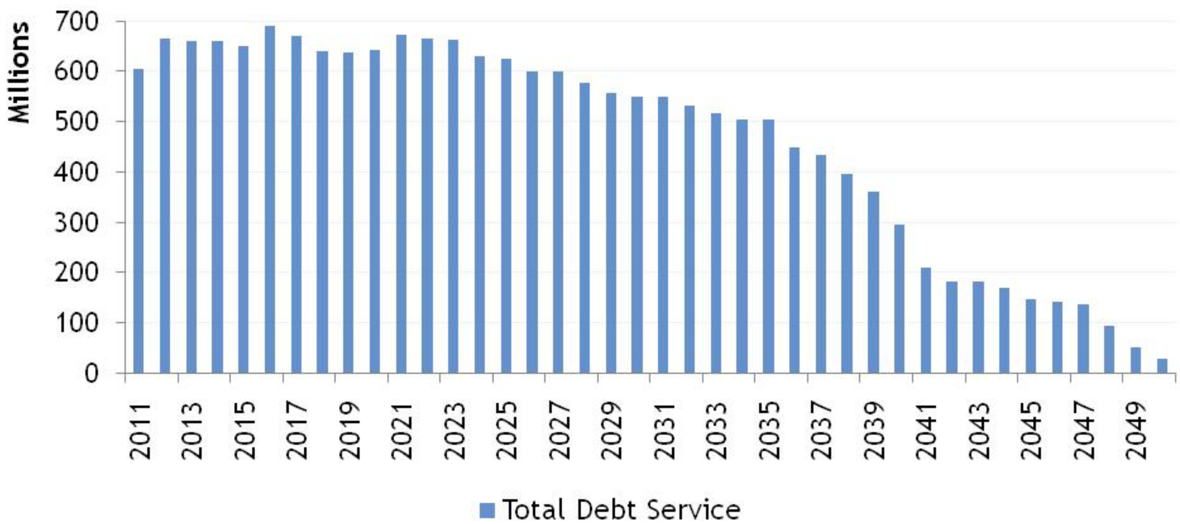
[5] Calculated from January 1, 2010 to December 31, 2010.

University of California Annual Debt Service* as of 12/31/2010



*Includes debt service on the University's General Revenue Bond (GRB) credit, Multi-Purpose Project (MPP) credit, Limited Project Revenue Bonds credit (LPRB) and medical center credit.

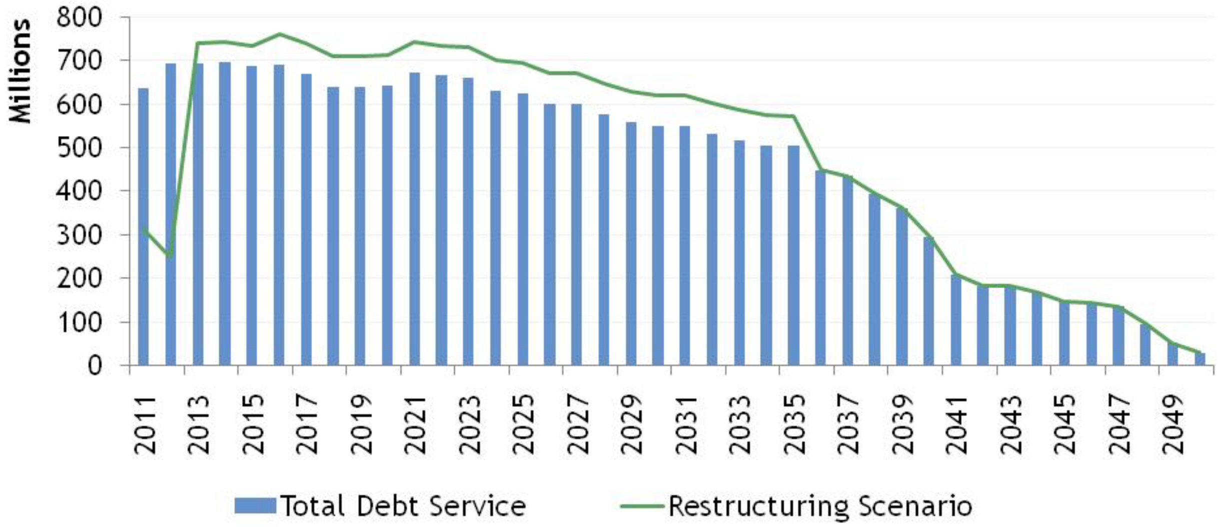
As shown in the graph, the University has a front-loaded debt structure with debt service dropping off significantly in approximately 20 years. The University's average annual debt service obligation in the next two years is approximately $660 million. The University would free up money to be redirected to UCRP by restructuring some of its existing debt, essentially pushing debt service scheduled to be paid over the next two years into future years.

The restructuring would have a neutral effect on campus budgets for the next two years, however, thereafter debt service for the restructured debt would be higher than currently projected. The restructuring would come at a small cost to the University on a present-value basis, but it would allow a large cash infusion into UCRP in the near term.

The restructuring would be focused on the University's debt portfolio from FY2010-11 to FY2011-12. The target amount of restructuring savings could be approximately $800 million, depending on the final structuring, for a total of not to exceed $1 billion (exclusive of refinancing costs). Refinancing bonds would be issued likely starting in calendar year 2011.

The following graph compares existing debt service to the proposed restructuring scenario. In this scenario, approximately $800 million of the University's existing debt portfolio in FY2010-11 to FY2011-12 is restructured. The pro-forma annual debt service is approximately $280 million for the next two years, representing an average of $380 million lower annual debt service. The estimated present value cost of the restructuring scenario is approximately $35 million given current market conditions.

University of California Projected Restructured Debt Service



The new, restructured debt service is assumed to amortize from FY2016-17 to FY2035-39. The shape and term of the refunding debt service would be subject to market conditions and certain tax restrictions related to average life of the underlying projects.