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Office of the President

TO MEMBERS OF THE COMMITTEE ON FINANCE:

ACTION ITEM

For Meeting of May 17, 2007

ESTABLISHMENT OF AN IRC SECTION 115 TRUST TO SUPPORT NEW GOVERNMENTAL ACCOUNTING STANDARDS BOARD REPORTING OF RETIREE HEALTH BENEFIT OBLIGATIONS

EXECUTIVE SUMMARY

The Departments of Financial Management and Human Resources and Benefits have developed a strategy to comply with the new financial reporting requirements established by the Governmental Accounting Standards Board (GASB) that will apply to postemployment benefits other than pensions (referred to as OPEB) starting with the fiscal year beginning July 1, 2007. The Regents were briefed on the proposal to establish a trust, including a discussion of the specific goals of the trust, at their March 2007 meeting. In addition, Financial Management and Human Resources and Benefits have consulted with the University's Committee on Faculty Welfare and its Task Force on Investments and Retirement.

This item requests authorization to establish an Internal Revenue Code (IRC) Section 115 trust to serve as a payment conduit between the University and the OPEB healthcare vendors and administrators in order to simplify the overall administrative compliance with the new financial reporting requirements.

This item does not change the University's retiree program or the funding policy related to the program. Further, the establishment of a trust as an administrative payment conduit would not require changes to the University's current funding practices or benefit programs. Those decisions are independent of the establishment of a trust, although a trust would be recommended for prefunding of OPEB liabilities should The Regents consider such a decision in the future.

RECOMMENDATION

The President recommends that the Committee on Finance recommend to The Regents that the President be granted authority to establish an IRC Section 115 trust to facilitate the University's administrative compliance with the Governmental Accounting Standards Board financial reporting requirements applicable to the University's retiree health benefit program, effective July 1, 2007, with The Regents serving as trustee of the trust and the Office of the Treasurer managing the investments, if any, consistent with policies established by The Regents.

BACKGROUND

In June 2004, the GASB issued Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions, that will substantially change the financial reporting for and disclosure of OPEB costs in the University's audited financial statements. It will affect not only the University's consolidated financial statements, but also the statements of all University and affiliate locations that issue separate audited financial statements, such as the University's medical centers, the Continuing Education of the Bar (CEB), University of California Press (UC Press), Associated Students-UCLA (ASUCLA) and others (referred to in aggregate as the "Carve Out Locations"). For this reason, the University's implementation strategy must broadly consider the potential operational concerns, administrative costs and financial reporting implications for the Carve Out Locations, as well as the University as a whole. The University must implement the GASB financial reporting changes starting with the fiscal year beginning July 1, 2007. In order to implement the new GASB requirements with the most administrative efficiency, the University has determined that an adoption of a trust as an administrative payment conduit would be the preferred method of implementation.

University-Specific Goals for the Trust

The University-specific goals for a trust to respond to the GASB requirements are to:

- Maintain consistency with the University's systemwide, cost sharing of benefit costs approach for pensions and retiree health benefits;
- Allow management flexibility to define the level of required contributions using a common assessment approach similar to the current process;
- Capitalize on existing administrative systems and capabilities by aligning the OPEB process with the operational processes associated with the University of California Retirement plan (UCRP) and Retirement Savings Program plans; and
- Minimize the potential administrative requirements and financial reporting implications to locations that currently issue audited financial statements separate from the University's consolidated financial statements.

Locations that continue to pay on an actual cost rather than cost-sharing basis, currently expected to be Lawrence Berkeley National Laboratory and Lawrence Livermore National Laboratory as a result of the contract language with the Department of Energy, would be treated as having individual OPEB costs and liabilities based on a separate actuarial valuation conducted for each of these two entities. The Hastings College of the Law, an affiliate of the University that participates in all of the University's employee benefit programs, has indicated it prefers the cost-sharing approach, in part to maintain administrative efficiency for its organization.

Significant Trust Provisions

In order to achieve the flexibility and administrative efficiencies available to cost-sharing employers, the GASB requires that the funding vehicle meet three requirements. It must provide that contributions will be irrevocable, assets accumulated in the vehicle will be used only to provide benefits to participants and beneficiaries, and assets will be legally protected from creditors. To satisfy the GASB requirements, as well as the goals listed in the prior section, and based on the advice of internal and external legal counsel, it was determined that the most appropriate vehicle would be a tax-exempt grantor trust described in Section 115 of the Internal Revenue Code. Key features of the trust document include:

- Participation in the trust is limited to the University's current cost-sharing locations plus the University's affiliate, the Hasting College of the Law. Any additional affiliates must be approved by The Regents.

- The fiduciary structure parallels that of UCRP. The Regents will serve as trustee and retain oversight responsibility for administrative and investment functions. The Associate Vice President, Human Resources and Benefits, is named as the "Trust Administrator" with primary responsibility for the administrative functions, including accounting and record keeping. The Office of the Treasurer will have primary responsibility for investing the assets of the trust, if any, according to policies established by The Regents.

- Contributions to the trust at the rate determined by the Trust Administrator are irrevocable. If a Participating Location requests to withdraw from the trust, the interest of the location in the trust accumulations, if any, must be transferred to a vehicle that will use the assets to provide health and/or welfare benefits unless the Participating Location's liabilities for all such benefits have been satisfied.

- The trust will pay vendors and administrative organizations for the programs included in the Annuitant Medical and Dental Plans. Each such benefit plan is defined to include a portion maintained for the cost-sharing employers with costs and expenses paid through the trust and a portion maintained for the non-participating locations whose costs and expenses are paid outside the trust based on actual cost.