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Office of the President

TO MEMBERS OF THE COMMITTEE ON FINANCE:

DISCUSSION ITEM

For Meeting of November 16, 2011

ANNUAL ACTUARIAL VALUATION OF THE UNIVERSITY OF CALIFORNIA RETIREE HEALTH BENEFIT PROGRAM

EXECUTIVE SUMMARY

Each year, Deloitte Consulting LLP performs an actuarial valuation of the University's Retiree Health Benefit Program to fulfill the University's financial reporting obligations and to inform the Regents on these obligations. The purpose of the annual valuation of the Retiree Health Benefit Program is to report the unfunded actuarial liability and the annual expense of the program for disclosure purposes and to analyze the preceding year's experience. This item addresses only the current year retiree health benefit actuarial valuation, including the effect of several assumption changes such as the assumed contribution policy for future years as a result of actions approved by the Regents based on recommendations from the President's Post-Employment Benefits Task Force.

Issues: ***Retiree Health Benefit Program Valuation Results***

All amounts shown are for University campuses and medical centers, which includes the Office of the President, Agricultural & Natural Resources and the Associated Students of UCLA, but excludes the Lawrence Berkeley National Laboratory and Hastings College of the Law.

- The July 1, 2011 Unfunded Actuarial Accrued Liability (UAAL) is $14.6 billion.

- The Annual Required Contribution (ARC) for Fiscal Year 2011-2012 is $1.76 billion, consisting of:

  - A Normal Cost of $0.56 billion, approximately 7.1 percent of the University of California Retirement Plan (UCRP) covered payroll, and
  - An amortization cost of $1.20 billion, approximately 15.2 percent of UCRP covered payroll.

Under governmental financial accounting and reporting requirements, the ARC is not required to be funded but it will be a component of the retiree health benefit expense recorded in the University's financial statements.

- Projected University cash costs for Fiscal Year 2011-2012 are $260 million, up from $255 million in Fiscal Year 2010-2011. This represents the projected pay-as-you-go cash costs of the retiree health benefits funded by a systemwide retiree health assessment.

- In December 2010, the Regents approved gradually reducing the University's contribution to 70 percent of total premiums, subject to an annual review. For purposes of this valuation, it has been assumed that the pattern of a three percentage point annual decrease in the contribution percentage will continue until the floor of 70 percent is reached (separately for Medicare eligible retirees and non-Medicare eligible retirees under 65). This change in the University's assumed contribution policy resulted in a decrease in the Actuarial Accrued Liability of $1,647 million (11.4 percent) and the ARC of $186 million (10.2 percent).

- In July 2011, the Regents adopted changes to the actuarial assumptions used for the retirement plans based on recommendations from the UCRP experience study covering the period July 1, 2006 through June 30, 2010. This valuation reflects the applicable changes in demographic assumptions that were adopted. (Note that the economic assumptions for the Retiree Health Benefit Program are different than those used by UCRP.) These changes in demographic assumptions resulted in an increase in the Actuarial Accrued Liability of $281 million (1.9 percent) and a decrease in the ARC of $46 million (2.5 percent). Due to certain assumption changes combined with the actuarial funding method, the liability and ARC moved in opposite directions.

- For the July 1, 2011 valuation, the methodology used for setting medical trend rates was changed by applying separate rates to Medicare and non-Medicare plans. This methodology change was made, in part, to reflect the recent pattern, where Medicare reimbursements for Medicare Advantage plans have been increasing more slowly than overall medical costs. It is assumed this pattern will continue until the costs of these Medicare Advantage plans are consistent with Medicare fee-for-service. The resulting pass through costs of these lower reimbursements is expected to significantly increase the University's premiums for Medicare Advantage plans. This methodology change resulted in an increase in the Actuarial Accrued Liability of $1,561 million (10.8 percent) and the ARC of $174 million (9.6 percent).

- The net effect of the three assumption and methodology changes explained above was an increase in the Actuarial Accrued Liability of $196 million (1.4 percent) and a decrease in the ARC of $58 million (3.2 percent).

Previous Actions: **December 2010**: the Regents approved changes to University-sponsored post-employment benefits.

July 2011: Following the recommendation of the UCRP Consulting Actuary, the Regents adopted changes to several of UCRP's actuarial assumptions as a result of the experience study covering the period July 1, 2006 through June 30, 2010, effective for the July 1, 2011 valuation. Some of these recommended changes also affect the actuarial valuation of the Retiree Health Benefit Program.

BACKGROUND

In Fiscal Year 2007-2008, the Regents' Consulting Health Actuary, Deloitte Consulting LLP (Deloitte), began performing annual actuarial valuations of the University's Retiree Health Benefit Program. The purpose is to report the Unfunded Actuarial Accrued Liability at the beginning of the fiscal year and the Annual OPEB Expense for the fiscal year. (OPEB refers to "Other Post Employment Benefits", *i.e.*, post-employment benefits other than pensions) The valuation report also provides an analysis of the change in liability from the prior year's valuation.

The retiree health benefit valuation results included with this item are based on the methods and assumptions that were initially approved by the Regents in May 2008 and updated based on approved recommendations from the latest experience study. Certain assumptions are updated annually (e.g., medical trend rates) and approved upon acceptance of the valuation. All of the assumptions are described in section XI of the attached actuarial valuation report.

Responding to a proposal from the University's auditors, PricewaterhouseCoopers, University management recorded an audit adjustment related to the University's obligation for retiree health benefits. Effective in 2018, an excise tax on "Cadillac Plans" will apply as a result of the Patient Protection and Affordable Care Act. Healthcare insurers who offer plans with a higher cost than the excise threshold will be charged a 40 percent tax on the costs exceeding the threshold. It is assumed that these insurers will pass this additional cost onto the plan sponsors through an increase in the premiums. At the time the July 1, 2010 actuarial valuation report was prepared and presented to the Regents in November 2010, there was not an industry-wide consensus on the appropriate accounting for the excise tax for GASB purposes nor were there consistent methodologies for measuring the liability. Actuarial practices and methodologies continued to evolve in this area, therefore, management made the decision that the July 1, 2010 actuarial valuation should be updated and reissued to include the effect of the excise tax on liabilities and expense that will be disclosed as of June 30, 2011. The effect of including this change was to increase the unfunded liability from $14.9 billion to $15.4 billion for retiree health benefits. The effect of the excise tax continues to be reflected in the liabilities and expense developed in the July 1, 2011 valuation. The restated July 1, 2010 Actuarial Valuation report is not included as an attachment to this item; however, it can be found on line at this url: http://www.universityofcalifornia.edu/regents/regmeet/nov10/f4attachrevised.pdf

Retiree Health Benefit Program Valuation Results

For the campuses and medical centers, valuation results are summarized below:

- The UAAL as of July 1, 2011 was $14.6 billion. As of July 1, 2010, the UAAL was $15.4 billion.

- The total UAAL is expected to increase every year because the program is currently not prefunded, and the benefits accrued by active participants during the year are greater than the benefits paid for retirees. If all assumptions during the year had been exactly realized, including pre-funding of the entire Fiscal Year 2010-2011 ARC of $1.92 billion, the *expected* UAAL at July 1, 2011 would have been $15.0 billion. The actual UAAL at July 1, 2011 was $367 million less than expected. This difference is considered a gain to the program and is comprised of the following:

    - Changes in actuarial assumptions and methodology resulted in a loss of $196 million.
    - The University's pay-as-you-go contributions being less than the ARC created a $1,609 million contribution loss.
    - There was a $2,172 million experience gain (actual experience of the program over the past year different than expected). The experience gain was caused primarily by lower than expected increases in premium rates and the change in the University maximum contribution rates for calendar year 2012.

- The Actuarial Value of Assets (AVA) as of July 1, 2011 was $78 million. Although the Retiree Health Benefit Program is currently funded on a pay-as-you-go basis, this year-end balance was caused by a combination of initial one-time funding for cash flow purposes and to facilitate administration, and the difference between the amounts collected from locations via the retiree health assessment and the actual pay-as-you-go benefit plan costs since inception. Actual market value of assets as of July 1, 2011 is $71 million.

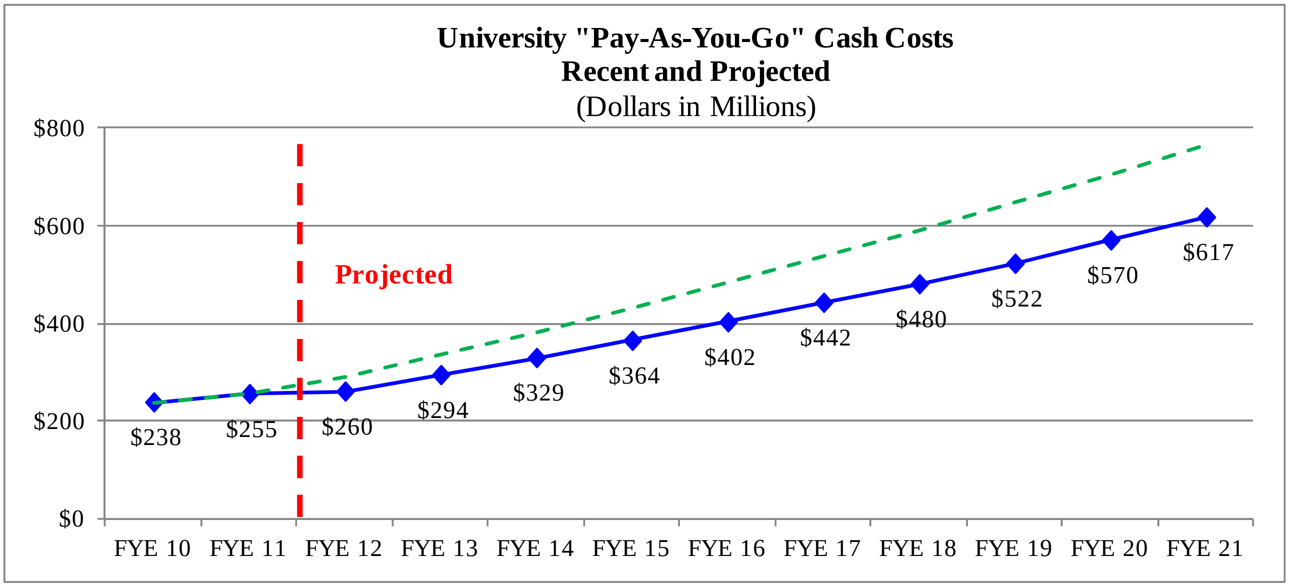
- The funded ratio is determined as the AVA divided by the Actuarial Accrued Liability (AAL). The funded ratio was 0.5 percent as of July 1, 2011.

- The ARC for Fiscal Year 2011-2012 is $1.76 billion. For Fiscal Year 2010-2011, the ARC was $1.92 billion.

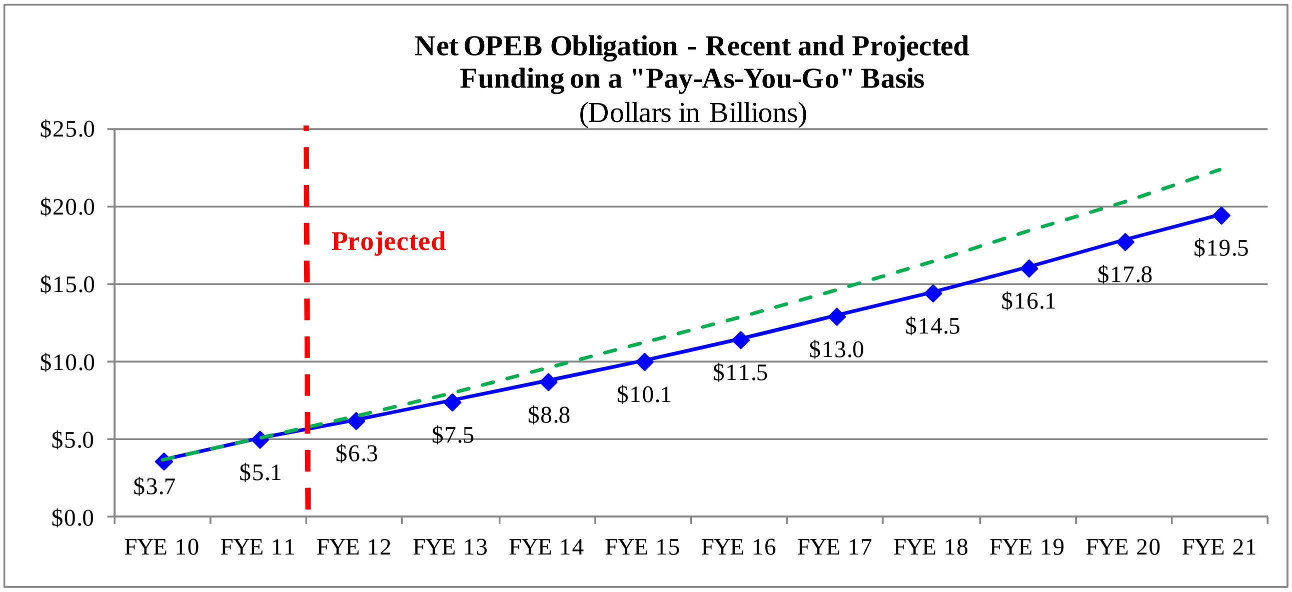
- The Net OPEB Obligation (NOO) is the portion of the UAAL that is included on the University's balance sheet. The NOO at July 1, 2011 is determined as the prior year's NOO plus the Fiscal Year 2010-2011 OPEB expense less the University contributions to the program. As of July 1, 2011, the NOO was $5.10 billion.

- The annual OPEB expense is the ARC plus interest on the NOO minus an ARC Adjustment. For Fiscal Year 2011-2012, the OPEB expense is $1.50 billion. The annual OPEB expense for Fiscal Year 2010-2011 was $1.74 billion.

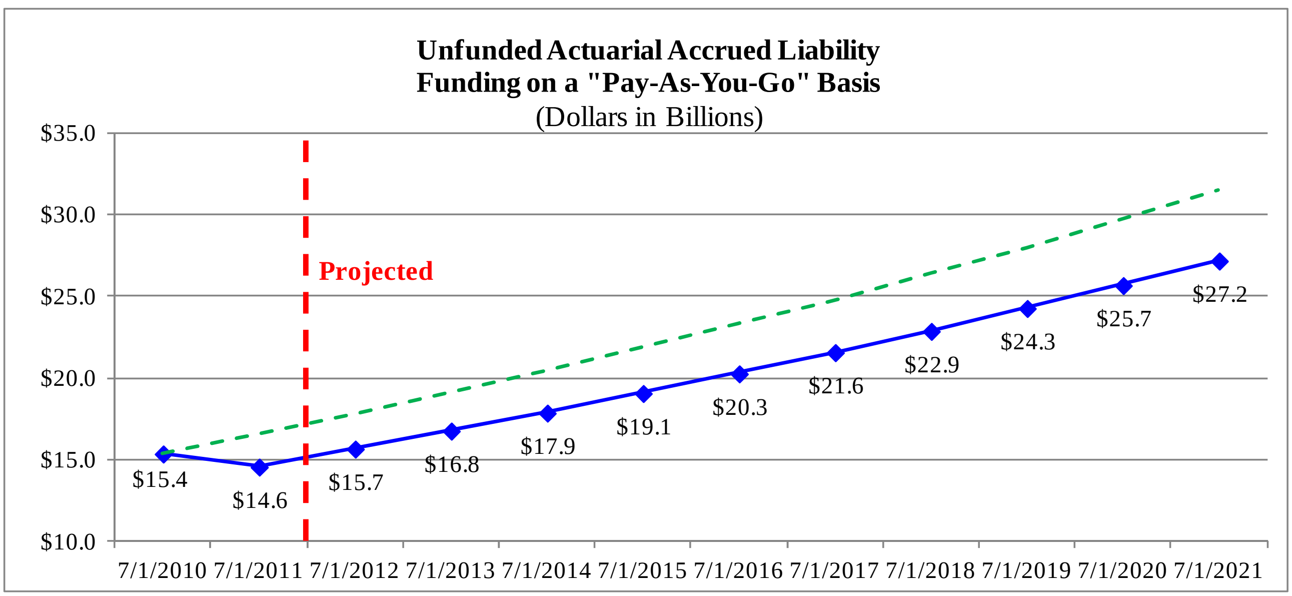
- The expected University pay-as-you-go cash costs for Fiscal Year 2011-2012 are $260 million. The chart below shows recent history and a 10-year projection of the expected University pay-as-you-go cash costs, assuming no future programmatic or contribution policy changes. The blue line reflects current policy and assumptions. The dashed green line reflects policy and assumptions used in the July 1, 2010 actuarial valuation.



- The expected NOO at July 1, 2012 is $6.30 billion, assuming $259 million of contributions on a pay-as-you-go basis. The chart below shows recent history and a 10-year projection of the expected NOO, assuming the program is funded on a pay-as-you-go basis only and assuming no future programmatic or contribution policy changes. The NOO grows by $1.2 to $1.7 billion a year due to the difference between the OPEB expense and the pay-as-you-go costs. The blue line reflects current policy and assumptions. The dashed green line reflects policy and assumptions used in the July 1, 2010 actuarial valuation.



The UAAL as of July 1, 2011 was $14.6 billion. The chart below shows recent history and a 10-year projection of the expected UAAL assuming the program is funded on a pay-as-you-go basis only, assuming no future programmatic changes. The blue line reflects current policy and assumptions. The dashed green line reflects policy and assumptions used in the July 1, 2010 actuarial valuation.



- As of July 1, 2011, there were 148,361 participants eligible or potentially eligible for the University's Retiree Health Benefit Program, compared to 146,186 participants as of July 1, 2010.

  - There were 113,898 active employees: 17,884 were fully eligible to retire and receive benefits under this program as of July 1, 2011; 96,014 could be eligible in the future.

- There were 34,463 retirees and surviving family members receiving benefits under this program. In addition to the 34,463 retiree participants, there were 18,948 covered family members (15,143 spouses/domestic partners and 3,805 children) receiving benefits under this program.

- Two of the key assumptions used in completing the valuation are the discount rate and the benefit cost trend rates. The discount rate is 5.5 percent and is developed in accordance with the prescribed Governmental Accounting Standards Board (GASB) requirements. The first year medical trend rates range from 7.5 percent to 20.0 percent, decreasing to the ultimate rate of 5 percent over nine years. The decrement assumptions, such as mortality, termination, and retirement, are consistent with those used in the UCRP actuarial valuation.

Similar results are presented in the attached valuation report for other reporting entities, including Lawrence Berkeley National Laboratory (LBNL) and Hastings College of the Law.

The University of California Retiree Health Benefit Trust (UCRHBT) allows certain University locations and affiliates (campuses and medical centers as defined above and Hastings College of the Law) that share the risks, rewards and costs of providing for retiree health benefits to fund such benefits on a cost-sharing basis and accumulate funds on a tax-exempt basis under a trust account segregated from University assets. The Regents have fiduciary responsibility and serve as the trustee for the UCRHBT. Currently, the University does not pre-fund retiree health benefits and instead provides for benefits on a pay-as-you-go basis through the UCRHBT. There is a balance in the UCRHBT as of July 1, 2011 of $71 million due to the timing of contributions and payments in and out of the trust.

- The pay-as-you-go financing for campuses and medical centers and Hastings College of the Law is accomplished via a common retiree health benefit assessment, which was set at 3.51 percent of covered UCRP payroll for Fiscal Year 2011-2012.
- In accordance with the University's contract with the Department of Energy (DOE), LBNL reimburses the University for the actual benefit costs paid by the University attributable to LBNL retirees and does not participate in either the UCRHBT or the retiree health benefit assessment.
- If pre-funding occurs in the future for campuses and medical centers and Hastings College of the Law, the UCRHBT will be used as the accumulation vehicle for those assets. Pre-funding is not able to be accomplished for LBNL retirees under the existing DOE contract, although the DOE is contractually obligated for LBNL retiree health costs.

Beginning January 1, 2010, the University established an overall maximum contribution for retirees, as a percentage of total premiums (including Medicare Part B premiums) that was more closely aligned to the percentage contributed for active employees, as part of a two-year process. In December 2010, the Regents approved the recommendation of the President's Post-Employment Benefits Task Force to gradually reduce the University's contribution to 70 percent of total premiums. For purposes of this valuation, it has been assumed that the pattern of a three percentage point annual decrease in the contribution percentage will continue until the floor of 70 percent is reached (separately for Medicare eligible retirees and non-Medicare eligible retirees under 65).

Each year the administration will reassess the level of the University contribution, the appropriateness of an additional 3 percent reduction in the contribution percentage, and whether the floor should be 70 percent or a higher amount. This assessment is typically done during the annual health plan renewal process, taking into consideration overall budget resources, salary adjustments for active employees, and COLAs for retirees.

For calendar year 2012, the University will determine the maximum contribution for retirees, as a percentage of total premiums (including Medicare Part B premiums) as follows:

- Medicare eligible retirees: 86 percent of aggregate premiums (including Medicare Part B premiums) for all Medicare eligible retirees covering only Medicare members.
- Non-Medicare eligible retirees under age 65: 78 percent of aggregate premiums for all non-Medicare retirees under age 65 covering only non-Medicare members.
- Non-Medicare eligible retirees age 65 and older: The same dollar amount as employees in Pay Band 2.

For the campuses and medical centers, this decrease in the maximum contribution percentage resulted in a decrease in the Actuarial Accrued Liability of $1,647 million (11.4 percent) and the ARC of $186 million (10.2 percent).

It is important to note that even with the continued decrease in the contribution percentage; the University is not expected to experience a significant decrease in the pay-as-you-go cash costs for retiree health benefits in Fiscal Year 2011-2012 (cash costs are expected to remain at approximately $260 million).

In July 2011, the Regents adopted changes to the actuarial assumptions used in the retirement plans based on recommendations from the UCRP experience study covering the period July 1, 2006 through June 30, 2010. This valuation reflects the applicable changes in demographic assumptions that were adopted. (Note that the economic assumptions for the Retiree Health Benefit Program are different than those used by UCRP.)

For the campuses and medical centers, the assumption changes related to the experience study resulted in an increase in the Actuarial Accrued Liability of $281 million (1.9 percent) and a decrease in the ARC of $46 million (2.5 percent).

For the July 1, 2011 valuation, the methodology used for setting medical trend rates was changed by applying separate rates to Medicare and non-Medicare plans. As part of this methodology change, it was recognized that Medicare Advantage plans have been receiving reimbursements from Medicare that are increasing more slowly than overall medical costs. It is assumed this pattern will continue until the costs of these plans to the Medicare program are consistent with fee-for-service plans. The resulting pass through costs of these lower reimbursements is expected to significantly increase the premiums for Medicare Advantage plans.

For the campuses and medical centers, this methodology change resulted in an increase in the Actuarial Accrued Liability of $1,561 million (10.8 percent) and the ARC of $174 million (9.6 percent).

For the campuses and medical centers, the net effect of the three assumption and methodology changes explained above was an increase in the Actuarial Accrued Liability of $196 million (1.4 percent) and a decrease in the ARC of $58 million (3.2 percent).

Health Care Reform

- The Patient Protection and Affordable Care Act ("PPACA") was signed into law on March 23, 2010. The primary objective of the act is to increase the number of Americans with health insurance coverage. The applicable provisions of PPACA were first accounted for in the July 1, 2010 valuation. There have been no changes to the provisions determined to be applicable to this valuation; however, some assumptions have changed that were used to value these provisions. In future years, there may continue to be an increased cost impact to the extent the retiree health program experiences increased utilization due to these changes, all of which are assumed to be in place indefinitely.

- The provisions of PPACA considered are as follows:

    - Prohibiting lifetime and annual limits on the dollar value of coverage for "essential health benefits"
    - Increasing the dependent child age limit to age 26
    - Elimination of cost sharing for preventive services
    - Excise tax on "Cadillac Plans" effective in 2018

- Due to the expectation that the medical trend rate will significantly exceed inflation over the long-term, the excise tax has a significant effect on the results of the valuation. For campus and medical centers, the Actuarial Accrued Liability associated with the excise tax is $582 million.

- No other changes were made to the valuation results to reflect other provisions of PPACA. These other provisions of PPACA have no impact on the program, are not measurable at this time, or are immaterial. Additional details about these provisions and the reasons they were not measured are provided below.

    - The provision to "close the donut-hole" (i.e., eliminate the coverage gap) in Medicare Part D by 2020 will increase the federal government's share of the cost for Medicare-eligible employees. The University's plans provide coverage through the donut-hole for generic drugs. Thus, this provision could decrease the cost of pharmacy coverage for the University and its retirees. However, if the University elects to expand coverage to include brand name drugs in the "prior" (i.e., "donut-hole") gap, the Medicare plans may experience increased utilization of name brand pharmaceuticals, potentially offsetting the cost impact for generic coverage provided by Centers for Medicare & Medicaid Services (CMS). Since University policy has not been set regarding this change, estimation of the cost impact is unknown.

- The cost sharing requirements included in PHS Act Section 2707 may apply to the University in the future. Additional guidance from the Secretary of Health & Human Services is required before the cost impact (if any) can be determined. Regardless, this section does not apply until 2014.

- Finally, there was an additional provision of the law that may impact the program, but the amount of the effect on costs and liabilities is uncertain at this time. This provision is the Early Retiree Reinsurance Program. The University applied for reimbursement under this program and was accepted. However, it is not clear for how many years and how much reimbursement will be provided due to the $5 billion cap on this program. The program ends at the earlier of the exhaustion of the monies or January 1, 2014.

Attachment 1 – July 1, 2011 Actuarial Valuation Report of the University of California Retiree Health Benefit Program