Reforming UC's Pension Plan:
Why the Regents Should Reject the PEB Task Force's Options A, B, and C and Develop a More Credible Process for Solving UCRP's Financial Crisis

Berkeley Faculty Association

The Post Employment Benefits Task Force (PEB Task Force) appointed to develop a plan for saving our pension plan, the University of California Retirement Plan (UCRP) from a snowballing unfunded liability has finished its report and made its recommendations. It has put forward two plans for increasing the funding of UCRP, "Option A" and "Option B." Of the two, Option A is its "preferred option." President Yudof will be forwarding one or both of Options A and B (or variations on them) to the Regents for their consideration at their November meeting.

Options A and B have stimulated a great deal of controversy. Seven PEB Task Force Work Group members so strongly oppose Options A and B that they felt it necessary to issue a dissenting report.[1] They are urging the Regents to reject both.

We strongly agree that Options A and B should be rejected. We call on the Regents to reject them both. Not only do they fail to provide credible plans for eliminating the pension fund's snowballing unfunded liability (as the Task Force itself admits), there is strong reason to believe that they grossly exaggerate the savings they claim to achieve, due to the use of a problematic actuarial cost method and other problems. In addition to raising contributions for all current employees in UCRP, both Option A and B will create a new tier for employees hired after June 31, 2013 and impose a unique set of contribution increases and benefit cuts on them. We are particularly concerned about the nature of the benefit cuts in the new tier. Options A and B slash benefits in the new tier in several ways. Most troubling for us, some of the cuts are severely regressive. Both will integrate UCRP benefits with Social Security and tie the age factor to salary in ways that reduce the pensions of employees at the low and mid range of the university pay scale much more deeply than those at the upper end. Because the cap on Social Security contributions is continually being raised, as time progresses, this regressivity will affect an increasingly broad range of employees, including an increasingly large portion of the faculty making more than $160,000 per year. Contributions in the new tier are progressively structured. However, the reductions in contributions for employees whose benefits are being most severely cut are slight. They in no way make up for the severe loss of total retirement income they will experience. Option A, the Task Force's preferred option, is more regressive than Option B (shockingly so) and will have a harsher effect on a much wider range of employees. As if this is not bad enough, neither Options A nor Option B requires that UC increase its employer contribution to the level to which the Task Force recommends they raise it (23% by 2018). Worse, the Task Force acknowledges that even if the Regents were to raise the UC employer contribution this much, it would not be enough to amortize the liability. They admit that that the university will still need to contribute an additional $4.5 B over the next ten years to fully amortize the debt. Unfortunately, neither Option A nor Option B includes a plan for doing this.

In short, neither Options A or B will solve the problem the Task Force was ostensibly tasked to solve. Despite the pain they would impose on employees through contribution increases and benefit cuts, on

[1] Three administration officials, Lawrence Pitts, Peter Taylor, and Nathan Brostrom, have since responded to the Dissenters, criticizing Option C and defending Options A and B and Robert Anderson, a dissenter, has responded to their response. Links to all these reports and responses can be found at http://universityofcalifornia.edu/sites/ucrpfuture/task-force-inf/ .

students (through tuition increases), and the university as a whole, they won't stop the growth of the unfunded liability. Though the speed at which the liability is snowballing will slow to some extent if one of them is implemented, UCRP will continue to face the specter of a financial meltdown that would have devastating effects on employee total remuneration, as well as the university's operations and its world class reputation. Although both options reduce pressure on UC operating budgets in the short term, they do not reduce the pressure over the long term, because they do not make the liability problem go away. They simply pave the way for more student fee increases, more lay-offs, more contribution increases, more benefit cuts, and more problems for UC – and ultimately the collapse of UCRP as a defined benefit pension program. This is unacceptable as a way of moving forward.

The dissenting members of the Task Force have recommended that President Yudof forward a different set of reforms to the Regents, "Option C." We strongly prefer it to Options A and B. It is significantly less regressive than they are because it does not integrate UCRP with Social Security or tie the age factor to salary. However, we also have deep reservations about it because it, too, fails to provide a credible path to amortizing the unfunded liability. We believe it is absolutely essential that UC implement a plan to amortize it as quickly as possible. For this reason, we believe that President Yudof and the Regents must reject it as well.

The purpose of this report is to explain our objections to Options A, B, and C in more detail and to propose elements of an alternative plan for extinguishing UCRP's unfunded liability. We call this alternative plan "Process D" because we believe that what is needed at this point is a professionally facilitated, collaborative process for developing a realistic, principled, balanced plan for quickly restoring UCRP to fiscal health – with as little damage to faculty, staff, students, and UC itself as possible, and in a way that elicits trust and buy in from members and other stakeholders, rather than dissent, division, and delay inducing litigation. To this end we have developed a list of principles to guide the process. We have also laid out a new way of thinking about the crisis that we believe could help the new task force develop effective, credible solutions. We distinguish between the regular Normal Cost of funding UCRP's member service and what we call the "Abnormal Cost" of amortizing the liability created by the failure to restart employer and member contributions on a timely basis at an appropriately level. The Normal Cost is the amount of money that needs to be put into the UCRP trust fund (through contributions and return on investment) each year to cover the present value of the future liability generated by members working for the year, while the Abnormal Cost refers to the amount that must be put into the fund above the Normal Cost to amortize the liability resulting from the failure to restart contributions soon enough and at a high enough level to cover the Normal Cost. We propose that different approaches be taken to covering each of these costs.

We call on President Yudof and the Regents to reject Options A, B, and C. We urge them to seriously consider our criticisms of them and to initiate Process D instead. The unfunded liability is a serious problem that must be solved quickly in order to prevent UCRP from collapsing financially. Process D lays out a principled, balanced, and credible strategy for accomplishing this crucial goal.

REPORT

Background: What are Options A, B, and C?

The most important things to know about Options A, B, and C are the following:

They Are Motivated By a Financial Crisis that will be Very Difficult to Resolve: The University of California Retirement Plan (UCRP) has a large, snowballing unfunded liability that it must eliminate to protect its long term financial stability. This is a big problem for members of the plan. Left alone, the liability will continue to grow, not only putting our retirements at risk, but also UC itself. Eliminating it will affect how much of our salaries we - and all future UC employees – receive as take-home pay as well as our pension benefits. As long as the state legislature refuses or is unable to pay the entire UC employer contribution, UC will be under pressure to keep hiking tuition, laying off staff, and making other cuts to meets its financial obligation to the pension fund. This threatens to seriously compromise its capacity to continue to provide high quality, affordable education to all qualified students in California, as well as its ability to continue to recruit and retain high quality faculty and support high quality research. Options A, B, and C are all plans to solve this problem.

Options A, B, and C all share the following characteristics:

- All retain the UCRP's current Defined Benefit structure.
- All involve converting UCRP into a two tiered pension program, establishing a "new tier" with different contributions and much lower benefits for new employees hired after June 31, 2013 compared to current employees, who will remain in the existing "main tier" of UCRP.
- All require significant contribution increases for employees in the main tier.
- All contain a one time "choice" provision that requires current employees to decide if they want to opt into the new tier or remain in the main tier. Once they opt in to the new tier, employees cannot opt out. [2]
- All recommend that UC increase its employer contribution above the 10% level recently approved by the Regents (to begin July 1, 2013) by an additional 2% per year through 2018 (to 23% of covered compensation), but provide no mechanism to ensure this will happen.
- All assume that UCRP can earn, on average, a 7.5% rate of return on assets per year.
- None raise employee and employer contributions enough, nor cut benefits enough to eliminate the unfunded liability – as the PEB Task Force openly acknowledges. They are intended only to reduce the pressure on operating budgets by reducing the normal cost of funding UCRP.
- Upon approval, each would kick in July 1, 2013, less than three years from now.

How Options A, B, and C Differ: The plans differ from each other in three main respects: 1) how they structure the increase in contributions; 2) how they structure the cuts in benefits imposed on employees in the new tier; and 3) the recommendations and assumptions they make about the increases that will be imposed on the contributions of members of the existing, main tier of UCRP starting in July 2013.

[2] Since it is currently illegal pension programs to deprive members of accrued benefits (as will happen if current employees opt into the tier that integrates their UCRP benefits with their Social Security benefits and otherwise renders them unable to receive their full accrued benefits), the university is in the process of investigating whether the U.S. Treasury Department will waive the current rule and allow current employees to opt in to the new tier without losing the tax exemption on their contributions going forward. If a waiver is not granted, the choice provision will be withdrawn from Options A and B.

* ***Contributions:*** Option A establishes a progressively graduated contribution rate for the new tier that allows UC's lowest paid employees to contribute a smaller percentage of their salaries to UCRP than more highly paid employees. As shown in Figure 1, the rate starts at 3.5% for employees making $30-65,000 per year, then steeply increases to 7% for employees making $65-150,000, before very slowly increasing for employees making more than $150,000 to a maximum of 8% for employees making $250,000 or more. The contribution rate for UC's lowest paid employees is less than half that for those making $250,000 or more per year.

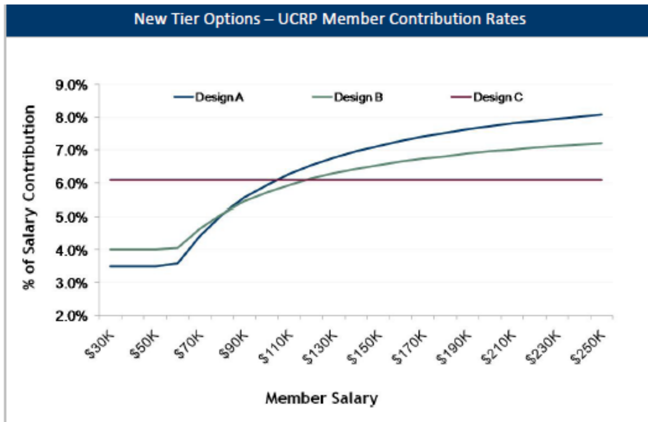

Figure 1: Member Contribution Rates of Options ("Designs") A, B, and C * (Pitts, Taylor & Bostrum, "Response to "A Dissenting Statement by Staff and Academic Senate Members of the Work Groups of The President's Task Force on Post Employment Benefits" (8/25/10), 4.)

Option B establishes a somewhat less progressively graduated contribution rate that requires employees making less than $65,000 to contribute 4%, then increases the rate that for employees making between $65,000 and $120,000 to 6%, before somewhat more gradually increasing the rate to a maximum of 7% for employees making more than this.

Option C imposes a flat 6% contribution rate on all employees in the new tier, regardless of salary. [3]

* ***Benefits*:** Both Options A and B impose deep benefit cuts on all employees in the new tier. Most important, both integrate UCRP benefits with Social Security benefits. This means they treat Social Security benefits as if they were an integral part of UCRP retirement benefits (rather than as a separate, independent source of income retirees receive in addition to their UCRP payments), adding the two benefit streams together for the purpose of calculating each retiree's total, individual "UCRP benefit" pay out. Both options also shift the minimum age factor to 55 and the maximum to 65 (from 50 and 60) and tie the age factor service credit to salary levels based on Social Security covered compensation categories in ways that will be described in our critique. They also eliminate lump sum cash outs, COLAS for inactive employees who leave UC employment before retirement, and free survivor benefits. They also limit COLA inflation adjustments to 2% per year and make other, seemingly minor technical changes in things like Social Security and HAPC offsets. The main differences between A and

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* Contribution rates in Figure 1 include only UCRP contributions. They do not include the social security contribution rate, which is currently 6.2% on earnings up to $106,800.

[3] We have heard that the Option C contribution rate is actually 6.1%. Unfortunately the actual rate is not stated anywhere in the Dissenting Report. The 6% number we give here is based on Figure 1. We found the lack of transparency of the various reports dispiriting.

B in the area of benefits relate to their treatment of age factors in the calculation of benefits for employees who retire early.
In contrast to Options A and B, Option C does not integrate UCRP benefits with Social Security benefits or tie the age factor to salary as they do. It does, however, adopt all the other benefit cuts in Options A and B.

* ***Main Tier Changes***: Another difference between Option C and Options A and B concerns their stance on increasing the contributions of employees who choose to remain members of the existing UCRP tier (the main tier). Options A and B propose – and the Task Force's calculations of their Normal Cost and the savings resulting from their adoption assume – that UC will raise the contribution rate to 7% on all employees in the main tier (i.e. all current employees who don't opt into the new tier), starting July 1, 2013. Option C proposes that contributions in the new Tier be raised to a maximum of 6%, on the grounds that raising contributions above 6% will completely devastate UC's ability to compete for outstanding faculty and staff. However, somewhat ironically, it also envisions that UC will raise contributions in the main tier to 7%, and it includes a choice option that will allow current employees to opt into the new tier and so pay only a 6% contribution in return for lower benefits.

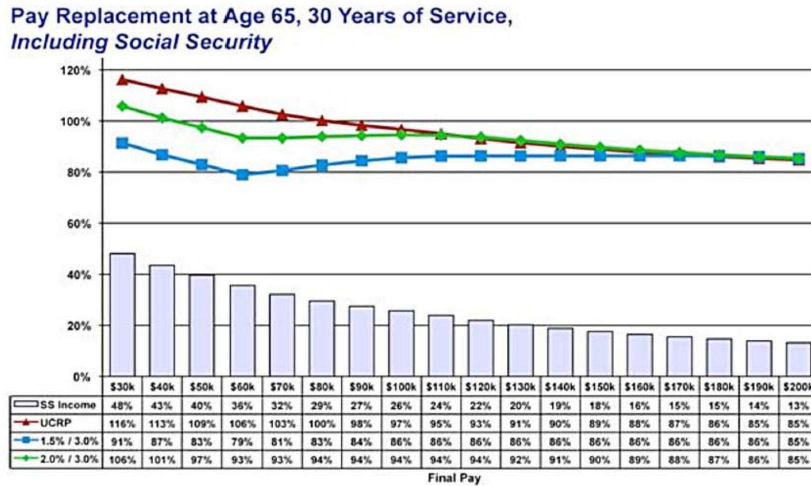
Why the Regents Need to Reject Options A and B

Regressive Benefit Cuts: In our view, the most serious problem with Options A and B is that they are severely regressive. They cut benefits for retirees at the low end of UC's pay scale much more deeply than those at the upper end. We believe that it is a violation of the university's commitment to employee equity to institute any changes to contribution and benefit schedules that impose significantly greater losses on those receiving the lowest salaries. It is also unwise. By provoking outrage among lower paid employees, it will make it even more difficult for the university to persuade its unions to vote in an expeditious way in favor of the reforms needed to put the pension back on an economically sustainable footing.

The severe regressivity of Options A and B comes from the fact that both "integrate" UCRP with Social Security for purpose of calculating benefits (but not contributions). UCRP calculates individual employee benefit levels on the basis of a complex formula that takes into consideration such things as the number of years an employee has been a member of UCRP, their age, and their Highest Average Plan Compensation (HAPC). The integration policy authorizes UCRP to subtract Social Security benefits from the total owed by UCRP under this formula. Social security income will "replace" income from UCRP in the determination of retiree pensions in the new tier.

As a result, under Options A or B, lower paid employees will receive a disproportionately large share of their UCRP retirement income from Social Security, rather than from the UCRP trust fund, compared to higher paid employees. In the chart in Figure 2 (next page), the blue columns represent the percent of UCRP retirement income employees at different pay levels will receive from Social Security under Option A or B. Employees making only $30,000 per year will receive nearly 50% of their UCRP pension income from Social Security and 50% from the UCRP trust fund. For people at the bottom end of the pay scale, this translates into a very big cut to their over-all retirement income, essentially reducing it by roughly 50% from what it would be under the current plan. In contrast, employees making $130,000 will get 80 % of their UCRP pension from the trust fund and 20% from Social Security, while those making $200,000 or more will receive even higher percentages of their university pension from the trust fund, because their Social Security income represents proportionately smaller fractions of what

UCRP owes them. Of course, even a 5-10% cut in combined UCRP and Social Security benefits will be painful to those who retire at the top of the UC pay scale, but the loss pales in comparison to what those at the bottom will experience.



	$30k	$40k	$50k	$60k	$70k	$80k	$90k	$100k	$110k	$120k	$130k	$140k	$150k	$160k	$170k	$180k	$190k	$200k
SS Income	48%	43%	40%	36%	32%	29%	27%	26%	24%	22%	20%	19%	18%	16%	15%	15%	14%	13%
UCRP	116%	113%	109%	106%	103%	100%	98%	97%	95%	93%	91%	90%	89%	88%	87%	86%	85%	85%
1.5% / 3.0%	91%	87%	83%	79%	81%	83%	84%	86%	86%	86%	86%	86%	86%	86%	86%	86%	86%	85%
2.0% / 3.0%	106%	101%	97%	93%	93%	94%	94%	94%	94%	94%	92%	91%	90%	89%	88%	87%	86%	85%

Example by Segal Consulting, actuary to The Regents

NOTE: Calculations assume retirement in 2010 and past salary increases of 4% per year. There is a slight reduction in Social Security benefits for early retirement under the program. Since the Social Security Covered Compensation is adjusted for inflation each year, results would change in future years.

- The blue columns = the percent of Social Security replacement income.
- The red line with triangles = the percent of total replacement income from Social Security + the current UCRP.
- The blue line with squares = the percent of total replacement income from Social Security + the New Tier design option A.
- The green line with diamonds = the percent of total replacement income from Social Security + the New Tier design option B.

Figure 2: Income Replacement Levels –
Social Security plus Current UCRP, Proposed New Tier Designs (PEB, *Final Report*, p. 37)

To make matters worse, Option A reduces total (UCRP + SS) retirement income relative to current UCRP retirement income in another regressive way. As the blue line in Figure 2 indicates, Option A will penalize everyone making less than nearly $180,000 when they retire, with those making between $60,000 and $80,000 taking the biggest hit. In our view, this makes Option A, the Task Force's preferred option, especially objectionable.

As we understand it, this additional regressivity results from pernicious changes to the treatment of the so called "age factor" that is part of the formula used by UC to calculate the dollar amount of the pension income individual retirees receive. As noted above, the formula involves multiplying a set fraction of the individual's highest average covered compensation (HAPC) by an "age factor" and the total number of years they have worked. The existing age factor is a service credit multiplier that rewards people for working past a certain age regardless of how much they are paid. Options A and B move up the ages from 60 to 65 for employees in the new tier, a concept we accept as a reasonable way to address the unfunded liability. What is disturbing is that they also tie the size of the service credit (i.e the multiplier) to the scale of the individual member's salary, reducing the multiplier for those who make less than Social Security covered compensation (SSCC) limit while gradually increasing it for those who make more than the SSCC limit up to the existing level in the main tier. Option A reduces the age factor multiplier much more for members making less than the Social Security covered compensation limit than Option B does. Currently, the UCRP age factor is 2.5% at age 60. Under option A, the age factor at age 65 is reduced to 1.5% up to SSCC; at age 60, it is reduced to 1.08%. (Under option B, the age factor at age 65 is 2.0% up to SSCC; at age 60, it is reduced to 1.44%.)

This change will not only reduce the pension income of employees making less than the SSCC, but, as Figure 2 indicates, also that of those making more than the SSCC. Options A and B move up the age factor multiplier for employees who retire at higher salaries very slowly. Under Option A, members in the new tier will not find their age factor restored to the full 2.5 unless their highest average covered compensation at retirement is at least $180,000. It is important to bear in mind that this change is tied to the Social Security Covered Compensation limits, which are moving targets. The Federal government gradually raises the Social Security payroll tax cap every year and plans are afoot to raise it substantially to help the Social Security trust fund remain solvent. This means that as time passes, more and more employees on the high end of the pay scale will be affected by this change, along with those in the middle – substantially more if the cap is raised a lot. Suresh Lodha, a Professor of Engineering at UCSC and the Chair of its Committee on Faculty Welfare, has determined that even if the Social Security cap is not substantially increased, by 2020, employees who retire at age 65 in the new tier of Option B will have to make at least $160,000 – and those in the new tier of Option A will have to make ***at least $240,000*** – to qualify for the full 2.5 age factor given employees in the main tier.

As the administration points out in its response to the Dissenting Report, the PEB Task Force incorporated progressively graduated contribution structures into the new tiers of Options A and B (see Figure 1).[4] We applaud the Task Force's effort to at least partially make up for the highly regressive impact of the cuts these options impose on the benefits side. However, the fact is that the reductions in contributions offered to lower paid employees do not come close to making up for the enormous cuts in total retirement income they will suffer if either Option A or B is approved. The severity of the regressive impact of the cuts imposed by Option A is particularly shocking and reprehensible. These provisions are unacceptable methods of restoring UCRP to fiscal health. [5]

Choice Provision: In light of the severe regressivity of the integrating Social Security benefits with UCRP benefits, we find the incorporation of the "choice" requirement for existing employees into Options A and B to be odious, especially so since there seems to be a plan to require employees to make this choice at the very moment that an increase in member contributions in the main tier to 7% is imposed.

We are also outraged that the plan to raise contributions to 7% is not a transparent part of the Task Force's Final Report. It is not included in the summary provided on p. 31, but buried in two paragraphs in the Task Force's Executive Summary (ES pp. 29, 41), one of which is literally in small print, and a single paragraph in the Final Report (FR p. 42). Yet according to the small print statement (ES p. 41), the figure the actuary has given for the savings from instituting Option A or B ($1.3 B) is based on calculations that "include the effect of an assumed 7% employee contribution to UCRP for current employees."

*** Two Tier Problem**: Another serious structural problem with Options A and B is that each converts UCRP into a two tier plan that discriminates against faculty and staff appointed after June 31, 2013 by imposing significantly more of the cost of refunding the pension plan on them than on current members.

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[4] Pitts, Taylor & Bostrum, "Response to "A Dissenting Statement by Staff and Academic Senate Members of the Work Groups of The President's Task Force on Post Employment Benefits" (8/25/10), 4.

[5] If the university succeeds in obtaining U.S. Treasury's permission to allow current employees to "choose" to opt into these draconian cuts (in return for lower contributions on the front in), it may become legal for public pension funds to impose Social Security integration on all employees, not just future hires. This would severely cut accrued benefits for everyone.

Concentrating the burden of reducing the cost of funding pension plan on what will be small subgroup of employees for many years to come is problematic for several reasons.

First, the two tier structure is counterproductive to the goal of restoring UCRP to financial health rapidly because it concentrates a large portion of the cost of funding of the liability on a very small fraction of the employee population. This is particularly troubling in light of the fact that the university is on track to significantly reduce the total number of permanent, UCRP eligible employees by shifting the burden of teaching from ladder faculty to temporary lecturers and GSIs and by cutting full time staff to reduce operating costs. Because it is in the nature of unfunded liabilities to snowball in scale, it is essential that the university maximize the speed at the liability is funded. This structure slows the process down.

Second, the two tier structure will make it harder to recruit and retain outstanding faculty and staff. Not only does it shift costs to future employees (the very people on whom the future of the university depends), it intensifies the hit they will take! This is because the increase in contributions and the cuts to benefits must be set higher to meet the Task Force's financial goals in a small tier than would be necessary if the changes were distributed evenly across the entire population of UC employees.

Third, as the *New York Times* revealed in an article published on Sept. 17, 2010, public pension actuaries routinely grossly exaggerate the savings that two tier pension reform plans generate by applying a complex "cost method" for calculating such savings. [6] This cost method allows actuaries to assume "that 100 percent of today's work force is already earning tomorrow's skimpier benefits." The method is currently approved by the Governmental Accounting Standards Board (GASB). In earlier times, when most pensions were fully funded, it apparently served a benign purpose by helping governments smooth out labor costs over many years. However, the method is now under harsh scrutiny, because when pension programs with unfunded liabilities try to pay down their losses by cutting benefits for future workers only, as is the case with Options A and B, it hides the true scale of the remaining liability. According to the *Times*, the SEC is investigating whether the use of this actuarial method by the state of Illinois constitutes a violation of disclosure rules. The Actuarial Standards Board is developing revised standards that, if adopted, would clarify this and other actuarial assumptions whose validity are now being questioned, forcing public pension managers to provide more transparent descriptions of risk.

We have not been able to find out whether UCRP's actuary utilized this widely applied, but questionable method to calculate the savings attributed to instituting the new tier. We certainly hope not, as it would mean that in practical reality the new tier will save UCRP much less than claimed. If, however, it has indeed been applied, this would further undermine the credibility of the PEB Task Force's contention that Options A and B are effective plans for beginning to restore the pension to financial health. The new tiers will not generate as nearly as much savings the Task Force says they will generate.

Fourth, a final problem with the two tiers embodied in Options A and B is that they unfairly discriminate against a category of employees – in this case all those that will be hired after July 1, 2013. Like the integration of UCRP and Social Security benefits, this violates the university's commitment to the principle of equal treatment of employees. The two tiers also violate the principle of sharing responsibility for meeting common goals. Existing employees have benefited from years of suspended

[6] Walsh, Mary Williams, "Illusion of Pension Savings," New York Times (Sept. 17, 2010).
http://www.nytimes.com/2010/09/18/business/18pension.html?pagewanted=1&_r=3&sq=pension fund accounting &st=cse&scp=1

employee contributions. We all have an obligation to share in the cost of funding the unfunded liability in order to protect our retirement incomes.

**** Neither Option A nor Option B Eliminate the Unfunded Liability:*** Another sobering weakness of Options A and B is that neither comes close to fully funding UCRP's unfunded liability, nor do they provide a clear path for doing so.

First, neither option contains any provision that commits the university to ramping up its employer contribution at the rate the Task Force recommends. The Final Report urges UC to ramp up its employer contribution by 2% a year to 23% by 2018, but neither Option A or B requires UC to do so.

Second, according to the Task Force Finance Work Group, even if the Regents follow through with the Task Force's recommendations and increase the UC employer by 2% a year to 23% by 2018-19, UC will still need to raise **an additional *$4.4 B*** over this period to stay on pace to extinguishing the unfunded liability – well over three times as much as the new tier is supposed to generate! The PEB Finance Work Group has suggested some ways that the university might be able to generate this additional $4.4 B. They include issuing pension obligation bonds, the sale of university property, the privatization or monetization of graduate student and faculty housing, additional workforce reductions, a partial moratorium on capital projects, borrowing from STIP, and restructuring outstanding debt. However, these are undeveloped suggestions only. They not are included in either Options A or B.

Third, the $4.4 B shortfall figure is a best case scenario figure that is based on a number of unrealistic, overly optimistic assumptions, including that:

- UC will ramp up its contributions by 2% a year to 23% by 2018-19,
- UC's unionized employees will immediately accept the establishment of the new tier and the assumed increase in main tier member contributions to 7% (in fact the unions strongly oppose the plan to integrate social security benefits with UCRP benefits in the new tier and have made it clear that they will tie the plan up in the courts for as long as possible, conceivably for many years.);
- the new tier will actually generate the savings calculated by UC actuary, which is presumably based on the highly questionable actuarial cost method described above and therefore grossly overestimates the savings;
- UCRP managers will be able to make an average 7.5% return on investment, an assumption many think is unrealistic in the near and possibly middle term.

The real short fall is therefore likely much higher – possibly **billions of dollars higher** than what the Task Force claims it will be**.**

Without a credible, realistic plan to devote enough resources to actually amortize (and eliminate) the full unfunded liability quickly, neither Option A nor Option B can restore UCRP to financial health. Quite the contrary, they can at best slow the rate at which the unfunded liability snowballs. As the Academic Council's Task Force on Investments and Retirement (TFIR) so aptly put it in their 2009 analysis of the unfunded liability, "Each dollar of contributions that is deferred cannot be invested to meet future pension obligations." They add: "The loss of investment earnings [will the need to increase employee and employer] contributions higher and higher." [7] In short, A and B are at best stop gaps that delay the inevitable day of debt reckoning. They do not put UCRP on a more stable financial footing.

[7] UCFW Task Force on Investments and Retirement, "TFIR Recommendation to Ensure Adequate Funding for UCRP" (June 2009), .

The Failure to Address the State's Responsibility: Neither Option A nor Option B includes any consideration of the state's role in the development of the unfunded liability problem, nor of its role in helping restore the fund to health. They offer no ideas about how to work more effectively with state legislators to develop a plan for the state to share the cost putting it back on a sustainable footing. They provide no new ideas for educating the public about the crisis, the state's role in it, or its destructive impact on the quality as well affordability of UC degrees, research, and world class reputation. Nor do they provide any ideas about how to engage alums and other university supporters and the public as a whole in an effort to restore state funding of the UC employer contribution.

The Problem with Option C

We agree with the dissenting members of the PEB Task Force that Option C is better than either Options A or B. The most important reason why it is better than Options A and B is that it is not severely regressive like they are, because it does not integrate Social Security with UCRP benefits or link the size of the age factor service credit multiplier to salary levels.

The main problem with Option C is that it shares the other major structural flaws of Options A and B. It is a two tier plan that does not provide a realistic path to restoring UCRP to financial health. As the Dissenting Report points out, it generates the same levels of savings as Option B and has the same employer normal cost as Option B. If it is adopted by the Regents, it will, like Option B and Option A, allow the financial crisis facing UCRP to intensify, somewhat more slowly than if nothing is done, but just as inexorably. The need to cover the still snowballing liability will put more and more negative pressure on UC's operating budget (and by extension student educational fees) while requiring further contribution increases and benefit cuts and more lay offs, in a downward spiral that will make recruiting and retaining outstanding faculty and staff increasingly difficult, seriously erode UC's world class status, and further undermine the stability of the trust fund on which our retirements depend. It is not a solution to a serious problem, it is another stop gap.

Process D

We believe that UC needs to develop a more realistic and credible plan to restore UCRP to financial health than either Option A, B, or C. In this section we sketch out elements of an alternative plan, "Process D," that we believe can restore UCRP to financial health more quickly than either of them, while treating employees more equitably. We urge the Regents to set up a new, professionally mediated process involving representatives of all of the various groups that have a stakeholder interest in developing an effective solution to UCRP's financial problems to develop a final plan based on the ideas we are suggesting (which include elements from Options A, B, and C as well as some fresh ideas). We need a new process to develop a credible and realistic plan to eliminate the unfunded liability that engages the support of faculty and staff and so avoids years of costly, time consuming litigation that will undermine the whole effort to put UCRP back on a sustainable footing.

We believe that pension reform must be conducted in a principled way as well as through a process that builds trust and buy in. We ask that the new task force be guided by the following principles:

The reforms must:

- provide a credible path to amortizing the entire unfunded liability as quickly as possible;
- be creative, approaching the problem at a systems level, rather than simply tinkering at the edges by making small changes
- be fully transparent and presented in a way that that clarifies complex provisions and proposals, without hiding important details in obscure parts of a long text;
- treat all members of UCRP fairly, without discriminating against future members or low and medium wage members;
- recognize that post-retirement pension income (including Social Security income) is a part of total remuneration and that accrued benefits are deferred compensation that members have earned;
- actively protect students – the people least responsible for the failure to resume contributions on a timely basis – from having to pay the cost of restoring the plan to financial health;
- actively balance competing interests (e.g. faculty compensation vs UC operating budgets) rather than privileging one over the other;
- create a path for reinstituting the state's obligation to pay its historic and fair share of the UC employer contribution, just as it pays the employer contribution for members of CalPERS, CalSTERS and other state pension funds.
- emerge from a collaborative, professionally mediated planning process that inspires confidence and trust in and support for the outcome, rather than inciting dissent, distrust, controversy, and delay inducing litigation.

Normal Cost vs Abnormal Cost: It is important to recognize that the nearly twenty year suspension of contributions poses two great challenges for UC and employees: 1) the need to cover the Normal Cost of funding the program after nearly twenty years of suspended contributions and 2) the need cover the "Abnormal Cost" of funding the unfunded liability that was created by the failure to restart contributions on a timely basis and set them high enough to restore UCRP to financial health quickly and fully. These are related problems, but they raise different issues. We believe it will simplify things to treat them as separate problems rather than conflating them.

Normal Cost: We must get to a full funding of the Normal Cost of UCRP as quickly as possible and stay there. We define "Normal Cost" as the normal cost of covering (through contributions and return on investment) the additional service credit earned each year by the members of UCRP and any temporary liability that might develop due to failure accurately predict market turns or meet rate of return on investment goals. This definition of the term explicitly excludes the cost of funding the snowballing deficit caused by the failure to resume contributions on a timely basis at the target levels set by the Regents in their funding policy of 2008.

We propose that member and employer contribution rates be set on an annual basis as they were prior to the suspension of contributions in 1991 so that contributions and return on investment cover UCRP's Normal Cost. Funding the Normal Cost will be an enormous challenge, since the financial markets are still recovering from the financial market collapse of 2007-08 and the state is currently refusing to pay its historic share of the employer contribution (i.e. 100% of it). Prior to the suspension of contributions, the amount employees and UC paid into the fund fluctuated over time, depending on the financial condition of the UCRP trust fund and the state economy. As shown in Figure 3, the University's employer contributions rose as high as 16.37% (for one year only) between 1976 and 1992. Member contributions were flat taxes on Social Security related wage categories (calibrated to offset the

regressive impact of the cap on the Social Security payroll tax) – the highest rates were 3%, 5% and 7% for the different salary categories represented by the green, purple and turquoise blue lines. The ratio between employee and employer contributions varied over time and by wage category, which complicates putting a single value on the ratio. For employees above the Social Security wage base, the ratio of the UC employer contribution usually ranged from over 2 to over 3 times the employee contribution (the purple line) until the late 1980s. For employees below the Social Security wage base, it was usually 4 to 6 times the employee contribution (the green line).

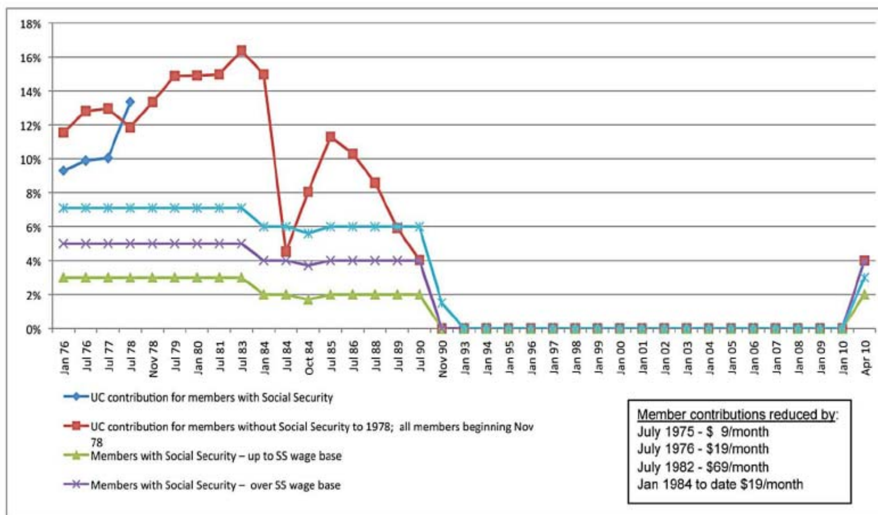

Figure 3: University and Member Contributions to UCRP: 1976 to 2010 (PEB Task Force, *Final Report*, p. 21)

In the best of all possible worlds, both UC and employees would simply resume paying contributions along the same lines as before. However, things have changed and this is not the best of all possible worlds. The state is not only currently refusing to resume its obligation to pay UC's employer contribution, it has cut hundreds of millions of dollars from the funding it gives UC for instruction. The only way UC can fund the employer contribution is by asking employees to pay a much higher proportion of the Normal Cost through their contributions than ever before – or by raising tuition substantially, or laying off employees, or finding alternative sources of internal funding in a time of state budget cutbacks when there are many other demands on those sources.

Our plan is founded on the principle of protecting students and balancing competing interests as well as protecting our own faculty and staff interests. We think most faculty and staff would be willing to pay a larger share of the total Normal Cost of funding UCRP in years when markets are down than we did in the 1970s and 80s, in order to ensure that our pensions will still be there for us when we retire, while protecting students from tuition increases and cuts to instructional budgets, reducing the pressure on UC to lay off employees, and shielding university support for research from cuts and so safeguarding the world class reputation of UC. However, we have no idea how much more employees might be willing to pay – or how much the university might be able to generate by tapping other sources of internal funds – or how to establish a balance between the competing interests that the various stakeholders would agree is reasonable and fair. We need a process to reach consensus about this, which we will describe shortly.

Abnormal Cost: We must likewise fully fund the Abnormal Cost of UCRP as quickly as possible. Here the issues are different, however. There is no historical precedent for funding a large, multi-billion dollar, snowballing unfunded liability resulting from a failure to make any contributions at all to the

UCRP trust fund for years after it was clear that a liability was developing. There is no historical precedent for funding a liability that is partly the product of the fact that contributions were deliberately restarted at a rate that was and still is too low to come near to fully amortizing the liability over 30 years. The history of this problem makes it much more difficult to argue that employee members of UCRP should embrace historically high contributions to take the pressure off of UC's operating budget. Years ago, long before the liability emerged, the Academic Council began warning UCOP and the Regents that liability was looming, warning them that it would snowball if it was not nipped in the bud, and demanding the Regents restart contributions quickly and at a rate that high enough to eliminate it, but no one listened. Not till 2008 did the Regents finally approve a funding policy that met this standard, but then it refused to carry it out. When contributions were finally restarted in April 2010, they were set much too low to meet the requirements of the policy or solve the problem. The Regents did not nip the liability in the bud when it would have been much easier to fix. Of course people are angry.

And yet, here too, we need to work together. In the absence of the state resuming its funding of the UC employer contribution, we face a zero sum game problem that is not going to go away of its own accord, that threatens all of our self interests as well as the very future of our university, and that will require for its solution extraordinary levels of creative thinking and collaborative effort. UCOP and the Regents need to explain and publically apologize for the mistake they made by refusing to restart of contributions immediately at a level that would have prevented the development a liability that presents us with the challenge of covering the present Abnormal Cost as well the Normal Cost. Members need to understand the reasons why this happened and get past their anger and resentment at not being listened to. We must all begin working together to develop a viable and fair solution to UCRP's financial crisis. We need a process that will enable us to do this.

This will not be easy. On the positive side, however, we need to recognize that covering the Abnormal Cost of the deficit is not the same as covering the Normal Cost of the program as a whole. The Abnormal Cost is not a permanent problem that requires that contributions be increased and/or benefits cut in perpetuity going forward. Instead it is a bitter, but temporary, pill that all stakeholders need to swallow and then move on from. Employer and employee contributions must be increased and alternative sources of funding mobilized (including state funding), but only for a relatively short period of years, until the deficit is on track to being fully amortized and the hole it put into the pension trust fund is plugged. After that the Abnormal Cost contribution increases (and benefit cuts, if any) can be cut back and eventually ended. [8]

<u>The New Process</u>: We urge President Yudof and the Regents to establish a new, collaborative, ***professionally facilitated***, stakeholder process for developing creative solutions to the crisis at UCRP that is modeled on mediated processes that have been used successfully to resolve difficult, divisive environmental problems. Facilitated processes have been used to bring together groups as disparate and antagonistic as small farmers, Native American tribes, city governments, environmental groups, and public utilities that operate hydroelectric plants in Oregon and elsewhere. They have enabled such groups to develop consensus policies for dealing with issues as sensitive and complex as the removal of hydroelectric dams and allocation of water rights. Facilitated planning processes are not easy, cost free, or risk free. It will be necessary to identify a really good facilitator with a track record of bringing adversarial groups together, with whom all stakeholders feel they can work productively. It will take

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[8] In contrast, the changes to benefits and contributions in Options A and B are all permanent changes, although they have been presented as solutions to the unfunded liability caused by the failure restart contributions properly and so are intended as a means of covering UCRP's Abnormal Cost as well as its Normal Cost.

time to build the stakeholder relationships needed to get a good process going. However, well planned, well managed, facilitated processes have a track record of success. We believe the pay-off (a credible, balanced solution to the Abnormal Cost problem in which all parties are invested) is worth the trouble and expense. At a minimum, it will create a basis for getting the stakeholder groups out of their preexisting mind sets and adversarial relationships so that they can begin to recognize shared, common interests and explore creative solutions for restoring UCRP to sustainability. If it goes well, it will enable the participants to develop a spirit of compromise and mutual respect that will provide a stronger foundation for developing creative solutions to the many other challenges UC faces.

This process will require the appointment of a new task force. Members should include representatives of UCOP as well as the unions, unrepresented staff, and faculty from all campuses. We believe membership in this group should be limited to people who can bring fresh perspectives and new ideas into consideration and who are not invested in the existing Options A, B, or C.

Because time is of the essence and this process will take time to organize and carry out, we propose that in the interim, a separate committee be appointed, composed of faculty Senate, union, and UCOP representatives, and immediately tasked with investigating and assessing in full, careful, and objective detail all possible internal sources for funding the UC employer contribution, including the sources identified by the Finance Work Group and the additional sources suggested in this report and any other possible sources. Since these sources are potentially critically important alternatives to huge increases in student fees for funding the UC employer contribution, as well as alternatives to large increases in the member contribution, it is important that detailed and objective analyses of what they have to offer and the costs and trade-offs they involve be made available to the new task force as soon as possible once the facilitated process starts.

Elements of a Creative Solution to the Problem of Covering UCRP's Normal Cost and Amortizing its Abnormal Cost:

To develop a credible, broadly accepted, equitable plan for solving the financial crisis facing UCRP, we urge the stakeholder representatives who take part in the new mediated process to base their decisions on the principles we listed earlier and to consider the following ideas:

1. **Do not propose regressive changes to contributions or benefits.** Regressive changes will be deal killers for the unions, the UC Faculty Associations, and other employee stakeholder groups.

2. **Do not propose a new tier that imposes costs only on future employees.** As explained above, this approach is not only unfair to the category of employees on which the future of the university depends, it undermines the ability of the university to amortize the unfunded liability quickly and efficiently by excluding most employees. In addition, there is good reason to believe that the savings attributed to it are grossly overstated because they are based on the application of a questionable actuarial cost accounting method.

3. **Changes to contributions and benefits to amortize the Abnormal Cost should be temporary in nature.** They should incorporate provisions requiring that they be phased out once the hole in the UCRP trust funded created by the unfunded liability is on track to being plugged.

4. **Structure changes to contributions and benefits to amortize the Abnormal Cost as progressively as possible.** While it is true that pension benefits are deferred compensation earned

by individual employees, rather than a public good, there are strong logical as well as ethical reasons to hold that UCRP members at the upper end of the UC salary scale should bear more of the burden of covering the Abnormal Cost of the snowballing liability than those at the lower end. First, amortizing the unfunded liability is different from covering the additional service credit earned each year by the members of UCRP. We are facing a crisis that requires extraordinary creativity and sacrifice to solve. Second, the university has moved away from the traditional merit system of compensating faculty and staff toward a market system that has led to increasing stratification of employee salaries. We are particularly aware of how this shift has impacted the distribution of faculty incomes. Some faculty are literally paid hundreds of thousands of dollars more than other faculty who are nominally at the same rank and step. Growing numbers of staff and executives also earn above scale salaries and other forms of compensation in the high six figures or more. They command these high salaries because of the university's embrace of "market based" compensation. In contrast to employees paid at rates set by our poorly funded merit system, they can't legitimately claim that they deserve UC's generous pension because they are earning less than market level salaries. They earn market salaries! [9]

5. **Focus on identifying and/or developing new internal sources of university funding for the UC's employer contribution other than student fee increases.** The PEB Task Force Finance Work Group suggests as possible sources of funds the issuance of pension obligation bonds, the sale of university property, the privatization or monetization of graduate student and faculty housing, additional workforce reductions, a partial moratorium on capital projects, borrowing from STIP, and restructuring outstanding debt. We agree with the Finance Work Group that all of these ideas need to be carefully investigated. Another idea not mentioned by the Work Group is the possibility of selling off or selling a large interest in one or more of UC Medical Centers, subject to agreements guaranteeing that they continue to serve as teaching and research hospitals for their associated UC medical schools. Though this would be disruptive to the medical schools, Harvard Medical School does not own its own hospital but has developed agreements that enable it to work productively with private hospitals in the Boston area. We also suggest that the new task force look into ways to generate funds by reducing the management fees paid to external investment managers. Using data in the 2009 Fiscal Year annual report of the UC Treasurer, Charlie Schwartz has calculated that UC paid $192 million in fees to external money managers as well $ 33 million in internal expenses in 2009 to manage the $42 B UCRP trust fund investments. He also reports that at the November 2007 meeting of the Committee on Investments, the Treasurer reported that too many of the active external money managers were just replicating the benchmarks; and thus paying them fees was just a waste of money. [10]

   These and other potential sources of internal funding for the UC employer contribution must be explored in more depth. Strategies for utilizing some or most of them must be developed and detailed plans put forward and instituted to enable UC to substantially increase its employer contribution without increasing student fees. This is particularly important for plans to amortize the Abnormal Cost but, in the absence of state funding of the UC Normal Cost contribution, may also be necessary to fund the Employer Normal Cost.

[9] There is ample precedent for progressive graduation of contributions. The Task Force itself has incorporated a progressively graduated contribution structure into Options A and B, and contributions have been graduated to adjust for the regressive impact of the cap on Social Security contributions since UCRP was founded.
[10] http://socrates.berkeley.edu/~schwrtz/WHPF26.html

6. **Establish a Stakeholders' Board of Trustees for UCRP.** For the principles at the core of our approach to restoring UCRP to become a credible foundation for the long term reform of UCRP, it is necessary to create permanent institutional mechanism that supports mutual trust among all groups with an interest in saving UCRP as well as a strong and conscious sense of shared purpose on an ongoing basis. For this we need **shared governance** of the pension program. We can accomplish this is by establishing a Stakeholders' Board of Trustees for UCRP.

   The 2007 California Senate Concurrent Resolution on Joint Governance directed the UC Regents to create a jointly governed Board of Stakeholder Trustees for UCRP that would enable employees to participate in the management of UCRP with Regents and their representatives, as the state constitution allows. Five UC labor unions, two Regents, and the Council of UC Faculty Associations endorsed the principle that the Regents should delegate their absolute authority regarding the management of UCRP to a jointly governed Board of Trustees. In response, UCOP rolled out a weak and flawed proposal for a joint board that neither the unions nor the Council of UC Faculty Associations have accepted. It has now offered to allow one representative of UC's unions to have a seat on the Pension Advisory Board, which is advisory only. This is not an adequate response to the Resolution.

   We strongly support the principle of shared governance and believe it is the key mobilizing the employee-management collaboration needed to restore UCRP to long term fiscal health and stability. It is time to establish a strong, jointly governed Board of Stakeholder Trustees that provides an institutional framework for employees to work with UCOP and the Regents to take the difficult actions needed to bring UCRP to fiscal health as quickly as possible. The purpose of this board is not to conduct the daily hands on financial management of the UCRP trust fund, but to pick up where the new, professionally facilitated task force group leaves off after it submits its proposals to President Yudof and the Regents. The Board's mission should be to monitor the implementation of the fully fleshed out Option D, develop and implement future plans for funding the Normal and Abnormal Cost as conditions change over time, and participate in decisions regarding investment priorities. It will be necessary to provide professional facilitation of this new Board of Stakeholder Trustees to ensure the spirit of cooperation and mutual respect continues.

   The reason to create a Board of Stakeholder Trustees for UCRP is to create a permanent institutional framework for enabling employees to work with UCOP and the Regents to develop fair and balanced solutions to UCRP's funding deficit going forward. A Joint Board Trustees will build trust by enabling employees to have access to full and accurate information about UCRP's management, fiscal status, and financial performance, while giving employees a direct and responsible way to participate in the difficult decisions that need to be made to restore the pension plan to fiscal health while minimizing the damage to UC's ability to continue to operate as a world class teaching and research institution that is affordable for all eligible California students.

   Though the precise structure needs to be negotiated among the parties, we suggest that the fairest, most reasonable way to proceed would be to give an equal number of seats to representatives of the UCOP, the Regents, ladder faculty, non-unionized permanent staff employees, and retirees and a somewhat larger number to unionized employees, to reflect the relatively large numbers of their members. We suggest that each of the first five groups be represented by three Trustees and that unionized employees be represented by four Trustees. To ensure that teaching faculty (and thus student interests) are adequately represented, at least one faculty representatives should be actively engaged in undergraduate teaching and another one should be actively engaged in graduate teaching.

In addition, at least one representative from each of the unionized, non-unionized, and retired employee groups should be people who work (or in the case of the retiree group, worked) for academic departments. The employee representatives should include equal representation from humanities, social science, and hard science disciplines in the university's Colleges of Letters and Sciences and its professional schools. This will help ensure that the Board is positioned to take into consideration the impact of its decisions a broad range of the university's instructional and research operations, as well contributions and benefits. All campuses should be represented.

7. D**evelop an aggressive strategy for working with state legislators, the LAO, the Governor, and the public to restore state funding for UCRP.** It would be a good idea to include representatives of state government on the new Process D task force as well as the Board of Stakeholder Trustees for UCRP (as non-voting members). Non voting alumni representatives could be included in these boards as well, with an eye toward enabling them to get the message out to other alumni and people in their home communities about the problems facing UCRP and the creative ways UC constituencies are coming together to try to solve them.

8. **Think outside the box of pension reform.** The fiscal crisis facing UCRP is symptomatic of a broader crisis facing public pension funds and local, state, and federal governments. It is a crisis of American culture and politics that is manifesting as a break down of public finance. UC should work with private donors to develop programs to support faculty and student research into these problems and their possible solutions. As the state's premiere public institution of research and instruction and its engine of innovation and economic growth, the University of California should assume a leadership role supporting research and messaging that helps people understand the roots of the crisis in public finance, the complexity of the challenges it poses to society, the scope of the harmful impact it is having on public welfare, and the nature of the changes in public policy and civic culture needed to ensure that the benefits generated by public universities (and other public institutions like parks, K-12 schools, police, etc.) remain available to all.