California Public Employee Post-Employment Benefits Commission

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Providing for the Pension and Health Care Needs of California's Schools

Testimony from:

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Chairperson Parsky and distinguished Commissioners, thank you for the opportunity to participate in this very important hearing today on post–employment pension and health care obligations. The University shares the Governor's and the Commission's concerns that these obligations are met without harming other governmental programs and taxpayers or by shifting the costs to future generations. Further, we hope to work together to structure sustainable post-employment benefits for future generations of faculty and staff at UC and at other schools and public employers throughout the great State of California.

I am Judy Boyette, Associate Vice President of Human Resources and Benefits at the University of California, and my department has responsibility for systemwide retirement and health and welfare benefits, HR policy and labor relations. In my role, I oversee retirement and health and welfare benefits for 188,000 faculty and staff and their families and over 45,000 retirees and their survivors. The benefits are of course very important to every one of them.

Prior to joining the University in 1997, I was a partner in one of the largest law firms in the country, now Pillsbury Winthrop, where I specialized in employee benefits. Virtually my entire career has been spent focused on employee benefit issues and it is an area of great personal passion for me.

Today I would like to tell you briefly about

- the pension and retiree health care benefits UC offers,
- the unique challenges UC faces,
- the ways we are working to manage liabilities so that we can maintain sustainable benefits,
- and UC's need for continued flexibility to design programs to meet UC needs to recruit and retain the very best faculty and staff.

The University of California is a diverse organization with ten unique campuses, five teaching hospitals, and three national laboratories managed under contract for the Department of Energy (DOE) – either by UC or in partnerships with other firms. We have about 120,000 current members in our pension plan, including over 9,000 tenure or tenure-track faculty. We operate many different “businesses,” including instructional campuses and hospitals, research facilities, clinical medical centers and the DOE labs, each with complex and differing funding sources. UC’s key missions are teaching, research, and public service, which includes patient care.

UC PENSION PLAN

The University of California Retirement Plan, or UCRP, has been the University’s defined benefit pension plan since 1961. UCRP has been fully funded for 20 years and non-contributory for the last 17. Our defined benefit pension plan has been a tremendous success and a tremendous asset to both UC and the State of California.

UCRP provides retirement income, or a “pension,” to employees who complete five years of service or more and retire from the University at or after age 50. The benefit is based on a formula that takes into account the employee’s years of service, age at retirement and the average of their highest three years, a full 36 full months, of eligible compensation. This is the primary pension plan offered to all eligible employees at the University.

UCRP is an important aspect of the University’s overall employment package. Along with the University’s retiree health plan, it produces a retirement package that is well suited to a number of the University’s key employment objectives:

- For Faculty and other positions for which career employment is a desirable outcome, the plan encourages longevity while making it financially feasible to retire at the end of a productive career.

- We believe it has been a key factor in the University being able to retain Faculty and other key staff despite shortfalls in the University’s competitive position for cash compensation that resulted from low or no salary increases for FY 2002-03 through 2004-05.

- UCRP provides our faculty and staff adequate retirement income, enables us to renew our intellectual capital by encouraging faculty and staff to retire at age 60, and benefits the State of California by allowing us to attract and retain high quality faculty and staff.

- The UCRP is not as effective for recruiting and retaining faculty and staff who may be more concerned about higher current salaries to afford California housing and those who intend to work shorter careers at UC and desire more portable benefits.

Due to earnings on pension plan assets that have on average exceeded assumptions, the University's employees, as well as the University and all those who provide funding to it (including the State of California), have been able to enjoy a "holiday" from having to contribute to UCRP since the early 1990's. In fact, over 50% of current active members have never made a contribution to UCRP.

That contribution holiday is not sustainable over time. The costs of future benefits accrued by plan members each year are roughly 16% of payroll and no money is currently going into the plan to defray those costs. For the fiscal year ending June 30, 2007, the amount totaled $1.3 Billion. This cost accrues each year and has been paid from surplus assets.

- UC has been able to fund the annual costs by applying the previously accrued surplus that resulted from investment gains. That surplus has been steadily declining as UC has added a significant number of new members without either UC or the employees making any contributions.

Although the UCRP is currently funded above 100%, and the Plan's investment return for the fiscal year ending June 30, 2007 has preliminarily exceeded an amazing 18½ %, mirroring the movements in U.S. and international equity markets, it would not be realistic or responsible to assume that we could sustain our plan indefinitely without contributions. Even with this most recent return, the plan is projected to be under-funded, i.e., below 100%, within the next few years. This assumes average future investment earnings of 7.5% and other assumptions, including new hires.

- If contributions are not made until the plan's funding reaches the 100% level, contributions would have to start immediately at the full Normal Cost (currently 16%) in order to keep the funded status from continuing to deteriorate.

- If funding begins while the funded status is still fully funded, contributions could potentially be increased gradually, which would ease the financial impact to faculty and staff and to the myriad UC funding sources, including the State of California.

- Prior to the temporary suspension of contributions, the University made contributions out of appropriations from the State ranging from about 4% to over 16% of eligible payroll each year;

employees historically had contributed between 2% and 5% of pay based on their salary level. According to University calculations, the suspension of employer contributions has saved the State approximately $1.3 billion over the last 11 years alone.

- In contrast, the PERS contribution rates for State Miscellaneous Members have remained in effect, with the exception of the suspension of employee contributions for two years and employer contributions for one year. The current contribution rate for this PERS classification is 5-6% of pay for employees plus 16.997% of pay for employers.

UCRP is not immune from the pressures of a potential unfunded liability. The Regents carefully review any retirement benefit enhancements to UCRP and consider them in light of business needs and future increased liabilities. Our recent actuarial studies indicate that the growing liabilities in UCRP, due to annual costs for both current employees and new hires, will erode the funded status over time.

Although our pension plan is fully funded today, we should be making contributions on the benefits accrued today, not simply paying for them out of our surplus. We should be capturing the costs today, for the liabilities incurred today, rather than not. Over 75% of our overall payroll is from self-supported enterprises and from federal contracts and grants. We should be capturing contributions to fund these future obligations as they are incurred, during the period of the contract or grant. However, we cannot charge these fund sources if we are not charging all fund sources.

This past year, UC was unsuccessful in obtaining State funding for even a small portion of the employer contribution to UCRP related to State funded salaries and as a result, the implementation date for employer and employee contributions for the entire plan has been deferred. The restart date for contributions is also subject to completion of the budget process and collective bargaining for represented employees.

We know that contributions to our pension plan will once again be necessary for sustainability. The Regents' fully understand their role as fiduciary of this trust and have spent significant time and resources studying this issue over the last several years. UC and the State of California have been very fortunate to enjoy this competitive advantage for so very long. We have not yet determined when contributions can be targeted to resume or the precise amount of contributions that will be necessary. Our actuaries are working on an updated actuarial valuation at this time. The most recent Actuarial Valuation, and an updated Experience Study, has been provided to the Commission as background for my testimony.

In summary, our pension plan has been and is fully funded. It will remain so in the near term. Contrary to recent media and other reports, UCRP remains healthy, well performing and poised to meet UC faculty and staff retirement needs for years to come. However, we must continue to work on obtaining funding to maintain and sustain the full funding of our plan well into the future so that there will be no unfunded liability.

UC POST–EMPLOYMENT HEALTH AND WELFARE BENEFITS

I would next like to talk about UC's retiree health and welfare benefits. The retiree health program offered by the University to employees and retirees is also an important recruitment and retention tool, and an important financial security benefit for our members.

In 1990, 17 years ago, the University implemented graduated eligibility, whereby all new employees must generally have 10 years of UC service credit to qualify for retiree medical benefits. At 10 years of service UC pays 50% of the current employer contribution towards the medical benefit premium cost. Employer contributions increase by 5% for each additional year of service, up to 100% of the employer contribution with 20 full years of UC service credit. Our current requirements are different than some other public entities in California that require only 5 years of service to qualify.

The recent governmental accounting changes, in combination with continuing health care cost increases, have made these long-term costs more visible. Although the retiree health benefit is not "vested" in the same manner as the defined benefit pension plan and is communicated differently from the pension plan, the University is committed to maintaining a sustainable retiree health benefit program.

- Financial Context. The University projects the following cost relationships for fiscal year 2007/2008:

  - "Pay-as-you-go" cash costs for current retirees of approximately $205 million;

  - GASB 45 "Annual Required Contribution (ARC)" of $1.3 to $1.4 billion;

  - GASB 45 Unfunded Liability of approximately $11 to $12 billion as of July 2007.

  The GASB 45 measures assume the University continues on a "pay-as-you-go" basis with no pre-funding. The "Normal Cost" for benefits currently being earned by employees is estimated to be over 7% of employee payroll. Including the amortization of the unfunded liability, the total cost equates to almost 19% of employee payroll.

Credit market reactions to the new accounting measures have focused on managing the benefits and costs going forward, rather than on the accounting liabilities now being made transparent. The University has begun analysis of potential pre-funding options and retiree health program changes that would manage future costs while maintaining a competitive benefit for retirees.

A retiree health trust has been established by UC to facilitate current "pay-as-you-go" funding, while providing a vehicle for any pre-funding the University may be able to do in the future. Any pre-funding from federal contracts or grants will require similar pre-funding for the remaining University population (e.g., the State and other self-sustaining enterprises).

Potential program design elements that could be evaluated include eligibility provisions and employer contribution policies. We must be sure to measure the impact on UC retirees with low income from all sources, with a potential safety net established at some level. We would also measure the potential effect on the overall University workforce due to any change in employee retirement patterns caused by changes to retirement or retiree health program design and the competitive recruiting and retention needs of the diverse enterprises within the University.

Any program changes will be subject to collective bargaining for represented employees and to the University consultation process with various stakeholders, particularly the Academic Senate. More than 71,000 of UC's employees are represented by 12 separate systemwide bargaining units.

The impact of post-employment benefit obligations is particularly important as it relates to limited term funding sources like contracts and grants.

- Failure to assess contracts and grants for the projected costs of the post-employment benefit liabilities incurred during the lives of the contracts means the ability to obtain funding from those contracts and grants is gone forever. The University will have incurred a future liability for retiree medical benefits with no way to obtain funding for that liability from the source for which the work was performed and the liability was incurred.

- This issue is a very significant problem for post-retirement health care. Unless the obligations to pay future health care liabilities are pre-funded in some way, the University's liability will continue to grow and at least part of the liability may have no appropriate funding source from which to pay benefits in the future.

- Finally, UC cannot charge federal contracts and grants for any benefit expenses such as funding retiree health unless all other funds, including State funds, are also provided for such purposes.

We are very concerned about deferring costs to the future as we could price ourselves out of the market if someday we had to fund huge accrued post-employment liabilities from future users. This would impact UC's ability to effectively compete for future contracts and grants, as well as impact affordability for students. Having to fund significant future liabilities through increased fees has the potential to adversely affect enrollment and could put the University – and California's economic competitiveness - at severe risk.

UNIQUE CHALLEGES FACING UC

UC has several unique competitive labor market considerations, including competing for talent in diverse labor markets:

- For faculty and other academic positions, key competitors are other top Universities
- For Medical Center professionals, we compete with other top academic medical centers and California hospitals
- For non-academic employees, the competition is primarily other large California employers

The University of California is different from many other public employers in California.
UC receives funding from a variety of sources, some of which are variable and not permanent in nature. Funding also varies by campus. Systemwide, in 2006-2007, approximately:

- 17% of overall funding is from State General Funds
- 8% is from Student Fees
- 21% is from University Medical Centers
- 12% is from Federal Contracts and Grants
- 12% is from DOE Laboratory Operations and
- 30% is from other fund sources (including self-supporting auxiliaries).

Already UC faculty salaries lag behind faculty salaries at our comparison eight institutions by approximately 10%. It is impossible to overstate the critical nature of the problems created by salary lags, and it is apparent that UC faculty salaries will continue to be lower than our comparison institutions for several years. Providing competitive compensation – *and* benefits -- is a key component in the

University's ability to recruit and retain the best faculty, and it is of paramount importance at this time, when UC faculty salaries are below our competitors that the University continues to offer competitive retirement benefits. The University must recruit about 7,000 new faculty during this decade to accommodate increases in enrollment and to replace faculty who retire or separate for other reasons. Without a competitive compensation and benefits package - if we cannot offer at least a pension package equal to our competitors - we will lose the best available faculty to our competitors.

The health of the University is important to the health of the State of California. The many positive impacts of UC on the state economy have been well documented. UC supports regional industry clusters in biotech, information technology and telecommunications and essentially trains much of California's workforce, including 7% of the nation's Ph.D.'s. And UC has a dramatic impact on California's technology through research and innovation – more than 160 companies have been founded based on UC developed technology. The continued success of UC, primarily through its excellent faculty, is good for the State.

Benchmarking studies of the retirement plans offered at the comparison eight research universities (four public and four private) agreed upon by the California Postsecondary Education Commission as the benchmarks for faculty salaries suggest that each of the institutions has developed a methodology to ensure they can attract and retain faculty. Some institutions offer both defined benefit and defined contribution plans, some offer choices between the two, and 3 out of 8 offer different plans to their faculty than they do to staff. UC must maintain a competitive retirement program design and must be able to adjust and adapt to compete for faculty.

Particularly for staff, the value provided by retirement and retiree health plans are attractive to some individuals as an alternative to opportunities found in the private sector for stock options and other forms of equity compensation, and often higher salaries and cash incentives.

MANAGING OUR LIABILITIES

Adequate retirement benefits, both pension and retiree health, have long been a key component of public employees' compensation packages. Managing our current and ongoing liabilities is a critical priority. In the absence of adequate funding for both pension benefits and retiree heath benefits, services provided by today's public employees will be paid for in part by tomorrow's taxpayers, and in the case of the University, tomorrow's students, patients and other users of University services.

UC evaluates retirement benefits as part of total remuneration in order to understand the extent to which the competitiveness of retirement and other benefits offsets any current lags in direct cash compensation. This process has and will enable UC to evaluate benefit offerings and designs to rebalance the mix of total remuneration to reflect competitive considerations. Again, the key factor for UC is being able to continue to recruit and retain the highest quality faculty and staff, while prudently managing the ultimate liabilities of the University.

IN CLOSING

UC is very aware of our obligations. We have been in broad consultation on these issues for some time, and look forward to helping design solutions to these issues. In closing, because of our complexity and diverse needs, the University needs flexibility to continue to provide the benefit plans needed to maintain our workforce. We need to be able to respond to the various market conditions we face. Such flexibility is critical to our ability to continue to accomplish our mission and contribute to the State.

UC faculty and staff are incredibly devoted and hard-working men and women. They care deeply about the University, and they proudly and tirelessly work to preserve the wonderful education our students receive, the excellent care our patients get, and the state's reputation as an innovator and national leader. They deserve a secure retirement and nothing less.

We share the concerns of the Commission and want to offer whatever help is necessary to carefully evaluate these very serious issues. I hope from my testimony today you understand that UC has been carefully studying these issues.

Again, I want to thank the Commission for the opportunity to discuss these difficult, but important, issues. I hope I have addressed at least some of your concerns, and helped you to understand and appreciate the challenges UC is facing. I would be happy to remain available to answer any questions you may have and will provide any further information that would be helpful.

Thank you.