

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)¹

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We are submitting this response to the August 25, 2010 “Dissenting Statement” by seven members of the Work Groups of the President’s Task Force on Post-Employment Benefits (PEB). We begin with a restatement of key principles in the PEB study and of points on which we agree with the dissenters. We will then focus on two subjects addressed throughout the “Dissenting Statement”: 1) the Task Force proposal for a new tier in the pension plan and 2) the use of total remuneration studies in evaluating changes in the University of California pension system.

With all members of the Task Force, we share a commitment to the following priorities which guide continuation of the University of California pension system

- Reward long serving employees by providing a defined benefit plan and a retiree health plan
- Sustain financial health of the institution – which requires fiscal responsibility and cost cutting measures in response to rising costs and diminishing state support
- Maintain an eminent university through competitive salaries and benefits that facilitate recruitment and retention of the best faculty and staff

In addition, we agree on many common features for a new pension tier for new hires after July 2013, including:

- Increase targeted retirement age to 65 and after a full career at the University for employees to receive full pension benefits
- Discontinue the lump-sum cash out option at retirement
- Discontinue the inactive member COLA

In addition, the Task Force recommended eliminating the Senior Management supplemental benefit.

Proposals for a New Tier in the Pension Plan for New Hires after July 2013

Building on these priorities and points of agreement, we are obliged to counter the “Dissenting Statement” in two primary subjects, first with respect to the proposed new tier.

¹ This statement is listed as “Dissenting Statement” on the PEB web site. See http://universityofcalifornia.edu/sites/ucrfuture/files/2010/08/peb_dissenting_082510.pdf

Integration with Social Security – A key feature of the two Task Force recommendations for a new tier is integration of the UC pension payouts with Social Security income. Almost all UC employees contribute to Social Security and UC contributes the employer share.² As of April 2010, UC employees also contribute to their defined benefit pension plan, and UC as employer also contributes a larger share. In calculating the level of income employees will need for retirement, experts advise that employees need between 70-90 percent of pre-retirement income to achieve the same after-tax income since they no longer contribute to Social Security or their pension plan and incur no work-related expenses. (page 5 of first paper in the Report at http://universityofcalifornia.edu/sites/ucrfuture/files/2010/08/peb_ax_k-4_overview-discussion-db-dc-plans.pdf).

Given that both UC and the employee contribute to both the defined benefit pension plan and Social Security, it is reasonable to count both sources of income when planning for a retiree income that is 70-90 percent of pre-retirement income.

All options for a new tier of the defined benefit pension fund must still address two needs:

- The “normal cost” which is the funding needed to meet the pension obligations for retirees each year; and
- The unfunded liability that has accrued (and will continue to increase until we reach total contributions that equal the annual normal cost)

Both Option A and Option B address these financial obligations, while proposing a progressive contribution scale that recognizes differences in salary and in mandated contributions to social security.

- “Option A” – integrated with Social Security
 - Estimated Long-Term Normal Cost 11.9%
 - Estimated Member Contribution Rate(s) 3.5%/9.5%³
 - Estimated Long-Term Employer Contribution 7.3%

Under Option A, income replacement for an employee at age 65 with 30 years of service and a final salary of \$60,000 is estimated at 79% of pre-retirement income when combined with Social Security. For employees with a final salary of \$40,000, the combined benefit would be 87% of pre-retirement income.

² There are a small number of employees who opted out of Social Security years ago, but they would not be affected by proposed changes for new employees after July 2013.

³ 3.5% contribution on wages below Social Security Covered Compensation, which is the 35 year average of social security wages (currently ~\$60,000) adjusted each year for inflation, and 9.5% for wages above the Social Security Covered Compensation.

- “Option B” – integrated with Social Security
 - Estimated Long-Term Normal Cost 13.8%
 - Estimated Member Contribution Rate(s) 4.0%/8.2%⁴
 - Estimated Long-Term Employer Contribution 9.0%

Under Option B, income replacement for an employee at age 65 with 30 years of service and a final salary of \$60,000 is over 90% of pre-retirement income when combined with Social Security. For employees with a final salary of \$40,000 or less, the combined benefit exceeds 100%. Option B has a higher employee contribution for lower-wage employees than Option A.

Implementing a New Tier does not change the current unfunded liability, but because these recommendations fully fund normal cost for new hires, they do limit the unfunded liability’s growth and help stabilize the funding status so that future contributions and investment returns will return the plan to a fully funded status over the long term.

Implementing Option A, with a 7.3% employer long-term normal cost reduces the long-term liability by an estimated \$20 billion between 2013 and 2038 compared to Option B, with a 9% employer long-term Normal Cost, that reduces the liability by an estimated \$13 billion.

The lower employer Normal Cost for new hires reduces pressure on operating budgets as the University seeks to pay off the unfunded liability. A fiscally responsible plan must provide such flexibility for the University’s long-term strength and we believe Options A and B do this.

Option C has been revived in the “Dissenting Statement” but we continue to support the Task Force Steering Committee’s decision NOT to forward it for consideration. This third option has an added average annual cost of \$211 million more over the next 30 years than Option A, a particularly high cost when added on top of the new \$1.6 billion cost that must also be covered annually to restore health to the retirement system. This added cost and other features of the plan detailed below prompted the Steering Committee to drop Option C from consideration.

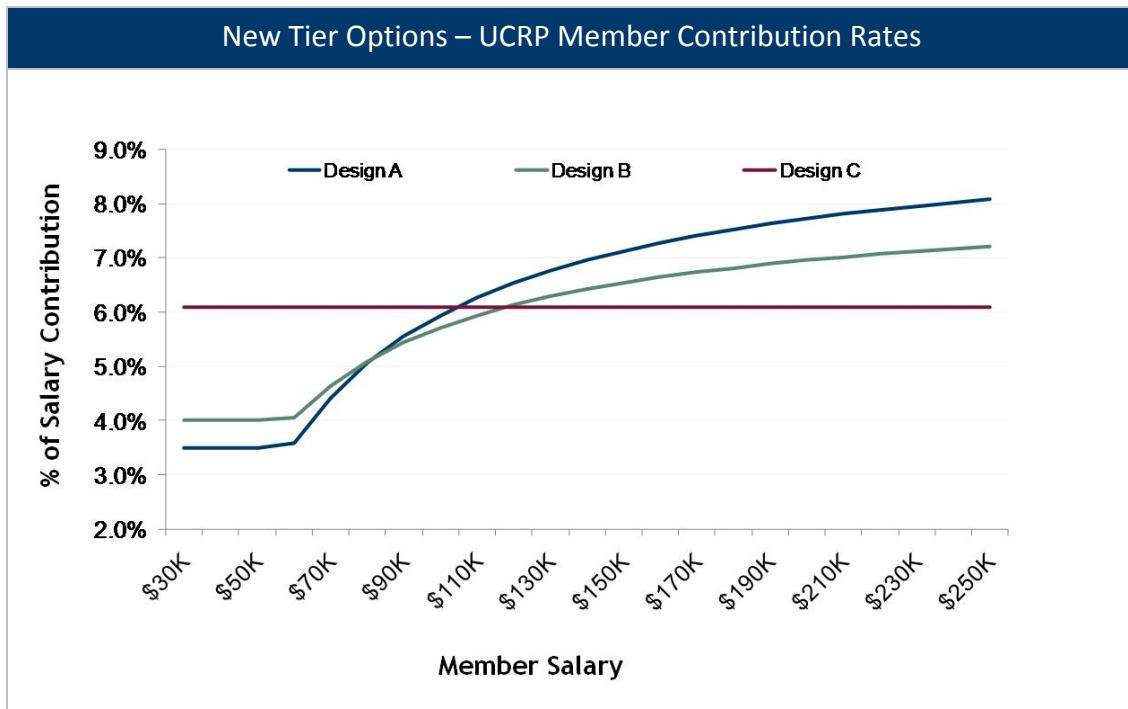
- “Option C” – proposed by the authors of the “Dissenting Statement” is NOT integrated with Social Security
 - Estimated Long-Term Normal Cost 15.1%
 - Estimated Member Contribution Rate(s) 6.1%
 - Estimated Long-Term Employer Contribution 9.0%

Option C is not integrated with Social Security, and does not have progressive contribution rates that increase as an employee’s salary rises. One of the important differences between

⁴ 4.0% contribution on wages below Social Security Covered Compensation (currently ~\$60,000) and 8.2% for wages above Social Security Covered Compensation.

the two options advanced by the PEB Task Force and Option C advanced by the authors of the “Dissenting Statement” is the impact on our lowest paid employees. As the chart below shows, Option C would impact lower wage employees most negatively, while lowering anticipated contributions from the highest paid staff and faculty. In other words, all employees, those making \$30K and those making \$250K, would contribute the same percentage of their salary to the pension fund under Option C.

Figure 1: New Tier Options – Member Contribution Rates



In considering Options A and B alongside Option C, we ask UC employees to consider the importance of progressive contributions by employees and of maintaining the financial health of the institution into the coming decades.

Total Remuneration

The Total Remuneration Study undertaken by the University evaluates the salary and benefits provided to UC employees with those of our comparator institutions to determine how competitive UC is in remunerating our faculty and staff. The same methodology has been used for the past several years, and the most recent study was released in October 2009.

Cash compensation is the most critical factor in the Total Remuneration Study, and UC salaries lag our comparators by 10 to 19 percent across all employee groups. The PEB Task Force recognize that this is a serious issue for the University, and all efforts must be made to increase

wages for employees, efforts that would also change the outcome of any total remuneration study more significantly than specific retiree benefit changes.

A critical point of consensus for the Task Force was the lag in compensation. Although it was outside the purview of their charge, the Task Force strongly recommends that the salary lags be addressed, especially in light of the impact on total remuneration of potential changes to Post-Employment Benefits.(Task Force Report page 88)

Retiree health benefits are also a significant factor in total remuneration calculations, and as the table below shows, greatly exceed the plans of our comparators. Proposed changes to the retiree health plan would reduce the value somewhat, but they still greatly exceed our comparators in most cases. For Ladder-Rank Faculty, the change would bring the value in line with our comparators.

Figure 2: Total Remuneration with comparator groups for all employees in New Tier Options A, B, and C

		UC EMPLOYEE GROUPS - CAMPUS & OP				
		All	Ladder-Rank Faculty	MSP	PSS-Policy	PSS-Represented
		<i>(values as percentage of appropriate comparator group values)</i>				
<i>Current UC Plans</i>	Cash compensation	-13	-10	-16	-13	-19
	Total retirement benefits	48	4	59	84	102
	Pension benefits	10	-8	24	25	25
	Retiree health benefits	228	75	494	483	310
	Total remuneration	-4	-6	-6	-2	-4
<i>Option A</i>	Cash compensation	same as current UC plans				
	Total retirement benefits	-22	-36	-14	-18	-7
	Pension benefits	-43	-41	-33	-52	-54
	Retiree health benefits	77	-3	219	212	120
	Total remuneration	-11	-11	-13	-11	-12
<i>Option B</i>	Cash compensation	same as current UC plans				
	Total retirement benefits	-9	-26	0	1	10
	Pension benefits	-27	-30	-17	-30	-31
	Retiree health benefits	same as option A above				
	Total remuneration	-9	-9	-12	-9	-11
<i>Option C</i>	Cash compensation	same as current UC plans				
	Total retirement benefits	-5	-23	3	8	14
	Pension benefits	-22	-26	-14	-22	-25
	Retiree health benefits	same as option A above				
	Total remuneration	-9	-9	-12	-8	-11

For pension benefits, however, **none of the three Options** (A and B in the Task Force Report and Option C in the “Dissenting Statement”) are competitive using the Total Remuneration study methodology. The URLs for comprehensive studies for all three options are in Appendix H in the full Task Force Report page 145.

<http://universityofcalifornia.edu/sites/ucrpfuture/task-force-inf/>

As with cash compensation, UC lags the comparators in total remuneration across all employee groups – under the current benefit plans as well as under any of the proposed new options. However, the differences for total remuneration among the options are small – only 1-3 percent for any employee group.

The Total Remuneration study results show that none of the proposals including the Dissenting Statement’s Option C are competitive, even though Options B and C require UC employer contribution levels of 9% compared to an 8.8% average for our overall faculty comparator group in “the Comp 26.” Due to these results, we have raised questions about whether Total Remuneration studies as performed in the past meet the need to give proper value to the proposed Options, particularly because UC has recommitted itself to a Defined Benefit plan, unusual among our competitors. The large majority of these other plans are **Defined Contribution (DC)** plans; UC offers a **Defined Benefit (DB)** plan and will continue to do so. In a DC plan, annual employer and employee contributions are deposited in the employee’s name in a tax-deferred account, which grows each year that contributions are made. Thus there is a steady growth, year-by-year, in the employee’s DC plan up until the time of retirement. Investment gains and losses are entirely the responsibility of the employee and are subject to market fluctuations. In contrast, a DB plan has a lower year-by-year value growth until employees are older and of longer service – exactly the employee group UC wishes to reward with a pension plan. UC employees develop great value in their DB plan with later age and longer service.

The primary difference between DB and DC plans are as follows:

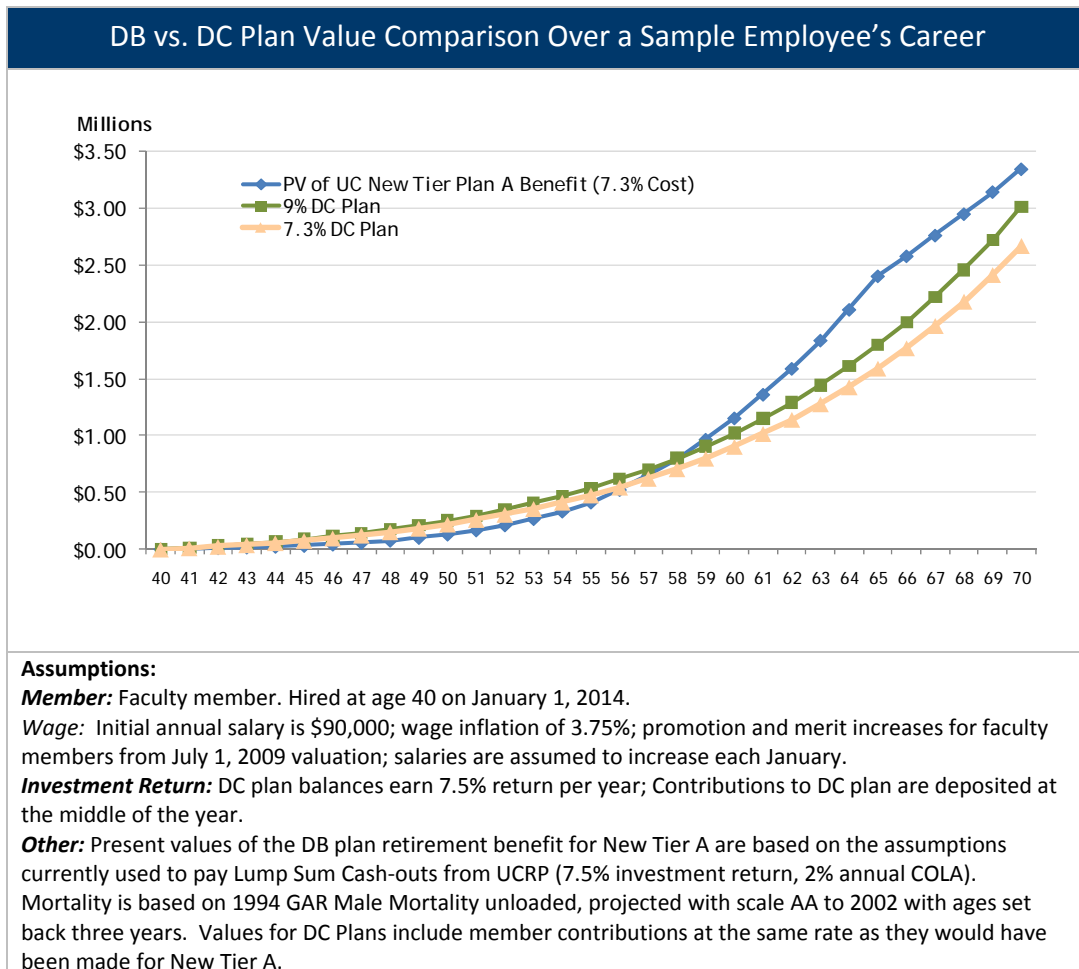
- With a DC plan, the employee assumes the investment risk; DB plans guarantee a pension, and the University assumes the investment risk
- DC plans are portable from one employer to another; DB plans are specific to one employer where the benefits are accrued; accrued vested benefits are available to the employee upon retirement

Because the Total Remuneration methodology looks at the year-to-year value of all employees, the DC plan which adds value annually appears to have greater remuneration for the workforce. A compensation valuation that looked at the ultimate benefit to a long-serving employee would show a higher remuneration for that employee. And as an employer, UC

benefits greatly from these long-serving employees. Since the Total Remuneration Studies are not designed to focus just on long-serving employees, the exceptional value to them could be overshadowed by the lower value of a DB plan to younger, shorter-serving employees. Given this logic, if UC changed to a DC plan, the contribution would result in a higher remuneration value than a DB contribution of the same amount. Nonetheless, the Task Force feels that the DB plan is the better choice for UC.

The graph below illustrates the value of a DB plan over a DC plan for long-serving employees. A faculty member in the New Tier Plan A (7.3% Employer Cost) who works at UC from age 40-62 will have accumulated a pension benefit value of over \$400,000 more than that of a counterpart with a 9% DC plan. A faculty member retiring at age 65 with the stated profile leaves with a pension value asset worth \$2.5 million, substantially higher than the value of DC plans at either 9% or 7.3% employer contribution. (The difference in values of the DB and DC plans is less if the hypothetical employee is hired at age 30, or if different assumptions are made for salary increases.)

Figure 3: DB vs. DC Plan Value Comparison Over a Sample Employee’s Career



The Benefits data used in the 2009 Total Remuneration Study were collected in 2008; the proposed New Tier pension plan options will not be started until 2013, and will apply only to new employees hired after that date or current employees who **choose** the new plan. The erosion of pension benefits in the public and private sectors in the past year makes it highly likely that the value of retirement benefits offered by our comparator and public institutions will diminish in the near term as shown in Appendix J and K of the Task Force Report. Also in Appendix L, page 164, trends in this area as well as information on changes either proposed or implemented by various California public entities are described.

As acknowledged in the “Dissenting Statement”, the Task Force recommendations are not about whether to retain a DB plan. Clearly, UC sees the DB plan as a hallmark of its commitment to recruiting the highest quality employees and creating incentives for their continuation at UC. This commitment does not play out well in standard Total Remuneration methodology, especially when UC has salaries below market. We believe UC can be a leader in finding new ways to understand the value of DC and DB plans, particularly in the context of massive changes in employee retirement plans at universities across the country.

Conclusion

The PEB Task Force worked hard to examine a large number of possibilities for addressing UC’s looming challenge of funding retiree benefits, and has recommended options that we feel can restore our pension and retiree health plans to a healthy status, although the restoration will be costly and difficult. The University is in continuing discussions with the state about their resuming paying for all or part of the “employer’s” portion of our post-employment benefits. But California’s recession and the challenges of meeting all the State’s obligations make it difficult now for the State to assume this obligation. Nonetheless the University has to craft the best possible solution with or without new support from the state. This requires a combination of paying for the current unfunded pension liability, and for reducing costs in the future. Commitment to the continuing quality of the institution is our priority and our primary reason for recommending Options A and B.

We encourage a continuing dialogue on these issues of how best to support the preeminence and quality of the University through this difficult financial transition. The President will make his best recommendation to the Regents on review of the Task Force report, the “Dissenting Statement,” and other comments and suggestions that will arise in the coming months.