IN SUPPORT OF AN INTEGRATED DESIGN

Submitted by

Provost and Executive Vice President Lawrence H. Pitts
Executive Vice President of Business Operations Nathan Brostrom
Executive Vice President and Chief Financial Officer Peter J. Taylor

Annotations by Professor James A. Chalfant and Professor Emerita Helen L. Henry

Background

For over a year, the pension workgroup of the Post Employment Benefit (PEB) Task Force developed alternatives for a new tier design that combined attractive benefits for new University employees with a financing plan that is sustainable for the University for decades to come.

*Attractive and sustainable are undefined. The goal of the PEB Task Force was to suggest options for competitive pension benefits; there is no disagreement about the fact that all three options currently under discussion are **not competitive**. The basis for that assessment is not assertions by faculty and staff, but modeling by national consulting firms selected by the University.*

After months of debate and analysis, the Steering Committee advanced a few potential alternatives, including two that are labeled "integrated," meaning that the UCRS pension plan would be integrated with Social Security.

These plans – called Options A and B – have been criticized during the recent rollout of the Task Force work. Yet some of this criticism neither reflects a solid understanding of the plan nor accurately represents the design features.

*It may be true that **some** of the criticisms of the integrated plans reflect a less that perfect understanding of these plans, but this certainly does not apply to all such criticisms. It is also true that documents in support of certain positions, beginning with the Task Force report itself, can be misleading not only by what they say but by what information is omitted, as we note below.*

Given the significant actions that must be taken over the next couple of months, both to provide competitive benefits to employees and create a sustainable funding model for the University, it is critical that the University community – faculty, staff, Regents—understand the benefits and shortcomings of an integrated pension design.

*There is no statement in the Pitts, Brostrom, and Taylor (PBT) document supporting the notion that Option B, or for that matter, Option C, is competitive. Both require substantial salary increases before UC's total remuneration could be competitive. The budget savings that PBT emphasize cannot be realized, because their proposal merely shifts compensation from benefits to salaries. To do otherwise would be to make faculty and staff compensation even less competitive than it is now. If benefits are cut as they propose, salary increases would be necessary **just to maintain our current, uncompetitive level of total remuneration.** These budget savings do not create new funding for salary increases or any other University priority.*

The benefits include:

- **An integrated plan is a fairer approach.** *All employees, regardless of income, will receive roughly the same amount of income replacement from a combination of Social Security and UCRS benefits.*

  The italicized portion of the statement above is accurate, but "fair" may be defined differently by other observers. For example, the integrated-plan outcomes for income replacement are achieved by a combination of paying lower benefits to lower-salaried employees and having higher-salaried employees pay increasingly high contributions while receiving no additional benefits. This occurs once the maximum age factor of 2.5% is reached (at approximately $120,000 at present, for Option B). We did not object to that cap, but limiting the age factor to 2.5%, not "fairness," was its motivation.

- **An integrated approach reduces long-term liabilities for the University**. The integrated plan carries a lower normal cost – the cost to annually support the plan – than a similar plan with one common age factor.

  PBT focus on the total normal cost—the sum of employee and employer contributions. What matters for the University's budget is the **employer** normal cost. The recommendations for Options B (integrated) and C (non-integrated) have identical employer normal cost of 9%. Under these recommendations, the higher estimated long-term total normal cost of Option C compared to B (15.1% vs. 13.8%) is borne by employees, who receive a higher benefit in exchange for their higher contributions. For comparison, the current UCRP benefit has a normal cost of around 17.6%, so Option C represents a decrease of nearly 15% from the total normal cost of the current benefit.

- **An integrated approach is better for lower-paid workers.** *By virtue of the plan's progressive contribution structure, employees who earn less, contribute a smaller percentage of pay each year to the pension program. While it is true that lower-paid workers will receive smaller benefits from UCRS, they will realize higher income replacement (as a percentage of HAPC) from Social Security than higher-paid workers.*

  Again, the statements in italics are correct. It does not follow that this is "better" for lower-paid workers, with the possible exception of those who do not intend to stay long at UC. It is also not at all clear that this is the plan that is "better" or preferred by long-term, more highly paid staff, who are not mentioned here. In fact the widely held sentiment among long-term career staff seems to be that employees want better benefits and that they accept the need to pay for them with higher employee contributions.

  This does not mean that the University can simply set employee contributions arbitrarily high. Employees prefer better benefits and employee contributions to dealing with the cost by simply cutting benefits, but there is a point beyond which employer cost cannot be cut without UC becoming uncompetitive for hiring the best faculty and staff.

Plan Design Details

The essence of an "integrated" pension design lies in combining an employee's future retirement benefits from the University of California Retirement Plan (UCRP) with payments from Social Security to provide a secure and comfortable retirement income for long-serving University employees.

An unappreciated fact is that UC employees already pay a great deal – 6.2% of their salaries up to a covered compensation level – into Social Security, and yet it is largely ignored in the current design of the UCRP pension plan. According to national studies, most retirees need between 70% and 90% of their pre-retirement income to enjoy the same cash income in retirement as they had while working. Yet under the current, non-integrated plan, some UC retirees receive more in combined retirement benefits than they did while working – a cost the Task Force determined the University, considering its current funding pressures, can no longer afford. As an alternative, the pension workgroup developed two integrated models that replace income at levels ranging from 80% to 100%, depending on income levels.

The claims about income replacement are based on faulty assumptions about adequate income replacement. We do not disagree about the math. For a given plan and a given projection of Social Security income, it is possible to plot the percentage of income that is replaced by Social Security plus that from the plan. There is, however, no credible study claiming that income replacement as low as 70% for a retirement income is in any way comfortable, adequate, or secure. Hence, while we agree that Options A and B fall in the slightly higher range, we disagree with the implication that they therefore more than meet a standard of adequacy.

The plans we are considering are not meant to replace UCRP for employees currently near retirement. They are meant to apply to newly hired employees, and those who elect to switch for their future service, if choice is allowed. Hence, the normal Social Security retirement age will be at least 67 for most of those individuals. If they retire at 65 or earlier, they fall short of the income-replacement percentages stated by PBT. More important, what happens over time? The protection against inflation provided by the current UCRP and the alternative recommended by the PEB Task Force is imperfect, with a recommendation for the latter to guarantee only 80% of original purchasing power. Suppose the UC portion of a retirement income represents 80% of pre-retirement income. That 80% becomes 64% in inflation-adjusted terms over time. Even a UC pension that provides 100% income replacement before Social Security becomes an inflation-adjusted 80%. Anyone anticipating that the integrated plans' focus on income replacement guarantees a particular standard of living in retirement would be sorely disappointed; relying on even 100% income replacement is meaningless without protection against inflation. Hence, the claims made by PBT are overstated considerably, if interpreted as statements about retirees' standard of living. Considering inflation, and also needs such as health care after retirement, it is very easy to see why an employee might feel that they cannot possibly retire at less than 100% of income replacement, when Social Security is included.

Finally, the assertion that the Task Force determined UC "can no longer afford" what PBT imply is excess retirement income is simply false. PBT believe UC has to spend less on pension benefits. However, as we noted earlier, the "problem" of excess retirement benefits—when UC pensions are combined with Social Security—has not been a particular concern for the several decades of experience with UCRP. Similarly, we have not been aware of any concern over variation in the percentage of pre-retirement income that is replaced by these two sources of pensions.

The focus on Social Security came about not because of design advantages over a non-integrated approach, but because it provides a target for income replacement in designing a cheaper plan. We do

not disagree about the mechanics of "integration". Originally, the Task Force focused on a plan with an employer normal cost of only 7%. The best way to spend only 7% of covered compensation to provide a pension benefit appeared to be an integrated plan. When the Steering Committee finally turned its focus to competitive total remuneration, as opposed to how much UC could cut its costs, it was recognized that 1) Option A was far from competitive; 2) Employer normal cost would have to be in the neighborhood of at least 9%. These two facts open up additional possibilities. With 9% to spend, Options B and C provided feasible alternatives.

To be clear, the proposed plans are not truly integrated in that an individual's particular circumstances are not accounted for in determining the level of UCRP benefits. For example, fluctuations in income or the death of a spouse could alter the payments received from Social Security. Instead, this design utilizes the highest average compensation of an employee as a proxy for the amount she or he would receive in Social Security benefits. These, when combined with UCRP benefits, yield the replacement retirement income that averages between 80% and 100% of income for employees who have served 30 years with the University.

To further demonstrate some of the benefits and drawbacks of the integrated plan, consider two of the options – Options B and C – with the same employer normal cost (8.0%) and the same maximum age factor (2.5%). The details of each plan are as follows:

An 8% employer normal cost, as proposed below, provides an even less competitive benefit than the 9% employer normal cost that was analyzed for Options B and C. These plans would fall even further short of providing competitive total remuneration, by asking employees to bear an even larger share of the cost of providing pension benefits.

Plan Features	Integrated Option B	Non-Integrated Option C
Age Factor	2.0% *up to the Social Security threshold* 3.0% *above the threshold (max at 2.5%)*	2.5%
Long-term normal cost	13.8%	15.1%
Employee contribution	*5% up to Social Security threshold* 9.2% *above threshold*	7.1%
Long-term employer cost	8.0%	8.0%

Integrated Plan Advantages

The benefits of the integrated plan, relative to the non-integrated plan, include:

- **More effective income replacement**. The integrated plan offers a more narrow band of income replacement, treating all employees more fairly in terms of retirement income and providing more effective use of UCRP resources. Under this design, all retirees realize at least 85% replacement income from the plan, and the majority of faculty will realize a maximum age factor of 2.5%, an important consideration for them since their careers can be 7 to 9 years shorter because of their increased educational requirements.

If we begin with the premise that the only goal is to remain within the 85% to 100% income replacement band, then yes, Option B is more effective. But this should not be confused with being effective in providing competitive benefits as part of competitive total remuneration. We do not imagine that we will successfully recruit the best new faculty and staff with claims about how effectively we prevent them from achieving greater than 100% income replacement in retirement, or how level the percentage remains across segments of the workforce.

- **Lower normal cost.** This more narrow band yields a lower total normal cost, achieving current savings for employees and a reduction in long-term liabilities for the University. In current dollars, the reduction in long-term normal cost saves roughly $100 million. Since the University cost is held the same, these savings will accrue to employees through reduced annual contributions.

  Employees receive these savings in exchange for a lower benefit. This is not free money. It makes no sense to us to focus on the total normal cost. As PBT note, "the University cost is held the same". We agree with PBT that employees should have full information about Option B, or the concept of an integrated plan, before they indicate a preference for Option C. But if they then indicate that preference for Option C, then PBT have themselves made the case for it: the University cost is the same.

- **Implicit support of lower-paid workers.** The integrated plan caps the age factor at 2.5%, and yet the amount of contributions continues to rise at all income levels. This produces an implicit subsidy of the University's lower-paid employees. As an example, for an employee at $80,000 in highest compensation, the income replacements levels between the two plans are very close but the employee pays 1% less in contributions under Option B. At lower levels, this ratio is more pronounced. The effect counters the trend of Social Security, which is regressive on its contributions.

  We are surprised at the claim that it is fair to ask for different contribution percentages from different employee groups, irrespective of the benefit. We do not disagree that Social Security acts as PBT indicate, but we do not see a case for reverse-engineering a particular income-replacement outcome, as PBT prefer.

  Since the Employer Normal cost remains the same, the "implicit subsidy" comes from employees at higher income levels. This principle has never been part of UCRP, which applies the same formulas to both employee contributions and benefits at all levels of HAPC. Each employee pays for the benefit he or she earns. To reiterate, in the PEB Task Force and in our Dissenting Statement, we did not disagree with any of the arithmetic about income replacement. PBT have described the benefit formula and the contribution percentage accurately for Option B. But it is highly inaccurate to imply that income replacement was the main target of the Task Force, the main problem the University faces, or a good solution to providing either comfortable retirement or competitive total remuneration.

Integrated Plan Disadvantages

The principal drawbacks to the integrated plans include:

- **The integrated plan proposals are complicated to understand.** While this is true, we can address the problem through a comprehensive consultation and education process around the new tier design. Because this tier will not be implemented for over two years, the University should be able to mount this education campaign.

  We do not disagree about the need for prolonged extensive education. The Academic Senate's Task Force on Investments and Retirement (TFIR), the University Committee on Faculty Welfare, and the University Committee on Planning and Budget all asked for a "retirement calculator", similar to what is current available on the *At Your Service* website, to allow UC employees to evaluate the PEB recommendations. The administration, however, did not think it would be appropriate to begin its education campaign while the recommendations are still being debated. We think that better choices come from better information, and that this should have been provided. We also note that the integrated plans have been covered in at least two and in some cases, now, three rounds of forums sponsored by UCOP on the campuses over the course of the past year; and we agree that there is still considerable confusion about the concept.

- **The plans are linked to Social Security benefits which could change over time.** This challenge can be overcome by decoupling our indices from the Social Security index. We could instead choose a plan that mirrors Social Security, but utilizes a separate index that more closely reflects our projections or salary growth and other relevant measures.

  This is all very interesting, but nothing of this sort has been put forth for discussion and analysis.

- **Lower-paid workers receive lower UCRS payouts.** While true, the plan is designed to lead to a consistent band of income replacement when combined with Social Security payouts. In fact, under Option B, employees making $120,000 and less all receive income replacement, combining Social Security and UCRS, of 94% or greater.

  This issue has been discussed above.

  These may be the principal disadvantages in the view of the authors. Another disadvantage, that is very important in the eyes of many people, is actually alluded to in the section on plan design above:

  "To be clear, the proposed plans are not truly integrated in that an individual's particular circumstances are not accounted for in determining the level of UCRP benefits. For example, fluctuations in income or the death of a spouse could alter the payments received from Social Security." That is, we cannot know for any individual how much income replacement can be expected from Social Security and therefore even the numbers in the models are only estimates.

Conclusion

Much of the debate around the three options comes from a shared goal of wanting what's best for UC. It is vital that the university offer retirement benefits that help it attract and retain top talent, but *those benefits cannot be so costly that they drain resources for fulfilling UC's academic and research mission.*

Task force steering committee members note *that Option C would cost the university about $211 million more annually, on average over the next 30 years, than Option A, money UC could otherwise use for its*

core academic mission. Proponents of Option C counter that Option A will make the university less competitive when it comes to attracting future faculty and staff.

We added italics to add emphasis to statements in the two preceding paragraphs because they require careful attention. What does draining of resources for fulfilling UC's mission actually mean? Any dollar spent on benefits is a dollar not spent on providing access to UC for undergraduates, or purchasing lab equipment. Should we redirect all spending on benefits, as result of this insight? Of course not. Benefits and salaries to compensate faculty and staff (and senior administrators) are indeed expensive. So are teaching assistants, small class sizes, electricity, lab equipment, and safe and effective buildings, classrooms, and labs. We have been told that we must pay high salaries to senior administrators because this is what the market requires, and we cannot attract the best people to UC without doing so. We agree with that. Why does the argument not apply to benefits or salaries for faculty and staff? If UC is uncompetitive, we are not fulfilling our academic mission by cutting benefits. Instead, we are choosing a future of mediocrity.

The faculty and staff who deliver instruction, bring in research money and advance the state of knowledge, and serve the state (generally agreed upon as the main components of the University's "core academic mission") can certainly be replaced by cheaper faculty and staff as a cost-saving step. We are asked to believe that this can be done without an effect on the quality of the University. We cannot maintain a great University with a policy of paying faculty and staff 85 cents on the dollar, compared to our competitors.

Option B is intended to offer a middle ground. For that reason, this option and its key feature – an integrated approach to retirement benefits – deserves a full and fair hearing by all University stakeholders, including its faculty, staff and Regents.

On this point we agree. But that full and fair hearing is muddled by statements comparing Option A's cost to Option C's cost. A fair analysis of campus costs shows that they will indeed be high, and painful. No one disputes that fact. But the $211 million cited by PBT does not apply to Option B vs. Option C, it applies to a comparison of Options C and A, and A is not even under discussion in this document. The financing plan developed by Peter Taylor, in fact, guarantees that there is not a dollar of difference in spending from the operating budget—***not one single dollar—***between even Option A and the other two options, until the year 2029.

There is not a dollar of difference between Options B and C ever. Even after 2029, there is no difference in employer costs between B and C: not a dollar of difference. **This follows from the finance plan the administration has put forward.**

It may well be that some oppose the integrated plans due to imperfect understanding of their features. It would be just as bad if supporters of these alternatives continue to favor them based on a misunderstanding of the University's budget situation or the proposal for employer costs. Let's make this choice based on what is best for the University and for faculty and staff, not just advocacy.