

## IN SUPPORT OF AN INTEGRATED DESIGN

Submitted by

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### 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.*

*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.*

*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.*

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

### 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.

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:

| Plan Features           | Integrated Option B  | Non-Integrated Option C |
|-------------------------|--|-------------------------|
| Age Factor              | 2.0% up to the Social Security threshold<br>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<br>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.

- **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.
- **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.

### **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.
- **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.
- **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.

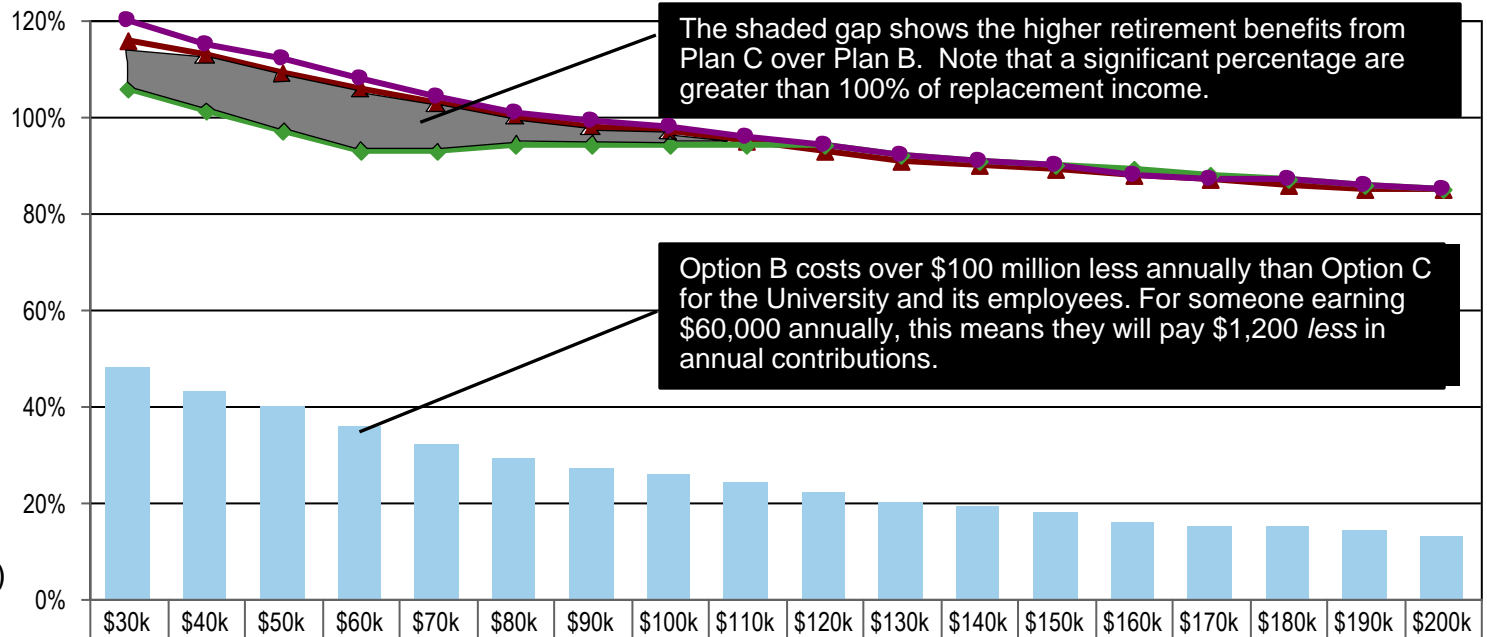
### **Conclusion**

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.

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.

# Pay Replacement at Age 65, 30 Years of Service, Including Social Security Average Member Rates Under New Tier Designs Also Shown



| Final Year Pay (Annual)        | \$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%    |
| Current UCRP + SS              | 116%  | 113%  | 109%  | 106%  | 103%  | 100%  | 98%   | 97%    | 95%    | 93%    | 91%    | 90%    | 89%    | 88%    | 87%    | 86%    | 85%    | 85%    |
| Plan Design B (2.0%/3.0%) + SS | 106%  | 101%  | 97%   | 93%   | 93%   | 94%   | 94%   | 94%    | 94%    | 94%    | 92%    | 91%    | 90%    | 89%    | 88%    | 87%    | 86%    | 85%    |
| Plan Design C (2.5%) + SS      | 120%  | 115%  | 112%  | 108%  | 104%  | 101%  | 99%   | 98%    | 96%    | 94%    | 92%    | 91%    | 90%    | 88%    | 87%    | 87%    | 86%    | 85%    |

|  |      |      |      |      |      |      |      |      |      |      |      |      |      |      |      |      |      |      |
|--|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|
| Average Member Rate—Design B (5.0%/9.2%) | 5.0% | 5.0% | 5.0% | 5.1% | 5.6% | 6.1% | 6.4% | 6.7% | 6.9% | 7.1% | 7.3% | 7.4% | 7.5% | 7.6% | 7.7% | 7.8% | 7.9% | 8.0% |
| Member Rate—Design C (Flat 7.1%)         | 7.1% | 7.1% | 7.1% | 7.1% | 7.1% | 7.1% | 7.1% | 7.1% | 7.1% | 7.1% | 7.1% | 7.1% | 7.1% | 7.1% | 7.1% | 7.1% | 7.1% | 7.1% |

Assumes retirement in 2010 and past salary increases of 4% per year  
The University contribution would be 8.0% for both Designs B and C.

Benefits for Current UCRP and possible new tier designs are based on three-year HAPC; replacement ratio is expressed as a percentage of final year pay  
Current UCRP benefits include \$133 offset to HAPC for Coordinated Members; new tier designs exclude this offset

Member rates shown for new tier plan designs A and B are averages for a calendar year; first rate applies to pay below Social Security Covered Compensation (about \$60,000 in 2010 and is the average of the Social Security Wage Base for the 35 years ending in that year) and the second rate applies to pay above SS Covered Comp