MINUTES

BOARD OF REGENTS COMMITTEE ON BUDGET AND FINANCE MEETING

MAY 24, 2018

I. CALL TO ORDER

Committee Chair Wayne Higaki called the meeting to order at 12:16 p.m. on Thursday, May 24, 2018, at the University of Hawaiʻi at Mānoa, Information Technology Building, 1st Floor Conference Room 105A/B, 2520 Correa Road, Honolulu, Hawaiʻi 96822.

Committee members in attendance: Committee Chair Wayne Higaki; Committee Vice Chair Benjamin Kudo; Regent Simeon Acoba; Regent Michael McEnerney; Regent Douglas Shinsato; Regent Michelle Tagorda.

Others in attendance: Board Chair Jan Sullivan; Regent Eugene Bal III; Regent Brandon Marc Higa; Regent Lee Putnam; Regent Ernest Wilson Jr.; Regent Stanford Yuen (ex officio committee members); President/Interim UH-Mānoa (UHM) Chancellor David Lassner; Vice President for Community Colleges John Morton; Vice President for Legal Affairs/University General Counsel Carrie Okinaga; Vice President for Academic Planning & Policy Donald Straney; Vice President for Research & Innovation Vassilis Syrmos; Vice President for Information Technology/Chief Information Officer Garret Yoshimi; Vice President for Budget & Finance/Chief Financial Officer Kalbert Young; Interim UH-Hilo (UHH) Chancellor Marcia Sakai; UH-West Oʻahu (UHWO) Chancellor Maenette Benham; Executive Administrator and Secretary of the Board of Regents Kendra Oishi; and others as noted.

II. APPROVAL OF MINUTES OF THE MARCH 8, 2018 MEETING

Regent McEnerney moved to approve the minutes of the March 8, 2018, meeting, seconded by Committee Vice Chair Kudo, and the motion carried unanimously.

III. PUBLIC COMMENT PERIOD

Executive Administrator and Secretary of the Board, Kendra Oishi announced that the Board Office received no written testimony, and no individuals had signed up to give oral testimony.

IV. AGENDA ITEMS

A. Approval of Extension of Fossil-Free Fuel Mandate Deadline to June 30, 2019

The committee considered extending the June 30, 2018, deadline stated in Regents Policy 8.207, Investments, regarding the fossil fuel-free mandate to afford administration additional time to negotiate the final services agreement with UBS Financial Services Inc. and establish the new investment platform that will enable the Legacy Endowment fund to more efficiently comply with the investment policy.

Questions and comments were raised regarding whether a year was needed and whether fossil fuel divestment was a potential breach of a board's fiduciary duty because the overall portfolio could result in a slightly reduced rate of return.

VP Young explained that administration probably did not require a year and expected to have things completed by the end of the calendar year, but requested a year to be consistent with existing board policy. UBS representatives explained that the current portfolio only contains a small percentage of fossil fuel exposure, and the long-term impact of further reductions will be minimal.

Regent McEnerney moved to recommend board approval of the extension of fossil fuel-free mandate deadline to June 30, 2019, seconded by Committee Vice Chair Kudo, and the motion carried unanimously.

C. <u>FY18 Third Quarter UBS Legacy Endowment Fund Investment Performance Report</u>

Committee Chair Higaki requested to take this out of order to respect the time of the UBS employees. There were no objections.

UBS provided an update on the economy and markets, reviewed the FY18 3rd quarter investment performance and compliance, reviewed all trades since the last committee meeting, and shared next steps.

As of March 31, 2018, the portfolio is down 0.47%, but is still outperforming benchmarks. The quarterly compliance review of the high-level endowment fund and underlying individual investments show no material changes in ownership, investment management team, or pending litigation. All equity funds are in compliance with the board's investment policy, except for the Deutsche X-Trackers MSCI Hedged Equity fund. Of the 11 fixed income funds, all fixed except for four are in compliance with the investment policy statement, UBS is monitoring these funds closely. UBS made purchases that are expected to do well in a rising interest rate environment and increase international equity exposure for long-term valuation and growth potential.

UBS indicated that the investment policy states that weighted energy should be below 1% by June 30, 2018, which is why the mandate extension was requested. The weighted energy position is currently at 2.96%; however, the new portfolio structure should help attain that goal fairly efficiently. UBS provided information on the weighted net expense ratio, portfolio costs, and overall asset composition, and stated that the portfolio is in compliance with the policy statement.

Questions were raised regarding the process UBS used when selecting the benchmarks, whether there had been any changes in components of the benchmarks, the dollar equivalent of the 0.23% net expense ratio and the impact it has on the portfolio, what UBS is doing to minimize weighted net expenses, and diversification of the portfolio.

UBS responded that the benchmarks, which were determined by the previous UBS team, have remained consistent throughout the time UBS has managed the portfolio. When formulating investment recommendations for the endowment, UBS selects benchmarks with similar types of asset classes in order to monitor against like investments. The 0.23% net expense ratio amounts to approximately $165,000, and all performance figures shown are after UBS' expenses are taken out. Similarly, the basis points for the individual managers are also taken out before UBS applies the 0.23% basis points. UBS has negotiated directly with investment managers regarding their portion of the fees in order to get the lowest price and the best return rate for the portfolio. The equity funds are all index funds, which is an efficient way to get the university exposed to various asset classes.

B. <u>FY18 Third Quarter Operating Budget Variance Report</u>

VP Young presented the quarterly Operating Budget Variance Report as of March 31, 2018. Third quarter revenues are higher than projected, with general fund revenues being higher than projected largely due to the Governor's release of half of the 10% contingency restriction in January. In March, the Governor released an additional 2.5% of the remaining 5% contingency restriction. Revenues for the Tuition & Fee Special Fund (TFSF) across all campuses are below projections due to enrollment trends with the exception of UHWO. Other special fund revenues are higher than projected while other revolving funds are lower than projected. A portion of the increase in revenues to other special funds revenues is attributed to an increase in the number of students residing on campus and purchasing meal plans at UHH.

Expenditures are lower than forecasted projections due to conservative budgeting and proactive response to declining revenues by the business units, which has put the university in a position of being optimistic that the fiscal year will close in the positive.

A question was raised regarding the likelihood of the Governor releasing the additional 2.5% of the remaining contingency restriction.

VP Young explained that the likelihood of the additional 2.5% of the contingency restriction being released appears to be good if revenue growth is any indication, but the state may want to be cautious and preserve some carryover balance in general funds heading into the next fiscal year.

D. <u>Review of Federal Tax Law Implications</u>

VP Young provided an overview of federal tax law implications of the Tax Cuts and Jobs Act on higher education and UH. Impacts on UH relate to activities including certain services provided to non-university users, certain rental income, certain employee fringe benefits such as parking, charitable deductions for payments made in exchange for college athletic event-seating rights, moving expenses, and repeal of refunding bonds. Unrelated Business Taxable Income (UBTI) is income regularly generated by a tax-exempt entity by means of taxable activities not substantially related to the exempt purposes of the organization that may be subject to an Unrelated Business Income Tax (UBIT). Administration took action to mitigate some of these impacts by expediting certain transactions before the law took effect.

A question was raised regarding the impact on UH's entrepreneurial opportunities. VP Young explained this could potentially impact some of UH's entrepreneurial activities but it depends on timing of when UBIT reform impacts UH versus when the activity actually occurred. A number of projects are currently being worked on that will be directly impacted or need to be assessed regarding how impacts will affect business opportunities. UH currently treats UBIT based on the aggregated net loss/gain across all UBIT activity, and with the reform measures, UH will need to look at each activity individually instead, which means net losses cannot be aggregated to offset net gains in other activities. Similarly, UH will need to review any new rental income activity to determine if it is subject to UBIT (e.g., the Mānoa Innovation Center lease with Hawaiʻi Technology Development Corporation).

Regarding fringe benefits, parking will be the biggest challenge because parking rates are not at fair market value and could be considered a subsidized benefit under the tax reform measures. As a result, parking could be taxable for either the university or the employee. The Collective Bargaining agreements do not require the university to provide parking or establish the rates. The regents are responsible for setting parking rates and those employees with parking are charged at the applicable rate. Not all campuses charge employees or students for parking, which may clarify that there is no taxable value to parking. Administration is researching alternatives, but more clarity and guidance in these areas is needed from the Internal Revenue Service so the university can make a determination what it will be assessing and who will be responsible for the tax liability.

College athletic seating rights are another area of concern. Administration has checked with the UHM athletics department, the Na Koa Football Club, and UHF regarding potential impacts on giving or their ability to generate giving. Administration is working with the UHM athletics department on revising the sale of season tickets and the benefits of athletic event seating for donors into a format that would not subject the donor to this tax impact. Both the UHM athletics department and UHF expect these new tax reform measures to negatively impact philanthropy and donor revenues.

The university currently has a program to reimburse certain moving expenses for specific types of employees who live out of state and accept a job offer at the university. Under the new tax reform, these reimbursements could be considered as income to the employee and will now be taxable. This will impact recruitment because moving expenses to Hawaiʻi is a big consideration. Administration is looking into changing the reimbursement approach that provides some flexibility in what the university can offer employees for relocation.

The tax reform repealed the ability of bond issuers to advance refund previously existing bonds ahead of the specified call date even if there are interest rate savings. This means the university will not be able to advance refund or call in the UH Cancer Center bonds early in order to take advantage of private activity use. A few other options remain that could potentially be used for the bonds at or near the 2020 call date.

Additional questions and comments were raised regarding the steps being taken to identify applicable expenses associated with UBTI; whether all the culinary programs can be aggregated under one UBTI or categorize each campuses on its own; the need to review or revise current operating practices, policies and procedures; whether extramurally funded positions limit exposure on fringe benefits; whether this will be a separate line item in the budget; and whether additional positions or reallocation of efforts will be needed.

VP Young responded that there are some major business processes that have to be reviewed regarding how these UBTI activities are accounted for and tracked. There could be a tremendous amount of UBIT exposure, which will impact business units. Kenneth Lum, UH System Tax Manager, explained that there are culinary activities related to students (e.g., cafeteria), to the culinary program itself, and to sales to non-students or non-university individuals, and the university plans to take the position that these could be aggregated within these categories.

VP Young noted that it is too early to tell which processes may have to be implemented or whether any additional positions or allocations of resources are required to accommodate the additional work. Mr. Lum explained that it does not matter whether a position is extramurally funded because the tax implications are based on whether an item is a fringe benefit, regardless of the source of funding. VP Young indicated that administration has not yet ascertained the dollar value of the tax consequences and therefore has not contemplated whether it should be a separate line item in the budget.

E. <u>Legislative Session & Budget Recap</u>

VP Young provided an end of session status update on legislative measures and the budget and noted that July 10 is the last day for the Governor to sign, veto, or allow bills to become law without his signature. The Legislature approved an operating budget that was significantly less than the original board-approved budget and about $10 million less than the Governor’s request. The final version of the budget included items that UH had not included as part of its original budget request. Some of those items are very useful, and others will need to be assessed as to how they fit into the overall programming for UH. Similarly, legislative appropriations for capital improvement projects included projects not included in the original budget request, and administration will need to assess whether the current funding levels allows UH to make progress towards deferred maintenance (DM) or renew, improve, and modernize (RIM) projects. Overall, UH is very appreciative of the funding level received.

Funding for the Hawai‘i Promise Program was provided in a bill separate from the budget. The budget also included three provisos which do not directly impact UH. Two of the budget provisos involve appropriations from the Department of Agriculture being transferred to the UHM College of Tropical Agriculture and Human Resources (CTAHR) and the other involves a Department of Health appropriation for expanding the family residency program at the John A. Burns School of Medicine.

Questions were raised regarding the impact of tobacco settlement funding legislation, and VP Young responded that under the tobacco settlement agreement, there was already a scheduled decrease in funding, which would impact the amount of revenue provided to the UH Cancer Center. The issue this year related to particular types of tobacco manufacturers or retailers that had been in appeal and weren’t contributing revenue under the settlement agreement. Hawai‘i was one of seven states that settled the portion under appeal, but the revenue that is owed under the law will potentially be diverted because the amount calculated on any annual basis is capped and the UH Cancer Center would not be authorized to receive any additional settlement moneys this year. Future revenues for the UH Cancer Center could potentially be augmented. VP Young also mentioned that a bill to ban smoking on any campus, including e-cigarettes, also passed. UH introduced a similar bill the past several years which failed to pass the Legislature, but another entity was successful this year. There will be some impact on UH in terms of implementation.

Questions were raised as to whether UH would be reintroducing any legislation next year and whether the relationship with the Legislature had improved. Administration will be assessing whether or not to reintroduce legislation next year. Overall, UH has better rapport and more active dialogue with members of the Legislature. There is more collaboration on legislative efforts and things are less adversarial. This may not be reflected in the budget, but the relationship is in better condition that prior years.

F. <u>Committee Annual Review</u>

Due to time constraints, this item was deferred to the next committee meeting. There were no objections.

V. ADJOURNMENT

There being no further business, Committee Vice Chair Kudo moved to adjourn, and Regent Tagorda seconded, and with unanimous approval, the meeting was adjourned at 1:53 p.m.

Respectfully Submitted,

/S/

Kendra Oishi
Executive Administrator and Secretary
of the Board of Regents