CalPERS

Board of Administration Offsite

July 16, 2018

Item Name: Senate Bill 783 – Public Employee Pension Funds: Divestment Proposals Review

As Amended June 14, 2018

Sponsor: Author

Program: Legislation

Item Type: Action

Recommendation
Adopt a **Neutral** position on Senate Bill (SB) 783 (Pan) as it would assist the Legislature in responding to the increasing number of legislative proposals that require the California Public Employees Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) to engage with, or divest, from portfolio companies and business partners whose activities have become subject to legislative scrutiny.

Executive Summary
SB 783 requests the University of California establish the Pension Divestment Review Program (Program) pursuant to its provisions, to produce specified written analysis and relevant data on any divestment-related legislation that impacts CalPERS and CalSTRS, to include financial impacts to the systems, members, and employers, and ability to achieve its intended policy goals. It requires the Program to produce its analysis within 60 days of a request by the President pro Tempore of the Senate, Speaker of the Assembly, chairperson of the Senate Committee on Public Employment and Retirement (PE&R), or chairperson of the Assembly Committee on Public Employment, Retirement and Social Security (PER&SS).

The CalPERS Board of Administration (CalPERS Board) and CalPERS team members have fiduciary obligations to the participants and beneficiaries of the retirement system. These fiduciary obligations generally preclude CalPERS from sacrificing investment performance for the purpose of achieving goals that do not directly relate to CalPERS operations or benefits. Although there is the potential for the Program's output to favor the public interest over CalPERS members' interests or not fully address the systemic risks that divestment proposals pose to the retirement systems, SB 784 does not replace or modify any of the existing decision points in the legislative process or the CalPERS Board's consideration of divestment proposals pursuant to its fiduciary obligations and plenary authority.

Strategic Plan
Divesting in response to external initiatives is outside the scope of the CalPERS 2017-22 Strategic Plan.

Investment Beliefs
This agenda item impacts Investment Belief 3 that investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and

beneficiaries. It also impacts Investment Belief 9 in that risk is multi-faceted and not fully captured through measures such as volatility or tracking error.

Background

CalPERS Divestment Policy

CalPERS Total Fund Policy defines divestment as external or internal initiatives to cause the System to sell investments or refrain from making additional investments for the purpose of achieving certain goals that do not appear to primarily investment-related, such as promoting social justice. Typically, divestment initiatives focus on companies that do business in a specified country, are engaged in a specified industry or in specific practices deemed undesirable by federal and state law. CalPERS' investment in a company does not necessarily signify that it approves of the company's policies, products, or actions. CalPERS, nevertheless, wants companies in which it invests to meet high corporate governance, ethical, and social standards of conduct. CalPERS believes that this generally will promote superior long-term investment performance.

The CalPERS Environmental Social Governance (ESG) Program is an investment program that has been carefully constructed by investment professionals to mitigate potential long-term, systemic risks to the portfolio. As such, it serves a legitimate investment purpose. CalPERS sees corporate engagement as a path to impacting corporate governance and investment. The act of pure divestment takes away the seat at the table needed to effect internal change. CalPERS' position is that corporate engagement is critical to our investment strategy. CalPERS has a long and successful history of engaging portfolio companies on environment, social, and governance topics, including climate change, natural resource availability, and respect for human rights.

Constitutional Authority and Fiduciary Responsibility

Article XVI, Section 17 of the California Constitution gives the boards of public retirement systems in California plenary authority and fiduciary responsibility for investment of pension assets and administration of the system. The Constitution expressly provides that the retirement board of a public pension system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. It further requires the members of the public pension or retirement system board to discharge their duties solely in the interest of, and for the exclusive purpose of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. The Constitution also requires the boards of public pension funds to diversify the investments of the systems so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so. In accordance with California Constitution Article XVI, Section 17, the retirement board's constitutional duties take precedence over any other considerations. The Constitution, however, also provides that the Legislature may by statute continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board.

Analysis

1. Specifically, the bill:
    - Defines a "divestment proposal" as a bill or constitutional amendment, introduced or amended in the Legislature, that would require a public employee pension fund to divest assets or restrict the fund from investing based on specific criteria or by reference to an external benchmark.

- Requires the Program to assess and prepare a written analysis with relevant data on the following pension fund effects:
  - The effect on the expected return on investment to the fund’s portfolio, including the probability of ongoing gains or losses resulting from the divestment mandate or investment prohibition.
  - The impact on the funded status of the pension fund.
  - The consequence to employer and employee contribution rates.
  - The administrative costs on the pension system to analyze, report, and implement the divestment proposal.
  - Whether the divestment proposal would have *de minimis* impact on the fund’s portfolio.
  - Whether the divestment proposal would, taken cumulatively with other divestment proposals, have significant impact on the fund’s portfolio.
- Requires the Program to assess and prepare a written analysis with relevant data on the following policy effects:
  - The probability that the divestment proposal will achieve its goal as described in the proposal and as advocated by its proponents in letters of support or testimony before legislative committees.
  - The priority established by the Legislature or the Governor for implementing the divestment proposal.
  - Whether other forms of policy measures have been attempted to achieve the policy goals as defined in the proposal and as advocated by its proponents in letters of support or testimony before legislative committees and the results of these other measures.
  - The ability of other investors to undermine the divestment proposal by supplanting the public employee pension fund’s divestment or curtailment of investment.
  - The probability that, if successfully implemented, the divestment proposal would garner substantial support from a significant number of other large institutional investors, as measured by their decisions to also divest.
  - The size and substance of the support of, or opposition to, the divestment proposal by members and beneficiaries of the public employee retirement fund.
- Requires the Program to assess and prepare a written analysis of the financial impact of a divestment proposal, by:
  - Utilizing the services of a certified actuary or other person with relevant knowledge and expertise to determine the financial impact, as recommended by the California Actuarial Advisory Panel.
  - Collaborating with experts in the public pension fund investment profession.
  - Utilizing the University’s resources that specialize in providing objective financial and policy analysis of policy and economic issues.
- Authorizes the Chairperson of the Assembly PER&SS Committee, the chairperson of the Senate PE&R Committee, the Speaker of the Assembly, and the President pro Tempore of the Senate to make requests for the Program to assess a divestment proposal.
- Requires the Program provide its analysis to the appropriate policy and fiscal committees of the Legislature that not later than 60 days after receiving a request, and to make its analysis publicly available.
- Establishes the Pension Divestment Review Program Fund in the State Treasury, and appropriates from the General Fund two million dollars ($2,000,000) to that Fund for the 2018–19 fiscal year for implementation purposes.
- Specifies that nothing in its provisions, nor in any assessment or analysis by the Program, shall require a pension fund to take any action unless the respective pension fund’s board finds that the action is consistent with its fiduciary responsibilities.

Senator Pan, the author of the bill and current Chair of the Senate PE&R Committee, intends to provide a process to review legislative proposals for CalPERS or CalSTRS to divest pension assets or otherwise restrict or prohibit public pension investments. The proposed process would be similar to the existing process used by the California Health Benefit Review Program (CHBRP) to evaluate legislative proposals to mandate health insurance benefit coverage. CHBRP responds to requests from the Legislature to provide independent analysis of the medical, financial, and public health impacts of proposed health insurance mandates and repeals. Pension fund divestment and the creation of an independent divestment review panel similar to the CHBRP were the subject of a joint informational hearing by the Senate PE&R and Assembly PER&SS Committees earlier this year titled: *"How California's Public Pension Funds Support California Values While Fulfilling Their Fiduciary Obligations."*

2. Arguments in Support

   The author states that:

   "There are an ever-increasing number of legislative proposals that seek to require or pressure state public employee pension funds to divest from or restrict specified investments. While motivated by important public policy purposes and with sincere and passionate support, divestment proposals are often in conflict with the fundamental public policy purpose of a public employee pension fund, which is to maximize returns to fund investments in order to ensure that monies are available to pay the deferred compensation earned by public employees over the course of their service to California and thereby, reduce the overall cost to the taxpayer of providing the employees' vested rights to a secure pension. As more divestment proposals are put forward, it becomes increasingly difficult to make substantive distinctions between meritorious proposals that have a minor impact on the funds and other proposals that have substantial impacts. This bill would help establish a process that would ensure that all divestment proposals were objectively analyzed so that the Legislature and the Governor receive accurate information upon which to base their decisions about the proposals."

3. Arguments in Opposition

   The Assembly PER&SS Committee analysis of the bill indicates:

   "While the State Controller expresses opposition regarding a prior version of this bill relating to the placement of what was formally a commission to be established in the Office of the State Controller, the measure was amended and removed that provision. Nevertheless, the State Controller states in opposition that, '…spending additional resources to create a [body] that will simply replicate the work of the state's pension board staff is not a productive endeavor. Rather, improved communications with the pension boards should provide the same information [to be sought by this bill], and in a quicker and more cost-effective fashion.'"

4. CalPERS Concerns

   Divestment, as an active investment decision, represents a form of active risk-taking that must be considered, first and foremost, within the context of the CalPERS Board's fiduciary duty. As a mature retirement system, CalPERS is obligated to seek out and implement the portfolio construction methods that best serve our mission – the sustainable delivery of promised benefits. In efficient markets, however, limiting the opportunity set for investments has generally been shown to have a detrimental effect on performance.

   CalPERS, CalSTRS, and the University of California's own investment portfolios have unique asset allocation strategies and portfolio construction methods, which results in widely varying financial-impact estimates. The CalPERS Board has adopted a broad set of investment and actuarial risk measures, and a clearly defined process for managing risk. The path of returns matters, because highly volatile returns can have unexpected impacts on contribution rates and funding status. However, the financial criteria established by SB 783 does not address the impact of divestment proposals on the risk and volatility of the investment portfolio, which, in turn, will impact funded status, returns, and retirement contribution rates for CalPERS and CalSTRS.

Under the bill, the Program would engage a qualified actuary to project the range of future impact of the specific investment and its removal from the portfolio on the systems' funded status and required contributions, which involves an examination of the expected return of asset classes, the expected standard deviation (volatility) of assets classes, and asset category correlation factors before and after the specific investment/divestment. This can be accomplished through a stochastic analysis, which requires extensive expertise, time and resources to perform, with the reliability of its results dependent on the assumptions used in the model. A simpler method based on a variety of single scenario projections (deterministic projections) could be used rather than the stochastic method, however its results may not be robust enough to draw appropriate conclusions. When a divestment proposal is referred to the Program for analysis and later becomes law, CalPERS would likely attempt to verify those findings as part of its due diligence.

The fundamental challenge posed by divestment proposals is reconciling the proposed divestment with public retirement boards' duty of loyalty to retirement system members and beneficiaries. For example, the CalPERS Board is not in a position to abdicate its duty to manage the Fund's assets in order to comply with an external mandate, with the sole exception of a mandate by the federal government (e.g. prohibited financial transactions with individuals and entities on the Office of Foreign Assets Control list, or the subject of federal divestment mandates and transaction prohibitions). This inherent conflict is implicitly recognized in the existing legislative divestment mandates in the form of an indemnification of present, future, and former board members of CalPERS and CalSTRS, jointly and individually, along with state officers, employees, and investment managers for liability arising out of any decision to restrict, reduce, or eliminate investments in targeted companies. The policy analysis required by SB 783 should also include an analysis of potential conflicts with federal authority to conduct foreign policy, and the associated legal risks for implementing a divestment proposal.

When legislative divestment proposals are enacted and the CalPERS Board approves their implementation, the absence of fund indemnification poses legal and financial risks to the System, which can, in turn, negatively impact CalPERS members and employers. The policy analysis required by SB 783 should also include an analysis of the benefits of indemnifying the retirement funds for potential financial losses associated with this exercise of legislative authority to divest in the public's interest.

Budget and Fiscal Impacts

Benefit Program Costs:

Divestment proposals can be expected to have a detrimental effect on investment performance. In consideration of CalPERS' asset and liability management, every dollar in investment returns that is foregone, or expended in unnecessary transaction costs and fees, must be made up for in employer and employee contributions. Therefore, divestment proposals can be expected to contribute to an increased burden on employers and employees through increased contribution rates, and potentially impair CalPERS' ability to deliver promised benefit payments.

<u>Administrative Costs</u>
While the Program is primarily responsible for evaluating the financial impacts of a divestment proposal, team members identify the potential for increased work in the Investment Office and Actuarial Office to identify and provide data inputs for the criteria required by SB 783.

Benefits and Risks

1. <u>Benefits:</u>
   - Affords the Legislature increased time and data required to properly evaluate divestment proposals.
   - Establishes a dispassionate, analytical method using clear criteria for evaluating each legislative proposal to divest or restrict pension fund investments.

2. <u>Risks:</u>
   - Duplicates current processes already in place at CalPERS at additional cost to the State.
   - Potentially marginalizes CalPERS and CalSTRS participation and effectiveness in the legislative process in terms of identifying the financial impact, risks and other implications of divestment proposals.
   - The criteria specified frames the question of financial-impact in terms of only the impact on returns (an essential unknown), ignoring risk (for which investors are more capable of creating some degree of assessment).
   - The criteria specified may reinforce erroneous beliefs about divestment, such as that:
     - The financial impact of any given divestment proposal can be reliably forecasted.
     - The propriety of a given divestment proposal hinges on the cost impact to the Fund, rather than its relationship to a legitimate portfolio-management purpose.
     - The central question in terms of fiduciary duty is whether the financial impact on the Fund can be called "*de minimis*."
     - Fiduciary duty is just any other public policy concern to be weighed in the balance against the Legislature's other priorities.
     - Fiduciary duty can vary as a function of a retirement system's funded status.

Attachments
Attachment 1 – Support & Opposition
Attachment 2 – CalPERS Total Fund Investment Policy, Divestment section

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