Board of Administration

Agenda Item 9e

February 19, 2020

Item Name: State Legislative Proposal: Public Disclosure of Private-Debt Records

Program: Legislation

Item Type: Action

Recommendation

Sponsor legislation to establish disclosure parameters within the California Public Records Act (PRA) regarding information related to private-debt investments by public pension systems.

Executive Summary

This proposal seeks to mitigate any competitive disadvantage to the State's public pension funds under existing state law in accessing private-debt investment opportunities, while ensuring full and complete public access to the data needed to evaluate investment performance. The proposal would parallel existing disclosure requirements for public-pension investments in alternative investment vehicles.

Strategic Plan

This proposal supports the CalPERS Strategic Plan goal to strengthen long-term sustainability of the pension fund while cultivating a high-performing, risk-intelligent, and innovative organization.

Investment Beliefs

This proposal supports the CalPERS Investment Belief 7, that CalPERS will take risk only where we have a strong belief we will be rewarded for it, and Investment Belief 8, that costs matter and need to be effectively managed.

Background

Private Debt as an Investment Strategy

The Opportunistic Strategies (OS) Division was established in 2016 by the Investment Office's (INVO's) executive management team to invest in a wide variety of public and private investments. Its broad mandate is to identify opportunities perceived to be substantially undervalued. The program is also permitted to establish innovative portfolios that do not necessarily "fit" within one of INVO's existing asset classes.

A private-debt investment strategy involves directly lending to a public or private issuer seeking funds for operations, growth, or other purposes. Private-debt strategies include, but are not limited to, direct lending to a borrower, fund investments made through an external manager, and asset-based lending. Unlike the fixed income investments that are the typical focus of Global Fixed Income, private debt is typically not traded on an exchange. The opportunity to earn a higher yield and return in many cases, combined with the ability to achieve additional diversification, is the driver for the addition of this strategy to the CalPERS investment portfolio.

According to a February 2019 report by the Principles for Responsible Investment Association, there is estimated to be over $600 billion allocated to private-debt investments by institutional investors, with the most active investors being pension funds, endowments, and insurance companies. For example, the Arizona State Retirement System recently announced it will be increasing its private-debt allocation from approximately 13.6% to 17% of their total fund (approximately $41 billion).

Prior Sponsored Legislation Relating to the PRA

CalPERS and the University of California sponsored earlier legislation, Senate Bill (SB) 439 (Chapter 258, Statutes of 2006), to clarify the disclosure requirements regarding information related to alternative investments. Disclosure of certain investment data, particularly company-level information, is generally regarded by the financial industry as proprietary or trade secret. At the time SB 439 was introduced, many alternative investment firms were hesitant to accept capital from California-based public pension systems without adequate protections from public disclosure of sensitive and proprietary information about underlying investments, putting California pension funds at a competitive disadvantage.

CalPERS acknowledged then, as it does now, the legitimate interest of the public in knowing how public monies are invested as well as the obligation to be responsive to information requests. SB 439 ensured that the public would be provided the data it needed to evaluate the performance of fund managers while protecting confidential financial information of individual, privately owned portfolio companies.

Analysis

Proposed Disclosure of Private Debt

This proposal would exempt the following information from disclosure under the PRA:

- proprietary due diligence information,
- information proprietary to the borrower(s), and

- details about potential collateral.

The exemption as proposed would not include records or information that have already been publicly released by the keeper of the records.

Consistent with similar sections in the PRA, the proposal would explicitly make specified information disclosable upon a public records request, including:

- the name and address of the borrower,
- the dollar amount of the loan,
- the investment return on the loan, and
- any undrawn loan commitments.

The proposal specifies that externally managed private loan investments would remain subject to disclosure requirements and restrictions under Government Code sections 6254.26 and 7514.7. The proposal defines private loan as a loan made pursuant to or evidenced by a loan agreement, debt instrument, or other evidence of indebtedness where such lending arrangement is exempt from registration as a security under federal securities laws.

Private Debt Opportunities and Challenges

After the financial crisis, global regulators placed enhanced regulatory capital requirements on banks, resulting in a reduction in the amount of leverage and lending many banks could have achieved in the past. Consequently, the private debt market is rapidly expanding and becoming more competitive, with active participation by public pension funds, external managers and institutional investors.

It is worth noting that the due diligence required for proper underwriting of private-debt investments involves comprehensive review of highly sensitive proprietary and trade-secret information concerning the borrower’s financial condition, credit history, and collateral. This is akin to an individual’s loan application in which tax returns, pay stubs, and credit reports are shared with a bank. CalPERS would receive and review various forms of documentation and records from borrowers that, in most cases, are not appropriate for public disclosure. The threat of such public disclosure would impair CalPERS’ ability to participate fully in future private-debt investment opportunities.

Budget and Fiscal Impacts

Administrative Costs/Savings:

Unknown potential savings associated with the use of internal versus external investment managers to execute this investment strategy.

Benefits and Risks

Benefits:

- Improves the ability of public pension systems to access private-debt investment opportunities.
- Balances the competing interests in preserving industry trade secrets and respecting the public’s right to access to investment information and evaluate the performance of public pension system investments.

- Potential decline in litigation arising from public records requests due to greater certainty as to the legal standard for disclosure.

Risks:

- Potential media and stakeholder objections to not disclosing some financial information of possible future borrowers from public pension systems.

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