Legislative Commission on Pensions and Retirement

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TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Chad Burkitt, Analyst

DATE: March 18, 2019

RE: H.F. 2294 (Long); S.F. 2277 (Pappas): State Board of Investment; Fossil Fuel Divestment Act.

Summary of H.F. 2294 (Long); S.F. 2277 (Pappas)

H.F. 2294 (Long); S.F. 2277 (Pappas) establishes a new section of statute in Minnesota Statutes, Chapter 11A, called the "Fossil Fuel Divestment Act." The act requires the State Board of Investment (SBI) to divest from all direct investments in fossil fuel companies by July 1, 2024, and immediately prohibits the SBI from investing in new fossil fuel company securities. Companies are permitted to request a review of the determination that they are a fossil fuel company. The SBI is required to report to the legislature regarding which companies it has divested from and which companies it has identified for divestiture.

Background Information

The SBI is currently subject to three divestment requirements. First, under Minn. Stat. § 11A.243, the SBI is required to divest from securities of companies that do business with the government of Sudan, are complicit in the Darfur genocide, or that supply military equipment within Sudan. Second, under Minn. Stat. § 11A.244, the SBI is required to divest from companies that are subject to the federal Iran Sanctions Act of 1996. Finally, in 1997 the SBI approved a resolution requiring the executive director to divest from actively managed shares of tobacco companies.

Calls for institutional investors to divest from fossil fuel companies began around 2011. A U.S. based non-profit that advocates internationally for divestment, called 350.org, claims that institutional investors worth more than $8 trillion have now made commitments to divest from fossil fuel companies. In 2018, Ireland enacted legislation requiring divestment from fossil fuel companies. More recently, Norway's $1 trillion national wealth fund decided to divest from certain fossil fuel companies.

The only U.S. state to enact legislation limiting fossil fuel company investment is California. In 2015, California enacted legislation requiring its Public Employees' Retirement System and Teacher's Retirement System to divest from thermal coal companies. According to the National Conference of State Legislatures, five other states have since considered legislation restricting investment in or requiring divestment of fossil fuel companies. The legislation failed in those five states except that Vermont passed a joint, nonbinding resolution urging its three pension systems to divest from fossil fuel assets.

Outside of state legislatures, several U.S. cities have taken action to divest from fossil fuel securities in their pension funds. The largest of these is New York City, which took action last year requiring divestment from direct investments in fossil fuel companies in its $193 billion combined pension fund (as of Nov. 2018).

Under statute, the SBI, its staff, and executive director are charged with the responsibility of prudently investing pension assets to maximize the total rate of return without incurring undue risk (see Minn. Stat. §§ 11A.01 and 11A.09). They are assisted by the Investment Advisory Council. Investment decisions are made pursuant to statute and the investment policies set by the SBI.

The SBI invests pension assets on behalf of the three statewide pension systems in the combined funds. As of July 1, 2018, the combined funds held assets valued at $68 billion. The SBI does not publish any estimate of their total exposure to fossil fuel companies. However, analysis produced by Divest-Invest Minnesota, a local divestment advocacy group, shows that the SBI holds at least $2.3 billion worth of securities of the 200 companies with the largest fossil fuel reserves.

Discussion and Analysis

1. Lack of information. The LCPR and the legislature lacks specific information regarding the expected financial effect of divesting from fossil fuel companies, which may include the cost of liquidating otherwise illiquid assets and possibly lower rates of return.

2. Effect on pension plan funding. As noted in the memorandum on H.F. 2329; S.F. 2276, the statewide pension plans are sensitive to relatively small changes in long-term investment returns. The half-percent reduction (1% for the Teachers Retirement Association) in the assumed rate of return in the 2018 Omnibus Retirement Bill caused a $5 billion increase in actuarial accrued liabilities.

3. Definition of "fossil fuel company." The bill defines fossil fuel company as:

   > *Any company or corporation or any subsidiary, affiliate, or parent of any corporation or company, among the two hundred largest publicly traded fossil fuel companies as established by carbon content in the companies' proven oil, gas and coal reserves.*

   By including "subsidiaries, affiliates and parents" of the 200 companies with the greatest fossil fuel reserves, the SBI's divestment may have unintended consequences; such as divesting from companies engaged in renewable energy production or other non-targeted activities.

4. Types of securities divested. According to the SBI's 2018 annual report, approximately 75% of the domestic stock program is passively managed. Passive managers select securities by attempting to replicate a stock index. For example, one of the SBI's passive managers seeks to match the asset allocation of the Russell 3000 index. The advantage of this approach is that the SBI earns returns very similar to the market but pays very low investment fees. The bill requires the SBI to divest from both passively and actively managed securities. This will likely cause an increase in investment fees for passively managed investments that would no longer be able to match their benchmark index. Alternatively, the commission could choose to require the SBI to divest from only actively managed securities. This would be less likely to lead to significant fee increases.

5. Divestment period. The bill requires the SBI to complete divestment by July 1, 2024. The issue is whether an alternative time period is appropriate.

6. Mitigation of investment risk. The issue is whether divestment from fossil fuel companies reduces the risk of lower than expected returns.

7. Effect on climate change. The issue is whether divestment from fossil fuels results in different behavior by fossil fuel companies or in expediting the transition from fossil fuels to other energy sources.