

## Virginia Retirement System

### 2022 Fiscal Impact Statement

**1. Bill Number:** SB213

**House of Origin**   ☒ Introduced   ☐ Substitute   ☐ Engrossed  
**Second House**   ☐ In Committee   ☐ Substitute   ☐ Enrolled

**2. Patron:** McPike

**3. Committee:** Finance and Appropriations

**4. Title:** Virginia Retirement System and local retirement systems; fossil fuel divestment; report.

**5. Summary:** Requires the Virginia Retirement System and local retirement systems to divest from fossil fuel companies by January 1, 2027. Also requires VRS to report on the progress of divestment annually through January 1, 2027, and independent local retirement systems to report on their progress annually through July 1, 2026.

**6. Summary of Impacts**

The VRS Board of Trustees unanimously opposes this legislation.

**Benefit(s) impacted:** The VRS Trust Fund, which impacts all VRS, Judicial Retirement System (JRS), State Police Officers' Retirement System (SPORS), and Virginia Law Officers' Retirement System (VaLORS) retirement benefits, retirement benefits for VRS-participating local employers, as well as other post-employment benefits, the Line of Duty Act (LODA) Fund, the Volunteer Firefighters' and Rescue Squad Workers' Service Award Fund (VOLSAP), any other funds invested by VRS on behalf of other entities as directed in Title 51.1 of the *Code of Virginia*, as well as funds invested by independent local retirement systems. VRS does not interpret the bill as drafted to apply to defined contribution (DC) plan investment options selected by participants.

**Impact to unfunded liability (see Item 9 for details):** Indeterminate. The impact of the estimates described here may generate additional unfunded liability. VRS estimates that, while fossil fuel likely makes up a much smaller percentage of total VRS holdings, the bill will require divestment of approximately \$22 billion, or 21% of the Total Fund. This estimated divestment amount includes entire partnership investments with any fossil fuel exposure (i.e., generalist investments with any exposure as well as energy-specific investments) and public holdings reasonably classified as "fossil fuel." VRS also estimates that divestment will incur one-time market losses between \$1.3 billion and \$2.5 billion. Further, VRS estimates that divestment will result in approximately \$15 billion to \$50 billion in foregone income over 30 years for the VRS portfolio. In addition, VRS estimates that divestment will have a one-time initial cost of more than \$2 million, and annual ongoing costs of \$21 million to \$41 million per year.

*Note: The divestment estimate of the Total Fund and the one-time market value losses estimate were based on June 30, 2021, market value information. Future market action will impact these estimates.*

**Impact to contribution rate(s) (see Item 9 for details):** Indeterminate. The impact of the estimates described here may increase contribution rates. VRS estimates that, while fossil fuel likely makes up a much smaller percentage of total VRS holdings the bill will require divestment of approximately \$22 billion, or 21% of the Total Fund. This estimated divestment amount includes entire partnership investments with any fossil fuel exposure (i.e., generalist investments with any exposure as well as energy-specific investments) and public holdings reasonably classified as “fossil fuel.” VRS also estimates that divestment will incur one-time market losses between \$1.3 billion and \$2.5 billion. Further, VRS estimates that divestment will result in approximately \$15 billion to \$50 billion in foregone income over 30 years for the VRS portfolio. In addition, VRS estimates that divestment will have a one-time initial cost of more than \$2 million, and annual ongoing costs of \$21 million to \$41 million per year.

*Note: The divestment estimate of the Total Fund and the one-time market value losses estimate were based on June 30, 2021, market value information. Future market action will impact these estimates.*

**Specific Agency or Political Subdivisions Affected (see Item 10):** VRS, all VRS members, all VRS-participating employers, and all political subdivision employers that administer retirement systems.

**VRS cost to implement (see Item 7 and Item 8 for details):** Approximately \$23-43 million for FY 2023 and \$21-41 million each subsequent year.

**Employer cost to implement (see Item 7 and Item 8 for details):** Each independent local retirement system will have costs to divest in accordance with the bill dependent on their plan holdings and will have costs to report annual progress to VRS.

**Other VRS, employer, and participant impacts:** See Items 7, 9, 11, and 12 for details.

- Prohibits VRS and local retirement systems from investing in any “fossil fuel company” as defined in the bill;
- Requires VRS and local retirement systems to review current holdings in fossil fuel companies;
- Requires VRS and local retirement systems to divest any holdings in fossil fuel companies by January 1, 2027;
- Provides an exemption from the divestment mandate and investment prohibition for any de minimis exposure to fossil fuel company investments;
- Requires VRS to report annually to the General Assembly on the progress of divestment and implementation of the bill, beginning January 1, 2023, through January 1, 2027;
- Requires local retirement systems to report annually to VRS on their divestment progress through July 1, 2026;

- Requires VRS and local retirement systems to include divestment progress in annual financial reports; and
- Designates that compliance with the bill's provisions satisfies the standards of care required by § 51.1-124.30(C) for VRS and § 51.1-803(A) for local retirement plans.

**GF budget impacts (see Items 7 and 8 for details):** Indeterminate. Increased unfunded liability and contribution rates will affect GF budgets of those GF-funded VRS-participating employers that must pay any increased contribution rates due to the costs of divestment.

**NGF budget impacts (see Items 7 and 8 for details):** Indeterminate. Increased unfunded liability and contribution rates will affect NGF budgets of those NGF-funded VRS-participating employers and other local employers that must pay increased contribution rates due to the costs of divestment.

VRS implementation is estimated at \$23,000,000 to \$43,000,000 NGF in FY 2023 \$21,000,000 to \$41,000,000 each subsequent year. Implementation includes costs for an additional full-time VRS employee necessary to manage divestment actions and ensure that future investment holdings do not include prohibited investments.

**7. Budget Amendment Necessary:** Yes.

In Item 499, VRS would need a NGF appropriation of approximately \$23,000,000 to \$43,000,000 for FY 2023 and \$21,000,000 to \$41,000,000 in each subsequent year for implementation of divestment, collection of the local annual reports, and production of the VRS annual divestment report, including an additional full-time employee necessary to manage divestment actions and ensure that future investment holdings do not include prohibited investments. Additionally, in order to implement the divestment provisions of this bill, VRS would enter into an agreement with a third-party vendor to screen for the affected securities held in the VRS portfolio. See Items 8, 9, and 12 for further detail.

Not included are possible budget amendments for GF and NGF employers that must pay any increased contribution rates due to the costs of divestment. VRS receives an actuarial valuation annually. The impact of the costs of divestment may require the VRS Board of Trustees to adjust Board-certified contribution rates prior to the next expected change for the FY 2025 -2026 biennium.

**8. Fiscal Impact Estimates:** It is difficult to quantify the future impact on the Trust Fund and VRS members, beneficiaries, retirees and employers of limitations on investment opportunities set forth in this legislation. More detail on the fiscal impact is explained in Items 9 and 12 below.

**Fiscal Impact Estimates/Expenditure Impact:** Fiscal impacts below are estimates only and do not include investment losses dependent on market conditions and divestment schedule to be developed to meet the timeline of the bill. Actual costs may change and be higher or lower than estimated. See Item 9 for more details.

The impacts below do not include the expected effects on contribution rates, which are determined actuarially.

Additionally, fiscal impact estimates in the chart below do not include local positions or the cost that local employers may incur to divest, or to produce the report required in § 51.1-803(D)(5) of the proposed bill. The bill does not state when local retirement systems shall begin reporting.

<i><b>Fiscal Year</b></i>	<i><b>Dollars</b></i>	<i><b>Positions</b></i>	<i><b>General Fund</b></i>	<i><b>Non-General Fund &amp; Local Funds</b></i>
2022	---	---	---	---
2023	\$174,500 + \$23 million to \$43 million	1	Indeterminate	\$174,500 + \$23 million to \$43 million
2024	\$170,300 + \$21 million to \$41 million	1	Indeterminate	\$170,300 + \$21 million to \$41 million
2025	\$170,300 + \$21 million to \$41 million	1	Indeterminate	\$170,300 + \$21 million to \$41 million
2026	\$170,300 + \$21 million to \$41 million	1	Indeterminate	\$170,300 + \$21 million to \$41 million
2027	\$170,300 + \$21 million to \$41 million	1	Indeterminate	\$170,300 + \$21 million to \$41 million
2028	\$169,000+ \$21 million to \$41 million	1	Indeterminate	\$169,000+ \$21 million to \$41 million

*Note: The above estimates do not include the estimated one-time market value loss between \$1.3 billion and \$2.5 billion, nor the estimated foregone income of approximately \$15 billion to \$50 billion over 30 years for the VRS portfolio.*

**9. Fiscal Implications:** See also Item 12, Other Comments, below.

Divestment will have a negative impact on the fund related to short-term implementation costs and future investment earnings

The VRS Board of Trustees unanimously opposes this legislation. VRS believes that mandatory divestment, particularly on a strict timeline, may have a sustained negative impact on the trust fund's earnings, which historically have funded more than 2/3 of the benefits paid out to Virginia's public workers. Requiring VRS to divest from certain types of investments can lead to investment losses and lost investment opportunities.

As a fiduciary and as explained in more detail below, VRS is required by state and federal law, and by Article X, § 11 of the *Constitution of Virginia*, to act only in the interest of the system's more than 750,000 members, retirees, and beneficiaries. Divesting of specific investments sooner than VRS otherwise may sell them will likely lead to investment losses to the fund's detriment due to timing concerns. See below for additional discussion of timing concerns. If the fund's investments do not meet the long-term investment return assumption

of 6.75%, then employer contributions, supported by taxpayer money, will need to be higher to make up for the lost opportunity for investment earnings.

VRS recognizes the importance of renewable and green energy but is concerned that the bill as drafted may discourage the transition to clean energy as some energy sector participants may still currently fall within the definition of “Fossil fuel company.” VRS believes it should have flexibility in investing instead of being forced to divest at this strategic and pivotal time as companies are transitioning to clean energy.

Direct engagement with companies and proactive proxy voting are more compatible with the fund's investment goals and fiduciary responsibilities. As described in more detail below, VRS believes that a policy of engagement with companies, such as fossil fuel companies as defined in the bill that are also exploring clean energy alternatives, would be far more effective in encouraging research and development of green and renewable energy and less detrimental to the trust fund. VRS has reviewed the approaches of several other state pension plans and believes that engagement rather than divestment is a more flexible and positive approach to encouraging green and renewable energy.

#### Divestment Time Horizon vs. Long-Term Shareholder Time Horizon

The fixed divestment time horizon of this bill presents long-term investors like VRS with an unnecessary limitation as we navigate the transition that is underway in the energy sector. Companies that would be subject to divestment have the potential to be future leaders as the long-term energy transition progresses. As long-term investors, VRS has the ability to engage with companies over time to support well-written shareholder and management proposals as opposed to a near-term divestment mandate. A recent example of this ability to influence change is last year's Exxon proxy in which VRS supported two directors proposed by shareholder “Engine No. 1” which are expected to advocate for a future Exxon that is less reliant on fossil fuels. VRS is always supportive of proposals that increase the probability of increasing shareholder value over the long-term.

Listed below are a number of considerations related to the proposed legislation:

#### Summary of costs

- Divestment has investment return implications and implementation costs. VRS views divestment as a last resort to effect corporate change. Direct engagement with companies and proactive proxy voting are more compatible with the fund's investment goals and fiduciary responsibilities.
- Academics have estimated losses in investment income from divestment to range from 0.15% to 0.50%<sup>1</sup> annually, translating to approximately \$15 billion to \$50 billion in foregone income over 30 years for the VRS portfolio.
- VRS estimates that divestment will incur a one-time decrease in market value between \$1.3 billion and \$2.5 billion.
- VRS estimates that divestment will have a one-time fee of more than \$2 million, and then annual ongoing explicit expenses of \$21 million to \$41 million per year charged to VRS.

These include additional fees, subscriptions to custom indices, a third-party contractor and subscriptions to data vendors, among other possible expenses.

See Details below for specific information on these costs.

### Details

- Divesting from private asset funds would likely result in having to sell assets in the "secondary market" at 10-20% below their current market value, equating to a one-time transaction cost of \$1.2 billion to \$2.4 billion.
- All hedge funds without a fossil-free option would have to be divested, with a one-time transaction cost of approximately \$100 million in loss to the portfolio.
- Internal and external systems would need to be re-programmed to monitor the restrictions and changes with an estimated one-time cost of more than \$2 million.
- Separate accounts and commingled funds would have to be transitioned to customized strategies, costing an additional 0.05% to 0.10% annually, equating to approximately \$20 million to \$40 million ongoing costs per year.
- Custom indexes and program benchmarks would need to be created and maintained with an estimated ongoing explicit cost of approximately \$750,000 per year.
- A third-party contractor would be required to identify which companies are impacted by the bill at an estimated ongoing explicit cost of \$250,000 annually.
- Subscriptions to data vendors would be required for portfolio construction at an estimated ongoing explicit cost of approximately \$200,000 per year (possibly more depending on the number of data vendors).

### Determining which companies fit within the definition of "Fossil fuel company" will be extremely difficult

While the legislation provides several definitions, the definition of "Fossil fuel company" is particularly difficult to apply to the broad range of investments in which VRS participates.

Fossil fuel company is defined in the legislation (beginning on line 52) as:

"Fossil fuel company" means any company that:

1. Is among the 200 publicly traded companies with the largest fossil fuel reserves in the world;
2. Is among the 30 largest public company owners in the world of coal-fired power plants;
3. Has as its core business the construction or operation of fossil fuel infrastructure;
4. Has as its core business the exploration, extraction, refining, processing, or distribution of fossil fuels; or
5. Receives more than 50 percent of its gross revenue from companies that meet the definition under subdivisions 1 through 4.

For example, there is not a readily available list of each company's fossil fuel reserves. With companies' holdings constantly changing, the companies in the top 200 publicly traded companies or top 30 largest public company owners may change often. There is also not a clear source to determine which companies own coal-fired plants. A company's "core business" is not always readily apparent when it has numerous affiliates and subsidiaries that operate varied business lines. Therefore, just attempting to identify allowable investments under the legislation will be challenging, costly, and time consuming.

Following are a few additional questions raised by the legislation:

- Does this apply to public and private companies?
- Are investments within commingled funds considered exposure or just direct holdings?
- Is ancillary exposure through broad market derivative contracts prohibited?
- What is the de minimis holding threshold?

Divestment should only be used as a last resort

As a large institutional shareholder, and with the Board of Trustees' unanimous support, VRS agrees with many other pension plans that divestment is a last resort action that can have a long-term negative impact on the health of the fund. VRS also agrees that divestment would severely limit its ability to shape corporate behavior for long-term sustainable growth.<sup>2</sup>

Some companies included in the definition of "Fossil fuel company" may be transitioning their business to include or focus on renewables, which would also be hurt by divestment because, while transitioning to renewables, these companies still retain some fossil fuels activity. Divestment increases the cost of capital and removes the ability to use corporate governance as a tool to redirect companies.

**10. Specific Agency or Political Subdivisions Affected:** VRS, all VRS members, all VRS-participating employers, and all local retirement systems.

**11. Technical Amendment Necessary:** No.

**12. Other Comments:** This bill:

- Prohibits VRS and local retirement systems from investing in any "Fossil fuel company" as defined in the bill;
- Requires VRS and local retirement systems to review current holdings in fossil fuel companies;
- Requires VRS and local retirement systems to divest any holdings in fossil fuel companies by January 1, 2027;
- Provides an exemption from the divestment mandate and investment prohibition for any de minimis exposure to fossil fuel company investments;
- Requires VRS to report annually to the General Assembly on the progress of divestment and implementation of the bill, beginning January 1, 2023, through January 1, 2027;

- Requires local retirement systems to report annually to VRS on their divestment progress through July 1, 2026;
- Requires VRS and local retirement systems to include divestment progress in annual financial reports; and
- Designates that compliance with the bill's provisions satisfies the standard of care required by § 51.1-124.30(C) for VRS and § 51.1-803(A) for local retirement plans.
- VRS does not interpret the bill as drafted to apply to DC plan investment options selected by participants.

The VRS Board of Trustees unanimously opposes this bill and has serious concerns regarding divestment legislation in general.

#### Fiduciary/Constitutional Concern

To satisfy federal law and the *Constitution of Virginia*, it is important for VRS to maintain the broadest opportunity set possible in its investment portfolio. VRS is charged with administering and investing the VRS trust fund in the sole interests of VRS members, retirees and beneficiaries as provided in the Internal Revenue Code (IRC), the *Constitution of Virginia*, and the *Code of Virginia*:

A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section ... if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be ... used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries.... 26 U.S.C § 401(a)(2).

The funds of the retirement system shall be deemed separate and independent trust funds, shall be segregated from all other funds of the Commonwealth, and shall be invested and administered solely in the interests of the members and beneficiaries thereof. Neither the General Assembly nor any public officer, employee, or agency shall use or authorize the use of such trust funds for any purpose other than as provided in law for benefits, refunds, and administrative expenses, including but not limited to legislative oversight of the retirement system. Va. Const. Art. X, § 11.

The Board shall discharge its duties with respect to the Retirement System solely in the interest of the beneficiaries thereof.... Va. Code § 51.1-124.30(C).

Divesting from or not investing in fossil fuel companies may contradict the fiduciary requirements set out in the *Constitution of Virginia*, the IRC, and the *Code of Virginia*, meaning it may require VRS to potentially sell profitable investments that provide a significant return to the fund that supports members, retirees, and beneficiaries. The IRC



specifically states that all activities and investments of the plan must be for the exclusive benefit of the plan beneficiaries.

VRS has a broad spectrum of investments in its portfolio. When looking at the representation of fossil fuel companies on a global market scale, they represent a small percentage of total investment opportunities. The VRS portfolio is similarly limited in this area and also includes renewable energy investments in our various programs, including public and private market investments. As the viability of renewable energy technology develops, these investments will become even more accessible for and attractive to asset managers.

### Identification Challenges

Since the energy sector is in the midst of transitioning away from carbon, the identification of fossil fuel companies can be quite complicated. The complexity may be derived in that the definitions are not uniformly deployed by companies. Additionally, energy companies increasingly have a mix of old and new energy sources, which makes their classification challenging. VRS' energy sector exposure includes both traditional carbon and new energy exposures, often within the same company. Using the definitions provided in the bill that may not relate to VRS holdings and without standardized reporting by companies, data providers, and managers that match these definitions, screening criteria will vary. VRS could inadvertently over divest or under divest.

Also, asset managers are integrating evaluation of environmental factors, among others, into their analysis. In fact, a growing number of asset managers with which VRS partners have signed on to the United Nations' Principles for Responsible Investments (UNPRI) to demonstrate their commitment to responsible investing. UNPRI establishes a set of six principles that provide a global standard for responsible investments as it relates to environmental, social and corporate governance factors.

The bill is identical to HB645.

**Date:** 1/26/2022

**Document:** SB213.DOC/VRS

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<sup>1</sup> Based on various studies for pension plans and endowments (Munnell, Chen, "New Developments in Social Investing", Center for Retirement Research at Boston College, 53, November 2016. Fischel "Fossil Fuel Divestment and Public Pension Funds, June 2017.)

<sup>2</sup> CalSTRS Green Initiative Task Force – Annual Report Ending June 30, 2019