MEMORANDUM

To: Senate Federal and State Affairs Committee

From: Alan D. Conroy, Executive Director

Date: March 7, 2023

Subject: Opponent testimony on SB 224; Environmental, Social and Governance (ESG) Investments

On behalf of the KPERS Board of Trustees, I respectfully appear before the Committee today to request that SB 224 not be passed. Senate Bill 224, as introduced, creates a framework for identifying companies that engage in an ideological boycott and requires the KPERS Board of Trustees to divest or limit investments in these companies.

Since 1961 when the Retirement System was created, the Legislature has delegated Trust Fund oversight and investment decisions to the Board of Trustees. The Board has carefully built the KPERS portfolio to provide the highest returns with the least amount of risk.

The KPERS Board of Trustees and all the Board's investment managers are fiduciaries (highest moral, ethical, and legal standard) to our members. All investment decisions are made for the sole purpose of providing promised benefits.

In support of this duty, the Legislature already addressed the issue of social investing in 1992 by **prohibiting investments "if the sole or primary investment objective is for economic development or social purposes or objectives."** K.S.A. 74-4921(3).

As written, KPERS opposes SB 224:

1. SB 224 creates a second definition of fiduciary. It will require the Board to make decisions that may **conflict with their legal and ethical duty** to act solely in the best interest of members.
2. The evidence of considering non-financial (nonpecuniary) factors in New Section 22 (page 13, line 31) is so broad it could **exclude nearly all current investment managers** and require divestment from all investment holdings. The Trust Fund would incur **extraordinary investment costs** due to the divestment. It is not clear if there are viable, institutional quality investment options that can comply with Section 22. A less effective portfolio translates into **higher employer contributions**, both for the State and other KPERS employers.
3. The proxy voting requirements are applied universally but are not germane to most of the System's private market managers. The requirements create an unnecessary layer of bureaucracy that will **make KPERS less competitive** with private market and real estate investments, a valuable part of KPERS' investment earnings. These requirements could also prevent the System from using

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commingled investment accounts which often provide a more efficient, low cost way of investing Trust Fund assets.

Funding is also a major concern. As introduced, SB 224 could require the immediate restructuring of the entire $24.4 billion investment portfolio. **This would create immediate asset losses. Losses reduce the funded status and decrease expected future returns, increasing required employer contributions.**

- The estimated losses from early withdrawal of investments in private markets alone totals $1.14 billion, which is 4.7% of the current net asset value. This would ultimately result in a 4% reduction in the funded ratio (assets divided by liabilities, currently at 71.6% funded).
- Restructuring the investment portfolio is estimated to reduce the expected investment returns by 0.85%. The restructured investment portfolio is estimated to earn $3.6 billion less over the next 10 years when compared to the current investment portfolio.
- Lowering the expected future investment returns by 0.85% annually will increase the State/School unfunded actuarial liability approximately $2.4 billion and actuarially required State/School employer contribution rate by 5.2%, about $267.8 million on the current covered payroll. This increase would trigger the 1.2% statutory cap on employer contribution increases, which is about $61.9 million on the current covered payroll.
- Local employers would also be impacted by lower investment returns. The estimated impact on the Local unfunded actuarial liability is $688.2 million and the increase in the employer contribution rate is 4.0%, which is about $75.8 million on the current payroll of more than 1,400 Local employers. This increase would trigger the 1.2% statutory cap on employer contribution increases, which is about $22.9 million on the current covered payroll.

Additional discussion of these issues is included in Attachment A to this memorandum.

We would be pleased to work with the Committee on bill language to mitigate the negative investment impacts of SB 224, while maintaining the intent of the legislation. We have included proposed amendatory language in Attachment B.

The issue of environmental, social and governance (ESG) investing is a timely topic, and we appreciate the efforts of the Legislature to balance the needs of the State. However, SB 224, as introduced, creates an unacceptable level of risk for the KPERS Board of Trustees and the KPERS Trust Fund.

I respectfully request that you not recommend SB 224 favorable for passage and would be pleased to stand for any questions the Committee may have at the appropriate time.

Attachments

Attachment A

Additional Detail on Senate Bill 224 Impacts on KPERS Investments and Funding

Issue 1: Fiduciary Duties

The Board of Trustees are fiduciaries, and all investment managers act as fiduciaries to KPERS members when making decisions about the assets of the KPERS Trust Fund. As fiduciaries, the Board and investment managers must make decisions solely in the best interest of KPERS members.

New section 22(c) establishes that a fiduciary may only consider "pecuniary" factors when discharging their fiduciary duty. It goes on to state that a fiduciary may reasonably be determined to have considered nonpecuniary factors if they have "branding, advertising, statements, explanations, reports, letters to clients, communications with portfolio companies, statements of principles or commitments."

Environmental, social and governance (ESG) products are widely offered by investment management firms. We believe that all or nearly all our managers would fall under this definition of having considered nonpecuniary factors and would be disqualified as fiduciaries.

Issue 2: Required Divestment

SB 224 contains several provisions pertaining to divestment from companies identified as engaged in an "ideological boycott." Among these provisions (Sections 7 through 11) is language allowing for the Board to act within its fiduciary duty if divestment would disadvantage the Trust Fund.

However, beyond the specific divestment requirements is the issue of divesting from investment managers who are not fiduciaries as defined in the bill. If an investment manager is disqualified as a fiduciary, the Board of Trustees, acting in its own fiduciary capacity, would have no choice but to terminate the management contracts with those investment managers.

If SB 224 disqualifies the current investment managers, the Board of Trustees would have to divest the existing positions with those investment managers, review what similar investment managers and funds are available that meet the new fiduciary requirements, and restructure the portfolio based on what investment options are available.

At this time, the number of investment managers who would qualify as fiduciaries under SB 224 is extremely limited. Even if the market for "anti-ESG" investment products expands, in the short term the expected investment returns would be lower than the current expectation. Even a limited period of lower investment returns (5-10 years) can decrease the expected assets by billions of dollars and further slow the funding progress of the System.

Assuming a reinvestment of liquidated assets into a 60% equity/40% bond portfolio with an equity manager that meets the requirements of SB 224, the investment management fees would increase $6.8 million to $25.1 million per year compared to the existing Russell 3000 index fund managers.

In addition, the expected return from the restructured portfolio is estimated to have a 0.85% lower investment return than the current investment portfolio. Over 10 years, the impact of this 0.85% reduction is $3.6 billion less in investment earnings when compared to the current investment portfolio. The loss of investment income to the Trust Fund must be made up through future employer contributions.

Issue 3: Proxy Voting Requirements

As investors in public markets, KPERS is entitled to voting common stock proxies. However, KPERS delegates that responsibility to the investment managers. KPERS provides guidelines for voting to our investment managers, including:

- In voting the proxies of common stocks, the manager must act with the care, skill, prudence, and diligence of a prudent person who is similarly situated and knowledgeable in the matters under consideration.
- The manager is to exercise its proxy voting authority for the exclusive benefit of System members and their beneficiaries.
- In all cases, the long-term economic best interests of members and their beneficiaries should guide voting decisions.

In FY 2022, the number of proxy votes cast by KPERS investment managers totaled nearly 100,000.

SB 224 would not allow KPERS to delegate those proxy votes unless it is not “economically practicable,” and the investment manager commits in writing to “act solely on pecuniary factors” when voting proxy shares. Pecuniary is not defined in the bill, but “nonpecuniary factor” is defined in the bill and means any factor intended to promote any environmental, governance ideological, political, social or other nontraditional goal or standard. We are treating pecuniary as meaning only financial factors in our analysis of SB 224.

For KPERS to research and evaluate each of the nearly 100,000 proxy votes based solely on financial factors, an entire team of investment professionals would have to be hired to manage proxy voting. This is not economically practicable, therefore we believe we would have to have investment managers commit in writing to vote proxies “solely on pecuniary factors.” We believe this requirement makes KPERS a less competitive investor, particularly in the private market space and would negatively impact our ability to select the highest quality investment options for the Trust Fund.

In addition, KPERS would not be able to enforce the proxy voting requirements of SB 224 in commingled accounts or in private market portfolios. We believe this would require divestment from these investments.

Issue 4: Actuarial Cost Impacts

KPERS funding is based on three sources of income:

- employee contributions,
- employer contributions, and
- investment income.

Employee contributions are set by statute (6% for KPERS and Judges members, 7.15% for KP&F members). Investment income is not guaranteed, but over the long term the expectation is that investment returns will be 7.0%. The only source of funding available if investment returns do not reach the investment target is employer contributions.

The required divestment discussed earlier will impact the current and future assets of the Trust Fund. Exiting the current private market investments is estimated to cost $1.14 billion, or about 4.7% of the current assets of the Trust Fund. In addition, based on the limited investment options that currently exist that could meet the requirements in SB 224, the expected annual investment return is 0.85% lower.

Reducing the assets in the Trust Fund by $1.14 billion is estimated to reduce the funded ratio (assets divided by liabilities) of the System by nearly 4.0% and increase the unfunded actuarial liability. Adding to the unfunded actuarial liability will increase the required employer contributions to fully fund the System. For the State/School group, the actuarially required contribution rate would increase 5.2%, which is about $267.7 million on the current State/School payroll. However, by statute the rate cannot increase more than 1.2% above the prior fiscal year, which totals about $61.9 million. The State would again be contributing less than the amount required to fully fund the System. Over the long term, this underfunding will cost the State billions of dollars more in employer contributions.

Local employers would also be impacted by lower investment returns. The estimated impact on the Local unfunded actuarial liability is $688.2 million and the increase in the employer contribution rate is 4.0%, which is about $75.8 million on the current payroll of more than 1,400 Local employers. This increase would trigger the 1.2% statutory cap on employer contribution increases, which is about $22.9 million on the current covered payroll.

The combined impact of the lost assets due to divestment and increased liabilities due to lower future investment returns could lower the funded ratio by approximately 10%, which would be close to 60%. KPERS was last 60% funded in the 12/31/2013 valuation, meaning SB 224 could negate 10 years of funding progress made by the State. The past decade included extraordinary focus by the Legislature on improving the funded status of the System, including a new plan design (KPERS 3 cash balance plan), two pension funding bond issues, and several extraordinary contributions to the Trust Fund totaling more than $1.5 billion.

Attachment B

Proposed Amendatory Language to SB 224 Addressing Impacts to KPERS

Amendment 1: Fiduciary Duties

If New Section 22 is narrowed to apply to only KPERS assets, this would address the disqualification of investment managers for not meeting the new fiduciary definition.

On page 13, in line 24, after "fiduciary" by inserting ", specifically of any assets managed on behalf of the system."

> (c) A fiduciary may reasonably be determined to have considered nonpecuniary factors based upon evidence indicating an intent to further an ideological boycott through portfolio company engagement, board or shareholder votes or otherwise as a fiduciary, specifically of any assets managed on behalf of the system. Such evidence may include, but not be limited to:

Amendment 2: Proxy Voting

The regulation of proxy voting in New Section 23 could be adjusted to allow KPERS to engage with a fiduciary who commits in writing to follow the provisions of the act and to exclude private market and real estate investments, which rarely have proxy votes due to the nature of the investment.

On page 14, in line 19, after the period by inserting "In which case, the system may entrust engage in share voting to a fiduciary."

> (d) Unless no economically practicable alternative is available, governmental plan public retirement system assets shall not be entrusted to a fiduciary, unless that fiduciary has a practice of, and in writing commits to, following guidelines when engaging with portfolio companies and voting shares or proxies that match the governmental entity's obligation to act solely upon pecuniary factors. In which case, the system may entrust engagement in share voting to a fiduciary.

On page 14, following line 36, by inserting "(h) This section is not applicable to alternative investments as defined in K.S.A. 74-4921(5)."

> (h) This section is not applicable to alternative investments as defined in K.S.A. 74-4921(5).

Amendment 3: Private Equity and Real Estate Exemptions

The requirement to divest from listed companies could be limited to direct holdings and exclude private markets and real estate to mitigate extraordinary divestment costs from these illiquid investments.

On page 9, in line 41, by striking "or private"; and in line 42 by striking "equity funds";

On page 10, in line 11, by striking "or private equity funds."

New Sec. 11. The board is also required to divest from any indirect holdings in actively or passively managed investment funds ~~or private equity funds~~ containing listed financial companies. The board shall submit letters to the managers of each investment fund containing listed financial companies requesting that they remove such financial companies from the fund or create a similar actively or passively managed fund with indirect holdings devoid of listed financial companies. If a manager creates a similar fund with substantially the same management fees and substantially the same level of investment risk and anticipated return, the board may replace all applicable investments with investments in the similar fund in a time frame consistent with prudent fiduciary standards but not later than the 450th day after the date the fund is created. If a manager does not create such similar fund, the board shall divest from such indirect holdings in actively or passively managed investment funds ~~or private equity funds~~.

On page 9, following line 6, by inserting "(e) This section is not applicable to alternative and real estate investments as defined in K.S.A. 74-4921 (5)."

(e) This section is not applicable to alternative and real estate investments as defined in K.S.A. 74-4921(5).