BILL NUMBER: SB 252 (Gonzalez) as introduced January 30, 2023

SUMMARY

SB 252 prohibits the CalSTRS and CalPERS boards from making additional or new investments or renewing existing investments in a fossil fuel company, as defined, and requires divestment from such investments by July 1, 2030, unless and only until January 1, 2035, an unforeseeable event creates conditions that materially impact normal market mechanisms for pricing assets. Commencing February 1, 2025, SB 252 also requires an annual report to be submitted to the Legislature and Governor with specified information. It also indemnifies present, former and future board members, officers and employees of and investment managers under contract with those retirement systems for actions related to the bill.

BOARD POSITION

Oppose. The board's policy is to oppose legislation that restricts or infringes on the plenary authority of the board to administer the retirement plans as provided in Section 17 of Article XVI of the California State Constitution. It is also the board's policy to oppose legislation that infringes on the investment authority of the board or is inconsistent with the investment policy adopted by the board as presented in the CalSTRS Investment Policy and Management Plan. By requiring the largest public pension funds in the United States to divest from fossil fuel companies, this bill would severely hinder the future success of institutional investor collaborations to affect meaningful change in the fossil fuel industry. In addition, by limiting engagement and requiring divestment, this bill would ignore CalSTRS' exposure to the broader economy and undermine efforts to reduce emissions and transition to a low-carbon world. The risks associated with climate change cannot simply be divested away.

REASON FOR THE BILL

As stated in the findings and declarations of the bill, the combustion of coal, oil and natural gas, known as fossil fuels, is the single largest contributor to global climate change, and it affects all parts of the California economy and environment. In addition, the purpose is to require CalSTRS and CalPERS to divest their holdings of fossil fuel company investments as part of the state's broader efforts to decarbonize the California economy and to transition to clean, pollution-free energy resources.

ANALYSIS

Existing Law:

Under the provisions of Section 17 of Article XVI of the California Constitution, as amended by Proposition 162 of 1992, the CalSTRS board has plenary authority and fiduciary responsibility over the investment of retirement plan assets and is required to discharge its duties solely in the interests of its members and beneficiaries for the exclusive purpose of providing benefits. The board must invest the assets of the plan with the care, skill and diligence of a prudent person engaged in a similar enterprise so as to maximize the investment gains and minimize the risk of loss. When considering investments, the preservation of principal and maximization of income is the primary and underlying criteria for the selection and retention of securities. The Constitution states, however, that the Legislature may by statute prohibit certain investments by a retirement board when it is in the public interest to do so and provided the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board.

This Bill:

Specifically, SB 252:

- Among other terms, defines “fossil fuel company” as one of the 200 largest publicly traded fossil fuel companies, as established by carbon content in the companies’ proven oil, gas and coal reserves.
- Prohibits the board from making additional or new investments or renewing existing investments in a fossil fuel company.
- Requires the board to liquidate investments in a fossil fuel company on or before July 1, 2030.
- Delays divestment until January 1, 2035, if the board determines an unforeseeable event creates conditions that materially impact normal market mechanisms for pricing assets and requires divestment within six months if the board finds that market conditions have substantially returned to normal ex-ante.
- Requires the board to submit an annual report to the Legislature and the Governor and to post the report on the board’s website commencing February 1, 2025, listing the fossil fuel companies from which the board has liquidated its investments, the fossil fuel companies from which the board still has not liquidated its investments, and the fossil fuel companies from which the board has not liquidated its investments because to do so would be inconsistent with its fiduciary responsibilities.
- Requires the annual report to include an analysis of methods and opportunities to reduce dependence on fossil fuels and transition to alternative energy sources in a realistic timeframe that avoids negatively contributing to economic conditions particularly damaging to public employee retirement funds and to overall net employment earnings of the California workforce.
- Indemnifies present, former and future board members, officers and employees of and investment managers under contract with CalSTRS for actions related to this bill.
- Specifies that this bill does not require the board to take any action unless the board determines the action to be consistent with its fiduciary responsibilities under Section 17 of Article XVI of the California Constitution.

Discussion

The board's policy is to oppose legislation that restricts its ability to invest in specific areas because, as described in its divestment policy, such restrictions could impair the board’s ability to exercise its fiduciary obligation to act exclusively for the benefit of the retirement plan members and beneficiaries. Divestment carries the risk of adversely affecting an investment portfolio. This is especially concerning as investment returns affect the CalSTRS Funding Plan (AB 1469–Bonta), which placed CalSTRS on a trajectory toward full funding.

CalSTRS shares the sense of urgency regarding climate change and is focused on understanding and responding to the risks it presents, both to the CalSTRS Investment Portfolio and to sustainable economic growth. Divestment is a blunt instrument and a last resort action that can have a lasting negative impact on the health of the Teachers’ Retirement Fund, while also severely limiting CalSTRS’ ability to shape corporate behavior for long-term sustainable growth. If CalSTRS divests of a company and some other entity acquires those shares, CalSTRS no longer has a seat at the table and cannot influence change in that company.

By requiring both CalSTRS and CalPERS to divest from fossil fuel companies, SB 252 would severely hinder the future success of institutional investor collaborations to affect meaningful change in the fossil fuel industry. Had such measures already been in place, the recently successful efforts to hold the ExxonMobil board accountable and elect new climate-conscious board members would have been much less likely. As the demand for energy continues to grow, it is important that long-term investors, such as CalSTRS, actively engage fossil fuel companies and the sectors that currently rely on fossil fuels, such as utilities and transportation, to transition their business models to cleaner forms of energy and to minimize the environmental impacts of their operations and products. It is not plausible to meet the world's growing energy demand immediately from renewable sources.

Preventing such engagements is just one way SB 252 would undercut CalSTRS' efforts to influence the broad market to make transformational changes needed to achieve a net zero emissions world. CalSTRS would also be required to acquire expertise and develop methodologies for determining the carbon content for every company in its portfolio, constantly monitor these companies and make all necessary transactions in order to avoid investing in the largest 200, which would change at any given moment. Not only would such an exercise be shortsighted, but it would also be resource intensive and, thus, limit staff's ability to implement every other aspect of CalSTRS' Net Zero Pledge.

For example, while the burning of coal, natural gas and oil for electricity and heat is the largest single source of global greenhouse gas emissions, representing 25% of emissions, another 24% comes from agriculture, forestry and other land uses. CalSTRS' net zero commitment takes a comprehensive view of how climate change is impacting multiple sectors. A narrow focus on the fossil fuel industry only captures a portion of the much larger carbon emissions challenge and detracts from developing a broader understanding of how the low-carbon transition affects the global economy and the CalSTRS' investment universe.

As with all other laws that restrict CalSTRS' investment authority, SB 252 provides that, per the California Constitution, the board shall not be required to take action unless the board determines in good faith that the action is consistent with its fiduciary responsibilities. Accordingly, and consistent with its divestment policy, CalSTRS has responded to previously enacted bills by rigorously evaluating *all* relevant factors and only divesting after determining that retaining the asset would pose an economic risk or was de minimis to the plan. CalSTRS has also initiated the divestment policy in the absence of legislation, most notably regarding tobacco. Similarly, CalSTRS only divested when, after a thorough financial analysis considering *all* factors, such an action was deemed to be consistent with its fiduciary responsibilities.

By preventing CalSTRS from investing in 200 companies based *solely* on the carbon content in their proven fossil fuel reserves, SB 252, however, would be significantly more challenging than all previous divestment measures. Such an arbitrary requirement, which lacks investment or financial rigor to the individual investment, would likely infringe upon the board's constitutionally enshrined fiduciary duties to administer the plan exclusively for the benefit of members and beneficiaries with the care, skill and diligence of a prudent person. As a long-term investor, CalSTRS must weigh *all* relevant considerations through the lens of economic risk to minimize the risk of loss and to maximize the rate of return. As a result, SB 252 would place the CalSTRS board under a tremendous amount of pressure to ignore its own divestment policy and its own fiduciary responsibilities.

CalSTRS follows an investment strategy, adopted by the board, of diversification and passive index management that does not generally exclude or include any investments in companies, industries or geographic areas. SB 252 would require CalSTRS to actively exclude new, additional or renewed investments in fossil fuel companies, reducing the diversification of the portfolio, increasing risk, and creating opportunity costs as well as costs to customize benchmark indices. While a specific investment restriction may be intended to address a concern associated with only a fraction of the portfolio, there can be cumulative effects from multiple investment restrictions that may even require the board to reevaluate its assumed investment return and lead to contribution rate increases.

In addition, the language that attempts to offer flexibility to delay divestment if an unforeseeable event disrupts the markets is vague and ambiguous, which could present challenges with interpretation and implementation. The provision may be addressing global events that have constrained energy distribution and emphasized the world's dependence on fossil fuels and may acknowledge the world's everchanging challenges that pose risks to the fund. However, CalSTRS already works to mitigate risks through existing policies and procedures, and as a long-term and passive investor, no single investment can work alone to diversify the fund and minimize risk while maximizing return. Also, as a pension fund, CalSTRS cannot speak to policy issues that fall outside of CalSTRS' scope, such as information on how to reduce dependence on fossil fuels or on how to avoid negatively impacting economic conditions that are damaging to California's workforce employment earnings.

LEGISLATIVE HISTORY

SB 1173 (Gonzalez, 2022) would have prohibited the CalSTRS and CalPERS boards from making additional or new investments or renewing existing investments in a fossil fuel company, as defined, and required divestment from such investments by July 1, 2030. This bill was held in the Assembly Public Employment and Retirement Committee.

SB 185 (De León, Chapter 605, Statutes of 2015) required the CalSTRS and CalPERS boards to engage with thermal coal companies, as defined, and to divest the public employee retirement funds of any investments in thermal coal companies and prohibited additional or new investments or the renewal of existing investments in thermal coal companies.

PROGRAM BACKGROUND

ESG Policy

CalSTRS has its own well-established and longstanding process for thoroughly vetting the environmental, social and governance (ESG) risks of potential investments. The board adopted its Statement of Investment Responsibility in 1978, making CalSTRS an industry leader as one of the first pension funds to adopt a written policy to navigate these complex issues. As a key component of that process, the board has developed a list of risk factors as part of its Investment Policy for Mitigating ESG Risks. The ESG Risk Factors help the board to identify and evaluate investment risks relating to the existence of certain conditions, such as recognition of the rule of law, shareholder rights, human rights, the environment, acts of terrorism and other unsustainable practices and governance crises with the potential to hurt long-term profits.

Divestment Policy

In addition to the CalSTRS ESG policy, the board has adopted a Divestment Policy, focusing on engagement, to respond to external or internal initiatives to divest of specific companies or industries. In accordance with this policy, CalSTRS has historically taken the position that active and direct engagement is the best way to resolve issues. Divestment bears the risk of adversely affecting an investment portfolio and severs any chance to advance positive change through shareholder advocacy. Meetings with shareowners and senior management, or the board of directors, are generally more effective in bringing about change in a corporation. Under the policy, the board will only consider divestment after all efforts at engagement have failed, and only then in cases where at least one of the ESG Risk Factors is violated over a sustained timeframe to the extent that it becomes an economic risk to the fund, creates a potential for material loss of revenue and weakens the trust of a significant portion of CalSTRS members. Finally, the Divestment Policy sets forth that the board will only instruct staff to divest of a security when it determines that continuing to hold a security is imprudent and inconsistent with its fiduciary duty.

Net Zero Pledge

In September 2021, the board adopted a Net Zero Pledge that commits to achieve a net zero portfolio by 2050 or sooner. CalSTRS recognizes the risks and opportunities presented by the foreseeable transition to a low-carbon economy, as well as the global acceleration towards alignment with the science-based emissions targets of the Paris Climate Agreement. The net zero portfolio emissions pledge is the continuation of CalSTRS' long history of climate risk integration into the investment portfolio. In August 2022, the board authorized a package of investment actions to accelerate its efforts to achieve a net zero investment portfolio:

1. The reduction of greenhouse gas emissions across the investment portfolio by 50% by 2030.
2. The adoption of processes to incorporate greenhouse gas emissions into investment decisions as part of traditional risk-and-return analyses and their potential impacts on the CalSTRS Funding Plan.
3. The allocation of 20% of the Public Equity portfolio to a low-carbon index. This index is designed to significantly reduce portfolio emissions while managing active risk by allocating more money to companies with low-carbon emissions. This shift alone could reduce portfolio emissions by as much as 14%.
4. The incorporation of future climate-related scenarios into CalSTRS' asset-liability modeling framework to help guide CalSTRS' investment allocations.

CalSTRS Expands Investments in Climate Solutions

Since 2004, CalSTRS has been actively integrating climate-oriented solutions into our portfolio and has invested more than $20 billion in low-carbon solutions. Examples of these investments include:

- $18.3 billion in LEED-certified buildings in the Real Estate Portfolio.
- $8.9 billion in the Total Sustainable Investments and Stewardship Strategies Portfolio.
- $1.8 billion in renewable power, agriculture, timberland and LEED-certified structure investments in the Inflation Sensitive Portfolio.
- $306 million in green bonds in the Fixed Income Portfolio.

ExxonMobil Board

In January 2022, after CalSTRS' support of Engine No. 1's campaign to elect three new directors to the ExxonMobil board in 2021, the company announced its first pledge to achieve net zero greenhouse gas emissions by 2050. CalSTRS' targeted approach to engagement and influence as a dependable long-term investor will continue to be needed as the pledge leaves out Scope 3 emissions that other U.S.-based oil and gas companies, including Phillips 66 and Chevron, have recently committed to reducing.

Climate Action 100+ (CA100)

CalSTRS is a lead signatory of the Climate Action 100+ (CA100), an initiative of more than 700 investors with a goal to mitigate investment exposure to climate risk and secure ongoing sustainable returns for their beneficiaries. Since CA100 launched, 119 companies have made commitments to reduce emissions, which equates to over a quarter of the global greenhouse gas emissions today.

Sustainability Accounting Standards Board (SASB)

CalSTRS was an inaugural board member and continues to be a critical participant and supporter of the SASB. SASB was formed to fill a void in corporate reporting to identify the financial impacts of sustainability issues. The work of SASB has pushed the market towards greater climate related disclosure. While these standards are voluntary, more than 50% of companies in the S&P Global 1200 use them. The International Financial Reporting Standards Foundation created the International Sustainability Standards Board, which will integrate and build on the work of SASB in establishing globally required sustainability reporting standards.

Task Force on Climate-related Financial Disclosures (TCFD)

The Financial Stability Board created the TCFD in 2015, and the TCFD issued a report containing climate-related financial disclosure recommendations in 2017. The recommendations fall into four thematic areas: governance, strategy, risk management and metrics. As of 2022, more than 1,500 financial institutions have expressed support for the TCFD framework, and 92 of the 100 largest public companies either support the TCFD, report in line with the TCFD recommendations or both. CalSTRS actively engages companies and regulators, including through collective engagement via the Climate Action 100+ group, to adopt the recommendations of the TCFD in order to help investors price climate risk and reward climate innovation.

Net Zero Reporting

Since 2004, CalSTRS has integrated climate considerations into our investment beliefs, policies, processes and portfolios. As part of assessing environmental risks, CalSTRS considers not only how a particular investment affects the environment but also how the environment affects a particular investment. CalSTRS staff report to the board regularly regarding progress toward net zero. In addition, CalSTRS reports to the California Legislature every three years on our efforts to measure and manage climate risk in our public market investment portfolio. The Addressing Climate-Related Financial Risk Report, focuses on CalSTRS' investment-related activities addressing climate risk across the fund, including proxy voting, corporate engagement and investment in climate solutions. It also analyzes CalSTRS' Public Equity and Corporate Credit portfolios' alignment with the goals of the Paris Climate Agreement.

The Cost of Divestment
Between June 2000 and January 2010, CalSTRS divested tobacco in the system's passive portfolios by removing the sector from benchmarks, as required by board policy. As of June 30, 2022, CalSTRS had divestment mandates for tobacco, Iran, firearms, thermal coal and private prisons. CalSTRS also divested securities related to Sudan from October 2008 to February 2021. CalSTRS estimates, since fully divesting tobacco in 2010, firearms in 2013, U.S. thermal coal in 2016, non-U.S. thermal coal in 2017 and private prisons in 2018, the CalSTRS Investment Portfolio, which is benchmarked against custom indexes that exclude those sectors, has underperformed standard indexes that include securities restricted by CalSTRS by roughly $4.39 billion. CalSTRS estimates the total compounded cost of all divestments, to date, and the prior restricting of tobacco under the prior benchmark modification policy is approximately $9.55 billion.

Thermal Coal Divestment
At its April 2015 meeting, the CalSTRS' Investment Committee initiated a 10-month research and engagement process that culminated in the divestment from thermal coal companies because divestment was consistent with CalSTRS' fiduciary responsibilities. The board determined that given the financial state of the industry, the movement of the regulatory landscape and coal's impact on the environment, its presence reflected a loss of value. Chapter 605, Statutes of 2015 (SB 185−De León), required the CalSTRS and CalPERS boards to engage with thermal coal companies, as defined, and to divest the public employee retirement funds of any investments in thermal coal companies and prohibited additional or new investments or the renewal of existing investments in thermal coal companies. Although the board's policy generally would be to oppose legislation that infringes on the investment authority of the board, the board held no position on this legislation due to its ongoing decision to divest from thermal coal companies. The board exercised its plenary authority and fiduciary responsibility to divest from companies that produce 50% or more of their revenue from the sale of thermal coal, in alignment with SB 185. Staff further lowered the revenue threshold to divest from companies that produce 25% or more of their revenue from the sale of thermal coal.

FISCAL IMPACT

Program Cost – CalSTRS must determine, as fiduciaries, the best approach to calculate its exposure to fossil fuel companies. To that end, the exposure was determined by including companies that have fossil fuel reserves for energy application and sales being more than 1% of revenue. CalSTRS invests in 159 companies with a combined market value of approximately $5.4 billion that meet this definition. Fossil fuel divestment, combined with existing CalSTRS divestments, would create deviation from the benchmark. Potential costs resulting from this deviation place the CalSTRS Funding Plan at risk. Any resulting costs would increase the unfunded liability and also may result in an increase in the state's contribution to the Defined Benefit Program.

Administrative Costs/Savings – An estimated $30.5 million resulting from transaction costs for liquidating securities, benchmark modification costs, additional costs related to external research services and staff resources for implementation. Ongoing compliance will also require reallocation of staff resources.

SUPPORT

California Faculty Association (Sponsor)
Fossil Free California (Sponsor)
San Francisco Board of Supervisors

OPPOSITION

CalSTRS

ARGUMENTS

Pro: May reduce the perception that CalSTRS is contributing to climate change by investing in fossil fuel companies.

Con: Infringes upon the investment authority of the board.

Reduces the investable universe, potentially adversely affecting portfolio performance and risk.

Undercuts CalSTRS' efforts to influence the market in a way that accelerates the global transition to a low-carbon economy.

Limits future opportunities for meaningful institutional investor engagement by CalSTRS and CalPERS.

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