BILL NUMBER: SB 560 (Allen) as amended April 17, 2017

SUMMARY

SB 560 requires the CalSTRS and CalPERS boards to consider the "financial climate risk," as defined, in their management of any funds they administer. Also, by January 1, 2020, and annually thereafter, the bill requires the boards to include the "financial climate risks" of their investments and their related engagement, as specified, in their comprehensive annual financial reports.

BOARD POSITION

Oppose, unless amended, to replace the term "financial climate risk," which continues to evolve, with "climate-related financial risk"; remove restrictions on the board's investment authority; clarify that no action shall be taken unless the board determines that the action is consistent with its fiduciary responsibilities; remove the requirement for reporting in the comprehensive annual financial report; and clarify the reporting requirements regarding the board's engagement activities with publicly traded companies within the fund**.** The board's policy is to oppose legislation that restricts 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.

REASON FOR THE BILL

As stated in the findings and declarations of the bill, the financial sector is not insulated from the adverse effects of climate change, which presents an array of material financial risks that reasonable investors must take into account when making investment decisions. Failure to acknowledge and address these risks could result in exposure to subsequent liabilities and financial risk.

SUMMARY OF AMENDMENTS

The April 17, 2017, amendments:

- Remove the requirement that, on or after January 1, 2019, the CalSTRS and CalPERS boards consider the financial risk of *each* investment or potential invest, as part of discharging their fiduciary duties.
- Add the requirement that the boards consider financial climate risk in their management of *any fund* they administer, including when making decisions regarding the fund's asset allocation; increasing, decreasing or maintaining investments in individual companies or commingled funds; or hiring investment managers.
- Remove the requirement that the boards report annually on the financial climate risks of their investments, including the carbon footprint of the investments computed using the Greenhouse Gas Protocol of the World Resources Institute, including Scope 3, which are indirect greenhouse gas emissions.
- Add the requirement that the boards, starting January 1, 2020, report annually, in their comprehensive annual financial reports, on the "financial climate risks" of their investments, including:

- o The alignment of the board's portfolio with the Paris Climate Agreement and California climate policy goals, the value at risk if these goals are achieved and the exposure of the portfolio to long-term risks.
- o Specified information on the board's engagement with carbon intense companies.
- Provide that the board shall not be required to take action that is not consistent with its fiduciary responsibilities.
- Make various changes to the findings and declarations in the bill.

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 the 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 investments 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.

This Bill:

Specifically, SB 560:

- Defines "financial climate risk" as:
  - o Material financial risk posed to an investment by the effects of the changing climate, including intense storms, rising sea levels, higher global temperatures, economic damages from carbon emissions, and
  - o Other financial risk due to public policies to address climate change, shifting consumer attitudes, changing economics of traditional carbon-intense industries, and other transition risks.
- Requires the CalSTRS and CalPERS boards, to consider "financial climate risk" in their management of any fund they administer, including when making decisions regarding the fund's asset allocation; increasing, decreasing or maintaining investments in individual companies or commingled funds; or hiring investment managers.
- Requires the boards, starting January 1, 2020, to report annually, in their comprehensive annual financial reports, on the "financial climate risks" of its investments, including:
  - o The alignment of the boards' portfolios with the Paris Climate Agreement and California climate policy goals, the value at risk if these goals are achieved and the exposure of the portfolio to long-term risks.
  - o Specified information on the boards' engagement with carbon intense companies.

SB 560 requires CalSTRS to consider the financial risk in its management of any fund it administers posed by the effects of climate change. As described below, CalSTRS has a longstanding and well-regarded track record of assessing external risks of investments, including those posed by climate change. SB 560 significantly increases the scope of CalSTRS' existing annual report on environmental risk management by requiring it to include information about the alignment of the board's portfolio with the Paris Climate Agreement and California policy goals, as well as specified information on the board's engagement with carbon intense companies, such as utilities, oil and gas producers.

SB 560 limits the constitutional mandate that the board invest consistent with its fiduciary responsibility by requiring it to consider "financial climate risk" in its management of any fund it administers. While CalSTRS believes climate risk to be an important consideration in its investments, adding a specific mandate to consider "financial climate risk" infringes on the board's authority to discharge its fiduciary duties with "due care." This represents an unreasonable and unnecessary infringement on the board's investment authority and fiduciary responsibility. In addition, requiring consideration of "financial climate risk" in its management of any fund it administers adds to the due diligence for investment decisions, resulting in delayed realization of investments and associated losses to the Teachers' Retirement Fund.

LEGISLATIVE HISTORY

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.

SB 1550 (Florez, 2008) would have required the State Controller, in consultation with the investment community and the Air Resources Board, to develop a climate change disclosure standard for voluntary use by listed corporations doing business in California. This bill was held on the Senate Floor.

AB 32 (Núñez, Chapter 488, Statues of 2006) enacted the "Global Warming Solutions Act of 2006," which required the Air Resources Board to adopt regulations to reduce California's greenhouse gas emissions to 1990 levels by the year 2020.

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 set forth in the board's Investment Policy for Mitigating ESG Risks. As a key component of that process, the board has developed a list of 21 Risk Factors, which help staff to identify and evaluate investment risks relating to the existence of certain conditions with the potential to hurt long-term profits, including climate change.

Climate Risk Disclosure Initiative
In addition to the ESG policy, CalSTRS was one of 14 leading investors that participated in the Climate Risk Disclosure Initiative (CRDI), which kicked off in 2005.

The CRDI aimed to standardize company climate risk disclosures to facilitate investor analysis and comparisons of company climate risk exposure. In 2006, the CRDI Steering Committee released a global framework for climate risk disclosure "in order to analyze a company's business risks and opportunities resulting from climate change, as well as the company's efforts to address those risks and opportunities."

Green Initiative Task Force and Annual Report

CalSTRS also established an environmentally focused Green Initiative Task Force, which produces an annual report to highlight environmental-themed investments, corporate governance and other environmental risk management efforts. 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 examines the extent to which portfolio assets are at risk of being exposed to extreme weather zones or changing climatic conditions. Similarly, CalSTRS examines the potential for demand disruption, as may be the case with increased regulation leading to the potential sequestration of fossil fuels.

CalSTRS works with its external managers to recognize and manage environmental risks and, where appropriate, directly engages with portfolio companies. CalSTRS also collaborates with other investors to broaden engagement reach whenever possible. CalSTRS routinely submits environment-related shareholder proposals to companies held in its public equity portfolio to raise their level of environmental risk awareness. Staff also considers and votes all environment-related proposals in a manner that aligns with CalSTRS' objectives of improving disclosure and mitigating risk.

OTHER STATES' INFORMATION

To date, only Hawaii has enacted legislation that broadly requires the state to expand strategies and mechanisms to reduce greenhouse gas emissions statewide in alignment with the principles and goals in the Paris Climate Agreement, although the legislation is not specific to public pension funds. The European Parliament enacted legislation that requires managers of retirement funds to take into account the ESG risks of their investments, and France enacted Article 173, which requires a wide range of investors to report on how they integrate ESG factors in general, as well as specifically how climate change considerations are incorporated.

FISCAL IMPACT

Program Cost – Potentially $26 million incurred for delaying the realization of investment gains by two weeks if staff are required to consider "financial climate risks" when making investment decisions in the private asset classes. In public asset classes, CalSTRS is a passive investor, and looking at each investment for "financial climate risk" would require a change in investment strategy and could result in additional large investment losses.

Administrative Costs/Savings – Potentially more than $250,000 if staff are required to evaluate and report on the "financial climate risk" of investments due to having to employ outside companies that would measure the risk. Unknown and potentially significant additional costs could be incurred for having to align with the Paris Climate Agreement and the California climate policy goals.

SUPPORT

Environment California (Sponsor)
Fossil Free California (Sponsor)
350 Sacramento

OPPOSITION

CalSTRS (oppose, unless amended)

ARGUMENTS

Pro: Enhances the perception that CalSTRS is actively engaged in considering the adverse impacts of climate change on the investment portfolio.

Con: Infringes on the board's authority to discharge its fiduciary duties with "due care."

Requires CalSTRS to incur significant administrative costs to assess climate risk of private investments.

Requires the Teachers' Retirement Fund to incur losses from delayed investment gains.

Would be logistically impossible to implement.

LEGISLATIVE STAFF CONTACT

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