BILL NUMBER: SB 560 (Allen) as introduced February 17, 2017

SUMMARY

SB 560 requires that on and after January 1, 2019, the CalSTRS and CalPERS boards consider the financial climate risk, as defined, of each investment, or potential investment, as part of their discharge of their fiduciary duties with respect to the investment. By January 1, 2020, and annually thereafter, the bill requires the boards to report on the financial climate risks of their investments, including the carbon footprint of the investments as specified.

BOARD POSITION

Oppose. The board's policy is 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.

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.

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:
    - 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

  - 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 board, on or after January 1, 2019, to consider the financial climate risk of each investment, or potential investment, as part of the board's discharge of its fiduciary duties; and
- Requires the board, starting January 1, 2020, to report annually on the financial climate risks of its 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.

SB 560 requires CalSTRS to consider the financial risk posed to an investment or potential investment 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 report the carbon footprint of all of its investments. As an investor in index funds, there are significant difficulties in estimating the carbon footprint of the 8,000 different securities in the CalSTRS' public equity investment portfolio. Vendors that assess the carbon footprint of public equity portfolios do not necessarily use the World Resources Institute's Greenhouse Gas Protocol or may only assess the more easily quantifiable emissions under the Scope 1 and 2 standards.

In a modeling analysis that was completed for the University of California, Office of the Chief Investment Officer by two firms, MSCI and South Pole Group, only 34 percent of securities in its portfolio are companies that publicly report their carbon emissions under the Scope 1 and 2 standards. The emissions of the remaining 66 percent of companies were estimated by the firms using multiple estimation methodologies and models. This illustrates the difficulty CalSTRS may have in getting the complete and accurate greenhouse gas emission data needed to comply with this bill. The difficulty of accessing this data would be greater for alternative or private asset classes in which ownership is held indirectly by CalSTRS.

SB 560 adds to the board's plenary authority and fiduciary responsibility by requiring it to include the concept of "financial climate risk" in its fiduciary obligations. 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 plenary authority and fiduciary responsibility. In addition, although the bill does not specifically require the carbon footprint to be included in the assessment of potential investments, directly including the general assessment as a fiduciary duty may compel the board to direct staff to include the carbon footprint assessment as part of the due diligence process, 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. 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. In its latest incarnation, the board developed a list of 21 Risk Factors as part of its Investment Policy for Mitigating ESG Risks. The 21 Risk Factors help the board to identify and evaluate investment risks relating to the existence of certain conditions with the potential to hurt long-term profits, including climate risk.

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, no other state has enacted legislation requiring the board of a public pension fund to consider the financial climate risk, as defined, of each investment, or potential investment, as part of their discharge of their fiduciary duties with respect to the investment. However, 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 is directed to assess the carbon footprint of potential private investments using the Scope 1 and 2 standards of the Greenhouse Gas Protocol of the World Resources Institute. Unknown and potentially substantial additional costs resulting from delayed investments to assess indirect business-related emissions under the Scope 3 standard.

Administrative Costs/Savings – More than $250,000 for assessing the carbon footprint of private investments under the Scope 1 and 2 standards of the Greenhouse Gas Protocol of the World Resources Institute. Unknown and potentially significant additional costs to assess indirect business-related emissions under the Scope 3 standard.

SUPPORT

Environment California (Sponsor)
Fossil Free California (Sponsor)

OPPOSITION

CalSTRS.

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.

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