Department of Legislative Services

Maryland General Assembly
2006 Session

FISCAL AND POLICY NOTE

House Bill 1001 (Delegate Marriott, *et al.*)
Appropriations

Divestment from the Republic of Sudan

This bill requires external asset managers selected by the State Retirement and Pension System to divest State pension funds from foreign companies with equity ties to the government of Sudan or its instrumentalities.

The bill takes effect July 1, 2006.

Fiscal Summary

State Effect: Potentially significant increase or decrease in State expenditures (all funds) depending on whether the bill results in substantial net increases or decreases in investment returns for the State Retirement and Pension System. Net investment losses would result in higher State pension contribution rates, while net investment gains could reduce State pension contribution rates.

Local Effect: None.

Small Business Effect: None.

Analysis

Bill Summary: The bill defines equity tie to mean the presence of:

- manufacturing or mining plants;
- employees or advisors;

- facilities; or
- investment, fiduciary, monetary, or physical presence of any kind.

The bill does not apply to firms providing humanitarian aid to the Sudanese people.

After consulting with an independent research firm specializing in global security risk, the board of trustees of the State Retirement and Pension System (SRPS) must sell, redeem, divest, or withdraw any funds that violate the bill's restrictions. If the immediate disposition of any assets would result in unduly negative financial consequences, the board of trustees may delay any action for up to three years.

On or before September 1, 2006, the board of trustees must notify the Joint Committee on Pensions about SRPS investments that violate the bill's restrictions. Beginning September 7, 2007, the board of trustees must submit annual reports detailing which investments have been sold, redeemed, divested, or withdrawn and describing progress the board is making in complying fully with the bill.

Current Law: There is only one restriction on the investment of SRPS assets: not more than 25% of assets invested in common stocks may be invested in nondividend paying common stocks.

Background: In 1997, President Clinton issued an executive order banning American companies and individuals from doing business with the government of Sudan because of its repressive human rights record. Since then, the Sudanese government has been linked to ongoing attacks on civilians in the country's Darfur region that has resulted in widespread death, poverty, and homelessness and prompted former Secretary of State Colin Powell to refer to the situation in Darfur as "genocide."

Several states, led by New Jersey and Illinois, have already enacted legislation requiring pension fund managers to divest assets from foreign companies with economic ties to the Sudanese government. The Illinois law uses criteria very similar to the language used in this bill to identify companies with ties to Sudan. KLD Analytics, an investment research firm, has compiled a list of approximately 130 foreign companies that continue to have ties with the government of Sudan, using the criteria in the Illinois law. Of those, about 80 are traded on American stock exchanges. According to KLD, the companies it has identified represent 8.9% of firms that constitute the Morgan Stanley Capital International (MSCI) index, the most commonly used benchmark for international equity funds.

Northern Trust, an asset management company that currently manages foreign holdings for the Illinois pension system, has developed an investment fund that does not include firms identified by KLD. It has identified firms that have similar equity and market profiles as the firms with ties to Sudan, and added them to the fund in an effort to match the performance of the MSCI index. However, the fund is only a few months old, so data on its performance are not available.

The SRPS board of trustees has established strategic guidelines for its $33 billion investment portfolio. The guidelines specify that the investment division may invest 13% of the system's assets in international equities, and 10% in global equities, which can include both domestic and international equities. The remainder of the assets are invested in other investment vehicles, with 42% in domestic and private equity, 30% in fixed income, and 5% in real estate.

All SRPS's asset management is conducted by external managers selected by the board of trustees. State Street Bank, the system's largest external manager, manages a $3.5 billion SRPS investment in an international equity fund that uses MSCI as its benchmark. The fund invests in approximately 2,000 securities, including some of the firms on the KLD list. The fund had returns of 26% during the year ending January 2006, and 16.5% during the year ending January 2005. However, because the fund commingles assets from other institutional investors, SRPS is not in a position to dictate its investment strategy. To implement the provisions of this bill, SRPS would have to sell its holdings in the international equity fund managed by State Street Bank, subject to the three-year delay allowed by the bill if losses from the sale would be excessive. Those funds would have to be reinvested in vehicles that met the terms of this bill, such as the fund established by Northern Trust or other similar funds. However, it cannot be determined whether those funds would trail, match, or exceed the returns earned by State Street Bank.

The State Retirement Agency also reports that it could be forced to sell off its entire private equity portfolio. Private equity is a potentially lucrative category that includes venture capital and start-up firms. SRPS's private equity holdings have lagged behind that of other large pension funds, which partially accounts for the system's poor investment performance relative to those other funds. However, SRPS has been taking steps to increase its private equity holdings. Its strategy has been centered on fund-to-fund investments, which involve investing in funds that invest in funds that invest in promising companies. Because SRPS is two steps removed from the actual firms, it does not know which firms actually receive its capital. To ensure full compliance with the provisions of this bill, it could be forced to sell off its private equity investments.

State Fiscal Effect: Investment performance by SRPS can have a profound effect on State pension contribution rates. This is best illustrated by examining the years bracketing the stock market downturn of 2001. Prior to the downturn, State pension contributions had declined as a percentage of payroll for four consecutive years, as SRPS enjoyed robust investment returns that exceeded its investment assumptions by considerable amounts. In the two years following the downturn, when SRPS investments lost money, State pension contributions increased by 9.0% the first year and would have increased by another 8.4% the following year if the State had not acted to restrict their growth.

However, without knowing whether SRPS would experience net gains, losses, or no change in its investment returns by implementing the provisions of this bill, it is difficult to predict the bill's effect on State pension contributions.

Additional Information

Prior Introductions: None, but HB 619 of 2005 imposed broader sanctions on Sudan, including divestiture of pension assets from firms doing business with the Sudanese government.

Cross File: None.

Information Source(s): Maryland State Retirement Agency, KLD Analytics, Northern Trust, Presidential Executive Order 13067, Department of Legislative Services

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Analysis by: Michael C. Rubenstein

Direct Inquiries to:
(410) 946-5510
(301) 970-5510