SB 22

Department of Legislative Services

Maryland General Assembly
2008 Session

FISCAL AND POLICY NOTE

Senate Bill 22 (Senator Colburn)
Budget and Taxation

State Pension and Retirement System - Divesting from Iran

This bill requires, by June 30, 2009, that the State Retirement and Pension System sell, redeem, or withdraw any assets it currently has invested in companies that are doing business in Iran, as defined in the bill. It further bars SRPS from investing any assets in those companies. Companies providing humanitarian aid to Iran are exempt from the divestment mandate. SRPS must report to the General Assembly regarding its implementation of the bill's provisions.

The bill takes effect July 1, 2008.

Fiscal Summary

State Effect: Significant increase in State pension liabilities and contribution rates, although the extent of those increases cannot be reliably estimated at this time.

Local Effect: Significant increase in pension liabilities and contribution rates for participating governmental units, although the extent of those increases cannot be reliably estimated.

Small Business Effect: None.

Analysis

Current Law: There are no statutory restrictions on the SRPS Board of Trustees' exercise of its fiduciary responsibilities in managing the system's assets "solely in the interest of the participants" and "for the exclusive purposes of providing benefits to the participants."

Chapters 39 and 40 of 2007 authorize the SRPS Board of Trustees to divest its holdings in companies that do business in Sudan after engaging those companies in an effort to encourage them to act responsibly and refrain from any activities that promote or enable abuses of human rights in the Darfur region of the country. The Sudan divestment laws apply only to shares of companies held in actively managed separate accounts, not to all SRPS assets. In deciding whether to divest from a particular company, the board must act in accordance with its fiduciary responsibilities. To date, SRPS has divested from one company: Schlumberger is the largest oil field services firm operating in Sudan.

Chapter 775 of 1985 prohibited SRPS from investing any net new assets (employee and employer contributions) in companies doing business in South Africa for two years, subject to certain exemptions.

Background: In 2005, the Missouri State Treasurer adopted a terror-free investment policy that barred the state from investing in companies with business ties to four countries that the U.S. government has deemed to be state sponsors of terrorism (Iran, North Korea, Syria, and Sudan). At her urging, the Missouri State Employees Retirement System adopted a similar policy the following year. Since then, four states (Florida, New Jersey, California, and Illinois) have enacted legislation to divest their pension plans of companies that do business in Iran. Some of those have targeted only Iran while others have engaged in "terror-free investing," which targets companies with ties to all four of the countries mentioned above.

Some Iran divestment or terror-free measures in other states have targeted only actively traded funds, while others have taken a more comprehensive approach, as this bill does. Missouri's approach was the most far-reaching in that it targeted about 190 companies in both actively and passively managed international funds, and is the only approach that has had enough time to develop a track record. State Street Global Advisors, the Missouri fund's sole passive manager of international assets, created a tailored index fund to conform to the Missouri Treasurer's terror-free "do-not-buy" list, and migrated the state's holdings into that account at minimal cost. According to the Missouri Treasurer's office, since inception, the terror-free tailored index fund has outperformed the Morgan Stanley Capital International (MSCI) index by almost 400 basis points. Legislative Services notes that State Street is also the only passive international asset manager for SRPS.

Several investment advisory firms either offer or have plans to offer proprietary lists of firms with business ties to Iran and other state sponsors of terrorism. Current industry leaders include Conflict Securities Advisory Group and Institutional Shareholder Services (ISS), which previously advised SRPS on divestment from Sudan. Risk Metrics Group, the SRPS corporate governance advisor, has a master list of 150 companies that conduct business or other activities in Iran. The American Israel Political Action Committee also developed a list of 22 companies with business ties to Iran.

Given the novelty of terror-free investing, asset managers have been slow to develop Iran- or terror-free investment vehicles for large institutional investors, but that is beginning to change. Until recently, there were only a handful of niche companies offering terror-free products. However, the FTSE Group, a global leader in the development and management of international equity indices, is currently developing a terror-free index series to parallel its Global Equity Index series that includes more than 2,000 international firms. Northern Trust, a major asset management firm that currently coordinates the SRPS Emerging Manager program, is also exploring terror-free investment products. Other managers, like State Street, have indicated a willingness to work with clients to developed tailored investment products.

State Fiscal Effect: Investment returns 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 2001-2002. 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.

The bill's comprehensive mandate that the fund divest any and all funds from companies doing business in Iran could have a significant effect on the System's assets. Unlike the mandate to divest from Sudan in actively managed separate accounts, or even Missouri's experience in adopting terror-free investing for its passive index funds, this bill would affect the system's investments in private equity, real estate, and fixed income.

The costs generated by this bill fall into two major categories: administrative and transaction costs associated with selling or migrating current holdings companies doing business in Iran, and the opportunity costs associated with a ban on future investments in those companies. Precise estimates of these costs are not possible for the reasons listed below, but they could be significant:

- SRPS was not able to provide DLS with an analysis of which of its funds hold shares of companies that do business in Iran.

- State Street Global Advisors has not indicated whether it would be willing to create a tailored Iran-free fund for SRPS at minimal cost as it did for Missouri.
- The availability of other Iran-free investment vehicles is still uncertain, especially in the real estate, fixed income, and private equity asset classes.
- DLS cannot predict the future performance of capital markets, so it cannot calculate the opportunity costs of divestment.

For the system's four commingled equity index funds, State Street provided a preliminary estimate that initial administrative and transaction costs of migrating holdings from those funds to other funds could be between $5.0 and $8.0 million, with ongoing costs of almost $1.0 million. These estimates are not consistent with Missouri's experience, so costs could be somewhat lower. However, this accounts for only one portion of the system's holdings. Transaction costs associated with divestment from actively traded funds and from other asset classes could be substantially higher.

The combination of significant transaction and administrative costs, and the prospect of future foregone returns, leads Legislative Services to conclude that this bill would have a significant negative effect on SRPS assets. That would increase the system's unfunded pension liabilities, resulting in increased State pension contribution rates, although the extent of the increase cannot be reliably estimated.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Maryland State Retirement Agency, Department of Legislative Services

Fiscal Note History: First Reader - February 18, 2008
ncs/jr

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