

Virginia Retirement System

2024 Fiscal Impact Statement

1. **Bill Number:** HB 388

House of Origin Introduced Substitute Engrossed

Second House In Committee Substitute Enrolled

2. **Patron:** Griffin

3. **Committee:** Appropriations

4. **Title:** Virginia Retirement System; investments; diversity, equity, and inclusion investing restricted.

5. **Summary:** Provides that unless the Board of Trustees of the Virginia Retirement System (VRS) can demonstrate that a social investment, defined in the bill, would provide a superior rate of return compared to a similar investment that is not a social investment with a similar time horizon and risk, neither the Board nor any external fiduciary utilized by the Board may invest or make recommendations regarding state funds for the purpose of social investment on or after July 1, 2024. “Social investment” is defined as “an investment that is based on diversity, equity, and inclusion in the investment, commitment, voting of shares, or engagement with portfolio companies with public funds for a purpose of obtaining an effect other than a maximized return for the Retirement System.”

6. **Budget Amendment Necessary:** Yes. In Item 485, VRS would need a NGF appropriation of approximately \$381,178 for FY 2025 and \$375,983 in each subsequent year for implementation of the bill. This appropriation would include funding for an additional full-time employee necessary to monitor the implementation of this investment mandate as well as additional monitoring systems or support.

7. **Fiscal Impact Estimates:** In addition to implementation and personnel costs for VRS, the bill’s limitation on investments may result in a substantial, albeit unquantifiable, negative financial impact on the Trust Fund and VRS members, beneficiaries, retirees, and employers in the form of increased unfunded liabilities and increased employer contributions resulting from lost investment opportunities and other investment losses. The bill would prohibit VRS and asset managers used by VRS from making a “social investment” unless such investment can be demonstrated to provide a superior rate of return than other similar non-social investments. While “social investment” is defined in the bill, from a practical and implementation standpoint, the definition lacks sufficient clarity.

As provided in the VRS Investment Policy Statement (posted on the VRS web site), the investment objective of the VRS defined benefit plan portfolio is to maximize return while managing risk within an acceptable range. While VRS uses economic considerations in its evaluation of investments, this legislation may preclude VRS from investing in companies or using asset managers that employ social considerations or criteria in their operations,

especially since it is difficult to discern the impacted universe of companies to which this applies.

As a practical matter, since VRS is an investor in both private and public markets, VRS could not invest in companies where VRS holds publicly traded individual stocks or bonds, and also not invest in entire private equity, real assets, credit strategies, and hedge funds (private market assets) that contain any such companies. Further, VRS does not have the ability to select among the individual holdings within externally managed private market assets. Mandating that VRS not make allocations to an investment that might implicate an ambiguous “social investment” criterion precludes VRS’ ability to participate with managers that might have any such exposure in their funds to such companies or practices; thereby limiting VRS’ access to important strategies and many external managers. While diversity, equity, and inclusion is a commonly used term across various sectors, though typically used in the context of the principles for organizational frameworks, there is no settled definition for the term. Moreover, it is not a common term in the investment industry. Thus, the bill provides little to no guidance for determining to which investments and companies the social investment definition should apply. Generally, and in nearly all cases, investment managers and publicly traded companies deploy some form of DEI with respect to their own hiring and internal policies. As this is the case, it is unclear whether such policies or hiring practices would implicate the conditions of this bill.

Requiring VRS to refrain from considering certain companies, industries or managers that include “social” factors (particularly since it is problematic to identify to which companies this provision applies, especially as a Global investor with a fully diversified portfolio that utilizes both public and private market assets) can lead to investment losses and lost investment opportunities and may have a sustained negative impact on the trust fund’s earnings. VRS investment earnings have historically provided 2/3 of the retirement benefits. Limiting access to the broadest opportunity set possible constrains VRS as an investor, is contrary to long-standing legislative history and practice, does not align with Constitutional and legal requirements, and may contravene VRS’ fiduciary obligations.

8. Fiscal Implications: See also Item 12, Other Comments, below.

VRS is concerned that this bill as drafted will impair its ability to fulfill its fiduciary responsibility to its members, retirees, and beneficiaries by constraining its ability to invest in the most beneficial investments due to the requirement to carve out any companies that may be considered “social investments” that VRS cannot necessarily demonstrate would definitively provide a superior return.

As a fiduciary and as explained in more detail below, VRS is required by state and federal law, and by Article X, § 11 of the *Constitution of Virginia*, to act only in the interest of the system’s more than 800,000 members, retirees, and beneficiaries. If the fund’s investment earnings do not meet the long-term investment return assumption of 6.75%, then employer contributions, will need to be higher to close any funding shortfalls. Again, as provided in the VRS Investment Policy Statement, the investment objective of the VRS defined benefit plan portfolio is to maximize return while managing risk within an acceptable range.

“Social investment” is defined in the legislation (beginning on line 20) as: "an investment that is based on diversity, equity, and inclusion in the investment, commitment, voting of shares, or engagement with portfolio companies with public funds for a purpose of obtaining an effect other than a maximized return for the Retirement System.

There is no standardized criteria, screen or definition for “social investment” that uses the parameters set out in this legislation. Therefore, determining which companies fit within the definition of “social investment” in the legislation will be extremely problematic. While the legislation provides a definition, as a practical matter there are no established parameters that could be applied by the VRS custodian (BNY Mellon) or managers that could be used as screens to identify any potential investments in which VRS participates that meet the legislative definition.

Further, there is not a readily available list of each company’s diversity, equity, and inclusion criteria. Therefore, just attempting to identify allowable investments under the legislation will be extremely challenging, costly, and time consuming as well as divert resources away from overall management and investment of trust assets.

9. Specific Agency or Political Subdivisions Affected: VRS, all VRS members, and all VRS-participating employers.

10. Technical Amendment Necessary: No, although as discussed in section 8 above, as drafted this bill cannot be administered.

11. Other Comments: This legislation would limit the VRS Board of Trustees’ investment independence for the first time since the system’s reconstitution in 1994 by prohibiting VRS and any external managers from investing or making recommendations regarding state funds for the purpose of “social investment” unless the Board can demonstrate that a “social investment” would provide a superior rate of return compared to a similar investment that is not a social investment and has a similar time horizon and risk.

For purposes of this legislation, "social investment" means an investment that is based on diversity, equity, and inclusion in the investment, commitment, voting of shares, or engagement with portfolio companies with public funds for a purpose of obtaining an effect other than a maximized return for the Retirement System.

Importantly, as a fiduciary of the Trust Fund, the VRS Board of Trustees does not use social or other criteria and seeks only the most prudent investments in line with the Board’s asset allocation and risk tolerances. In addition, the VRS Defined Benefit Plan Investment Policy Statement includes the following: “The investment objective of the VRS defined benefit plan portfolio is to maximize return while managing risk within an acceptable range.” Further, VRS’ strict adherence to the prudent investor rule is statutorily required by Va. Code § 51.1-124.30(C), which provides as follows:

The Board shall discharge its duties with respect to the Retirement System solely in the interest of the beneficiaries thereof and shall invest the assets of the Retirement

System with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. The Board shall also diversify such investments so as to minimize the risk of large losses unless under the circumstances it is clearly prudent not to do so.

The lack of clarity and specificity in the bill language alone will cause substantial problems for VRS as it attempts to operationalize the bill's provisions. As introduced, the language of the bill will be exceedingly difficult at best, and likely impossible to implement due to ambiguities in the bill language and a lack of clarity of what will be required to comply with the bill's provisions. Further, the language could encompass a broad universe of publicly traded companies, private market assets and investment managers.

More important, though, is the precedent that the bill could set for future legislation further dictating or restricting VRS' ability to make investments. If passed, this legislation would be the first legislative control over the VRS Board of Trustees' ability to invest in nearly 30 years.

VRS' investment policy is based solidly on its fiduciary duty to act in the best interests of its members, retirees, and beneficiaries, and to maximize its investments' rate of return for a given risk level. To meet its fiduciary duty, VRS carefully analyzes economic factors and assesses pecuniary risk. This does not include reviewing investments through a "social screen," and does not consider information such as diversity, equity, and inclusion factors that do not relate directly to the alignment of the investment with the aims of the VRS Trust Fund. It should also be noted that VRS' longstanding approach to assessing risk has included governance, as governance is foundational to a VRS enumerated core tenet of balancing economic risk and reward. Any external constraints imposed on VRS' discretion to make investments, such as the ones in this bill, could impair VRS' fiduciary responsibility to act solely in the best interests of plan members and beneficiaries.

VRS' investment policy is a function of the Board's fiduciary duties as set forth in the Constitution of Virginia, the Code of Virginia, and federal law. Federal law, 26 U.S.C. § 401(a)(2), expressly provides that government retirement plans must be maintained "for the exclusive benefit" of the beneficiaries of the plans. Likewise, art. X, § 11 of the Virginia Constitution provides that the VRS Trust Fund "shall be invested and administered solely in the interests of the members and beneficiaries thereof." See also Va. Code § 51.1-124.30(C) ("The Board shall discharge its duties with respect to the Retirement System solely in the interest of the beneficiaries thereof[.]").

A blanket prohibition on the consideration of "social investment" criteria while investing may contradict the fiduciary requirements set out in the Constitution of Virginia, the Internal Revenue Code, and the Code of Virginia, as it may require VRS to forego certain investments or preclude VRS from utilizing certain financial companies that employ "social investment" criteria. Moreover, it could potentially result in a negative financial impact on the Trust Fund and VRS members, beneficiaries, retirees, and employers in the form of

increased unfunded liabilities and increased employer contributions resulting from lost investment opportunities and other investment losses.

As a practical matter, since VRS is an investor in both private and public markets, VRS could not invest in companies where VRS holds publicly traded individual stocks or bonds, and also not invest in entire private equity, real assets, credit strategies, and hedge funds (private market assets) that contain any such companies. Further, VRS does not have the ability to select among the individual holdings within externally managed private market assets. Mandating that VRS not make allocations to an investment that might implicate an ambiguous “social investment” criterion precludes VRS’ ability to participate with managers that might have any such exposure in their funds to such companies; thereby limiting VRS’ access to important strategies and many external managers.

Further, external constraints imposed on the types of investments allowed would erode VRS’ independence. VRS has been an independent agency outside of the other three branches of government since 1994. Prior to that point, VRS was in the executive branch. The decision to make VRS an independent agency stemmed from concerns about the ability of VRS to maintain its independence to act in the best interests of its members and beneficiaries as an executive branch agency. The history and reasoning underlying the decision to insulate VRS from the influence of the other branches of government can be seen in the 1994 report from the Joint Legislative Audit and Review Commission (JLARC). JLARC was tasked with reviewing how to assure VRS’ independence as a public trust and, based on JLARC’s recommendations, VRS became an independent agency and art. 10, § 11 was added to the Virginia Constitution. VRS’ governance structure contains best-in-class provisions.

Additionally, although the bills permit VRS to make a “social investment” if such “social investment” will provide a higher rate of return compared to other similar investments that are non-social investments, each investment opportunity requires careful consideration of numerous factors unique to the investment and it will be difficult to characterize investments as similar but for the consideration of social investment criteria. More importantly, the bill mandates that VRS must demonstrate that the “social investment” provides a higher rate of return. While all investments are evaluated prior to investing for their rate of return, such an evaluation is necessarily an approximation, and it is unclear that such an evaluation would satisfy the bill's requirement that VRS definitively demonstrate that a "social investment" provides a higher rate of return than a non-social investment.

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