

## **Actuarial Impact on Pension Funds due to Divestment of Certain Investments that are Associated with Terrorism or Social Atrocities**

In recent months, many states have proposed legislation that would require state sponsored pension funds to divest investments with holdings in certain countries, because these countries are either associated with terrorism or with social atrocities. These bills are often popular with legislators and their constituents – since divesting these assets seems to be well intentioned and the "politically correct" thing to do. However there is another side to this issue. Divesting these assets could result in the Boards of Trustees to be in violation of their fiduciary standards. In addition, there is considerable discussion as to whether or not these bills violate state constitutions, or even the U.S. Constitution. Finally, divestment may have a negative actuarial impact on the funding of retirement benefits. As a result of these issues, state and large municipal pension systems, and their advocates, generally oppose any legislation requiring divestment of certain assets.

### **The Case for Divestment**

Iran and Sudan are the two primary countries that the proposed legislation targets. The rationale behind the divestment bills is that legislators do not want any money that they believe is under their control to benefit countries that either encourage terrorism or permit atrocities against their own citizens. These proposed bills are often politically popular, owing in part to the fear of terrorism that is prevalent today and the widespread media coverage of current events in these countries.

The use of economic pressure to encourage social or political change has a long history. The lengthy American trade embargos against Cuba and Iran are prime examples. During the apartheid years, in addition to limited government sanctions, many investors, including several public pension funds in accordance with state legislation, removed their assets from South Africa. In addition, as the western nations attempt to deter Iran from developing nuclear technology, additional economic sanctions are the prime threat.

Another important argument in the case for divestment is the belief that divestment would not materially impact a system's investment performance. American firms are already prohibited from operating in Sudan and trade between American firms and Iran is currently subject to many restrictions. In a parallel situation, many union sponsored pension plan have long had policies restricting their investments to exclude companies that have adopted anti-union practices. This practice is generally considered acceptable provided their investment professionals are able to reasonably conclude that the policy does not result in impaired asset performance.

## The Case against Divestment

The arguments against divestment take several forms. The most basic argument against divestment is that a state legislature has no business adopting a policy towards a foreign nation. The conduct of foreign relations is generally considered to be the responsibility of the United States Congress and the President. Many opposed to divestment believe that state legislators are both overstepping their responsibilities, and their expertise, when they propose legislation designed to influence events that are not just outside of their state, but also on the other side of the globe.

An additional argument against divestment is the belief that economic penalties are not effective. There is considerable debate as to whether or not punishing a country financially helps to encourage reform. It does not appear that the situations in either Cuba or Iran have improved significantly due to many years of international economic sanctions. While the disinvestment from South Africa certainly hurt its economy, there is no consensus as to the role that it played in the downfall of apartheid. As a detailed analysis of the role that economic pressure plays in political change is outside the scope of this article, the preceding discussion is only intended to illustrate the fact that the social benefits of divestment are unclear.

The third argument against divestment is that pension plans exist to provide retirement income to pension plan members, and not as vehicles for social policy. Consistent with this view, the trustees of a pension plan are prohibited from using the assets for any purpose that is not for the exclusive benefit of plan participants. This is part of the broader fiduciary responsibilities that trustees have to their membership. Pension assets are held in a trust, belong solely to the participants, and are not the assets of the state. Diverting assets away from providing retirement income and onto a political agenda is a risky move with potentially dangerous consequences.

The final argument against divestment is the potential that it will cause the pension fund to realize reduced investment earnings. If each pension system currently holds an investment portfolio that it believes provides the highest possible expected return for their level of risk tolerance, then it follows that any material change to the investments that does not increase risk will lower the expected earnings. Large pension funds typically invest a large portion of their assets in the equity markets, which would be impacted by a divestment bill. In particular, it is no longer unusual for pension systems to invest up to 25% of its assets in international securities, which would likely be most impacted by a divestment bill. Also, systems that invest heavily in index funds may need to alter their strategies, since many large indices will contain at least one prohibited company. Lastly, some divestment bills place a significant burden on systems to determine which investments are permissible. As this determination may be beyond the capacity or expertise of the system's investment staff, they will need to incur expenses through additional consulting or investment management fees to ensure compliance.

**Potential Cost**

The cost associated with a divestment bill is based upon the amount of lost investment earnings due to the divestment. Each system's investment staff and consultants will need to estimate this amount based on the factors discussed above. While the variety of provisions in the proposed divestment bills and diversity of assets held by various retirement systems make developing a rule of thumb nearly impossible, estimates of lost investment earnings range from no impact to approximately 30 basis points.

The best way to understand the potential cost is to look at an example. The state of Ohio has four statewide pension systems, with combined assets of nearly \$170 billion as of the end of their 2006 fiscal years. Using an estimate of 15 basis points of lost investment return and additional investment expense, the Ohio pension systems would lose over \$250 million of investment return annually. If the investment restrictions remain in place for ten years, the total cost of the divestment bill could exceed \$3 billion. Assuming these losses are funded using 10-year level percent of payroll amortization beginning with the passage of the bill, the annual cost would represent approximately 1% of total payroll.

The following table illustrates the sensitivity of the costs to the amount of lost investment earnings:

<u>Lost Investment Earnings</u>	<u>Estimated Total Cost over 10 Years</u>	<u>Estimated Cost as a Percentage of Payroll</u>
5 Basis Points	\$1 Billion	0.3%
15 Basis Points	\$3 Billion	1.0%
30 Basis Points	\$6 Billion	2.0%

Who will bear this cost? State pension systems typically receive their funding from three sources:

- State contributions
- Local municipality contributions
- Member contributions

State contributions and local municipality contributions are primarily taxpayer dollars, with state contributions coming mostly from income taxes and local municipality contributions coming mostly from property taxes. Members typically pay their contributions through payroll deductions. The distribution of the contributions between these sources varies significantly depending on the system.

## Summary

The decision of whether or not it is appropriate to force state pension funds to divest their assets from Iran or Sudan comes down to two questions. The first asks if it is the proper thing to do, the second asks what it costs. While the preceding discussion outlines some of the major issues in the question of propriety, ultimately it is a question that should be answered by all constituents, not just the politicians. As for the cost, a great deal rides on the analysis of the investment professionals. Some will claim that they can comply with a divestiture bill without sacrificing any return, while others will anticipate a measurable drop in earnings. As shown in the Ohio example, even a fairly minimal drop in return can generate significant costs owing to the great size of the state retirement systems. What matters most is that the legislators, taxpayers, and members understand both the potential costs, and who will bear those costs, before any legislation passes.

### Author Contact Information:

Kim Nicholl  
PricewaterhouseCoopers  
312-298-2134  
Kim.Nicholl@us.pwc.com

Josh Shapiro  
PricewaterhouseCoopers  
312-298-2580  
Joshua.A.Shapiro@us.pwc.com