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Red state dilemma: Banning ESG could cost billions

Three analyses of state-level efforts to purge environmental, social and governance investing in Kansas, Indiana and Texas found that the plans or proposals would cost pensioners billions of dollars over the next decade.

BY: **AVERY ELLFELDT** | 03/17/2023 06:36 AM EDT

People walk by the New York Stock Exchange in New York City at the start of the trading day on June 3, 2022.| Spencer Platt/Getty Images

CLIMATEWIRE | There's growing evidence that Republican efforts to eradicate ESG investing in the name of profit and "anti-wokeness" will bruise — not benefit — retirees across the country.

Three analyses of state-level efforts to purge ESG investing in Kansas, Indiana and Texas found that the plans or proposals would cost pensioners billions of dollars over the next decade.

In at least one case — Indiana — the warning from state financial officials prompted lawmakers to revise their legislation to reduce the fiscal impact of targeting money managers that consider environmental, social and governance, or ESG, issues when making investment decisions.

Taken together, the three findings fly in the face of the anti-ESG movement, which is rooted in the idea that financial firms that incorporate ESG do so to the detriment of their own clients. It also suggests that the practice of considering factors such as climate impacts or board diversity when investing has become so commonplace that avoiding the acronym altogether is a complicated and ultimately losing game.

"Any constraints you put on how public funds can be invested has the potential to lower returns. And in particular, I think [with] these constraints, we're seeing lots of evidence it is likely they will lead to lower returns," said Daniel Garrett, an assistant professor of finance at the University of Pennsylvania's Wharton School.

"There's a learning process about the nature of risk and return, and people are trying to be more and more forward looking about the way they think about risk and return," Garrett added. "Trying to change that behavior is … going to be costly."

Kansas is the most recent example. Republican lawmakers there have introduced legislation that would prohibit any state entity from giving preferential treatment to — or discriminating against — finance firms based on ESG factors. The legislation also says that for plan managers to fulfill their "fiduciary duty," they may not be associated with ESG in any way.

The Kansas Public Employees Retirement System looked at the legislation and published an analysis about its likely impacts last week. The pension system found that the bill as currently written would apply to every single one of its current investment managers — and would require the system's board of trustees to terminate those contracts and restructure the pension's portfolio.

Doing so would come at a cost to retirees, KPERS found. Divesting from existing investment managers would spur up to $1.14 billion in losses due to the early sale of assets and could drive down investment returns. Over the next decade, that could mean the public pension would earn a whopping $3.6 billion less than it would if the legislation is never passed.

All told, KPERS said the bill's required divestment combined with reduced future returns "could negate 10 years of funding progress made by the state."

"I respectfully request that the committee not recommend H.B. 2436 as it was introduced and would stand for questions at the appropriate time," Alan Conroy, KPERS executive director, said in testimony last week before the state's House Financial Institutions and Pensions Committee.

KPERS communication officer Kristen Basso said in an email that KPERS has worked with the state treasurer and legislators on possible amendments to the legislation.

Kansas isn't the only state that's been confronted with the likelihood that its efforts to fight ESG investing could backfire on the same retirees it says it is trying to protect.

Lawmakers in Indiana introduced a similar bill that seeks to block the state's public pension retirement system and the Indiana State Police Pension Trust — as well as the financial managers they rely on — from considering ESG factors. As is the case in Kansas, the bill would require those funds to terminate all business relationships with investment managers that violate those terms.

The state's Office of Fiscal and Management Analysis put out a fiscal impact statement in early February and put a price tag on the legislation: $6.7 billion in losses over the next 10 years for the Indiana Public Retirement System.

Lawmakers appear to have heard that number loud and clear. Later the same month, a new version of the bill — with a much smaller estimated fiscal impact of $5.5 million — cleared a key financial panel in the Indiana Legislature.

Bill author Rep. Ethan Manning (R) made that happen by introducing an amendment that quelled concerns by the Indiana Public Retirement System and said the legislation only would apply to what investment managers do "on behalf of assets managed for the public pension system," among other changes, the *Indiana Capital Chronicle* reportedin February. That change means that as long as a manager doesn't considering ESG issues while managing pension system dollars, the pension system does not need to terminate the relationship. The amendment also exempted private equity investment managers from key provisions.

Texas has enacted a similar law. But when Garrett and a researcher at the Federal Reserve Bank of Chicago zeroed in on the law's impact on the state's municipal bond market, versus public pensions, they found the law prompted JPMorgan Chase & Co., Goldman Sachs Group Inc., Citigroup Inc., Bank of America Corp. and Fidelity Investments — five of the state's largest underwriters — to exit the market.

Those firms' exits in turn drove down competition for borrowing and increased interest rates — costing taxpayers an additional $302 million to $532 million in interest over eight months.

Put simply, Garrett said, "if you want someone to make an investment that's not return maximizing, that's going to be costly."

"Investors and financial institutions value their policies on how they engage with environmental, social and governance-related risks, and so they're willing sometimes to put their money where their mouth is," he added. "And when they do that, of course, the states that are trying to change the behavior of the investors and financial institutions incur costs."

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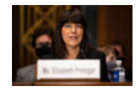

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Kate Murphy

Senior Manager, Business Development, Pro

katelmurphy@politico.com