LEGISLATIVE BUDGET BOARD
Austin, Texas

FISCAL NOTE, 80TH LEGISLATIVE REGULAR SESSION

March 12, 2007

TO: Honorable Rodney Ellis, Chair, Senate Committee on Government Organization

FROM: John S. O'Brien, Director, Legislative Budget Board

IN RE: **SB247** by Ellis (Relating to prohibiting the investment of state funds in certain private business entities doing business in Sudan.), **As Introduced**

Estimated Two-year Net Impact to General Revenue Related Funds for SB247, As Introduced: an impact of $0 through the biennium ending August 31, 2009.

The bill would make no appropriation but could provide the legal basis for an appropriation of funds to implement the provisions of the bill.

General Revenue-Related Funds, Five-Year Impact:

Fiscal Year	Probable Net Positive/(Negative) Impact to General Revenue Related Funds
2008	$0
2009	$0
2010	$0
2011	$0
2012	$0

All Funds, Five-Year Impact:

Fiscal Year	Probable Revenue Gain/ (Loss) from *S.E.R.S. Trust Account* 955	Probable Revenue Gain/ (Loss) from *TRS TRUST ACCOUNT FUND* 960	Probable Revenue Gain/ (Loss) from *Other Funds (Local)*
2008	($12,402,334)	($51,100,000)	($150,000)
2009	($1,239,419)	($4,027,000)	($150,000)
2010	($1,267,715)	($4,338,100)	($150,000)
2011	($1,299,548)	($4,664,500)	($150,000)
2012	($1,331,382)	($5,393,800)	($150,000)

Fiscal Year	Change in Number of State Employees from FY 2007
2008	5.0
2009	5.0
2010	5.0
2011	5.0
2012	5.0

Fiscal Analysis

The bill would add a new chapter to Subtitle F, Title 10 of the Government Code to prohibit state funds from being invested, or remaining invested, in publicly traded securities of certain companies that engage in business operation in the country of Sudan.

The bill would require the Employees Retirement System of Texas (ERS) to compile, maintain, and update a list of "scrutinized companies" that engage in business activities in Sudan. Each state entity that has investments would have to identify any scrutinized companies in which the state governmental entity owns direct or indirect holdings. Depending on the type of business operations a scrutinized company was engaged in, the state entity would have to send written notice to the scrutinized company encouraging or warning that company to refrain from business activities in Sudan. If, after a specified timetable, the company continued to have scrutinized active operations in Sudan, the state agency would have to divest its assets of the scrutinized company.

Annually, each state agency would have to file a public report summarizing its compliance with the provisions of the new chapter. The new chapter would expire if the U.S. government declared that the Darfur genocide had been halted for at least 12 months, if the U.S. government declared that mandatory divestment of the type provided for in the chapter interfered with the conduct of U.S. foreign policy, or if the U.S. revoked its sanctions against the government of Sudan.

Methodology

The affected entities' flexibility in choosing investments—and their ability to diversify and reduce risk—could be reduced.

For the Employees Retirement System, an estimated loss of $23 million in 2008, with incremental losses each year, are calculated based on the percentage of the maximum loss reported by the Employees Retirement System. According to ERS, the maximum potential loss from divestment in FY 2008 could be 50 basis points of $23 billion or $115 million. This assumes that the full loss would be realized in FY 2008. It is also possible that the full amount of the loss might not be realized until subsequent years. There would be additional incremental losses from divestment each year as the value of ERS’ assets under management increase and the maximum divestment amount also increases. The projected ongoing loss has been calculated using the actuarially assumed rate of return of 8 percent, less deductions for retirement benefits and agency administrative expenses.

Currently, ERS does not have a staffing unit that performs the functions required by the bill. ERS estimates that two additional FTEs would be necessary to research all publicly tradable companies worldwide, create and maintain the list of scrutinized companies, and report periodically on those companies according to the provisions of the bill.

Two additional FTEs would be necessary to engage scrutinized companies and fund managers in an effort to persuade the companies to either cease their scrutinized business operations or convert such operations to inactive business operations in order to avoid qualifying for divestment by the state. Costs to defend ERS, its board and staff for any action that could be brought as a result of compliance with the statute, such as payment of judgments, attorneys’ fees and legal costs, are not included in the above cost estimates.

The Teacher Retirement System has conducted a review of its holdings as of December 31, 2006 and determined that actual losses would be estimated at about $51 million per year, based on a comparison of the performance of Sudan-related holdings as compared with the International Equity Index. Implementing the provisions of the bill would require the addition of one FTE at TRS at an annual cost of $100,000 paid out of the TRS Trust Account Fund to monitor business activities of “scrutinized companies,” to maintain the list of holding in such companies, to communicate with these companies, and to prepare the annual report required by the bill. According to the Teacher Retirement System (TRS), the maximum potential loss for divestment in fiscal year 2008 associated with the 50 basis point limit would be about $500 million. Estimated losses above reflect the estimated maximum potential losses under the provisions of the bill and ongoing losses based on an 8 percent annual return on investment assumption, less investment costs.

The University of Texas (UT) System reports the increased administrative costs to be at least $150,000 per year. To arrive at the annual estimated cost of $150,000, the UT System estimated that the annual hours of involvement and the average billing rates for each level of personnel that would be impacted by the administration of this process. Additionally, estimates for cost of printing, mailing and other general expenses would be required to comply with the legislation.

The UT System is uncertain of the fiscal impact of opportunity costs. Dollar costs from early liquidations, losses from declines in value in funds that hold investments in scrutinized organizations before liquidation is possible, and lost investment opportunities in general as a result of this initiative.

Note: The prohibition against the investment in publicly traded securities of companies doing business in Sudan could be difficult to implement because some of the affected entities have the authority to purchase mutual funds. An investor in a mutual fund may not know what companies are in the fund's investments from day to day.
The affected entities' flexibility in choosing investments—and their ability to diversify and reduce risk—could be reduced.

An estimated loss of $51 million in 2008, with incremental losses each year, are calculated based on the percentage of the maximum loss reported by the Employees Retirement System. According to ERS, the maximum potential loss from divestment in FY 2008 could be 50 basis points of $23 billion or $115 million. This assumes that the full loss would be realized in FY 2008. It is also possible that the full amount of the loss might not be realized until subsequent years. There would be additional incremental losses from divestment each year as the value of ERS' assets under management increase and the maximum divestment amount also increases. The projected ongoing loss has been calculated using the actuarially assumed rate of return of 8 percent, less deductions for retirement benefits and agency administrative expenses.

Currently, ERS does not have a staffing unit that performs the functions required by the bill. ERS estimates that two additional FTEs would be necessary to research all publicly tradable companies worldwide, create and maintain the list of scrutinized companies, and report periodically on those companies according to the provisions of the bill.

Two additional FTEs would be necessary to engage scrutinized companies and fund managers in an effort to persuade the companies to either cease their scrutinized business operations or convert such operations to inactive business operations in order to avoid qualifying for divestment by the state. Costs to defend ERS, its board and staff for any action that could be brought as a result of compliance with the statute, such as payment of judgments, attorneys' fees and legal costs, are not included in the above cost estimates.

The Teacher Retirement System has conducted a review of its holdings as of December 31, 2006 and determined that actual losses would be estimated at about $51 million per year, based on a comparison of the performance of Sudan-related holdings as compared with the International Equity Index. Implementing the provisions of the bill would require the addition of one FTE at TRS at an annual cost of $100,000 paid out of the TRS Trust Account Fund to monitor business activities of "scrutinized companies," to maintain the list of holding in such companies, to communicate with these companies, and to prepare the annual report required by the bill. According to the Teacher Retirement System (TRS), the maximum potential loss for divestment in fiscal year 2008 associated with the 50 basis point limit would be about $500 million. Estimated losses above reflect the estimated maximum potential losses under the provisions of the bill and ongoing losses based on an 8 percent annual return on investment assumption, less investment costs.

The University of Texas (UT) System reports the increased administrative costs to be at least $150,000 per year. To arrive at the annual estimated cost of $150,000, the UT System estimated that the annual hours of involvement and the average billing rates for each level of personnel that would be impacted by the administration of this process. Additionally, estimates for cost of printing, mailing and other general expenses would be required to comply with the legislation.

The UT System is uncertain of the fiscal impact of opportunity costs. Dollar costs from early liquidations, losses from declines in value in funds that hold investments in scrutinized organizations before liquidation is possible, and lost investment opportunities in general as a result of this initiative.

Note: The prohibition against the investment in publicly traded securities of companies doing business in Sudan could be difficult to implement because some of the affected entities have the authority to purchase mutual funds. An investor in a mutual fund may not know what companies are in the fund's investments from day to day.

Local Government Impact

No fiscal implication to units of local government is anticipated.

Source Agencies: 304 Comptroller of Public Accounts, 323 Teacher Retirement System, 327 Employees Retirement System, 720 The University of Texas System Administration

LBB Staff: JOB, MN, SD, JW, JSc, SJS