Wisconsin Department of Administration
Division of Executive Budget and Finance

Fiscal Estimate - 2007 Session

☒ Original ☐ Updated ☐ Corrected ☐ Supplemental

LRB Number **07-0823/1**	Introduction Number **AB-0124**

Description
Prohibiting the Investment Board from making certain investments relating to Sudan

Fiscal Effect

State:
☐ No State Fiscal Effect
☒ Indeterminate
☐ Increase Existing Appropriations
☐ Decrease Existing Appropriations
☐ Create New Appropriations
☐ Increase Existing Revenues
☐ Decrease Existing Revenues
☒ Increase Costs - May be possible to absorb within agency's budget ☐ Yes ☒ No
☐ Decrease Costs

Local:
☐ No Local Government Costs
☒ Indeterminate
1. ☒ Increase Costs ☐ Permissive ☒ Mandatory
2. ☐ Decrease Costs ☐ Permissive ☐ Mandatory
3. ☐ Increase Revenue ☐ Permissive ☐ Mandatory
4. ☐ Decrease Revenue ☐ Permissive ☐ Mandatory
5. Types of Local Government Units Affected
☒ Towns ☒ Village ☒ Cities
☒ Counties ☐ Others
☒ School Districts ☒ WTCS Districts

Fund Sources Affected
☐ GPR ☐ FED ☒ PRO ☐ PRS ☐ SEG ☐ SEGS

Affected Ch. 20 Appropriations
20.536

Agency/Prepared By	**Authorized Signature**	**Date**
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Fiscal Estimate Narratives

INV 3/9/2007

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Assumptions Used in Arriving at Fiscal Estimate

Sudan Divestment
Potential Fiscal Effects of Assembly Bill 124

The State of Wisconsin Investment Board (SWIB) currently manages over $90 billion of trust fund assets. The Wisconsin Retirement System (WRS) trust funds account for nearly 94% of the total. The WRS is a trust created to pay benefits to retired or disabled public employees and their beneficiaries. SWIB also invests six other trust funds, including the cash management fund for the state and local governments. SWIB has investments in thousands of companies domiciled in the US and throughout the world, including bonds issued by many governmental entities. International investments are in both developed and emerging market countries. SWIB makes direct investments in its name and makes other investments in commingled passive index funds and actively managed funds. For purposes of this fiscal estimate, these are referred to as "indirect investments" as SWIB is an investor in the fund, and the underlying investments are owned by the fund, not SWIB. The bulk of the assets are invested in publicly issued securities, but approximately 9% are in private market investments that include real estate, private equity and private debt.

With limited exceptions, Assembly Bill 124 would require SWIB to divest any holdings it has in companies with business operations in Sudan that include military equipment, mineral extraction activities, oil-related activities and power production activities. The definitions for these activities include providing supplies or services in support of any related project or activity. The bill refers to these companies as "scrutinized" companies.

Under the provisions of the bill, the trust funds managed by SWIB could incur losses of approximately $440 million (0.5% of the value of assets at the end of 2006) before the bill's divestment provisions would be suspended. Our analysis indicates that the bill could result in a loss of this magnitude in just the first two to three years after enactment due to the ongoing potential effect of reduced investment returns and increased costs required to manage screened portfolios. This projected loss significantly exceeds the actual value of SWIB's current investments with companies that have some operations in Sudan.

To prepare this estimate, SWIB relied, in part, on estimates and information from the largest investment firm that currently manages assets for SWIB. While this firm manages "Sudan-free" portfolios, its experience and that of other managers with Sudan-free portfolios is limited. In addition, the Sudan-free portfolios they currently manage were created using different criteria than those included in AB 124.

If AB 124 is enacted into law, SWIB will be required to perform the following tasks and incur at least the following estimated expenses. Those costs will in turn affect the net returns for the funds that SWIB manages, which will ultimately affect the fund participants and taxpayers.

Screen and Monitor Companies

• The bill requires that the board shall make its best effort to identify all scrutinized companies in which the board has direct or indirect holdings or may foresee having any holdings in the future. The bill establishes a number of specific humanitarian, financial, geographic and business segment criteria that SWIB must use to identify companies that may have business operations in Sudan and thus subject to divestment.

• The Sudan Divestment Task Force, a group supporting divestment, developed a list of approximately 40 companies that it asserts currently meet the definition of "scrutinized company" in which investment would be prohibited under the bill. For purposes of this estimate, SWIB used those companies to determine current holdings that may be subject to divestment if the bill is enacted. Holdings that SWIB has in companies that may have sold supplies or services to any of the scrutinized companies or to companies that may be owned by or affiliated with the scrutinized companies are not included in this estimate. Because of the costs and time involved, SWIB did not analyze all holdings to determine if other companies might fall under the definition of "scrutinized". However, if AB 124 is enacted, SWIB would have to screen and monitor thousands of current and potential investments on an ongoing basis to determine if: (1) they have active or inactive business ties to Sudan or any "scrutinized" company, and (2) whether investment in any of the companies would be prohibited under the bill.

• SWIB currently obtains information from a variety of sources to evaluate the risk associated with any investment. In addition, it reviews available data and monitors a company's business ties to any country that is subject to federal sanctions, including Sudan. However, the level of detail required to comply with AB 124 is not available through usual research sources, nor is it provided by companies in their standard financial reports. For example, the bill requires SWIB to obtain reliable information to determine what portion of a power company's production serves particular groups in particular regions of Sudan.

• SWIB does not have the internal resources necessary to conduct this ongoing level of review and would need to hire an independent, non-partisan research firm. According to a research firm that currently does Sudan investment screening for the State of Illinois and for SWIB's largest investment manager, the information the research firm currently provides does not meet the level of detail required by AB 124. Any firm hired for this assignment would have to expand its current information gathering and evaluation processes to attempt to implement the screens that the bill would require. However, assuming a research firm is able to obtain verifiable information at the required level of detail, the cost for the service would be at least $50,000 annually. If neither a research firm nor SWIB staff is able to secure the information on a timely basis, it could result in lost investment opportunities, which in turn would affect investment returns.

• Once the initial screening is completed, the bill requires ongoing screening and monitoring and would increase the tracking and reporting that SWIB currently does. In turn, this would increase staff workload.

Investment Returns and Contribution Rates

• Under the bill, SWIB could incur investment losses of up to 0.5% of the total value of all assets under management before divestment could cease. As of December 31, 2006, the total value of assets under management was $88.4 billion. Therefore, if the bill had been in effect on that date, the trust funds managed by SWIB could have incurred losses of over $440 million before the bill's investment prohibitions would have been suspended. The loss threshold will increase as total assets grow.

• Reduced investment returns for the WRS would have several effects. The statutes require that contributions be paid to the WRS by public employers and employees. Over the years, public employers have negotiated with public employees and currently pay with tax dollars nearly all employee required contributions. Once the contributions are received by the WRS, however, they are no longer tax dollars but are held in trust for the benefit of public employees. The WRS actuary estimates that each $100 million reduction in earnings equates to a 0.1% increase in contribution rates. Using the combined WRS payroll of $11.3 billion for 2005 and an assumed loss of just under $440 million based on assets under management at year end 2006, this would have resulted in an additional $45.2 million to be paid by public employers and employees to the WRS in 2007. The actuary further estimates that this would reduce dividends to retirees by approximately 0.4%.

• Retirees share in the investment earnings by receiving a post-retirement dividend that is based on earnings that exceed an assumed 5% return needed to fund the base annuity for the retiree's life. The actuary estimated that a $400 million loss in 2006 would have reduced the Core Fund dividend by about 0.3%. However, because gains and losses in the Core Fund are smoothed over five years, only 20% of the loss would have been recognized immediately. By the time the entire $400 million flowed through the smoothing calculation, cumulative dividend reductions would have been over 1%. Because dividends are built on the base, that means a 1% reduction in a monthly annuity for the retiree's lifetime.

• Based on currently available information, it is not possible to predict with certainty the companies in which SWIB would be prohibited from investing. The bill is primarily aimed at a group of foreign oil and power companies identified by the Sudan Divestment Task Force. As of December 31, 2006, SWIB had direct and indirect investments of approximately $110 million in those companies. WRS trust funds held all of the investments except approximately $500,000, which was held by the Injured Patients and Family Compensation Fund. However, to determine all holdings that might be subject to AB 124, SWIB would need to screen its entire portfolio.

• Passive index funds are subject to the divestment requirements, but the bill includes language that exempts SWIB's holdings in actively managed commingled funds with certain conditions. This includes commingled enhanced index funds that are considered to be actively managed. Using the list of "scrutinized" companies identified by supporters of the bill, approximately $27 million of the $110 million identified above would be excluded from divestment. However, if the commingled fund contains investments in any "scrutinized" companies, the bill requires SWIB to move its investment from the commingled fund that contains the "scrutinized" companies to a similar fund that excludes those companies if the manager creates such a fund. The companies included in a commingled fund change frequently as companies move in and out of the market index against which the commingled fund is measured. Because SWIB is only one of many investors in the commingled fund, the fund manager is unlikely to sell off companies that may have business operations in Sudan just to comply with Wisconsin law. Instead, the external manager would likely create new funds to meet SWIB's needs, and then charge an additional management fee plus transaction costs for moving the assets. In essence, that means SWIB would be required to move all public equity and fixed income investments in actively managed commingled funds and passive index funds to newly created funds that meet the bill's requirements. At year end, SWIB had $21.9 billion in enhanced actively managed commingled funds and $17.1 billion in passive index funds for its public equities.

• An external manager, currently employed by SWIB, estimated the transaction cost to liquidate emerging market investments would be 1.0% to 1.5% of the securities' value. Liquidating just SWIB's investments valued at $110 million in the companies considered to be "scrutinized", which are primarily in emerging markets, would cost $1.1 million to $1.6 million. SWIB would incur a similar cost if the divestment process is suspended and SWIB reinvested in those companies.

• Based on the experience of SWIB's largest external manager, excluding companies targeted by the bill could reduce emerging market investment returns by approximately 1% annually. Estimates of potential reduced returns were also provided for developed global and domestic portfolios. Using SWIB's holdings in externally managed domestic and international equity portfolios as of December 31, 2006 as a base, this would reduce annual returns for the trust funds by $21.3 million, $88.2 million and $54.7 million for emerging market, developed global international and domestic portfolios, respectively.

• After its effective date, the bill prohibits SWIB from making virtually any investment in a scrutinized company. This would include investing in any index fund that does not have a Sudan restriction and any dedicated, actively managed portfolio without a Sudan restriction. It would also preclude investment in commingled funds of publicly traded securities as well as any private equity fund that does not have a Sudan restriction if the managers of such funds offer a similar Sudan restricted fund. This would limit SWIB's opportunity to select fund managers who best meet return and risk objectives and increase management fees.

• The bill's restrictions would be particularly problematic for private market investments, which include private equity and real estate. SWIB's investments in these asset classes have outperformed the public markets in the last few years and were instrumental in increasing the total returns for the WRS and thus reducing contributions paid by taxpayers. The best funds are oversubscribed, and most managers refuse money from investors that have country limitations or extra reporting requirements. SWIB routinely makes about 14 to 18 private equity fund commitments totaling $1.25 billion–$1.5 billion and 14 to 18 real estate commitments totaling $1.1 billion–$1.25 billion a year. Any restriction that would make this process more difficult or would exclude funds from SWIB's investment universe would adversely impact SWIB's ability to meet the funding expectations of the trust funds it invests.

• In addition to the WRS, the smaller funds that SWIB invests would also be subject to the bill. With the exception of the Injured Patients and Family Compensation Fund (IPFCF), those funds are invested exclusively in fixed income instruments that consist of government and U.S corporate bonds. However, the corporate bonds would be subject to screening to assure they are not issued by a company that is either scrutinized or provides supplies or services to a scrutinized company. The IPFCF is invested in some of the same actively managed or passive commingled funds in which WRS funds are invested and will be subject to the same management fees and reduced returns as the WRS. Any additional costs to the portfolio could translate into higher premiums paid by the participating medical providers.

Management Fees

• The bill would require SWIB to move its passive index fund investments to funds that comply with the Sudan restrictions. As of December 31, 2006, SWIB had $17.1 billion invested in passive equity index funds that would be subject to the Sudan restriction. To comply with the bill, SWIB would need to negotiate with the current manager or other managers to create one or more index funds that meet the bill's restrictions. The current manager estimates that the cost to manage an index fund that complies with this bill would increase management fees that SWIB pays by 20% to 25%. This equates to an additional $652,000 to $815,000 per year based on fees paid during 2006 just for the equity funds.

• The bill requires SWIB to make a written request to existing external managers of actively managed commingled investment funds asking the managers to exclude investments in certain companies from the fund. If the managers refuse, SWIB would be required to ask the external managers to create a similar actively managed commingled fund that excludes the scrutinized companies. If the manager creates such a fund, the bill requires that SWIB replace all applicable investments in the similar fund in an expedited time frame consistent with prudent investment standards. SWIB discussed the potential of developing "similar actively managed commingled funds" with the firm that manages a number of commingled enhanced funds for SWIB. For this service, this manager estimates an increase in management fees of 20% to 25% (similar to the index funds). However, for these funds, this cost is more significant as the fees paid for these funds are based on performance and are considerably higher than fees for a passive index fund. For just the enhanced funds managed by this manager in which SWIB is invested, the estimate for the fee increase is $8.3 to $10.4 million per year. Applying that estimate to all actively managed commingled equity funds in which SWIB was invested at the end of 2006, the fee increase would be $12.0 million to $15.0 million.

• If the newly created passive index or actively managed quantitative index funds are created only for SWIB, those investments could no longer be considered to be in commingled funds. They would, therefore, be subject to the current 20% statutory limit that applies to assets being actively managed by external managers. This will create an untenable situation, particularly in the international developed and emerging markets, as SWIB would not be able to hire sufficient investment professionals with the expertise to manage assets internally in order to comply with the 20% limit, even if authorized the positions needed.

Potential Litigation and State Costs to Reimburse Trust Funds for Losses

• By statute, SWIB has a fiduciary duty to ensure that the funds and trusts under its management are invested solely for the purposes for which the trusts were established. Fiduciaries, including the trustees, are subject to personal liability for breach of that fiduciary duty if they implement a law that is subsequently determined to be unconstitutional. If the trustees are sued for breach of their fiduciary duty the attorney general would be required to defend or to secure outside counsel to defend the trustees. It is impossible to estimate the defense costs or the costs for damages if the trustees are found to have violated their fiduciary duty.

• In several cases spanning more than 40 years, the Wisconsin Supreme Court has found that legislation that result in the use of pension funds of public employees for non-trust purposes constituted an unconstitutional taking of private property for a public purpose. On that basis, if investing and divesting in accordance with the bill results in losses to the WRS and is found to be an unjust taking, the state would be required to make the trust fund whole for any losses, including lost investment earnings. It is impossible to speculate what the state might have to reimburse the funds, but the total amount the state would owe when the case is finally resolved would likely be in excess of the original loss. For example, a 1997 decision in Wisconsin Retired Teachers Association v. Employee Trust Funds Board ordered the state to repay the trusts $216 million from GPR in a case that involved an original $80 million taking from the trust funds.

Additional Staff and Resources

In addition to the above costs, SWIB would need to create the following positions to carry out the requirements of the bill:

• Corporate relations position (1 FTE) – to review all data received about companies from the firm that will provide initial screening; communicate with screened companies; negotiate with and monitor external managers; serve as liaison with investment staff, trustees, companies; interested parties; and other public pension funds; prepare required reports.

• Quantitative analyst (1 FTE) – to research, analyze and maintain records for all investments and funds to determine financial effect of divestment requirements on funds and effect of 0.5% loss limit.

• Legal services to negotiate and produce new contracts with all external managers. Estimate 600 hours at $350 per hour.

Note: The following worksheet on costs does not include potential increases in contribution rates paid by public employers and employees as the result of reduced earnings or the legal costs associated with any suit to recoup the lost earnings as a result of using trust fund assets for non-trust purposes. It also does not include all potential reduced earnings because of lost investment opportunities in fixed income and private market investments as the estimate only includes investments in equities. Neither the bill nor the estimate address another issue, namely the possible over-concentration of assets with vendors that offer Sudan-free products and the effect that may have on the SWIB's fiduciary responsibility to be a prudent investor.

Long-Range Fiscal Implications

Ongoing

Potential Costs Related to Sudan Divestment (SB 57 & AB 124)

Only the staff related costs apply to SWIB's program revenue operating budget under s. 20.536. The remainder of the investment and legal related expenses would be charged directly

				Annual
Staff				
1 FTE Corporate Relations				
Compensation				70,000
Fringe Benefits				21,000
1 FTE Quantitative Analyst				
Compensation				65,000
Fringe Benefits				19,500
				175,500
	One-Time			**Annual**
Screening and Monitoring Expenses				$50,000 **
Investment Returns				
a. Transaction costs to exit holdings (100 to 150 bp)*				
Dedicated	611,800		917,700	
Commingled	264,400		396,600	
Passive	219,300		329,000	
	1,095,500	to	1,643,300	
b. Reduced Returns				
(1) Emerging Markets (100 bp reduction)				
Dedicated				5,840,000
Commingled				12,210,000
Passive				3,300,000
				21,350,000
(2) Developed International (50 bp reduction)				
Dedicated				34,880,000
Commingled				29,475,000
Passive				23,880,000
				88,235,000
(3) Domestic (15 to 23 bp reduction)				
Dedicated				2,838,200
Commingled				24,399,900
Passive				27,475,800
				54,713,900
Management Fees (20 to 25 bp increase)				
Passive				651,700
Active/Enhanced				8,315,000
				8,966,700
Legal Counsel				
1,000 at $350 per hour	350,000		$350,000	
TOTAL	$1,445,500	to	$1,993,300	$173,315,600

Wisconsin Department of Administration
Division of Executive Budget and Finance

Fiscal Estimate Worksheet - 2007 Session

Detailed Estimate of Annual Fiscal Effect

☒ Original ☐ Updated ☐ Corrected ☐ Supplemental

LRB Number	**07-0823/1**	Introduction Number	**AB-0124**

Description
Prohibiting the Investment Board from making certain investments relating to Sudan

I. One-time Costs or Revenue Impacts for State and/or Local Government (do not include in annualized fiscal effect):

Transferring billions of dollars of investments from current funds to newly created funds that exclude certain companies with business transactions in Sudan and legal fees to renegotiate contracts with external managers -- $1,445,500 to $1,993,300.

II. Annualized Costs:	**Annualized Fiscal Impact on funds from:**	
	Increased Costs	Decreased Costs
A. State Costs by Category		
State Operations - Salaries and Fringes	$175,500	$
(FTE Position Changes)	(2.0 FTE)	
State Operations - Other Costs		
Local Assistance		
Aids to Individuals or Organizations		
TOTAL State Costs by Category	**$175,500**	**$**
B. State Costs by Source of Funds		
GPR		
FED		
PRO/PRS (175500)	175,500	
SEG/SEG-S		

III. State Revenues - Complete this only when proposal will increase or decrease state revenues (e.g., tax increase, decrease in license fee, ets.)		
	Increased Rev	Decreased Rev
GPR Taxes	$	$
GPR Earned		
FED		
PRO/PRS		
SEG/SEG-S (173315600)		-173,315,600
TOTAL State Revenues	**$**	**$-173,315,600**

NET ANNUALIZED FISCAL IMPACT		
	State	Local
NET CHANGE IN COSTS	$175,500	$
NET CHANGE IN REVENUE	$-173,315,600	$

Agency/Prepared By	**Authorized Signature**	**Date**
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