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State Pension Funds and Climate Risk: A Roadmap for Navigating the Energy Transition

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1. Introduction

Public pension funds are a cornerstone of the financial system. As of 2022, US state and local public pension funds—trusts that hold portfolios of financial assets meant to sustain retirees—comprised $4.5 trillion in assets and distributed $323 billion annually. Roughly 6,000 state and locally administered public pension funds provide retirement security for 11.2 million current retirees, in addition to 14.7 million future beneficiaries who are currently working—a combined total that is 14 percent of the US workforce (PPD 2022). Such funds are critical for the retirement security of the public-sector workforce and are sometimes analyzed solely from the perspective of financial returns. Yet if public pension funds do not proactively address the risks of climate change, it is those same public-sector workers—the current and future economic beneficiaries of pension funds—who will bear the burden.

In this issue brief, we explore how state and local public pension funds can be managed for the clean energy transition—and the risks that retirees will face if they are not. Facilitating an energy transition will require action from federal policymakers, and ensuring that that transition is orderly and minimally disruptive to the financial system will also require action from federal financial regulators. However, state and local policymakers have authority over their own public pension funds, and we focus here on mapping the path forward for this group of policymakers. We believe that large-scale, direct public investment is the best route to transform the economy for decarbonization (Mason 2022). Nevertheless, there are trillions of dollars in household financial assets held at the state and local levels that can be directed in ways that support or detract from the goal of decarbonization. For example, fund managers are divided over whether their portfolios should include holdings of fossil fuel companies. We argue that public pension funds, in serving the interests of their "economic beneficiaries" (the public-sector workforce), should be part of the energy transition—since public-sector workers, like all people, everywhere, have an interest in a livable planet and resilient economy. In fact, to ignore the climate risk inherent in holding fossil fuel equity jeopardizes the economic stability of workers' capital. We propose several policy reforms for states to move public pension funds closer to meeting the interests of the public-sector workforce, including both current and future retirees.

A. The Importance of Public Pension Funds

Public pension funds are a key part of the complex system of retirement assets in the United States. In the private sector, pensions—meaning a guaranteed annuity payment—have, to a large extent, disappeared for today's workforce (even though millions of private-sector retirees still rely on pension commitments made in past decades). However, the public-sector workforce has been able to maintain access to pensions, and these funds represent a major source of financial assets invested in financial markets. In turn, public pension funds hold corporate securities as part of their portfolios, which means that they are also bound up in the "shareholder primacy" paradigm that governs relationships between production-oriented corporations and the networks of institutions holding and trading equities issued by these companies in the financial markets.

According to the Census Bureau's Annual Survey of Public Pensions, there were 5,302 public-sector retirement plans in the United States (as of July 2021): 301 at the state level and 5,001 at the local level. The plans serve a total membership of 34 million people, including 14.9 million members who are currently working and 7.5 million retirees. State and local government pensions pay benefits to retirees out of trust funds, rather than general operating revenue, and these funds are invested in financial assets. Much of the debate around public pensions focuses on their underfunding (Sgouros 2017). For the purposes of this issue brief, we do not seek to resolve uncertainties regarding the appropriate measurement of underfunding, but it is important to note that full funding does rely on aggressive asset appreciation of the pension fund portfolios.

Defined-benefit state and local government employee pension plans held $9.3 trillion in Q4 2021, of which $3.2 trillion was in corporate equities. For comparison, total private defined-benefit pension funds held total assets of $3.7 trillion, though defined-contribution pension plans hold $9.4 trillion; the federal government defined-benefit pension fund held total assets of $3.8 trillion. Overall, pension funds hold $7.8 trillion in corporate equity (Federal Reserve Financial Accounts Table L.117). Public Plans Data presents a more detailed analysis of state and local pension asset allocation: Equities made up 47.2 percent of plans' portfolios in 2021, fixed income (bond holdings) made up 22 percent, and private equity and real estate each made up over 5 percent.

B. Roadmap for this Issue Brief

In Section One, this brief will discuss the role of state chief financial officers (usually called state treasurers), who serve as the top banker overseeing the state's finances through the issuance and management of state debt. All state treasurers have some role in public pension investment portfolio management, although their power can vary widely. While some state treasurers serve as "sole fiduciaries" with broad unilateral authority over public pension fund investment decisions, most share responsibility for setting public pension fund investment strategies with a board or set of trustees collectively acting as fiduciaries. The fiduciaries of public pension funds have a critical role to play in adopting strong climate policies to ensure the resilience of their funds.

In Section Two, this brief describes how state and local public pension funds function and interact with asset managers, and those managers' fiduciary duty requirements. In setting policies for state pension investments, state and local policymakers with the authority to determine parameters for state pension funds need not defer to the federal definition of fiduciary duty or rely exclusively on federal agencies to identify climate as a systemic risk. We propose revising pension fund fiduciary duties to include an affirmative commitment to long-term sustainability in the interest of their economic beneficiaries: current and future retirees. Because pension funds delegate much of the actual corporate governance engagement for which they are responsible to asset managers, we also propose reforms to asset manager fiduciary duties (as described in a related publication, "Responsible Asset Managers: New Fiduciary Rules for the Asset Management Industry").

Finally, we describe the current trends in states' integration or rejection of climate risk analysis and propose how state policymakers can enact a set of policies that build on federal efforts to standardize climate risks and environmental, social, or governance (ESG) disclosures. State officials can and should recognize that proper analysis of climate risk is essential to their stewardship of public pension fund assets. While some states are moving forward with a dangerous approach that directs state fiduciaries to ignore certain financial stability risks, states that are already incorporating ESG analysis into their investment decisions can create a pathway for more stable fund performance in the long term by:

- Building on the new federal framework for ESG and climate risk disclosure standards, thereby strengthening our understanding of these risks as systemic threats;
- Revising and strengthening their conception of fiduciary obligations, including integration of systemic risks like climate change; and
- Embedding climate risk management and mitigation into the assessment of their investment portfolio and corresponding portfolio management decisions, including proxy voting.

2. Current Debates over State Public Pension Funds and "ESG" Investing & the Risks of the Status Quo

State pension funds have become key players in the debate over whether asset managers should appropriately engage with companies to reduce their contributions to climate change, with Republicans arguing against such actions and Democrats arguing that asset managers need to do much more. Officially, state treasurers are the bankers for state governments and the stewards of the financial assets of public-sector workers, and make investment decisions that affect public pension funds holding trillions of dollars in retirement funds (PPD 2022). While some state and municipal financial officers have taken action regarding the effects of climate change on their funds, right-wing state treasurers have raised the opposite concerns—that any ESG considerations in the investment process are an inappropriate distraction from their favored narrow "returns only" focus. In this section, we describe the current efforts by right-wing state officials to reject even tentative moves to include consideration of climate change in the investment process, and the risk to public-sector workers that comes from simply maintaining the status quo.

In 2022, a number of right wing state officials took steps to prevent pension funds from engaging with institutions that employ ESG and climate analysis in their investment strategies. In late July 2022, Florida governor Ron DeSantis gave a speech deriding ESG investing as "woke capitalism," and announced plans to pass legislation banning financial institutions within Florida from using ESG factors (Vanderford 2022). DeSantis soon followed up with an executive action blocking ESG considerations from use by state pension fund managers (Office of Governor Ron DeSantis 2022). At least seven states have withdrawn pension funds from BlackRock, supposedly in retaliation for BlackRock's pro-ESG stance (Nishant 2022). As we will show, studies are already finding that anti-ESG legislation and actions are increasing debt servicing costs by limiting competition in municipal bond markets. Costs are likely to further grow as financial stability concerns from climate risk increase, both from increasingly rapid climate change and the acceleration in the clean energy transition sparked by the Inflation Reduction Act and other climate policies.

At the legislative level, in an effort coordinated by an organization called the State Financial Officers Foundation (SFOF), Republican state treasurers have opposed President Biden's nominees for several financial regulatory positions based on the nominees' views on climate risk (Gelles 2022). The American Legislative Exchange

Council (ALEC) has joined with SFOF in drafting and promoting model legislation called the Energy Discrimination Elimination Act (EDEA), which prohibits state pension funds and related governmental entities from contracting with financial institutions that are deemed to be "boycotting" fossil fuels.

As of the end of 2022, the EDEA, or similar legislation aimed at undermining ESG investing, had been introduced in 20 states and passed into law in seven (Ropes and Gray 2022). Already in the 2023 legislative session, over 100 pieces of anti-ESG legislation based on SFOF/ALEC models have been introduced in 28 states (Foundation for Middle East Peace 2023). State treasurers organized by SFOF have also taken a host of further actions to restrict ESG considerations in their investment decisions, and to cancel management of pension funds by the asset management giant BlackRock, supposedly in retaliation for BlackRock's pro-ESG stances (Kerber 2022). Some SFOF officials have expressed their explicit intention to take the culture war to the ESG world, stating their belief that "ESG is going to be the [critical race theory] of 2023 and 2024" (Kotch 2022).

In justifying anti-ESG actions, SFOF officials have insisted that ESG investing requires the consideration of "non-pecuniary factors" that will diminish pension funds' ability to maximize returns. The truth, however, is that ignoring ESG considerations is exposing workers' pensions to enormous financial risks. In Indiana, for instance, fiscal analysts estimated that proposed legislation requiring the state to divest from funds that use ESG analysis would cause a loss of nearly $7 billion in returns over 10 years (Bonilla Muñiz 2023). Directing pension funds to ignore climate factors turns a blind eye to a risk that has been highlighted as an "emerging and increasing threat" by all the major financial regulators. Even members of the public who do not have any money in public pensions are paying for these laws, as shown in a June 2022 study by Garrett and Ivanov, which estimated that Texans paid as much as $532 million in higher debt servicing costs in the first eight months the law was in effect. Garrett and Ivanov found that after the EDEA excluded certain banks from participating in the municipal bond market, "the remaining banks may enjoy increased market power due to barring banks with certain social and environmental policies from the market." In other words, in states where it has passed, the EDEA lowers competition and raises costs for municipalities (Garrett and Ivanov 2022). Another recent study used similar econometric analysis to estimate the impact on the municipal bond market in six states that have either already passed legislation like that of Texas (Kentucky, West Virginia, and Oklahoma) or seem primed to in the next year (Florida, Louisiana, and Missouri). The study found that interest costs would rise by a combined estimated total of $708 million over 12 months (Econsult Solutions, Inc. 2023).

To be clear, there is nothing inherently wrong with public officials scrutinizing whether external asset managers are acting in the public interest. On the contrary, we believe public options for asset management should be explored and that there are healthy examples of public officials questioning private asset managers, such as recent statements made by Pennsylvania governor Josh Shapiro suggesting that fees charged by external asset managers are excessive (McGoldrick and DiStefano 20203). But the "forced fossil fuel financing" approach being taken by anti-ESG politicians constrains public and private actors, increases costs and risks, and limits competition in financial markets—all in an attempt to tether public workers and state finances to today's economy and its pronounced climate-related threats to financial stability (Masters et al. 2022).

More than a dozen state treasurers have spoken out against these misguided attacks on prudent consideration of ESG factors and climate risks (Office of New York City Comptroller Brad Lander 2022). So far, however, few state policymakers have developed a clear proactive set of policy reforms to counter the efforts by right-wing treasurers to arbitrarily penalize financial institutions for alleged fossil fuel boycotts. In Section Four, we turn to a proactive way forward to mitigate climate risk for public pension funds.

3. The Varied Landscape of State & Local Pension Fund Management: Fiduciary Duty, and Public vs. Private Asset Management

A. State and Local Pension Fund Trustees Have Fiduciary Duties of Care and Loyalty to Public-Sector Workers

Across the country, the trillions of dollars in public pension funds are managed under a wide range of different structures, with trustees holding varying degrees of power and responsibility (NASRA n.d.). The obligation of trustees to act in the interest of the individuals whose retirement savings they manage is governed by pension codes, which differ in crucial ways from state to state. Most state pension codes, though not all, include a definition of fiduciary duty that is modeled off of the federal definition provided in the Employee Retirement Income Security Act of 1974 (ERISA). ERISA assigns a set of responsibilities to any fiduciary with a role in managing ERISA plans, and generally establishes that fiduciaries must act in the interest of fund beneficiaries, including through actions such as the diversification of pension fund investments. As we will show, even these duties spelled out through federal law can be subject to different interpretations.

Republican administrations have traditionally pushed for an interpretation of ERISA that excludes supposedly "non-economic factors" such as job security, and focuses exclusively on maximizing returns.[1] Now, right-wing institutions like SFOF and ALEC are partnering with Republican politicians to advocate that state governments revise their definition of fiduciary duty in the same way (Wolman 2022). Promoters of the anti-ESG narrative frame consideration of climate implications as putting "ancillary interests before investment returns" (Cameron 2022), a framing that seems to assume that fossil fuel companies will continue producing returns consistent with fiduciary duty indefinitely, even if companies fail to align their behavior with the emissions reductions necessary to avert an unsafe level of global warming. Thus, anti-ESG campaigners seek to impose a definition of fiduciary duty that forces trustees to ignore serious projections both of climate-related financial stability risks and substantial economic damage from an unchecked climate crisis (Stern et al. 2022).

The view that fiduciary duty should focus only on maximizing returns can hinder the financial performance of the fund by exposing it to major financial stability risks and can also result in perverse outcomes. For example, in one case, public pension fund trustees in Massachusetts and Louisiana defended how their investments in the firm Aramark were consistent with their fiduciary duty because it offered high returns, even though the overall health of the pension fund was threatened by Aramark's actions to privatize certain public services—which resulted in the loss of jobs and pension benefits by some public workers, in turn diminishing contributions to the fund itself (Webber 2014; Braun and Selway 2012). Similarly, for public pension fund managers, the interpretation of their fiduciary duties as focused only on the economic interests of the pension fund beneficiaries has meant that their interests in corporate governance has been, in some cases, extractive, and resulted in negative outcomes for those same beneficiaries. This, despite the fact that the fiduciary duties of public pension fund managers require them to act in the "best interests" of the economic beneficiaries of the fund (Webber 2014).

These types of contradictions are possible, in large part, because "fiduciary duty" is an open-textured legal standard. Like other open-textured legal standards, such as the "reasonable" person for tort law analyses or "materiality" in securities law, evolving contexts, facts, and developments outside the law will have an effect on how courts evaluate these standards.

Vulnerability is inherent in the fiduciary relationship; there always exists the potential for the asset manager to take advantage of the beneficiary and abuse their trust. That is why the standards for being a reasonable fiduciary are so important. When fiduciary duties are interpreted as requiring the financial assets held by funds to appreciate as quickly as possible—in line with the precepts of shareholder primary—it justifies

[1] See, e.g., Interpretive Bulletin Relating to Investing in Economically Targeted Investments, 73 Fed. Reg. 61734 (Oct. 17, 2008) (to be codified at 29 C.F.R. 2509).

practices like the privatization of public services or the holding of fossil fuel companies without regard for the long-term consequences to the economic beneficiaries of the fund. Such a reality calls for not only a reconsideration of the fiduciary duties of public pension fund managers and their asset managers, as we will discuss in Section Four, but also a broader reconception of shareholder primacy itself.

B. Climate Risk Analysis as a Key Component of Fiduciary Duties

As climate change has emerged as a risk to financial stability, state treasurers have separated into two distinct groups. Some state treasurers have taken the risk seriously and begun using climate risk analysis to inform their proxy voting decisions. In 16 states, at least one pension fund has adopted a policy of voting against directors at corporations that fail to develop a plan to bring the company into alignment with the pollution targets identified by the Paris Climate Accords (CFA 2021). The most thorough approach to climate risk analysis to date was approved by Maryland's legislature in 2022: HB 740 requires each fiduciary within the Maryland state retirement and pension system to conduct a climate risk assessment of investments, and to use that analysis to inform proxy voting decisions.[2]

Conversely, other states have sacrificed meaningful climate risk mitigation in the name of financial performance, only to jeopardize performance and incur additional financial risk. As David Arkush (2021) argued in *Unsafe at Any Charge*, both climate change and the low-carbon energy transition represent unprecedented risks to the health and safety of the financial sector. And since pension fund fiduciaries are required to abide by a "duty of care" that compels them to exercise "reasonable care, skill and caution" with respect to pension fund investments, they should be especially sensitive to insulating workers' pensions from large swings in the financial cycle.

Climate or ESG risk analysis can serve this goal well. A 2016 analysis found that focusing investments on higher-rated ESG forms could have helped investors avoid exposure to 90 percent of corporate bankruptcies (Subramanian et al. 2016). Similarly, one paper looked at the stock market performance during two significant downturns, the 2001 tech bubble and the 2008 financial crisis, comparing corporations with high corporate social responsibility scores with those that had lower scores, and found that firms with higher scores were substantially better positioned to weather the downturns (Lins et al. 2019).

[2] Department of Legislative Services, Maryland General Assembly. 2022. Fiscal and Policy Note for House Bill 740. Maryland General Assembly. https://mgaleg.maryland.gov/2022RS/fnotes/bil_0000/hb0740.pdf.

4. Policy Reforms to Promote State Climate Action

As policymakers continue to grapple with climate change as an economic problem and threat to financial stability, state lawmakers are facing cross pressures that pose major risks for their constituents. Some states are proactively taking steps to understand and minimize their exposure to climate risk, as in the case of Maryland's HB 740. But states that have moved in the opposite direction are exposing their constituents to major potential harms; as one financial regulatory expert warned, the EDEA and other similar bills attacking ESG investing are "in essence, forced fossil fuel financing laws" that "endanger financial stability by encouraging risky loans to energy firms" (Masters et al. 2022).

Policymakers in states where EDEA-like legislation has been introduced should do all that they can to draw attention to the costs and risks that such bills would impose on the public. Governors should veto any EDEA-like legislation that reaches their desks, and state and local treasurers, county commissioners, city councilors, and school board members should speak out about the more expensive financing that these laws force them to pursue.[3]

Because climate change is such an enormous systemic risk, states that require climate risk disclosure and integrate climate risk assessments into state budgeting and investment practices will protect the economic beneficiaries of public pension funds: the public-sector workforce, both present and future. We therefore recommend that state and local officials follow federal financial regulators by erecting a climate risk supervision framework within their purview.

Instead of ignoring financial stability risks and costs from climate change, state policymakers should look at what financial market participants and federal regulators are doing to improve their understanding of climate risk. As suggested by a host of academic literature, the long-term financial performance of funds will be enhanced—not hurt—by requiring greater ESG analysis. States can bolster the safety and long-term performance of their pension funds by embedding systemic risk principles into this ESG analysis and committing to an approach to investment that limits the funds' exposure to such risks. Toward that end, we offer several policy recommendations for state officials:

1. *Strengthen state pension codes to incorporate systemic risks into the definition of fiduciary duty:* States have the power to revise and strengthen their

[3] For example, after UBS was placed on the "boycott" list as a result of the EDEA in Texas, the Normangee Independent School District was forced to cancel its bond deal with UBS and pursue another, more costly bond deal (Albright and Moran 2022).

definition of fiduciary duty. Rather than focusing on a "returns only" approach that can expose workers to greater risks—up to and including losing their jobs and pensions altogether—states should strengthen the definition of fiduciary duty to allow for a more holistic understanding of what is in the economic interest of workers and retirees. The state-established definition of fiduciary duty should recognize the systemic risks presented by climate change (Cort et al. 2022), and pension fund managers should be required to factor in these risks in making investment decisions and exercising their proxy voting power.

Additionally, laws governing state pension fund management should be updated to clarify that pension funds can and should act in the economic interests of the workers who pay into them. They should affirm and codify federal court rulings that have found that pension funds may consider factors relevant to the economic interest of fund beneficiaries beyond maximizing returns.[4] State pension funds should also consider emulating New York City's pension fund by establishing responsible contractor policies that ensure prevailing wages and benefits (NYCERS 2017). Finally, pension codes should include language like that of Ohio's, which prohibits investments that promote privatization of public-sector jobs, [5] and require prioritization of investments in state and local economic development projects.

2. *Require greater climate risk disclosure:* All states should consider legislation like California's Climate Corporate Accountability Act, which would require corporations of a certain size that do business in California to disclose their Scope 1, 2, and 3 emissions. [6] In March 2022, the SEC published a rule requiring publicly traded companies to disclose information about their greenhouse gas emissions (SEC 2022). However, there is some question as to how robust the rule will be once it is finalized, and some members of Congress have urged that the final rule exclude disclosure of Scope 3 emissions, which are critical for understanding the full picture of a corporation's climate activity, including their vulnerability to climate-driven supply chain shocks (Harty 2022; Thornton and Phillips 2022). Enacting legislation like this at the state level will help fill any gaps that are left by the final SEC rule, thus equipping investors, regulators, and the public with a fuller picture surrounding the financial stability risks of climate change.

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4 See Brock v. Walton 794 F.2d 586 (1986) and Bandt v. Board of Retirement, San Diego County Employees

5 Ohio Rev Code § 145.11 (2021).

6 Climate Corporate Accountability Act SB-260 117th Cong. (2022).

3. *Incorporate climate risk management and mitigation into state fiduciaries' assessment of their investment portfolio and their corresponding portfolio management decisions, including proxy voting:* Maryland's HB 740 serves as a useful model for states seeking to enhance protections from workers' exposure to climate risk. HB 740 directs trustees of the state pension board to review and update all policy guidelines surrounding investment of state pension funds to incorporate the establishment of climate risk management principles. Trustees are then required to conduct a climate risk assessment of the state's investment portfolio, including all state pension funds. The climate risk analysis will require analysis of both physical and transition risks posed by state pension fund holdings across all industry sectors and asset classes. Trustees are required to conduct their assessment at least once every two years, and to update their analysis based on the most recent scientific literature, data, and financial tools available. Finally, HB 740 requires the climate risk assessment to include an overview of growth and investment opportunities in emerging technological sectors, including clean and renewable energy.

HB 740 also prompted pension fund managers to act on the findings of the climate risk assessment by integrating climate risk management into proxy voting guidelines. This is a strong approach to protecting the long-term stability of worker capital. HB 740 puts Maryland on a path toward not only mitigating pension funds' exposure to climate risk but exploring how Maryland can capitalize on the economic benefits of the clean energy transition. We recommend that any states exploring similar legislation build on HB 740's approach by also requiring a study of the exposure of state government finances to climate risk. As shown in the early stages of recovery from the COVID-19 recession, states with the greatest reliance on fossil fuel revenue tended to experience the largest budget shortfalls (Leachman and McNichol 2021). Incorporating climate change into budget forecasting and developing a long-term plan for diversifying revenue is another way that state leaders can insulate their constituents from the greatest harms of the climate crisis and position their economies to reap benefits from the energy transition.

5. Conclusion

As Republican state treasurers continue to push back against proactive climate risk mitigation efforts, it is crucial that states take legislative action to protect pension fund assets and beneficiaries from the risks of climate change. The trillions of dollars of financial assets that belong to public pensioners must be managed and invested in a manner that is responsible and forward-thinking, one that does not needlessly put the funds at risk—now or in the future. Progress toward climate risk mitigation at the federal level should not be undermined at the state level.

The vehement backlash at the state level against so-called "woke capitalism" is a misguided phenomenon that is likely to continue as federal climate policy takes effect, with forces on the right seeking to apply the culture war rhetoric they've adopted in other contexts to the Biden administration's climate policy. While in the past we have offered federal policy recommendations—including reforming asset manager fiduciary duties and establishing a public asset manager—federal-level reform, while essential, is not the only path forward. Ultimately, state reforms can move forward and in some cases be more politically viable.

It is crucial that policymakers at the state level develop—and advocate for—a framework that insulates their constituents from the financial and economic harms of climate change, regardless of what is happening in Washington, DC. States can begin this process by building on the new federal framework for ESG and climate risk disclosure standards, revising and strengthening their conception of fiduciary obligations to expand the interpretations of beneficiaries' "best interest," and materially embedding climate risk management and mitigation into their assessment of their investment portfolio and corresponding portfolio management decisions (including the important tool of proxy voting). Several state legislatures are taking steps toward these goals and others should follow suit.

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