





City and County of San Francisco  
Employees' Retirement System

**RETIREMENT BOARD CALENDAR SHEET**  
**Retirement Board Meeting of April 10, 2013**

**Date:** April 10, 2013

**To:** Retirement Board

**From:** Jay Huish   
Executive Director

Robert L. Shaw, CFA   
Interim Deputy Director for Investments

**Subject:** Consideration of Level 1 and Level 2 Engagement of Certain Bank Mortgage Servicing Companies under the SFERS Social Investment Policies and Procedures

**Background:**

This item was added to the Retirement Board agenda at the request of Commissioner Meiberger. Over the past three months, representatives of the Alliance of Californians for Community Empowerment (ACCE), Occupy Noe, Occupy Bernal, Occupy the Auctions/Evictions and the San Francisco chapter of the Service Employees International Union (SEIU) Local 1021 have petitioned the Retirement Board through public comment to consider divestment of SFERS holdings in Wells Fargo, JPMorgan Chase and Bank of America in response to the banks' alleged "predatory and discriminatory lending practices."

The purpose of this item is for the Retirement Board to evaluate and consider the investment risk posed by bank mortgage servicing companies against the SFERS Social Investment Policy and Procedures and potentially to direct Retirement staff to evaluate and/or engage the bank mortgage servicing companies identified herein under the Board's policy.

The Retirement Board's Social Investment Policy provides that, secondary to the Retirement Board's fiduciary responsibility of producing investment returns for the exclusive benefit of the plan participants, the Retirement Board can address social consequences of corporate actions and portfolio investment decisions by directing action as outlined under Level I - Shareholder voting, Level II - Promoting Social Rights and Interests, or Level III - Investment Restrictions of the policy. Generally, social concerns should be addressed in the order of action outlined in the policy unless the Retirement Board determines that actions contemplated in an early level have been initiated prior to engagement under the policy and found to be ineffective or non-relevant.

One of the social investment policies adopted by the Retirement Board under its Social Investment Policy on September 27, 1988 was a Level I engagement under the category of "Community Relations" which provides as follows:

The relationship of the corporation to the communities in which it operates shall be maintained as a good corporate citizen through observing proper environmental standards, supporting the local economic, social and cultural climate, conducting acquisitions and reorganizations to minimize adverse effects and not discriminate in making loans or writing insurance.

As fiduciaries to the SFERS Trust, Retirement Board members are required to carry out their official duties with respect to the plan in accordance with strict standards of conduct, including the duties to act prudently and solely in the interest of the plan's participants and beneficiaries. Fiduciaries are to make investment decisions (including whether to invest or sell off a plan's investments) solely on the basis of a consideration of the financial aspects of the proposed investment, including the investment's position in the plan's overall portfolio, the risk of loss associated with the investment, the opportunity for income, the investment's impact on the diversification of the plan's portfolio, and the plan's liquidity and cash flow needs. Fiduciaries are subject to the duty of loyalty to plan participants and beneficiaries in addition to the fiduciary duty of prudence. In general, the duty of loyalty would prohibit a fiduciary from making investment decisions solely to accomplish social objectives.

### Business Risks

The mortgage lending and servicing industry shares a common exposure to heightened regulatory, investigative and legislative actions that have the potential to significantly impact industry-wide earnings. Among those actions taken are:

- In July 2010, the *Dodd-Frank Wall Street Reform and Consumer Protection Act* was signed into law, which included among its stated purposes "to assure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans and that are understandable and not unfair, deceptive or abusive."
- During the fourth quarter of 2010, interagency reviews were conducted by the Federal Reserve System, the Office of the Comptroller of Currency, the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) of foreclosure processing at 14 federally regulated mortgage servicers (Ally Bank/GMAC, Aurora Bank, Bank of America, Citibank, Everbank, HSBC, JPMorgan Chase, MetLife, OneWest, PNC, Sovereign Bank, SunTrust, U.S. Bank and Wells Fargo) which resulted in formal enforcement actions against all 14 mortgage servicers related to unsafe and unsound foreclosure practices and/or violations of applicable federal and state law and requirements.
- In May 2011, California Attorney General Kamala Harris created the California Attorney General's *Mortgage Fraud Strike Force* to monitor and prosecute violations of lending, servicing and foreclosure practices.
- In February 2012, 49 state attorneys general and federal agencies including the U.S. Department of Justice (DOJ), U.S. Department of Housing and Urban Development (HUD) and the U.S. Department of Treasury, reached a \$25 billion settlement with the country's five largest mortgage servicers (Ally/GMAC, Bank of America, Citibank, JPMorgan Chase and Wells Fargo) to provide relief to distressed borrowers in the states who signed on to the settlement and direct payments to signing states and the federal government.
- Enactment of California *Homeowner Bill of Rights*, effective January 1, 2013, which prohibits certain unfair bank practices and provides borrowers access to courts to enforce their rights under this legislation.
- In January 2013, consent orders related to enforcement actions against 13 mortgage service providers (Aurora Bank, Bank of America, Citibank, Goldman Sachs, HSBC, JPMorgan Chase, MetLife Bank, Morgan Stanley, PNC, Sovereign Bank, Sun Trust, U.S. Bank and Wells Fargo) were issued for deficient practices in mortgage loan servicing and foreclosure processing which require servicers to provide \$9.3 billion in payments and other assistance to borrowers.

As a result of the actions above, as well as other settlement agreements reached with individual mortgage lending and servicing providers related to litigation initiated alleging discriminatory lending practices, the mortgage lending and servicing industry is subject to significantly increased regulatory monitoring and legal actions that have the potential to substantially impair industry-wide earnings.

### Investment Risk

Retirement staff estimates that capitalization of the U.S. mortgage lending and servicing industry is approximately \$4.8 trillion of the total financial sector capitalization of \$7.6 trillion. SFERS' public holdings as of December 31, 2012 in the 14 federally regulated mortgage servicers<sup>1</sup> who were the target of most of the regulatory, investigative and legislative actions detail above are detailed below.

<b>Common Equity</b>		
<u>Company</u>	<u>Shares Owned by SFERS</u>	<u>Market Value</u>
Bank of America	2,652,144	\$ 30,764,870
Citibank	787,320	31,146,379
Everbank	5,283	78,770
HSBC	3,381,174	35,524,457
JPMorgan Chase	1,062,939	46,737,428
MetLife	301,042	9,916,323
PNC	135,917	7,925,320
SunTrust	115,446	3,272,894
U.S. Bank	526,913	16,932,349
Wells Fargo	1,326,274	45,332,045
<b>Total:</b>		<b>\$ 227,630,836</b>

<sup>1</sup> Ally/GMAC, Aurora Bank, One West and Sovereign Bank are not publicly traded equities.

<b>Issued Debt</b>		
<u>Company</u>	<u>Par Value of Issued Debt</u>	<u>Market Value</u>
Ally/GMAC	\$ 400,000	\$ 491,833
Bank of America	10,187,216	13,640,000
Citibank	11,865,000	13,280,195
Everbank	-	-
HSBC	3,965,000	4,790,676
JPMorgan Chase	10,060,000	11,071,628
MetLife	2,821,241	4,805,830
PNC	7,350,000	5,360,022
SunTrust	-	-
U.S. Bank	-	-
Wells Fargo	3,301,437	5,123,812
<b>Total:</b>		<b>\$ 58,563,996</b>

In addition to public equity and debt holdings in the above companies, SFERS also owns mortgage securities in these companies in excess of \$240 million.

Through February 28, 2013, investment returns on these securities are as follows:

<b>Investment Returns</b>					
<u>Company</u>	<u>YTD Rate of Return</u>	<u>FYTD Rate of Return</u>	<u>1 Year Rate of Return</u>	<u>3 Years Rate of Return</u>	<u>5 Years Rate of Return</u>
Bank of America	(3.38%)	37.24%	40.53%	(12.01%)	(19.95%)
Citibank	6.19%	53.54%	26.51%	7.33%	(28.60%)
Everbank <sup>1</sup>	(3.92%)	-	-	-	-
HSBC (London)	5.58%	27.51%	30.93%	1.99%	(2.09%)
HSBC (Hong Kong)	5.54%	26.78%	27.40%	3.77%	(2.10%)
JPMorgan Chase	11.98%	39.91%	28.49%	7.26%	6.36%
MetLife	8.15%	18.63%	(4.78%)	1.53%	(5.27%)
PNC	8.00%	4.21%	7.50%	8.40%	3.92%
SunTrust	(2.51%)	13.62%	21.48%	6.50%	(11.15%)
U.S. Bank	6.13%	6.73%	18.29%	13.84%	4.39%
Wells Fargo	3.37%	7.05%	15.41%	10.66%	6.56%

<sup>1</sup> IPO in May 2012; December 2012 holdings were sold in February 2013

### **SFERS Social Investment Policy and Procedures**

As set forth in the California Constitution and the San Francisco Charter, the SFERS Retirement Board and staff are required to discharge their fiduciary duties solely in the interest of the participants and beneficiaries [as a whole] for the exclusive purpose of providing benefits to members and their beneficiaries. These requirements are also mandated by the Internal Revenue Code of 1954 as amended in order for SFERS to maintain its status as a qualified plan.

The SFERS Retirement Board and staff are also required to invest the SFERS Trust with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims. The prudence requirements are generally satisfied if, in the analysis, the Retirement Board and staff are guided principally by economic and business factors. Whether an investment benefits a social goal may be a secondary consideration.

The attached SFERS Social Investment Policies and Procedures do not apply to segments of the portfolio that track market indices, as SFERS policies and contractual mandates require those segments to invest in all companies included in an index. Additionally, the policy does not apply to investments in a Limited Partnership due to SFERS' legal position of limited liability as a Limited Partner rather than a General Partner or comingled funds due to SFERS contractual relationship with other investors in such funds.

The SFERS Social Investment Policies and Procedures provide that the Retirement Board, as fiduciaries to the beneficiaries of the SFERS Trust, must give adequate recognition to the social consequences of corporate actions and investment decisions to achieve maximum long term investment return from Trust assets while ensuring that, in no event, will the tenets of the policy take precedent over the fiduciary responsibility of producing investment returns for the exclusive benefit of the members and beneficiaries. Social concerns addressed through the policy will follow the order of action outlined in the policy except where the Retirement Board determines that action contemplated in

an earlier step has been initiated prior to consideration of action under the policy and found to be ineffective or non-relevant.

The SFERS Social Investment Procedures outline three levels of action that the Retirement Board can direct staff to implement to engage companies on social issues of concern:

**Level I – Shareholder Voting:** SFERS' shareholder voting rights will be exercised reflecting specific Board social investment considerations and directions or by authorization under procedures which reflect the Retirement Board's directions on social issues.

**Level II – Engagement:** SFERS will proactively promote social interests individually or in concert with other shareholders to assure proper recognition of social interests with the goal of influencing corporate activities or policies. Activities at this level may include direct communication with the company and/or initiation of shareholder resolutions, individually or in concert with other shareholders.

**Level III – Investment Restrictions:** In the event that Level I and Level II engagement has not provided the Retirement Board's desired results and alternatives to the restricted holdings are available which do not compromise investment return and risk, the Retirement Board may direct staff to restrict investment activities in specific areas to promote the interest of the SFERS Trust beneficiaries. Under Level III engagement, Retirement staff would provide directions to the investment manager that would include restricting purchase of additional shares of the targeted securities and directing the manager to research alternative securities to replace the targeted holdings that would provide comparable investment return with comparable risk.

### **Board Actions proposed by Commissioner Meiberger**

At the time he requested that this item be calendared for the Retirement Board's consideration, Commissioner Meiberger further requested that the following alternative motions for Retirement Board action be included in the Board item:

#### **Level 1 Motion**

SFERS will implement Level 1 of its Social Investment Procedures and heighten scrutiny of its proxy voting with regard to Wells Fargo, Bank of America and JPMorgan Chase. SFERS will instruct its proxy voting service to cast its proxies as follows:

- 1) Vote in favor of resolutions that call for separation of Chair and CEO following our current policy<sup>1</sup>;
- 2) Withhold votes from (vote against) candidates for Board Chair who are also CEO – withhold support from John Stumpf of Wells Fargo and Jamie Dimon of JPMorgan Chase;
- 3) Vote in favor of resolutions that seek additional disclosure and/or reform of mortgage and lending practices<sup>2</sup>; and
- 4) Vote "no" on executive compensation advisory resolutions (Say on Pay)<sup>3</sup>.

Retirement staff will report to the Retirement Board on proxy votes cast following each shareholder meeting.

<sup>1</sup> For example: *Item 5: Require Independent Board Chairman* on Wells Fargo 2013 Annual Meeting agenda

<sup>2</sup> For example: *Item 7: Review Fair Housing and Fair Lending Compliance* on Wells Fargo 2013 Annual Meeting agenda and *Proposal 8: Mortgage Servicing* on Bank of America 2013 Annual Meeting agenda

<sup>3</sup> For example: *Item 2: Advisory Vote to Ratify Named Executive Officers' Compensation* on Wells Fargo 2013 Annual Meeting agenda and *Proposal 2: Advisory Vote to Approve Executive Compensation* on Bank of America 2013 Annual Meeting agenda



### Level 2 Motion

SFERS will implement Level 2 of its Social Investment Procedures against Wells Fargo, Bank of America and JPMorgan Chase as follows:

- 1) Take all actions listed under Level 1 motion above;
- 2) Call on Wells Fargo, JPMorgan Chase, and Bank of America to do the following:
  - a) Stop predatory and discriminatory lending practices,
  - b) Implement and disclose policies and practices to prevent recurrence of predatory and discriminatory lending, and
  - c) Grant affordable permanent loan modifications to all borrowers who request them and who are entitled to such by the settlement with states' attorney general;
- 3) Call on other institutional investors to join in these actions;
- 4) Safeguard the SFERS from risks associated with other banking practices which contribute to volatility in the markets or which pose reputational, compliance, litigation or regulatory risks; and
- 5) Take other steps as outlined in the Social Investment Procedures appropriate to accomplish the above, such as offering resolutions, attending shareholder meetings and other activities.

Retirement staff will make regular progress reports to the Retirement Board on the success of Level 2 Engagement.

### Recommendation:

As the decision whether to engage any segment of the mortgage lending and servicing industry through the SFERS Social Investment Policies and Procedures is a policy decision solely in the purview of the Retirement Board, Retirement staff does not provide a recommendation regarding the prudence of directing engagement under the policy.

However, should the Retirement Board determine that engagement of the mortgage lending and servicing industry through its policy is prudent, Retirement staff recommends engagement at Level 1 – Shareholder Voting of the Board's Social Investment Procedures. As the Retirement Board has previously engaged "corporations...(to) not discriminate in making loans" at a Level 1 engagement as part of its "Community Relations" engagement on September 27, 1988, Retirement staff recommends that the Retirement Board direct staff to exercise SFERS' shareholder voting rights reflecting the Board's specific social investment considerations related to the targeted corporate behavior – discrimination in making loans. Retirement staff recommends that the Level 1 engagement be against all public mortgage lending and servicing companies which SFERS currently owns: Ally/GMAC, Bank of America, Citibank, Everbank, HSBC, JPMorgan Chase, MetLife, PNC, Sun Trust, U.S. Bank, and Wells Fargo.

Retirement staff will provide regular reports to the Retirement Board on the results of its engagement as directed by the Retirement Board.

Attachment: SFERS Social Investment Policies and Procedures