



## Agenda Item 5b

November 18, 2013

**ITEM NAME:** Adoption of Global Derivatives and Counterparty Risk Policy and Repeal of Legacy Policies

**PROGRAM:** Total Fund

**ITEM TYPE:** Policy & Delegation – Action

### **RECOMMENDATION**

Adopt the Global Derivatives and Counterparty Risk Policy (Policy) as shown in Attachment 1 and repeal the legacy derivatives policies as shown in Attachments 2 and 3. The list of additional policies that will be updated through the administrative change process, to reflect the repeal of the legacy derivatives policies and the adoption of the new Policy, is provided as Attachment 4. The Wilshire Associates consultant opinion letter is provided as Attachment 5.

### **EXECUTIVE SUMMARY**

The Policy was presented to the Investment Committee (IC) for initial review on October 14, 2013. The Policy includes one change based on feedback from the initial review by the IC. In the *Purpose* section of the Policy, staff have included reference to the recently adopted CalPERS Investment Beliefs Policy. Changes made to the Policy based on the IC's feedback are denoted with yellow highlighting in Attachment 1.

Staff seeks approval of the Policy to ensure that CalPERS has effective operational, risk management and compliance controls when using derivatives within the investment process. Additionally, the new Policy consolidates and replaces two legacy derivatives policies and requires adjustments to asset class policy language where reference is made to the legacy derivatives policies or where the new Policy language now supersedes existing language. Upon approval of the new Policy staff will update any affected policies through the administrative change process.

### **STRATEGIC PLAN**

This agenda item supports the CalPERS Strategic Plan goal to improve long-term pension and health benefit sustainability. The adoption of a clear and unified Policy will enhance CalPERS ability to achieve the System's investment objectives.

## **INVESTMENT BELIEFS**

This agenda item supports the following CalPERS Investment Beliefs:

Investment Belief 9: Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error

- CalPERS shall develop a broad set of investment and actuarial risk measures and clear processes for managing risk

Investment Belief 10: Strong processes and teamwork and deep resources are needed to achieve CalPERS goals and objectives.

- CalPERS will be best positioned for success if it:
  - Has strong governance
  - Operates with effective, clear processes

## **BACKGROUND**

The purpose of the Derivatives Central Clearing and Processing Target Operating Model initiative (Initiative) was to establish capabilities needed within the Investment Office (INVO) to implement central clearing mandated by Dodd Frank and improve policies and procedures associated with derivatives trading. As a part of the Initiative, INVO formally established a Derivatives Committee comprised of senior staff to provide ongoing oversight of derivatives and derivatives strategies. Derivatives Committee members are selected based on their senior oversight responsibilities and subject matter expertise with derivatives.

A specific responsibility outlined in the Derivatives Committee Charter is the “creation, management, and maintenance of the Global Derivatives Policy framework.” The development of the new Policy constitutes an important step in establishing the Derivatives Committee as the owner of the derivatives policy framework and creation of any new derivatives policies and procedures thereunder. The new Policy was developed by Derivatives Committee members including representation from Absolute Return Strategies, Global Equity, Global Fixed Income, Investment Compliance and Operational Risk, Investment Servicing Division and Risk Management.

## **ANALYSIS**

The new Policy was designed from the outset to support the following goals:

1. Provide an overarching framework for how derivatives should be monitored and managed within INVO.
2. Merge the existing Development of Derivatives Strategies and Derivatives – External Money Managers policies into one policy inclusive of all means of implementation (i.e., Internal Management, Externally Managed under Investment Manager Agreements and Limited Liability Entity investments).
3. Provide for inclusion and oversight of the Affiliate Funds within the new Policy.

4. Enhance and clarify responsibilities for a counterparty risk process that is measured and managed jointly across asset classes and inclusive of external manager exposures.
5. Remove procedural language contained in the existing derivatives policies.
6. Align the new Policy with regulatory requirements under the Dodd Frank Act.

The new Policy accomplishes these goals and sets a solid foundation to allow INVO to adapt to any future derivatives regulations or changes in investment strategies.

### **BUDGET AND FISCAL IMPACTS**

Not Applicable

### **BENEFITS/RISKS**

The new Policy is designed to reduce operational, compliance and regulatory risk by establishing a consolidated governance and procedural framework for monitoring and managing derivatives across INVO. The Policy formalizes the role and responsibilities of the Derivatives Committee in providing oversight to the use of derivatives across INVO. In addition, the Policy positions CalPERS to be in alignment with Dodd Frank requirements and creates a process for evaluating and elevating potential issues and matters that are likely to impact derivatives markets to the Investment Strategy Group and Operating Committee.

If the Policy is not adopted, INVO staff would be required to continue with a status quo derivatives governance framework that is fragmented and does not acknowledge the current tempo of regulatory changes in the derivatives market.

### **ATTACHMENTS**

- Attachment 1 – Proposed Global Derivatives and Counterparty Risk Policy
- Attachment 2 – Black-lined Development of Derivatives Strategies Policy
- Attachment 3 – Black-lined Derivatives – External Money Managers Policy
- Attachment 4 – List of additional policies to be updated through the administrative change process
- Attachment 5 – Wilshire Associates Opinion Letter

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