Agenda Item 5a

October 20, 2015

ITEM NAME: Treasury Management Reserve Policy (Second Reading)

PROGRAM: Financial Office

ITEM TYPE: Action

RECOMMENDATION
Staff recommends the Board adopt the Treasury Management Reserve Policy which includes the revisions to the policy resulting from the Board's first reading of the policy during the August 2015 meeting of the Finance and Administration Committee.

EXECUTIVE SUMMARY
The first strategic objective of the Treasury Management Program ("TMP") is to ensure the payment of member benefits and organizational expenses without interruption regardless of financial markets and environmental conditions. In support of this strategic objective, the Treasury Management Policy further states that, "as necessary, the TMP will establish and oversee cash reserves for programs that serve as an option for payment of CalPERS' obligations if a market or external environment event results in the depletion of cash."

The proposed Statement of Financial Policy for Treasury Management Reserves ("Policy") has been developed by Staff to govern the practices related to the establishment and oversight of such reserves. The Policy also identifies which program require a Treasury Management Reserve ("TM Reserves") and which do not based on the Staff's assessment of the relevant characteristics of the Public Employees' Retirement Fund ("PERF") and the other funds.

This Agenda Item puts forth the Treasury Management Reserve Policy to be reviewed by the Board for approval.

STRATEGIC PLAN
This agenda item supports Goal B of the CalPERS 2012-2017 Strategic Plan, which is to cultivate a high-performing, risk-intelligent, and innovative organization.

BACKGROUND
In March 2015, the Finance & Administration Committee adopted the first ever Policy for Treasury Management. The Treasury Management Policy directs Staff to follow a risk-based approach to the optimization of fund assets in the payment of CalPERS' obligations to ensure the most cost effective method of funding is achieved during normal, stressed, and crisis environments. A key component of the policy and the

Treasury Management Program is the ability to establish TM Reserves in order to ensure the payment of member benefits and other obligations without interruption regardless of market or non-market conditions.

In Q2 2015, Staff began development of a policy to govern the practices related to the establishment and management of TM Reserves. Staff has analyzed each program to determine if a TM Reserve is needed. The Policy and TM Reserve strategy presented herein are the result of a collaborative effort with the Investment Office, Financial Office, Benefit Programs Policy and Planning, and Customer Services and Support.

During the August 2015 meeting of the Finance and Administration Committee, the Board performed a first reading of the Treasury Management Reserve Policy and provided the staff with guidance on potential policy revisions.

ANALYSIS

Staff assessed the need to establish TM Reserves for the PERF during stressed and crisis environments. Stressed environments are a severe market or non-market events for which Funding contingency plans have been made and options are identified and available to meet CalPERS' obligations. Given the current liquidity allocation target of the PERF, as well as its liquidity allocation at the new target of 1%, the fund's coverage ratios with respect to its monthly obligations to pay benefits and operating expenses are 1.6 times the cash on hand and 6.1 times the total cash that can be generated in order to meet the projected monthly outflow of $1.8 billion. Therefore, Staff has determined that there currently is no need for TM Reserves under stressed conditions.

Crisis event is defined as a one week (five business days) market lockup which occurs with no ability to foresee or plan for the event and no ability to generate cash through investment activity such as the sale of public market securities or the security lending program. For example, the September 11, 2001 attack on the World Trade Center resulted in the markets being closed for five business days. During a crisis situation, the PERF would be 100% reliant on cash and cash equivalents held in the PERF to meet its obligations, including the payment of benefits.

Staff evaluated the current process for raising cash to assess the need for TM reserve during a crisis event. The Investment Office (INVO) raises cash to pay benefits and sets this cash aside in three tranches during the month at 10 day intervals. With roughly $1.7 billion in monthly benefits payments, the cash raised and set aside is as follows:

Cash Raised (Dollars in Millions) Tranche and Timing			Cash Transferred to Pay Benefits
Tranche 1 Day 1-10	Tranche 2 Day 11-20	Tranche 3 Day 21-30	Day 30-31
$600	$600	$500	$1,700

Staff determined the need to address the funding risk associated with raising funds for the last tranche. Staff assessed the options of keeping a TM reserve or prefund the amount associated with the amount of the last tranche. Staff determined that it is most cost effective to prefund 100% of the monthly member benefit payments five business days prior to the payment date. Pre-funding the monthly benefit payments in this manner would require holding approximately $250 million less in average daily cash balances than the alternative of holding a permanent TM Reserve of approximately $500 million to ensure the payment of member benefits and enterprise obligations without interruption. Therefore, staff recommends that no TM Reserve be established at this time but that the PERF fully prefund its benefit payment obligations five business days in advance of the payment date.

This recommendation is reflected in the Policy.

Staff has also assessed the need for TM Reserves for all other funds and programs and recommends the following:

- Maintain existing TM Reserve for Judges' Retirement Fund
- Prefund obligations by 5 business days for Legislators' Retirement Fund and California Employers' Retiree Benefit Trust Fund
- The Public Employees' Health Care Fund, the Contingency Reserve Fund, the Public Employees' Long-Term Care Fund, the Deferred Compensation Fund, the Supplemental Contribution Plan Fund, and the Replacement Benefit Fund are not considered for TM Reserves due to the self-funding nature of these programs and existence of self-insurance funds for program specific events.

BUDGET AND FISCAL IMPACTS

The recommendation of prefunding the monthly benefit payments results in approximately $250 million less in average daily cash balances than holding a permanent TM reserve of approximately $500 million. This approach allows for the $250 million in fund assets to remain in the market and generating a return.

BENEFITS/RISKS

An Enterprise Treasury Management Program is important to identify and mitigate risks early, avoid future liquidity problems, strengthen internal controls and facilitate better decision-making. The implementation of this Treasury Management Reserve Policy will help safeguard CalPERS against future market events and cash flow stresses which could jeopardize its ability to meet its obligations without interruption.

ATTACHMENTS

Attachment 1 – Statement of Financial Policy for Treasury Management Reserves – Redlined version

Attachment 2 – Statement of Financial Policy for Treasury Management Reserves – Clean version

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