CalPERS

Investment Committee

Agenda Item 6a

November 14, 2016

Item Name: State Legislative Proposal: Authorized Collateral for Security Loan Agreements

Program: Legislation

Item Type: Action

Recommendation

Sponsor legislation to modify restrictions on CalPERS securities lending transactions, consistent with the fiduciary authority of the CalPERS Board of Administration (Board).

Executive Summary

Staff seeks approval of a legislative proposal to expand the types of eligible marketable securities that CalPERS can accept as collateral when engaging in security lending agreements with borrowers, while maintaining existing collateral levels, consistent with existing law.

The collateral restrictions imposed on CalPERS by current statute are dated and do not reflect today's global investment market where non-cash collateral is increasingly prevalent due to changes in the regulatory landscape. Currently, 40 percent of securities lending transactions utilize non-cash collateral. Allowing CalPERS to add other marketable securities as acceptable collateral provides flexibility to adapt to the changing securities lending marketplace while reducing risk and maximizing revenue.

Strategic Plan

This proposal supports the following CalPERS 2012-2017 Strategic Goals to:

- Improve long-term pension and health benefit sustainability by delivering target risk-adjusted investment returns; and
- Engage in state and national policy development to enhance the long-term sustainability and effectiveness of our programs.

Investment Beliefs

This agenda item supports CalPERS Investment Belief 7, that CalPERS will take risk only where we have a strong belief we will be rewarded for it.

Background

Chaptered legislation from 1975 authorizes the Board to enter into security loan agreements, which are agreements where a lender (in this case CalPERS) agrees to loan securities to a borrower in exchange for collateral. Existing law sets a minimum collateral value of 102 percent of the market value of the loaned securities, and limits the acceptable forms of collateral to cash, bonds, other interest-bearing notes and obligations of the United States or federal instrumentalities eligible for investment by a lending state agency.

The CalPERS Securities Lending Program (Program) began in 1980 in an effort to earn additional income from the CalPERS portfolios. Since inception, cumulative net earnings of the Program are $2.2 billion.

Recognizing the potential for substantially greater income from an actively managed lending approach, CalPERS implemented a web-based auction platform approximately fifteen years ago as a means to maximize the value of lendable assets. The first few auctions were tremendously successful and immediately boosted returns. Revenue increased by 63 percent the first year the auction process was utilized. The increased price transparency of the auction format allowed CalPERS to realize the true value of its lendable asset base. By increasing the number of counterparties and creating portfolio subsets that matched borrower needs, CalPERS extracted additional value from its existing asset base.

Over the last fifteen years, CalPERS has lent $1.7 trillion in assets through 64 separate auctions. Over 88 percent of the total cumulative income has been generated since moving to the auction based platform.

Analysis
The last several years have witnessed a change in the securities lending marketplace. Increased regulatory requirements have resulted in the greater use of non-cash collateral among borrowers entering security lending agreements. Initially, non-cash collateral bids were small in number, but they have become more frequent. CalPERS recently had to decline a winning bid of $15.5 million due to statutory limitations on accepting certain non-cash collateral.

Staff recommends seeking legislative changes to expand the types of collateral that CalPERS can accept in security lending agreements to include public equity securities and international government bonds. The value of all collateral will continue to be at least 102 percent of the market value of the loaned securities. CalPERS Investment Policies, specifically the securities lending policy, will include the specific requirements for allowable collateral. Those requirements will include, but are not limited to, a stipulation that the securities used for securities lending collateral are liquid, freely transferable on an electronic exchange, and priced daily, at a minimum. These proposed changes will allow the Program to continue to thrive in this changing market environment.

Budget and Fiscal Impacts
Expanding the types of collateral CalPERS can accept when engaging in security lending agreements would encourage more bids, possibly resulting in higher income for the Public Employees' Retirement Fund (PERF). It would also reduce the possibility of CalPERS having to reject a winning bid because the collateral offered is not in the appropriate form.

Benefits and Risks
Benefits:

- Aligns the Program with current financial marketplace methods.
- Allows CalPERS to maximize the amount it can earn through security loan agreements.
- Provides sufficient flexibility to manage the CalPERS investment portfolio in a cost-effective, transparent and risk-aware manner in order to generate returns to pay benefits.
- Properly managed, accepting public equity securities and international government bonds as collateral reduces overall risk to the securities lending program.

Risks:

- Expanding eligible collateral may increase the complexity of the Program's collateral management activities.

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