CALSTRS

CALIFORNIA STATE TEACHERS'
RETIREMENT SYSTEM

CREDIT ENHANCEMENT PROGRAM POLICY

INVESTMENT BRANCH

~~JULY 2008~~Decommission March 2024

INTRODUCTION

In accordance with the decision by the California State Teachers' Retirement System (CalSTRS) to pursue the development of a Credit Enhancement Program, CalSTRS has established an ongoing program that emphasizes earning fee income through the enhancement of bond transactions.

Credit Enhancement is an off-balance sheet activity that does not affect the CalSTRS asset allocation. The primary objective of the program is to earn fee income. The bond transactions are either governmental or private activity, which have a public purpose (e.g. multi-family housing, industrial development, pollution control). The credit enhancement opportunity set is considered low risk.

Internal professionals, who operate under the direction of the Chief Investment Officer, or designee, perform the management of the credit enhancement activities.

This manual will establish the policies involved in the management of the Credit Enhancement Program. The policies are designed to set boundaries for expected performance, diversification, and investment structure. The procedures are designed to provide guidelines for the implementation of the approved policies.

WHAT IS CREDIT ENHANCEMENT?

Credit enhancement is an agreement by CalSTRS to provide for the payment of principal and interest in the event that the primary obligor does not meet the terms and conditions of the bond indenture. This substitution (for a fee) allows the public or private entity borrowing access to the capital markets and permits them to pay a lower interest rate to investors. The most utilized form of credit enhancement is a letter of credit. Another form of credit enhancement used by the CalSTRS Credit Enhancement Program is called a liquidity enhancement. Liquidity enhancement is used for short term or variable rate securities to give investors confidence for liquidity associated with a specific security. Most liquidity enhancements contain a lesser degree of credit exposure than letters of credit.

The Credit Enhancement Program is an off-balance sheet program since it is a commitment to pay investors in circumstances that are expected to be highly infrequent. The strategic asset allocation plan is not affected.

FORMS OF CREDIT ENHANCEMENT

- Liquidity Support
- Credit Support
- Combination of Liquidity and Credit Support

CREDIT ENHANCEMENT INSTRUMENTS

Credit enhancement transactions normally utilize financial instruments known as letters of credit (LOC). A LOC is an unconditional promise to make payments up to a stated amount for a specified period upon receipt of a proper notice. The commitment is irrevocable. The following are the type of LOCs that CalSTRS utilizes:

Confirming Letter of Credit
A bank issues a fronting letter of credit and CalSTRS issues a confirming letter of credit. For this LOC, the investor (through the trustee) looks to the bank supporting the obligor to make the interest and principal payments to investors. If the bank fails to make these payments, the trustee calls upon CalSTRS to make the payment. CalSTRS would then demand reimbursement from the bank.

Direct Pay Letter of Credit
The Direct Pay LOC Bank (CalSTRS) issues a fronting letter of credit and a bank issues a standby letter of credit. For this letter of credit, the investor (through the trustee) looks to the Direct Pay LOC Bank for all interest and principal payments to investors. The obligor (company or municipality seeking credit) then reimburses the Direct Pay LOC Bank. If the obligor fails to reimburse for the LOC drawing, the standby bank reimburses CalSTRS.

Letter of Credit
An instrument issued by a bank or pension plan that unconditionally promises to make debt service payments and provide liquidity support on a bond issue up to a stated amount for a specified period of time upon receipt of proper notice in the event of a default. Letters of credit are usually required for variable rate bond issues.

Line of Credit/Liquidity Facility
This form of LOC is an availability to purchase securities under specific situations. The bonds or commercial paper that this facility supports may be remarketed on a daily, weekly, or monthly basis. There is a need to have their marketability guaranteed. If there is a failed remarketing, CalSTRS may be required to “purchase” these bonds and receive pre-agreed interest payments. In the case of commercial paper, this commitment may be revocable under certain circumstances.

CREDIT ENHANCEMENT PROGRAM POLICIES

A credit enhancement is the substitution of a public or private entity’s credit standing with that of a financial institution that has a higher credit rating. It is an agreement by a third party to pay the investor any scheduled interest and/or principal payments in the event the primary obligor does not pay. This substitution (for a fee) allows the public or private entity access to the capital markets and permits them to pay a lower interest rate to investors. The most utilized form of credit enhancement is a letter of credit. Another form of credit enhancement used in the CalSTRS Credit Enhancement Program is called a liquidity enhancement. Liquidity enhancement is used for short term or variable interest rate securities to give investors confidence for liquidity associated with a specific security. Most liquidity enhancements contain a lesser degree of credit exposure than letters of credit.
The following represent the approved policies to be utilized in the management of the Credit Enhancement Program. The policies are designed to set boundaries for the expected performance

and structure. Policies approved by the CalSTRS Board cannot be altered without explicit direction from the CalSTRS Board.

1. The Credit Enhancement Program of the California State Teachers' Retirement System is invested in a prudent manner for the sole benefit of CalSTRS' participants and beneficiaries in accordance with California State Law.

2. The primary objective of the Credit Enhancement program is to provide fee income through the enhancement of low risk bond transactions for either governmental entities or private activities that serve a public interest (e.g., multifamily housing, industrial development, pollution control).

3. The structure of the transaction is a primary form of risk management. However, diversification by municipal finance sectors is important to control risk. These transactions are considered low risk and frequently have structural protections that are the primary form of risk control.

4. Credit enhancement is considered a selective investment activity. The maximum amount of outstanding commitments enhanced under the Credit Enhancement Program is limited to three percent (3%) of the market value of the CalSTRS Investment Portfolio.

5. No investment vehicle or activity prohibited by the Investment Resolution adopted by the Board in 1984, as amended from time to time will be authorized for the Credit Enhancement Program.

6. Authorization letters, which indicate who may sign on behalf of CalSTRS, shall be included at the time of the closing of a transaction.

7. Prior to being processed by the Operations Area, all wire transfers and bond purchases shall be signed by two Investment Officers.

8. Graduated limitations of daily authority to wire transfer funds or purchase bonds under specific situations are as follows:

Investment Officer I	$ 50 Million
Investment Officer II	$ 75 Million
Investment Officer III	$ 100 Million
Portfolio Manager	$ 300 Million
Director of Private Equity	$ 400 Million
Chief Investment Officer	$ 600 Million

9. The Credit Enhancement Program will be managed according to an annual business plan whose main business components will encompass an assessment of the credit enhancement market, a review of the portfolio, a review of the strategy, a review of targets, and a resource allocation budget.

10. The Credit Enhancement Program will report on a monthly basis: a) new transactions, b) summary of existing transactions broken down by structure, and c) financial institution risk.

11. The rejection decision for a credit enhancement transaction is delegated to staff, with the stipulation that all investment opportunities receive equal opportunity and subject to the appropriate amount of due diligence as defined in the credit enhancement procedures.

12. The approval decision for up to $400 million, per transaction, is delegated to staff as it relates to the Credit Enhancement Program. Each transaction shall have a written positive recommendation by the CalSTRS staff and Chief Investment Officer.

13. The approval decision for the Credit Enhancement Program is delegated to staff considering the following stipulations:

    a. All credit enhancement and liquidity enhancement transactions must be for projects that are located in the United States, territories, or the District of Columbia.

    b. All credit enhancement and liquidity enhancement transactions must be completed in conjunction with a third party external to CalSTRS. This “partnership” with another financial institution is designed to help ensure that the private market discipline is present in all transactions.

    c. The amount of risk associated with each transaction will be limited to the amount of the total credit risk as defined below, subject to limitations in 13C- 4:

        1. 50% of the pro-rata direct risk transaction which is shared with a partner financial institution; this limit is net of participations. For example, CalSTRS may underwrite up to 100% of the risk and participate out (sell down) to another financial institution, so that CalSTRS’ net hold does not exceed 50% of the transaction, or

        2. 100% of a credit enhanced transaction in the form a letter of credit supporting a project that has another financial institution taking the direct credit risk, or

        3. 100% of the liquidity risk in a transaction that is enhanced by a bond insurer.

        4. 25% of transactions involving employing agencies such as the California public schools, public colleges and universities, or California Agencies and Departments.

    d. All financial partners, as identified in policy 13C, must have an investment grade credit rating by a recognized credit rating agency (such as Moody’s, S&P, Fitch or Thomson BankWatch) or equivalent credit rating documented by the CalSTRS Staff.

e. To the extent possible, all fees charged, credit terms, legal conditions and project structures for credit and liquidity transactions should reflect current market conditions at the time of the transaction.

f. Diversification by geography, industry sector and transaction type is desired. The following types of transactions may be financed under the program (the list is not exhaustive):

1. Private activity bonds such as industrial development bonds, pollution control bonds, and multi-family housing,

2. Public and private non-profit entities providing a public good or service,

3. Tax and revenue anticipation notes and commercial paper,

4. City, special district and other governmental financing.

Policies and procedures adopted in February, 1994
Revised to reflect legislation regarding employer-related transactions in April, 1999
Revised to increase portfolio size to 3% of CalSTRS Investment Portfolio on December 4, 2000
Revised to expand geographic market from contiguous states to national on June 1, 2005
Revised to eliminate ranges for geographic market on July 13, 2007
Revised to increase limits on daily trading authority on July 10, 2008
Decommission policy (no program activity since 2017) on March 6, 2024

Addendum

GLOSSARY OF TERMS

BOND INDENTURE: An agreement between an issuer of bonds and a trustee, on behalf of the bondholders, setting forth the terms of the bonds.

BOND INSURANCE: Noncancellable insurance purchased by the issuer from a monoline bond insurer pursuant to which the insurer promises to make scheduled payments of interest and principal on a bond issue if the issuer/obligor fails to make timely payments. When the bond issue is insured, the investor relies upon the creditworthiness of the insurer rather than the issuer.

COLLATERALIZED LETTER OF CREDIT: A letter of credit issued by a fronting bank, which has pledged AAA-rated collateral to CalSTRS, in order for CalSTRS to issue a confirming letter of credit. CalSTRS is the beneficiary of the pledged collateral. This structure is typically used when the fronting bank has a low credit rating or no credit rating.

COMMERCIAL PAPER: Short term debt obligations commonly maturing in 270 days or less.

CONFIRMING LETTER OF CREDIT: A letter of credit issued by CalSTRS that confirms a fronting bank's letter of credit. The CalSTRS confirming letter of credit is drawn upon in the event the fronting bank fails to pay upon a draw. CalSTRS is in the second loss position. The credit rating of the bond issue is based on CalSTRS' rating.

CREDIT ENHANCER: A financial institution, such as a bank, or a pension plan, such as CalSTRS, that provides credit enhancement by issuing a letter of credit, which guarantees to investors that principal and interest payments will be made as scheduled, or a line of credit which provides liquidity support for the bond issue. When the bond issue is credit enhanced, the investor relies upon the creditworthiness of the credit enhancer rather than the issuer.

DIRECT PAY LETTER OF CREDIT: The Direct Pay LOC Bank (CalSTRS) issues a fronting letter of credit and a bank issues a standby letter of credit. For this letter of credit, the investor (through the trustee) looks to the Direct Pay LOC Bank for all interest and principal payments to investors. The obligor then reimburses the Direct Pay LOC Bank. If the obligor fails to reimburse for the LOC drawing, the standby bank reimburses CalSTRS.

EMPLOYER OR EMPLOYING AGENCY: Means the State or any agency or political subdivision thereof for which creditable service subject to coverage by the State Teachers' Retirement Plan is performed.

LETTER OF CREDIT: An instrument issued by a bank or pension plan that unconditionally promises to make debt service payments and provide liquidity support on a bond issue up to a stated amount for a specified period of time upon receipt of proper notice in the event of a default. Letters of credit are usually required for variable rate bond issues.

LINE OF CREDIT/LIQUIDITY FACILITY: This form of LOC is an availability to purchase securities under specific situations. The bonds or commercial paper that this facility supports may be remarketed on a daily, weekly, or monthly basis. There is a need to have their marketability guaranteed. If there is a failed remarketing, CalSTRS may be required to "purchase" these bonds and receive pre-agreed interest payments. In the case of commercial paper, this commitment may be revocable under certain circumstances.

MONOLINE INSURER: An insurer that writes only financial guaranty insurance.

OBLIGOR: The obligor is the beneficiary of the funds raised by the bond issuance and is responsible for paying off the bonds.

PARTICIPATION: An ownership interest in a letter of credit or liquidity facility issued by another financial institution. The ownership interest in the letter of credit or liquidity facility is sold or purchased to decrease/increase direct risk exposure to an obligor.

REIMBURSEMENT AGREEMENT: An agreement between the credit enhancer and underlying obligor setting forth the terms and conditions of the letter of credit and the responsibilities of the obligor.

SAFE HARBOR TRANSACTION: A transaction where the State Teachers' Retirement System extends credit enhancement to an Employing Agency. In such case, CalSTRS may have no more than a 25 % involvement in the credit enhancement transaction at the time of issuance. In addition, persons affiliated with the System, Employing Agencies, and other California public sector retirement systems would not be permitted collectively to account for more than 50 % of such credit enhancement transaction.

STANDBY LETTER OF CREDIT: A letter of credit that is drawn upon only if there are insufficient funds from other sources.

STANDBY BOND PURCHASE AGREEMENT: A form of liquidity facility or enhancement.

TRUSTEE: A financial institution with fiduciary responsibilities to bondholders (investors) to make principal and interest payments as well as administer all other aspects of the bond indenture.