CALSTRS

CALIFORNIA STATE TEACHERS'
RETIREMENT SYSTEM

# SECURITIES LENDING PROGRAM POLICY

INVESTMENT BRANCH

MARCH 2019

## G. Securities Lending Program Policy

### EXECUTIVE SUMMARY

In accordance with the CalSTRS Investment Beliefs and the CalSTRS Investment Policy and Management Plan, IPMP, the California State Teachers' Retirement System Board has established a Securities Lending Program, SLP. The SLP is to be managed in a prudent manner for the sole benefit of its participants and beneficiaries in accordance with the California Constitution, the Teachers' Retirement Law and other applicable statutes. The CalSTRS Investment Beliefs provide a foundational framework to all of CalSTRS investment decision makers and shall guide investment decisions. The SLP was designed to enable CalSTRS to use its existing asset base and investment expertise to generate a steady source of income. CalSTRS' size and presence in the capital markets make it a prime resource for securities lending. No investment instrument or activity prohibited by the IPMP shall be authorized for the Securities Lending Program.

This document is intended to summarize the fundamental objectives and considerations used in the investment, administration, and management of the SLP. These policies are designed to set boundaries for the structure and oversight of the management of the SLP, as well as to manage the risks associated with securities lending.

CalSTRS believes that environmental, social, and governance, ESG, issues can affect the performance of our investments. As a result, the CalSTRS ESG Policy has been developed as a tool that both internal and external investment managers are expected to use to assess the impact of ESG risk when making an investment on behalf of CalSTRS.

Detailed procedures and guidelines for the SLP are maintained separately.

As with all other plan assets, these policies cannot be altered without explicit direction from the Board. A flow chart (Exhibit 1) is included to provide the context for the policies within the general process of implementing the SLP. Words and terms that may be unfamiliar to the reader are referenced in the glossary.

## PROGRAM OBJECTIVES

The strategic objective for the SLP is to assist CalSTRS in meeting its investment goals by generating incremental income through collateralized, low-risk, short-term loans using a portion of the lendable assets within the total investment portfolio.

Monitoring and oversight of the implementation of the SLP shall come under the purview of the director of fixed income.

## PERFORMANCE OBJECTIVES

There are no explicit goals with respect to the nominal amount of income generated by the SLP.

The performance objective for the program is to achieve lending income commensurate with: 1) the market demand for the securities made available for lending and, 2) the return earned on the investment of the cash collateral within the SLP guidelines.

## PROGRAM BENCHMARK

There is no policy benchmark for the Securities Lending Program.

## PROGRAM STRUCTURE

The Securities Lending Program shall be designed to provide a balance between risk control and diversification and structured to take advantage of the benefits of both internal and external management in a prudent manner.

**Asset Allocation:** Under the direction of the director of fixed income, staff has discretion to implement tactical shifts of lendable portfolios among the lending agent(s).

**SLP Internal/External Management:** The SLP is managed by both internal staff and external investment managers. The decision to hire an external manager or utilize internal investment staff for an investment strategy is made by applying a board-approved criteria matrix (Exhibit 2) to evaluate a variety of factors including, but not limited to, cost effectiveness/control, market transparency and liquidity, market efficiency, active risk, and infrastructure/resource requirements. CalSTRS uses active external lending agent specialists as an additional resource and to provide an additional layer of diversification to the SLP.

Within the boundaries and ranges established by these policies, staff is responsible for the selection, allocation, and oversight of the external lending agents. Manager guidelines, objectives, benchmark selection, volatility parameters, constraints and trading activities are to be administered by staff and integrated into the securities lending risk budget. CalSTRS shall also maintain a pool of managers to supplement the existing managers or replace a terminated manager as needed.

**Transition Management:** Securities Lending Program unit may use internal staff or external managers to prudently administer and liquidate, if advisable, the existing cash collateral portfolios of managers that have been relieved of investment management responsibility for CalSTRS.

**Other Strategies:** Periodically the Board will approve investment strategies that may or may not be managed within the SLP specifically, but are instead designed to take advantage of an opportunity and/or to meet a performance objective. Unless a strategy is addressed by a specific policy of its own, SLP staff is responsible for the implementation of any strategy that may be directed by the chief investment officer, deputy chief investment officer or designee within the boundaries and ranges established by this policy. Investment guidelines, benchmark selection, tracking error, portfolio composition, constraints, and trading activities are to be administered by staff and integrated into the CalSTRS strategic asset allocation process and risk budget.

## RISK MANAGEMENT

**Delegation of Authority:** The investment, administration and management of the Securities Lending Program is delegated to staff within the boundaries established by policy and the processes described within the relevant investment guidelines.

**Authorized Staff:** Authorization letters which specify who may transact business on behalf of CalSTRS shall be sent to the appropriate parties, initially at the time an account is opened, and then periodically to all Securities Lending counterparties with whom CalSTRS conducts business. Whenever a change in authorized staff occurs, the affected parties shall be notified within 24 hours in the event of termination, and as soon as possible in the event of newly authorized investment staff.

**Diversification:** Diversification within investment portfolios is critical in order to control risk and maximize returns. Minimum and maximum ranges, with respect to security types, credit exposure, and security maturity, shall be established for the Cash Collateral portfolios that are being managed both internally and externally. Such ranges shall be documented within the SLP guidelines and are subject to change as conditions warrant, as determined by the director of fixed income.

**Trading Parameters:** Given that the trade activity for this program is governed by the investment and securities lending markets, no daily limits with respect to the approval of trade activity within CalSTRS' internally managed Cash Collateral portfolio shall be established.

**Collateralization:** The collateral shall be marked-to-market daily in order to maintain the negotiated margin level. Given the dynamic nature of the securities lending markets, any nontraditional (traditional being defined as cash, U.S. Treasury and U.S. Agency securities denominated in U.S. dollars) collateral must be reviewed and approved by the director of fixed income.

**Borrower Concentration:** Borrower diversification shall be reviewed in order to evaluate and control the borrower exposure within the SLP. Given the increasingly broad utilization of these firms throughout the SLP, this exposure is to be reviewed periodically, with CalSTRS reserving the right to exclude or limit any borrower from the SLP.

**Counterparty Risk:** Each loan shall be collateralized by securities and/or cash delivered to CalSTRS' custodian/sub-custodian bank prior to or simultaneously with the release of CalSTRS' assets. To protect CalSTRS, the borrower must post collateral in the form of cash and/or other approved securities in an amount that exceeds the market value of the securities borrowed. The margin percentages shall be documented within the SLP guidelines and are subject to change as conditions warrant, as determined by the director of fixed income.

## MONITORING AND REPORTING

The following reports will be prepared and presented to the Board, unless otherwise stated, in order to facilitate visibility of compliance monitoring and reporting according to this document:

a. **Securities Lending Status Report** – prepared by staff and distributed to the chief investment officer and deputy chief investment officer (monthly)

b. **Securities Lending Program Annual Report** – prepared by staff (annually)

c. **Business Plan** – prepared by staff (annually)

## BOARD REVIEW

Consistent with all other plan assets and programs, the Board or the Investment Committee will review and/or alter this policy periodically, as deemed appropriate, and in keeping with its fiduciary duties and standards**.**

*Adopted by the Teachers' Retirement Board on February 9, 1994*
*Revised to combine Credit Enhancement and Currency Management with Securities Lending into "Off Balance Sheet Programs" on September 11, 1996*
*Revised to reflect the internal management of a portion of the cash taken as collateral on January 7, 1998*
*Revised to separate Credit Enhancement, Currency Management and Securities Lending into their own Policies on May 5, 1999*
*Revised to reflect Board review but no Policy changes on May 1, 2002*
*Revised to reflect new standard Policy format across the Unit on June 7, 2006*
*Revised to reflect Board review in keeping with the investment standard on July 12, 2012*
*Revised to add ESG language on April 4, 2014*
*Revised flowchart (Exhibit 1) to reflect APM in the hierarchy on April 5, 2017*
*Revised to reflect new policy format on March 27, 2019*

Exhibit 1

# POLICY IMPLEMENTATION FLOWCHART

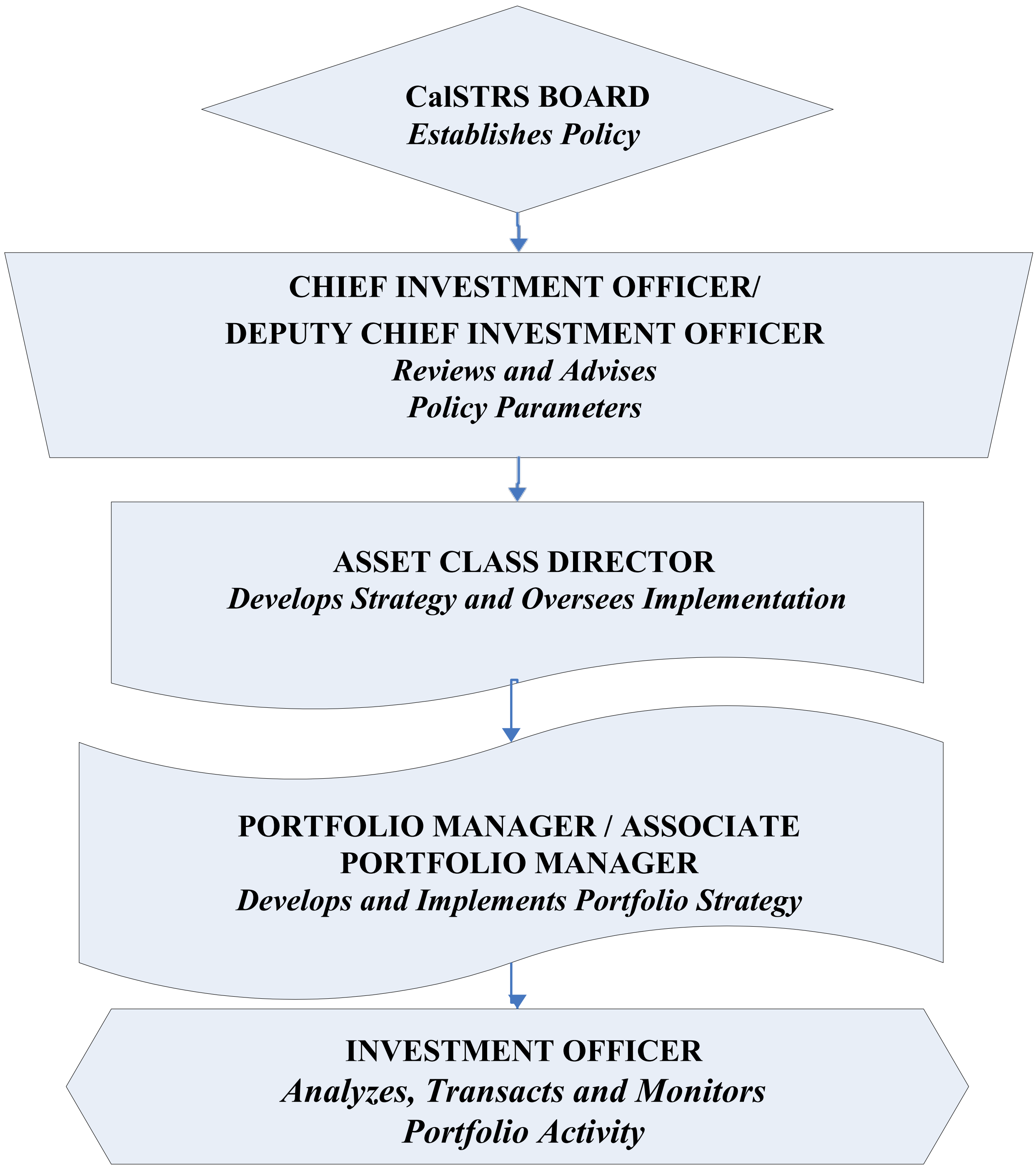

**Exhibit 2**

## INTERNAL / EXTERNAL DECISION CRITERIA MATRIX

| Decision Factors | Low | Medium | High |
|---|---|---|---|
| **Cost-Effectiveness/ Control** | External | External/Internal | Internal |
| **Market Liquidity & Transparency** | External | External/Internal | Internal |
| **Market Efficiency** | External | External/Internal | Internal |
| **Active Risk** | Internal | External/Internal | External |
| **Infrastructure/ Resource Requirements** | Internal | External/Internal | External |

**Cost-Effectiveness/Control**

After including all costs, is internal management able to add more value than external management? All things being equal, management fees increase in direct relation to the risk and complexity of the strategy being managed. Given the narrower band for tracking error (i.e., risk) described earlier in this paper, passive management usually provides opportunities for more cost-effective management of assets, while active management presents the potential to generate alpha. For active management to make sense in the Portfolio, the strategy must generate returns in excess of the benchmark net of management fees which, as discussed in last year's active/passive study, is difficult to accomplish consistently.

The decision to manage a portfolio internally or externally should not be based solely on who provides the cheapest management fees. Even though many studies have shown that internal asset management typically has a lower cost structure than external management, a more holistic view should be used in the decision making process, which includes control of the assets and market awareness of internal staff. Internal management, it has been argued, allows better coordination over when and how assets are deployed, permits greater control over corporate governance issues, and allows for a more straightforward mechanism to customize investment mandates that align with a plan sponsor's unique directives. In other words, internal management is able to focus on CalSTRS as its one and only client, versus the multiple accounts among which an external manager must divide its attention. Also, as internal staff begins to manage new strategies, staff should continue to identify additional ways to take advantage of market inefficiencies when they occur. It should be noted, however, that building in-house investment management expertise can be difficult, given the employment and hiring practices dictated by State employment.

While there seem to be many benefits to internal management, we should recognize that bringing assets in-house requires significant up-front costs which can then be amortized over the investment period. These costs include sufficient staffing levels, computer support systems, specialized software/technology, and access to investment-related data. It is clear that building and sizing the infrastructure, risk management and trading systems, and people are critical to investment success. The same criteria we apply to external managers in terms of people, process, and philosophy apply internally, as well. However, once an infrastructure has been established for an asset class, the incremental costs of adding new strategies may be minimal, depending upon the strategy.

## Market Transparency and Liquidity

Does the market have enough liquidity and transparency to allow for effective management of the strategy? While it appears that the internal versus external management debate centers around the public (i.e., fixed income and equity) markets, as opposed to the private markets (i.e., private equity and real estate), it is really the transparency, and liquidity of the markets within which each strategy trades that is the primary decision factor.

Private markets are generally less transparent and liquid than other asset classes within the Fund. Public equity and debt markets are more transparent, have broadly and widely recognized indices, are highly liquid, and are amenable to structuring a broadly diversified portfolio. This liquidity and transparency, in terms of widely followed market information and pricing, make equity and fixed income portfolio management a different kind of management challenge, as the assets are broadly available for purchase and sale to all with a mandate and the proper business infrastructure/resources.

## Market Efficiency

Does the strategy operate in a market that is efficient or inefficient? Market efficiency refers to the degree that all investors in a market have access to the same information and, at any given time, security prices reflect all available market information. The decision to manage an active or passive strategy should be directly based on the efficiency of the market. For markets that are considered highly efficient, the probability of consistently outperforming the market is relatively low, which suggests that a passive/core strategy would be appropriate. In markets that are less efficient, the opportunity exists to generate alpha. Finding these market inefficiencies requires dedicated resources to identify securities that are considered mispriced. When these inefficiencies are evident, a skilled active manager can take advantage of these opportunities and construct a portfolio that should generate fee-adjusted returns in excess of the market.

**Active Risk**

Does internal staff have the knowledge and competence to manage the strategy in house? An active strategy requires highly specialized and skilled individuals who are well versed in the pursued strategy and willing to make educated decisions to take prudent risk, in order to achieve a net return higher than the benchmark. A passive or less active strategy still requires skilled individuals; however, the goal of this type of strategy is to track or slightly exceed the strategy's benchmark, and the research effort is much less intensive than active managers.

Private equity and real estate are uniquely active markets in which expertise, in terms of property or company type, leverage, deal structure, deal components, and terms, make them truly active investments requiring resources capable of reviewing the fundamentals of the deal structure and capital to fund the deal. With internal management, recruiting investment professionals who have highly specialized skills in active strategies may be difficult. CalSTRS' compensation structure and the current environment of state budget cuts may provide a headwind to attracting new investment talent. There is also the potential for key investment staff turnover. This will always be a concern in both internal and external portfolios. CalSTRS, like external managers, would seek to construct a bench of talent for any strategy undertaken.

**Infrastructure/Resource Requirements**

Does CalSTRS have sufficient infrastructure and the resources to support the strategy? Technology and risk management systems, along with proper staffing levels (front and middle office) are a key ingredient to operating a successful investment management operation. CalSTRS has gained much of this experience over the last 20 years through the development of our own internal infrastructure, in terms of communications, specialized investment software, and analytical criteria needed to operate in the public fixed income and equity markets, as well as our exposure to external managers.

## GLOSSARY

**AGENCY SECURITIES –** Investments issued by federal corporations and federally sponsored corporations that are able to issue debt at a lower cost to such constituencies as farmers, homeowners, and students.

**AGENT –** An individual or organization that is authorized to act on behalf of another, called the principal.

**ASSET/LIABILITY MANAGEMENT** – The ability to manage the differences between your assets (which, in Securities Lending, are the securities in the cash collateral portfolio(s)) and the liabilities (which in Securities Lending are the outstanding loans).

**BASIS POINT** – One one-hundredth of a percent of yield; .0001 in decimal form.

**BORROWER –** An individual or organization that borrows securities in return for contracting into an obligation to return those securities together with a fee payment.

**CASH COLLATERAL ASSET MANAGEMENT** – Investment portfolio managers that are responsible for investing the cash taken as collateral from loans of securities. Each portfolio is diversified among different asset classes based on investment guidelines developed by CalSTRS and emphasizes safety of principal and adequate liquidity.

**COLLATERAL –** An asset, such as U.S. dollars or other liquid securities, which is pledged to a lender in the event that a loan payment cannot be met. The collateral may be appropriated from the borrower and sold in order to fulfill financial obligations.

**COLLATERALIZED** – A security that is secured by an asset.

**COUNTERPARTY –** An individual or organization on the opposite side of a loan.

**CUSTODIAN –** An agent, such as a broker or a bank, that stores a customer's investments for safekeeping.

**LENDABLE ASSET** – A security that has an established market or demand by borrowers, such as domestic and international equities and fixed income, in order to provide liquidity and facilitate investment strategies.

**LENDER –** An individual or organization that lends securities to a borrower.

**LENDING TERMS** – Specific requirements of a loan such as length of the loan, type of collateral, and rebate rate.

**MARGIN LEVEL –** The amount of cash or eligible securities the borrower will deposit when borrowing securities.

**MARKED-TO-MARKET –** An adjustment in valuation to reflect the current market values of the respective securities in a portfolio. This process is also used to ensure that margin accounts are in compliance with maintenance requirements.

**NON-CORE INVESTMENT PROGRAM** – A program that provides additional income to the Fund beyond the traditional asset classes within the investment office. The CalSTRS programs that fall into this category are: Credit Enhancement, Currency Hedging, Home Loan and Securities Lending.

**PRINCIPAL –** The major party in a transaction.

**REBATE** – The interest rate that the lender pays the borrower on the cash collateral.

**RISK AVERSE** – Investing conservatively, or avoiding risk unless adequately compensated for it.

**SECURITIES LENDING –** An agreement between a lender and a borrower to transfer ownership of a security temporarily in order to earn additional income. The lender retains ownership rights of the security and is entitled to any distributions that occur with respect to that security during the life of the loan, such as coupon and dividend payments. The borrower backs the agreement by delivering collateral to the lender, either in the form of cash, which is currently the dominant form of collateral in securities lending transactions, or other liquid securities, in an amount that exceeds the market value of the securities borrowed.

**SHORT SELLING** – The practice of selling a security that a seller does not own. Therefore, the seller must borrow the security in order to complete the transaction.

**SPREAD INCOME** – Difference between the yield on the investment of the cash and the interest (rebate) paid to the borrower.

**UNITED STATES TREASURY SECURITIES –** Debt issues of the U.S. Government, such as Treasury bills, notes and bonds.