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San Bernardino County Employees'
Retirement Association

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Area:	<i>Investments</i>
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Applicability:	<i>SBCERA systemwide</i>

Counterparty Risk Policy

POLICY NO. 019

Background

The Board is aware that derivative contracts involve counterparties. This policy codifies the existing SBCERA protocols and approach to counterparty risk management as well as outlines Investment Manager responsibilities.

Policy

SBCERA has a strong preference for using counterparties that are regulated by the 1934 Securities Exchange Act. We believe the 1934 Securities Exchange Act provides the best protection for assets held as collateral at the bank. SBCERA in all cases with counterparties seeks to exchange cash flows to mitigate the potential for SBCERA capital to be held by a defaulting entity. SBCERA is highly skeptical to provisions that only apply to SBCERA and not to the other counterparty.

Contracts covered by International Swaps and Derivatives Association (ISDA)

ISDA contracts have three components: The Master Agreement, the Schedule, and the Credit Support Annex. Master Agreements are updated periodically. At the time of this writing, there are two of the ISDA Master Agreements (1992 and 2002). SBCERA was advised by counsel at K&L Gates that the 1992 ISDA Master Agreement is more favorable. SBCERA will generally negotiate to use the 1992 version.

SBCERA will negotiate for \$0 dollar thresholds; this means that neither party has a buffer before cash is exchanged. Much like a futures contract, SBCERA would like to settle each day with the counterparty.

SBCERA will negotiate for low minimum transfer amounts (\$250,000); this provision ensures that if the daily change in balance between the counterparties is more than \$250,000 the parties will transfer that cash. This minimum transfer amount attempts to balance the operational burdens of transferring cash between parties and mitigating the potential stranded assets in case of default.

SBCERA is suspicious of all Additional Termination events, and reviews this section carefully. We have successfully negotiated provisions to include rebalancing exclusions in most of the agreements as well as improved Net Asset Value (NAV) triggers.

Contracts covered by a Futures Clearing House

Derivative contracts under the auspices of a Futures Clearing House (like the Chicago Mercantile Exchange) are standardized and the margin requirements of all parties are overseen by the Clearing House.

Counterparty Selection

SBCERA's business needs, the bank's ability to perform, and its overall financial health will be considered before a new counterparty is engaged. SBCERA has a reluctance to proliferate counterparties. Strategies that use more counterparties are not necessarily less risky as there are more legal contact provisions to monitor; moreover, SBCERA believes the provisions governing the exchange of cash flows in the ISDA are the best protections for all involved. However, when buying options where SBCERA pays upfront (as with lending), the counterparty is a very high priority as SBCERA's upfront premium would be held by the counterparty.

Oversight of ISDA

SBCERA engages investment managers to invest on our behalf. Some of those managers will use derivatives and prime brokerage for their strategies. Once an ISDA is in place, the manager is obligated to oversee the transfer of capital pursuant to the agreement, and monitor the other provisions of the agreement.

Investment Managers and Investing in Funds

In cases where SBCERA has invested in a fund and the manager has responsibility to negotiate any prime brokerage agreements and ISDA documents, SBCERA expects the manager will have a policy on the selection and approval of counterparty relationships which is appropriate to the investment strategy and risks. SBCERA expects the manager to have a documented compliance process related to the oversight of the agreed upon provisions of the agreements.

Attachments

No Attachments

Applicability

SBCERA, SBCERA Internal