Derivatives Risk Statement

December 2020

Improving the future prosperity of Victoria

Contents

1 Introduction

1.1. Objectives

The Derivatives Risk Statement outlines the policies and controls in place covering the use of derivatives by VFMC, and the processes for assessing compliance with those controls.

These policies and controls are intended to ensure the proper use of derivatives in the management of client investment portfolios.

The Derivatives Risk Statement was first approved by the Board of Directors of VFMC on 20 December 2010.

1.2. Scope

This statement is accessible to the full VFMC team and it is a requirement that all those involved in the management of derivatives understand and are familiar with the principles in this document.

2 Definition of Derivatives

Derivatives are financial contracts the value of which depends on, or is derived from, assets, liabilities or indices. Derivatives include futures, options, swaps, forward contracts, and combinations of these instruments.

Some derivatives replicate physical investments and their risks are similar. Others exhibit optionality i.e. they derive their value from giving or receiving the right but not the obligation to undertake a transaction (e.g. options, warrants).

Where uncertainty exists about whether an instrument is a derivative, it should be treated as a derivative for the purpose of this Statement.

3 Relationship to Investment Strategy

VFMC's aim is to meet clients' investment objectives. The use of derivatives must be consistent with this aim and with the client investment strategies as set out in the Investment Risk Management Plan (IRMP), Client Investment Management and Funds Management Service Agreements, VFMC Multi Strategy Funds Brochure, and Section 9A of the VFMC Act.

4 Purpose of the Use of Derivatives

Derivatives may be used by VFMC as part of an overall strategy to achieve each client's return objective. For example:

- As a substitute for physical instruments;
- As a hedge against adverse movements in market prices and exchange rates;
- To implement a strategy that cannot be replicated as efficiently with physical assets on a net of fees / transaction cost basis;
- To manage asset-liability mis-match volatility;
- To control the market impact on portfolio valuations from significant transactions;
- To facilitate cash management;
- To achieve transactional efficiency through reducing transaction costs and obtaining prices that may not be available in the physical market;
- To manage market exposure and rebalance portfolios.

5 Restriction on the Use of Derivatives

For clients covered under the IRMP, VFMC may only use derivatives in accordance with the Treasurer's approval under section 11 of the Borrowing and Investment Powers Act 1987 (BIPA) initially dated 1 May 2007 and as amended. Section 11 of BIPA applies to each client which is referred to in the BIPA Schedule.

For trusts where VFMC acts as trustee, VFMC may only use derivatives in accordance with the approval of the Treasurer under section 11 of the BIPA.

For other clients, where appropriate, the use of derivatives will be as prescribed in the client agreement.

VFMC must ensure that client portfolios and VFMC trusts are not leveraged. In the case of derivatives other than hedges, this will generally be achieved by notionally allocating an amount of cash (physical or synthetic) or a 'cash like' asset to 'back' each derivative position. 'Cash like' assets are assets that in VFMC's professional judgement have a market exposure substantially equivalent to cash (i.e. approximately zero beta and a cash benchmark) and have sufficient liquidity to meet the derivative's settlement requirements. Hedges will be backed by the asset which is being hedged.

6 Risk Analysis

Risk management is a fundamental part of the investment management process. VFMC is committed to having a strong control environment and culture to ensure that portfolios are managed in accordance with their relevant investment strategies and statutory approvals.

There are various risks associated with the use of derivatives. The key risks, and the controls in place to mitigate these, are outlined below:

6.1 Market Risk

Market risk is the potential short-term loss from fluctuations in the market value of client portfolios and their constituent securities. Market risk is taken on behalf of clients as part of achieving their long-term investment objectives.

Market risk analysis for client portfolios and their components is conducted on a regular basis. VFMC monitors and controls market risk by ensuring that all positions including derivatives are marked to market, and that net exposure to an asset class does not go outside limits set in the client's or VFMC trust's investment strategy.

6.2 Liquidity Risk

Derivatives pose two types of liquidity risk. The first is the risk that VFMC cannot easily unwind or offset a particular position at or near the previous market price, because of inadequate market depth or because of disruptions in the market.

The second is the risk that VFMC cannot meet financial obligations resulting from its derivative activities, such as meeting margin calls on futures contracts or posting collateral on swaps.

In controlling liquidity risk, the decision to invest in any instrument involves consideration of the instrument's liquidity and the size of the position to be taken, plus the potential for calls on liquidity to maintain the position. Each client's and VFMC trust's liquidity is monitored to ensure any future obligations can be met.

Various mitigants are utilised to manage liquidity risk across client portfolios including having cash in client portfolios, staggering the due dates for settlements, operating a cash management trust, undertaking liquidity coverage ratio analysis, and maintaining a REPO facility with the Treasury Corporation of Victoria.

6.3 Counterparty (Credit) Risk

Counterparty risk is the risk that a counterparty (the other party with whom a derivatives contract is made) will fail to perform its contractual obligations (i.e. default in either whole or part) under a contract.

Derivative transactions can only be undertaken with approved counterparties in accordance with VFMC's Counterparty Approval and Exposure Monitoring Policy.

6.4 Basis Risk

Basis risk is the risk that a derivative security does not exactly mirror the price movements of the underlying security or benchmark index. VFMC considers basis risk along with other considerations such as transaction costs and liquidity, when evaluating portfolio implementation options.

6.5 Operational Risk

Operational risk is the risk that deficiencies in the effectiveness and accuracy of the information systems or internal controls and processes will result in material loss. This risk may be associated with human error, systems failures, inadequate procedures and lack of internal management controls.

VFMC mitigates operational risks with the following processes and controls:

- Organisational structure ensures separation of Investment, Middle Office, Data Management and Settlement functions.
- Within the Investments function, the CIO sets out authorisations to implement strategies and transact securities, including derivatives as per the Authorisation to Trade Policy.
- Investment guidelines restriction monitoring is performed via a combination of automated and manual processes. The Custodian performs post trade investment guideline monitoring on all portfolios managed by VFMC and mandated external fund managers.

IRMP asset allocations are monitored by the Investments, Operations and Risk & Compliance teams:

- All derivatives positions, margins and cash balances are reconciled by the Custodian with counterparties and clearing brokers' statements.
- The Custodian captures and settles all derivative transactions.
- The Custodian values all securities, including derivatives, daily for Investment Administration, Investment Management & Technology and Analytics services, including performance, mandate monitoring, and client and fund accounting purposes. VFMC also values derivatives daily for portfolio management purposes consistent with the Investment Pricing and Valuation Policy.
- For portfolio management purposes, the Custodian reconciles daily all portfolio holdings and valuations in the Investment Book of Record (IBOR) to VFMC's portfolio management system (SCD) and resolves any discrepancies. The Custodian also reconciles daily all portfolio holdings in the IBOR to the Custody and Accounting records. The VFMC Operations team will perform daily oversight activities and quality assurance for these reconciliation functions.
- A business continuity plan is in place to ensure the business can continue to operate in the event of a disaster.

6.6 Legal Risk

Legal risk is the risk that counterparty performance obligations are not documented or legally enforceable. Legal arrangements and documentation are reviewed by the Legal and Tax team and must be signed off before execution. Where necessary, the legal department utilises external legal counsel with the appropriate skills and experience for particular transactions. VFMC only executes over the counter contracts with counterparties with whom ISDA Master Agreements are in place.

6.7 External Manager Derivatives Risk

VFMC utilises external fund managers for investment management services. External manager derivatives risk is the risk that these managers:

- use derivatives in a manner that is not consistent with VFMC's investment management process; or
- have deficient or ineffective internal controls and processes, which may result in material loss.

VFMC mitigates this risk via:

- Investment Management Agreements with mandated managers which specify investment guidelines and any limitations on the use of derivatives;
- Ensuring Derivatives Risk Statements (where available) and Reports on Internal Controls are received annually from mandated managers;
- Where utilising pooled vehicles, ensuring an understanding of the manager's derivatives and risk management process as part of its due diligence; and
- Monitoring and reporting of any manager investment guideline breaches.

7 Currency

Foreign currency exposure will naturally arise from investment in overseas assets, including derivatives, and creates another dimension of portfolio risk management. Such foreign currency exposure, and any use of derivatives to manage such exposure, must be consistent with the client's investment strategy and the VFMC trust's investment objectives.

The use of Forward Foreign Exchange or other similar contracts to manage currency risk adds potential liquidity risk to client portfolios which is monitored daily and managed across time (refer to section 6.2 above). Material issues are escalated to the CEO by the CIO.

8 People Management

A strong control environment and focus on risk management is embodied across the organisation via policies, training and regular risk reporting across the various functions. Recruitment procedures are designed so that VFMC recruits team members of appropriate calibre, expertise and background. There is a clear definition and separation of responsibilities and regular performance assessments. Appropriate training is made available to VFMC's people.

9 Assessment of Controls

VFMC's people demonstrate compliance with their obligations through attestations and confirmations provided in the compliance monitoring and reporting system. This contains obligations arising from legislation, the Prudential Standard, regulatory approvals, risk controls, reporting and audit standards.

In addition to the above, internal and external audit periodically perform reviews of, and report on, VFMC's operations, internal controls and service providers.

Any breaches of legal and regulatory obligations or breakdown of control procedures are reported to the Operational Risk Management Committee and corrective action is taken as necessary.

10 Reporting

VFMC is responsible for regular reporting to clients. This includes making this Derivatives Risk Statement available to all relevant parties and any material updates as they occur.

VFMC is required to certify on a periodic basis that client funds are being managed in accordance with the IRMP and clients' investment objectives, and on the adequacy of internal controls.

Material breaches of internal controls in relation to the Derivatives Risk Statement and the use of derivatives will be reported to the Operational Risk Management Committee and the Board.

11 Related Documents

11.1 Related policies

11.1.2 Counterparty Approval and Exposure Monitoring Policy

11.1.3 Investment Pricing and Valuation Policy

11.1.4 Authorisation to Trade Policy

11.2 Related Acts

11.2.1 Victorian Funds Management Corporation Act 1994 (VFMC Act).

11.2.2 Borrowing and Investment Powers Act 1987

12 Document Information

1.1 Document Status

The current status of this document is shown below.

Original issue date	29 June 2007
Current approval date	December 2020
Document category	Operational policy
Annual attestation required	No
Policy induction session required	Yes, part of Investments onboarding materials

1.2 Document Review and Approval

Policy Role	VFMC Role	Minimum review frequency	Last review date	Next review date
External review	N/A	N/A	N/A	N/A
Owner	Head of Portfolio Risk & Solutions	Annual	December 2020	December 2021
Approver 1 (ELT Member)	CIO	Annual	December 2020	December 2021
Approver 2 (Management committee)	EIC	Every three years or following a material change	September 2019	December 2022
Approver 3 (Board committee)	N/A	N/A	N/A	N/A
Approver 4 (Board)	N/A	N/A	N/A	N/A

1.3 Document History

The history of changes made to this document is shown below.

Version	Date	Summary of changes
1.0	June 2007	First issue
2.0	April 2008	Reissued with minor amendments
3.0	December 2010	Board Approved with minor amendments
4.0	September 2011	Reviewed – no changes
5.0	September 2012	Annual Review: Section 8.4 added monitoring of IRMPs and clarity around valuations. Section 11 removed verification section.

Version	Date	Summary of changes
6.0	July 2014	Annual Review (Nov 2013 ARCC, July 2014 Board approval) The changes adopted observations for improvement that were provided by the Prudential Supervisor's following its review of the DRS. Section 7 a new sentence added on synthetic cash Sections 8.1 and 8.2 modified to enhance disclosure on market risk and liquidity risk and a new Section 8.4 incorporated to address basis risk Amended last sentence of section 9 to provide further clarity on the management of foreign exchange
7.0	December 2014	Annual review in December 2014, with Board approval not until May 2015. Minor amendment to section 8.5 relating to Middle Office team reconciliations against NAS.
8.0	January 2016	Annual review in February 2016, with minor language changes made.
9.0	November 2016	Updates post transition to new custodian and clarification of “backing” requirements.
10.0	November 2017	Minor amendments to section 7 ‘Restriction on use of derivatives’ and section 8.5 ‘Operational risk’.
11.0	November 2018	Annual review, with minor language changes made.
12.0	September 2019	Annual review. No changes.
13.0	December 2020	Annual review. Alignment with new VFMC Policy Guidelines and minor language changes.