Cbus Charter

Counterparty Risk Policy Summary

1. Purpose of Charter

The purpose of this Counterparty Risk Policy is to support the Trustee's Investment Policy Statement by documenting the Fund's approach to managing counterparty risk. In particular, it provides an overview of the key sources in the portfolio of counterparty risk and provides insights into how the Fund monitors and manages this risk.

The Policy is set by the Investment Committee and reviewed annually or more frequently if required.

2. Responsibilities and Accountability

The Trustee is at all times responsible for the Fund's investments, which includes managing the Fund's exposure to counterparty risks. The Fund manages counterparty risks by:

- Identifying where the Fund is exposed to counterparty risk;
- Identifying risk controls and where the Fund has an ability to meaningfully influence and manage these risks; and
- Ongoing monitoring and reporting of counterparty exposures and risks.

3. What is counterparty risk?

The Fund defines counterparty risk as the risk that a party to a transaction or financial contract will be unable or unwilling to fulfil its contractual obligations. This definition does not include credit risk, which is a risk the Fund expects to be rewarded for over the medium to long term.

This Policy focuses particularly on the investment risk posed to the Fund from counterparties to *'Over the Counter'* OTC derivatives and contracts and also the counterparty risk from the Fund's custodian.

The Fund primarily uses OTC derivatives and contracts to manage risks in the portfolio and, as such, counterparty risk is largely accepted and managed as a consequence of these activities.

4. Why manage counterparty risk

Management of counterparty risk is required to reduce the possibility of the Fund becoming overly exposed to the risk that a counterparty, or group of counterparties, fail to fully honour their financial obligations to the Fund. This can result in the possibility of the Fund losing profits from 'in the money' derivative position, losing collateral posted as margin, or loss due to insolvency, negligence or fraudulent action.

The risks associated with an individual counterparty changes over time due to a number of factors, including but not limited to: financial loss/solvency; systemic risks; regulatory or legal claims; and operational failures/fraud. In particular, counterparty risk often peaks in stressed market environments as the likelihood of a counterparty coming under financial stress increases.

5. General approach to managing counterparty risks

Due to the nature of the Fund's investment structure it does not have the ability to manage the entire counterparty exposure in an aggregate way. Rather, the approach is to individually manage the portfolios with meaningful exposure to counterparty risks and overlay this with regular monitoring of the aggregate exposures.

Date of this Policy:
June 2017

Cbus' Trustee: United Super Pty Ltd
ABN 46 006 261 623 AFSL 233792
Cbus ABN 75 493 363 262
MySuper authorisation
75 493 363 262 473

06/15

That is, the Fund evaluates the investment managers' approach for managing counterparty risks and where the Fund is able to exert influence (within mandates for example) it will engage with the manager to ensure appropriate counterparty risk control procedures are in place, with broad diversity across a range of high quality counterparts and maturities. This is aligned with the Fund's general approach to managing investment managers.

In general, the overall aim of managing counterparty risk is to minimise the impact on the Fund from a counterparty defaulting on its obligations. As such, the Fund focuses on the areas that pose the greatest risks and where the Fund can exercise a level of control in managing these risks, including:

- Ensuring the Fund's investment managers have strong counterparty risk controls, such as ensuring the mandates include adequate exposure and P&L limits (in both $ and % terms), regions, and maturities;
- Regular monitoring and oversight of the exposures within portfolios, including unrealised profit and losses and net exposures;
- Ongoing due diligence of investment managers, including regular onsite meetings with the managers, covering both investment and operational issues; and
- Regular monitoring of the Fund's custodian.

6. Key counterparty risk exposures

The following sets out an overview of the primary sources of counterparty risk to the Fund. In particular, it focuses on derivatives within mandates and also comments on the risks from the Fund's Custodian.

7. OTC Derivatives and Contracts

Derivatives, and in particular OTC derivatives and contracts, pose the most significant counterparty risk to the Fund. This is primarily due to the potential future size of the exposures, which can be substantially different to the nominal amount of a transaction, and the complexity and diversity of the instruments available.

The Fund does not enter into OTC derivatives directly but is exposed via a number of mandates with investment managers. The material exposures include but are not limited to:

- **FX Forwards –** Particularly within the currency overlay mandate but also within a number of other mandates that are permitted to hedge directly; and
- **Interest Rate Derivatives –** Within credit mandates and Cbus Property.

8. Exchange Traded Derivatives

As a general rule, the counterparty to an exchange traded derivative transaction is the regulated Clearing house of the exchange on which the trade is executed, which essentially acts as a guarantor to the transaction. Cash collateral (margin) is marked to market, exchanged daily and generally held in an account segregated from the Clearing house. As such, the counterparty risk associated with exchange traded derivatives tends to be low. However, in stressed environments the Trustee acknowledges the possibility of large intraday market movements, which can expose the Fund to material changes in unrealised Profit and Loss (P&L) since the last mark to market.

There could be circumstances where the Clearinghouse becomes insolvent resulting in losses greater than the intraday price movements of the Fund's positions, particularly if margins are held in omnibus accounts (i.e. shared prorate across multiple clients). However, this can be minimised by daily sweeping unrealised gains and, although not fully tested, Clearinghouses may be candidates for 'too big to fail' institutions.

9. The Fund's Custodian and Sub Custodians

Custodial risk is often viewed as a subset of counterparty risk and refers to the risk of loss suffered by the Fund due to the insolvency, negligence or fraudulent action of the Fund's prime custodian, or its sub custodians.

A. Custodian Activities

Even though the Fund's assets are held separately to the custodian, the Fund acknowledges that should the custodian suffer financial instability it could undermine its ability to provide the contracted services and lead to operational issues for the Fund and/or increased risks on transactions and settlements. Therefore, the Fund maintains regular oversight and monitoring of the custodian.

The Fund conducts annual reviews of the custodian, which includes evaluating solvency risk. This includes reviewing such aspects as, but not limited to:

- The quality of the balance sheet;
- Adequacy of regulatory capital;
- Stability and diversity of earnings;
- Credit ratings;
- Outstanding legal proceedings;
- Independent assurance reports, such as GS007; and
- Reviewing the corporate structure and legal entities.

B. Securities Lending

The Fund's primary exposure to securities lending is via its custodian, which is permitted to lend out the Fund's equity and fixed income securities. The custodian is fully responsible for the administration of the lending program, with the Cbus investment team providing regular oversight and monitoring of exposures, counterparties and collateral. The custodian is required to produce a monthly report outlining the activities over the month and the income earned.

The custodian acts as an agent to the lending program and indemnifies the Fund against borrower default and in the event of a default shall provide the Fund with replacement securities or, if not available, cash. The value of the replacement securities/cash may be reduced if the value of the security decreases; insolvency of a tri-party institution; or incorrect information provided by a pricing vendor.

10. Ongoing monitoring and reporting

The Fund measures counterparty risk as the P&L (netted where applicable) from OTC contracts.

The P&L is preferred to the notional contract amounts because the P&L more accurately reflects the total amount at risk (assuming no collateralisation) should a counterparty fail to honour the arrangement. Net is preferred as the Fund's managers typically employ ISDAs and/or netting agreements.

The Fund monitors the counterparty exposures within individual mandates each quarter, or more frequently if required, these findings are reported to the Investment Management Group (IMG).

The Fund does not have overall exposure limits to individual counterparts but rather uses the information from the reviews to inform discussions with investment managers and the ongoing management of the portfolio.

If there is a perceived issue with a particular counterparty, this will be raised and discussed at the IMG. The Fund may also conduct its own assessment of its financial strength and credit worthiness. If a material concern remains, the Fund may discuss the health of the counterparty with the investment managers and seek to limit the exposure to that counterparty.