GREATER**LONDON**AUTHORITY

REQUEST FOR MAYORAL DECISION – MD2034

Title: Treasury Management - revisions to the GLA investment strategy for 2016-17

Executive Summary:

This decision covers improvements and amendments to the investment strategy under the current Treasury Management Strategy Statement (MD1634) in order to improve fitness for purpose under challenging market conditions, such as those witnessed following the recent EU Referendum.

Decision:

The Mayor approves the proposed revisions to the GLA Treasury Management Strategy Statement for 2016-17 (MD1634).

Mayor of London

I confirm that I do not have any disclosable pecuniary interests in the proposed decision, and take the decision in compliance with the Code of Conduct for elected Members of the Authority.

The above request has my approval.

Signature:

Date: 30/9/16

PART I - NON-CONFIDENTIAL FACTS AND ADVICE TO THE MAYOR

Decision required – supporting report

1. Introduction and background

a. The GLA's Treasury Management Strategy Statement ("TMSS") for 2016-17 is prepared in accordance with the Treasury Management in the Public Services Code of Practice ("the Code") of the Chartered Institute of Public Finance and Accountancy ("CIPFA") and guidance issues by the Department for Communities and Local Government ("DCLG").

b. The TMSS sets out an Annual Investment Strategy, however, in line with best practice set out by DCLG and CIPFA, the TMSS is a 'living document' subject to continual review and revision.

c. The GLA operates a shared service for Treasury Management for LFEPA, MOPAC, LLDC and the London Pensions Fund Authority ("LPFA"). Active discussions are currently underway with several London Boroughs seeking to join the shared service.

d. The GLA has pioneered diversification and continual improvement of risk-adjusted investment returns as one of the first Local Authorities to invest directly in corporate bonds, Treasury Bills and more recently, high-quality UK residential mortgage backed securities ("RMBS").

e. A cornerstone of the GLA's shared service offer is the GLA Group Investment Syndicate ("GIS"), a collective investment scheme allowing participating Authorities' ("the Participants") cash balances to be invested on a pooled basis, leading to economies of scale, greater bargaining power, increased ability to diversify and more stable average balances, enabling longer term investment to secure better returns and public value for money. The GIS has consistently outperformed relevant wholesale interbank deposit rates since inception, while maintaining an overall level of risk of loss no greater than a one year deposit with a typical AA- rated bank. The GLA is the investment manager for the GIS, with this function being discharged day to day by the Chief Investment Officer.

f. The GLA regards maintaining a market-leading investment strategy as essential to the attractiveness of its shared service and hence access to the benefits of pooled resources, viz. improved investment outcomes, opportunities for intra-group lending and shared funding of a resilient, specialised team.

g. The GIS investment strategy must be compatible with each participating body's individual investment strategies. For expediency, and in common with the approach used by all GIS Participants, the TMSS sets out the GIS investment strategy and notes the GLA may additionally invest directly in any way permitted for the GIS. Additionally investments made in the GLA's own name are not subject to the current GIS weighted average maturity limit of 91 days. This report amends the GIS investment strategy with the intention that it will apply to the GLA on the same basis.

h. The GLA adjusted the GIS and its own name investment positions to reduce risk in the approach to the EU referendum of 23 June 2016. These considerations, together with ongoing concerns around excessive concentration of investments in the banking sector and the impact of general market nervousness on some of the inputs to the GLA's counterparty limits suggested opportunities for improvement and the need for clarification of certain delegations and reporting requirements.

i. **Appendix 1** sets out the proposed changes together with explanatory notes.

2. Objectives and expected outcomes

a. The Investment Strategy seeks to provide a framework to support the following objectives:

   i. Public funds are not lost

   ii. Cash is available for essential expenditure as and when it falls due

   iii. Returns are maximised, so far as the above constraints allow, to offset the impact of inflation on the spending power of public funds held by the GLA.

b. **Appendix 1** represents the GIS Strategy in the style of a mandate to an external manager, followed by explanatory notes in case required for public or non-specialist internal use. The purposes of this are to:

   i. Streamline the document for use as a working tool by the GLA's Group Treasury officers; and

   ii. Facilitate sharing with external managers to ensure they can easily align their proposals for the sub-portfolios they are appointed to manage with the overall strategy.

c. Key improvements are summarised as follows:

   i. Reporting ambiguities relating to breaches are eliminated and the levels of discretion for both breach resolution, suspension of counterparties and use of Credit Default Swap ("CDS") data are now set out clearly.

   ii. Provisions relating to the duties and discretions of external managers are made clear.

   iii. The risk appetite implied by the previous strategy is stated explicitly.

   iv. Practical arrangements for the exercise of the Chief Investment Officer's discretions are set out explicitly along with the arrangements for exercise of discretion in that officer's absence.

d. A number of minor changes and simplifications are also made:

   i. Permitted durations for certain types of bond, including UK Gilts, have been reduced. A uniform limit of 2 years applies for internally managed investment and 5 for externally managed.

   ii. The use of covered bonds and repurchase agreements has been added. These instruments offer additional security but the enforcement of such security does involve operational risks, therefore a prudent view has been taken in respect of limits:

      - In general no counterparties may be used who do not themselves meet GIS investment criteria, however their exposure limits may be increased by up to 10% to reflect the additional level of security.

      - Unrated counterparties may be used for repo transactions of less than one year provided the repo is appropriately over-collateralised with UK government securities. This is currently intended to unlock the opportunity to lend to pension funds engaged in liability management activities, with the limit per counterparty being 2.5% and an aggregate limit of 20%.

   iii. The framework for the use of RMBS is set out in greater detail.

iv. The overall limit on non-financial corporate bonds (previously 20%) has been removed as it is redundant.

v. Equivalence tables for ratings of funds and structured finance products, in addition to issuer credit ratings are set out

vi. Preferential limits for UK banks in significant UK Government ownership have been withdrawn, due to the restrictions on state support for banks and the potential for mandatory losses for bank creditors arising from so called 'bail in' legislation.

3. Equality comments

None arising from the contents of this report

4. Other considerations

a. The GLA's role as a strategic funding body means it is exposed to high levels of investment and borrowing risk. The GLA therefore maintains a responsive stance to market conditions and invests in the management of treasury risks through a professional team subject to high audit and governance standards. Improved risk management, operational clarity and transparency are expected from the proposed changes.

b. Shared services support Mayoral priorities of efficiency and cost savings, while the improved returns delivered through the GIS contribute to budgetary resilience.

c. There are no formal consultation requirements in respect of the contents of this report. All of the current Shared Service participants have been consulted on the investment strategy changes and have agreed to apply the revised strategy to pooled monies within the GIS.

5. Financial comments

a. There are no additional treasury management costs arising from adoption of the revised investment strategy.

b. However, adoption of the proposed revisions will provide a greater range of options to mitigate the financial risk of loss through default and revisions to the use of Credit Swap Data in setting limits may prevent unnecessary transactions, leading to reduced direct and opportunity costs.

6. Legal comments

a. Part I of the Local Government Act 2003 introduced a statutory regime to regulate the borrowing and capital expenditure of local authorities. Section 23(1)(d) and (e) provides that the GLA and the functional bodies are local authorities for this purpose. Under section 1 of that Act the GLA and functional bodies may borrow money for any purpose relevant to their functions under any enactment or for the purposes of the prudent management of their financial affairs; they may also invest for the same purposes under section 12.

b. Section 3(1) of the 2003 Act provides that all local authorities are to determine and keep under review how much money they can borrow. Section 3(2) of the Act is more specific in relation to the Mayor and functional bodies by providing that the determination is to be made by the Mayor following consultation with the Assembly, in the case of the GLA, or the relevant functional body.

c. Under section 127 of the Greater London Authority Act 1999 the Authority has a duty to make arrangements for the proper administration of its financial affairs. Responsibility for the administration of those affairs lies with the Executive Director of Resources as the statutory chief finance officer of the Authority under section 127(2)(b) of the Act. The management of the authority's treasury function and the development and monitoring of the Treasury strategy fall within this responsibility of the chief financial officer. The GIS operates as a professional technical and administrative function delegated to the GLA under section 401A of the GLA Act 1999, whose members are covered by that provision.

7. Investment & Performance Board

IPB approval is not required – treasury management matters are delegated to the Executive Director of Resources.

8. Planned delivery approach and next steps

All Participants will have approved similar revisions by end September 2016. The Group Treasury team is prepared to implement the revised strategy immediately on receipt of approval.

Appendices and supporting papers:

Appendix 1 – Revised GIS Investment Strategy

MD1634 – TMSS for 2016/17
https://www.london.gov.uk/sites/default/files/md1634_gla_16-17_tmss_signed_pdf.pdf

GLA Oversight Committee 10 March 2016 – Treasury Management Shared Service
http://www.london.gov.uk/moderngov/documents/s55328/Treasury%20Management%20Shared%20Service.pdf

Public access to information
Information in this form (Part 1) is subject to the Freedom of Information Act 2000 (FOI Act) and will be made available on the GLA website within one working day of approval.

If immediate publication risks compromising the implementation of the decision (for example, to complete a procurement process), it can be deferred until a specific date. Deferral periods should be kept to the shortest length strictly necessary. **Note**: This form (Part 1) will either be published within one working day after approval or on the defer date.

Part 1 Deferral:
Is the publication of Part 1 of this approval to be deferred? NO

Part 2 Confidentiality: Only the facts or advice considered to be exempt from disclosure under the FOI Act should be in the separate Part 2 form, together with the legal rationale for non-publication.

Is there a part 2 form – NO

ORIGINATING OFFICER DECLARATION:	Drafting officer to confirm the following (✓)
Drafting officer: Luke Webster has drafted this report in accordance with GLA procedures and confirms the following have been consulted on the final decision.	✓
Assistant Director/Head of Service: David Gallie has reviewed the documentation and is satisfied for it to be referred to the Sponsoring Director for approval.	✓
Sponsoring Director: Martin Clarke has reviewed the request and is satisfied it is correct and consistent with the Mayor's plans and priorities.	✓
Mayoral Adviser: David Bellamy has been consulted about the proposal and agrees the recommendations.	✓
Advice: The Finance and Legal teams have commented on this proposal.	✓

EXECUTIVE DIRECTOR, RESOURCES:
I confirm that financial and legal implications have been appropriately considered in the preparation of this report.
Signature M. J. Allen **Date** 29.9.16

CHIEF OF STAFF:
I am satisfied that this is an appropriate request to be submitted to the Mayor

Signature D. Bellamy **Date** 29/9/2016.

Appendix 1 - GIS Investment Strategy 2016/17 [Revised September 2016]

Limits and Compliance

1.0 **All limits, unless explicitly stated otherwise, refer to the composition of the daily balance of the GIS**; for compliance purposes, all limits will be assessed daily.

2.0 The making of any investment which causes a breach of limits is not permitted and constitutes an **active exception.**

3.0 **Active exceptions of any size will be reported immediately** upon identification to the CIO, Syndics and their nominated substitutes. Relevant committees or boards will be notified as specified in each Participant's TMSS.

4.0 Additionally, breaches of daily limits may occur due to changes in the GIS balance or the credit assessment of existing investments, including the credit status of the country of domicile. Such an occurrence constitutes a **passive exception**. Passive exceptions will be reported immediately to the CIO, the GLA's statutory CFO and his deputy. Subsequent reporting will be threshold based as follows:

Passive Exception Level (lower of)	Temporary: ≤ 3 consecutive days	Persistent: >3 days
<5% or £25m	Logged and reported quarterly to Syndics within 1 month of quarter end	Logged and reported quarterly to Syndics within 1 month of quarter end
5-10% or £50m	Logged and reported quarterly to Syndics within 1 month of quarter end	Reported to Syndics immediately
>10% or £50m	Reported to Syndics immediately	Reported to Syndics immediately

The percentage limits above apply to total daily balance of the GIS or the total number of days in the case of limits expressed as days.

5.0 As an additional, prudent measure, forward looking diversification limits for new, internally-managed investments shall be maintained. These limits **apply to the forecast average GIS balance over the life of the investment being considered**; for operational expediency the forecasts shall be produced up to the last day of the following maturity 'buckets' given in days and limits applied accordingly:

O/N	2-7	8-30	31-60	61-90	91-120	121-150	151-180	181-210	211-240	241-270	271-300	301-330	331-397	398-730

6.0 If an investment is made in breach of these forward-looking limits, it is an active breach of investment strategy and will be reported per 3.0. Where changes in cash flow forecasts or counterparty and/or instrument status result in forward-looking limits being exceeded by existing investment positions, the CIO will be notified, who may then modify investment tactics to reduce the likelihood of a passive exception as defined in 4.0 occurring. Such an occurrence does not constitute an exception of any kind and need not be reported further.

7.0 Mitigating actions for all breaches will in the first instance be taken at the discretion of the CIO (or the GLA's statutory CFO, or his deputy). Such decisions must be supported by an analysis of the costs and benefits of attempting to reduce the overexposure in question versus tolerating it. In all cases a file note of the decision will be retained and circulated to the Syndics. A majority of the Syndics may instruct alternative action.

Risk Appetite Statement

8.0 Capital preservation is the primary GIS objective at the portfolio level, followed by provision of liquidity to meet Participants' cash flow needs.

9.0 In order to deliver best value on public funds, the Participants are prepared to take some investment risk to the extent outlined below, where such risk is rewarded by yields above UK government securities held to maturity.

10.0 The risk of loss through default in the entire portfolio (or any subsection delegated to an external manager) should not exceed risk of loss through default equivalent to a 1 year exposure to a typical AA- rated issuer.

11.0 No individual instrument/investment should pose a greater risk of loss through default than a 90 day exposure to a typical BBB issuer.

12.0 The Participants will tolerate price volatility where there is an expectation of holding an investment to maturity; where the expectation is that sale before maturity is likely or where the investment is in a variable NAV fund, the combined risk of loss through default and crystallised falls in price should not exceed the risk tolerance specified in 10.0.

13.0 This strategy sets out risk controls and limits that, in the opinion of the Participants, deliver these objectives.

14.0 Alternative controls and limits, save for the overarching requirements of 15.0-17.0 and 22.0, may be used by external managers appointed in accordance with 18.0, if those limits are judged by the Syndics, on the advice of the CIO or other independent professional advice, to be appropriately effective.

Permissible Investments

15.0 All investments must be Sterling-denominated financial instruments

16.0 Specified Investments (i.e. 'low risk' instruments as defined by Statutory Guidance) shall constitute at least 50% of the portfolio at any time.

17.0 Approved Specified (S) and non-Specified (NS) Investments:

Investment type	Eligibility criteria	≤ 1 year to maturity at time of investment	> 1 year to maturity at time of investment	Maximum total exposure as a proportion of daily balance
Senior Unsecured Debt ▪ UK Gilts and T-Bills ▪ Deposits ▪ Call Accounts ▪ Notice Accounts ▪ Certificates of Deposit ▪ Loans ▪ Commercial Paper ▪ All other senior unsecured bonds	Issuer (and security where separately rated) Investment Grade (IG) defined per 37.0 OR UK Government (including the Debt Management Account Deposit Facility, Local Authorities and bodies eligible for PWLB finance) OR Issuer not meeting general criteria but instruments explicitly guaranteed by IG entity or sovereign national government meeting acceptable sovereign ratings per 33.0	S	NS	100%
Constant Net Asset Value Money Market Funds	Fitch AAA_{mmf} or above See 37.0 for equivalents from other agencies. Daily liquidity	S	*N/A*	100% *Not more than 20% per fund*
Other Collective Investment Schemes structured as Open Ended Investment Companies (**OEICs**)	Fitch AAA_{mmf} or equivalent from other agencies per 37.0	NS	*Not permitted.*	20%
Senior UK Prime or Buy to Let **Residential Mortgage Backed Securities** (RMBS)	Bond rating Fitch $AA+_{sf}$ or above or equivalent from other agencies per 37.0	NS	NS	20%
Covered bonds	Bond rating Fitch $AA+_{sf}$ or equivalent from other agencies per 37.0 AND Issuer rated Fitch A- or above or equivalent from other agencies per 37.0	NS	NS	20%

Investment type	Eligibility criteria	≤ 1 year to maturity at time of investment	> 1 year to maturity at time of investment	Maximum total exposure as a proportion of daily balance
Repurchase Agreements (Repo)	Counterparty meets senior unsecured criteria AND proposed collateral (Min 100%) itself meets permitted investment criteria Or Collateralisation is >102% with UK Gilts / T-Bills meeting permitted maturity limits.	S – UK gilts or T-Bills AND Counterparty meets senior unsecured criteria NS – other	*Not permitted.*	S – 100% NS – 20%, and not more than 10% with counterparties not meeting senior unsecured criteria.

18.0 The Syndics may delegate the management of a portion, not exceeding the forecast minimum GIS balance for the next 12 months, of the GIS to external fund managers if this is deemed prudent.

Liquidity and Maturity Limits

19.0 Portfolio Weighted Average Maturity (WAM) ≤ 91days

[Maturity here refers to the final expected maturity or if relevant the first call option of the instrument; in the case of funds the maturity will be the redemption period; in the case of call or notice accounts, the notice period].

20.0 Sub-portfolio (managed by an external manager) WAM ≤ 3years

21.0 Individual maturity limit, internally managed instruments: ≤ 2 years

22.0 Individual maturity limit, externally managed instruments: ≤ 5 years

[Note – in the case of RMBS these limits apply to the date by which all principal is expected to received, based on analysis of the underlying mortgage pool and indicated call dates – the legal maturity date, based on the longest dated mortgage in the relevant pool, is not limited given the extremely low probability of the bond failing to be repaid by that time;

In the case of covered bonds, these limits apply to the expected maturity date, which may not include the exercise of the extension option]

23.0 Limit for total exposure >12months: ≤25% of total daily balance.

24.0 Forward Dealing limit: aggregate value of outstanding forward deals ≤20% of daily balance; forward deals must not be struck with an individual counterparty if the limit forecasts defined in 5.0 indicate this is likely to cause an exception. See also 43.0 for credit risk management of forward deals.

[The GIS defines 'forward' as negotiated more than 4 banking days in advance of delivery. The CIO may make exceptions to this limit where the counterparty is a GIS Participant and the forward period is less than 3 months]

25.0 Internally managed investments should only be made where GIS cash flow forecasts or best estimates suggest the instrument may be held to maturity. Externally managed investments may be purchased with lower certainty subject to the provisions of 12.0

Counterparty Concentration Limits
(Apply individually and cumulatively to groups)

26.0 The total exposure to a group of companies (a parent company and any subsidiaries, i.e. companies of which it owns 20% or more of authorised share capital) shall not exceed the maximum individual exposure limit of the constituents of the group.

27.0 Maximum unsecured exposure to company or group: ≤5% (subject to enhancements below)

28.0 Enhanced limits apply for UK Government (including the Debt Management Account Deposit Facility, Local Authorities and bodies eligible for PWLB finance) and institutions covered by Capita's Colour Banding Methodology:

Cash Exposure Limits – applied to individual counterparties		
Band	Overnight	> 1 day
UK Sovereign	100%	100%
Yellow	50%	25%
Purple	50%	20%
Orange	25%	15%
Red	25%	10%
Green	10%	5%
No Colour	5%	5%

29.0 The Bands above are calculated based on a range of credit ratings data, including published rating Watches and Outlooks. Where the price of 5 year Credit Default Swaps for a given counterparty exceeds barrier levels proposed by Capita with regard to market history, the Band will normally be adjusted downwards. The CIO may postpone such adjustments in consultation with the Syndics, for instance, if it is felt that changes in CDS prices do not reflect an increase in the individual credit risk of a particular counterparty.

30.0 Additionally, an enhanced overnight limit of 100% applies to the GIS banker, RBS.

31.0 If, in the judgement of the Chief Investment Officer, the structure of a bond associated with a local authority is such that the credit risk is not identical to a bilateral loan with that authority, the rating of the bond itself will be used and the 5% limit will apply.

32.0 Maximum aggregate exposure including indirect or collateralised exposures:

Security Type	Cumulative Enhancement
Non-specified Repo	2.5%
Covered Bond	5%
RMBS	7.5%
Specified Repo	10%

[These enhancements are cumulative so the maximum possible total enhancement is 10% above is the counterparty's senior unsecured limit]

Geo-political risk limits [under review]

33.0 Maximum exposures to non-UK institutions apply by country, based on the relevant sovereign ratings outlined in the table below:

Max. Aggregate Exposure (%)	Fitch Sovereign Rating	S&P Sovereign Rating	Moody's Sovereign Rating
25	AAA	AAA	Aaa
15	AA+	AA+	Aa1
5	AA	AA	Aa2

34.0 Where more than one rating is available the lowest common denominator will be used, unless in the opinion of the CIO there is an overriding reason to favour or disregard a particular agency's view. The use of this discretion will be reported immediately to the Syndics.

35.0 If 5y CDS spreads for the relevant country's central government bonds exceed barrier levels from time to time agreed by the Syndics on the advice of Capita or the CIO, the aggregate exposure limit will normally be reduced to that of the lower rating, or in the case of a AA sovereign, further investment will be suspended. The CIO may postpone such adjustments in consultation with the Syndics.

36.0 The Participants recognise that the approach above does not perfectly mitigate geopolitical risks, therefore the CIO is empowered to suspend investment in any particular country should concerns arise. The use of this discretion will be reported immediately to the Syndics.

Credit Risk Limits

37.0 Permitted issuer credit ratings and equivalence mappings

Senior Unsecured Bond and/or Issuer Ratings					
Long term			Short term		
Fitch	Moody's	S&P	Fitch	Moody's	S&P
AAA	Aaa	AAA			
AA+	Aa1	AA+			
AA	Aa2	AA	F1+	P-1	A-1+
AA-	Aa3	AA-			
A+	A1	A+			
A	A2	A	F1	P-1	A-1
A-	A3	A-			
BBB+	Baa1	BBB+			
BBB	Baa2	BBB	F2	P-2	A-2

Structured Finance Ratings		
Fitch	Moody's	S&P
AAA_{sf}	Aaa (sf)	AAA (sf)
$AA+_{sf}$	Aa1(sf)	AA+ (sf)

Money Market Fund / OEIC Ratings		
Fitch	Moody's	S&P
AAA_{mmf}	Aaa-mf	AAAm

38.0 Where more than one rating is available the lowest common denominator will be used, unless in the opinion of the CIO there is an overriding reason to favour or disregard one particular agency's view. The use of this discretion will be reported immediately to the Syndics.

39.0 For internally managed investments Credit Factors will also be calculated individually and Portfolio Credit Factor (PCF) on a book value weighted average basis with reference to the following tables:

Credit Factors based on Issuer Default Rating (Fitch and Fitch Equivalents) Use instrument rating or if not rated, rating of Issuer.									
Days	AAA	AA+	AA	AA–	A+	A	A–	BBB+	BBB
O/N	0.01	0.01	0.01	0.01	0.02	0.03	0.04	0.07	0.10
2-7	0.02	0.04	0.06	0.10	0.15	0.20	0.30	0.50	0.80
8-30	0.10	0.15	0.25	0.40	0.60	0.75	1.30	2.10	3.50
31-60	0.20	0.30	0.50	0.80	1.20	1.50	2.60	4.20	7.00
61-90	0.25	0.50	0.75	1.25	1.50	2.50	5.00	7.50	10.00
91-120	0.35	0.65	1.00	1.50	2.30	3.30	6.60	10.00	13.50
121-150	0.40	0.80	1.25	2.10	2.90	4.20	8.30	12.50	16.50
151-180	0.50	1.00	1.50	2.50	3.50	5.00	10.00	15.00	20.00
181-210	0.60	1.20	1.75	3.00	4.00	5.80	11.70	17.50	23.50
211-240	0.70	1.30	2.00	3.30	4.70	6.60	13.30	20.00	27.00
241-270	0.75	1.50	2.25	3.75	5.25	7.50	15.00	22.50	30.00
271-300	0.80	1.70	2.50	4.20	5.80	8.30	16.70	25.00	33.50
301-330	0.90	1.85	2.75	4.60	6.50	9.20	18.50	27.50	37.00
331-397	1.00	2.00	3.00	5.00	7.00	10.00	20.00	30.00	40.00
398-730	2.70	5.30	8.00	13.00	19.00	27.00	43.00	69.00	106.00

Other treatments	
UK Government (including the Debt Management Account Deposit Facility, Local Authorities and bodies eligible for PWLB finance)	Treat as AAA above Except: If, in the judgement of the Chief Investment Officer, the structure of a bond associated with a local authority is such that the credit risk is not identical to a bilateral loan with that authority, the rating of the bond itself will be used
Instruments explicitly guaranteed by IG entity or sovereign national government meeting acceptable sovereign ratings per 33.0	Use Credit Factors appropriate to guarantor strictly for the period of the guarantee, reverting to rating of issuer thereafter
Repo	Use Credit Factors appropriate to repo counterparty, not collateral; Unrated or sub-BBB counterparty with >102% Gilt/T-bill collateralisation – treat as BBB
AAA_{mmf}	Use Credit Factor of 1.5

Covered Bonds or RMBS	Use Credit Factor of 5

40.0 Where a counterparty's (or its country of domicile's) 5 year CDS spreads exceed barrier levels from time to time agreed by the Syndics on the advice of Capita or the CIO, the Credit Factor used for the PCF calculation will be from the factor set of one or more notches below the issuer or security rating (e.g. If a AA+ counterparty's CDS spread exceeds the first barrier level, AA factors will be used to the PCF).

41.0 The following limits apply at all times:

- Maximum Credit Factor of any single security: 10.00
- Maximum PCF: 5.00

42.0 The PCF will be calculated and recorded daily.

43.0 The total contractual exposure of any transaction with counterparty, i.e. in the case of a forward deal, the forward period PLUS the eventual length of the deal should be considered at the time of the transaction and compared to table 39.0 – the Credit Factor for the total exposure period at the counterparty's credit rating at the time of the deal must not exceed 10.

Deposit Facility of Last Resort

44.0 In the circumstance of being unable to place funds with counterparties within approved limits, the Investment Manager will attempt to place the surplus funds with the Debt Management Account Deposit Facility (DMADF). This facility may, of course, also be used in other circumstances if it offers rates above equivalent market levels, though in past experience this is unlikely.

45.0 In the instance of technical failures or unexpected monies being received after the cut-off time for sending payments, the GLA, as the GIS Investment Manager, will have no choice but to leave the funds with the GLA's bankers, RBS. In such circumstances, the funds will be moved to the GLA's call account at RBS.

Custody Arrangements

46.0 Internally or externally managed securities may be held by a Custodian; in such circumstances:

a. The Custodian or any Sub-Custodian employed by the Custodian (whichever actually holds the GIS securities) must be Fitch A- rated or equivalent

b. Any cash held by the Custodian or any Sub-Custodian pending transactions must be properly identified as an unsecured deposit and consolidated into the PCF calculation

c. The Custodian or any Sub-Custodian shall not be entitled to invest such cash in any money market fund or other product without the permission of the GIS. Any such investment must meet the criteria of 17.0.

47.0 The above applies to any Custodian or Sub Custodian holding collateral on behalf of the GIS in respect of a Repo transaction. Note – 'Held in Custody' Repos where collateral is held at the borrower's custodian in the borrower's title are NOT permitted.

CIO Discretions

48.0 The CIO may restrict the use of any counterparty for any reason related to the management of risk, including reputational risk to any Participant. Such restrictions may be overturned by any majority of Syndics.

49.0 When postponing CDS-driven adjustments to exposure limits, the Group Treasury team will notify the Syndics of the CIO's decision immediately. Syndics will have until 12pm to register concerns otherwise the decision will be implemented for that day. Any majority of Syndics may reverse the decision subsequently.

50.0 All above mentioned CIO discretions may also be exercised by the GLA's statutory CFO and his deputy.

Explanatory Notes

Background to the GIS Investment Strategy

i. The GIS is a vehicle for investing pooled short term cash balances belonging to 'participants', currently the Greater London Authority (GLA), the London Fire and Emergency Planning Authority (LFEPA), the London Legacy Development Corporation (LLDC), the London Pensions Fund Authority (LPFA) and the Mayor's Office for Policing and Crime (GLA). The GLA acts as the Investment Manager under the supervision of the Syndics (the participants' respective chief financial officers).
ii. By pooling resources, the participants can achieve economies of scale through larger individual transactions; can exploit the greater stability of pooled cash flows to obtain better returns and can achieve greater levels of diversification.
iii. A risk sharing agreement ensures risk and reward relating to each investment within the jointly controlled portfolio are shared in direct proportion to each participant's daily investment.
iv. The Investment manager (the GLA) operates the GIS cash balances in accordance with the GIS Investment Strategy

4.0

i. Reporting thresholds are capped at £25m and £50m, these limits are conservative based on the expected scale of the GIS – based on the GIS composition as at 30 June the absolute exposure reporting thresholds for each participant would be:

£m	25	50
GLA	20.4	40.8
LFEPA	0.2	0.5
MOPAC	0.2	0.3
LPFA	2.8	5.7
LLDC	0.2	0.4

17.0

i. The concept of "Specified" and "Non–Specified" Investments is defined in the DCLG Guidance on Local Government Investments (revised 2010).

<u>Specified Investments</u>

ii. An investment is a Specified investment if all of the following apply:

a) The investment is denominated in sterling and any payments or repayments in respect of the investment are payable only in sterling;

b) The investment is not a long-term investment (i.e. due or required to be repaid within 12 months);

c) The making of the investment is not defined as capital expenditure by virtue of regulation 25(1)(d) of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (SI 3146 as amended) (i.e. the investment is not share capital in a body corporate)

d) The investment is made with a body or in an investment scheme of high credit quality (defined by the minimum credit ratings outlined in table 17.0) or with one of the following public-sector bodies:

- The United Kingdom Government
- A local authority in England or Wales (as defined in section 23 of the 2003 Local Government Act) or a similar body in Scotland or Northern Ireland
- A parish council or community

Non Specified Investments

iii. Non-Specified Investments are defined as investments assessed by the GIS Participants to be appropriate and prudent, but not meeting the one or more of the Specified Investments criteria.

New instruments introduced since previous strategy

iv. Reflecting increased market risk and difficulties in diversifying, this strategy introduces the new and highly secure option of UK Residential Mortgage Backed Securities, which provides a genuine diversification away from institutional credit risk and additional options for secured lending, enabling limits to be increased with existing counterparties in exchange for security of some sort of asset in the event of the borrower becoming insolvent.

v. RMBS

- Since the approval of the GIS Participants' Treasury Strategies, which all set out the rationale for senior UK Prime and Buy to Let RMBS, the GLA has appointed two managers to manage £100m each of GLA core cash in this asset class.

  Almost half of the investments were made prior to the market turbulence following the EU referendum, enabling the GLA to reduce its exposure to banks; additionally, this action has provided an excellent market test of extreme conditions for the asset class.

Unlike a number of banks and the UK itself, the ratings of UK RMBS were untouched by the negative market perception of the UK's actions and liquidity in the asset class was no worse than any other within the current investment strategy. Yield remains higher than other available options.

- 15 UK Banks and Building Societies have over £100bn of AAA-rated RMBS outstanding, via bankruptcy-remote issuing companies, which ensures full credit de-linkage

- This report therefore recommends inclusion of UK RMBS in the GIS subject to the limits proposed and the overall GIS WAM limit, in order to reduce risk and improve returns. The 20% limit reflects the fact that the GIS currently has a 91 day WAM limit and most of these instruments will have a WAM > 1 year.

- Only senior RMBS are permitted at this stage, i.e. the GIS has first priority over the cash flows from the underlying pools of thousands of diversified UK residential prime or buy-to-let mortgages. These to date have always been AAA rated at inception with some isolated cases of downgrades to AA+ due to lower ratings of associated counterparties within the RMBS structure such as the bank servicing the mortgages, rather than the underlying mortgages, reflecting the increased risk of possible payment disruption should the servicing bank fail (though no increased risk of non-payment). The strategy does not exclude these downgraded senior notes as the risk of loss is still very low but it should be noted that changes to RMBS structures since 2008 make this circumstance very unlikely in future.

- The cash flows from RMBS are generated by both interest and principal repayments of the mortgages in the relevant pool. In particular, when homeowners refinance (or move house) the pool experiences principal inflows, which are then passed through to the RMBS bondholders (which the most senior tranches, proposed here, receive before all others). Refinancing typically occurs much earlier than the final date of the mortgage, therefore it is not proposed to limit the legal maturity of RMBS, as these are set with reference to the longest dated mortgage in the pool and do not reflect the expected maturity date. In addition, RMBS deals are structured with financial penalties for the issuer beyond the expected maturity date, to ensure that deals mature as expected.

- The strong cash flow characteristics of senior RMBS mean that principal is repaid incrementally, therefore a proposed WAM limit of 3 years per security for the whole RMBS portfolio is proposed alongside a 5 year expected final maturity limit per security.

vi. Covered Bonds

- Covered bonds are also secured on mortgage assets, but do not depend on mortgages for the cash flows. They are more like a normal bond issued by the relevant bank or building society except that should the issuer default, the covered bond holders will have security over the banks' mortgage assets, which could be sold to another bank to meet the obligation.

- Whilst the credit risk is clearly lower than unsecured lending to the issuer, the situation is different to RMBS and when the issuer is downgraded, covered bonds are typically downgraded too. Accordingly, the strategy does not permit the use of covered bonds issued by counterparties who do not themselves meet approved investment criteria.

- Another feature of covered bonds are extension clauses, typically of 2 years. For this reason, the strategy only permits the use of counterparties of A- rating or above to allow for downgrades over the extension period, should it be invoked.

- Because they are lower risk than unsecured lending to a given counterparty, covered bond yields are generally lower. Accordingly, the main circumstance in which they would be used in the current environment is to increase exposure to a strong and well understood counterparty already at its unsecured concentration limit.

vii. Repurchase Agreements "Repos"

- Repos are a form of secured lending whereby rather than lend directly to a counterparty, the GIS would buy from them a security e.g. a bond and agree to sell it back at an agreed (higher) price at a future date. The profit on this transaction replaces interest in a normal lending agreement but there is the additional feature that if the borrower becomes insolvent, the GIS may keep the security, which is referred to as collateral.

- For this reason, only securities that meet GIS criteria may be accepted as collateral.

- Furthermore, if such a default occurred, the GIS may need to sell the collateral for cash flow reasons so there may be some price risk between the default and the sale. Therefore, minimum levels of collateral, expressed as a percentage of the market value of collateral relative to the purchase price, are proposed.

- The strategy permits very limited repo exposure (2.5% and 10% in aggregate) to counterparties not meeting unsecured investment criteria. In this case, minimum collateral is set at 102% (in line with minimum standards for repo use by AAA rated money market funds) and the provision is designed to enable transactions with pension funds engaged in liability hedging activities, to mutual advantage.

- There are a number of ways to implement a repo. This is delegated to officers and their advisors or external managers, however per 47.0, legal title to the collateral must be unequivocally obtained and safe custody arrangements be in place.

- Repos will provide a further tool for balancing GIS risk and return: the risk is very much lower than unsecured lending to banks and others, although not as low as T-bills, however repo returns are slightly higher than T-Bills and there is more flexibility with maturity dates.

<u>20.0</u>

i. For the purposes of this limit, WAM is the sum of each expected nominal cashflow and its respective expected incidence in days from the calculation date, divided by the total nominal cashflows; the use of expectations rather than contractual maturities reflects the use of instruments like RMBS which are subject to uncertain repayments. The Syndics place reliance on the systems and investment process of appointed managers to monitor and implement this limit.

29.0

i. Credit Default Swaps (CDS) are effectively insurance contracts against a given counterparty defaulting; their price (typically expressed as an additional interest cost or 'spread' in basis points – i.e. 100ths of one percent). Higher prices may therefore reflect greater market perception of risk, although other supply and demand factors can distort this, including the activity of speculators. For this reason, the CIO has discretion to propose postponements to the impact of CDS data on limits.

ii. Although the GIS typically participates in short term investments, it refers to 5 year CDS prices as this market has higher volumes of trading and therefore more accurately reflects market sentiment.

iii. The GIS's advisor and data provider, Capita, proposes barrier levels dependent on market conditions as indicated by one of the main CDS indices, ITRAXX 5 year senior financials.

iv. When the ITRAXX is below 100 basis points, a counterparty's limit band will be adjusted down one notch if their CDS price is between 100 and 150 or to 'no colour' if above 150

v. When the ITRAXX is above 100, a counterparty's limit band will be adjusted down one notch if their CDS price between 1 and 50 basis points above the ITRAXX or to 'no colour' if more than 50 basis points above.

<u>39.0</u>

i. Book value weighted average here means the sum of the products of principal sums invested (plus any capitalised interest, less any impairments or partial repayments but excluding any accrued interest or unrealised gains or losses) and the respective Credit Factors at the date of calculation, divided by the sum of principal sums invested (plus any capitalised interest, less any impairments or partial repayments but excluding any accrued interest or unrealised gains or losses)

<u>50.0</u>

i. In the absence of the CIO, the senior member of the Group Treasury team present should assume responsibility for reviewing circumstances where discretion might be used, and make appropriate recommendations to the CFO or deputy, who will decide whether to exercise their powers under this strategy,