**MD3041 Appendix 2 – Rationale for greater treasury management integration**

1. Since 2011, the GLA Group has pursued a strategy of pooling the treasury management resources of the Functional Bodies under a shared service managed by the GLA and, the establishment of a collective investment arrangement, the GLA Group Investment Syndicate (GIS), for the following well-rehearsed reasons:

    a. **Resilience and risk**: Prior to integration, each organisation maintained a small (typically 1-2 FTE staff) and specialist function, giving rise to key person risk, challenges in the separation of duties and extremely limited scope for career progression and succession planning. The shared service has substantively mitigated these risks, leading to the establishment of a high performing team with considerable scope for renewal and progression, with more effective separation of duties and the establishment of an investment subsidiary, London Treasury Limited (LTL), authorised and regulated by the Financial Conduct Authority (FCA).

    b. **Administrative synergies**: Multiplication of expenses such as professional advice, data subscriptions and systems has been eliminated, greater bargaining power achieved, and in respect of investments, the direct financial costs (bank fees, brokerage, etc.) and indirect costs of officer time, not to mention risk of error, has been reduced by making one transaction under a pooled arrangement rather than each GIS participant transacting individually.

    c. **Cash flow synergies:** pooling the cash balances of the GIS participants created several useful opportunities:

        i. **Investment duration**: the pooled balance of the GIS is generally less volatile than participants' individual balances, due to each participant's pattern of deposits and withdrawals being different, therefore to some extent cancelling each other out. This means there is a stable core balance that can be prudently invested for longer periods than might be prudent for participants individually. Since, *on average*, longer investment periods and/or lower liquidity are compensated by higher returns, the GIS has been able to deliver improved yield for participants over time.

        ii. **Diversification**: many investment opportunities have a minimum size, either explicitly (e.g. a wholesale bank with a minimum deposit requirement) or in practical terms (e.g. due diligence and manager selection costs for a complex investment are the same in absolute terms whether the sum invested is £1m or £100m, so the relative impact may be acceptable in the latter case, but prohibitive in the former). Therefore, the GIS has had a far wider range of investment opportunities than most participants had individually. This has served both to reduce risk and improve returns, especially through the inclusion of more complex assets such as Residential Mortgage Backed Securities (RMBS) which would have been beyond the capacity of most participants to access individually.

        iii. **A short-term liquidity backstop**: if a participant in the GIS has a temporary borrowing requirement, the GIS is able to provide loans to the participant in question, priced at the opportunity cost to the GIS. This is useful both:

            - where such a loan can be substituted for a loan that would otherwise be made to a non-participating local authority, on which case intermediary costs can be saved and shared between the GIS and the borrowing participant; or

- in cases of necessity, such as difficulties accessing short-term finance from the markets, where the opportunity cost to this is generally cheaper than accessing funds from the Public Works Loan Board (PWLB) when the requirement is for less than three months.

2. The shared service and GIS now encompass all of the group excluding TfL, together with the London Pensions Fund Authority (LPFA) and the waste authority, ReLondon. One London borough is in the process of joining and there is a plan to secure more borough participation from 2023-24 onwards.

3. The historically very much larger borrowing and cash investment balances managed by TfL relative to others in the group and TfL's already substantial and sophisticated treasury function have hitherto meant that, for TfL considered as a stand-alone entity, the advantages listed in 1.a were less relevant from a risk perspective and 1.b and 1.c less relevant financially.

4. However, several developments suggest that the conclusions in 3 bear revisiting from a group-wide rather than stand-alone perspective:

    a. The GLA's investment and borrowing balances have grown considerably (the former now considerably exceeding TfL's), meaning the GLA and by extension the GIS can offer much greater liquidity support to TfL, the basis for the proposed additional support.

    b. The GLA's proposed additional support to TfL will involve the transfer of significant sums of GLA cash to TfL. Since TfL will for operational reasons continue to maintain high cash balances, a significant mismatch between the returns on TfL balances, versus the GIS, would lead to a net loss at group level.

    c. The devolution of London's funding arrangements means that funding sources are now shared (at the Mayor's discretion) within the group, or put another way, the different parts of the group are competing for a finite pool of resources; therefore opportunities for additional income that may be immaterial to larger organisations could be significant to the smaller ones, and if so, need to be pursued vigorously.

5. TfL's current treasury investment strategy is both more liquid and less exposed to valuation and default risks than that of the GIS. This reflects operational needs, and organisational culture, resulting from historical experience (losses to Icelandic bank deposits and being of a very different financial scale to the rest of the group with limited interlinkage of funding and liquidity).

6. The operation of the GIS is relevant to understanding the implications of the above.

    a. The GIS is a liquidity tool; therefore the investment team plans investments around the aggregate cash flow forecasts of the participants so that investments mature to coincide with expected net withdrawals. Additionally, a buffer of overnight funds is maintained to cover additional uncertainty (c.10% of average assets under management (AUM)), supplemented by c.35% of average AUM held in highly liquid AAA RMBS, which could be sold in an emergency.

b. Standard cash investments together with the overnight balances make up 55% of the portfolio on average, with a weighted average maturity of <91 days. Including the RMBS accounts for 90% of AUM, with only the remaining 10% being tied up in less liquid strategic investments, such as long-term funds or partnerships.

c. Liquidity and yield are subordinate to the primary objective, i.e. not to lose money on a net basis. This is nuanced: some pursuit of yield is required to offset the erosion of the spending power of public money through inflation, however, yield generally comes with risk, which in the spirit of prudence, should not exceed an amount that can be absorbed by participants' reserves.

7. Reflecting 6.c, the GIS risk appetite is very low: currently that the portfolio should lose no more than 2% in value in 95% of expected outcomes over the course of a year. In practice this means that even though cash flow needs might justify more long-term investment than the current 10%, the risk constraint prevents this, as risk generally increases with investment duration. An analysis of the last decade shows that maximum daily drawdowns have never exceeded 21%, save for which occasion have remained below 18%, and on 99% of occasions have remained below 10%. Relative to cash flow need, there is therefore considerable surplus liquidity.

8. Table 1 below shows the illustrative cash implications of TfL joining the GIS (or more likely, the successor fund being created), demonstrating a high degree of confidence that in the event of a shock similar to the recent pandemic, cash would be available to release to meet TfL's needs within 60 days.

9. The GLA has offered to underwrite TfL's share of any losses under the collective investment arrangement, and borrow on TfL's behalf on a temporary basis, to ensure liquidity is maintained and TfL is not exposed to greater budgetary risks because of joining the arrangements.

10. The GIS investment strategy should deliver some 0.5% above TfL's cash portfolio, leading to a net group benefit of some £5m per annum assuming TfL maintains c.£1bn in the collective arrangements.

11. In addition to integration of investment activity, there is an obvious case for co-ordinated borrowing, taking an holistic view of group cash as a substitute for external borrowing and making use of the higher credit rating of the GLA arising from its position in the group funding hierarchy, for instance aggregating borrowing requirements related to expenditure with environmental benefits to create scale for a mayoral green bond.

**Appendix 2, Table 1 – Illustrative cash scenarios**

| | TfL own account | TfL balance in GIS | GLA balance in GIS | Others' balance in GIS | Total GIS balance | Overnight funds in GIS | GIS funds accessible within 60 days | Max. requirement, GLA and others | Surplus liquidity |
|---|---|---|---|---|---|---|---|---|---|
| **Status quo** | 1,200 | - | 3,500 | 600 | 4,100 | 1,845 | 2,563 | 820 | 1,743 |
| **TfL joins the collective investment arrangement** | 200 | 1,000 | 3,500 | 600 | 5,100 | 2,295 | 3,188 | 820 | 2,368 |
| **Net cash impact of GLA capex (£1,500m)** | 200 | 1,000 | 2,000 | 600 | 3,600 | 1,620 | 2,250 | 520 | 1,730 |
| **GLA support to TfL (£500m)** | 200 | 1,000 | 1,500 | 600 | 3,100 | 1,395 | 1,938 | 420 | 1,518 |
| **GLA substitutes TfL commercial paper (£800m)** | 200 | 1,000 | 700 | 600 | 2,300 | 1,035 | 1,438 | 260 | 1,178 |
| **TfL withdrawal** | 1,200 | - | 700 | 600 | 1,300 | 585 | 438 | 260 | 178 |

**<u>Notes</u>**

1) The scenarios above represent the most pessimistic cash flow outcomes for downside illustrative purposes
2) The impact of additional recruitment of boroughs is not included
3) The estimate of funds accessible within 60 days relates to 35% RMBS plus 50% of other investments, excluding longer term strategic investments; again, this is a worst-case estimate, with liquidity historically being higher