GOVERNMENT DEVELOPMENT BANK
INVESTMENTS AND TREASURY

The Department

Trading Desk

The trading desk handles, among other responsibilities, investments of GDB funds, GDB funding (deposits, commercial paper, repo), transfer orders, active management of the GDB portfolio, disbursements of credit lines, maintenance of the matched book for credit lines, pricing/valuation of portfolios (GDB and others), loans and also of bonds issued in the capital markets, maintenance of outstanding Commonwealth Swaps, coordination of the investment of bond issue proceeds in GICs. The trading desk also monitors constantly the liquidity of the bank and also its profitability.

Asset Management

The asset management department manages various investment portfolios, some of which are a subsidiary of GDB. Besides this, it maintains the PRSI (Puerto Rico Stock Index) and gives advice upon request to Government Agencies with regards to investments. Since this division manages funds, there is a separate section at the end of this report.

The department also acts as the in-house counsel to the financing department of GDB as it pertains to structuring and pricing bond deals. The execution strategy of the capital market transactions is scrutinized in depth by the department as well as the financing calendar in a bid to hit the market during periods of robust liquidity as we see them from a buy side perspective.

The Investment Portfolio

For a detailed description of the portfolio composition please refer to the attached presentation marked as Exhibit I.

The investment portfolio is professionally managed by the trading desk with the oversight of the treasurer. The head trader is responsible for managing the on desk team. He coordinates with the liquidity analyst and the repo trader all the funding needs and also selects the specific assets within the predetermined asset allocation framework.

The investment portfolio is positioned based in an investment thesis that's based on the fundamental perspective regarding rates and money flows in a global macroeconomic context while the tactical trading strategy is executed using as base the aforementioned underlying thesis. The allocation process between asset class is dynamic and always within the allowed investment policies. Therefore, the portfolio weights shift between CMOs, Agency debentures, US government treasury securities, Passthroughs, Muni Bonds, etc.

Fed Funds

These are overnight deposits with mostly A and AA commercial banks. Local banks do not qualify for this facility as they are all junk rated. GDB deals directly with the commercial banks and tries to avoid using brokers in a bid to avoid the additional layer of expenses. The allocation to fed funds is the bank emergency liquidity cushion that usually fluctuates between $100MM and $300MM.

Agency CMO portfolio

This is the largest asset allocated sector of the portfolio. This portfolio comprises of an array of structures that are bought in a holistic way so that each structure within the portfolio acts as a counterweight so that prepayment and extension risks are minimized. During the past couple of years we have tried to maintain the average life of the portfolio below 4 years in a bid to minimize duration and avoid excess negative convexity.

ALCO Presentation

The ALCO presentation is a key report that is prepared on a monthly basis and discussed with the ALCO Committee (Asset Liability Committee) as well as with the Investment Committee that meets concurrently. The presentation covers all the key components of the portfolio, the investments and the funding composition, as well as the details of the loan portfolio and its monthly evolution. It also covers the risk exposure to the bank and the investment portfolio from a credit perspective as well as from an interest rate perspective. The ALCO also addresses key macroeconomic events and maket data that's relevant to the management of the portfolio and the risk exposure of GDB and the Commonwealth. The presentation wraps up with an overview of the liquidity of the bank. See Exhibit I.

Liquidity Statement of the Bank

The liquidity statement contemplates all the disbursements during a forward 6 month period as well as all the programmed inflows to the bank. This report is stressed tested in order to make sure the bank can withstand systematic shocks in the system as well as a possible temporary loss of market access by the Commonwealth and any of its agencies or instrumentalities. We recommend, under the current disbursement rate and needs to maintain at least $1.8 billion in readily available liquidity. This can be made available either through repos of highly liquid collateral or in cash balances that are kept at the bank. We do not recommend keeping such staggering amount of liquidity uninvested as it renders a significant negative carry position.

On the liabilities side, GDB has a robust notes issuance program at the local level as well as at the state side level. The local program provides important flexibility as it can absorb enormous amounts of long dated 1yr callable paper and it does not penalizes on pricing of the callable option. On the other hand, issuing paper in the taxable market has enabled us to refinance local notes with those proceeds, hence, providing significant amounts of liquidity to the local market so that it could provide financing capacity for other transaction such as the Qualified School Construction Bonds. The taxable market is only attractive relative to the local market only on the belly of the curve as the long tail is extremely expensive. It is impossible at this market juncture to issue taxable paper in the US with a short callability feature as pricing is very unattractive. From a risk management perspective it is of the outmost importance for management to be aware of the risks of rolling over bullet maturities. We have strived to accommodate on our maturity term structure these bullets in amounts that we feel comfortable that the bank will be able to absorb through a deleveraging on its own without accessing the capital markets.

GDB Revolving Financing Facilities

GDB currently has only one existing *facility* with Scotiabank and it has $250MM of available credit. Please see attached report for details.

Outstanding Swaps of the Commonwealth

The Commonwealth contracted with Mohanty & Gargiulo, a swap advisor, in order to maintain a close monitoring of the swap portfolio and its collateral posting activity. Attached, as Exhibit II, you will find a comprehensive summary of all the transactions in place and all collateral threshold and triggering levels.

During our tenure we have strived to simplify the portfolio and reduce it. The main fundamental view of our strategy is guided by the fact that the Commonwealth sustains a significant debt load that impairs it of the ability of holding excess liquidity that could be used to withstand collateral calls from the swap portfolio during times of duress and global market stress. Payable swaps were terminated as the underlying variable debt was fixed, and Basis Swaps were terminated partially both on the GO credit as well as on the PREPA credit, in addition to, novating significant amounts to exogenous counterparties to the initial transaction in a bid to garner more threshold capacity that would serve as a cushion in moments of stress. This bigger margin cushion reduces the government risks of liquidity shocks.

Achievements

Since mid 2010 the treasury department began a significant restructuring that resulted in enormous economic gains for the bank. For the previous 10 years the treasury department had been managing its business mostly as a cash transferee without paying much attention to portfolio management theory, meanwhile, having a significant amount of its balance sheet allocated to the investment portfolio. This failed philosophy resulted in significant forgone investment carry gains, as the yield of the portfolio was approximately .60% and duration inside 30 days. We believe that this situation needs to be avoided as it hinders capital growth in the bank, hence, impacts negatively the banks mission of creating a credit expansion in the economy by funding government agencies and corporations. We believe that this situation can be avoided by recruiting personnel for the department with in depth financial knowledge, preferable candidates that have completed the three exams of the CFA institute. This is extremely important as the history shows that government bureaucrats do not understand the dynamics of the bank's balance sheet and therefore are not able either to hire competent portfolio managers as treasurers or realize that by not managing the investments the bank is incurring in an implicit loss per annum.

Milestone Achievements

- NIM expansion from .50% to 2.00%
- Record net income (before write downs and adjustments) of $297MM
- Record trading gains of $69.9MM
- Stable liquidity
- Installed the BondEdge platform for portfolio analytics

- Maximized the use of FINSERV by plugging it to the accounting software hence creating asset/liability management synergies
- Constructed a coherent investment portfolio
- Conducted the first taxable notes transaction in history in order to diversify funding and push liquidity into the local market
- Executed a coherent hedging strategy for PREPA fuel consumption

Future Plans

There is a large amount of GDB notes outstanding that could be refinanced in the local market to obtain at least $32MM worth of PV savings. It is worth mentioning that this transaction should not be executed prior to unloading a portion of the HTA lines into the capital markets. The reason for this is that currently GDB has a very concentrated exposure to this credit which can potentially result in a credit downgrade for the bank. Also there is a series of outstanding notes in the 103 market that can be refunded as well; Barclays and Goldman Sachs monitor this transaction constantly for savings.

The treasury department should be institutionalized in the future in order to make it as technocratic as possible.

Treasury risk oversight should be improved and enhanced.

Goals

The GDB should aim at maintaining a NIM above 1.85% at all times and strive to keep it as close or above 2.00%. The department should safeguard the bank’s liquidity and act as an indirect fiscal agent to the financing department as it pertains to lending activities that put pressure on liquidity. It should serve as the soundboard regarding overconcentration of credits through its ALCO. Also the GDB should aim at maintaining a minimum readily available liquidity at all times of at least $1.8billion. This number should grow as the balance sheet of the bank expands and contract as the balance sheet of the bank contracts.

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