

Finance Committee

Date: 18 October 2017

Item: Treasury Activities

This paper will be considered in public

1 Summary

- 1.1 This paper provides a brief update on key Treasury activities for the period from 1 April 2017 to 30 September 2017 (the Reporting Period), as requested by the Committee.
- 1.2 During the Reporting Period, we have complied at all times with the Treasury Management Policies and the Treasury Management Strategy approved by the Board on 29 March 2017, including the GLA Responsible Investment Policy.
- 1.3 A paper is included on Part 2 of the agenda, which contains exempt supplemental information and documentation. The information is exempt by virtue of paragraph 3 of Schedule 12A of the Local Government Act 1972 in that it contains information relating to the financial affairs of TfL or of a sensitive nature to our listed counterparties. Any discussion of that exempt information must take place after the press and public have been excluded from this meeting.

2 Recommendation

- 2.1 **The Committee is asked to note the paper and the supplementary information on Part 2 of the agenda.**

3 Treasury Highlights

- 3.1 There are a number of activities undertaken by TfL's Treasury function (now part of the Corporate Finance team) since 1 April 2017 that are of note:
 - (a) the continued active investment management of TfL's cash portfolio (£2.6bn including Crossrail, as at 29 September 2017) resulted in a year-to-date weighted average return of 0.27 per cent versus the average benchmark seven-day London Interbank Bid Rate (LIBID) of 0.11 per cent;
 - (b) a £250m 10-year loan with Export Development Canada (EDC) was signed on 17 May 2017;
 - (c) on 18 May 2017, £150m was drawn down under the £500m Crossrail Rolling Stock and Depot loan with EDC;
 - (d) on 15 September 2017, £300m was drawn down under the £1bn Urban Mobility for London loan with the European Investment Bank (EIB). Two further drawdowns under the Crossrail rolling stock and depot loan with the EIB, for a total of £500m, are expected to take place by 31 March 2018;

- (e) Treasury has actively supported the wider TfL organisation in identifying and managing financial risks (foreign exchange risk, interest rate risk, counterparties' credit risk);
- (f) Treasury has actively managed relations with external financial investors, lenders and credit rating agencies; and
- (g) the migration of 89 of TfL's bank accounts, as part of the banks' ring-fencing project, was successfully completed on 4 September 2017.

4 Borrowing Update

Authorised Borrowing Limit

- 4.1 The authorised borrowing limit for 2017/18 is £11.9bn, a number higher than the £10.4bn target debt (see paragraph 4.3) as it includes, for example, the option to raise all incremental borrowing and refinance the existing debt due to mature in year before the outstanding debt is repaid.

New EDC Loan Facility

- 4.2 On 17 May 2017, TfL signed a new £250m 10-year corporate loan facility with EDC to support the delivery of the new signalling system by Thales, as part of the Four Lines Modernisation project. The new facility is TfL's second transaction with EDC following a £500m loan agreement signed in 2015, which supports the purchase of Crossrail rolling stock and depot. The facility will allow TfL to forward fix interest rates and draw down the proceeds over a period of three years.

Borrowing Requirement

- 4.3 Table 1 below sets out TfL's borrowing requirement for 2017/18 as per TfL Budget 2017/18 (TfL Budget). TfL Budget assumes that £331m of the £950m available for incremental borrowing (£900m incremental borrowing limit agreed with HM Treasury plus £50m of incremental borrowing deferred from 2016/17) will be deferred to 2018/19. As at 29 September 2017, TfL had £10,203m of debt outstanding, of which £688.5m was short-term commercial paper. The weighted average interest rate on TfL's debt was 3.55 per cent (with a weighted average life of 19.2 years). The target debt for 2017/18 is £10.4bn.

Table 1: Borrowing requirement for 2017/18

	£m
Incremental borrowing as per TfL Budget 2017/18 (including amount deferred from 2016/17)	619.5
Refinancing of £300m 1.250% notes due November 2017	300
Refinancing of other debt maturing within 12 months	331
Total borrowing requirement	1,250.5
<i>Financed by:</i>	
EIB Crossrail Rolling Stock and Depot loan (to be drawn in November 2017 and March 2018)	500
EIB Urban Mobility for London loan (drawn in September 2017)	300
EDC Crossrail Rolling Stock and Depot loan (drawn in May 2017)	150
Total committed for 2017/18	950

Balance to raise for 2017/18	300.5
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TfL's Credit Ratings

- 4.4 While TfL does not have any direct financial covenants, TfL does have an implicit financial covenant through its commitment to maintain its high credit rating.
- 4.5 On 22 September 2017, Moody's downgraded the UK sovereign long term rating from Aa1 with negative outlook to Aa2 with stable outlook. Moody's rating action brought the UK sovereign rating in line with the other two major agencies as both Fitch and Standard & Poor's have had the AA rating since June 2016. The decision to lower the UK sovereign rating is based on the weakening of the public finances, the erosion of the UK economic strength as a result of Brexit and increasing challenges to policy-making.
- 4.6 This rating action was followed by a downgrade of TfL's long term rating from Aa2 with negative outlook to Aa3 with stable outlook on 26 September 2017, due to the close institutional, operational and financial linkages between TfL and the UK sovereign. The stable outlook on TfL reflects the stable outlook on the UK sovereign and the expectation that TfL will be able to absorb potential negative implications of Brexit, such as diminishing funding from the EU and slower growth in ridership. We do not expect any immediate financial impact from this rating action.
- 4.7 Table 2 below sets out TfL's current credit ratings. There have been no changes to TfL's credit ratings by Standard & Poor's and Fitch since June / July 2016.

Table 2: Current credit ratings

	Standard & Poor's	Moody's	Fitch
Long-term rating	AA	Aa3	AA-
Outlook	Negative	Stable	Negative
Short-term rating	A-1+	P-1	F1+

- 4.8 The rating agencies indicated that a further downgrade of the UK sovereign, a dilution of the UK Government's support, a significant weakening in TfL's revenue growth prospects, cost overruns on large capital projects, or a failure to realise savings from the cost reduction programme are the main factors that could lead to a further downgrade of TfL's rating. Conversely, the rating could be upgraded if the UK sovereign rating is upgraded, TfL's revenues significantly increase, or the level of debt is substantially reduced.

5 Risk Management Update

Foreign Exchange Risk

- 5.1 TfL has exposure to a number of currencies as part of its commercial procurement activities, including Euro, Canadian Dollar and Swedish Krona.

While the underlying potential exposure is material in the context of the five year business plan, it can only be fully hedged once there is a high level of certainty over the amount and timing of the foreign currency cash flows.

- 5.2 Treasury has continued to support commercial teams on procurements which contain foreign currency exposure for TfL. Over the Reporting Period, foreign currency exposure relating to the Central Line AC Traction upgrade project has been hedged and a number of other procurements are being monitored for potential hedging. Additional information is provided in the paper on Part 2 of the agenda.

Interest Rate Risk

- 5.3 A number of interest rate swaps, used to fix the borrowing rate for the commercial paper programme, have matured over the course of 2017/18. As at 29 September 2017, floating rate debt comprised 1.6 per cent of total borrowing outstanding, which is in line with the Board approved Treasury Management Indicator for the upper limit on variable rate borrowing of 25 per cent.
- 5.4 As indicated in Table 1, £950m out of a total £1,250.5m budgeted borrowing requirement for 2017/18 has been pre-arranged at fixed rates of interest, leaving £300.5m exposed to interest rate fluctuations. The financial markets currently expect an interest rate increase of 0.25 per cent by the Bank of England in early November 2017. Although interest rates are expected to rise, TfL considers its exposure to interest rate risk relative to the 2017/18 budget to be acceptable.

Commodities Price Risk

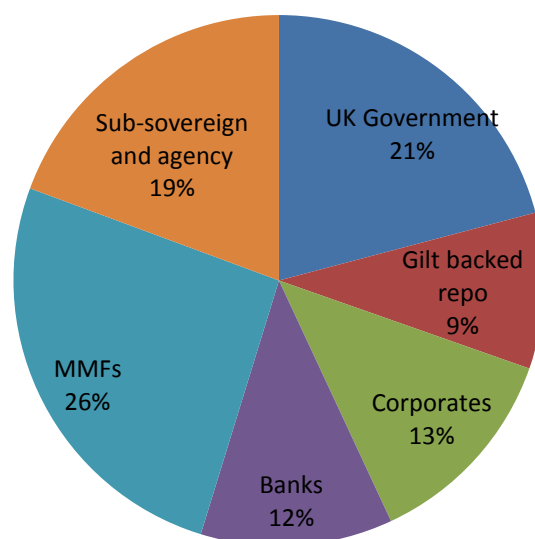
- 5.5 Over the course of the year, Treasury has also assessed a number of other financial risk exposures across the business, including power purchasing arrangements and diesel costs in the bus operator contracts. It has been concluded that the risk of fluctuations in energy prices is managed effectively through the existing contract with Crown Commercial Services and no further hedging is recommended. The price of diesel in the bus contracts currently references a non-hedgeable index, therefore further work is required to determine whether there are opportunities for more efficient risk management.

6 Investment Update

- 6.1 TfL has complied with the Board approved investment limits and the GLA Responsible Investment Policy at all times during the year to date. As part of its standard investment procedures, TfL has also implemented internal forward looking and dynamic investment limits within the Board approved counterparty investment limits. These limits allow TfL to further increase the security of cash under management.
- 6.2 As at 29 September 2017, TfL had £2.6bn of cash under management, including £1.5bn of cash ring-fenced to fund the construction of the Crossrail project.
- 6.3 TfL's cash balances have built up as a result of securing the most favourable funding and financing terms for TfL's capital investment programme to a pre-agreed schedule with Government, which sometimes comes in advance of delivery of major projects – including for example Crossrail. All of the cash under management above the target minimum cash level is allocated to planned

projects within the Business Plan. The allocation of TfL's cash investments is summarised in Chart 1 below.

Chart 1: Cash investment allocation as at 29 September 2017



- 6.4 TfL's year-to-date average yield at 29 September 2017 was 0.27 per cent, 16 basis points above the seven-day LIBID benchmark, which is widely regarded as the market benchmark for short term cash investments for professional investors, such as Money Market Funds (MMFs).
- 6.5 Active management of the investment portfolio by Treasury has resulted in a greater return compared to a passive approach that would involve investing cash surpluses in MMFs only. TfL has continued to benefit from a favourable return versus risk profile, mostly from having the ability to invest in Euro denominated corporate paper and swapping back to Sterling, and having a diverse range of high quality investment counterparties. The weighted average maturity of cash investments is just over two months.

7 Liquidity Update

- 7.1 Over the Reporting Period, the liquidity position has been strong and TfL has maintained sufficient liquidity to meet its contractual payment obligations.
- 7.2 The two liquidity measures included in TfL's Balanced Scorecard – daily closing cash vs. target minimum cash and average cash balance over the period – have consistently met their respective targets.

8 Other Activities

Banking

- 8.1 Changes in the Financial Services (Banking Reform) Act 2013 meant that TfL's banking provider, HSBC, had to ring-fence its UK retail banking operations from any wholesale or investment banking activity. This meant that all 89 of TfL's bank accounts needed to migrate to a new sort code and account number. The new bank accounts and systems migration in SAP, Quantum and Oracle was successfully implemented and went live on 4 September 2017, one month ahead of the scheduled delivery date of 1 October 2017.

- 8.2 The EU Capital Requirements Directive IV and the Capital Requirements Regulation 575/2013 imposed new requirements on the way banks have to report notional pooling to central banks, which necessitated changes to legal documentation related to pooling arrangements.

MiFID II

- 8.3 Under the current Markets in Financial Instruments Directive (MiFID), TfL (the local authority) and Transport for London Finance Limited (subsidiary of TfL and party to derivatives) are both classified as 'professional clients' by investment counterparties, enabling access to a wider range of investment products and services than those available to 'retail clients'.
- 8.4 MiFID II, which will come into force on 3 January 2018, makes important changes in relation to the client classification of local authorities. Local authorities will by default be classified as retail clients, with the need to meet certain conditions to elect up to professional clients status.
- 8.5 TfL needs to be able to maintain its professional client status in order to continue to access the wide range of investment products and services currently accessible to it. Treasury has therefore started the process of electing up to professional client status with its investment counterparties to ensure appropriate classification by January 2018.
- 8.6 Transport for London Finance Limited is not expected to be considered as a local authority for the purposes of MiFID II, and therefore only needs to meet the same conditions as today to be classified as professional client.

Review of the Prudential Code, Treasury Management Code and Statutory Investment Guidance

- 8.7 Treasury, along with the GLA, took part in the consultation on the proposed changes to the Prudential Code and Treasury Management Code (the Codes), which closed on 30 September 2017.
- 8.8 It is proposed in particular that the Codes and the Guidance on Local Authority Investments published by the Department for Communities and Local Government should also apply to non-treasury investments, in order to ensure appropriate management of risks and returns. Such investments are described as commercial investments held for financial returns, and include investment properties. If this is confirmed, TfL's Treasury Management Strategy and Policies might have to cover all such non-treasury investments.
- 8.9 It is also proposed that financial guarantees and contingent liabilities are covered by the Codes.

List of appendices to this report:

A paper containing exempt supplemental information is included on Part 2 of the agenda.

List of background papers:

None.

Contact Officer: Emanuela Cernoia, Interim Corporate Finance Director, Finance
Number: 020 7535 5321
Email: Emanuelacernoia-russo@tfl.gov.uk

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