Finance Committee

Date: **26 January 2017**

Item: **Group Treasury Activities**

This paper will be considered in public

1 Summary

1.1 This paper provides a mid-year update on Group Treasury's activities for the period from 1 April 2016 to 30 November 2016 (the Reporting Period), as required by the Treasury Management Policy Statement and Treasury Management Practices 2016/17 (TMP) approved by the Board in March 2016.

1.2 During the Reporting Period there have been no instances of non-compliance with the Treasury Management Policy Statement and Treasury Management Practices or the Treasury Management Strategy.

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 Background

3.1 On 17 March 2016, the Board approved the Treasury Management Strategy (TMS) 2016/17, including an Investment Strategy 2016/17, a Borrowing Strategy 2016/17 and a Risk Management Strategy 2016/17, and reiterated the following strategic objectives for Group Treasury:

(a) to ensure that sufficient cash is available to enable TfL to discharge its financial obligations when they become due, in accordance with approved spending plans;

(b) to undertake treasury management operations with primary regard for the security and liquidity of capital invested;

(c) to maximise the yield from investments consistent with the security and liquidity objectives identified above;

(d) to undertake treasury management activities having regard to Prudential Indicators;

(e) to secure TfL’s funding requirements by accessing the most cost efficient source of finance, while ensuring TfL has flexibility and sufficient alternatives not to be dependent on any particular source; and

(f) to use TfL’s statutory power relating to risk management to achieve greater value for money through reducing costs or protecting revenues, reducing volatility / increasing certainty in the Business Plan and to holistically manage financial risks across the whole of TfL.

3.2 This paper provides an update on the treasury management activities and risks, and the performance of the treasury management function. By doing so, the paper fulfils the requirement under the TfL Treasury Management Policy Statement and Treasury Management Practices 2016/17 to provide a semi-annual monitoring report on the same.

4 Group Treasury Highlights

4.1 There are a number of activities undertaken by Group Treasury since 1 April 2016 that are of note:

(a) the continued active investment management of TfL’s cash portfolio, £1.93bn including Crossrail as of 30 November 2016, resulted in a year-to-date weighted average return of 0.49 per cent versus the average benchmark seven-day London Interbank Bid Rate (LIBID) of 0.24 per cent. The return on 30 November was 0.36 per cent and LIBID was 0.12 per cent;

(b) during the Reporting Period, a very competitive interest rate was forward fixed on a £100m tranche of an existing £500m 20-year Crossrail Rolling Stock and Depot corporate loan facility with Export Development Canada (EDC). This created savings against budget of £3.5m for the 2016/17 financial year;

(c) Group Treasury has actively supported the wider TfL organisation in identifying and managing financial risks (foreign exchange risk, interest rate risk, counterparties’ credit risk) and in assessing the impact of key strategic choices on TfL’s balance sheet;

(d) Group Treasury has actively managed the relationship with external financial investors, lenders and credit rating agencies through a period of political and economic uncertainty in the United Kingdom;

(e) the Treasury Management System was successfully upgraded in October 2016;

(f) Group Treasury ran a competitive tender for a Supply Chain Finance solution, which resulted in the selection of Taulia UK Limited (Taulia) as the preferred bidder. A contract was signed outside of the Reporting Period on 22 December 2016; and

(g) an Internal Audit was completed during the year and all activities were concluded to be well controlled.

5 Performance against Treasury Management Practices

5.1 This section reviews performance against Treasury Management Practices (TMPs).

TMP 1 – Risk Management

5.2 The Director of Group Treasury has continued to monitor arrangements for the identification, management and control of treasury management risk, a summary of which is detailed further below.

Investment Limits

5.3 TfL has complied with Board approved investment limits at all times during the year to date.

5.4 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.

Borrowing Limits

5.5 TfL has remained within the Authorised Limit (the Legal limit) for Borrowing at all times during the financial year to date. The Authorised Limit was established by the Mayor and approved by the Board in March 2016.

Borrowing Documentation & Covenants

5.6 Group Treasury has complied with all reporting requirements and undertakings included in the financing documentation. The ongoing increase in the amount of debt outstanding and the increasing amount of lending notionally linked in the case of the European Investment Bank (EIB) and Export Development Canada (EDC) or explicitly linked (in the case of the Green Bond issued in April 2015) to specific projects requires ongoing project monitoring and significant interaction between Group Treasury and the wider organisation.

5.7 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.

TfL's Credit Ratings

5.8 At least once a year TfL holds a general update meeting with each one of the three rating agencies that rate TfL's short and long term debt. Following these meetings, each rating agency reviews TfL's credit rating and outlook. TfL manages the risk of downgrade through strong governance and financial discipline and an open dialogue with each agency. A ratings downgrade could potentially result in a higher cost of borrowing for TfL as well a greater refinancing risk for existing debt.

5.9 In June 2016, the credit rating of the UK Sovereign was downgraded as a result of the decision to leave the European Union. As a result, Standard & Poor's and Fitch downgraded TfL's credit rating by one notch from AA+ to AA and from AA to AA- respectively. In addition, S&P, Fitch and Moody's changed the outlook on TfL from 'Stable' to 'Negative'.

5.10 The rating agencies have indicated that a further downgrade of the UK Sovereign, substantially higher debt, and reduced support from the UK Government (in the form of grants reduction, including capital funding) are the main factors that could lead to a further TfL rating downgrade. The rating could be upgraded if the UK Sovereign is upgraded, TfL’s total revenue rises to such an extent that any deficit after capital expenditure is eliminated, or if the level of debt is significantly reduced.

5.11 Table 1 sets out TfL’s current credit ratings.

Table 1: Current Credit Ratings

	Standard & Poor’s	Moody's	Fitch
Long-term rating	AA	Aa2	AA-
Outlook	Negative	Negative	Negative
Short-term rating	A-1+	P-1	F1+

Foreign Exchange Risk

5.12 Group Treasury has supported commercial teams on procurements which contain foreign currency exposure for TfL. Foreign currency exposure relating to the purchase of Crossrail engineering trains; two ferries; and a Central line data transmission system have each been hedged in the Reporting Period.

Interest Rate Risk

5.13 As shown in table 2, £806m out of a total £838.5m borrowing requirement for 2016/17 has been arranged at fixed rates of interest, leaving only £32.5m to raise by 31 March 2017. As a result, TfL’s exposure to increases in interest rates is not material to TfL’s financial position for the financial year 2016/17. TfL remains exposed to the risk of increases in interest rates in future years. The Treasury Management Strategy for 2017/18 will cover exposure to interest rates for future debt.

5.14 Interest rate derivatives were entered during the reporting period to mitigate floating interest rate risk related to an operating lease for the most recent purchase of London Overground rolling stock resulting in savings of £1.3m per annum compared to budget.

Potential Impact of Forthcoming Accounting, Legislative and Regulatory Changes

Money Market Fund (MMF) Reform

5.15 New EU rules governing Money Market Funds (MMFs), announced in November 2016, are set for final approval in the first quarter of 2017. If approved there would be an 18 month transition period during which TfL would determine how to best respond to the changes. One of the main impacts on TfL would be the move away from constant net asset value (CNAV) funds to low-volatility NAV (LVNAV) funds. LVNAV funds can maintain a constant NAV provided certain criteria are met, including that the market value does not deviate by more than 20 basis points. Additionally the proposed regulations would introduce mandatory liquidity fees and redemption gates to protect funds by discouraging withdrawals in times of financial distress.

Markets in Financial Instruments Directive II (MIFID II)

5.16 MIFID governs the provision of investment services in financial instruments by banks. Under MIFID II TfL would agree to continue to be classified with a professional status. This would mean it would continue to use and invest in financial instruments without the various restrictions imposed on retail parties. This is now due to come into effect January 2018.

Financial Transaction Tax

5.17 This is a proposal to tax a large variety of equity and bond transactions. There has been little progress to date and there is no implementation date.

5.18 Group Treasury is also monitoring:

(a) potential changes to Public Works Loan Board lending (PWLB), following the consultation on the transfer of its functions to another body and to which TfL responded;

(b) potential impact of IFRS 16 lease accounting standard, which will be applicable from 2019/20, when a number of operating leases might be accounted for as finance leases; and

(c) potential impact of the UK decision to leave the EU on legislation relevant for treasury activities.

TMP 2 – Performance Measurement

5.19 Group Treasury's borrowing and investment performance are measured against external benchmarks. Further information is available in the paper in Part 2 of the agenda.

TMP 3 – Decision-Making and Analysis

5.20 Group Treasury has maintained full records of its key treasury management decisions during the Reporting Period. Compliance with maintenance of records was part of the Internal Audit process conducted in August/September and this was considered to be well controlled.

Borrowing

5.21 As well as the overall strategic objectives that underpinned the 2016/17 Treasury Management Strategy (as detailed in section 3), the main specific objectives for borrowing were:

(a) to manage borrowing in a manner that combines flexibility, security of access to funds, diversity of funding sources and value for money;

(b) to maintain the credit rating relative to that of the UK Government; and

(c) to borrow an additional £730.5m in 2016/17 (in accordance with the Spending Review 2015).

5.22 Objective (a) was achieved by maintaining access to capital markets through TfL’s Euro Commercial Paper (ECP) programme, as well as being further complemented by the availability of a £500m facility with EDC and £1bn facility with the EIB. The EMTN Programme was not renewed in July 2016, when the Base Prospectus expired, as Group Treasury opted to postpone the update to early 2017, following the publication of the new Business Plan in December 2016.

5.23 TfL’s credit rating was downgraded as a result of the downgrade of the UK Sovereign, thus leaving TfL’s credit rating unchanged relative to that of the UK Government (objective (b)).

5.24 Objective (c) has been achieved through the financing detailed in Table 2 below, which shows the amount of borrowing TfL had to raise and refinance by 31 March 2017, as per the TMS. The balance of £32.5m is likely to be raised through Commercial Paper (CP) by 31 March 2017 or deferred to the following financial year (the latter option is possible if an eight week notice is provided to HM Treasury).

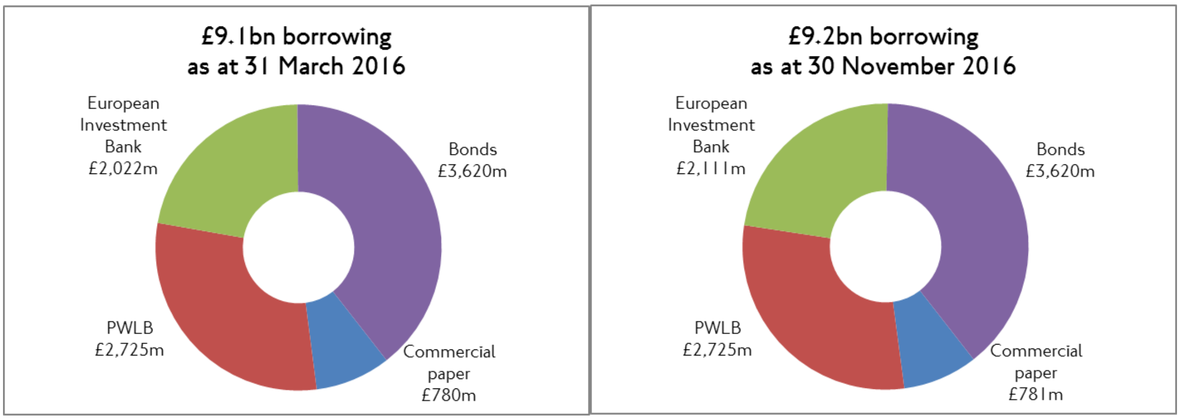
Table 2: 2016/17 Borrowing requirement as at 30 November 2016

	£m
2016/17 Incremental Borrowing agreed with DfT	730.5*
Debt maturing within 12 months	108.0
Total borrowing requirement	**838.5**
Financed by:	
EIB loan (drawn September 2016)	100.0
EIB loan (to be drawn by 31 March 2017)	400.0
EDC loan (to be drawn by 31 March 2017)	250.0
Commercial paper	56.0
Total drawn or committed as at 30 November 2016	**806.0**
Incremental balance to fund before 31 March 2017	32.5

* Based on the March 2016 Spending Review letter from government which includes £30.5m borrowing related to the Croxley Rail Link scheme.

5.25 Between 1 March and 30 November 2016 TfL increased its outstanding borrowing by approximately £100m, mainly as a result of drawing down on the £1bn EIB facility. As at 30 November 2016, TfL had £9,238m of debt outstanding, of which £781m was short-term CP. The weighted average interest rate on TfL’s debt as at 30 November 2016 was 3.67 per cent (with a weighted average life of 19.3 years).

Chart 2: TfL Debt Outstanding 31 March 2016 and 30 November 2016



Investments

5.26 The 2016/17 TMS Strategic Objectives specific to Investments are:

(a) to ensure that sufficient cash is available to enable TfL to discharge its financial obligations when they become due, in accordance with approved spending plans;

(b) to undertake treasury management operations with primary regard for the security and liquidity of capital invested; and

(c) to maximise the yield from investments consistent with the security and liquidity objectives identified above.

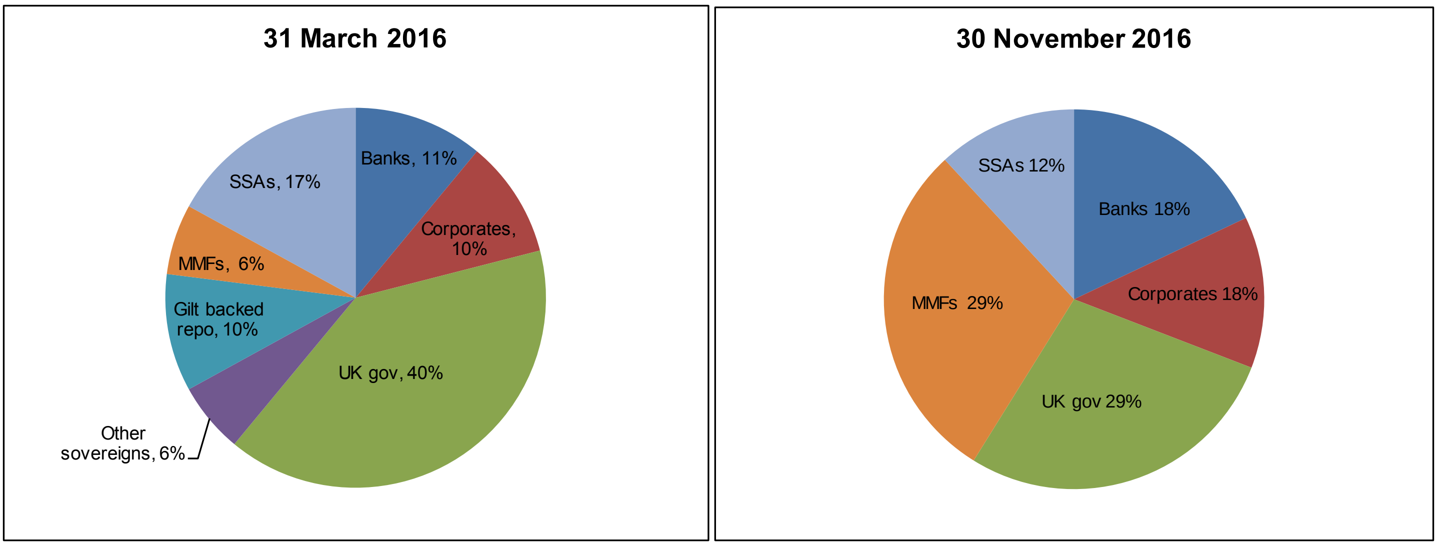
5.27 In order to achieve the strategic objectives outlined in 5.26, which prioritise security and liquidity over yield, the current investment strategy seeks to maintain approximately 30 per cent of TfL's investment portfolio in UK Government investments, such as UK Treasury Bills. UK Treasury Bills are considered the most highly rated (AA) and liquid of domestic assets within the portfolio. Given the parties on the list of approved investment counterparties are of high credit quality across the board, the average weighted total portfolio rating currently falls in the AA to AA- range which is only marginally below that of the UK Government.

5.28 In accordance with the TMS for 2016/17, Group Treasury manages its cash and liquid assets to ensure that a minimum of £250m is available for redemption on any business day to ensure TfL has sufficient liquidity to meet its financial obligations. Investment decisions are made with regard to expected cash flow requirements.

5.29 As at 30 November 2016, TfL had £1.93bn of cash under management (including £0.97bn of cash ring-fenced to fund the construction of the Crossrail project). TfL's cash balances have been 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 is allocated to planned projects within the Business Plan.

5.30 TfL's investments have reduced by £1.2bn from £3,13bn to £1,93bn in the Reporting Period. The allocation of TfL's cash investments is summarised in Chart 3.

Chart 3: Cash Investment Allocations



TMP 4 – Approved Instruments, Methods and Techniques

5.31 Group Treasury has continued to undertake its treasury management activities by employing recognised and approved instruments, methods and techniques within the limits and parameters defined in the Board approved treasury management policies and practices. All decisions on capital/project financing, borrowing, investments and derivatives were made in accordance with the financial limits in TfL Standing Orders and relevant policies and the Treasury Management Strategy.

TMP 5 – Organisation, Clarity and Segregation of Responsibilities and Dealing Arrangements

5.32 Group Treasury is organised in segregated teams including front, middle, and back office roles to ensure effective control and monitoring of its treasury management activities. This structure, together with the implementation of Treasury Management Strategy, ensures activities are managed in a fully integrated manner and that there is at all times clarity of treasury management responsibilities. Every deal entered into the Treasury Management System is inputted and then approved by separate members of the Group Treasury team.

5.33 Accounting and monitoring of prudential indicators is undertaken by group accounting which reports to the Chief Finance Officer.

TMP 6 – Reporting Requirements and Management Information Arrangements

5.34 Group Treasury continues to report in line with the Treasury Management policy and/or practices. During the period there have been no instances of non-compliance with the Treasury Management Policy Statement and Treasury Management Practices or the Treasury Management Strategy.

TMP 7 – Budgeting, Accounting and Audit Arrangements

5.35 Group Treasury has continued to prepare and, if necessary, amend the annual budget for treasury management including both financing costs and investment income. Budgets are regularly monitored and updated as required to reflect the latest market conditions.

5.36 The Budget for 2016/17 finance costs and interest income is set out in Table 4. The 2016/17 forecast outturn is as per the 2016 Business Plan. Financing costs show an expected saving of £20.3m against budget. The forecast outturn for interest income for the year shows a reduction of £5m of interest over budget due to a fall in interest rates.

Table 4

£m	16/17 Forecast outturn (£m)	16/17 Budget	Variance
Financing costs	371.3	391.6	(20.3)
Interest income	8.3	12.3	(5.0)

5.37 In August 2016, Internal Audit completed a review of the adequacy and effectiveness of controls in place to manage Group Treasury activities in TfL. The audit focused on the control environment in relation to the following key areas: Treasury strategy, policy, procedures and legislation, roles and responsibilities, investment, borrowings, hedging activities, banking process, system reconciliations, management reporting, and risk management. Internal Audit concluded the activities are well controlled and there were no management actions arising from the audit. This will be reported to the Audit and Assurance Committee in March 2017 within the Internal Audit Quarter 2 report.

TMP 8 – Cash and Cash Flow Management

5.38 All monies in the hands of the TfL Group continued to be under the control of the Director of Group Treasury, and have been aggregated for cash flow and investment management purposes during the period. The only exceptions to this are for monies of subsidiaries whose bank accounts need to remain separate for regulatory reasons, or for specific individual accounts where there is a third party interest. Cash flow projections are prepared on a regular and timely basis and are adequate for the purposes of monitoring compliance with this policy statement.

TMP 9 – Money Laundering

5.39 Group Treasury has remained alert during the period to the possibility of money laundering and has complied with all laws and regulations in this respect. Amendments to existing and the input of new counterparty bank details within the TMS are tightly controlled.

5.40 The Financial Service Centre maintains responsibility for the integrity of bank details within the Group ERP system. Financial crime, fraud, Payment Card Industry compliance and money laundering are monitored by Internal Audit.

TMP 10 – Training and Qualifications

5.41 Group Treasury is aware of the importance of ensuring that all staff involved in the treasury management function are fully equipped to undertake the duties and responsibilities allocated to them. Only staff with relevant skills, experience and/or qualifications are recruited. A number of team members are also currently studying for professional Treasury qualifications. Training is provided as required for each individual as part of their learning and development objectives.

TMP 11 – Use of External Service Providers

5.42 With the exception of work on the Treasury Management System upgrade see section 6.3 no external providers of treasury management services were used during the Reporting Period and operations were carried out internally. Group Treasury will continue to monitor the potential value in employing external service providers and engage, if and when, appropriate.

5.43 Group Treasury does engage with professional advisors when there is a business requirement and will continue to do so as appropriate.

TMP 12 – Corporate Governance

5.44 Group Treasury remains committed to the pursuit of proper corporate governance through the Treasury Management Policy and Treasury Management Practices. All risk management practices have been complied with during the Reporting Period, as per section 5.

6 Other Activities

Banking

6.1 Changes in banking regulations (Banking Reform) Act 2013 mean that TfL's banking provider must ring fence its UK retail banking operations from any wholesale or investment banking activity. Therefore all TfL bank accounts will need to migrate to a new sort code and account number. Group Treasury has started assessing the impact of the change as the implementation deadline is 31 December 2017.

6.2 EU Capital Requirements Directive IV and the Capital Requirements Regulations 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.

Treasury Management System Upgrade

6.3 Group Treasury utilises the FIS Quantum treasury management system. The system was upgraded with FIS support in October 2016 to enable TfL to receive best continued support from FIS and a more efficient user interface.

Supply Chain Finance

6.4 TfL awarded a contract after the Reporting Period to Taulia for the provision of a Supply Chain Finance solution that will provide TfL's suppliers with the option of earlier settlement on approved invoices.

Commercial

6.5 Group Treasury supported the Commercial Development team on the new TfL advertising contract by providing advice in determining the preferred option for structuring the contract and taking part in the financial assessment of the bidders.

6.6 Group Treasury also supported the Commercial Development / commercial teams in evaluating the financial aspects of the bids for new property partnerships (for example Kidbrooke). Group Treasury led the development of internal guidance relating to the mitigation of risks arising from property developments. The guidance sets out a common approach for evaluating and managing financial risk and received widespread support from the business. A training course will be rolled out in the coming months following further consultation with Property Development.

List of appendices to this report:

A paper containing exempt supplemental information is included in Part 2 of this agenda.

List of Background Papers:

None

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