Finance Committee

Date: **5 March 2018**

Item: **Treasury Activities**

This paper will be considered in public

1 Summary

1.1 This paper provides a brief update on our key treasury activities for the period from 1 April 2017 to 13 February 2018 (the Reporting Period). The paper contributes to the monitoring of TfL's financial prudence, one of the measures on TfL's scorecard.

1.2 During the Reporting Period, we have complied at all times with the Treasury Management Strategy and the Treasury Management Policies 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 Since 1 April 2017 we have undertaken a number of treasury activities of note, which include:

(a) the continued active investment management of the cash portfolio (£2bn including Crossrail, as at 13 February 2018) resulted in a year-to-date weighted average return of 0.31 percent versus the average benchmark of seven-day London Interbank Bid Rate (LIBID) of 0.19 percent;

(b) a £250m 10-year loan facility with Export Development Canada (EDC) was signed on 17 May 2017;

(c) a total of £700m has been drawn under our European Investment Bank (EIB) and Export Development Canada (EDC) facilities, with a further £250m drawdown to take place on 15 March 2018;

(d) we have actively supported the wider organisation in identifying and managing financial risks (foreign exchange risk, interest rate risk, counterparties' credit risk) and implemented hedging programmes in order to mitigate foreign exchange risk on a number of commercial procurements;

(e) we have responded to changes in financial markets regulation, including migrating 89 TfL bank accounts as part of HSBC's ring-fencing project (September 2017) and opting up to a professional client status as part of the Markets in Financial Instruments Directive II (MiFID II), and

(f) we have worked with PwC to review our risks and controls and PwC concluded that processes were robust for our daily activities.

4 Borrowing Update

Authorised Limit, Target and Current Borrowing

4.1 The Authorised (legal) Limit for borrowing for 2017/18 is £11,925m. Target borrowing by 31 March 2018 is £10,448m. As at 13 February 2018, we had £10,127m outstanding borrowing.

4.2 The difference between the Authorised Limit and target borrowing gives us the option to temporarily exceed, within the financial year, our incremental borrowing limit where necessary or desirable. For example, for working capital purposes, or to refinance existing debt due to mature before the outstanding amount is repaid. We have remained within the Authorised Limit for borrowing at all times during the Reporting Period.

4.3 Table 1 sets out our borrowing requirement for 2017/18 as per the TfL Budget 2017/18. The TfL Budget assumes that (i) we will borrow £619.5m of the £950m incremental borrowing limit agreed with HM Treasury for 2017/18, as set out in the March 2017 funding letter and (ii) we will defer the remaining £330.5m of incremental borrowing to 2018/19. This borrowing requirement results in a target outstanding borrowing by 31 March 2018 of £10,448m. On 30 January 2018, we informed HM Treasury of our decision to defer £330.5m of borrowing to the following financial year (2018/19).

Table 1: Borrowing requirement for 2017/18

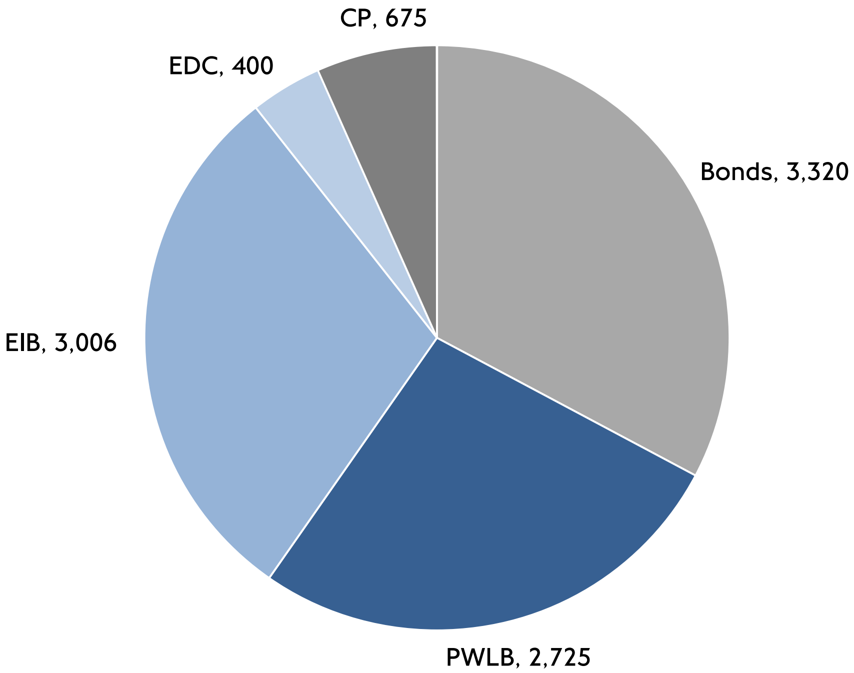
	£m
Incremental borrowing as per TfL Budget 2017/18	619.5
Refinancing of £300m bond due November 2017	300
Refinancing of other debt maturing within 12 months	331*
Total borrowing requirement	**1,251**
Financed by:	
EIB Crossrail Rolling Stock and Depot loan (to be drawn in March 2018)	250
EIB Crossrail Rolling Stock and Depot loan (drawn in November 2017)	250
EIB Urban Mobility for London loan (drawn in September 2017)	300
EDC Crossrail Rolling Stock and Depot loan (drawn in May 2017)	150
Short-term unhedged commercial paper	200
Total raised and committed	**1,150**
Remaining balance to be raised in 2017/18	**100**

*Includes £250m of commercial paper, whose hedging matured over the Reporting Period and £38.5m of unhedged commercial paper

4.4 The £10,127m of debt outstanding comprises £675m of short-term commercial paper (CP), of which £200m is unhedged. Keeping an element of unhedged CP has given us the flexibility to vary the amount outstanding during the year to align with our requirements and adjust depending on the cost of carry.

4.5 We have raised or agreed to raise most of the required borrowing, apart from £100m that is expected to be raised in the form of unhedged CP by 31 March 2018.

Chart 1: Outstanding borrowing as at 13 February 2018 (£m)



4.6 The weighted average interest rate on our debt was 3.65 percent (with a weighted average life of 19.5 years).

EDC Loan Facility

4.7 On 17 May 2017, we 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 facility will allow us to forward fix interest rates and draw down the proceeds over a period of three years. As at 13 February 2018 this facility remains undrawn.

TfL’s Credit Ratings

4.8 While we do not have any direct financial covenants, we do have an implicit financial covenant through the commitment to maintain a strong credit rating.

4.9 Table 2 shows our current credit ratings. There have been no changes to our credit ratings by Standard & Poor’s and Fitch since June and July 2016 respectively. Standard & Poor’s affirmed our long-term rating at AA with negative outlook on 31 March 2017, and Fitch affirmed our long-term rating at AA- with negative outlook on 31 October 2017.

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+

4.10 In September 2017, Moody’s downgraded the UK Sovereign rating, citing weakening of public finances, erosion of UK economic strength as a result of Brexit and increasing challenges to policy-making. Due to the close institutional, operational and financial linkages between TfL and the UK Sovereign, our long term credit rating (along with those of 53 other UK sub- sovereign entities) was subsequently lowered from Aa2 with negative outlook to Aa3 with stable outlook. The stable outlook reflects the expectation that we will be able to absorb potential negative implications of Brexit, such as diminishing funding from the EU and slower growth in ridership. There has been no financial impact from this rating action. Our credit rating remains on negative outlook with Standard & Poor’s and Fitch, in line with the outlook for the UK Sovereign.

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

5 Risk Management Update

Foreign Exchange Risk

5.1 We are exposed to a number of currencies as part of our commercial procurement activities, including Euro, Canadian Dollar, US Dollar, Swedish Krona, Swiss Franc and Chinese Renminbi. 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 We have continued to support commercial teams on procurements which contain foreign currency exposure. Over the Reporting Period, we have hedged foreign currency exposure on a number of projects, including an upgrade of traction power on the Central line, signalling enhancements for the Northern line and purchase of pontoons and auto mooring system for Woolwich ferries. 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 13 February 2018, floating rate debt comprised two per cent of total borrowing outstanding, which is in line with the Board approved Prudential Treasury Indicator for the upper limit on variable rate borrowing of 25 per cent.

5.4 As indicated in paragraph 4.5, the remaining £100m of borrowing for 2017/18 is likely to be raised in the form of short-term commercial paper, which will increase the portion of the floating rate debt to 2.9 per cent at 31 March 2018. This level of interest rate exposure is consistent with our low risk appetite, while allowing us to benefit from the lower cost of borrowing and reduce the cost of carry.

Commodities Price Risk

5.5 Over the course of the year, we have 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 the terms of the contracts should be amended in order to allow for more efficient risk management.

6 Liquidity Update

6.1 Over the Reporting Period, the liquidity position has been strong and we have maintained sufficient liquidity to meet our contractual payment obligations.

6.2 The two liquidity measures included in TfL's scorecard – daily closing cash versus target minimum cash (30 days' forecast operating costs or £540m for 2017/18) and average cash balance above the minimum target over the period – have consistently met their respective targets.

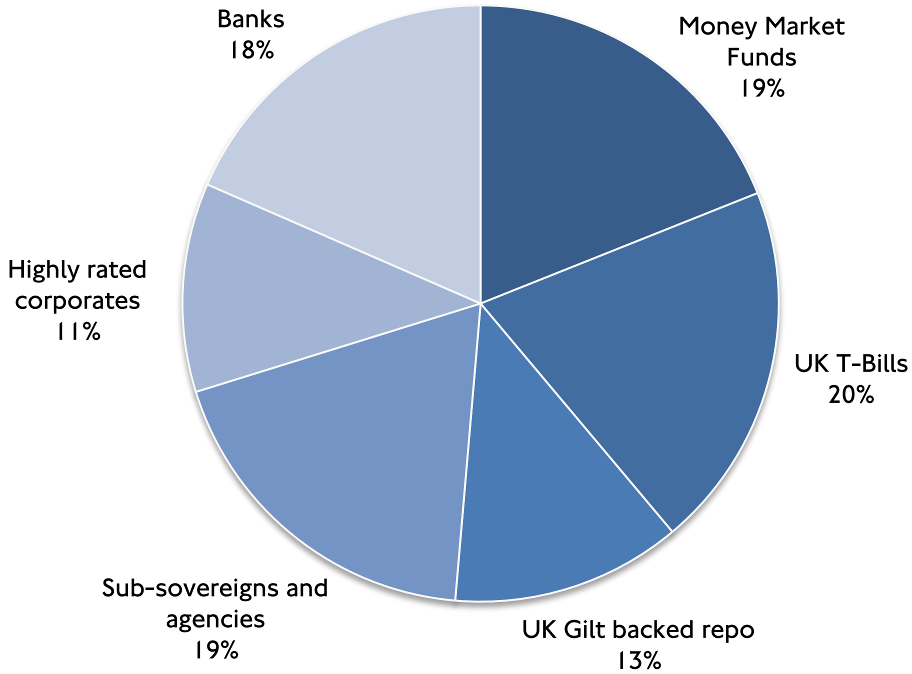
7 Investment Update

7.1 We have complied with Board approved counterparty exposure limits and the GLA Responsible Investment Policy at all times during the Reporting Period. As part of our standard investment procedures, we have also implemented internal forward looking and dynamic investment limits within the Board approved counterparty exposure limits. These limits allow us to further increase the security of cash under management.

7.2 As at 13 February 2018, we held £2bn of cash under management, which includes £683m of cash ring-fenced to fund the construction of the Crossrail project.

7.3 Our cash balances have built up as a result of securing the most favourable funding and financing terms for our capital investment programme to a pre-agreed schedule with Central Government, which sometimes comes in advance of delivery of major projects, including for example Crossrail. The majority of the cash under management in excess of the target minimum cash of £540m is allocated to planned projects within the Business Plan. The allocation of our cash investments is summarised in Chart 2 below.

Chart 2: Cash investment allocation as at 13 February 2018



7.4 Our year-to-date average yield at 13 February 2018 was 0.31 percent, 12 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). The weighted average maturity of cash investments is 46 days.

7.5 Our active management of the investment portfolio has resulted in a greater return compared to a passive approach that would involve investing cash surpluses in MMFs only. We have 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.

7.6 An increase in interest rates from 0.25 percent to 0.5 percent by the Bank of England in November 2017 has helped to increase the weighted average interest rate of the portfolio. However, lower cash balances than previous years continue to subdue total investment returns.

8 Other Activities

Banking

8.1 Changes in the Financial Services (Banking Reform) Act 2013 directed a transfer of our bank accounts to a new ring-fenced branch of our incumbent bank, HSBC. 89 TfL sterling bank accounts were transferred successfully across to a new sort code and account number in September 2017, one month ahead of schedule.

8.2 We launched our banking and cash management services tender in January 2018, with a market sounding questionnaire published on the TfL's e-Tendering portal on 16 January 2018. This will be followed by an Invitation to Tender in June 2018. The tender will ensure competitive pricing and that the latest technology and innovation available is reviewed. A target award date has been set for October 2018.

MiFID II

8.3 Under MiFID II, which came into force on 3 January 2018, local authorities are by default classified as retail clients by their financial counterparties, with the need to meet certain conditions to elect up to professional clients status. These requirements specify a minimum level of relevant experience and knowledge of financial markets, in respect of both local authorities in general and individuals responsible for executing transactions.

8.4 We need to be able to maintain our professional client status in order to continue to access the wide range of investment products and services currently accessible to us, including investments in gilt backed repos, commercial paper and certificates of deposit. We have therefore decided to keep the professional client status and elected up with all our investment counterparties. As part of this process, we acknowledge that we will continue not to have access to certain protections and compensation rights available only to retail clients, such as more detailed reporting provided by financial counterparties.

8.5 Transport for London Finance Limited, TfL's subsidiary which solely enters into derivatives, is not considered as a local authority for the purposes of MiFID II, and therefore there is no change to its existing professional client status.

Review of the Prudential Code, Treasury Management Code and Statutory Guidance on Local Authority Investments

8.6 In September 2017, we took part in the consultation by the Chartered Institute of Public Finance and Accountancy (CIPFA) on proposed changes to the Prudential Code and the Treasury Management Code. The revised codes were subsequently published in December 2017, and we have reflected a few minor amendments to the Treasury Management Code in our Treasury Management Policies, including a reference to our classification as a professional client under MiFID II.

8.7 The revised Prudential Code provides for local authorities to have in place a capital strategy that sets out the long-term context in which capital expenditure and investment decisions are made, and gives due consideration to both risk and reward and impact on the achievement of priority outcomes. We expect our Business Plan and Treasury Management Strategy to form the basis of such capital strategy, and are working to establish the appropriate format for this new requirement.

8.8 The revised Prudential Code also confirms that its principles cover all capital expenditure and investment decisions, which we understand include both treasury and non-treasury investments. In parallel, the revised Treasury Management Code introduces a new section on "investments that are not part of treasury management activity", and proposes management practices for these investments. Such investments would include loans made to support service outcomes as well as investment property portfolios. Engagement across the organisation will therefore be necessary to ensure we give appropriate consideration to the expanded scope of the revised codes in due course.

8.9 In December 2017, we took part in a consultation by the Department for Communities and Local Government (DCLG) on proposals to update the Statutory Guidance on Local Government Investments. The revised guidance was subsequently published in February 2018. Changes include extending the scope of the guidance to investments in non-financial assets held solely or in part to generate revenue income, where the previous edition of the guidance only covered investments in financial assets. The guidance applies from 1 April 2018 and supersedes previous editions. It requires additional disclosures to better explain the rationale for investments in non-financial assets. In light of the short turnaround time, the guidance allows local authorities presenting investment strategies before 1 April 2018 not to implement all new disclosure requirements in 2018/19. Engagement across the organisation is necessary to ensure we give appropriate consideration to the revised guidance to be in a position to include the required disclosures the first time the relevant strategy is updated or superseded.

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.

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