

Date: 5 March 2018

Item: Treasury Management Strategy 2018/19

This paper will be considered in public

1 Summary

- 1.1 The purpose of this paper is to ask the Committee to recommend that the Board approves the proposed Treasury Management Strategy (TMS) for 2018/19. The TMS 2018/19 comprises the Investment Strategy, the Borrowing Strategy, the Liquidity Strategy, the Risk Management Strategy and the Counterparty Exposure Limits. This paper supports the TfL objective of prudence and financial sustainability.
- 1.2 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.

2 Recommendations

2.1 The Committee is asked to:

- (a) note the paper and the supplementary information on Part 2 of the agenda;**
- (b) recommend that the Board approves the Treasury Management Strategy (TMS) for 2018/19, attached at Appendix 1, including the Investment Strategy, the Borrowing Strategy, the Liquidity Strategy, the Risk Management Strategy and the Counterparty Exposure Limits;**
- (c) recommend that the Board authorises the Committee to approve any changes to the TMS 2018/19 during the course of the year;**
- (d) note that the proposals to the Committee for derivative investments set out in Recommendation 2.1(e) have been approved by the Chief Finance Officer, as required under the TfL Group Policy Relating to the Use of Derivative Investments (the 'Derivatives Policy'); and**

subject to the Board approving the TMS 2018/19 and the Derivatives Policy:

- (e) approve, pursuant to Section 49 of the Transport for London Act 2008 (as amended by the Transport for London Act 2016, together**

the Act, and in accordance with the Derivatives Policy) for 2017/18 (or 2018/19 as may be applicable at such time), Transport for London Finance Limited (as a qualifying TfL subsidiary for the purposes of the Act) entering into derivative investment(s) in relation to:

- (i) mitigating exchange rate risk related to specific currency exposures arising from the procurement of goods or services by any member of the TfL Group or receipts of European Union subsidies or other grants or revenues payable other than in Sterling to any member of the TfL Group in the ordinary course of business as soon as practicable once the quantum of exchange rate risk to any member of the TfL Group is established;
- (ii) mitigating exchange rate risk arising from any TfL Group investments in foreign currencies in accordance with the TMS 2017/18 (or 2018/19 as may be applicable at such time);
- (iii) mitigating commodity rate and/or price risk related to specific commodity (including fuel and electricity) exposures arising from the procurement of goods or services by any member of the TfL Group in the ordinary course of business as soon as practicable once the quantum of commodity risk to any member of the TfL Group is established;
- (iv) mitigating interest rate risk and if applicable currency risk related to any existing, imminent and future TfL Group borrowing (including any leases), once the borrowing has become certain and authorised in accordance with the TMS 2017/18 (or 2018/19 as may be applicable at such time);
- (v) mitigating inflation risk related to specific exposures arising from the procurement of goods or services by any member of the TfL Group once the quantum of inflation risk to any member of the TfL Group is established; and
- (vi) mitigating risk related to any index reflecting any of the above matters referred to in paragraphs (i) to (v).

2.2 The following Officers and Subsidiaries shall have delegated authority:

- (a) TfL Officers: the Commissioner, Chief Finance Officer under sections 114 and 115 of the Local Government and Finance Act 1988 and section 127 of the Greater London Authority Act 1999, the Managing Director (Chief Finance Officer), General Counsel and Corporate Finance Director; and
- (b) Subsidiaries: Subsidiaries of TfL including Transport Trading Limited and any other subsidiary (whether existing presently or to be formed) of Transport Trading Limited and any of the directors of

the relevant company shall be authorised to act for and on behalf of that company.

3 Treasury Management Strategy 2018/19

- 3.1 The TMS 2018/19 has been prepared having regard to the Local Government Act 2003 and the Local Authorities (Capital Finance and Accounting) Regulations 2003 (as amended), as well as the key recommendations of (i) the Code of Practice and Cross-Sectoral Guidance Notes for Treasury Management in the Public Services (the 'Treasury Management Code') issued by the Chartered Institute of Public Finance & Accountancy (CIPFA) and last updated in 2017, (ii) the Prudential Code for Capital Finance in Local Authorities (the 'Prudential Code') issued by CIPFA and last updated in 2017, and (iii) the Statutory Guidance on Local Authority Investments (the 'Investments Guidance') issued by the Department for Communities and Local Government (DCLG) 2010.
- 3.2 The TMS 2018/19 includes TfL's proposed strategies for investment, borrowing, liquidity and risk management for the financial year 2018/19, as well as proposed counterparty exposure limits. It sets out TfL's borrowing requirement and risk exposure for 2018/19.

4 Investments

- 4.1 Despite the Bank of England rate increasing from 0.25 per cent to 0.50 per cent in November 2017, interest rates remain low by historical standards. While the Euro market has become accustomed to negative yields, the UK market has generally still seen positive yields.
- 4.2 The proposed investment strategy will provide operational flexibility to invest in the short-term opportunities as available. Given that the priority is given to security and liquidity of the investments, it is worth highlighting a number of factors that we expect will have an impact on the yield of the investment portfolio.
- 4.3 The amount of investment opportunities in Sterling market is limited compared to Euro and US Dollar, and the attractiveness of investing in Euro or US Dollar securities varies over time depending on the FX forward market.
- 4.4 Reducing cash balances require shorter investment tenors in order to maintain liquidity. Due to the current market constraints, including borrowers' preference for longer-dated instruments, it has been more difficult to source shorter dated investments with attractive yield.
- 4.5 Forthcoming Money Market Fund (MMF) reform is expected to adversely impact MMF yields which are used primarily for overnight investments. Due to a reduced investment portfolio and greater focus on liquidity a high proportion of cash is invested in MMF. This may result in overall pressure on the portfolio yield.

5 Regulation

- 5.1 Under new regulation from the UK Government large UK banks are required to separate retail (ring-fenced) and investment banking (non-ring-fenced) activities. While some products and services would continue to be provided by the ring-fenced retail banks, others will move to the non-ring-fenced entity. Non-ring-fenced banks are expected to have a lower credit rating than the ring-fenced retail bank, resulting in a lower counterparty limit.
- 5.2 New accounting standard IFRS 9 will replace IAS 39 and will apply to financial instruments and be effective for annual reporting periods beginning on or after 1 January 2018. It specifies how an entity should classify and measure financial assets and liabilities, either as amortised costs or fair value through profit or loss. It introduces new impairment models based on expected losses, relaxes effectiveness testing for hedge accounting and expands on exposures permitted to be hedged. We are currently assessing the impact of the new standard on our hedging programmes and will be adopting it in due course.

List of appendices to this report:

Appendix 1: Treasury Management Strategy 2018/19

A paper on Part 2 of the agenda contains exempt supplemental information.

List of background papers:

None

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TRANSPORT FOR LONDON

TREASURY MANAGEMENT STRATEGY 2018/19

1 SUMMARY

1.1 This Treasury Management Strategy (TMS) 2018/19 comprises the:

- (i) Investment Strategy;
- (ii) Borrowing Strategy;
- (iii) Liquidity Strategy;
- (iv) Risk Management Strategy; and,
- (v) Counterparty Exposure Limits.

2 BACKGROUND

2.1 The TMS 2018/19 has been prepared having regard to the Local Government Act 2003 and the Local Authorities (Capital Finance and Accounting) Regulations 2003 (as amended), as well as the key recommendations of

- (i) the Code of Practice and Cross-Sectoral Guidance Notes for Treasury Management in the Public Services (the 'Treasury Management Code') issued by the Chartered Institute of Public Finance & Accountancy (CIPFA) and last updated in 2017;
- (ii) the Prudential Code for Capital Finance in Local Authorities (the 'Prudential Code') issued by CIPFA and last updated in 2017; and
- (iii) the 2010 Statutory Guidance on Local Authority Investments (the '2010 Investments Guidance') issued by the Department for Communities and Local Government (DCLG).

2.2 TfL has reviewed the Statutory Guidance on Local Government Investments (3rd Edition), published in February 2018 (the '2018 Investment Guidance'). The 2018 Investment Guidance is not reflected in the TMS 2018/19, as permitted, given its very recent publication. It will be reflected, to the extent required, when the TMS is next updated.

2.3 As recommended by the Treasury Management Code, this strategy will be updated at least annually and submitted for the approval of the Board.

3 POLICIES AND DELEGATIONS

3.1 The TMS 2018/19 will be implemented, operated and administered in accordance with the Treasury Management Policies and the TfL Group Policy Relating to the Use of Derivative Investments approved by the Board.

- 3.2 The arrangements for the implementation, execution, operation and administration of the TMS 2018/19, including the arrangements for banking, cash management, investment of cash balances, borrowing, liquidity management and financial risk management are delegated to the managing Chief Finance Officer¹ and the Corporate Finance Director, provided no decision contravenes the TMS 2018/19, the Treasury Management Policies, the TfL Group Policy Relating to the Use of Derivative Investments or the approved Counterparty Exposure Limits.

4 STRATEGIC OBJECTIVES

4.1 The objectives underpinning the TMS 2018/19 are:

- (i) to ensure that sufficient cash and liquidity facilities are available to enable TfL to discharge its financial obligations when they become due, in accordance with approved budgets;
- (ii) to undertake treasury management operations with primary regard for the security and liquidity of capital invested;
- (iii) to maximise the yield from investments consistent with the security and liquidity objectives identified above;
- (iv) to undertake treasury management activities having regard to Prudential Indicators (including Treasury Management Indicators) and to remain at all times within the Authorised Limit for external borrowings;
- (v) to manage its borrowing in a manner that is affordable, sustainable and prudent and combines flexibility, security of access to funds, diversity of funding sources and value for money;
- (vi) to support TfL's commitment to maintaining its credit rating relative to that of the UK Government as it recognises the value of its strong credit rating; and
- (vii) to use TfL subsidiaries' statutory power relating to risk management to achieve greater value for money through reducing costs or protecting revenues, reducing volatility or increasing certainty in the Business Plan and to manage treasury financial risks across the whole of TfL.

5 INVESTMENT STRATEGY

5.1 The Investment Strategy will be applied in accordance with the TMS 2018/19 strategic objectives listed in 4.1.

5.2 TfL maintains a low risk appetite consistent with the good stewardship of public funds, the overriding principle being the prioritisation of security before liquidity and liquidity before yield.

¹ References to managing Chief Finance Officer in this document mean the Managing Director (Chief Finance Officer) or any successor post.

- 5.3 Where possible, TfL will seek to maximise active investment in counterparties, rather than passive investments held through Money Market Funds (MMFs). This allows greater control over the quality of investments, may allow higher returns, and reduces fees. Some MMF investments will still be required for liquidity purposes.
- 5.4 TfL will have regard to expected cash flow requirements and aim to maintain a range of maturities within the investment portfolio.
- 5.5 All investments will have a maximum tenor of one year and at the time of investment will be rated a minimum of A-2, P-2 or F2 by Standard & Poor's, Moody's or Fitch Ratings credit rating agencies, with no more than 20% of the portfolio invested in counterparties with a credit rating of less than any of A-1, P-1 or F1.
- 5.6 TfL will consider the risk of its overall portfolio as well as individual investments, seeking to diversify its investments as much as possible and have regard to the exposure to any one counterparty, country, industry, investment type, and credit. TfL will target allocating a portion of the portfolio across sovereign exposures, government agencies, financial institutions, and corporate instruments, subject to investments available at the time.
- 5.7 TfL will consider investing in instruments including: sovereign Treasury bills and bonds, UK Debt Management Office deposits, repurchase agreements, bank deposits, certificates of deposit, bonds, commercial paper, floating rate notes, MMFs or any other instrument allowing TfL to achieve the objectives set out in 4.1. Due to the short term nature of TfL's investments and the desire not to lose any principal, TfL will not invest in equity.
- 5.8 TfL may invest in non-sterling denominated investments where:
 - (i) currency is bought in advance of a payment or payments in that currency, or where the currency is otherwise received and TfL can identify other future expenditures in that currency to offset against; or
 - (ii) instruments permitted under the TMS 2018/19 and denominated in currencies other than Sterling are swapped back to GBP as a matter of course.
- 5.9 TfL will generally hold investments to maturity, however where the Corporate Finance Director deems it appropriate, TfL may seek to break or resell fixed term investments early (including where doing so will result in TfL incurring penalties or crystallising a loss), in order to protect TfL against potential losses, meet unexpected liquidity requirements, improve its investment return or for ethical or reputational reasons.
- 5.10 TfL will seek to achieve year to date returns greater than the year to date average benchmark of seven day London Interbank Bid Rate (LIBID), which is widely regarded as the appropriate benchmark for short-term cash investments and is used by professional investors such as Money Market Funds.

6 BORROWING STRATEGY

- 6.1 The Borrowing Strategy will be applied in accordance with the TMS 2018/19 strategic objectives listed in 4.1.
- 6.2 TfL's objective is to manage its borrowing in a manner that is affordable, sustainable and prudent and combines flexibility, security of access to funds, diversity of funding sources and value for money.
- 6.3 TfL's annual borrowing requirement, set out in Table 1 for 2018/19, is driven by the financing requirement of its capital investment programme and the refinancing of its maturing debt.

Table 1 – 2018/19 borrowing requirement

Description	£m
2018/19 incremental borrowing per latest funding settlement	500
Incremental borrowing deferred from 2017/18 to 2018/19	300
Refinancing of debt maturing within 12 months, including rolling short-term commercial paper	472
Borrowing requirement for 2018/19	1,272
Financed by	
European Investment Bank Urban Mobility for London loan	100
Total committed for 2018/19	100
Balance to raise for 2018/19	1,172

- 6.4 The annual increase in total outstanding borrowing will be within the incremental borrowing limits set out in the March 2017 funding letter from Central Government. To the extent that permitted incremental borrowing is not required in 2018/19, it may be deferred to the following financial year, subject to notification to HM Treasury eight weeks prior to the end of 2018/19. The notional amount of outstanding debt is expected to be £11,248m at the end of 2018/19.
- 6.5 The total value of outstanding borrowing and other long-term liabilities will be within the Authorised Limit set by the Mayor and adopted by the Board (as required by the Local Government Act 2003).
- 6.6 TfL seeks to achieve its borrowing objectives by maintaining access to capital markets through its Euro Commercial Paper programme, Euro Medium Term Note programme and stand-alone capital market transactions, and complementing this with loans and other facilities from financial institutions where appropriate. TfL's borrowing plans are ultimately underpinned by access to the Public Works Loan Board (or any future body replacing it), a readily available source of liquidity. Other sources of finance will be used where they further TfL's stated objectives.

- 6.7 As debt service represents a relatively significant part of TfL's annual expenditure, a high level of certainty over the interest payment amounts is desirable to meet the balanced budget requirement. While fixed rates of borrowing are generally preferred, as they provide more certainty, TfL will assess the merits of having a certain amount of floating debt, where it is consistent with the borrowing and risk management objectives. The limits on fixed and variable interest rates exposures are set out on an annual basis as suggested by the Treasury Management Code, and are the subject of a separate Prudential Indicators document approved by the Board. For 2018/19, the strategy is to have at least 75% of all outstanding borrowing at fixed interest rates and up to 25% of borrowing at variable rates.
- 6.8 All borrowing is expected to be drawn in Sterling, as currently permitted by HM Treasury. Should TfL receive HM Treasury approval to raise debt in foreign currencies, any foreign currency exposures arising from such borrowing will be subject to risk mitigation measures consistent with the principles of the Risk Management Strategy.
- 6.9 Given the long life of the majority of the assets financed by TfL, TfL's objective is to have a weighted average tenor of TfL's debt of at least 15 years. TfL will aim to structure its borrowing in a way that avoids large concentrations of debt of the same maturity in order to minimise the refinancing risk. The limits for maturity structure of borrowing are set out on annual basis, as suggested by the Treasury Management Code, and are the subject of a separate Prudential Indicators document approved by the Board.
- 6.10 TfL will seek to arrange loan facilities that enable drawdown of debt in future years. Where TfL has the ability and option to do so, it will consider fixing the borrowing for drawdowns beyond the 2018/19 financial year, in order to mitigate interest rate risk related to future borrowing requirements. Any fixed borrowing will be within the incremental borrowing limits and Authorised Limit for borrowing, where applicable.
- 6.11 The source, tenor, currency (subject to 6.8) and interest rate basis of individual debt transactions will be determined on a case by case basis taking into account value for money, TfL's risk appetite, market conditions, interest rates expectations, investors' preferences, the impact on TfL's debt maturity profile and target weighted average tenor.
- 6.12 TfL will consider opportunities to buy back, refinance, or otherwise restructure, existing liabilities (including leases) where doing so represents value for money, or will improve the structure of TfL's liabilities, or facilitate changes to TfL's corporate structure.

7 LIQUIDITY STRATEGY

- 7.1 The Liquidity Strategy will be applied in accordance with the TMS 2018/19 strategic objectives listed in 4.1.
- 7.2 TfL must maintain sufficient liquidity to be able to meet its contractual payment obligations, including debt service.

- 7.3 The TfL Group (excluding Crossrail) will hold a minimum level of cash and short-term investments as defined in the Treasury Management Policies.
- 7.4 Where appropriate, the cash and short-term investments will be supplemented by access to external liquidity sources, such as bank overdrafts, revolving credit facilities and other standby credit facilities. The adequacy of the external liquidity sources will be reviewed on an ongoing basis and TfL will arrange and maintain these facilities as required.
- 7.5 Bank overdrafts and standby credit facilities will not be used in the normal course of business, however TfL would consider borrowing temporarily within the Authorised Limit to address short-term liquidity issues, where it represents prudent management of TfL's financial affairs.
- 7.6 Cash and short-term investments balances ring-fenced for the construction of Crossrail will be managed to ensure sufficient liquidity to meet Crossrail Limited's forecast payment obligations.
- 7.7 In order to limit the liquidity risk created by rolling the commercial paper programme, TfL will aim to manage its maturities so that no more than £200m of short-term borrowings fall due for repayment in any three-day period.

8 RISK MANAGEMENT STRATEGY

- 8.1 The Risk Management Strategy will be applied in accordance with the TMS 2018/19 strategic objectives listed in 4.1.
- 8.2 TfL maintains a low risk appetite consistent with the good stewardship of public funds. It aims to mitigate financial risks to the extent possible, aiming to provide security of TfL's funds and certainty of costs and revenues.
- 8.3 The objectives of the Risk Management Strategy are to:
- (i) achieve greater value for money through reducing costs or protecting revenues;
 - (ii) reduce volatility or increase certainty relating to the impact of financial risks upon the Business Plan; and
 - (iii) holistically manage financial risks across the whole of TfL.
- 8.4 TfL is materially exposed to a number of specific financial risks in the ordinary course of business, arising from the borrowing programme, the capital investment programme and certain ongoing contractual obligations. These risks include:
- (a) interest rate risk related to TfL and its subsidiaries' existing or planned future borrowing requirements (including leases);
 - (b) exchange rate risk related to specific currency exposures arising from the procurement of goods or services by TfL or its subsidiaries; from receipts of European Union subsidies or other grants or revenues payable other than

in Sterling; from any foreign currency borrowing (as permitted); and in the course of making foreign currency investments;

(c) commodity price and/or rate risk related to specific procurements or contracts across TfL and its subsidiaries containing a significant cost element for a commodity component and/or ongoing operational procurements such as power and fuel whether direct or indirect exposures; and

(d) inflation risk across TfL and its subsidiaries.

8.5 Financial risks will be identified, managed and controlled through a number of instruments, methods and techniques, including passing the risk to the counterparty where appropriate. Where the identified risks fall into the categories described in paragraph 8.4 and have highly probable exposures with a highly certain risk profile, TfL may use financial instruments to manage exposure to these risks.

8.6 Where TfL arranges derivative investments through its subsidiary, Transport for London Finance Limited, it may put in place intra-group arrangements to confer the benefit of those derivative investments to the TfL entity bearing the underlying risk.

9 COUNTERPARTY EXPOSURE LIMITS

9.1 The managing Chief Finance Officer and/or the Corporate Finance Director will approve individual counterparties and will set individual counterparty exposure limits following detailed analysis of each counterparty and its impact on the overall portfolio, including sector and country concentration risk.

9.2 The maximum exposure limit per investment counterparty will be within the counterparty exposure limits set out in Table 2. Counterparties within the same group will be classified as one counterparty for the purposes of the concentration limit. Where banks are required to have separate entities for retail (ring-fenced) and investment (non-ring-fenced) activities, TfL will apply separate counterparty exposure limits to the applicable entities. This may result in ring-fenced banks having different counterparty limits to non-ring-fenced banks.

9.3 To reduce investment risk and in line with the requirement to have primary regard to security, TfL aims to keep a diversified portfolio of investments by limiting exposures to individual counterparties. As the maximum tenor of investments is one year, short-term ratings will be the primary ratings used to determine these limits.

9.4 As Moody's short-term rating does not have a P-1+ category, when a counterparty is rated P-1, its concentration limit will be based on the average limit derived from any Standard & Poor's and Fitch ratings. In the event the counterparty only has a short-term rating from Moody's and it is P-1, its limit will be 7.5%. Where it is rated P-2, its limit will be based on the average of all the rating agencies supplying a rating. If any of the rating agencies rates the counterparty A-3, P-3, or F3, no investments will be permitted.

Table 2 – Investment counterparty exposure limits

Moody's		Standard & Poor's		Fitch		Concentration limit per counterparty (as a percentage of total portfolio)
ST	LT	ST	LT	ST	LT	
P-1	Aaa Aa1 Aa2 Aa3 A1	A-1+	AAA AA+ AA AA-	F1+	AAA AA+ AA AA- A+	10%
	A2 A3		A+ A		F1	
P-2	A3 Baa1 Baa2	A-2	A- BBB+	F2	A- BBB+ BBB	5%
P-3	Baa2 Baa3	A-3	BBB BBB-	F3	BBB BBB-	0%
UK Sovereign						100%

- 9.5 Where a counterparty does not have a short-term rating, the equivalent long-term rating as shown in the above table will be used to determine the counterparty exposure limit.
- 9.6 The exposure limit for TfL's clearing bank may be temporarily exceeded (for example, where cash is made available for investment after the daily deadline for deposits with other entities has passed).
- 9.7 Where an instrument benefits from a UK Government Guarantee, the limit will be that for the UK Sovereign rather than that of the entity.
- 9.8 For investments benefitting from collateral arrangements, the counterparty exposure will not be counted as the full face value of the investment, but will be calculated based on the potential shortfall caused by any expected movement in the value of the collateral.
- 9.9 TfL calculates its derivative counterparty exposures based on accepted market methodology. The current fair market value (FMV) of each derivative is added to the potential future exposure (PFE). The PFE is calculated based on the maximum counterparty exposure assuming a 95% confidence level of possible future movements in interest rates over the life of the instrument.
- 9.10 TfL expects to hold all derivative contracts to maturity. As such, exposures under derivative contracts are contingent exposures during the life of the contract. The contingent exposure is therefore the relevant risk factor rather than the notional value of the contract. For 2018/19, the maximum potential notional value of financial exposures requiring hedging is estimated to be £3.1 billion, resulting in an estimated PFE of £2.1 billion, which is the current level of

PFE available with TfL's existing derivative counterparties under this methodology.

- 9.11 Derivative counterparty exposures have a limit based on long-term credit ratings, as these exposures will generally be for over one year. The limits are shown in Table 3.

Table 3 – Derivative counterparty exposure limits

Moody's	Standard & Poor's	Fitch	Derivative limit per counterparty (£m)	CSA threshold for new derivative counterparties* (£m)
Aaa	AAA	AAA	400	50
Aa1	AA+	AA+	400	40
Aa2	AA	AA	350	40
Aa3	AA-	AA-	250	40
A1	A+	A+	200	25
A2	A	A	175	25
A3	A-	A-	150	20
Baa1	BBB+	BBB+	0	0

* Will apply to new derivative counterparty ratings at the time the Credit Support Annex (CSA) is entered into.

- 9.12 Where a counterparty has a split rating, the limit for each rating is calculated as the average of the relevant limits for each rating available.
- 9.13 TfL will apply the investment and derivative limits as set out in this section for each counterparty unless circumstances outside its control prevent it from doing so. In this case the managing Chief Finance Officer and/or Corporate Finance Director will implement appropriate replacement limits for that counterparty.
- 9.14 If any investment or derivative limit applicable to a counterparty changes while TfL has an outstanding investment or derivative with that counterparty it will not be considered a breach of these limits. TfL may seek to bring its exposure down to within the revised limits, or at the Corporate Finance Director's discretion, may decide to allow an investment or derivative to run its course for economic reasons.