Finance and Policy Committee

Date: 13 March 2013

Item 6: Group Treasury Activities

This paper will be considered in public

1 Summary

1.1 The purpose of this paper is to provide an update on Group Treasury's activities for the period from 1 April 2012 to date.

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. 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 related paper on Part 2 of the agenda.**

3 Background

3.1 On 15 March 2012, the Board approved the Treasury Management Strategy 2012/13 (TMS 2012/13, which includes an Investment Strategy 2012/13, a Borrowing Strategy 2012/13 and a Risk Management Strategy 2012/13) and established the following strategic objectives for Group Treasury:

(a) to undertake treasury management operations with primary regard for the security and liquidity of capital invested with reference to the Guidance issued by the Department for Communities and Local Government;

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

(c) 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;

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

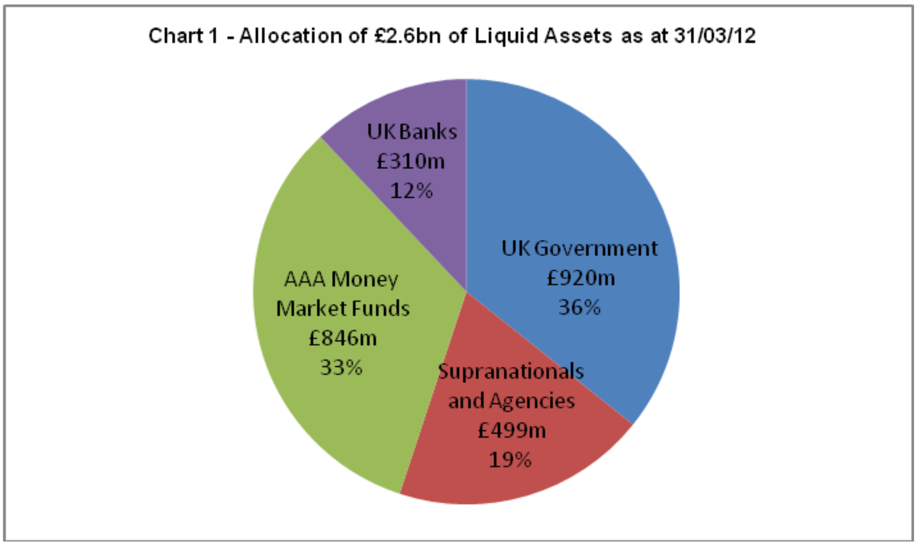
(e) to secure TfL's funding requirements by accessing the most cost efficient source of finance, while ensuring TfL has flexibility and sufficient alternatives not to be dependent on any particular source; and

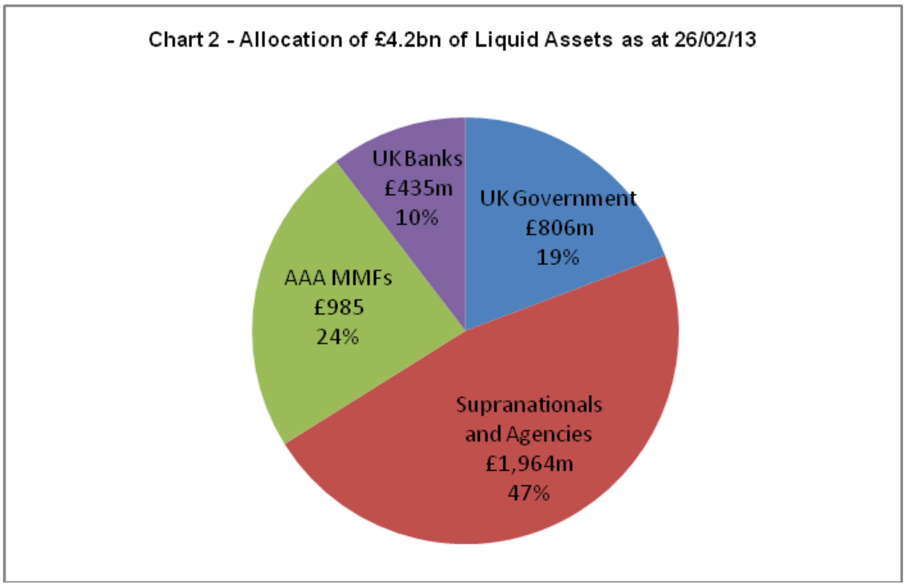
(f) to exercise TfL's statutory power relating to risk management to achieve greater value for money through reducing costs or protecting revenues, reducing volatility/increasing certainty in the Business Plan and to holistically manage financial risks across the whole of TfL.

3.2 This paper provides a summary on TfL's investment, borrowing and risk management activity in 2012/13.

4 Investments Update

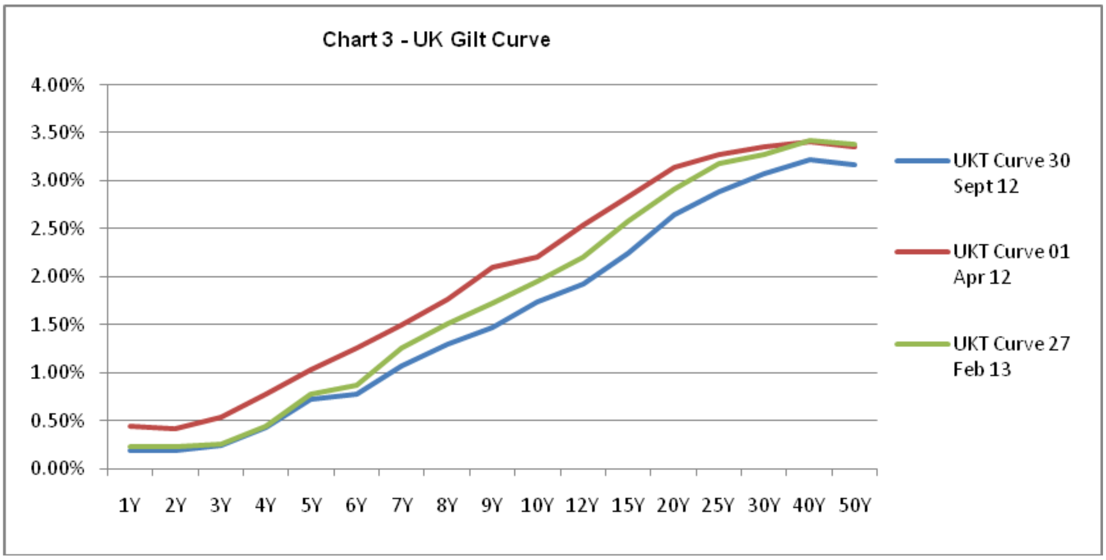
4.1 As at 26 February 2013, TfL had £4.2bn of cash under management (including £1.6bn of cash ring-fenced to fund the construction of the Crossrail project), compared with £2.6bn (of which £1.2bn for Crossrail) as at 31 March 2012. TfL's cash resources are fully allocated to the organisation's operations, transport services and large investment programme, which will be delivered over a number of years as outlined in TfL's latest Business Plan. The allocation of these funds as at 31 March 2012 and as at 26 February 2013 is summarised in Charts 1 and 2.





4.2 In the TMS 2012/13, TfL aimed to increase over time direct investments in the highly rated instruments, which are generally targeted by AAA rated Money Market Funds (MMFs). As shown in Charts 1 and 2, over the past twelve months TfL has significantly increased its direct investments in Supra-nationals and Agencies (SSAs) from around £500m (19 per cent) to around £2bn (47 per cent), an increase equivalent to approximately 87.5 per cent of the additional cash under management. TfL has been able to achieve the increased allocation by adding seven new highly rated SSAs in TMS 2012/13 to the seven SSAs approved previously.

4.3 The cash invested in UK Government instruments has reduced by approximately £100m over the year (at around £806m): such instruments have become relatively difficult to source during the year, as a result of investors' risk aversion. Chart 3 shows the UK Gilt curve as at 27 February 2013, 1 April 2012 and 30 September 2012, which shows a very stable position over that period.



4.4 The cash invested in MMFs has increased in absolute terms from around £850m to around £1bn over the past year, but it has decreased in percentage terms in line with the aims set out in TMS 2012/13. A number of MMFs in Europe are considering how the structure of their funds may need to change if yields continue to fall and the aggregate return of the fund turns negative. TfL is monitoring closely the developments in Europe and has been in discussion with the MMFs on the Approved Investments List about the issue.

4.5 Finally, investments in banks have increased in absolute terms from £310m to £435m, partially as a result of £50m of Repurchase Agreement transactions, which are included in this category.

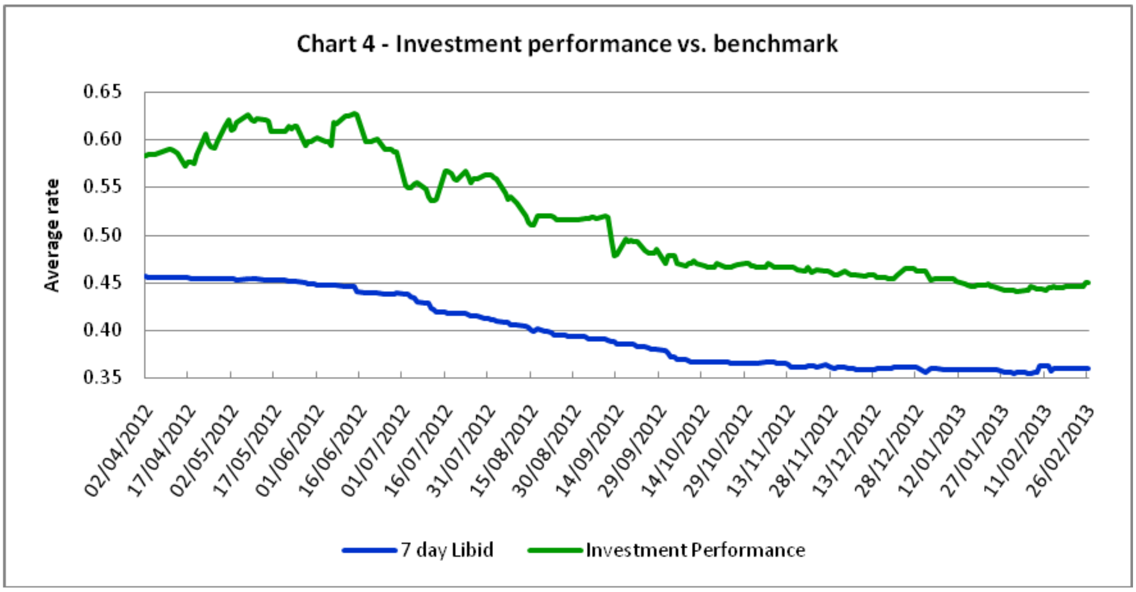
4.6 The strategy of direct investments in SSAs has been very successful to date:

(a) TfL maintains control over the investment allocation by selecting the specific assets to invest in;

(b) TfL saved the management fees charged by the MMFs; and

(c) the direct investments outperformed the yield on MMFs net of fees, with stronger credit quality.

4.7 The return on TfL's cash investments has decreased in line with market rates. Seven day London Interbank Bid Rate (LIBID) has decreased since 2 April 2012, from 0.46 per cent to 0.36 per cent, while TfL's investment returns have decreased from 0.58 per cent to 0.45 per cent. Chart 4 shows the movements in the return on cash and LIBID from 2 April 2012 to date.



4.8 TfL's year to date average yield is 0.525 per cent, 13bps above benchmark, with an average of 101 days to maturity.

4.9 No breaches of the TMS 2012/13 in respect of TfL's investments have occurred in the year to date.

TfL's Management of Investments

4.10 The Committee requested a brief summary of the arrangements for the management of TfL's cash investments.

4.11 The TfL Group Treasury team (TfL Treasury) consists of 10 full time staff with extensive and varied experience in areas essential to the successful delivery of TfL's Treasury Management Strategy and operations.

4.12 TfL Treasury's qualifications include Accountants and Treasurers and combines individuals with experience across treasury, banking, Payment Card Industry (PCI) compliance and corporate finance in both the public and private sectors. TfL Treasury's focus is organised into sub-groups focussed on Investments, Derivatives, Financing and Banking Operations with operations structured to reflect best practice in terms of segregating responsibility for dealing, approval and settlements.

4.13 In managing TfL's cash, TfL Treasury works closely with the finance teams across the TfL Group to forecast the cash position as accurately as possible. TfL Treasury has access to Bloomberg and engages in a constant dialogue with relevant contacts at the panel of financial institutions that TfL uses for investments. TfL Treasury also engages more widely with the full spectrum of financial market participants, analysts and advisors to ensure a thorough understanding of market dynamics and trends and in order to manage the counterparties with whom TfL trades.

4.14 TfL's cash is managed in accordance with the Investment Strategy approved by the Board. TfL Treasury manages within the bounds of that strategy and prioritises security and liquidity while also trying to maintain a reasonable yield on the cash, with a key objective of delivering returns above the market investment benchmark of seven day LIBID.

4.15 In managing the tenor of investments in the portfolio, TfL Treasury considers the expected profile of expenditure, the relative value for a given counterparty of investments of different maturities, the cost and tenor of TfL's own short term borrowings and the relative value of a term investment implied by the forward curves e.g. whether a six month investment is expected to represent good value compared to two three month investments based on forward curves.

4.16 The Board approved Investment Strategy establishes absolute limits on counterparty exposures but the team actively manage the proportion of the maximum Board approved exposure to utilise based on a wider range of criteria. The system of dynamic limits the team use is based on relative Credit Default Swaps rates and Bloomberg's implied default measure, equity price trends and the limits on the proportion of a fund size the investment would represent and a limit on the proportion of TfL's portfolio a counterparty represents. TfL Treasury monitors markets and news sources for issues that may impact on the credit strength of counterparties and considers the case for disposing of existing investments to mitigate a real or perceived increased risk of losses.

4.17 TfL Treasury undertakes analysis of the counterparties including regular analysis of MMFs underlying investments (which informed the decision to increase direct investments in non-financial counterparties in recent years).

4.18 TfL's investments team also works closely with those managing TfL's own short term debt issuance to leverage market insights gained across both sides of the operations.

4.19 Market leading Treasury Management systems and industry best practices are employed to monitor and complete the settlement of all investments, which the team actively manage via our custodian, HSBC.

5 Borrowing Update

Transactions and Debt Outstanding

5.1 Of the £1.5bn medium to long-term borrowing undertaken since April 2012, £445m represents TfL's incremental Prudential Borrowing for 2012/13 (being the additional borrowing agreed with the Government as part of the 2010 Funding Settlement) and £1.055bn represents the replacement, with medium to long term funding, of short-term commercial paper (down by £755m) and of the one year £300m Floating Rate Note (FRN) which matures on 22 March 2013.

Table 1 (figures in £m)	**Borrowing Strategy 2012/13**
2012/13 Prudential Borrowing agreed with DfT	445
Commercial Paper *carried forward from 2011/12:*	1,857
Floating Rate Note *carried forward from 2011/12:*	300
Total 2012/13 funding (including refinancing) expected at 31 March 2013	**2,602**
Financed by:	
EIB Crossrail Loan drawdown (completed)	200
1st Bond – 30 Year (completed)	500
2nd Bond – 10 Year (completed)	500
3rd Bond – 5 Year (completed)	300
Commercial Paper (prospective)	1,102
PWLB	nil
Total 2012/13 borrowing	**2,602**

5.2 In April 2012, TfL completed the scheduled drawdown of £200m under the existing £1bn Crossrail loan facility with the European Investment Bank (EIB) at a pre-agreed fixed rate, set in October 2009. The final two drawdowns under this facility are scheduled for April 2013 (£150m) and April 2014 (£100m).

5.3 In July 2012, TfL took advantage of positive market conditions to issue two £500m bonds, thereby achieving the long-standing objectives of re-establishing TfL's presence in the capital markets (providing an additional borrowing source and generating cost savings compared to the Public Works Loan Board (PWLB) equivalent) and replacing a portion of TfL's short term borrowing with longer term debt:

(a) on 12 July 2012, TfL successfully issued a £500m 30 year bond at an annual coupon of 3.875 per cent (3.896 per cent semi annual yield) and a spread over the benchmark UK Gilt of 98bps, which equates to a saving of 16bps versus the equivalent 30 year PWLB annual rate of 4.09 per cent (4.06 per cent semi annual rate). Total savings over the life of the bond will amount to approximately £25m (undiscounted). The bond was issued at a rate 63bps lower than expected in the Business Plan, allowing £3.1m p.a. of savings to be released; and

(b) in response to strong investor demand, on 31 July 2012, TfL successfully issued a £500m 10 year bond at a coupon of 2.25 per cent (with a semi annual yield of 2.338 per cent) and a spread over the benchmark UK Gilt of 88bps, which equates to a saving of 36.2bps against the equivalent 10 year PWLB rate of 2.70 per cent. That equates to a saving of £18m (undiscounted) over the 10 years compared to borrowing from PWLB. The bond was issued at a rate 77bps lower than expected in the Business Plan, allowing £3.85m p.a. of savings to be released.

5.4 The two bond issues in part represent the refinancing of existing Commercial Paper issued to repay long term Tube Lines Finance PLC debt in 2011/12.

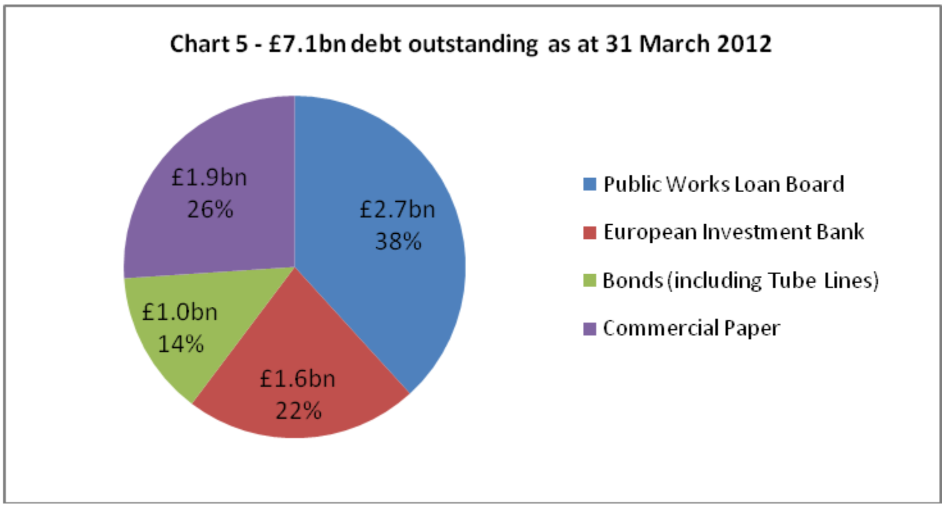
5.5 In November 2012, TfL successfully issued a £300m five year bond at a coupon of 1.25 per cent (with a semi annual yield of 1.282 per cent) and a spread over the benchmark UK Gilt of 70bps, which equates to a saving of 37.8bps against the equivalent five year PWLB rate of 1.66 per cent. That equates to a saving of £6m (undiscounted) over the five years compared to borrowing from PWLB. The bond was issued to refinance the £300m one year FRN maturing in March 2013.

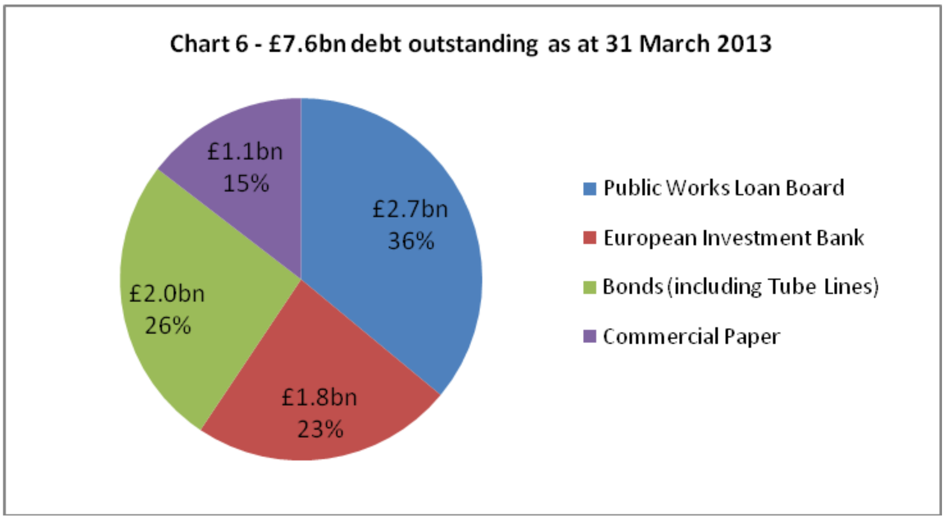
5.6 All three bonds are performing well in the secondary market, reflecting further unmet investor demand for TfL's bonds. The 30 year bond is currently trading 65-70bps over the benchmark UK Gilt, the 10 year bond is trading at approximately 75-80bps over the benchmark UK Gilt, and the five year bond is trading at 55-60bps over the benchmark UK Gilt. The secondary performance of the first bond was instrumental in achieving the more advantageous pricing of the second and third bond. As at 26 February 2013, the debt levels of the TfL Corporation are £80m above the Operational

Boundary (broadly speaking, TfL's expected debt levels given the aggregate incremental borrowing agreed with the Department for Transport in any one year) while remaining within the Authorised Limit. Both the Operational Boundary and Authorised Limit were approved by the Board and established by the Mayor in March 2012. TfL's aggregate debt will be returning to the expected levels of £7.57bn and below the Operational Boundary before 31 March 2013, as the one year £300m FRN matures on 22 March 2013.

5.7 The TMS 2012/13 provides that, where existing debt is being refinanced, new borrowing may be undertaken in advance of repayment of the existing debt and that this may lead to a temporary increase in aggregate debt levels to above the Operational Boundary, provided TfL remains within the legal limit on its liabilities at all times (the Authorised Limit).

5.8 The combined effect of borrowing transactions completed in the year are reflected in Charts 5 and 6, which show TfL's debt outstanding as at 31 March 2012 and 31 March 2013 (expected).





5.9 As at 31 March 2012, TfL had £7.1bn of debt, of which approximately £2.2bn was short term borrowing (comprising £1.9bn of Commercial Paper and £300m of a one year FRN). The weighted average interest rate on TfL's debt was 3.44 per cent (weighted average life of 16.3 years). As at 31 March 2013, TfL is expected to have £7.57bn of debt outstanding, of which £1.1bn will be short term. The weighted average interest rate on TfL's debt is expected to be 3.6 per cent (weighted average life of 19.0 years).

5.10 The increase in the weighted average interest rate reflects the increase in the weighted average life of TfL's debt. This increase in average life largely represents the end of the temporary benefit that resulted from buying back the long term Tube Lines Finance PLC debt and funding that buy back with Commercial Paper pending the issuance of longer term debt. This use of Commercial Paper resulted in a £29m saving against budget in the current year.

Medium Term Note Documentation and PWLB Rate

5.11 On 23 August 2012, TfL issued the updated documentation for its £5bn Medium Term Note (MTN) Programme. The update of the Base Prospectus was required to enable TfL to retain its access to the capital markets. The Base Prospectus is publicly available on tfl.gov.uk.

5.12 Following the announcement in the March 2012 Budget, in August 2012 the Department for Communities and Local Government published the arrangements under which borrowers providing improved information and transparency on their locally determined long term borrowing and associated capital spending plans will be able to access a discounted rate of Gilts + 80bps on borrowing from the PWLB. Borrowers are required to complete a form annually which provides a forecast of borrowing requirements and brief details of the capital investments being financed. TfL completed this form as required and was granted access to the discounted PWLB rate from 1 November 2012. Access to the discounted rate reduces the cost of TfL's lender of last resort. However, TfL was able to borrow in the capital markets more cheaply than the discounted PWLB rate (November 2012 bond). The Government is also still considering the potential for an independent body to facilitate the provision of PWLB lending at a further reduced rate, to authorities demonstrating best quality and value for money.

5.13 There have been no breaches of the TMS 2012/13 in respect of TfL's borrowing in the year to date.

TfL Credit Rating

5.14 On 22 February 2013, Moody's Investor Services ("Moody's") downgraded the rating of the United Kingdom ("UK") by one notch from Aaa to Aa1 and revised its outlook to stable from negative.

5.15 Following the rating action on the UK, on 25 February 2013 Moody's downgraded the long term debt rating of a number of UK sub-sovereign entities including TfL, given the economic, financial and institutional linkages between the sovereign and the UK sub-sovereigns.

5.16 The credit rating of TfL's long term debt was downgraded by Moody's one notch from Aa1 to Aa2. The credit rating of the short-term debt was maintained at P-1 and the outlook was revised from negative to stable. The table below shows TfL's current credit ratings.

TfL's Credit Ratings

	S&P	**Moody's**	**Fitch**
Long-term rating	AA+	Aa2	AA+
Outlook	Stable	Stable	Negative
Short-term rating	A-1+	P-1	F-1
Date of the last rating action	1 June 2012	25 February 2013	16 March 2012

5.17 Moody's and Fitch had put TfL and other UK sub-sovereigns on negative outlook in 2012, following the rating action on the UK sovereign. Fitch is expected to review the UK's Sovereign rating after the 2013 Budget on 20 March 2013. S&P has not put TfL's credit rating on negative outlook, although the agency did put the UK Sovereign's credit rating on negative outlook in December 2012.

5.18 At this stage, TfL does not expect that its borrowing costs will be materially affected by the downgrade of the UK's and its long term debt rating. The market's reaction to the downgrade of the UK was muted, indicating that the risk was already priced into the market. However, TfL will continue to monitor closely the impact of both the UK Sovereign's and TfL's downgrades on market rates and fiscal and/or monetary policies decisions.

5.19 TfL is in the process of completing annual update meetings with all three credit rating agencies to permit the agencies to update their assessment of TfL's credit strength. In late January and early February 2013, TfL conducted annual update meetings with Fitch and Moody's respectively. The meetings covered the operational and financial performance, a review of the latest Business Plan, TfL's funding sources and debt and liquidity management. The update meeting with S&P is planned for late March. TfL has been informed that, from April 2013, Rating Agencies might have to review the credit rating of every entity they rate at least twice a year.

Investor Relations

5.20 Over the past twelve months, TfL has continued to pursue a strategy of establishing closer relationships with its existing and potential investors, as well as with the broader banking community.

5.21 In June 2012, TfL and Crossrail hosted a “Bank Day” to offer a large number of financial institutions the opportunity to learn about TfL’s investment programme and pipeline of future projects. Representatives of over 25 financial institutions attended the event and confirmed that the presentations were extremely useful to understand the large extent of TfL’s activities.

5.22 In November 2012, TfL’s Group Treasurer had a series of one-to-one meetings with leading UK real money investors interested in learning more about TfL’s credit story. Members of the Group Treasury team have also made presentations to the sales force of a number of investment banks.

5.23 Further improvements have also been introduced in the relevant TfL web-pages to ensure that existing and potential investors have easy access to key information on TfL. Investors have commented positively on the quality of TfL’s Investor Relations pages compared to those of other issuers.

Delegation of Authority

5.24 Under the Borrowing Strategy 2012/13, the Committee’s approval is required for any new debt issuance under the MTN programme.

5.25 In July 2012 and October 2012, the Committee delegated authority to issue new notes under the MTN programme to the Managing Director, Finance, subject to the Managing Director, Finance discussing the proposed term and amount of any such notes and associated Supplementary Prospectus(es) with Members of the Committee who were available. The delegation was time limited to 31 March 2013.

5.26 This delegation proved critical in enabling TfL to access the market promptly when market conditions were favourable. Without this, TfL might have been unable to access the markets promptly in July and November 2012.

5.27 In October 2012, the Committee extended the delegated authority to the hedging of the proposed bond issuance. Such delegation expires on 31 March 2013.

6 Other Activities

HSBC Investment Limit

6.1 On 18 September 2012, the aggregate exposure to HSBC, TfL’s clearing bank, exceeded the Investment Limit implied by its credit rating by £2.3m, as the result of a delay in settlement of an investment with a third party. Circumstances such as this are specifically permitted under the TMS 2012/13 and the issue was reported to the Managing Director, Finance and Chief Finance Officer as required by the TMS 2012/13.

Barclaycard Risk Reduction Programme

6.2 In December 2012, TfL was accepted onto the Barclaycard Risk Reduction Programme. This means that Barclaycard is confident in TfL's implementation plans to become PCI compliant and will now protect TfL from any possible fines. TfL was one of the first organisations to be accepted on this programme.

Power PFI Contract - update

6.3 On 16 August 2012 London Underground issued a termination notice under the Power PFI contract. Under the terms of that contract London Underground is liable to pay to the contractor an amount which includes, among other things, sums in respect of the repayment of the contractor's EIB loan and the breakage of associated hedging arrangements. On 31 August 2012, TfL Group Treasury provided oversight of a swap pricing process which London Underground believes will form the basis of its liability. This process resulted in the hedge provider banks reducing the cost of breaking the swaps by around £100k compared to their original proposal to the contractor.

Systems

6.4 The Treasury Management System continues to be developed and now holds comprehensive credit rating information, more automated cash forecasting tools, an investment dashboard report, highly controlled dynamic and Board investment limits, automated links to ReVal (TfL's derivative accounting and valuation system) and utilises electronic statement files sent directly from HSBC to the system.

6.5 Group Treasury implemented a money market fund portal allowing all money market funds to be transacted electronically and to give full audit trails and access to historical rates, fund compositions and reconciliation reporting on interest due.

6.6 Tube Lines Limited was added to the TfL wide HSBC electronic banking platform allowing them to make same day value payments (i.e. CHAPS and Faster Payments) in a secure manner.

Cash Collection

6.7 Group Treasury set up bulk cash collection and deposit facilities for the Emirates Air Line at late notice. These facilities normally take approximately ten days to put in place and they were set up within 48 hours allowing the Air Line ticket offices to operate efficiently and securely from day one.

Commemorative Coins

6.8 As from late January 2013, London Underground 150th anniversary £2 commemorative coins were delivered to be dispensed from LU ticket machines. The total value of £1.3m (£650,000 of each design) is scheduled to be delivered to stations by the end of February 2013. Group Treasury led in all arrangements pertaining to the coin delivery liaising with all parties involved from the Royal Mint to station coin delivery requests.

Team Awards

6.9 In January 2013, Group Treasury won the International Finance Review Sterling Bond of the Year.

6.10 In February 2013, the team received the "highly commended" award as runner-up in the Association of Corporate Treasurers Treasury Team of the Year Awards. The Special Recognition Award in the Treasurer magazine states that "a world-class business is being served by a world-class treasury team". The award winners are selected by corporate treasury professionals across the UK and Europe. The winner was SAB Miller, for issuing $7 billion in the biggest bond issue of 2012.

List of appendices to this report:

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

List of Background Papers:

Treasury Management Strategy 2012/13

Contact Officer: Simon Kilonback, Group Treasurer
Number: 020 7126 4137
Email: SimonKilonback@tfl.gov.uk