Finance and Policy Committee

Date: **2 March 2016**

Item: **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 year 2015/16, as required by the Treasury Management Policy Statement and Treasury Management Practices 2015/16 (TMP) approved by the Board in March 2015.

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 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 26 March 2015, the Board approved the Treasury Management Strategy (TMS) 2015/16 (which includes an Investment Strategy 2015/16, a Borrowing Strategy 2015/16 and a Risk Management Strategy 2015/16) and reiterated the following strategic objectives for Group Treasury:

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

(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 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, together with the effects of decisions taken and the transactions executed in the past year, and on any non-compliance with the organisation’s Treasury Management Policy Statement and Practices from 1 April 2015 to date. By doing so, the paper fulfils the requirement under the TfL Treasury Management Policy Statement and Treasury Management Practices 2015/16 to provide an 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 2015 that are of note:

(a) the continued active investment management of TfL’s cash portfolio, currently £3.88bn, resulted in a year-to-date weighted average return of 0.558 per cent versus the benchmark seven-day London Interbank Bid Rate (LIBID) of 0.36 per cent. The 2015/16 full year outturn shows an additional investment return of £1m against the budget;

(b) the support provided to commercial procurement activity with foreign currency exposure has crystallised savings of £8.8m for TfL from reduced contract pricing;

(c) during the period to 12 February 2016, rates were forward fixed on £900m of a new £1bn ‘Urban Mobility for London’ framework facility with the European Investment Bank (EIB). The EIB facility agreement was signed in June 2015;

(d) during the period to 12 February 2016, rates were forward fixed on £300m of a new £500m 20-year Crossrail Rolling Stock and Depot corporate loan facility with Export Development Canada (EDC). The EDC facility agreement was signed in May 2015;

(e) in April 2015, TfL issued its inaugural £400m Green bond which, with a 10-year tenor, represented the longest Sterling Green bond at the time of issuance. The TfL Green Bond framework was the first such framework developed purely for sustainable transport; and

(f) in April 2015, TfL issued a £120m 15 year private placement at the tightest spread to Gilts to date of any TfL bond issue.

Further detail of activities from 1 April 2015 to 30 September 2015, are included within the background paper listed at the end of this report.

5 Performance Against Treasury Management Practices

5.1 This section reviews performance against Treasury Management Policies (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 2015.

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 EIB and EDC) or explicitly linked (in the case of Green Bonds) to specific projects requires ongoing project monitoring and significant interaction between Group Treasury and the wider organisation.

5.7 Whilst 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 re-assesses TfL's credit rating and outlook. TfL manages the risk of downgrade through an open dialogue with each agency as well as strong governance and financial discipline. A ratings downgrade would result in a higher cost of borrowing for TfL as well a greater refinancing risk for existing debt. 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	Stable	Stable	Stable
Short-term rating	A-1+	P-1	F1+

5.9 Moody’s, Standard & Poor’s and Fitch affirmed their ratings in March 2015, May 2015 and November 2015 respectively.

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

Potential Impact of Forthcoming Regulatory Changes

5.11 Since the Committee was last updated in September 2015, there has been no further significant progress in regard to the following proposed regulatory changes:

(a) Money Market Fund Reform;

(b) Financial Transaction Tax; and

(c) European Markets Infrastructure Directive.

5.12 From 1 January 2016 banks within the EU are subject to the European Bank Recovery and Infrastructure Directive. Rating agencies have reviewed and updated their methodologies for financial institutions which resulted in numerous downgrades due to the reduced likelihood of government support. TfL’s investment strategy has been updated where required to account for the new landscape.

5.13 The Markets in Financial Instruments Directive (MIFID), has been in force since November 2007. It governs the provision of investment services in financial instruments by banks and investment firms and the operation of traditional stock exchanges and alternative trading venues. New legislation, known as MIFID II, is due to come into effect in January 2017, although this is widely expected to be delayed.

5.14 TfL is a user of investment services and is considered a professional client under the existing MIFID legislation. In line with a proposed default classification of all local authorities (for local Government financing purposes) as retail clients, TfL will be viewed as a retail client under MIFID II, and as such, there would be restrictions in terms of the financial instruments TfL could use and/or invest in. TfL would seek to elect up to professional client status and will be required to provide supporting evidence for such proposed election. As a retail client TfL would be unable to carry out many of its day to day treasury activities such as transacting in derivatives, investments in financial instruments, issuance of commercial paper or bonds. TfL will continue to monitor developments and requirements of MIFID II.

TMP 2 – Performance Measurement

5.15 Group Treasury's borrowing and investment performance is measured against the MD Finance scorecard. Further information is available in part 2 of this paper.

TMP 3 – Decision-Making and Analysis

5.16 Group Treasury has maintained full records of its key treasury management decisions during the period in its Treasury Management System.

Borrowing

5.17 As well as the overall strategic objectives that underpinned the 2015/16 Treasury Management Strategy (as detailed in section 3), the main specific objectives for borrowing were as follows:

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

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

(c) build upon the success of the liquid, benchmark sized bonds issued under its EMTN programme where this represents good value for money; and

(d) borrow an additional £600m in 2015/16 (in accordance with the 2013 funding settlement).

5.18 Objective (a) was achieved by maintaining access to capital markets through TfL's Euro Commercial Paper (ECP) programme and Euro Medium Term Note (EMTN) programme, as well as being further complemented by the signing of a new £500m facility with the EDC and £1bn facility with the EIB.

5.19 TfL's credit rating was maintained as per Table 1, thus fulfilling objective (b).

5.20 Objectives (c) and (d) were achieved through the financing detailed in Table 2, which shows the amount of borrowing TfL had to raise and refinance by 31 March 2016, as per the TMS. The balance of £55m is likely to be raised through Commercial Paper by 31 March 2016. Table 2 also illustrates the saving against the PWLB certainty rate. The PWLB is effectively TfL's 'backstop facility' and as such is the baseline against which all debt is measured.

Table 2: Borrowing and savings against PWLB to March 2016

Borrowing Strategy 2015/16	**£m**	**Savings to PWLB***	
2015/16 Incremental Borrowing agreed with DfT	600		
Refinancing of Principal repayments	25		
Refinancing of Commercial Paper (CP)	35		
	660		
Financed by:		**bps**	**£m**
EIB LOCIP Loan	85	45	3.8
Green Bond – 10 Year	400	32.6	13.0
Private Placement – 15 Year	120	35.1	6.3
Public Works Loan Board (PWLB)	nil		
Incremental balance to fund before 31 March 2016	55		
	660		

**Saving is on an undiscounted basis over the life of the loan versus PWLB certainty rate*

Rates achieved are commercially sensitive so cannot be disclosed

5.21 Table 3 below shows the expected savings (over the life of the loans) against the PWLB certainty rate of future disbursements fixed under both EIB and EDC facilities from 1 April 2015 onwards.

Table 3: Lifetime savings against PWLB

Future borrowing	**£m**	**Savings to PWLB***	
		bps	**£m****
EIB UML Tranche 1, 18 yrs	100	87	15.7
EIB UML Tranche 2, 18 yrs	100	95	17.1
EIB UML Tranche 3, 20 yrs	100	103	20.6
EIB UML Tranche 4, 18 yrs	50	106	9.5
EIB UML Tranche 5, 19yrs	150	108	30.8
EIB UML Tranche 6. 18 yrs	100	88	15.8
EIB UML Tranche 7, 35 yrs (amortising)	300	90	54.6
EDC Tranche 1, 20 yrs	150	62	18.6
EDC Tranche 2, 20 yrs	150	63	18.9
	1,200		**201.6**

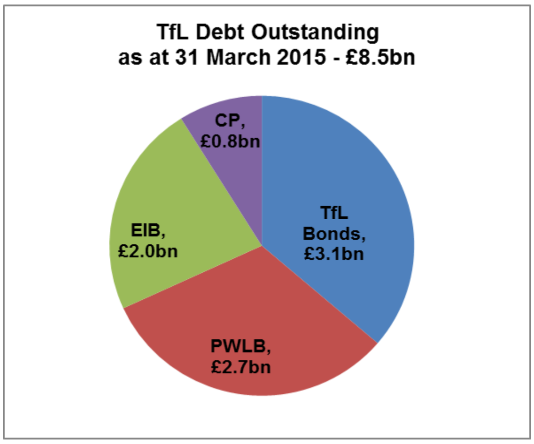
** Due to the forward starting nature of the disbursements, the current PWLB Certainty Rate has been adjusted using forward points derived from the forward Gilt curve for each of the respective disbursement dates.*

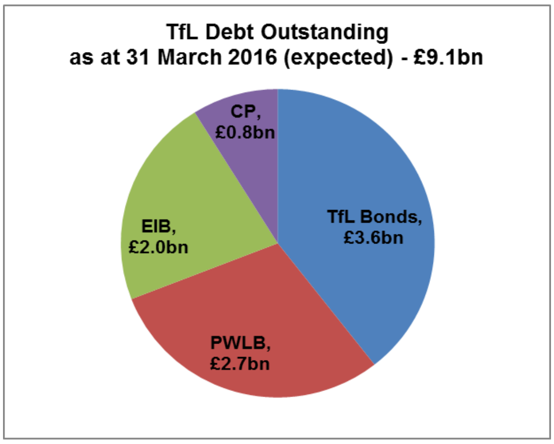
***Saving is on an undiscounted basis over the life of the loan*

5.22 As at 31 March 2015, TfL had £8,548m of debt, of which approximately £760m was short-term borrowing under the ECP Programme. The weighted average interest rate on TfL's debt was 3.81 per cent (with a weighted average life of 21.5

years). As at 31 March 2016, TfL is expected to have £9,148m of debt outstanding, of which £780m is expected to be short-term CP. The weighted average interest rate on TfL's debt as at 31 January 2016 was 3.71 per cent (with a weighted average life of 20.1 years).

Chart 2: Tfl Debt Outstanding 2015 and 2016





Investments

5.23 The 2015/16 TMS Strategic Objectives specific to Investments were as follows:

(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.

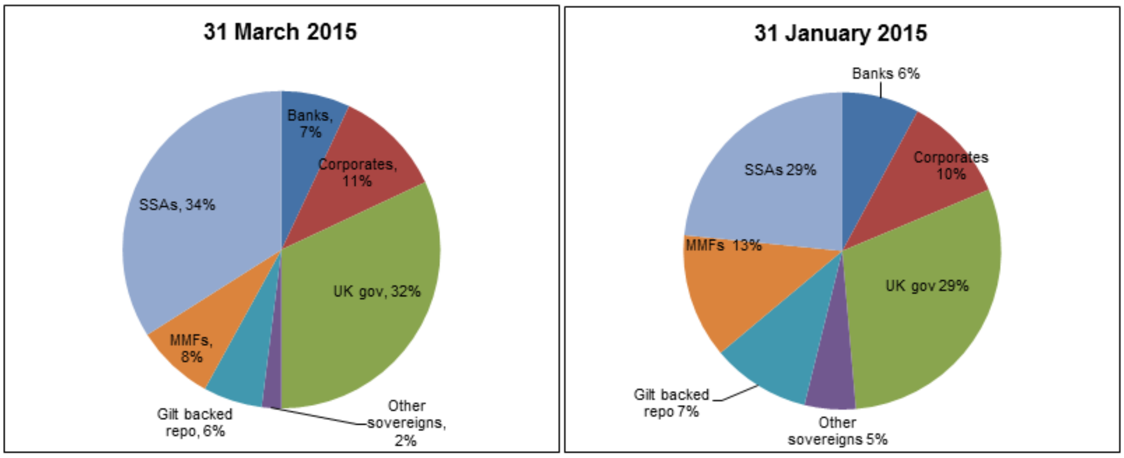
5.24 In order to achieve the strategic objectives outlined in 5.31, which prioritise security and liquidity over yield, the current investment strategy seeks to maintain approximately 30 per cent of TfL's investment portfolio in UK Government investments, such as UK Treasury Bills. UK Treasury Bills are considered the most highly rated (AA+) and liquid of domestic assets within the portfolio. Given the 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.

5.25 Furthermore, in order to ensure there is enough cash available to meet TfL's obligations as they fall due, Group Treasury ensures that a minimum of £250m of cash is available on any day. £250m was selected as the minimum cash provision required to maintain liquidity based upon historical cash flows.

5.26 As at 31 January 2016, TfL had £3.97bn of cash under management (including £2.1bn 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.

5.27 The allocation of TfL's cash investments is summarised in Chart 3.

Chart 3: Cash Investment Allocations



TMP 4 – Approved Instruments, Methods and Techniques

5.28 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 its board approved treasury management policies and practices. All decisions on 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

5.29 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.

5.30 Accounting and monitoring of prudential indicators is under taken by Group Accounting which reports to the CFO.

TMP 6 – Reporting Requirements and Management Information Arrangements

5.31 Group Treasury continues to report in line with the Treasury Management Policy including, but not limited to the following:

(a) Treasury management updates;

(b) Group Treasury Activities paper;

(c) weekly report to CFO;

(d) daily Cash report;

(e) investments and borrowing report;

(f) counterparty limit report;

(g) derivatives exposure report; and

(h) short term cash forecast.

5.32 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 that have required immediate reporting to the Chief Finance Officer.

TMP 7 – Budgeting, Accounting and Audit Arrangements

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

5.34 Budget for 2015/16 debt service and interest income is set out in Table 4. The 2015/16 forecast outturn for debt service represents an expected saving of £26.6m against budget. The forecast outturn for interest income represents an expected additional £1m of interest over budget.

5.35 External auditors discussed and conducted walkthrough testing of controls with Group Treasury during January 2016.

Table 4

	15/16 Budget	15/16 Forecast outturn
Debt service £'m	401	372
Interest income £'m	22.9	23.9

TMP 8 – Cash and Cash Flow Management

5.36 All monies (with the exception of London Transport Insurance (Guernsey) Limited) 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. Cash flow projections are prepared on a regular and timely basis and are adequate for the purposes of monitoring compliance with this policy statement.

5.37 In accordance with the TMS, Group Treasury manages its cash 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.

TMP 9 – Money Laundering

5.38 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.

5.39 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 is monitored by Internal Audit.

TMP 10 – Training and Qualifications

5.40 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. Internal and external training is provided as required for each individual as part of their learning and development objectives.

TMP 11 – Use of External Service Providers

5.41 No external providers of treasury management services were used during the period, all 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.

5.42 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

5.43 Group Treasury remains committed to the pursuit of proper corporate governance through the Treasury Management Policy and Treasury Management Practices.

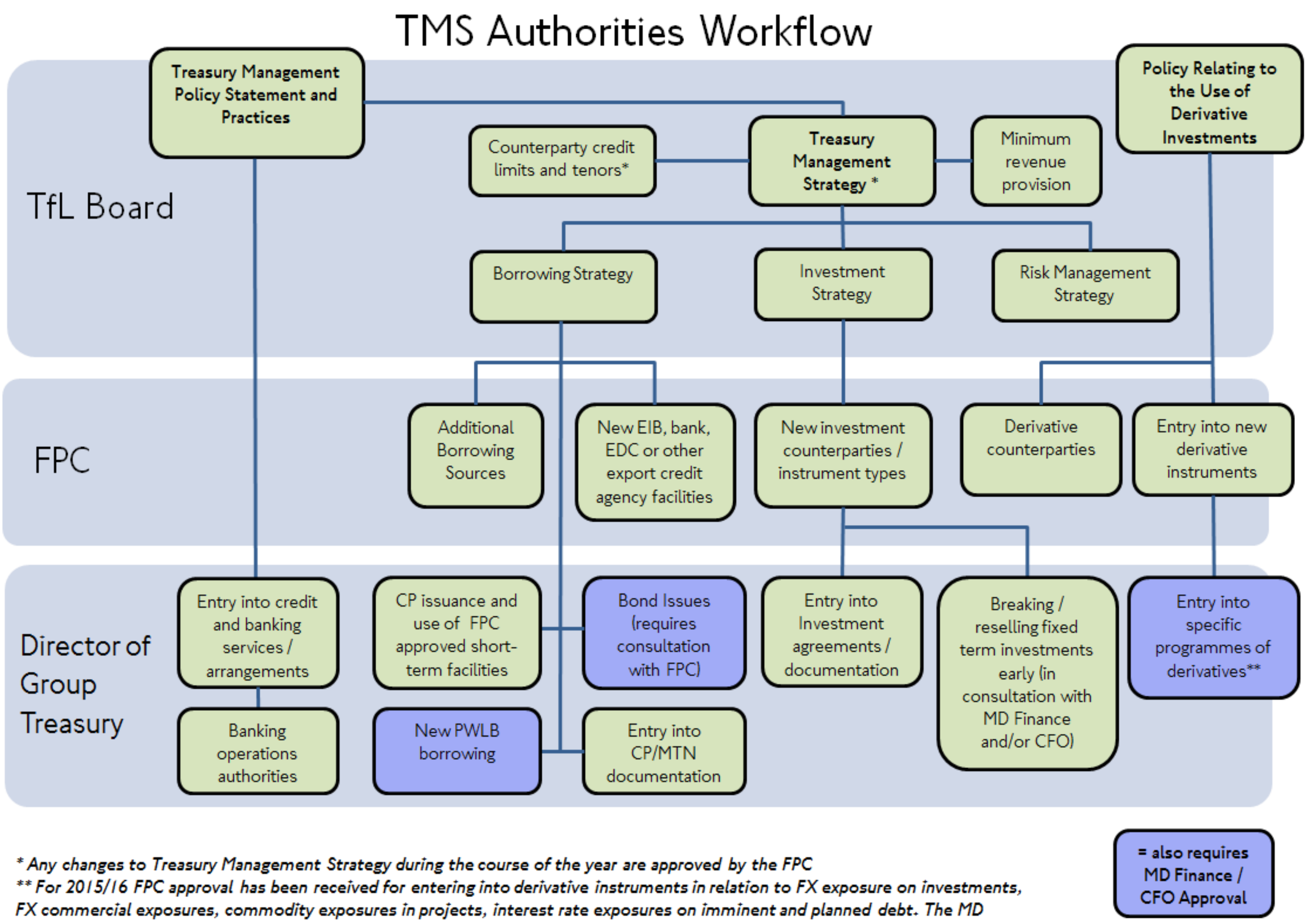
5.44 Diagram 1 illustrates some of TfL’s key financial statutory powers. Diagram 2 illustrates TfL’s corporate governance for treasury activities.

Diagram 1: TfL's Key Statutory Powers

Greater London Authority (GLA) Act 1999	• TfL is a statutory corporation, subject to local government finance rules • Functional body of the GLA (The Mayor and the London Assembly) • Secretary of State for Transport must pay a transport grant
Local Government Finance Act (LGFA) 1988	• TfL must produce a balanced budget each year. The sum of revenues, grant, contingency and borrowing has to equal total operating and capital costs, and debt service
Local Government Finance Act 2012	• Local authorities retain a share of the business rates generated and any growth on such share • Since April 2013 business rates have replaced an element of TfL central government transport grant
Local Government Act 2003	• Enables TfL to borrow for any purpose relevant to its functions under any enactment, or for the purposes of the prudent management of its financial affairs • All money borrowed by TfL, together with interest on the money borrowed, shall be charged indifferently on all the revenues of TfL • TfL is required to have regard to the CIPFA[†] Treasury Management Code of Practice and other relevant CIPFA guidance
Public Works Loan Act 1875 and the National Loan Act 1968	• Immediate access to central government funding via the Public Works Loan Board (PWLB) eliminates liquidity risk
TfL Act 2008	• The power to make arrangements for risk mitigation
ONS Treatment	• The Office for National Statistics treats TfL as part of Government in terms of Public Sector Net Debt and key metrics monitored by the EU

† Chartered Institute of Public Finance and Accountancy is the lead accounting body for accountancy and financial management in the public sector.

Diagram 2: TMS Authorities Workflow



** Any changes to Treasury Management Strategy during the course of the year are approved by the FPC*
*** For 2015/16 FPC approval has been received for entering into derivative instruments in relation to FX exposure on investments, FX commercial exposures, commodity exposures in projects, interest rate exposures on imminent and planned debt. The MD Finance / CFO approval is required prior to any specific transactions.*

6 Other Activities

Supply Chain Finance

6.1 Group Treasury released an OJEU notice on 3 December 2015 for a Supply Chain Finance (SCF) solution, which would give TfL's suppliers the option to seek early settlement of their invoices at an attractive rate of financing that is reflective of TfL's credit risk, rather than that of the suppliers. If a suitable solution is identified the contract is forecast to be awarded in July 2016.

6.2 For an SCF solution to be successful and provide most value to TfL's supply chain, a number of process and system changes will be necessary to ensure efficiency in the processing of supplier invoices is maximised. A number of initiatives to address this have been identified including changes to SAP escalation rules and approval limits which went live in period 8. Early indications show an improvement in processing times, further initiatives for improvement will continue to be sought.

6.3 Group Treasury met with the Federation of Small Businesses (FSB) in November 2015 prior to the release of the OJEU notice to explain the various benefits of the solution for each party and how the concept works. The FSB was supportive of the proposed solution in principle and welcomed a further meeting if a suitable solution is identified.

Banking

6.4 Group Treasury advises, liaises and acts with business units and financial institutions to implement both updated and new banking solutions. To date Group Treasury has worked on the new congestion charging contract with Capita, the creation of the Surface Trading division of Transport Trading Limited and with other units such as Customer Experience and London Transport Museum on various improved processes.

Commercial

6.5 Working with the Commercial team, Group Treasury has developed a spreadsheet tool for monitoring the credit ratings, equity prices, Credit Default Swap rates, key news items and market sentiment for TfL's key suppliers, as well as its investment and performance bond counterparties. This tool is being used to flag any significant financial issues or concerns about TfL's counterparties to senior management and the operating businesses. A shortlist has been identified of suppliers that are considered strategically important to the business and more detailed monitoring of these entities is in place.

6.6 Group Treasury has developed a guidance document and a training programme for TfL commercial and contract managers on performance bonding arrangements, parent company guarantees and other forms of financial risk mitigation to be inserted into TfL contracts.

6.7 Group Treasury led the development of internal guidance relating to the mitigation of risks arising from property developments.

List of appendices to this report:

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

List of Background Papers:

Finance and Policy Committee, Group Treasury Activities paper 15 October 2015 Part 1

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