

**Date:** 27 July 2016

**Item:** Group Treasury Update

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As provided for under section 100B(4)(b) of the Local Government Act 1972, the Chair has accepted a late item on the Group Treasury Update to enable Members to be provided with the latest information on the impact of the UK's vote to leave the European Union on TfL's borrowing programme and TfL's management of credit risk in relation to investment counterparties.

**This paper will be considered in public**

## **1 Summary**

- 1.1 This paper has been prepared in response to the questions raised at the Committee's meeting on 8 July 2016 on:
- (a) the impact of the UK's vote to leave the European Union (EU) on TfL's borrowing programme; and
  - (b) the management of credit risk in relation to investment counterparties.
- 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 the meeting.

## **2 Recommendation**

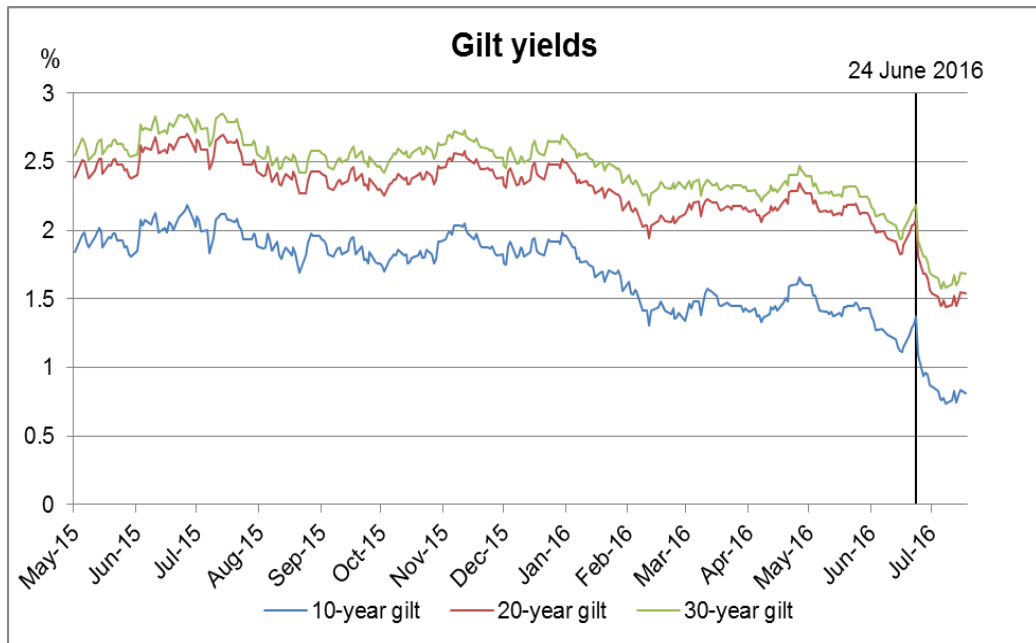
- 2.1 **That the Committee note the paper.**

## **3 Impact on TfL Borrowing**

### **Update on Market Conditions and Rates**

- 3.1 Following the UK vote to leave the EU on 23 June 2016, UK gilt rates fell sharply to record low levels across the curve, as investors looked to increase their holdings of "safe heaven" government instruments. On 24 June 2016 10-year UK government bonds dropped from 1.373 per cent to 1.086 per cent overnight and have continued to fall further (Chart 1).
- 3.2 Markets expected the Bank of England to cut the base rate in July, however this did not happen. Markets are now expecting that the rate will be cut by 25 basis points in August. It is also perceived that the fall in gilt yields reflects expectations for the future path of UK monetary policy.

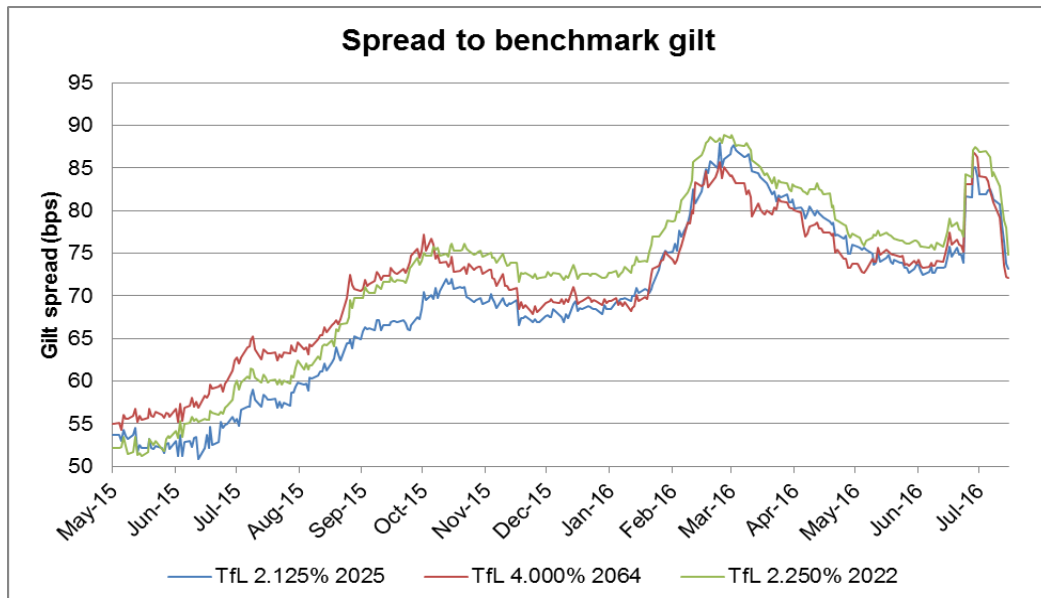
**Chart 1 – Gilt yields (%)**



Source: Bloomberg, 18 July 2016

3.3 While secondary credit spreads on TfL bonds increased marginally immediately after the EU referendum, they have come down to the pre-vote levels since then. As can be seen in Chart 2 below, TfL spreads, along with the rest of the market, have been climbing steadily since TfL last issued a bond in May 2015, reaching a peak of 85-90bps in March 2016. The post-vote increase in spreads was in line with March 2016 levels.

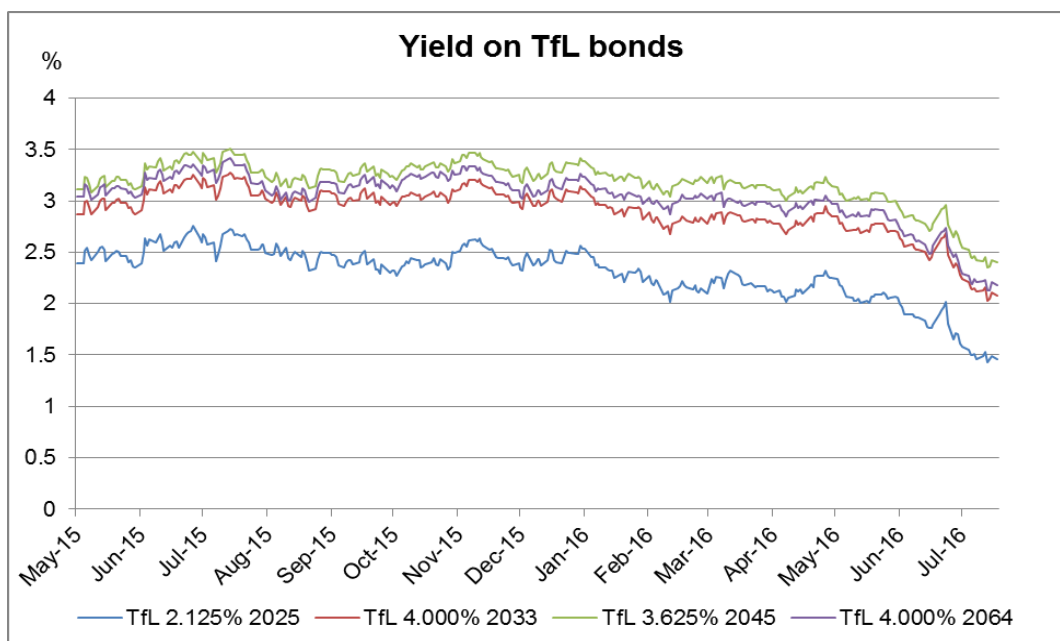
**Chart 2 – TfL bond spreads to benchmark gilts**



Source: Bloomberg, 18 July 2016

3.4 The overall effect has resulted in yields on outstanding TfL bonds falling to historic lows. Chart 3 shows the secondary yields on selected TfL bonds.

**Chart 3 – Yield to maturity on selected TfL outstanding bonds**



Source: Bloomberg, 18 July 2016

## **4 Investment Counterparty Credit Review Process**

### **Treasury Management Strategy**

- 4.1 Under the Board-approved Treasury Management Strategy (TMS), TfL maintains an Approved Investment List. Investments are limited to counterparties and types of investment that have been placed on the list. All investment counterparties are required to be approved on an individual basis by the Committee before they can be added to the list.
- 4.2 In making recommendations to the Committee for new names or deletions of existing names (typically once or twice a year), Group Treasury has regard to a number of credit factors (as described in more detail below). It also takes account of the need to obtain sufficient diversification with high quality, investment grade names, and ensuring that there are sufficient approved counterparties currently issuing in the market.
- 4.3 The maximum investment in any counterparty and the maximum tenor of any investment is determined from a Counterparty Exposure Limits table in the TMS. These limits are determined directly by credit ratings and, unlike the Approved Investment List, are approved by the Board.

### **Internal Limits**

- 4.4 As well as the exposure limits approved by the Board as part of the TMS, Group Treasury also applies internal limits. These add an extra layer of scrutiny and are generally more stringent than the Board limits.
- 4.5 Some of the limits are driven by market data including bond yields and Credit Default Swap (CDS) spreads. This means that the internal limits that TfL applies will take account of any credit concerns that markets are pricing in but that rating

agencies have not yet adjusted for.

- 4.6 The internal limits also allow for specific limits to be applied to particular types of investment counterparty. For example, at present Group Treasury has an internal limit of not having any non-collateralised investments with banks that are rated below AA-.

### **Credit Reviews and Monitoring Process**

- 4.7 Group Treasury also undertakes credit reviews and monitoring of all the names on the Approved Investment List, as well as any new names that are due to be recommended to the Committee.

#### Daily Monitoring

- 4.8 On a daily basis Group Treasury actively monitors not only its investment counterparties but also TfL's key suppliers for:
- (a) Changes in credit ratings;
  - (b) Significant movements in equity prices and CDS spreads;
  - (c) Quarterly, semi-annual and annual financial results;
  - (d) Other significant counterparty or market news.
- 4.9 A summary of this information is provided each day to the Investments team, Director of Group Treasury, the Chief Finance Officer and the Commercial Director.
- 4.10 Where the Daily Monitoring process identifies a potential credit concern, Group Treasury staff will suspend any new investments until the Director of Group Treasury is consulted. As a result of the consultation, a recorded decision is made as to whether there will be:
- (a) No change (in which case the team will be informed);
  - (b) Temporary suspension of the counterparty (while further analysis is carried out, or the outcome of an event is awaited); or
  - (c) Permanent removal of the counterparty (in which case Treasury systems will be updated and the counterparty removed at the next update of the Approved Investment List).

#### Credit Reviews

- 4.11 In addition to the Daily Monitoring process, Group Treasury also carry out regular, detailed credit reviews on all counterparties on the Approved Investment List, as well as ahead of proposing new counterparties to the Committee.
- 4.12 The reviews will vary by counterparty type but will typically cover:
- (a) Group structure;
  - (b) CDS history compared with rest of portfolio and that of the relevant country the counterparty is based in;

- (c) Share price history compared with the movement in the relevant underlying index;
- (d) Credit ratings compared with the rest of the investment portfolio;
- (e) Rating agency analysis (including business profile, sector comparisons, key positive and negative credit factors, any uplifts for external support, reasons for positive / negative outlooks);
- (f) Any external support, such as Government explicit or implicit guarantees;
- (g) Key financials and ratios history, such as profitability, liquidity, solvency, capital adequacy and asset quality compared with the rest of the investment portfolio;
- (h) Commentary on the most recently released quarterly results; and
- (i) Significant news stories or other credit factors not already covered.

4.13 The output of the review is captured in a standardised report template. These reports are also typically presented to the Committee when any new names are proposed to be added to the Approved Investment List.

4.14 As with the Daily Monitoring, the outcomes of the Credit Reviews include no change, temporary suspension or permanent removal.

**List of appendices to this report:**

Supplementary information is provided in a paper on Part 2 of the agenda.

**List of Background Papers:**

None

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