

Date: 17 October 2013

Item 6: Group Treasury Activities – Part 1

This paper will be considered in public

1 Summary

1.1 The purpose of this paper is to:

- (a) provide an update on Group Treasury's activities for the six months period between 1 April and 30 September 2013, as required by the Treasury Management Policy Statement and Treasury Management Practices 2013/14, approved by the Board in March 2013; and
- (b) update the Committee on the proposed plans to implement the agreed Treasury Management Strategy 2013/14 (TMS 2013/14).

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 27 March 2013, the Board approved the TMS 2013/14 (which includes an Investment Strategy 2013/14, a Borrowing Strategy 2013/14 and a Risk Management Strategy 2013/14) 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;
- (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 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 an update on TfL's investment, borrowing and risk management activity in the half-year to 30 September 2013 in pursuit of these strategic objectives. By doing so, the paper fulfils the requirement under the TfL Treasury Management Policy Statement and Treasury Management Practices 2013/14 to provide the Committee with a mid-year monitoring report on treasury management activities and risks, and the performance of the treasury management function.

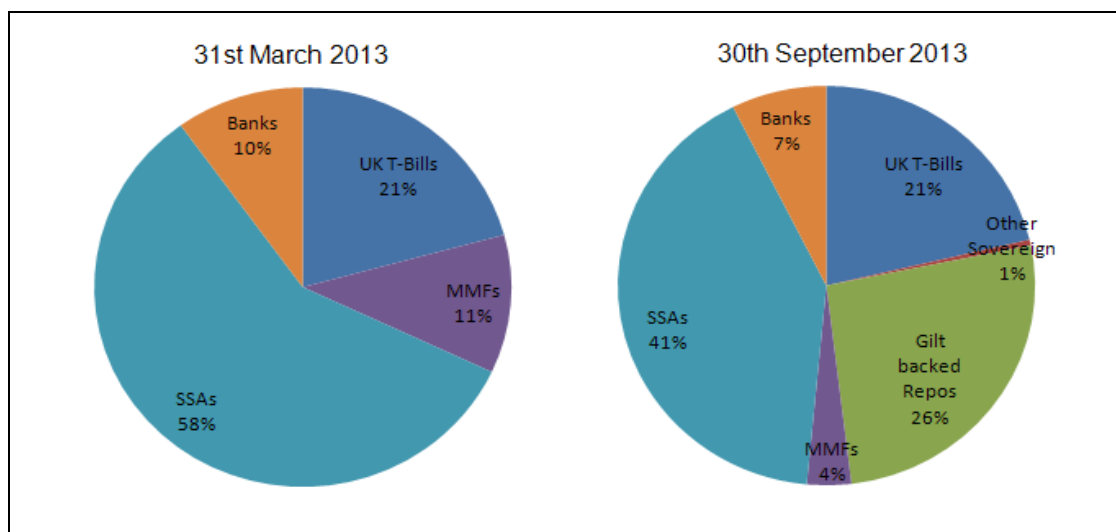
4 Compliance with the TMS 2013/14

- 4.1 The TMS 2013/14 sets out the parameters under which the Group Treasury function is permitted to operate.
- 4.2 There have been no breaches of the TMS 2013/14 (comprising the Investment Strategy 2013/14, Borrowing Strategy 2013/14 and Risk Management Strategy 2013/14) in the year to 30 September 2013.

5 Investments Update

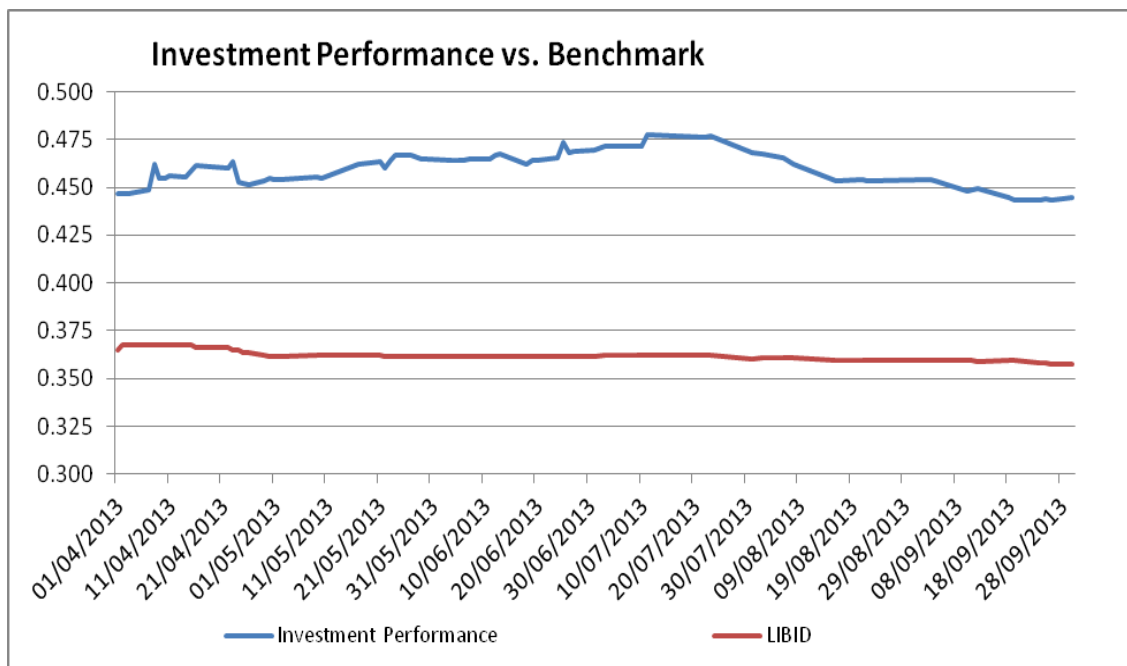
- 5.1 As at 30 September 2013, TfL had £4.3bn of cash under management (including £1.8bn of cash ring-fenced to fund the construction of the Crossrail project). The allocation of these funds is summarised in Chart 1.

Chart 1



- 5.2 The share of cash in UK Government backed securities has been increased over the first half of the year, due to increased investment in repurchase agreements (repos). Repos have been placed for tenors up to three months, but also increasingly for overnight liquidity as a substitute for Money Market Funds (MMFs). The yield on repos has generally been above the yields on both Sub-Sovereign Agencies and MMFs, while still being fully collateralised by UK Government securities.
- 5.3 The return on TfL's cash investments has decreased in line with market rates. The seven-day London Interbank Bid Rate (LIBID) has decreased since 2 April 2013, from 0.37 per cent to 0.36 per cent, while TfL's investment returns have increased slightly from 0.45 per cent to 0.46 per cent. Chart 2 shows the movements in the return on cash and LIBID over the half-year to 30 September 2013.

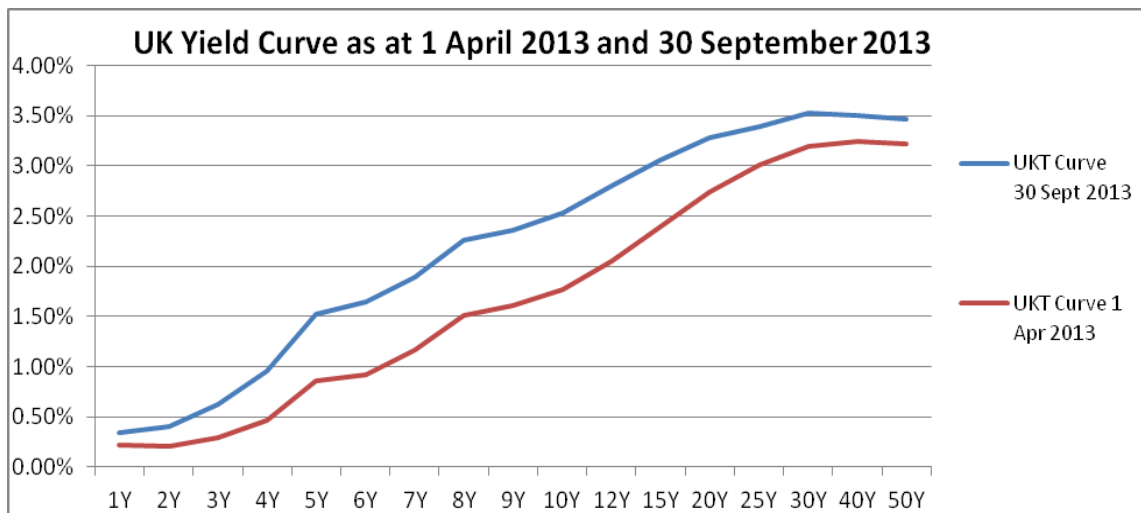
Chart 2



- 5.4 TfL's year-to-date average yield is 0.46 per cent, 10 basis points above benchmark, with an average of 106 days-to-maturity.
- 5.5 The UK economy has shown signs of recovery over the first half of the year. Central bank policy appears to be the main market driver with significant developments and announcements within the Federal Reserve and the Bank of England. The Federal Reserve followed up an announcement suggesting Quantitative Easing would be tapered by then deciding that this would be delayed and short term rates would only increase once the economic data warranted it. The Bank of England appointed a new governor, Mark Carney, in July 2013 and announced that overnight rates would remain at 0.50 per cent until unemployment drops below seven per cent, which it doesn't foresee happening until the second half of 2016.

- 5.6 However, recent data releases in the UK have suggested that the market may outperform Carney's forward guidance. Second quarter GDP grew by 0.7 per cent in the UK after growth of 0.3 per cent in quarter 1. The main driver of this was the services industry, which makes up 78 per cent of the UK economy, with the purchasing managers' index rising to 60.5 in August from 52.9 in April (a level of above 50 indicates growth). This was its highest level since December 2006 and is an indicator of an upturn in the industry since the beginning of the financial year.
- 5.7 The UK Government yield curve has shown increases across all tenors since 1 April 2013. This is shown in Chart 3.

Chart 3



- 5.8 The majority of TfL's investments have been under one year in the first half of the year, largely due to uncertainty regarding future budget and borrowing capabilities, but also due to lack of reward in the yield for the increased tenor risk. Recent upbeat economic data have put pressure on long term rates, with little effect on short term rates to date, although they are expected to increase significantly around the end of 2015 or beginning of 2016. SONIA (Sterling Overnight Index Average) rates have been a better indicator than LIBOR rates regarding yields available on TfL's investments. Table 1 shows the forward rates for three month SONIA showing little change expected during 2014. More pronounced increases are expected by the end of 2015:

Table 1

Current	Forward Rates for 3 Month SONIA						
	3 months	6 months	9 months	1 year	18 months	2 years	3 years
0.4229	0.42	0.43	0.47	0.54	0.75	1.14	1.81

- 5.9 The implication of the above data is that while medium and long-term interest rates have risen in recent months, short-term rates, and therefore TfL's return on cash invested, have not risen. The forward SONIA rates indicate that a significant increase in returns on short-term cash is not expected in the near future.

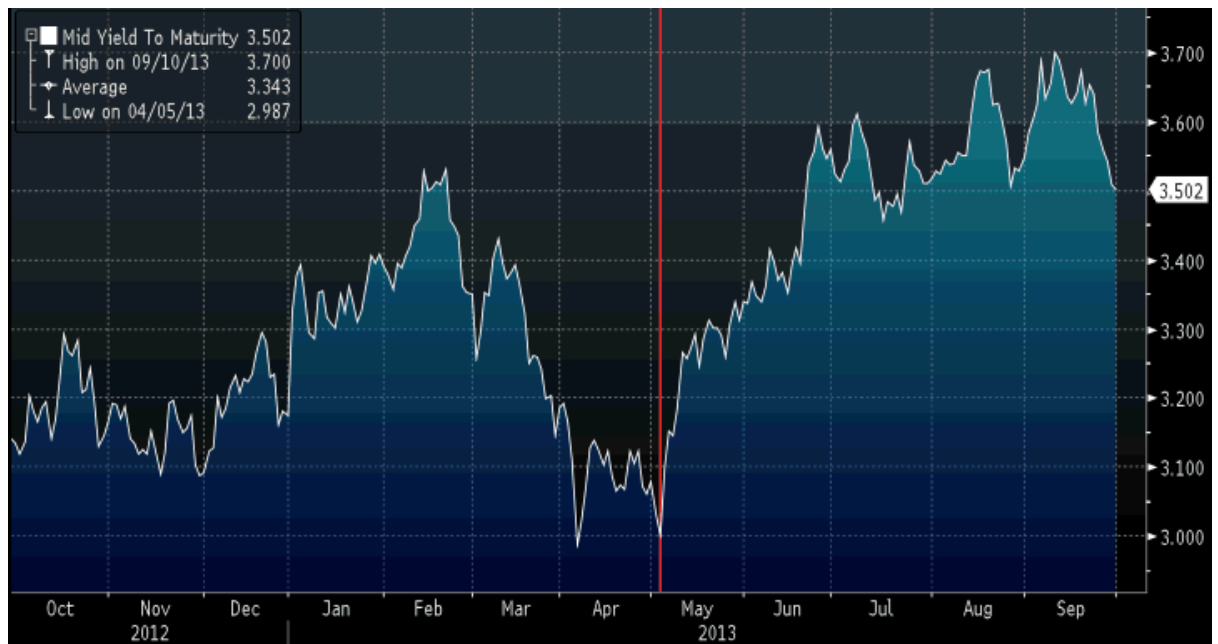
6 Borrowing Update

- 6.1 Since April 2013, TfL has undertaken £850m of long-term borrowing. This includes £700m of bonds and £150m from the European Investment Bank (EIB) under the Crossrail Loan Facility. Of the £850m of new borrowing, £345m represented TfL's incremental Prudential Borrowing for 2013/14 (being the additional borrowing agreed with Government as part of the 2010 Funding Settlement), £410m represented the replacement of short-term commercial paper with long term funding and £95m represented borrowing headroom created by the buyback of the Tube Lines B Notes on 28 June 2013. These transactions are in line with TfL's Borrowing Strategy for 2013/14 and are outlined in further detail below.
- 6.2 In April 2013, TfL completed the scheduled drawdown of £150m under the existing £1bn Crossrail loan facility with the EIB at a pre-agreed fixed rate, set in October 2009. The final drawdown of £100m under the overall £1bn facility is scheduled for April 2014.
- 6.3 Since the beginning of the financial year, TfL has also successfully issued two bonds:
- (a) a £400m bond for 32 years at a fixed rate coupon of 3.625 per cent (with a semi-annual yield of 3.638 per cent) issued at an all-in-price including bank fees of 98.891 per cent in May 2013 (the "May 2045s"); and
 - (b) a further £300m bond for 20 years at a fixed rate coupon of 4.000 per cent (with a semi-annual yield of 3.974 per cent), issued at an all-in-price including bank fees of 99.592 per cent in September 2013 (the "September 2033s").
- 6.4 The May 2045s were issued at a spread of 60 basis points over Gilts, while the September 2033s achieved a tighter spread than any of TfL's recent issues, with a spread of 58 basis points over the UK Gilt. The bonds compare very favourably with the alternative of borrowing from the Public Works Loan Board (PWLB), with:
- (a) the May 2045s saving 23.2 basis points against the PWLB rate (or £29.7m in interest over the 32 year term); and
 - (b) the September 2033s saving 32.6 basis points (or £19.6m over the 20 year term).

- 6.5 Both bonds have allowed TfL to take advantage of historically low interest rates and to lock-in a low cost of funding. The May 2045s were issued at an underlying rate which is very close to the low in the eight months preceding the transaction (see red line on Graph 1). This is approximately 50 basis points lower than the high in that period.

Graph 1

Yield Graph (1 October 2012 to 30 September 2013) – UK Gilt 2046:

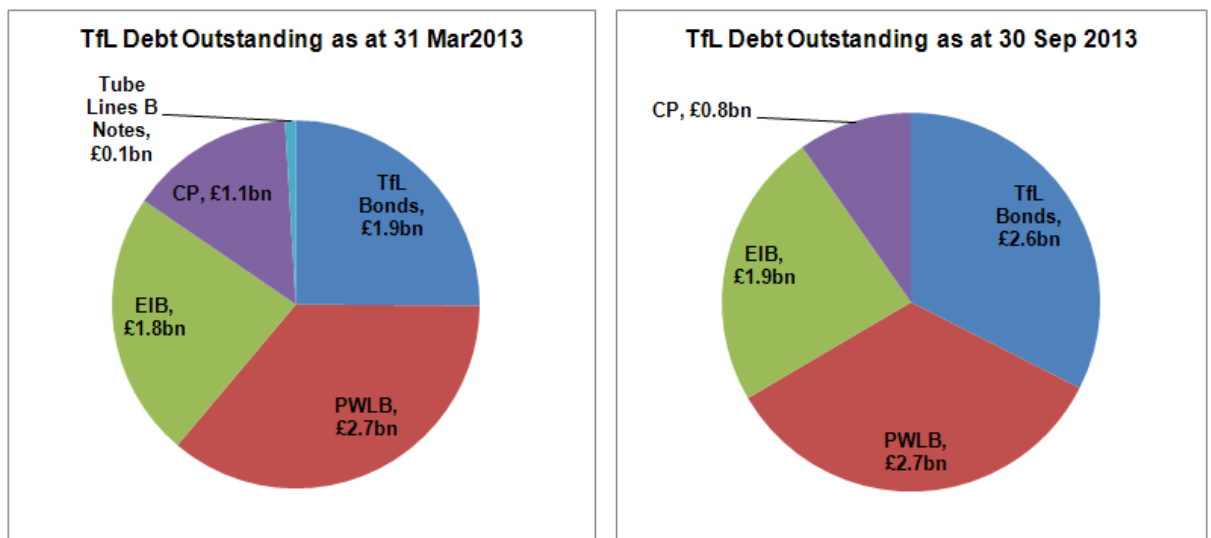


Source: Bloomberg

- 6.6 The headroom for the September 2033 bond has largely been created by reducing Commercial Paper balances. By doing this, TfL has effectively brought forward an element of next financial year's long-term borrowing requirement, as this has allowed it to lock in rates before any further increases in rates. TfL evaluated the use of derivative investments to hedge the underlying element of the borrowing rate as opposed to bringing forward future borrowing, and found that for reasons of cost and cashflow certainty these were not preferable to a new bond issue.
- 6.7 The choice of a 20 year tenor for the bond was partially driven by reverse enquiry interest in a private placement from a large Japanese investor. This interest was successfully converted to a lead order for the public benchmark issue, with 21 per cent of the final book. This represents a significant achievement for TfL in terms of diversifying its investor base, and the order proved critical in allowing TfL to drive down the issuance spread.
- 6.8 The 20 year issue also fills a significant gap in TfL's benchmark curve between the 10 and 30 year bonds issued in 2012. Investors have advised TfL that they prefer to invest with issuers who have a well established curve of varying tenor debt and this should help TfL to achieve the best possible pricing in future.

- 6.9 The TMS 2013/14 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).
- 6.10 Following the £150m drawdown from the EIB and the £400m and £300m bond issues, aggregate debt levels were slightly 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 2013. TfL's aggregate debt level returned below the Operational Boundary by 25 September as Commercial Paper that had fallen due for repayment was not replaced.
- 6.11 The combined effect of borrowing transactions completed in the year to date are reflected in the Chart 4, which shows TfL's debt outstanding as at 31 March 2013 and 30 September 2013.

Chart 4



- 6.12 As at 31 March 2013, TfL had £7.565bn of debt, of which approximately £1.1bn was short-term borrowing under TfL's Commercial Paper Programme. The weighted average interest rate on TfL's debt was 3.68 per cent (with a weighted average life of 19.5 years). As at 30 September 2013, TfL had £8.002bn of debt outstanding, of which £0.8bn was short-term Commercial Paper. The weighted average interest rate on TfL's debt was 3.77 per cent (weighted average life of 20.8 years).
- 6.13 Following the Committee's approval on 18 July 2013, on 8 August 2013 TfL issued the updated documentation for its £5bn 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.

- 6.14 In April 2013, TfL followed the process required to maintain access to the PWLB at the discounted 'Certainty Rate' of Gilts plus 0.80 per cent for the year beginning 1 November 2013.

Secondary Performance

- 6.15 Table 2 shows TfL's recent transactions and their current spreads.

Table 2

Bond	Size (m)	Tenor	Coupon (per cent)	Issue date	Issue Spread	Current Spread
1	500	30	3.875	13/07/2012	98	56
2	500	10	2.250	31/07/2012	88	56
3	300	5	1.250	14/11/2012	70	47
4	400	32	3.625	03/05/2013	60	47
5	300	20	4.000	12/09/2013	58	56

- 6.16 The secondary performance of TfL's recent transactions has been extremely encouraging, all five bonds have traded inwards and each one directly contributed to the success of the following deal. To date TfL has decreased issuance spreads from 98 basis points (£500m 30 year July 2012) to 58 basis points (£300m 20 year September 2013).
- 6.17 The details of TfL's short to medium term borrowing plans are outlined in a separate item ('Borrowing Strategy') on the agenda.
- 6.18 A further paper seeking approval for a new £500m corporate loan facility from the European Investment Bank is also on the agenda.

Liability Management

- 6.19 On 28 June 2013 TfL redeemed 100 per cent of the B Notes held by Tube Lines (Finance) PLC at a price equal to Gilts plus 68 basis points. This transaction represents the final step in the long term strategy of restructuring the legacy Tube Lines PPP debt.
- 6.20 TfL reached an agreement with Deutsche Bank (holder of 80 per cent of the notes) to acquire at a price of Gilts plus 68 basis points. Following unsuccessful attempts to identify the remaining unknown 20 per cent of note holders, TfL and Deutsche Bank agreed to vote amendments to the notes in order to purchase Deutsche Bank's 80 per cent and to sweep up the unidentified 20 per cent. A Call option was inserted, which TfL duly exercised.

- 6.21 The redemption was at a clean price of 133.1658 per cent with accrued interest of £1,268,094.58. This represents a premium of £23,200,924.17 on the outstanding balance of £69,954,363.14. The size of this premium is driven by the high coupon of 7.4547 per cent and will be offset by future savings as TfL will pay significantly less interest on the replacement debt.
- 6.22 The headroom created by the buy back of the outstanding B Notes principal was partially utilised by the £300m September 2033 bond issue. Due to the lower ongoing interest cost, and the fact the new bond has a bullet basis for repayment rather than amortising, the transaction delivers an overall present value benefit of £5.6m, while also creating £45.7m of cashflow benefits to 2021/22. As the equivalent portion of the replacement bond issue is of substantially longer tenor than the B Notes, the interest expense over the extended period will result in an £61.1m net increase in cashflow.

TfL Credit Rating

- 6.23 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 such meeting, each Rating Agency re-assesses the entity's credit rating and outlook. Table 3 sets out TfL's current credit ratings:

Table 3

	S&P	Moody's	Fitch
Long-term rating	AA+	Aa2	AA
Outlook	Stable	Stable	Stable
Short-term rating	A-1+	P-1	F1+

- 6.24 On 24 April 2013, Fitch downgraded TfL's credit rating one notch from AA+ to AA. This was as a result of a downgrade to the UK Sovereign rating from AAA to AA+. Other entities close to the UK Government, for example Network Rail, were also downgraded at the same time. The rating downgrade has not had an adverse effect on TfL's ability to borrow at attractive interest rates as it was driven by a well understood mechanistic link between TfL's credit and that of the Government.
- 6.25 On 8 June 2013, Standard & Poor's confirmed TfL's credit rating and its stable outlook.

Investor Relations

- 6.26 In April 2013, Group Treasury carried out investor meetings in London and Edinburgh. The purpose of these meetings was to provide an annual update rather than being part of a transaction specific roadshow.

- 6.27 Over the past twelve months, TfL has pursued a strategy of establishing closer relationships with its existing and potential investors, as well as with the broader banking community. TfL has also sought to engage with non-traditional sterling investors (such as those in the far east) in order to diversify its investor base and thereby achieve the tightest pricing possible. The significant allocation to a Japanese investor in the 20 year bond issue was a direct result of this engagement.
- 6.28 Group Treasury is in the process of introducing improvements in the relevant TfL web-pages to ensure that existing and potential investors have easy access to key information on TfL and it is planning to host other events for the financial community in the future.

7 Regulatory Update

Money Market Funds¹

- 7.1 On 4 September 2013, the European Commission published its new rules for all MMFs domiciled, managed or marketed in the European Union. These rules still need to be agreed by both the European Council and European Parliament, which is unlikely to happen before May 2014. However, once agreed, the transition period for the new regulation is only six months.
- 7.2 The key changes published are:
- (a) MMFs will have to hold 10 per cent of their portfolio in assets that mature within a day and a further 20 per cent that mature within one week;
 - (b) a maximum five per cent exposure will be allowed with any single issuer;
 - (c) any funds wanting to remain using Constant Net Asset Valuation (CNAV) will need to hold a capital buffer of three per cent of the fund;
 - (d) MMFs will only be able to buy Asset Backed Commercial Paper backed by short-term debt instruments that have arrived in the course of normal business activity, for example trade receivables; and
 - (e) MMFs will need to implement customer profiling policies to help anticipate any upcoming large redemptions from the fund.

Financial Transactions Tax

- 7.3 Regulatory developments remain ongoing regarding the possible introduction of a Financial Transactions Tax (FTT). Due to the rising number of people expressing concern about FTT any decision about its introduction has been delayed, making it less likely that anything will be implemented for 1 January 2014 and the target date would become 1 January 2015. An introduction of a

¹ Some text was removed from this section after initial publication as it was considered to be market sensitive.

FTT will have an impact on some of TfL's investments as although the UK is not one of the 11 European countries making up the FTT Zone, the market will still be affected.

- 7.4 The FTT would apply to secondary market trades that are negotiable on the capital markets, money market instruments and derivative contracts. The rates to charge have been proposed at 10 basis points on all cash instruments and one basis points on notional for derivatives. The obvious impact of this would be a significant reduction in volume, and therefore liquidity, in the secondary market, which in turn would have an impact on primary issues.
- 7.5 Potential impacts for TfL include, but are not limited to: the rate on Commercial Paper may increase to cover the impact of the tax; MMFs may scale back the liquidity they can offer to clients; and on all transactions, the additional cost would likely be passed on to the clients. FTT could also mean an increased cost of funding for TfL.

European Market Infrastructure Regulation

- 7.6 In August 2012, the European Markets and Infrastructure Regulation (EMIR) came into force as binding law within the European Union. Compliance with the requirements is being phased in over time. A key purpose of EMIR is to reduce systemic risk in the financial markets.
- 7.7 Under EMIR, TfL is classified as a Non-Financial Counterparty (NFC). NFCs that only enter into derivatives contracts that are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the NFC, are exempt from certain requirements under EMIR.
- 7.8 However, for transparency, NFCs must comply with requirements to report to trade repositories and certain requirements for risk-management procedures in relation to non-cleared over-the-counter derivatives (which are not conducted on an exchange).
- 7.9 The risk management requirements that apply to all NFCs are timely confirmation of trades, portfolio reconciliation, dispute resolution procedures and portfolio compression. TfL complied with the risk management requirements in September 2013. The timetable for reporting requirements is not yet certain, but the earliest possible date is currently 12 February 2014. TfL will continue to monitor the reporting requirements and implementation date.

8 Other Activities

Systems

- 8.1 The Treasury Management System continues to meet Group Treasury's requirements and has now been further enhanced to receive electronic statement files from TfL's bankers, ensuring accurate and timely information is used to calculate the cash position of the Group on a daily basis.

- 8.2 A further enhancement to the system is also being investigated whereby bank information can be utilised to compare movements to forecast allowing for daily variance analysis and trends.

Collaboration with Customer Experience

- 8.3 Group Treasury is working with Customer Experience to develop a process whereby London Underground Charter refunds are paid electronically to customers' bank accounts rather than via a paper voucher.
- 8.4 Group Treasury is working with Customer Experience to provide approximately 4,000 contactless procurement cards to be utilised for the pilot of the use of these cards on London Underground.

Collaboration with the Financial Services Centre

- 8.5 It is proposed to collect rent payments via direct debit rather than by multiple channels as at present and Group Treasury is actively involved with the Financial Services Centre (FSC) and Information Management (IM) in the set-up of this payment method. The implementation of direct debit will allow for more accurate cash forecasting and prompt payment of rents due.
- 8.6 The FSC currently operates approximately 300 bank accounts on behalf of Surface Transport in respect of section 278 receipts from third parties. Group Treasury is in the process of implementing specialist bank software to reduce this to a single bank account in order to reduce costs and simplify procedures, while maintaining appropriate segregation functionality.
- 8.7 The FSC currently make multiple electronic payment submissions (BACS) and it is proposed to consolidate these into a single payment run, thereby streamlining current processes. Group Treasury is working with the FSC, IM and TfL's bankers to implement this as soon as possible.

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 2013/14

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