Appendix 2

SOUTH YORKSHIRE MAYORAL COMBINED AUTHORITY

2023/24 Treasury Management Review (Budget Revision 1)

The following report sets out the Authority's performance as at Budget Revision 1 against the indicators and targets set in the 2023/24 treasury management strategy approved by the MCA Board in March 2023.

As stated in the 2023/24 treasury management strategy the quarterly reporting process during the course of the year will, by exception, highlight significant actual or forecast deviations from the approved indicators and targets. Quarterly outturn reports (rather than half yearly) are now a requirement arising from the 2021 Treasury Management Code.

This is the first quarterly performance review. A mid year review will take place at quarter 2 and a third quarterly performance review at Budget Revision 3.

Integration

The dissolution of SYPTE on 31 March 2023, and the transfer of all of its functions, rights, assets and liabilities to the SYMCA with effect from 1 April 2023 has resulted in the novation of ex SYPTE debt to SYMCA on integration along with the liability relating to Doncaster Interchange PFI scheme.

All of the Group's borrowing and other long term liabilities are therefore now consolidated within SYMCA.

Investment strategy

Given the risks and uncertainties in the current economic climate, the Authority's focus will continue to be on maximising returns from traditional types of investment rather than on diversification.

This approach is consistent with the MCA's investment priorities which are: security first, portfolio liquidity second and then yield (return). The MCA will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and within the MCA's risk appetite. One way of doing this is to invest over longer terms in line with medium term forecast to take advantage of stronger returns. This has the added benefit of locking into higher interest rates for longer especially as Link's current interest rate forecasts are predicting a fall in the base rates next year.

Investment Performance

The MCA's treasury advisors Link Group periodically produce interest rate forecasts. The most recent forecast was produced on 26 June 2023, 4 days after the Bank Rate was increased from 4.50% to 5.00%.

The previous interest rate forecasts were produced by Link on 25 May 2023. Table 1 below shows a slight shift in the advisors' view of future rate rises as a result of the latest Bank of England base rate rise, as indicated by the figures in the dark orange row entitled 'Change'.

As shown in the forecast table below, the Bank Rate is expected to increase from the current level of 5.00% announced on 22 June 2023 to 5.50% by September before there is an expected fall in interest rates from June 2024 - assuming that the current levels of inflation are brought under control.

Based on forecast rates in June 2023, returns on investments are therefore expected to improve, at or above 5.6% on investments of shorter duration and at 6.2% on investments of 12 months during 2023 before falling in 2024.

PWLB interest rates on borrowing are expected to remain around 5.0% to 5.3%, depending on the term of the loan, over the next 6 months or so before falling to between 3.1% and 3.6% over the next three years.

Table 1 - Prospects for interest rates

Comparison of forecasts for current Bank Rate v previous forecasts

Bank Rate	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26
26.06.23	5.00	5.50	5.50	5.50	5.25	4.75	4.25	3.75	3.25	2.75	2.75	2.50	2.50
25.05.23	4.75	5.00	5.00	4.75	4.50	4.00	3.50	3.25	2.75	2.50	2.50	2.50	2.50
Change	0.25	0.50	0.50	0.75	0.75	0.75	0.75	0.50	0.50	0.25	0.25	0.00	0.00

Overall return on investments

Forecast outturn performance against the target return on the investment portfolio as a whole set in the Treasury Management Strategy is as follows as at Quarter 1:

Table 2 – Overall returns on investments

Returns on investments	2023/24 Indicator %	2023/24 Quarter 1 %
Target return on treasury investments	2.18	3.70

The weighted average return on investments forecast outturn performance is 1.52% above the target set at the start of the year. This reflects the successive base rate increases over the past 18 months but also since the budget/ strategy was set in March 2023.

The target return should also be exceeded further by year-end if the Bank of England continue to increase base rates although as the table shows the scale and frequency of future rate rises is expected to slow and eventually fall. In addition, the outturn % rate will continue to be dampened down slightly by the investment portfolio still having some fixed investments that were made before the first base rate rise in December 2021.

Table 3 – Return on investments split between short- and long-term

	2023/24 Quarter 1 £'000
L T investments	73,000
S T investments	430,766
All investments	**503,766**
L T investments return	2.95%
S T investments return	4.42%
All investments – weighted average	**3.70%**

Returns on short term investments reflect the rapid rise in the base rate. Moreover, returns should improve further if there are, as predicted, further increases in the base rates.

Returns on long term investments are currently forecast to outturn at 2.95% which is much lower than the average. This is the average return and reflects a number of longer term investments that were taken out prior to the start of the base rate increases (December 2021) and whilst they were higher than the prevailing rates at the time, they now dampen down the overall return. To illustrate this point, rates on fixed term deposits range from 0.25% (a 2 year investment with London Borough of Hillingdon in 2021) to 5.57% (a 6 month deposit with Goldman Sachs in 2023). Clearly the return on long term investments will improve as some of the longer dated investments with the lowest returns mature and we can re-invest at much higher returns.

In conclusion, returns are projected to exceed the budgeted treasury investment income for the year by £4m.

Investment portfolio

The MCA Group has continued to hold a substantial investment portfolio throughout the first half of 2023/24.

At the start of the 2023/24 financial year, the investment portfolio stood at £439.8m and has increased to £503.8m by the end of June 2023. The change is entirely represented by an increase in short term investments.

The increase in the size of the portfolio is due to the inflow of major funding streams which have been received in advance of delivery. These include, for example, 2023/24 Gainshare allocation, devolved Adult Education Budget funding and City Region Sustainable Transport Settlement capital funding which has not yet been defrayed.

Investment portfolio by type of investment

Table 4 - Analysis of investments by type as at Quarter 1

Investments by type	Quarter 1	Mid Year
	Actual	Actual
	£'000	%
Fixed term local authority deposits - long term *	73,000	14%
Fixed term local authority deposits – short term **	157,000	32%
Fixed term bank deposits - short term	100,000	20%
Call accounts	40,000	8%
Money Market Funds	133,766	26%
Total investments	**503,766**	**100%**

*-deposits with 12+ months plus remaining to maturity
**-deposits with less than 12 months remaining to maturity

The MCA Group continues to hold a substantial investment portfolio as it did throughout the 2022/23 financial year.

The MCA's investment portfolio is largely shaped by the timing of funds received (largely grant from Government) and the pace of expenditure. Despite record spending in 2022/23, the MCA slipped significant capital expenditure into this financial year and along with unexpected underspends on revenue activity, there are now very high cash balances. This position has been augmented by significant Government grant receipts during April and May 2023.

This position is largely temporary. In time slipped activity will catch-up and cash balances will begin to fall. The investment portfolio has been reviewed throughout the year to ensure that the length over which investments are placed matches – as far as is possible – medium-term expenditure forecasts, particularly related to the capital programme. As mentioned previously, these reviews have allowed for a reshaping of our portfolio, with more investments placed over a longer term than had been the case at the start of the year.

It is also worth noting that the Money Market Funds, although technically equity instruments, are treated as cash equivalents as they are instant access, very low risk funds with a high credit rating which are subject to only minimal risk of price fluctuation.

Whilst our investment approach has been to move into longer term durations to take advantage of stronger returns, by keeping over a quarter of the MCA's investments in instant access accounts, this gives officers sufficient flexibility to take advantage of high yield offers in future especially as further base rates are predicted.

Longer term investments of more than 365 days

The table below summarises the current level of longer term investment instruments against the maximum limit approved in the 2023/24 Treasury Management Strategy.

As at the end of June 2023, there were fixed term deposits with a duration of more than 365 days (from 1 July 2023) of £73m.

Table 5 – Investments greater than 365 days

Investment greater than 365 days	2023/24 Estimate £m	2023/24 Quarter 1 £m
Maximum - end of the year	£144	£144
Existing long term investments	£33	£73
Balance available to invest	**£111**	**£71**

All of the longer term investments are fixed term deposits held with local authorities.

Security

The risk of default in respect of the current narrow range of investment types is considered to be very low (potential default risk is assumed to be zero on local authority deposits and was estimated to be c. 0.014% in respect of reputable banks with a high credit rating based on historic default rates.

This is considered an acceptable level of risk against an investment portfolio of £503.8m as at 30 June 2023.

Liquidity

The 2023/24 Treasury Management Strategy stated that a balance of £25m should be maintained in highly liquid instant access investments / the bank in order to manage day to day treasury activity. This relatively high balance is considered necessary given the uncertainty of the timing of expenditure on the MCA's major capital investment programmes and major initiatives that the MCA is responsible for delivering.

The £25m minimum threshold has been maintained throughout the year to date.

Borrowing Strategy

On 23 March 2022, the Combined Authority (Borrowing Powers) Regulations 2022 came into force, thus conferring on the South Yorkshire Mayoral Combined Authority the same borrowing powers as its constituent member authorities. However, unlike other constituent member authorities the MCA's ability to borrow is subject to an annual agreement on an aggregated 'debt-cap' with Government. Each year the MCA submits a request to HM Treasury, with that cap reviewed against appropriateness and affordability. Whilst the MCA has no new plans to borrow for expenditure it has sought a cap that would afford it headroom to take on borrowing if a suitable investment opportunity arose. The MCA's debt-cap is based on the capital finance requirement (CFR) and for 2023/24 is held at £209m. This cap level provides headroom for additional debt of c. £86m in 2023/24. This headroom is more than sufficient to meet known and potential investment requirements.

The current borrowing strategy is to meet any borrowing need for the year internally from treasury investments rather than taking out external borrowing. This is in the expectation that the cost of new borrowing will continue to exceed likely investment returns.

By way of example, the latest fixed term PWLB rates at the end of June 2023 range from 6.3% for 'short term' borrowing (1 year) to 5.8% (5 years) to 5.35% (10 years and 30 years) to 5.1% for 50 year borrowing.

By comparison, our treasury advisors have suggested that returns on short term investments of three months duration are currently in the region of 5.4% but are forecast to fall to 4.3% in 2024/25 and 2.7% in 2025/26. Hence, the differential between borrowing rates and returns on investment remains such that the cost of borrowing remains higher than returns on investments.

In addition, the current strategy is to repay debt as it falls due rather than to refinance debt. This assumption has been built into the medium term financial strategy, resulting in a projected fall in debt servicing costs as debt is repaid.

The borrowing strategy also seeks to take the opportunity to reschedule existing debt where this will lead to an overall saving. This has now become a real prospect as borrowing rates have increased and we are now actively investigating the cost benefit analysis of repaying some of the MCA's debt early. This is covered in more detail later on in the report.

Capital Financing Requirement (CFR) estimates

There has been a significant increase in the size of the 2023/24 capital programme since the capital estimates indicator was set in the 2023/24 treasury management Strategy.

The expansion in the size of the programme has been met by a corresponding increase in the capital resources available to fund it.

As a consequence, as illustrated in the table below as at the end of Quarter 1, it remains the case that the MCA has no underlying need to borrow to fund its programmed capital investment in 2023/24.

Group Capital Financing Estimates	2022/23	2023/24	2023/24
	Outturn	Original Estimate	Rev 1 - Revised Estimate
	£m	£m	£m
Total capital investment	£112	£153	£186
Total capital funding	**£112**	**£153**	**£186**
Net borrowing needed for the year	**£0**	**£0**	**£0**

Table 6 – Capital Financing Requirement

Group Capital Financing Requirement	2022/23	2023/24		2023/24	
	Outturn	Original Estimate		Rev 1 - Revised estimate	
	Loans	Loans	OLTL	Loans	OLTL
	£m	£m	£m	£m	£m
Opening CFR	**£110**	**£107**	**£0**	**£107**	**£0**
Opening adjustment - PTE CFR on integration				**£6**	
Opening adjustment - Doncaster Interchange PFI			**£10**		**£10**
Implementation of IFRS 16					
movement in CFR					
Additional borrowing requirement	0	£0	£0	£0	£0
MRP	-£3	-£3	-£0	-£4	-£0
Capital receipts set aside for the repayment of debt	£0	£0	£0	£0	£0
Other adjustments	£0	£0	£0	£0	£0
Closing CFR	**£107**	**£104**	**£10**	**£109**	**£10**

The opening adjustment of £6m in respect of the PTE CFR has crystallised as a consequence of integration on 1 April 2023. Intercompany capital financing arrangements between the MCA and SYPTE put in place in 2013/14 and 2014/15 sought to transfer all of the underlying need to borrow (Capital Financing Requirement) to the MCA. Whilst this successfully transferred £103.4m of the underlying need to borrow, integration has identified that a £6m residual Capital Financing Requirement remains within SYPTE.

The Prudential Code recommends that borrowing and other long-term liabilities (OLTL) are distinguished from one another in order to relate prudential indicators directly to the Balance Sheet. Accordingly, Doncaster Interchange PFI liability has been included in the table above under other long term liabilities from 2023/24 to better comply with the requirements of the Prudential Code.

<u>Amount of external debt against the Capital Financing Requirement (CFR)</u>

The purpose of this indicator is to assess the extent to which borrowing is only being used in the medium to longer term to finance capital expenditure.

Table 7 – Group external borrowing

Group external borrowing	2022/23	2023/24		2023/24	
	Actual	Original Estimate		Rev 1 - revised estimate	
	Loans	Loans	OLTL	Loans	OLTL
	£m	£m	£m	£m	£m
MCA Loans - start of the year	£25	£117		£117	
Expected change in MCA Loans	£0	-£50		-£50	
SYPTE Debt - start of the year	£100				
Expected change in SYPTE Debt	-£8				

Doncaster Interchange PFI - start of the year			£10		£10
Expected change in PFI liability			-£0		-£0
Implementation of IFRS 16					
Gross Debt - end of the year	**£117**	**£67**	**£10**	**£67**	**£10**
Capital Financing Requirement	£107	£104	£10	£109	£10
Gross Debt in excess of / (less than) CFR	**£11**	**-£37**	**£0**	**-£42**	**£0**

The benchmark recommended by CIPFA is that the estimated amount of gross debt should not exceed the estimated CFR for the current and following two years.

Historically, gross debt has exceeded CFR is due to the fact that historic debt taken out in the 1990s has only recently started to be repaid whereas over the same period MRP has been charged annually to the transport levy to write down the CFR.

However, as this debt is now starting to mature the level of gross debt is falling. Further substantial loan repayments of £50m due to be made in 2023/24 will result in gross debt falling below CFR from 2023/24 onwards. The extent to which CFR exceeds gross debt in 2023/24 has been revised at Budget Revision 1 to reflect the additional £6m CFR that has crystallised on integration.

The loan repayments included in Table 7 are based on the assumption that loans are repaid as they fall due.

<u>Debt Rescheduling / Early Repayment</u>

The recent increase in interest rates means that, for the first time since the financial crisis in 2008, the opportunities for debt rescheduling are becoming more realistic.

Hence, for example, PWLB rates for early repayment at the end of June 2023 ranged from 5.30% short term borrowing (1 year) to 4% for long term borrowing (50 years). These rates are therefore starting to approach the rates on the Group's existing PWLB debt portfolio which range from 4.25% to 8.50%.

The interest rates on the Group's market loans range from 4.50% to 4.95%. As these remain above the prevailing rates used by the market to price borrowing it is considered unlikely that the lender would exercise their call option at this stage. However, the risk of them being called is now greater than it has been for some time. Were this to be the case, as the interest rates on new PWLB borrowing at the end of June 2023 were in the range 6.4% short term to 5.4% long term, there may be a need to manage the cash position by avoiding taking out new borrowing and drawing down on investments instead until rates for new borrowing become more favourable.

In light of the changed environment, officers are undertaking a cost benefit analysis in consultation with the Authority's treasury advisors to ascertain whether there is any merit in repaying loans early.

The prospect of refinancing or paying off early some of the underlying PFI debt relating to Doncaster Interchange in order to reduce future unitary payments over the remainder of the PFI term is discussed at the regular review meetings with the PFI Operator. No such opportunities have presented themselves to date.

<u>Financing Costs</u>

The affordability of decisions taken to finance capital investment is assessed by the ratio of Financing Costs to Net Revenue Stream.

As illustrated in the table below, the ratio of financing costs to net revenue stream continues to fall.

This is due to a combination of the repayment of borrowing which is reducing the amount of interest payable coupled with an increase in treasury investment income generated through the rising Bank Rate and additional cash held on deposit.

The Rev 1 revised estimate reflects the fact that interest on ex SYPTE debt is forecast fall from £5.4m in 2022/23 to £3.2m in 2023/24 as a consequence of £8m of borrowing being repaid in 2022/23 and a further £46.4m due to be repaid in 2023/24.

The Rev 1 revised estimate for other unrestricted income includes £7m of projected treasury investment income which is £4m higher than budget.

Table 11 – Financing costs

Ratio of financing costs to net revenue streams	**2022/23**	**2023/24**	**2023/24**
	Actual	**Original Estimate**	**Rev 1 - revised estimate**
	£m	**£m**	**£m**
Interest	£8	£5	£5
MRP	£3	£4	£4
Financing Costs	**£11**	**£9**	**£9**
Income - transport levy	£54	£55	£55
Other unrestricted income	£21	£20	£23
Net Revenue Stream	**£76**	**£75**	**£78**
Finance Costs/net Revenue Stream	15%	12%	12%