Appendix 2

SOUTH YORKSHIRE MAYORAL COMBINED AUTHORITY

2023/24 Treasury management review (Budget Revision 2)

The following report sets out the Authority's performance as at the mid-year point 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 second quarterly performance review.

A mid-year Treasury Management Report will be taken to Audit, Standards and Risk Committee on 13 December 2023.

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 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.

As the latest predictions are that the Bank of England base rate has now peaked or is close to peaking, the investment strategy is refocussing on taking out longer-term investments to lock into the higher interest rates currently available and provide budget certainty on the level of investment returns over the medium term.

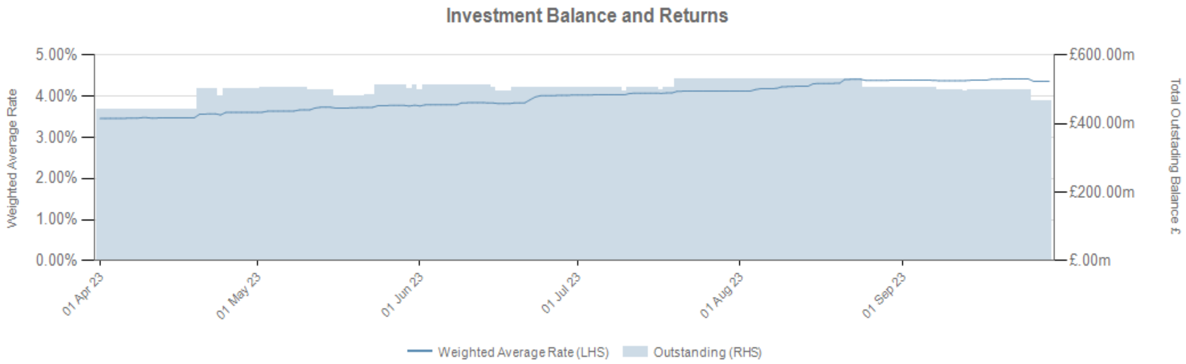
Investment portfolio

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

As at the end of Q2 (as illustrated in Table 2 below), the investment portfolio stood at £464.8m. This compares to £439.8m at the start of the 2023/24 financial year and £503.8m at the end of Q1.

The weighted average level of investments over the 6 months to September 2023 was £500m – see Table 1 below

Table 1 – Investment balances and returns over the 6 months to September 2023



Investment portfolio by type of investment

Table 2 - Analysis of investments by type

Investments by type	Quarter 1 Actual £'000	Quarter 2 Actual £'000	Mid-Year Actual %
Fixed term local authority deposits - long term *	123,000	113,000	24%
Fixed term local authority deposits – short term **	107,000	107,000	23%
Fixed term bank deposits - short term	100,000	100,000	22%
Call accounts	40,000	40,000	9%
Money Market Funds - Low volatility	133,766	104,766	22%
Total investments	**503,766**	**464,766**	**100%**

*-deposits with original term of 12+ months
**-deposits with original term of less than 12 months

The MCA's investment portfolio is largely shaped by the timing of funds received (largely grant from Government) and the pace of related expenditure. Despite record spending in 2022/23, the MCA slipped significant capital expenditure into 2023/24 along with unexpected underspends on revenue activity. This led to capital grant of £264m being carried forward from 2022/23 to 2023/24.

In addition, there has been an 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.

The combination of these factors has led to a substantial investment portfolio being maintained in the first half of 2023/24.

The high level of investments is largely temporary. In time, as activity is delivered, cash balances will fall as investments are drawn down to fund this activity.

The investment portfolio is being kept under review to ensure that the length over which investments are placed is commensurate – as far as is possible – with 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 – see Table 3 below

Table 3 – Investments Greater than 365 days

Longer Term Investments greater than 365 days	Quarter 1 Actual £m	Quarter 2 Actual £m
Maximum	£144	£144
Existing long term investments	£123	£113
Balance available to invest	£21	£31
Total Investment Portfolio (Long term and Short term)	**£504**	**£465**
Long Term Investments as a % of total investment portfolio	**24.4%**	**24.3%**

All longer term investments are fixed term deposits held with local authorities

The returns on short term investments, most notably instant access Money Market Funds, have seen marked increases in returns as they tend to track changes to the Bank of England base rate. As a consequence, returns on Money Market Funds have increased from c. 4.1% at the start of 2023/24 to 5.30% at the end of September 2023 following the increase in the base rate to 5.25% on 3 August 2023. Retaining a significant proportion of the MCA's investments in MMFs at present provides an opportunity to generate higher returns whilst retaining liquidity, and, providing flexibility to take advantage of high yield offers in the future as they arise.

<u>Investment Performance</u>

Performance against the target return set in the Treasury Management Strategy is as follows as at Quarter 2:

Table 4 – Overall returns on investments

Returns on investments	2023/24 Target %	2023/24 Quarter 1 %	2023/24 Quarter 2 %
Return on treasury investments	2.18	3.7	4.0

As illustrated above, the weighted average return on investments for the 6 months to September 2023 is now 4.0%. This reflects the increase on returns from 3.5% at the start of the 2023/24 financial year to 4.5% at the end of September. This has tracked the increase in the Bank of England base rate which has increased from 4.25% to 5.25% over the same period.

The target for 2023/24 of 2.18% was set against a backdrop of a weighted average return on investments in 2022/23 of 1.88%. Returns were dampened down due to a significant number of fixed term investments being made before the first base rate rise in December 2021. Whilst these were higher than the prevailing base rates at the time, they are now much lower than the prevailing rate. This is illustrated in Table 5 below

Table 5 – Return on Investments split between short- and long-term

	2023/24	2023/24

	Quarter 1 £'000	Quarter 2 £'000
L T investments	£123,000	£113,000
S T investments	£380,766	£351,766
All investments	**£503,766**	**£464,766**
L T investments return	2%	2%
S T investments return	4%	6%
All investments – weighted average	**4%**	**4%**

The continued unwinding of these long-term investments in the second half of 2023/24 will improve performance as some of the longer dated investments with the lowest returns mature and we can re-invest at much higher returns.

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

Prospects for Interest Rates

The MCA's treasury advisors Link Group periodically produce interest rate forecasts.

Their most recent forecast following the increase in the Bank of England base rate to 5.25%, is that the base rate will remain at this level until June 2024 and will only start to fall incrementally thereafter. The judgement that interest rates have plateaued is finely balanced and there is still perceived to be a prospect that the rate might still increase to 5.5%.

Based on this assumption target returns on investments are expected to remain at or slightly above the base rate of 5.25% over the period to June 2024, falling only incrementally thereafter to c.4% by the end of 2024/25.

Investment Performance – Overall Conclusion

Based on the returns made in the 6 months to September 2023 and future prospects for interest rates over the remainder of the financial year, it is now expected that treasury investment income for the year will amount to £17m.

<u>Security</u>

To minimise the risk of default, investments made in the first half of 2023/24 have complied with the creditworthiness policy adopted by the MCA's treasury advisors.

Investments have been made with local authorities (on which the potential default risk is assumed to be zero) and in banks with a high credit rating (default risk at or below c. 0.014%).

For the sake of clarity, there have been no commercial investments made in the first half of 2023/24, ie 'investments taken or held primarily for financial return and not linked to treasury management activity'.

<u>Liquidity</u>

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.

In practice, a balance of £10m has been maintained throughout the year to date. This is invested overnight in an interest bearing current account.

Borrowing Strategy

The borrowing strategy for the existing debt portfolio has been for many years - and continues to be - 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. Historically, under the previous low interest rate environment, the cost of repaying debt early was prohibitively high. However, as the base rate has risen to 5.25% it has made early repayment much more economic. As reported at Q1, as a consequence of this changing scenario, the MCA has been actively investigating the cost benefit analysis of repaying some of the MCA's debt early. This has led to £20m of market loans (LOBOs) being repaid early in Q2 (see section below on early repayment for further detail).

The Combined Authority (Borrowing Powers) Regulations 2022 which came into force in March 2022, confer 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. The MCA's debt-cap for 2023/24 is held at £209m. This cap level provides headroom for additional debt of c. £90m in 2023/24. This headroom provides flexibility to meet known and potential investment requirements. As things stand currently, the 2023/24 capital programme is fully financed so there are no plans for any new borrowing requirements in the current year.

The combination of the early repayment of £20m market loans plus scheduled repayment of £43.5m of PWLB debt together with the absence of any new borrowing requirements means that the MCA is now in an under-borrowed position as illustrated in Table 6 below. The strategy is to meet this borrowing requirement internally from treasury investments in the short to medium term rather than taking out external borrowing. This is because PWLB rates are forecast to fall from their current rates of between 5 and 5.5% (depending on duration) to between 3.8% and 4.1% by September 2025 so should a borrowing need arise it is preferable to defer taking out borrowing for the next 2 to 3 years.

Amount of external debt against the Capital Financing Requirement – under/overborrowing

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 6 – Group external debt against CFR (under/overborrowing)

Group external borrowing	2022/23	2023/24					
	Actual	Original Estimate		Rev 1 - revised estimate		Rev 2 - revised estimate	
	Loans	Loans	OLTL	Loans	OLTL	Loans	OLTL
	£m	£m	£m	£m	£m	£m	£m
MCA Loans - start of the year	£25	£117		£117		£117	
Expected change in MCA Loans	£0	-£50		-£50		-£70	
SYPTE Debt - start of the year	£100						
Expected change in SYPTE Debt	-£8						
Doncaster Interchange PFI - start of the year			£10		£10		£10
Expected change in PFI liability			-£0		-£0		-£0
Implementation of IFRS 16							

Gross Debt - end of the year	**£117**	**£67**	**£10**	**£67**	**£10**	**£47**	**£10**
Capital Financing Requirement	£107	£104	£10	£109	£10	£109	£10
Over / (under) borrowing	**£11**	**-£37**	**£0**	**-£42**	**£0**	**-£62**	**£0**

The increase in the forecast level of under-borrowing in 2023/24 is as a result of the £20m of market loans being repaid early in Q2.

The level of under-borrowing thereafter is forecast to remain broadly constant at c.£62m over the three years to 2026/27.

In 2027/28, a further £22m of PWLB debt is scheduled to be repaid (see Table 7 Maturity of Group Borrowing below). This will increase the level of under-borrowing to c. £80m. It is then forecast to step down to c.£77m in 2030/31, at which point all of the external debt will have been repaid with the exception of one PWLB loan of £5m which is scheduled to be repaid in 2051/52.

From 2031/32, the amount of under-borrowing is expected to fall by £30m over the 10 years to 2040/41.

The under-borrowed position is considered sustainable, at least in the short to medium term, as the MCA group had reserves of £118m (£100m revenue and £18m capital) and capital grant unapplied of £264m at the end of 2022/23.

Debt Rescheduling / Early Repayment

As noted above, the rise in the base rate to 5.25% has meant that early repayment has become an economic prospect for the first time since the global financial crisis in 2008 due to the rate being comparable with the MCA's market loans which ranged from 4.50% to 4.95%.

A cost benefit exercise was therefore undertaken with the MCA's treasury advisors on whether it would be economically beneficial to repay the loans early.

The results of this exercise were that there was a net benefit to the MCA from repaying the market loans early in present value terms. This involved paying a premium of £2.784m in order to create annual interest savings of £945k p.a. In accordance with local authority capital finance and accounting regulations, the cost of the premium will be charged over a 30 year period at an annual cost of c. £100k p.a.

Early repayment also de-risks the impact of the market loans being called at a time when interest rates are higher than the rates of 4.50% to 4.95% over the unexpired 30 year term of the loans which would have resulted in higher debt interest charges in the future.

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.

Maturity profile

The maturity profile of the remaining debt has changed significantly as a consequence of the early repayment of the market loans as illustrated below.

Table 7 – Maturity profile of borrowing

Maturity of Group borrowing:	2022/23		2023/24 Rev 2	
	£m	%	£m	%
2023/24	50	43%	70	60%
2024/25	4	3%	4	3%
2025/26	4	3%	4	3%
2026/27	4	3%	4	3%
2027/28	22	19%	22	19%
2028/29	0	0%	0	0%
2029/30	4	3%	4	3%
2030/31	4	3%	4	3%
2043 to 2056	25	21%	5	4%
Total	**£117**	**100%**	**£117**	**100%**

Financing Costs

The annual interest cost of the £20m market loans was £945k.

The interest in 2023/24 as a consequence of early repayment is £391k giving an in year saving of £554k against the £945k. This is offset by an additional charge of £93k for the amortisation of the premium on early redemption giving a net saving a net saving of £461k in 2023/24.

Thereafter the annual interest saving will be £945k offset by an additional annual charge of £93k p.a for the amortisation of the premium on early redemption, ie a net saving of £852k p.a

In addition to the annual savings on interest, a one off windfall gain of £865k has arisen on early repayment of the market loans due to the way in which interest on LOBOs is accounted for at its effective rate.

In addition to the lower cost base relating to capital financing, as noted above in relation to investment performance treasury investment income is now projected to be £17m in 2023/24 - £10m higher than that forecast at Rev 1.

The impact on the ratio of financing costs to net revenue stream of a reduction in debt financing costs and increase in treasury investment income is illustrated in Table 8 below

This has had the effect of reducing finance costs as a proportion of net revenue stream to 9% at Rev 2.

Table 8 – Financing Costs

Ratio of financing costs to net revenue streams	2022/23 Actual £m	2023/24 Original Estimate £m	2023/24 Rev 1 - revised estimate £m	2023/24 Rev 2 - revised estimate £m
Interest	8.00	5.00	5.00	4.00
MRP	3.00	4.00	4.00	4.00
Financing Costs	**11.00**	**9.00**	**9.00**	**8.00**
Income - transport levy	54.00	55.00	55.00	55.00

Other unrestricted income	21.00	20.00	23.00	33.00
Net Revenue Stream	**76.00**	**75.00**	**78.00**	**88.00**
Finance Costs/net Revenue Stream	15%	12%	12%	9%