APPENDIX 2

SHEFFIELD CITY REGION MAYORAL COMBINED AUTHORITY

Investment strategy

The investment strategy agreed at the start of the year set out the intention to look at options to diversify the investment portfolio in view of the availability of core funds over the longer term to seek better returns on investments, whilst paying due regard to security, liquidity and yield.

This was before the advent of the Coronavirus pandemic.

The greatly increased uncertainty this has brought about has meant that, for the time being at least, the MCA has continued with its existing prudent approach to managing its investment portfolio. This entails investing in a relatively narrow range of financial instruments with highly rated counterparties, namely:

- Fixed term deposits with local authorities through the local authority to local authority market
- Call accounts with reputable banks with a high credit rating, and
- Low volatility low risk highly liquid Money Market Funds which provide for instant access.

The MCA Group follows statutory MHCLG investment guidance and CIPFA recommended good practice in placing a high priority on the prudent management of risk by prioritising security and liquidity over maximising returns.

Expected return on Investments.

The expected return on investments at the time that the 2020/21 Treasury Management strategy was agreed were as follows:

Average earnings in each year	
2020/21	0.75%
2021/22	1.00%
2022/23	1.25%
2023/24	1.50%
2024/25	1.75%

The landscaped has completely transformed since and our treasury advisors are now suggesting that the target performance for relatively short term investments of three months duration is as follows:

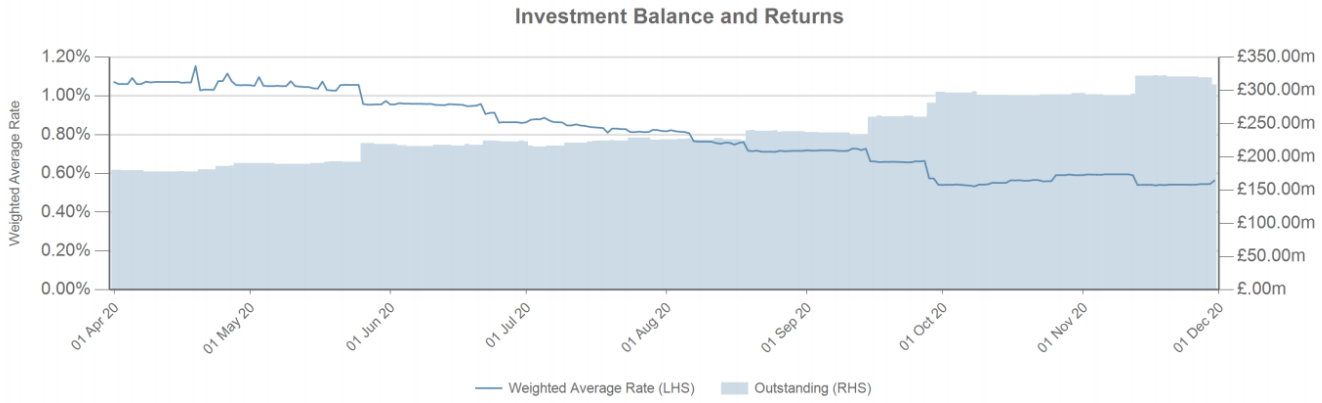
Average earnings in each year	
2020/21	0.10%
2021/22	0.10%
2022/23	0.10%
2023/24	0.10%
2024/25	0.25%

Current investment portfolio

The SCR Group has continued to hold a substantial investment portfolio throughout the 2020/21 financial year up to and including November 2020.

As illustrated below, core funds have increased from £217m at the end of March 2020 to £308m at the end of November 2020.

The increase in core funds is primarily of a temporary nature reflecting the inflow of funding relating to LGF, Gainshare, Getting Building Fund, Transforming Cities Funding, South Yorkshire transport capital funding which has not yet been defrayed.



Longer term investments of more than 365 days

Whilst much of the increase in core funds is of a temporary nature, some of them are longer term, principally those relating to funds being built up to repay MCA Group debt as it falls due.

This allows some of the investment portfolio to be invested longer term which has helped secure much better returns than those available on short duration investments.

The table below summarises the current level of longer term investment instruments in absolute terms and as a percentage of the total investment portfolio against the maximum approved in the 2020/21 Treasury Management Strategy as at the end of November 2020.

Investment greater than 365 days	**2020/21 Indicator £'000**	**2020/21 Period 8 £'000**
Total core funds - maximum available	£113,400	£113,400
Existing long term investments	£60,000	£75,000
Balance available to invest	£53,400	38,400
As a % of total investment portfolio	**75.0%**	**24.3%**

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

Overall return on investments

Performance against the target return on the investment portfolio as a whole set in the Treasury Management Strategy is as follows for the year to date up to and including November 2020:

Returns on investments	**2020/21 Indicator %**	**2020/21 Period 8 %**
Target return on treasury investments	1.4	0.77

Whilst performance for the year to date is less than the target set at the start of the year it is nevertheless still considerably higher than the revised target for 2020/21 of 0.1% suggested by the MCA's treasury advisors.

This has been achieved because of the significantly higher returns being earned on longer term investments. This is illustrated in the table below which shows the average return on investments on a quarterly basis together with the average level of investments:

	2020/21		
	Q1	Q2	Period 8
	£'000	£'000	£'000
L T investments	65,000	60,000	75,000
S T investments	133,760	174,885	226,547
All investments - weighted average	**198,760**	**234,885**	**301,547**
L T investments return	2.155%	2.160%	1.855%
S T investments return	0.448%	0.271%	0.132%
All investments – weighted average	**1.006%**	**0.754%**	**0.561%**

The table clearly illustrates the declining returns being earned on short term investments which have fallen from 0.448% on average in Q1 to 0.132% in Period 8.

Security

The 2020/21 Treasury Management Strategy permitted in principle that there be a limited relaxation of the criteria for investing with counterparties (duration and type of investment) in order to progress the diversification of the portfolio outside the current narrow range of investment types.

The continuation of the existing prudent approach to managing the investment portfolio has meant it has not been necessary to consider such a relaxation to date.

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 estimated to be c. 0.013% in respect of reputable banks with a high credit rating based on historic default rates).

Liquidity

The 2020/21 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 (for example the £30m Tier 3 business assistance scheme) that the MCA is responsible for delivering.

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

Borrowing Strategy

The borrowing strategy currently relates solely to the transport functions of the MCA pending powers being granted to enable borrowing to be taken out in respect of its LEP functions.

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

On 26 November 2020 the Government introduced changes to the terms under which it provides Public Works Loan Board (PWLB) loans to local authorities. This resulted in a 1% cut in the interest rate payable on new loans taken out with effect from 26 November onwards. This has meant that, where previously, PWLB rates were in the range of 2% for loans of 1 year rising to 3% for 25 year borrowing, they are now available in the range between 0.95% and 1.90%.

However, as noted in the section above on investment strategy, there has been a substantial fall in the expected returns on short duration investments to 0.1%

Hence, the strategy agreed at the start of the financial year still remains valid and is likely to remain so for the short to medium term at least, whilst ever returns are forecast to stay at the current historic low level of c. 0.1%

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 financial plans resulting in a projected fall in debt servicing costs as debt is repaid.

The strategy also seeks to take opportunity to reschedule existing debt where this will lead to a net benefit. However, for the reasons described further on in this report it is considered very unlikely that any such opportunities will arise.

Capital Financing Requirement (CFR) estimates

The table below shows how planned capital expenditure was expected to be financed at the start of the financial year and the latest current forecast as at Period 8.

2. Capital Financing Requirement Estimates	**2020/21**	**2020/21**
	Indicator	**Period 8**
	£'000	**£'000**
South Yorkshire Transport Programmes:		
Government Grants	£54,809	£115,056
Borrowing	£5,279	£0
Capital Receipts	£0	£0
Earmarked reserves	£664	£0
Revenue contributions	£588	£0
	£61,340	**£115,056**
Local Growth Fund Programme:		
Government Grant	£60,400	£18,000
	£60,400	**£18,000**
Corporate	£0	£0
	£0	**£0**
Net borrowing needed for the year	**£5,279**	**£4,707**

Any capital expenditure not funded by capital grants, capital receipts, or revenue contributions, results in a need for borrowing.

The borrowing need for 2020/21 of £5.279m as originally approved comprised £4.235m for re-railing and £1.043m towards the M1 junction 31 Highways Improvement scheme which Barnsley MBC are funding from their share of the BDR capital pot.

In the event, Barnsley accelerated their draw down from the BDR capital pot in 2019/20 which means that there is only £472k remaining to be drawn down in 2020/21.

The overall borrowing requirement after allowing for the additional borrowing need of £5.279m remains within the overall amount approved by the MCA in 2018/19 to borrow up to £23.3m to support capital investment on South Yorkshire transport schemes (Rotherham Interchange, re-railing and the BDR capital pot).

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The forecast change in the underlying need to borrow or Capital Financing Requirement (CFR) in 2020/21 is as follows:

Capital Financing Requirement	**2020/21**	**2020/21**
	Indicator	**Period 8**
	£'000	**£'000**
Opening CFR	£115,603	£116,054
movement in CFR		
Additional borrowing requirement	£5,279	£4,707
Amounts set aside from revenue for the repayment of debt (MRP)	-£4,022	-£3,647
Capital receipts set aside for the repayment of debt	£0	£0
Other adjustments	£0	£0
Closing CFR	**£116,860**	**£117,114**

The lower than budgeted charge for MRP is due to a reprofiling of MRP in relation to Rotherham Interchange.

<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.

CURRENT BORROWING POSITION	**2020/21**	**2020/21**
	Indicator	**Period 8**
	£'000	**£'000**
External Debt		
-MCA Loans at 1st April / 30 November	£25,660	£25,660
-Expected change in MCA Loans	£0	-£660
-SYPTE Debt at 1st April / 30 November	£161,375	£123,375
-Expected change in SYPTE Loans	-£53,000	-£15,000

Gross Debt	**£134,035**	**£133,375**
The Capital Financing Requirement	£116,860	£117,114
Debt in excess of CFR	**£17,175**	**£16,261**

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.

The reason why gross debt is in excess of 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.

This situation is now starting to rebalance as debt matures and significant loan repayments are being made. Hence, the £53.6m of loan repayable in 2020/1 has reduced the amount by which debt exceeds CFR from £71m in 2019/20 to £16m in 2020/21.

Further substantial loan repayments will be made as debt matures as illustrated in the table below. This will bring gross debt below the CFR.

Maturity of borrowing:	**Amount**	
	£'000	**%**
2020/21	53,000	28%
2021/22	7,975	4%
2022/23	8,000	4%
2023/24	50,400	27%
2024/25	4,000	2%
2025/26	4,000	2%
2026/27	4,000	2%
2027/28	22,000	12%
2028/29	0	0%
2029/30	4,000	2%
2030/31	4,000	2%
2043 to 2056	25,000	13%
Total	**£186,375**	**100%**

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

The interest rates on the existing debt portfolio ranges from 4.25% to 8.50%.

Following the government's introduction of the new lending terms for PWLB interest rates for new borrowing are in the range in the range between 0.95% and 1.90%. The interest rates for premature repayment which might facilitate rescheduling or early repayment of existing debt are c. 1% lower than this in the range -0.2% to 0.8%.

The differential between the rates on the existing debt portfolio and premature repayments determine what premium would be incurred from rescheduling or repaying debt early.

The size of the differential at present means that cost of premature repayment will far outweigh any potential gain. There is therefore little realistic prospect of repaying PWLB debt early in the current environment.

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.

Borrowing limits

There are two indicators on borrowing limits: the authorised limit and operational boundary

The authorised limit represents a control on the maximum amount of debt that can be borrowed for capital investment and temporary cash flow purposes. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the long term. The authorised limit allows £40m headroom over the maximum expected amount of gross debt in the year.

The operational boundary is the maximum amount of money that the MCA group expects to borrow during the financial year. It acts as a useful warning if breached during the year that underlying spend may be higher than expected or income lower than budgeted. The operational boundary allows for £25m headroom.

Authorised Limit	2020/21	2020/21
	Indicator	Period 8
	£'000	£'000
Loans	£228,500	£228,500
Other Long Term Liabilities - PFI	£11,500	£11,500
Total	£240,000	£240,000
Operational Boundary	2020/21	2021/22
	Indicator	Period 8
	£'000	£'000
Loans	£213,500	£213,500
Other Long-Term Liabilities - PFI	£11,500	£11,500
Total	£225,000	£225,000

The amount of external debt at the end of Period 8 stood at £149m and is forecast to fall to £133m by the end of the financial year.

No temporary revenue borrowing has been necessary or is anticipated.

The PFI liability is on profile to fall by £0.246m in 2020/21 from its current balance of £11.019m.

Hence, for the year to date, borrowing is well within the Authorised Limit and operational Boundary approved at the start of the year, and, no changes are required.

Financing Costs

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

As illustrated below the latest forecast outturn position at Period 8 shows financing costs of 22.1% to be within the ratio approved at the start of the year. It represents a marked reduction against the comparative figure for 2019/20 of 25.8% due to interest savings of £3.6m being made as a consequence of £53m of debt being repaid in 2020/21.

Ratio of financing costs to net revenue streams	2020/21 Indicator £'000	2020/21 Period 8 £'000
Interest	£9,541	£9,572
MRP	£4,022	£3,647
Less Investment Income	-£1,274	-£1,197
Net Financing Costs	**£12,289**	**£12,022**
Income - transport levy	£54,365	£54,365
Finance Costs/Unrestricted Revenue Income %	22.6%	22.1%

Managing exposure to the risk of interest rate changes

Borrowing

The MCA Group's debt portfolio as at Period 8 comprises the following :

Gross Debt	Period 8 Actual £'000	Period 8 Actual %
Fixed rate PWLB	128,375	80
Market loans	20,000	12
Other loans	660	1
Doncaster PFI	11,019	7
Total	**160,054**	**100**

All of the PWLB debt is fixed rate. As such there is no risk to the amount of interest payable from interest rate fluctuations. The interest payable is therefore a function of the maturity profile and future interest can be forecast accurately.

The £20m of market loans include an option for the lender to change the interest rate periodically on specified call dates, typically every 6 months. As the interest rates currently being paid on these loans range from 4.50% to 4.95% it seems most unlikely in the current low interest rate environment that the option will be exercised. Future interest can therefore be forecast with a good degree of certainty.

Investments

The table overleaf shows the analysis of investments by investment type at Period 8.

Investments by investment type	Period 8	Period 8
	Actual	Actual
	£'000	%
Fixed term local authority deposits - long term	75,000	24
Fixed term local authority deposits – short term	35,000	11
Call accounts	60,000	20
Money Market Funds	138,605	45
Total investments	**308,605**	**100**

The strategy is to move money out of Money Market Funds into other types of investment as soon as possible as the returns being offered on MMFs are now very low.

This strategy is however being hampered by the fact that the local authority to local authority market for deposits of longer duration remains suppressed due to the amount of Government funding being pumped into local authorities to support their response to Covid.

It is 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.