Appendix 2

SOUTH YORKSHIRE MAYORAL COMBINED AUTHORITY

Investment strategy

The 2020/21 investment strategy 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.

Investment Performance

At the time that 2021/22 Treasury Management Strategy was agreed, the prospects for returns on investment were very poor, with no increase anticipated on the prevailing returns up to and including the end of 2023/24. Target returns ranged from 0.10% to 0.20% for short term investments of three to twelve months duration.

However, since then, as illustrated in the table below, the prospects have improved a little.

Table 1 - Prospects for interest rates

Link Group Interest Rate View 29.9.21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
BANK RATE	0.10	0.10	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.75
3 month ave earnings	0.10	0.10	0.20	0.20	0.30	0.40	0.50	0.50	0.60	0.70
6 month ave earnings	0.20	0.20	0.30	0.30	0.40	0.50	0.60	0.60	0.70	0.80
12 month ave earnings	0.30	0.40	0.50	0.50	0.50	0.60	0.70	0.80	0.90	1.00
5 yr PWLB	1.40	1.40	1.50	1.50	1.60	1.60	1.60	1.70	1.70	1.70
10 yr PWLB	1.80	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.10
25 yr PWLB	2.20	2.20	2.30	2.30	2.40	2.40	2.40	2.50	2.50	2.60
50 yr PWLB	2.00	2.00	2.10	2.20	2.20	2.20	2.20	2.30	2.30	2.40

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 as at Mid Year:

Returns on investments	**2021/22 Indicator** %	**2021/22 Mid Year** %
Target return on treasury investments	0.7	0.43

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 2021/22 of between 0.1% and 0.2% suggested by the MCA's treasury advisors.

This has been achieved because of the significantly higher returns being earned on longer term investments as illustrated in the table below.

	2021/22
	Mid Year
	£'000
L T investments	99,628
S T investments	302,197
All investments - weighted average	**401,825**
L T investments return	1.45%
S T investments return	0.09%
All investments – weighted average	**0.43%**

The weighted average return on investments has declined steadily over the first 6 months of 2021/22 from 0.56% in April 2021 to 0.34% in September 2021. This is principally due to an increase of c. £170m in the amount invested in short term investments between April and September.

The returns on short term investments have remained low throughout the period - 0.25% on notice accounts, 0.01% on Money Market Funds, and in the range 0.1% to 0.3% for fixed term deposits.

Returns on long term investments have held reasonably steady in the first half of 2021/22. However, these will start to fall in the second half of the year as £22m of fixed term deposits earning interest at 2.20% to 2.30% have just matured and it will not be possible to reinvest at similar rates in the current economic climate. This may reduce the returns on long term investments by c £200k in the second half of 2021/22.

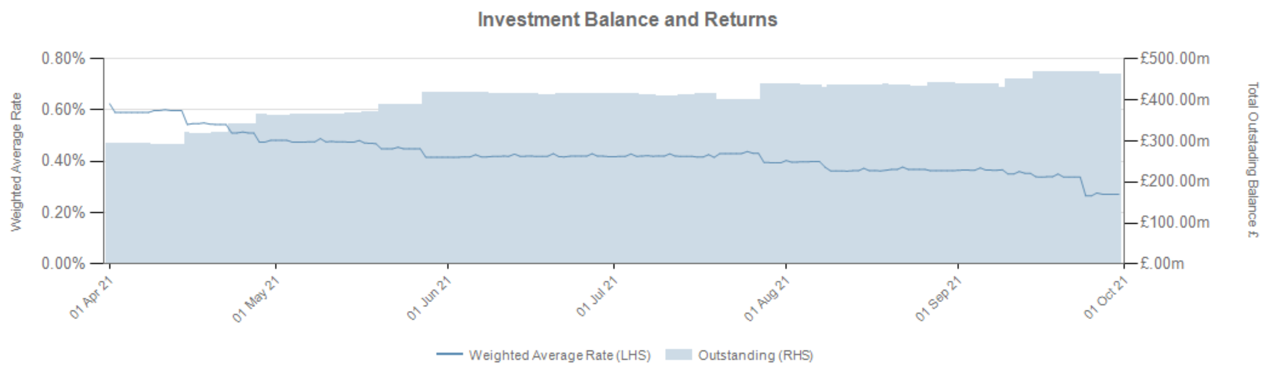
However, notwithstanding this, returns are still on track to exceed the budgeted treasury investment income for the year of £0.945m

Investment portfolio

The MCA Group has continued to hold a substantial investment portfolio throughout the first half of 2021/22.

As illustrated below, at the start of the 2021/22 financial year, the investment portfolio stood at £304.5m and has remained at or above this level throughout the first 6 months rising to £462.5m at the end of September 2021. The change is represented by an increase in short term investments of £170m and reduction in long term investments of £12m.

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, 2021/22 Gainshare allocation, devolved Adult Education Budget funding, Getting Building Fund tranche 2, Brownfield Housing, City Deal, Transforming Cities Funding, and South Yorkshire transport capital funding which has not yet been defrayed.



Investment portfolio by type of investment

The table shows the analysis of investments by investment type at Period 6

Investments by investment type	Mid Year Actual £'000	Mid Year Actual %
Fixed term local authority deposits - long term	88,000	19
Fixed term local authority deposits – short term	25,000	6
Fixed term bank deposits - short term	20,000	4
Call accounts	60,000	13
Money Market Funds	269,446	58
Total investments	**462,446**	**100**

The investment strategy of investing in a relatively narrow range of financial instruments with highly rated counterparties in order to maximise security during the pandemic, together with the depressed state of the local authority to local authority market due to Central Government support for local government to support the response to Covid, has limited opportunities to diversify out of Money Market Funds.

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.

Longer term investments of more than 365 days

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 limit approved in the 2021/22 Treasury Management Strategy.

As at the end of September 2021, there were fixed term deposits with a duration of more than 365 days of £88m. However, £63m of this will mature in 2022/23 leaving £25m in long term investments at the end of 2022/23.

Investment greater than 365 days	2021/22 Estimate £'000	2021/22 Mid Year £'000	2022/23 Estimate £'000
Maximum - end of the year	£80,000	£80,000	£27,500
Existing long term investments	£63,000	£88,000	£25,000
Balance available to invest	£17,000	-£8,000	£2,500

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. 0.012% in respect of reputable banks with a high credit rating based on historic default rates at 2020/21 year end).

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 that the MCA is responsible for delivering.

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

Borrowing Strategy

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.

This remains likely to be the case despite the Government reducing PWLB rates on new loans by 1% under new lending arrangements which came into effect on 26 November 2020.

The latest fixed term PWLB rates range from 1.4% for short term borrowing rising to 2.2% for 20 year borrowing falling back to 1.9% for 50 year borrowing.

Returns on relatively short term investments of three to twelve months duration are forecast to increase only slowly from 0.1% to 0.3% currently to 0.7% to 1% by the end of 2023/24. This is on the assumption that the Bank of England base rate would increase to 0.75% by the end of 2023/24 with the first rate rise in June 2022. The latest indications, based on the Spending Review on 27th October 2021, are that an earlier rate rise may take place due to the higher than expected rate of inflation. Nevertheless, the differential between borrowing rates and returns on investment remains such that 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 financial plans resulting in a projected fall in debt servicing costs as debt is repaid.

The strategy also seeks to take the opportunity to reschedule existing debt where this will lead to an overall saving. However, for the reasons described further on in this report it is considered unlikely that any such opportunities will arise in the short to medium term.

The new lending arrangements introduced in November 2020, in addition to lowering interest rates, also tightened the rules governing local authorities, including MCAs, access to PWLB borrowing. The new rules do not allow access to PWLB where a local authority intends to buy commercial investment assets held primarily or partially to generate a profit for yield within its capital plans at any point in the next three years regardless of whether the transaction would notionally be financed from a source other than PWLB. The definition of commercial investment assets in this case is that contained within MHCLG Statutory Guidance on Local Government investments and includes, for example, investment property portfolios whose main purpose is to generate a profit.

The MCA Group’s investment property portfolio is a legacy of bus deregulation and comprises former transport assets which are not being actively managed to achieve commercial returns. Accordingly, they are not considered to fall within the definition of commercial investment assets under the Statutory Guidance. This will however be kept under review should there be any plans to expand or diversify the portfolio.

Capital Financing Requirement (CFR) estimates

The table below shows the forecast change in the MCA Group’s underlying need to borrow (Capital Financing Requirement) as at Period 6.

Group Capital Financing Requirement	2020/21	2021/22	2021/22
	Actual	Estimate	Mid Year
	£'000	£'000	£'000
Opening CFR	£116,054	£117,114	£108,806
movement in CFR			
Additional borrowing requirement	£0	£80	£4,522
MRP	-£3,648	-£3,860	-£3,380
Capital receipts set aside for the repayment of debt	-£3,600	£0	£0
Other adjustments	£0	£0	£0
Closing CFR	**£108,806**	**£113,334**	**£109,948**

There are two factors why the closing CFR at 31 March 2021 was lower than previously forecast at the time the 2021/22 Treasury Management Strategy was agreed prior to the start of the 2021/22 financial year:

- Firstly, the MCA took advantage of capital financing flexibilities to fund two capital schemes from grant instead of borrowing in 2020/21 (£3.970m Re-railing and £0.472m BDR capital pot). In 2021/22, it is anticipated that the funding will be reversed so that the borrowing requirement of £4.442m will fall on 2021/22
- Secondly, capital receipts / capital grant of £3.600m were applied to write down the CFR at the end of 2020/21. This was undertaken as part of the Group Reserves Strategy to establish a Project Feasibility Fund of £3.6m for the early stage development of capital projects. This was done by means of a transfer from the levy reduction reserve with the annual MRP savings arising from the £3.600m of capital receipts / capital grant applied to write down the CFR being used to build the levy reduction reserve back up over a period of time. In 2021/22, the annual MRP savings expected to be generated are £0.480m, which is why the mid year forecast MRP for the year is £3.380m compared to the initial estimate of £3.860m

There is no change to the estimated borrowing need for 2021/22 of £0.080m which relates to Re-railing. The overall borrowing requirement of £4.522m comprises the £0.080m plus the borrowing need deferred from 2020/21 of £4.442m.

Amount of external debt against the Capital Financing Requirement (CFR)

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.

Group external borrowing	2020/21	2021/22	2021/22
	Actual	Estimate	Mid Year
	£'000	£'000	£'000
External Debt			
-MCA Loans	£25,660	£25,000	£25,000
-Expected change in MCA Loans	-£660	£0	£0
-SYPTE Debt	£161,375	£108,375	£105,400
-Expected change in SYPTE Loans	-£53,000	-£7,975	-£5,000
Gross Debt	**£133,375**	**£125,400**	**£125,400**
The Capital Financing Requirement	£108,806	£113,334	£109,948
Debt in excess of CFR	**£24,569**	**£12,066**	**£15,452**

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.

Two SYPTE PWLB loans with an aggregate value of £2.975m were repaid at the end of September 2021 with a further SYPTE PWLB loan repayment of £5m scheduled for the beginning of January 2022. This will reduce the external debt by £7.975m by the end of 2021/22.

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

Maturity of borrowing:	**Amount**	
	£'000	**%**
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	**£133,375**	**100%**

<u>Borrowing limits</u>

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 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.

Hitherto, the MCA has only had borrowing powers in relation to its transport functions. However, Government has now agreed to grant the MCA new powers for non-transport borrowing. As a first step towards this, as set out in the body of the report (para 2.52 ff), a debt cap of £171m has been offered by HM Treasury for the period to March 2022, with a new cap to be negotiated for the period commencing April 2022. This provides for up to £35m of new borrowing if required between now and March 2022.

At the time that the borrowing limits in the 2021/22 treasury management strategy were set prior to the start of the financial year, there was uncertainty as to when non transport borrowing powers might be granted. Accordingly, the Borrowing Limits set at the start of the year allowed for £500m headroom to borrow to fund the South Yorkshire Investment Programme backed by gainshare plus a further £40m headroom as has typically been the case in previous years.

On the assumption that the debt cap of £171m is accepted by the MCA, the Authorised Limit and Operational Boundary have been amended accordingly as follows

Authorised Limit	2021/22 Estimate £'000	2021/22 Mid Year £'000
Loans	£673,500	£211,000
Other Long Term Liabilities	£11,000	£11,000
Total	**£684,500**	**£222,000**

Operational Boundary	2021/22 Estimate £'000	2021/22 Mid Year £'000
Loans	£658,500	£171,000
Other Long Term Liabilities	£11,000	£11,000
Total	**£669,500**	**£182,000**

The amount of external debt at the end of Period 6 stood at £141.4m and is scheduled to reduce by a further £5m to £136.4m by the end of the financial year. The revised operational boundary of £182m provides for up to £35m of new borrowing as referred to above.

No temporary revenue borrowing has been necessary or is anticipated.

Hence, for the year to date, borrowing is well within the revised Authorised Limit and Operational Boundary based on the proposed debt cap, and no difficulties are foreseen in remaining within these limits.

Debt Rescheduling / Early Repayment

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

The interest rates for premature repayment which might facilitate rescheduling or early repayment of existing debt are currently in the range 0.3% to 1.1%.

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.

To give an indication of the magnitude of the premium across the MCA Group's debt portfolio as a whole, as at 31 March 2021, it was in the region of c. £45m.

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.

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 Mid Year forecast shows a reduction in financing costs due to the saving on MRP. Financing costs as a percentage to net revenue income is therefore a little lower than at the time that 2021/22 Treasury Management strategy was set.

Ratio of financing costs to net revenue streams	2021/22 Estimate £'000	2021/22 Mid Year £'000
Interest	£8,359	£8,359
MRP	£3,859	£3,380
Less Investment Income	-£870	-£870
Net Financing Costs	**£11,348**	**£10,869**
Income - transport levy	£54,365	£54,365
Finance Costs/Unrestricted Revenue Income %	21.2%	20.0%

Managing exposure to the risk of interest rate changes

Borrowing

The MCA Group's debt portfolio as at Period 6 comprises the following :

Gross Debt	Mid Year Actual £'000	Mid Year Actual %
Fixed rate PWLB	110,400	78
Market loans	20,000	14
Doncaster PFI	10,773	8
Total	**141,173**	**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.