APPENDIX 2TREASURY MANAGEMENT STRATEGY

1. Summary

1.1. This appendix sets out the proposed Treasury Management Strategy for 2022/23 given the interest rate outlook and the Council's treasury needs for the year, and in accordance with the Treasury Management Policy.

1.2. A balanced strategy is proposed which continues to maintain a significant proportion of short term and variable rate loan debt in order to benefit from low short term interest rates, whilst taking some long term or fixed rate borrowing to maintain an appropriate balance between the risks of fixed rate and variable rate borrowing. The balance between short and long term funding will be kept under review by the Director of Council Management (Section 151 Officer) and will be maintained within the prudential limit for variable rate exposures.

1.3. Separate loan portfolios are maintained for the General Fund and the HRA; therefore, separate treasury strategies are set out below where relevant[1].

1.4. The ongoing impact on the UK from coronavirus, any post-Brexit trading arrangements and expectations for higher interest rates will have a major influence on the Council's treasury management strategy for 2022/23.

2. Treasury Management Policy and Objectives

2.1. The Treasury Management Policy sets the Council's objectives and provides a management and control framework for its Treasury Management activities, in accordance with CIPFA's Code of Practice for Treasury Management in the Public Services.

2.2. For the Council, the achievement of high returns from treasury activities is of secondary importance compared with the need to limit the exposure of public funds to the risk of loss.

2.3. In addition, and due to the growing importance of environmental, social and governance (ESG) issues including climate emergency agendas, the Council will consider ESG factors in the context of its treasury activities.

2.4. These objectives must be implemented flexibly in the light of changing market circumstances.

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[1] This Strategy relates to loan debt only. Other debt liabilities relating to PFI and finance leases are not considered in this Strategy and are managed separately. Throughout this Financial Plan, debt and investments are expressed at nominal value, which may be different from the valuation basis used in the statutory accounts.

3. Council Borrowing Requirement

3.1. The Council's forecast of its required gross loan debt is set out in the Capital Strategy and is a combination of its new prudential borrowing for capital, reduced by the amounts set aside to repay debt, and short term cashflows. Most of the Council's loan debt is in existing long term loans which mature over periods of up to 40 years or more. The balance of new loans which the Council will need to obtain in each of the next four years is set out in Table M.1:

Table M.1 Forecast Borrowing Requirement

	2022/23	2023/24	2024/25	2025/26
	£m	£m	£m	£m
Forecast gross loan debt	3,642.4	3,524.9	3,527.3	3,446.7
Forecast treasury investments	(40.0)	(40.0)	(40.0)	(40.0)
Forecast net loan debt	3,602.4	3,484.9	3,487.3	3,406.7
of which:				
forecast long term loans outstanding	2,903.7	2,883.7	2,808.7	2,749.8
Short term investments working balance	(40.0)	(40.0)	(40.0)	(40.0)
Required new/ replacement loan balance	738.7	641.3	718.6	696.8
	3,602.4	3,484.9	3,487.3	3,406.7

3.2. This strategy sets out how the Council plans to obtain the required new borrowing shown above, by a combination of short term and long term borrowing.

3.3. The Council's forecast gross loan debt is due to decrease in forthcoming years. The fall is partly attributable to scheduled debt repayments. If further capital expenditure funded from borrowing is decided on in the future, this will increase the debt levels.

3.4. The Council has £71.1m of Lender's Option Borrower's Option (LOBO) loans outstanding. In these loans, the lender has the right to increase the interest rate at certain dates during the loan term, and in this event the Council has the right to repay the loan immediately without penalty. £41.1m of the loans have the potential to be exercised during 2022/23. This would increase the Council's borrowing requirement, but it is considered unlikely that it would happen in the current market environment.

3.5. In previous years the Council has repaid some of its LOBO loans early; in May 2019, £30m of LOBO loans held with Commerzbank were repaid. This resulted in a significant saving for the Council and it removed a substantial amount of LOBO loans from its loan portfolio. The Council will consider further loan restructuring opportunities if they become available and where they provide a cost saving or a reduction in risk.

4. Interest Rate and Credit Outlook

4.1. UK Bank Rate is fundamental for the Council's treasury management activity, in terms of expenditure on loan interest where new loans are taken out and on income received from investments. UK Bank Rate is set by the Bank of England's Monetary Policy Committee (MPC) and their interest rate outlook is influenced by domestic and international economic and political developments.

4.2. The UK economy continues to recover from the coronavirus pandemic; in November 2021, the MPC revised its growth forecasts and it now expects the UK to regain its pre-pandemic size in Q1 2022, earlier than the mid-2022 previously expected. However significant challenges lie ahead and a sustained recovery is not entirely secure. The MPC has revised down growth forecasts for the UK economy to lan a5% in 2022 from the previous 6%.

4.3. The resurgence in demand following the various lockdowns in the past year has led to an expected rise in inflation. However supply side factors resulting in shortages in the economy have amplified inflationary pressures, especially in the UK as a result of Brexit. Annual CPI inflation was 3.1% in September 2021 with the MPC expecting inflation to peak at around 5% in April 2022 before falling back. The MPC believe transitory factors will feed longer-term inflation expectations that will require interest rates to rise in the coming months.

4.4. The MPC has held Bank Rate at 0.1% since November 2020. Although rate rises are expected it does not envisage a rise to 1% as implied by financial markets. Arlingclose, the Council's treasury advisor, has forecast the Bank Rate to rise in Q2 2022 but also not to the levels expected by the market. Given the level of uncertainty over economic growth the Council has taken a prudent view and has assumed an increase in Bank Rate for the treasury budget by the end of 2022/23.

4.5. Upside risks to UK interest rates in 2022/23 include:

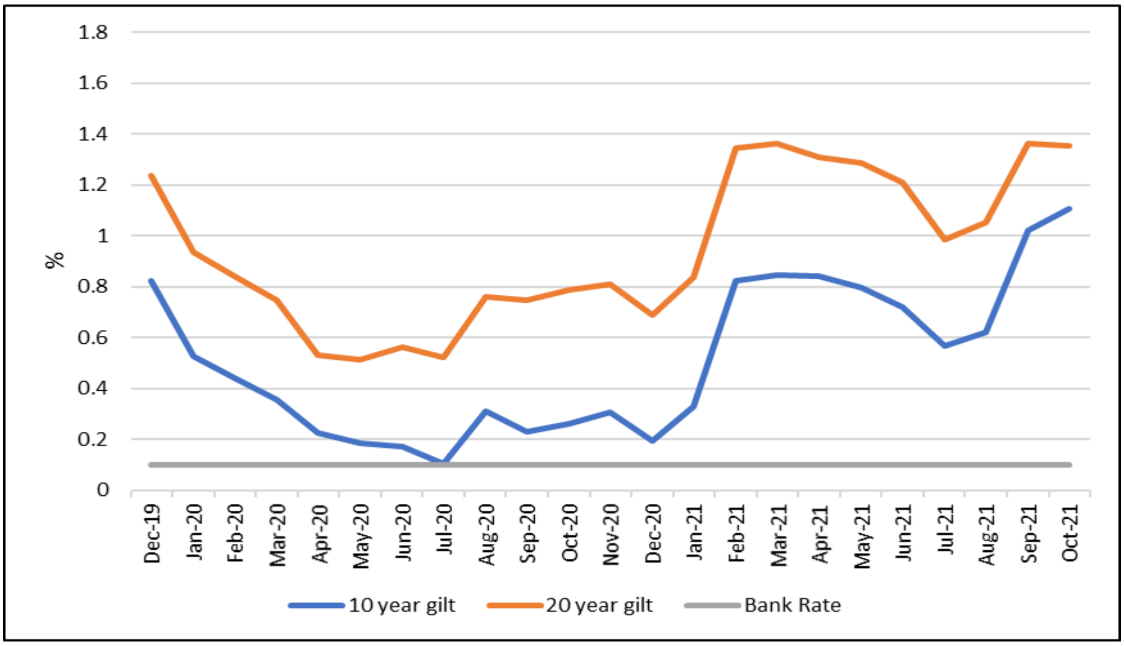
- Higher than expected economic growth as the impact of the pandemic eases
- Higher than expected inflation rates due to the persistence of supply side factors
- A positive impact from trade arrangements made post-Brexit

Downside risks to UK interest rates include:

- The effects of coronavirus on global and UK economic recovery remain significant
- UK economic growth falters as household spending comes under pressure from rises in prices and pressures on household income.
- Brexit risks to the UK economy

4.6. Longer term interest rates are typically represented by UK Government Gilt yields. The chart at Figure M.2 shows that Gilt yields fell to record low levels in 2020 with the onset of the global pandemic. Since then gilt yields have risen sharply due to expectations of interest rate rises on the back of longer term inflationary fears. Volatility arising from both economic and political events are likely to continue although yields do still remain at near historically low levels.

Figure M.2 Bank Rate and Gilt Yields



4.7. The credit outlook for banks relates to their risks for default and became more significant following the 2015 Bank Recovery and Resolution Directive (BRRD). Here a failing bank would need to be 'bailed in' by current investors instead of being 'bailed out' by the Government, thus increasing the risk of loss for local authorities holding unsecured bank deposits.

4.8. Due to better economic growth prospects for the UK, banks are perceived to be in a better position than earlier this year with some institutions able to reduce their provisions for bad loans. Credit ratings agencies have recognised their improved capital positions and upwardly revised the outlook on a number of UK banks. The Council will continue to monitor bank credit worthiness and seek the advice of its treasury advisor, Arlingclose.

5. Borrowing strategy

5.1. The Council's capital investment programme allows it to deliver key priorities such as economic regeneration, transport, housing and school improvements, and to support service transformation. The capital investment programme can be funded from government grants, revenue resources, capital receipts from asset sales and prudential borrowing.

5.2. It is appropriate for the Council to borrow to fund its capital expenditure. The Council will receive long term service benefit over a number of years so it should be able to fund the capital expenditure over the years benefits are received.

5.3. As part of its borrowing strategy, the Council has targeted a short term or variable rate loans balance (less than 12 months) of around £600m, to take advantage of the prevailing low short term borrowing rates. Short term rates reduced significantly in 2021/22 and low rates are expected to continue into 2022/23. It is proposed to continue with a short term loans level of around £600m, with the balance of the Council's borrowing needs being met through long term borrowing (i.e. for periods of one year or more).

5.4. Based on this strategy, the following table summarises, for the Council as a whole, the new long term and short term borrowing proposed to fund the required new or replacement borrowing each year:

Table M.3 Proposed Borrowing Strategy

	2022/23	2023/24	2024/25	2025/26
cumulative new borrowing:	£m	£m	£m	£m
total long term loans	140.0	140.0	140.0	140.0
new short term loans	598.7	501.3	578.6	556.8
Required new/ replacement loan balance	738.7	641.3	718.6	696.8

5.5. The strategy results in a forecast for new long term borrowing of £140m in 2022/23. The balance of new long term borrowing does not increase in the following years as the requirement for new loans is generally lower from 2023/24.

5.6. In 2020/21, the Council paid a three year advance pensions payment for which it received a discount; this means there are reduced pensions cash outflows in 2021/22 and 2022/23. If the Council is offered a similar discount in 2023/24, it may choose to make an advanced payment which could be funded by further long term loans. The borrowing strategy to fund the advance pensions payment will be to take loans for one to three years. The forecast debt figures at Table M.1 do not include future pensions advanced payments as these are yet to be agreed.

Short term borrowing

5.7. The Council's short term borrowing needs are largely met through other local authorities who lend their surplus cash balances at comparatively low rates. Loans from local authorities are deemed to meet the Council's ESG considerations as surplus funds will have been obtained from sources with public service objectives.

5.8. The availability of loans from other local authorities can tighten especially at financial year end when authorities have used much of their cash balances. Given the size of the its short-term debt portfolio, the Council has sought to diversify its sources of short term borrowing from reliance on the local authority lending market:

- The Council has a Working Capital Facility available with its current bankers should it require loans for a short period.

- The Council is exploring the possibility of using a short term loan solution offered by the UK Municipal Bond Agency (MBA), in a partnership with the Council's treasury advisors Arlingclose, through the issuance of commercial paper. The MBA Commercial paper proposal is expected have rates comparable to the local authority lending market and without the risks and administration of issuing commercial paper individually.

5.9. Short term and variable rate exposures remain within the 30% prudential limit set out in Appendix T4 (of the Financial Plan).

5.10. It should be noted that a possible scenario is that short term and long term interest rates may rise (or are expected to rise) more sharply than currently forecast. A higher level of long term borrowing may be taken if appropriate to protect future years' borrowing costs.

Long Term Borrowing

5.11. The main source of long term borrowing for local authorities has been the Public Works Loans Board (PWLB), managed by HM Treasury. At the end of November 2020, the Treasury returned PWLB rates to 0.8% above gilts with the condition that local authorities would not be able to access PWLB loans if their 3 year capital programme included capital expenditure primarily for yield. The Council has not undertaken, nor has plans to undertake,any investments primarily for yield.

The consequence of the PWLB rate decrease is that it is likely to offer a cheaper and quicker route to borrowing than alternative sources of borrowing, by at least 0.5% based on latest market analysis. For value for money, it is important that the Council continues to meet the PWLB's lending criteria. It is also uncertain how private sector lenders would view the risk profile for councils that were no longer eligible for PWLB loans.

5.12. Nonetheless, the Council will continue to monitor market developments and will seek to use and develop other funding solutions if better value may be delivered. This may include other sources of long term borrowing if the terms are suitable, including listed and private placements, bilateral loans from banks, local authorities or others, Islamic forms of finance and sale and leaseback arrangements.

5.13. The Council will also consider forward starting loans from capital markets, where the interest rate is fixed in advance, but the cash is received in later years. The Council may also restructure existing loans and other long term liabilities e.g. by premature repayment and replacement with new loans.

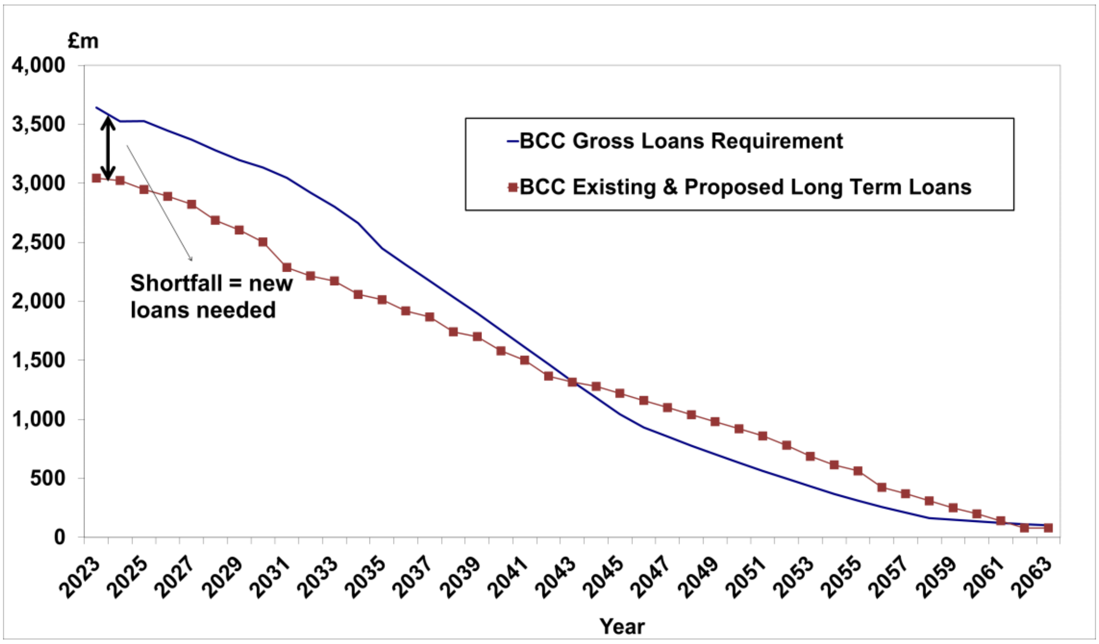
5.14. After the PWLB amended its lending terms in November 2020, private debt capital markets were unable to match the PWLB's lower rates. However, more recently, the market has suggested ESG bonds could be competitive when compared to the PWLB, due to a lack of supply and increasing demand from institutional investors. ESG bonds are used to finance projects that support environmental and social goals; most local authority capital schemes, including significant aspects of Birmingham's capital programme, could be linked to ESG objectives and fit the criteria for an ESG bond.

5.15. The Council will consider the use of ESG bonds in sourcing long term borrowing, should they provide better value through lower costs and rates when compared to PWLB borrowing.

Liability benchmark

5.16. The Council's loan maturity profile can be compared with the level of loan debt outstanding required by this Financial Plan, as follows:

Figure M.4 BCC Loans Outstanding vs. Gross Loans Requirement



5.17. The Gross Loans Requirement in Figure M.4 represents the level of outstanding loan debt required by this Financial Plan. It takes account of existing loans outstanding plus planned prudential borrowing; this reduces over time as a result of the Minimum Repayment Provision (MRP) for debt. The difference between the Gross Loans Requirement and Existing & Proposed long term loans represents forecast short term borrowing or investments. The Gross Loans Requirement represents a liability benchmark against which to measure the amount and maturity of required borrowing. In practice, future borrowings would never allow the outstanding loans to reach nil as matured debt is replaced by debt for new capital projects.

5.18. The shortfall shown in the chart is planned to be met by a short term loans portfolio of around £600m, in line with the current strategy (see paragraph 5.3).

5.19. The Treasury Management Prudential Limits and Indicators consistent with the above strategy are set out in Appendix T (of the Financial Plan), including a summary loan debt maturity profile.

5.20. The Treasury Management Strategy must be flexible to adapt to changing risks and circumstances. The strategy will be kept under review by the Director of Council Management (S151) in accordance with treasury management delegations.

6. HRA and General Fund Treasury Strategies

6.1. The Housing Revenue Account (HRA) inherited a largely long term fixed rate debt portfolio at the start of the current HRA finance system in 2012. As a result, the Council is looking to increase the HRA’s exposure to short term loans whenever possible. The General Fund and HRA exposures to short term and variable interest rates in accordance with the strategy are as follows:

Table M.5 Forecast Variable Rate Exposure Based on the Proposed Borrowing Strategy

(taking account of debt maturities and proposed long term borrowing)	2022/23 £m	2023/24 £m	2024/25 £m	2025/26 £m
Housing Revenue Account				
Year end net exposure to variable rates	219.0	249.3	257.6	262.4
Closing HRA net loan debt	1,112.0	1,124.4	1,129.7	1,119.7
Variable exposure % of debt	19.7%	22.2%	22.8%	23.4%
General Fund				
Year end net exposure to variable rates	359.8	287.0	339.9	321.4
Closing General Fund net loan debt	2,490.4	2,360.5	2,357.7	2,287.0
Variable exposure % of debt	14.4%	12.2%	14.4%	14.1%
Year end variable interest rate assumption provided for in the budget	0.75%	0.75%	1.00%	1.00%

Note: the variable rate figures above include long term loans with less than a year to maturity. Potential repayment option calls on LOBO loans are excluded as none are expected in this period.

6.2. The variable rate exposure means that a 1% rise in variable rates at the end of 2022/23 would cost an estimated £3.6m per annum for the General Fund and £2.2m per annum for the HRA. However, the budget provides for a potential increase in variable rates (as shown above), which is considered to be prudent in this context.

6.3. This strategy therefore acknowledges the risk that maintaining a significant variable rate loan debt may result in increased borrowing costs in the longer term, but balances this against the savings arising from cheaper variable interest rates. The Director of Council Management (Section 151 Officer) will keep the strategy under close review during the year, in the light of the Council's financial position and the outlook for interest rates.

7. Treasury Management Revenue Budget

7.1. Based on this strategy the proposed budget figures are as follows:

Table M.6 Treasury Management Revenue Budget

	2022/23	2023/24	2024/25	2025/26
	£m	£m	£m	£m
Net interest costs	127.706	127.064	123.921	122.995
Revenue charge for loan debt repayment	115.258	122.859	127.538	141.550
Other charges	(9.694)	4.182	2.102	1.998
Total	233.271	254.106	253.560	266.543
Met by the HRA	52.619	50.410	49.248	55.219
Met by the General Fund	180.652	203.696	204.312	211.324
Total	233.271	254.106	253.560	266.543

7.2. The budgeted interest cost in each year reflects a prudent view of borrowing costs and the cost of the additional borrowing in this Financial Plan. Actual interest costs will be affected not only by future interest rates, but also by the Council's cash flows, the level of its revenue reserves and provisions, and any debt restructuring.

8. Investment Strategy

8.1. The Council has surplus cash to lend only for short periods, as part of day-to-day cashflow management and to maintain appropriate cash liquidity. A month end investment balance of £40m in deposits is used as guidance in order to maintain adequate liquidity to meet uncertain cashflows. Any such surplus cash is invested in high credit quality institutions and pooled investment funds such as Money Market Funds (MMFs). MMFs are expected to continue to form a major part of the cash investment portfolio, as they are able to reduce credit risks in a way the Council cannot do independently, by accessing high quality institutions and spreading the risk more widely.

8.2. In terms of the Council's ESG considerations for its investment strategy, MMFs are not typically managed with the explicit or implicit aim of being an ESG or 'ethical' product. MMF managers have varying approaches to ESG incorporation with many preferring active engagement, using their shareholding and voting rights to influence and improve corporate behaviour and responsibility.

8.3. The ESG credentials of the MMFs that the Council invests in have been reviewed, based on information provided by individual MMFs. All MMF managers have engaged with ESG as an issue for their investors and the Council will consider those MMFs that show a genuine commitment to incorporate ESG as a source of enhanced financial risk management.

8.4. Due to the coronavirus pandemic, councils experienced increased uncertainty over their cashflows during 2021/22. Central Government had provided significant grants to the Council as it looked to use local authorities to coordinate the support required by the local population in dealing with the financial impact of the pandemic. As a result, the Council held liquid cash balances that far exceeded the guidance of £40m throughout the year. This is unlikely to continue into 2022/23 unless the financial impact of the pandemic coronavirus resumes.

8.5. Although the outlook for the UK economy has improved, a degree of uncertainty from the coronavirus pandemic remains; a further economic downturn could force the Bank of England to set Bank Rate at or below zero. This could feed through to negative interest rates on low risk, short term investment options. Since investments cannot pay negative income, negative rates would be applied by reducing the value of investments. In this event, the Council would measure security as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

8.6. Long term investments of one year or more are not currently expected to be appropriate for treasury management purposes, as the Council does not expect to have temporary surplus cash to invest for that length of time.

9. Other Treasury Management Exposures and Activities

9.1. During 2021/22, the Council established a Treasury Management Panel consisting of senior Finance Officers and treasury officers at the Council. The Council's Treasury Management Panel meets regularly, usually monthly, and act as an advisory body, providing guidance, support and scrutiny to decisions made by treasury officers.

9.2. The Council has guaranteed the £73m loan debt issued by NEC (Developments) Plc, which since the sale of the NEC Group has been a wholly owned subsidiary of the Council. The value of this liability, due to mature in 2027, is reflected in the Council's own debt and is managed as part of treasury activity.

9.3. The Council is a constituent member of the West Midlands Combined Authority (WMCA). Participating authorities share an exposure to any unfinanced revenue losses of WMCA, including debt finance costs. The Council and other member authorities support WMCA's capital investment plans, which include substantial prudential borrowing (subject to revenue funding support). This exposure is managed through the authorities' voting rights in WMCA including approval to its annual revenue and capital budget.

10. Advisers

10.1. Arlingclose Limited are appointed to provide treasury management advice to the Council, including the provision of credit rating and other investment information. Advisers are a useful support in view of the size of the Council's transactions and the pressures on staff time. The Council's contract with Arlingclose is due to expire during 2022/23 so a tender exercise will be undertaken to appoint a treasury management advisor.

11. Prudential Indicators for Treasury Management

11.1. The Council is required under the Local Government Act 2003 and the CIPFA Treasury Management Code to set Prudential Indicators for treasury management. These are presented in Appendix T4 (of the Financial Plan).