APPENDIX 2a: TREASURY MANAGEMENT STRATEGY

1. Summary

1.1. This appendix sets out the proposed Treasury Management Strategy for 2023/24 given the interest rate outlook and the Council's treasury needs for the year, and in accordance with the Treasury Management Policy at Appendix N ((of the Financial Plan).

1.2. A balanced strategy is proposed which maintains a proportion of short term and variable rate loan debt in order to benefit from lower short term interest rates, whilst taking 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 Strategic 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 expectations for inflation and higher interest rates, government fiscal policy and the cost of living crisis will have a major influence on the Council's treasury management strategy for 2023/24.

2. Treasury Management Policy and Objectives

2.1. The Treasury Management Policy (Appendix N of the Financial Plan) 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. Due to the importance of environmental, social and governance (ESG) issues including climate emergency agendas, the Council will continue to 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 Table 7.2 in Chapter 7 (of the Financial Plan), and is a combination of its forecast capital expenditure funded from borrowing, reduced by the amounts set aside to repay debt, and short term cashflows. The Council's gross loan debt is forecast to start decreasing in forthcoming years; if further capital expenditure funded from borrowing is decided on in the future, this will increase the debt levels.

Table M.1 Forecast Borrowing Requirement

	2023/24 £m	2024/25 £m	2025/26 £m	2026/27 £m
Forecast gross loan debt	3,394.5	3,467.6	3,430.8	3,398.3
Forecast treasury investments	(40.0)	(40.0)	(40.0)	(40.0)
Forecast net loan debt	3,354.5	3,427.6	3,390.8	3,358.3
of which:				
long term loans outstanding	2,888.6	2,813.6	2,754.8	2,687.9
Short term investments working balance	(40.0)	(40.0)	(40.0)	(40.0)
Required new/ replacement loan balance	505.9	654.1	676.0	710.4
	3,354.5	3,427.6	3,390.8	3,358.3

3.2 Most of the Council's loan debt is funded from existing long term loans which mature over periods of up to 40 years or more. Table M.1 above shows that the Council's outstanding long term loans decrease over the next few years as they are repaid upon maturity. This means that its new loans requirement increases in order to meet the forecast net loan debt.

3.3 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.

3.2. The Council currently has £71.1m of Lender's Option Borrower's Option (LOBO) loans outstanding. For these loans, the lender has the right to increase the interest rate at certain dates during the loan term; in this event the Council has the option to accept the rate increase or repay the loan immediately without penalty. All £71.1m of the Council's LOBO loans have the potential to be exercised during 2023/24. As market rates have increased significantly in the past year, some LOBO lenders may choose to exercise their option. Repayment of these loans would require refinancing and increase the Council's borrowing requirement.

3.3. 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 loans 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 Bank of England has been raising the Bank Rate in its monthly MPC meetings since December 2021 and raised it by a further 0.75% to 3% at its November 2022 meeting. This was on the back of rising inflation in the UK and globally, due to higher energy prices, as a result of the war in Ukraine and supply chain disorder as global economies adjusted following covid pandemic policies. UK inflation measured by the Consumer Prices Index (CPI) was 10.1% in September 2022 and is at the highest levels seen in four decades.

4.3. The impact of inflation and interest rate rises are already being felt in the UK with current Bank of England forecasts indicating the economy is already in recession; GDP is expected to fall by around 0.75% during H2 2022 and continue falling until mid-2024. However the MPC expects inflation to remain above 10% in the coming months and the jobs market remains tight with high job vacancies. Although the MPC expects further increases in Bank Rate to return inflation to its target of 2%, it does not believe rates will peak to the levels priced by financial markets. Anticipated fiscal tightening in November's Autumn Statement means the MPC may not need to be as aggressive on further interest rate rises.

4.4. Arlingclose, the Council's treasury advisor, has forecast the Bank Rate to peak at 4.25% in Q1 2023 and remain there for the remainder of the financial year. Given the level of uncertainty over economic growth and interest rates the Council has taken a prudent view on Bank Rate for the treasury budget by the end of 2023/24.

4.5. Upside risks to UK interest rates in 2023/24 include:

- Higher than expected inflation rates due to the persistence of supply chain factors
- Prolonged high energy prices resulting from the continued conflict in Ukraine
- Higher than expected economic wage growth

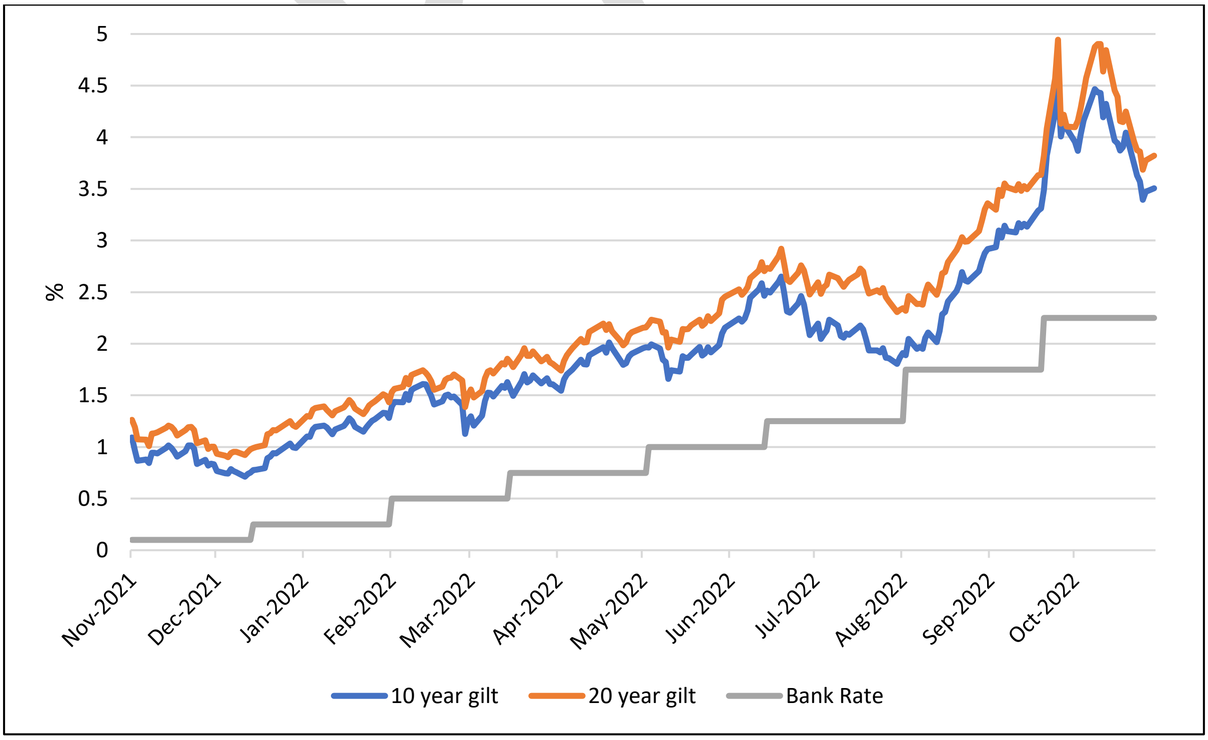
Downside risks to UK interest rates include:

- Impact of UK recession causes: UK GDP to fall by more than expected with inflation falling below the target of 2%.
- Post Brexit trade risks to the UK economy
- The effects of coronavirus on global and UK economic recovery remain significant

4.6. Longer term interest rates are typically represented by UK Government Gilt yields. The chart at Figure M.2 shows that Gilt yields have increased significantly during 2022 in line with interest rate increases and expectations for interest rates. Gilt yields are near the levels since before the financial crisis of 2008 and are no longer at the historically low levels seen in the last decade.

4.7. In recent months there has been unprecedented volatility in the gilt markets. Gilt yields initially shot up after the announcement of the 23 September 2022 ‘mini budget’, with its fiscal stimulus measures, but have since recovered following Bank of England intervention to buy gilts and the reversal of most of those fiscal measures. The Autumn Statement on 17 November 2022 and the announcement of government plans to reduce debt may help to further stabilise gilt markets. However, volatility arising from both economic and political events are expected to continue during 2023/24.

Figure M.2 Bank Rate and Gilt Yields



4.8. 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.

4.9. With the UK economy likely to be in recession territory the risks for UK banks are heightened as shown by recent increases in UK bank Credit Default Swap (CDS) prices. However, the banking sector is generally better positioned to withstand shocks to the economy due to their required capital positions. 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. Although borrowing costs (including interest costs and repayment charges) reflect a substantial investment in capital, the Council will ensure borrowing for the capital programme remains at an affordable and sustainable level. The Council periodically reviews its capital programme and associated prudential borrowing requirements and will reduce this where it can as long as it does not impede the Council's key priorities.

5.4. The Council can use capital receipts to repay debt and reduce its borrowing costs in accordance with its MRP Policy (Appendix S of the Financial Plan). In 2023/24 the Council has planned to use capital receipts to repay some debt which should allow it to make savings in borrowing costs in the following years.

5.5. Borrowing costs are also managed by the type of loans the Council takes. As part of its borrowing strategy, the Council has previously targeted a short term or variable rate loans balance (less than 12 months) of around £600m, to take advantage of lower short term borrowing rates. Although short term rates increased significantly during 2022/23 they are not forecast to go much higher in 2023/24. It is proposed to maintain a short term loans level of around £500m for 2023/24, with the balance of the Council's borrowing needs being met through long term borrowing (i.e. for periods of one year or more).

5.6. 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

cumulative new borrowing:	2023/24 £m	2024/25 £m	2025/26 £m	2026/27 £m
total long term loans	50.0	150.0	200.0	200.0
new short term loans	455.9	504.1	476.0	510.4
Required new/ replacement loan balance	505.9	654.1	676.0	710.4

5.7. The strategy results in a forecast for new long term borrowing of £50m by 2023/24. Further new long term loans of £100m in 2024/25 and £50m in 2025/26 are planned to meet the required loan balance. Taking long term loans maintains the Council's balanced borrowing strategy; although borrowing rates are not forecast to be significantly higher than current rates, the outlook is uncertain and taking some long term loans will remove some refinancing risk.

5.8. 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 cash balances or a temporary increase in borrowing. 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

5.9. 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.

5.10. 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 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 proposed 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 to have rates comparable to the local authority lending market and without the risks and administration of issuing commercial paper individually.

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

5.12. 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

5.13. 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.

5.14. 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 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.

5.15. 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.

5.16. The Council will consider forward starting loans from capital markets, where the interest rate is fixed in advance, but the cash is received in later years. This would be beneficial when interest rates are forecast to rise in later years and the Council has a future borrowing requirement.

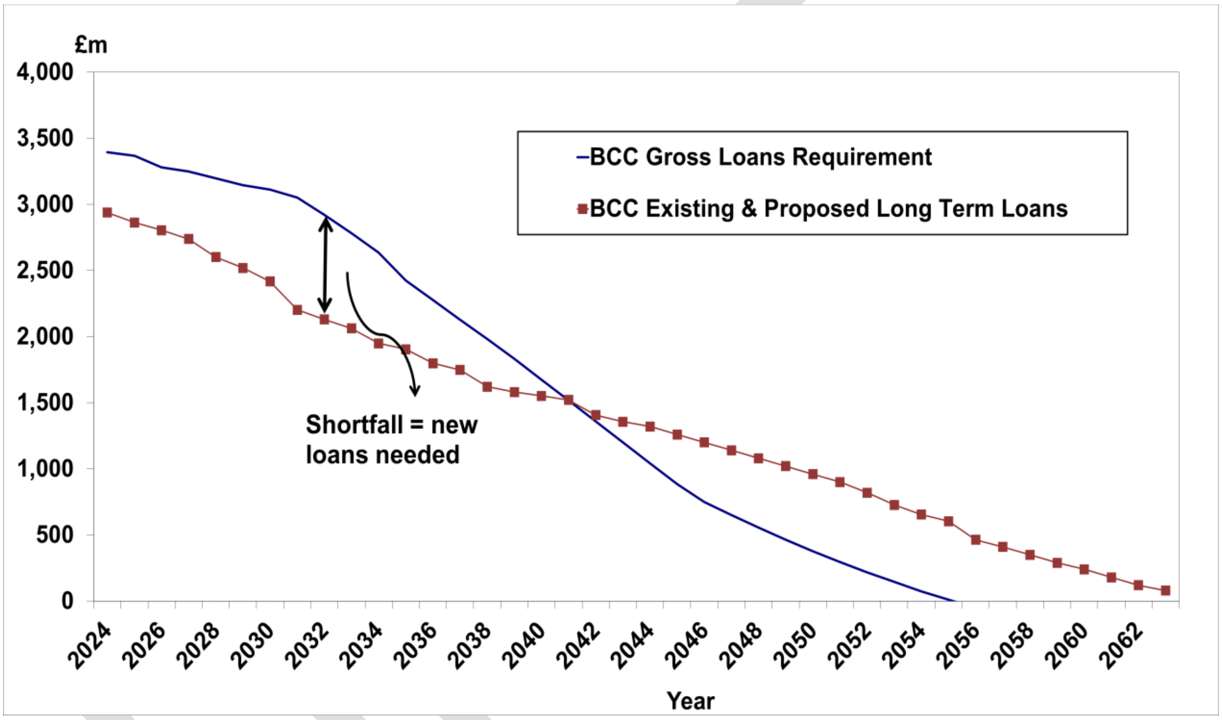
5.17. Debt capital markets have indicated ESG bonds or ESG private placements could be competitive when compared to the PWLB, due to a lack of supply and increasing demand from institutional investors. ESG bonds are used to finance projects that support environmental and social goals. Most local authority capital schemes, including significant aspects of Birmingham's capital programme, could be linked to ESG objectives and fit the criteria for an ESG bond. 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.

5.18. The Council may also restructure existing loans and other long term liabilities e.g. by premature repayment and replacement with new loans.

Liability benchmark

5.19. 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



5.20. 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.

5.21. The shortfall shown in the chart is planned to be met by a short term loans portfolio of around £500m, in line with the current strategy (see paragraph 5.5).

5.22. 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.

5.23. The Treasury Management Strategy must be flexible to adapt to changing risks and circumstances. The strategy will be kept under review by the Strategic 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)	2023/24	2024/25	2025/26	2026/27
	£m	£m	£m	£m
Housing Revenue Account				
Year end net exposure to variable rates	275.4	295.8	300.6	296.8
Closing HRA net loan debt	1,150.5	1,167.9	1,157.9	1,147.6
Variable exposure % of debt	23.9%	25.3%	26.0%	25.9%
General Fund				
Year end net exposure to variable rates	215.5	227.1	202.2	309.6
Closing General Fund net loan debt	2,204.0	2,259.7	2,232.9	2,210.7
Variable exposure % of debt	9.8%	10.0%	9.1%	14.0%
Year end variable interest rate assumption provided for in the budget	5.50%	5.50%	4.50%	4.25%

Note: the variable rate figures above include long term loans with less than a year to maturity.

6.2. The variable rate exposure means that a 1% rise in variable rates at the end of 2023/24 would cost an estimated £2.2m per annum for the General Fund and £2.8m 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 Strategic 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

	2023/24	2024/25	2025/26	2026/27
	£m	£m	£m	£m
Net interest costs	133.411	138.438	141.801	137.662
Revenue charge for loan debt repayment	120.076	125.793	142.671	147.864
Other charges	4.495	2.416	2.312	2.317
Total	257.982	266.648	286.784	287.842
Met by the HRA	57.402	58.699	66.349	64.412
Met by the General Fund	200.580	207.949	220.434	223.431
Total	257.982	266.648	286.784	287.842

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. 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 Activities and Exposures

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 and acts 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 expired during 2022/23 and they were reappointed as the Council's treasury management advisor following a competitive tender exercise.

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).