DRAFT TREASURY MANAGEMENT STRATEGY

This is a draft version for Audit Committee only to demonstrate the management of Treasury risks. The figures quoted and details of the strategy are to be finalised for approval as part of the Council's Budget at Full Council in February 2024

1. Summary

1.1. This appendix sets out the proposed Treasury Management Strategy for 2024/25 given the Council's current financial position, its treasury needs for the year and the interest rate outlook, and in accordance with the Treasury Management Policy.

1.2. On 5 September 2023 the Council's Interim Director of Finance (Section 151 Officer) issued a notice under Section 114(3) of the Local Government Finance Act 1988. The Council is in a challenging financial position primarily because it has insufficient resources to meet the expenditure required in relation to the costs of providing for Equal Pay claims. Its planned Financial Recovery Plan will have a significant impact on the Council's treasury management strategy for 2024/25.

1.3. The Council is intending to make an application to the Government for Exceptional Financial Support (EFS). This is likely to be in the form of a capitalisation direction. A condition of the EFS may be that all borrowings from the PWLB after the Direction will be subject to a premium for as long as the Council's Capital Financing Requirement (CFR) includes amounts related to the Capitalisation Direction. In addition to the premium the Council will also need to make annual provisions for the repayment of any borrowed amounts part of the Capitalisation Direction in line with its MRP policy or Government directions, if any.

1.4. At the time of writing this Strategy a 1 percentage point premium on such borrowings has been assumed, along with a repayment period of 20 years.

1.5. The Council proposes to continue with a balanced borrowing strategy that maintains a proportion of short term and variable rate loan debt, whilst taking long term or fixed rate borrowing to maintain an appropriate balance between the risks of fixed rate and variable rate borrowing. However, this strategy will be kept under review by the Director of Finance (Section 151 Officer) within the context of Financial Recovery and the availability of short-term loans. Any short-term loans will be maintained within the prudential limit for variable rate exposures.

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

1.7. Externally, a weaker economic outlook for the UK with uncertainty around inflation and interest rate expectations, uncertain government policy with an upcoming general election and geopolitical risk from the conflict in Ukraine and the Middle East will also have a major influence on the Council's treasury management strategy for 2024/25.

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. The Strategy will try to minimise the cost of borrowing to the Council whilst balancing its security and liquidity risks.

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.

3. Council Borrowing Requirement

3.1. The Council's forecast of its required gross loan debt (excluding the Capitalisation direction) 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 increase in forthcoming years due to significant investments required for the Housing Revenue Account (see paragraph 9.2 below). If additional capital expenditure funded from borrowing is decided on in the future, this will further increase the debt levels.

Table J.1 Forecast Borrowing Requirement

	2024/25 £m	2025/26 £m	2026/27 £m	2027/28 £m
Forecast gross loan debt	3,249.1	3,567.4	3,618.0	3,656.3
Forecast treasury investments	(40.0)	(40.0)	(40.0)	(40.0)

[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.

	2024/25 £m	2025/26 £m	2026/27 £m	2027/28 £m
Forecast net loan debt	**3,209.1**	**3,527.4**	**3,578.0**	**3,616.3**
of which:				
long term loans outstanding	2,843.5	2,784.7	2,717.9	2,581.9
Short term investments working balance	(40.0)	(40.0)	(40.0)	(40.0)
Required new/ replacement loan balance	405.5	782.7	900.1	1,074.4
	3,209.1	**3,527.4**	**3,578.0**	**3,616.3**

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 J.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 will increase 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, where short term lenders are available (see paragraph 5.6 below).

3.2. The Council currently has £61.1m 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. In May 2023, a £10m LOBO loan held with Dexia was repaid after the bank exercised its option to raise the interest rate. In November 2023 the Council chose to accept a rate increase on a £10m LOBO loan held with Erste as the new rate was well below forecast market rates at the time.

3.3. During 2024/25, £41.1m of the Council's LOBO loans have the potential to be exercised. As market interest rates remain relatively high, further LOBO lenders may choose to exercise their option. If LOBO loan options are exercised, the Council will look to repay these loans through refinancing where this is financially viable.

3.4. 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 early following negotiations with the bank. The repayments 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 for its entire loans portfolio 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. To combat high and persistent inflation in the UK, the Bank of England made consecutive increases to Bank Rate from December 2021 to reach 5.25% by September 2023. Monetary policy appears to have had the desired effect with UK inflation, measured by the Consumer Prices Index (CPI), falling to 3.9% in November 2023, down from a high of 11.1% observed in October 2022.

4.3. With the decreasing inflation numbers, the MPC has paused further Bank Rate rises. Financial markets now indicate rates have peaked and have priced in rate cuts from Q1 2024/25. The impact of interest rate rises is already being felt in the UK with GDP growth remaining below pre-pandemic rates in the medium term. GDP is forecast to rise by 0.4% in 2023 and by 1.0% in 2024. However, the MPC continues to warn about retaining tight financial conditions in the UK whilst service inflation and wage growth remain elevated. Continued economic uncertainty means the MPC has not ruled out further increases to Bank Rate in order to return inflation to its target of 2%.

4.4. Arlingclose, the Council's treasury advisor, has forecast the Bank Rate to have peaked at 5.25% and do not expect rate cuts until Q3 2024/25 and only when the MPC are confident that risks of 'second round' effects of inflation (e.g. on wage growth) are diminished. 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 2024/25.

4.5. Upside risks to UK interest rates in 2024/25 include:

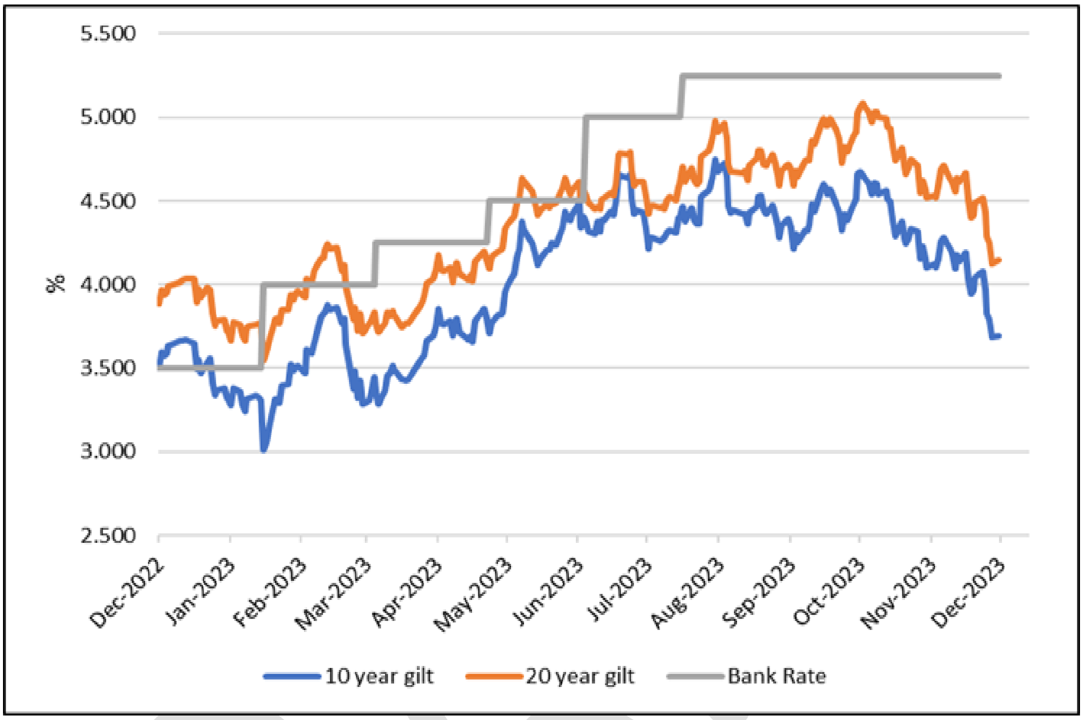
- Persistence of inflation where the UK economy remains resilient to the recent rate hikes
- Continued wage growth and high vacancies in the UK labour market
- Increased energy prices due to continued geo-political risks from the conflict in Ukraine, the Middle East and elsewhere

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%.
- Higher than expected falls in the level of unemployment
- Risks of economic downturns in the US and China causing a global slump

4.6. Longer term interest rates are typically represented by UK Government Gilt yields. Figure J.2 below charts Gilt yields and Bank Rate over the past year.

Figure J.2 Bank Rate and Gilt Yields



4.7. Gilt yields increased significantly during 2023 in line with interest rate increases and expectations for interest rates. Since October 2023 gilt yields have fallen sharply as the market currently expects Bank Rate to have peaked with rate cuts expected from the middle of next year. However, considerable uncertainty remains around future Bank of England monetary policy.

4.8. Gilt yields are still near the higher levels seen before the financial crisis of 2008 and are no longer at the historically low levels seen in the last decade. The Council expects long-term gilt yields to remain relatively higher than in the past, partly due to quantitative tightening, with periodic volatility arising from both economic and political events.

4.9. 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.

4.10. With the UK economy expected to experience a downturn due to the effects of higher interest rates, the risks for UK banks are heightened as shown by recent volatility 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.

It can be appropriate for the Council to borrow to fund its capital expenditure. However, given the Counci's current financial situation and expected capitalisation direction, borrowing for capital purposes is being kept to an absolute minimum.

5.2. 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.

5.3. 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 2023/24 they are not forecast to go much higher in 2024/25.

5.4. It is proposed to try to continue to maintain a short term loans portfolio for 2024/25 although not at the levels targeted in the past. This will in part depend on the availability of short term loans. The balance of the Council's borrowing needs is proposed to be met through long term borrowing (i.e. for periods of one year or more).

5.5. During 2023-24 there has been a notable reduction in the supply of short term local authority lenders. More significantly, the Council's issuance of a Section 114 Notice has meant the number of lenders willing to lend to the Council has considerably reduced. Both of these factors are likely to impact on the Council's ability to source new short term funding. Where short term funding cannot be sourced it will be replaced with long term borrowing.

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 J.3 Proposed Borrowing Strategy

Cumulative new borrowing:	2024/25 £m	2025/26 £m	2026/27 £m	2027/28 £m
total long term loans	230.0	470.0	580.0	730.0
total short term loans	175.6	312.7	320.1	344.4
Required new/ replacement loan balance	405.6	782.7	900.1	1,074.4

5.7. This strategy results in a forecast for new long term loans in the next four years to meet the required loan balance. The Council may still reprofile new long term loans during this period depending on market conditions. Although future borrowing rates are not forecast to be significantly higher than current rates, the outlook is uncertain and taking some long term loans earlier may remove some refinancing risk.

6. Short term borrowing

6.1. 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.

6.2. As mentioned in paragraph 5.7 above, the Council has experienced limited availability of loans from local authority lenders since it issued its Section 114 notice and this may continue into 2024/25. The Council has sought to diversify its sources of short term borrowing from reliance on the local authority lending market. The Council currently has a Working Capital Facility available with its bankers should it require loans for a short period. However this Facility would not be able to meet the Council's total requirements for short term borrowing.

6.3. Short term and variable rate exposures remain within the 30% prudential limit set out in Appendix J.4.

6.4. 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.

7. Long Term Borrowing

7.1. The main source of long term borrowing for local authorities has been the Public Works Loans Board (PWLB), managed by HM Treasury. PWLB lending comes 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.

7.2. The PWLB rate is likely to offer a cheaper and quicker route to borrowing than alternative sources of borrowing. For value for money, it is important that the Council continues to meet the PWLB’s lending criteria.

7.3. The Council is aware that its Financial Recovery will likely require additional Exceptional Financial Support (EFS) from the Department of Levelling Up, Housing and Communities (DLUHC) including capitalisation to cover provisions for Equal Pay, capitalisation costs involved in a redundancy scheme, and the forecast budget deficit 2024/25. The Council will need to be mindful of the criteria for borrowing from the PWLB under these circumstances including the potential premium being charged.

7.4. The Council will continue to monitor market developments and will seek to use and develop other funding solutions if better value may be delivered. Again, any request for EFS from DLHUC is likely to have an impact on the Council’s ability to source long term funding from other sources alternate to the PWLB.

7.5. Other sources of long term borrowing which could be considered if available and the terms are suitable, include listed and private placements, bilateral loans from banks, local authorities or others, Islamic forms of finance and sale and leaseback arrangements.

7.6. The Council may 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.

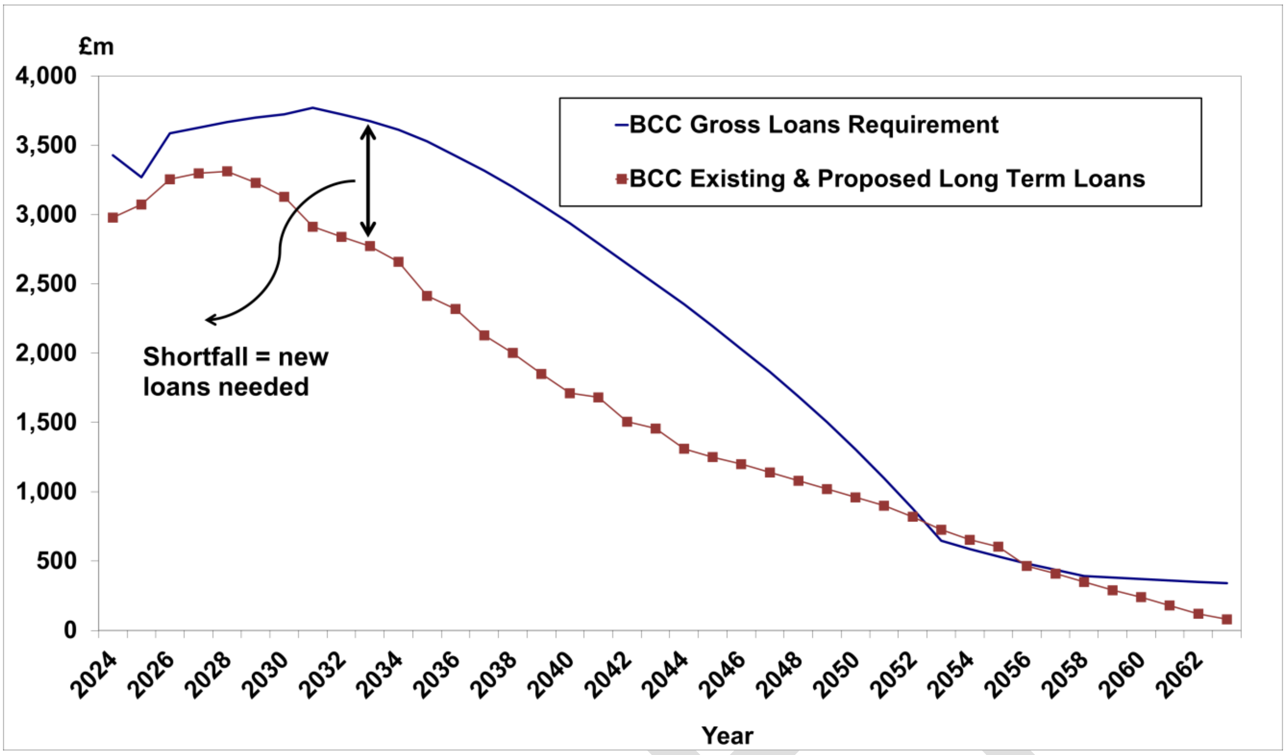
7.7. Debt capital markets have indicated ESG bonds or ESG private placements could be competitive when compared to the PWLB, due to a lack of supply and increasing demand from institutional investors. ESG bonds are used to finance projects that support environmental and social goals. Most local authority 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 may consider the use of ESG bonds in sourcing long term borrowing, should they be available and if they provide better value through lower costs and rates when compared to PWLB borrowing.

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

8. Liability benchmark

8.1. The Council’s loan maturity profile can be compared with the level of loan debt outstanding required by this Financial Plan (excluding potential Capitalisation Direction), as follows:

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



8.2. The Gross Loans Requirement in Figure J.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 long term and 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.

8.3. The shortfall in the medium term as shown in the chart is planned to be met by a short term loans portfolio, in line with the current strategy, although this may be restricted by the availability of local authority lenders following the Council's issuance of its Section 114 notice (see paragraph 5.7 above).

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

8.5. 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 Finance (Section 151 Officer) in accordance with treasury management delegations.

9. HRA and General Fund Treasury Strategies

9.1. 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 has previously looked to increase the HRA's exposure to short term loans whenever possible.

9.2. The current HRA Business Plan has substantial investment plans for its existing housing stock in order to achieve compliance with Decent Homes Standards. As the HRA seeks to increase its prudential borrowing levels significantly in the next few years, the Council will supplement the HRA with further long term loans, a significant factor in the Council's overall net loan debt increasing over the next few years.

9.3. The following table shows how net loan debt for the HRA increases as a result of forecast new long term debt. Conversely net loan debt for the General Fund reduces over the same period although some new debt will be required:

Table J.5 Forecast net loan debt for the HRA and General Fund based on the Proposed Borrowing Strategy

Cumulative debt (taking account of debt maturities and proposed long term borrowing)	**2024/25 £m**	**2025/26 £m**	**2026/27 £m**	**2027/28 £m**
Housing Revenue Account				
Year end net exposure to variable rates	235.0	286.8	330.1	353.1
Existing HRA long term debt	872.1	857.3	850.8	840.1
Forecast HRA new long term debt	180.0	330.0	440.0	590.0
Closing HRA net loan debt	**1,287.1**	**1,474.0**	**1,620.9**	**1,783.2**
General Fund				
Year end net exposure to variable rates	-40.6	52.7	85.9	33.6
Existing GF long term debt	1,912.6	1,860.7	1,731.1	1,659.6
Forecast GF new long term debt	50.0	140.0	140.0	140.0
Closing General Fund net loan debt	**1,922.0**	**2,053.3**	**1,957.0**	**1,833.2**
Year end variable interest rate assumption	5.50%	4.25%	4.00%	4.00%
Year end fixed interest rate assumption	4.50%	4.25%	4.00%	4.00%

Note: the variable rate figures above include long term loans maturing in less than a year net of short term investments.

9.4 Variable rate exposure means that a 1% rise in variable rates at the end of 2024/25 would cost an estimated £2.4m per annum for the HRA and neutral for the General Fund. The budget provides for a potential increase in variable rates (as shown above), which is considered to be prudent in this context. Variable rate exposure for the HRA and General Fund are likely to be lower than previous years due to the limited availability of local authority lenders since the Council issued its Section 114 notice.

9.5 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 Finance (Section 151 Officer) will keep the strategy under close review during the year, in light of the Council's financial position and the outlook for interest rates.

10. Treasury Management Revenue Budget

10.1 Based on this strategy the proposed budget figures (excluding Capitalisation Direction) are as follows:

Table J.6 Treasury Management Revenue Budget

	2024/25 £m	2025/26 £m	2026/27 £m	2027/28 £m
Net interest costs	136.2	137.0	139.1	141.6
Revenue charge for loan debt repayment	123.8	129.9	138.9	143.0
Other charges	5.8	6.5	5.8	5.8
Total	**265.8**	**273.4**	**283.9**	**290.4**
Met by the HRA	64.0	67.6	71.9	76.2
Met by the General Fund	201.8	205.8	211.9	214.3
Total	**265.8**	**273.4**	**283.9**	**290.4**

10.2 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.

10.3 Investment Strategy

10.3.1 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.

10.3.2 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.

10.3.3 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.

10.3.4 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.

10.4 Other Treasury Management Activities and Exposures

10.4.1 The Council has 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.

10.4.2 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.

10.4.3 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.

10.5 Advisers

10.5.1 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. Arlingclose were reappointed as the Council's treasury management advisor following a competitive tender exercise during 2022/23.

10.6 Prudential Indicators for Treasury Management

10.6.1 The Council is required under the Local Government Act 2003 and the CIPFA Treasury Management Code to set Prudential Indicators for treasury management..