Cabinet meeting on the 20 January 2016

Treasury Management, Annual Investment and Minimum Revenue Provision Strategies 2016/17

Report summary from Ian Parry, Deputy Leader and Cabinet Member for Strategy, Finance and Corporate Issues

Ian Parry said "The UK economy has improved in the last few years but the County Council still faces significant risks in undertaking its treasury management activities. This means we will continue with our sensible approach of investing carefully and using cash instead of borrowing to save money"

1. This report sets out how the County Council plans to manage its investment and borrowing activity in the coming year. This will take place against an improved economic backdrop but where the risk of investing has actually increased for local authorities. This is due to changes in how the regulators would act if a financial institution failed and is reflected in this treasury strategy.

2. The report explains that, where possible, we will continue to use our own cash instead of borrowing money, whilst retaining the flexibility to take out loans if we need to. Using cash instead of borrowing means that we have less to invest, thus reducing our exposure to banks and building societies. This is still an important consideration, especially with the new regulations.

3. When we do invest, we will continue to work on the prudent basis that the return of our money is more important than the return on our money.

4. Our treasury activities involve large sums of money and reflect the huge scale of the County Council's operations. The amount of financing raised to fund capital investments, for example on schools and highways, is expected to be £581 million on the 31 March 2016.

5. Overall the report shows that the County Council's borrowing and investment activities are being undertaken prudently and sensibly against an improved but still challenging economic background.

Recommendation – I recommend that Cabinet approve the detailed set of recommendations set out in the attached report.

Local Members Interest
N/A

Cabinet – 20 January 2016

Treasury Management, Annual Investment and Minimum Revenue Provision Strategies 2016/17

Recommendations of the Deputy Leader and Cabinet Member for Strategy, Finance and Corporate Issues

1. That, in accordance with regulations, the Cabinet recommends to the County Council, at its meeting on the 17 March 2016, the adoption of the Annual Investment Strategy (AIS) 2016/17 detailed in **paragraphs 24** to **67** and as detailed in **Appendix 2** and **Appendix 4.**

2. That Cabinet approve, as required by guidance, policies on;
   a) reviewing the strategy
   b) the use of external advisors
   c) investment management training
   d) the use of financial derivatives.

   As described in **paragraphs 91** to **100.**

3. That the Cabinet approve the proposed borrowing strategy for the 2016/17 financial year comprising;
   a) the use of cash in lieu of borrowing required in 2016/17
   b) the use of cash to repay loans early, subject to market conditions
   c) as a contingency, the ability to borrow new loans as a result of;
      - unexpected changes in the capital programme
      - a reduction in the level of cash balances
      - the repayment of LOBO's.
   d) a forward borrowing strategy that will not be used in 2016/17
   e) a loan rescheduling strategy that is unlimited where this re-balances risk.
   f) The above to operate within the prudential limits set out in **Appendix 5** and in consultation with the Deputy Leader and Cabinet Member for Strategy, Finance and Corporate Issues with respect to early loan repayment, raising new loans and loan rescheduling.

4. That, in accordance with regulations, the Cabinet also recommends to the County Council the adoption of the Minimum Revenue Provision (MRP) policy 2016/17 as summarised in **paragraphs 101** to **103**; the full policy statement is shown at **Appendix 8.**

Report of the Director of Finance and Resources

Reasons for recommendations

5. The UK Economy has grown steadily over the last 12 months and continues to outperform its European peers. Inflation has been low, reaching negative levels at some points and the Bank of England has maintained its historically low base rate of 0.5%. The financial environment however still remains risky.

6. A major risk for local authorities is the UK implementation of the Bank Recovery and Resolution Directive (BRRD) in January 2015. The BRRD ensures EU Member States are consistent in how they deal with the failure of banks and investment firms. Under these new rules, instead of a government "bail out" of a bank, a "bail in" of current investors will be forced upon the bank by regulators. The risk of loss for local authorities in a bail-in situation is much greater, as any unsecured fixed-term deposits would be ranked near the bottom of the capital structure and would be one of the first to suffer losses.

7. Risks also remain in the global economy. An example was seen in August 2015 when world markets crashed because of concerns about growth prospects in China. As a result of these remaining risks, the treasury strategy retains the low risk approach adopted in recent years, based on prioritising security, liquidity and then yield.

Link to the Medium Term Financial Strategy (MTFS)

8 It is a statutory requirement under Section 33 of the Local Government Finance Act 1992 for the County Council to produce a balanced budget. In particular, Section 32 requires the calculation of a budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. Capital expenditure must not exceed an amount which can be afforded, in terms of interest charges and running costs for the foreseeable future.

9. The Local Government Act 2003 requires a local authority to have regard to the Prudential Code and to set Prudential Indicators for the next three years to ensure that its capital investment plans are affordable, prudent and sustainable. The Prudential Indicators are approved as part of the Medium Term Financial Strategy (MTFS), but the treasury indicators are included in this report as they require consideration as part of the Treasury Management Strategy. **Appendix 5** lists these indicators for the next five financial years in order to provide a link to the MTFS. A brief narrative of the reason for each indicator is also shown.

10. The Treasury Management Strategy is a key element of the MTFS as the planned capital expenditure programme drives the borrowing required. This is explained further in the Borrowing Strategy from **paragraph 68** onwards.

Economic and financial background

Interest rates

11. In considering the County Council's borrowing and investment strategies, it is important that account is taken of the likely economic environment and the potential level of interest rates. For the last couple of years there has been

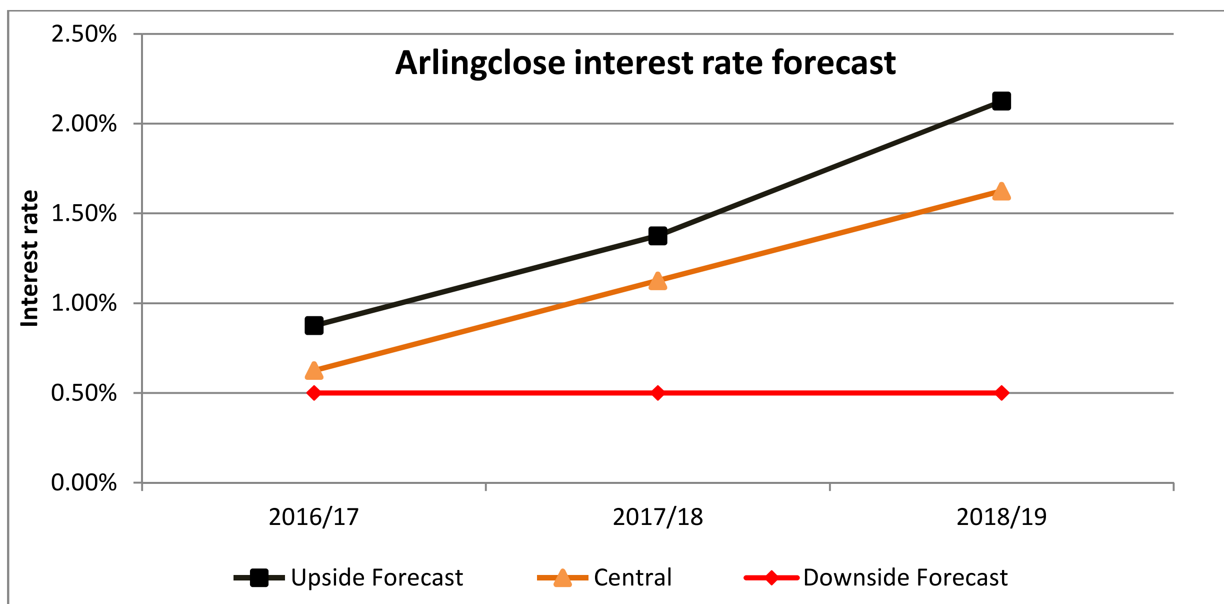
much discussion in markets about the timing of the first increase in bank rate (the interest rate set by the Bank of England) with the expected first move repeatedly pushed into the future.

12. Forecasting is notoriously difficult in such a complex economic environment but there is tension between separate issues which will effect the Bank of England's decision:
    - The current benign inflationary environment and potential for external shocks in the global economy reduces the pressure for a rise.
    - The continued GDP growth in the UK economy supports a rise.

    In December 2015 the US Federal Reserve (Fed) raised it's interest rate for the first time since the financial crisis. It has been widely believed in financial markets for some time that the Fed would act first in raising rates and then other central banks would follow.

13. In terms of treasury management, the bank rate is fundamental to the income received and it may also affect expenditure on loan interest where new loans are taken out or variable rate loans are held.

14. The following graph shows an interest rate forecast for the forthcoming three years as provided by the County Council's advisor, Arlingclose. Three possibilities are shown, an upside (the higher of the three), central and downside forecast.



15. The central forecast is Arlingclose's most likely scenario for interest rates and is considered prudent for setting the budget. The forecast has been used in the MTFS and reflects the fact that short-term interest rates may start to rise slowly in 2016.

16. So whilst interest rates are expected to rise in 2016 and thereafter, they are not expected to reach pre-crisis levels for many years into the future.

<u>Credit outlook</u>

17. Bail-in legislation (see **paragraph 6**) has now been fully implemented in the UK, USA and Germany, the rest of the European Union will follow suit in

January 2016. The credit risk for a local authority of making unsecured investments with banks has therefore increased. Meanwhile changes to the UK Financial Services Compensation Scheme and similar European schemes mean that most private sector investors are now partially or fully exempt from contributing to a bail-in.

18. The credit rating agencies have taken a new approach with the introduction of the new regulations and moved to a 'loss absorbency' approach. This now takes account of the differing impact a credit event would have on the different classes of investments (e.g. covered bonds, unsecured deposits). In some cases this has meant some banks and building societies have actually had a credit rating uplift.

19. The varying fortunes of the global economy are reflected in the market indicators for credit risk for UK Banks. Those operating in Asia and parts of Europe have seen perceived risk increase whilst those with a UK focus have seen improvement. The sale of most of the government's stake in Lloyds and the first sale of it's shares in the Royal Bank of Scotland have been seen as credit positive.

20. Stress tests conducted by the Bank of England's Prudential Regulatory Authority (PRA) also give an indication of the health of the largest and most important UK banks. In December 2015 the most recent results were announced and five of the seven banks "passed" which means that their balance sheets are strong enough to survive an extreme economic downturn. RBS and Standard Chartered were found not to have enough capital strength but having already taken steps to address this, were not ordered to come up with a new plan by the PRA.

21. Although the risk under the new regulations has increased, the County Council will continue to follow the advice of Arlingclose. The full creditworthiness approach is outlined from **paragraph 37**.

Policy framework

21. In order to assess the various options for borrowing and investment it is important to have a policy framework. The table that follows sets out three main elements:
    1. Objectives.
    2. Economic considerations.
    3. Relevant risks.

23. The table compares borrowing and investments side by side to highlight the similarities and differences. For example, some of the economic considerations (i.e. the yield curve) are similar, whilst some aspects are different.

	Borrowing strategy	**Investment strategy**
Objectives	• Reduce the average rate (cost) of debt ensuring debt is affordable • Maintain medium term budget stability • Be able to respond to changes in the external environment	• Ensure security (and to ensure bills are paid) • Provide liquidity (i.e. to pay the bills as they fall due) • Earn interest

Economic considerations	• The shape of the whole yield curve* (the level of interest rates for different lengths of time) • The steepness of the yield curve • Forecast changes in interest rates • The relative position of interest rates to the average cost of the debt • The direction of travel of overall debt in the future • Cash balances available to support the strategy	• The shape of the short-term yield curve* • Forecast changes in interest rates • Counterparty issues (credit worthiness) • Type of financial instrument • Risk in the financial environment
Relevant risks	• Security • Liquidity • Interest rate • Market risk • Refinancing • Regulatory and legal	• Security • Liquidity • Interest rate • Market risk • Refinancing • Regulatory and legal

**The yield curve is a fundamental concept; it represents the price paid by the County Council for its long-term loans or the price received for the money it invests.*

Annual Investment Strategy (AIS) 2016/17

24. The County Council manages a significant investment portfolio that can reach over £200m each year. Since the financial crisis in 2008, the County Council has taken a low risk approach and the AIS continues in this vein.

<u>Investment options</u>

25. The main characteristics which determine an investment strategy are related to;
    - the credit risk of the counterparties that you invest with
    - the length of the investment
    - the type of financial instrument that is used.

26. These issues have to be considered in the light of the regulatory framework provided by the Government.

27. Key parts of this framework are the Government Guidance on Local Government Investments, issued in March 2010 and the CIPFA Code of Practice for Treasury Management in the Public Services. These state that the two prime risk issues are;
    - the security of capital
    - the liquidity of investments.

28. In addition, government regulations specify the type of financial instruments you can invest in and divide them into what they term ‘specified’ investments and ‘non-specified’ investments.

Specified investments

29. Specified investments are investments made in sterling for a period of less than a year that are not counted as capital expenditure and are invested with;
- the UK Government
- a local authority
- a parish or community council
- a body, or in an investment instrument, **that has 'high credit quality'.**

30. The first three named investments will be used by the County Council by virtue of their inclusion within the guidance (referred to as regulation investments subsequently in this report). The assessment of the fourth aspect is dealt with in the paragraphs that follow.

31. Whilst it is difficult to define 'high credit quality', credit ratings are published by credit rating agencies (for example, Fitch, Standard and Poors, Moodys); this information is provided by the County Council's treasury adviser, Arlingclose, where available.

Money Market Funds (MMF's)

32. Money Market Funds are pooled investment vehicles consisting of money market deposits and similar instruments. Arlingclose recommend the use of MMF's by their local authority clients, and these have been used for some time by the County Council.

33. In the background there is the possibility of European Commission (EC) regulations that may affect how MMF's operate and in the light of these, it is MMF's that meet the criteria listed below which will be considered to have high credit quality and will be included on the lending list:
- Recommended to clients by the County Council's treasury adviser, Arlingclose.
- Diversified – MMF's are diversified across many different investments, far more than the County Council could hope to achieve on its own account.
- Same day liquidity – this means that funds can be accessed on a daily basis.
- Ring-fenced assets – the investments are owned by the investors and not the fund management company.
- Custodian – the investments are also managed by an independent bank known as a custodian, who operates at arms-length from the fund management company.

34. All treasury activity carries an element of risk and MMF's are no different. In the event of a further financial crisis, the failure of one or more of an MMF's investments could lead to a run on the MMF as investors rush to redeem their investment. This could then spread to other MMF's as investors take flight from this asset class.

35. The very low interest rate environment also threatens the ongoing continuity of MMF's. Each MMF charges a fee and this could mean that interest earned becomes negative after its deduction. If this problem arises then it would be a matter of moving funds to an alternative class of investment.

36. All of these issues point towards the fundamental need for diversification across MMF's and also investment categories where possible. This issue is dealt with later in this report (**paragraph 52** onwards).

The credit management strategy for 2016/17

37. Government guidance requires an explanation of how credit quality is monitored, what happens when it changes and what additional sources of information are used to assess credit quality.

38. The assessment of what "high credit quality" is for banks or building societies is set out in this section of the report.

39. Arlingclose are the County Council's treasury advisor and an important aspect of this service is credit advice. This is where the advisor provides information to the County Council about suitable investments in the context of the current economic risk environment and incorporates the views of credit rating agencies. What follows is an overview of how this operates, it is important to understand that the County Council is responsible for the decisions it takes with its investments.

40. Credit ratings provided by the three main credit rating agencies form an important, but not the only, aspect of how creditworthiness is assessed by Arlingclose. For 2016/17 minimum credit-rating thresholds are set at a long-term rating of "BBB" where available. Counterparties that are rated below this level are excluded.

41. In addition the following are also considered:
- Statements of potential government support.
- Credit Default Swap prices (CDS) (i.e. the cost of insuring against counterparty default).
- Share prices.
- Gross Domestic Product (GDP) in the country of incorporation.
- Macro-economic factors.
- Information in the press.
- A subjective overlay, i.e. a judgement being made about whether the counterparty should be recommended or not.

42. In practical terms all of this information is considered by Arlingclose when they determine their recommendations. Any change in these criteria can result in a counterparty being removed from the lending list, not solely a change in credit rating.

43. In the recent past, the economic environment has been very volatile, so the advice provided by Arlingclose results in counterparties with high quality credit characteristics that are intended to insulate the County Council against further volatility. Of course, the future cannot be foreseen and in some situations changes may need to be made quickly, but this is considered a cautious approach.

44. The County Council remains responsible for its investment decisions. The Treasury Management Panel, chaired by the Director of Finance and Resources, meets monthly and a review of the lending list and any changes made by Arlingclose will take place at these meetings. In between meetings the

treasury team will implement any recommendations made by Arlingclose. On the rare occasion that Arlingclose do not make a firm recommendation then this will be referred to the Panel for their review.

45. Under stressed market conditions, additional Panel meetings may take place at very short notice after which the Panel may decide to adjust the County Council's investment risk profile. The end result may involve moving investments to lower risk counterparties or instruments.

46. The proposed AIS would be based on the following definition of high credit quality:
    - Regulation investments as set out (**paragraph 29 and 30**)
    - Diversified sterling Money Market Funds meeting the criteria set out (**Paragraph 33**).
    - A bank or building society that is recommended by Arlingclose for inclusion on the lending list.

Monitoring

47. As required, an overview of the monitoring process is outlined below:
    - Rating changes and significant changes in risk indicators will be communicated to the treasury team by Arlingclose together with any revisions to their recommendations.
    - Changes are sent by e-mail and in urgent situations followed up by a phone call.

The County Council's banker

48. The County Council recently completed the implementation of its new banking provider, Lloyds Bank. Under the new arrangements funds are retained with Lloyds Bank each night earning interest at a market rate; the amount retained will be set in line with the diversification policy set out at **paragraph 52** onwards.

49. Should the Lloyds credit rating fall below the minimum specified in this report, then small balances may be retained with the bank for operational efficiency. This will be determined by the Treasury Management Panel chaired by the Director of Finance and Resources.

Investment duration for specified investments

50. In considering the financial instruments that meet the definition of a specified investment, there is the scope to consider the length of the investment period.

51. One of the important lessons of the banking crisis has been to exercise caution in the duration of investments with banks and building societies. This recognises that the factors that led to the investment being considered sound can change adversely over time. As such it is judged reasonable to limit unsecured fixed-term deposits with banks or building societies to a maximum duration of 12 months, even if Arlingclose recommend a longer duration.

Investment diversification

52. Having determined the lending list of highly rated counterparties and the duration of investments, the last piece of the process is to overlay the methodology for ensuring diversification. This is achieved by setting a maximum amount to be invested with each counterparty to limit risk and to spread investments.

53. Ensuring diversification has never been more important; it protects the security of the investments by limiting the County Council's loss in the event of a counterparty default. However, diversification does not protect the County Council from a systemic failure of the banking sector, although the risk of this has diminished as a result of new the bail-in banking regulations introduced.

54. Investment balances rise and fall during the year, so diversification needs to take account of this. The limits shown are based upon percentages of investments and the treasury team will review and reset these limits at least once a month with reference to forecast future balances. This action will then be ratified by the Treasury Panel at their next meeting. The interval between each review is very much a matter of balance between ensuring diversification and efficient processing as investment balances cannot practically be moved each day to accommodate shifting limits. It is judged that a monthly review strikes this balance.

55. Investment diversification is proposed at two levels; firstly at investment category level:

Investment category	**Maximum % of total investments**
Regulation Investments*	100%
MMF's	50%
Banks and Building Societies	50%

**no limit is proposed (in certain circumstances these may be utilised for all of the County Council's investments)*

56. Secondly, diversification will also take place at investment category level:

Banks and Building Societies Lower of:	
£m	Maximum investment as a proportion of the total forecast balances
30	5% (unsecured) 10% (secured)

MMF Lower of:	
Maximum investment as a proportion of total MMF size	Maximum investment as a proportion of the total forecast balances
0.50%	10%

57. There is an exception to these rules, that where balances are low then the amount invested in MMFs may be as high as 100%. This recognises the fact that there may simply be no other available investment for small amounts where liquidity is needed.

58. Arlingclose amended their advice during 2015/16 to take account of the new bail-in regulations, previously discussed in this report. Before they recommended a maximum of 10% of balances be invested per bank or building society, now they recommend 10% but only if investments are secured (e.g. covered bonds). The limit for investments which are unsecured (e.g. fixed term deposits) was reduced to 5%.

59. It is proposed that both the application and amendment of the investment diversification policy are delegated to the Treasury Management Panel chaired by the Director of Finance and Resources, with the results reported to Cabinet in the regular treasury management reports.

Non-specified investments

60. The Government regulations define non-specified investments as all other types of investment that do not meet the definition of specified investments. In contrast to specified investments, government guidance indicates that the AIS should;
    - set out procedures for determining which categories of non-specified investments should be prudently used
    - identify such investments
    - state an upper limit for each category of non specified investment
    - state upper limits for the total amount to be held in such investments.

61. The non-specified investments proposed for use within the AIS are listed below. None of these present any additional security risk to the investments within specified investments and each is explained below.

    - Covered Bonds – These are issued by banks and building societies and guaranteed by a group company that holds the bank or building societies mortgage assets. Covered bonds are exempt from bail-in and the structure enables investors to have effective security over the mortgage assets, which means they could be sold if needed. Covered bonds could be classified as a specified investment but only if the maturity was under 12 months with a bank or building society recommended by Arlingclose.
    - Repos (a Repurchase Agreement) – The purchase of securities with the agreement to sell them at a higher price in the future. Repos involve investments being exchanged for assets, such as government bonds which can be sold in the case of a loss.

- Certificates of Deposit (CD's) – Identical to a fixed term deposit and not exempt from bail-in. A certificate is issued for the specified length of time and rate of interest which could be sold in the secondary market if needed. CD's could be classified as a specified investment but only if the maturity was under 12 months with a bank or building society recommended by Arlingclose.
- Government gilts – equivalent to the Debt Management Account Deposit Facility (DMADF) account and Treasury Bills, simply a longer term investment with the UK Government that can be sold.
- Multilateral development bank bonds – "AAA" rated, these are institutions created and backed by a group of countries which can be sold as needed.
- Collective schemes - There are many types of collective schemes, from enhanced MMF's (which have 3-5 day liquidity as they invest further along the yield curve) to property and equity funds. These all have varying risk and return profiles. The category is included here for possible use, subject to a decision by the Treasury Management Panel.

62. Where investments are subject to market risk (this is the risk that the value of the investment can go down as well as up), the inclusion of these investment instruments is proposed only on the basis that if purchased they would be held until maturity under normal circumstances. At maturity the investment and expected interest would be paid in full. In the case of Certificates of Deposit then these would only be sold early on the basis that there were concerns over the borrower defaulting.

63. Investments that involve the considerations referred to above, the decision to invest will only be taken after due consideration by the Treasury Management Panel chaired by the Director of Finance and Resources.

64. For the purpose of setting investment amount and duration limits, it is planned to split non-specified investments into two categories (see **Appendix 2**).
    - For long-term local authority loans and UK Government Gilts it is proposed to have a combined investment limit of £45m (up to 40 years duration) due to their similar high credit quality. The County Council has held £30m of long term local authority investments since 2013.
    - For other non-specified investments, it is proposed to cap the individual investment amount per asset class at £20m (up to 5 years duration) with an overall cap of £50m for this group.

    This means a total of £95m can be invested in non-specified investments in 2016/17 and is reflected in **Appendix 5,** prudential indicators (point 5).

65. **Appendix 2** sets out the investment categories authorised for use in 2016/17 and **Appendix 4** lists the County Council's lending List, as recommended by Arlingclose, at the time of writing this report.

Risk assessment

66. Although guidance sets out security and liquidity as being the main treasury risks, they are not the only risks in investing faced by the County Council. **Appendix 3** sets out a high-level risk assessment of six of the key risks which are summarised in the following table:

Risk	Assessment
Security	Low
Liquidity	Low
Interest rate	Low to Medium
Market	Low
Refinancing	Low to Medium
Regulatory and Legal	Low

67. The proposed AIS has been assessed against these risks and the judgement is that the most important risks have been reduced as far as possible. This is not to say that all risk has been eliminated, which is not possible in treasury terms.

Borrowing strategy 2016/17

Link to the Medium Term Financial Strategy (MTFS)

68. The following table shows how new borrowing is calculated and demonstrates how the MTFS and the capital expenditure programme are related. The table includes an allowance for the Minimum Revenue Provision (MRP), which is a contribution towards the repayment of debt. Some of the MRP is not payable by the County Council, but the treasury team manage the entire position whether it relates to County Council debt or not.

	2016/17 £m	**2017/18 £m**	**2018/19 £m**
capital expenditure programme	158	78	56
less funding from other sources of finance	92	61	39
= funding from borrowing	66	17	17
less gross MRP *	(22)	(22)	(22)
= net new borrowing for planned capital expenditure / (repayment) **	**44**	**(5)**	**(5)**
* County Council MRP	(19)	(20)	(20)

** *excluding the borrowing needed to replace maturing loans*

Borrowing position

69. Although the County Council's debt is forecast to slowly decrease after 2016/17, the following table shows the levels of cash used to support this debt will actually increase (under current forecasts and assuming no change in policy). This is due to £20m of PWLB loans maturing and not being replaced, which will increases the use of cash.

	2016/17 £m	**2017/18 £m**	**2018/19 £m**
forecast gross debt at 31 March	626	621	616
forecast loans position	518	513	498
difference funded from cash	108	108	118

70. The loans position includes £81.5m of what are known as LOBO (Lender Option Borrower Option) loans. In each case the lender has a loan call option

which could amend the interest rate on a pre-determined date to a higher rate. Therefore the County Council's policy on LOBO loan calls will be to repay these in all cases and either;

- take up a shorter term and cheaper loan, say with the Public Works Loan Board (PWLB).
- finance the balance from cash in line with this strategy.

71. It is judged unlikely in the current interest rate environment that LOBO loans options will be exercised. However, the financing stress that banks are under and a recent parliamentary investigation into the potential mis-selling of this type of loan to local authorities could lead to banks considering this. Whilst the loans have been arranged to stagger the potential impact of options being exercised, in 2016/17 £61.5m of loans are subject to a call option.

Borrowing options

72. The County Council has three main options available to it in a borrowing strategy:

- To use cash (i.e. do not borrow).
- To bring borrowing up to the amount needed to fully fund the capital programme at any point in time.
- To forward borrow up to two years in advance.

73. Overall, the economic environment continues to favour using cash for a further year because of the reasons below:
- There is a normal yield curve (i.e. it's cheaper to use cash than to borrow).
- With the introduction of bail-in legislation it is more important than ever to minimise security (investment) risk (as using cash reduces investment balances).
- Future debt levels are forecast to fall (i.e. new loans are not forecast to be needed).
- Arlingclose are forecasting the first rise in bank rate in Q3 2016 with a slow increase over further years to a peak of around 3%. This means that rates will remain below the County Council's average debt rate for a number of years.

74. Continuing to use cash within practical cash management limits would meet the policy outlined at **paragraph 27**.

75. As shown in the interest rate forecast (**paragraph 14**), bank rate is at a very low level and it is expected to remain well below the average debt rate for the next year and beyond. Following this strategy therefore meets the objective of bringing down the average rate of interest for borrowing and provides an opportunity to fund the capital programme at low cost.

76. A key part of the CIPFA Code of Practice for Treasury Management is to assess the risk of the treasury management borrowing strategy. It sets out a number of risks to be considered and this assessment for the six risks considered most relevant is shown at **Appendix 7**. A summary is provided in the following table:

Risk	Assessment
Security	Low
Liquidity	Low
Interest rate	Low to Medium
Market	Medium
Refinancing	Medium
Regulatory and Legal	Medium

77. Other risks CIPFA set out have not been considered as they are less important when determining a borrowing strategy. These are inflation, operational and foreign exchange risks.

78. Overall the use of cash in lieu of borrowing is considered a relatively low risk strategy.

Proposed contingency arrangements and flexibility

79. To date, cash balances have been sufficient to allow the strategy of using cash to continue without taking out external loans. The possibility of further unexpected reductions in cash balances needs to be recognised. This could be due to;
    - increases in the capital programme
    - budget pressures
    - changes in the County Council's cash funding as a result of structural changes
    - LOBO loan call options being called.

80. Where additional liquidity is needed temporarily, then the County Council can call upon short-term temporary loans raised from the money markets, including from other local authorities with surplus cash to invest.

81. If these facilities are not available then new long-term loans, for a year or more, must be raised to allow the County Council to continue to pay its day to day bills.

82. If new long-term loans are needed it is necessary to consider their exact nature. The following observations are important:
    - The County Council's existing loan portfolio is very long-term as can be seen on the graph at **Appendix 6.** Taking shorter term loans would rebalance the portfolio.
    - As stated already, the yield curve is normal. Shorter term loans are cheaper.
    - PWLB interest rates are much higher than they were historically (see point 89).

83. It is clear that in the current economic climate, loans should be shorter-term in nature. In terms of the choice of loans there are a number of possibilities:
    - PWLB loans – a well known route for local authorities, still seen as the "lender of first resort" because of the flexibility and ease of access. However the risk of this facility being discontinued or amended further should be noted.

- Local authority loans – other local authorities may have different cash flow positions which create cheap funding opportunities in the short to medium term.
- Market loans – these may come in various forms, such as bank loans, and may be cheaper than the PWLB.
- The UK Municipal Bonds Agency - an organisation set up by the Local Government Association in 2014 as an alternative to the PWLB. This agency plans to issue bonds on the capital markets and lend the proceeds to local authorities.

84. Should the decision to borrow long-term be needed, it will be taken by the Director of Finance and Resources in consultation with the Deputy Leader and Cabinet Member for Strategy, Finance and Corporate Issues because the optimum timing cannot be foreseen and a decision often needs to be taken at short notice. Members will be kept informed via the outturn and half-year treasury management reports.

Policy on borrowing in advance of need

85. The Prudential Code allows borrowing to take place for the current year plus two future years. However, Government regulations state that there should be a specific policy on borrowing in advance of need.

86. As the borrowing strategy set out for 2016/17 involves use of cash resources in the first instance, then the policy is not to borrow in advance of need this year. This will be reviewed each year as part of the overall borrowing strategy.

Loan restructuring

87. Movements in interest rates over time may provide opportunities to restructure the loan portfolio in one of two ways:
    - Replace existing loans with new loans at a lower rate (known as loan rescheduling).
    - Repay loans early, without replacing the loans. This would increase the use of cash.

88. The County Council's ability to adjust its loan portfolio through restructuring is only possible if;
    - the Government allow it; PWLB rules have been changed in the past with no notice
    - market conditions allow economic repayment.

89. Currently loan restructuring would be very expensive and unattractive for the County Council. This is because:
    - Gilt yields are still historically low. This would lead to large penalties to compensate the PWLB if loans were repaid early.
    - New loans are much more expensive than in the past even though Gilt yields are so low. Since 2010 the Government has increased the margin on top of Gilts at which it onward lends to local government via the PWLB (originally 1.00%, subsequently dropped to 0.80%).

90. Market conditions and regulations do change so it is proposed to allow loan restructuring. The decision will be delegated to the Director of Finance and

Resources in conjunction with the Deputy Leader and Cabinet Member for Strategy, Finance and Corporate Issues.

Review of strategy

91. Regulations require that the circumstances under which a revised strategy would be prepared should be stated. These circumstances would be a change in;
    - the economic environment
    - the financial risk environment
    - the budgetary position
    - the regulatory environment.

92. The responsibility for assessing these circumstances and proposing changes to the strategy is allocated to the Treasury Management Panel chaired by the Director of Finance and Resources.

Policy on the use of external service providers

93. Regulations require the County Council to disclose its policy on the use of external providers. Arlingclose were appointed as the County Council's external treasury management adviser from 1 April 2013.

94. Arlingclose are contracted to pass on information, provide technical accounting assistance and an investment advice service. The County Council recognises that responsibility for treasury management decisions remains with itself at all times.

95. An annual review of service quality is carried out by senior officers on the Treasury Management Panel. Arlingclose attend meetings bi-annually to discuss how well they are assisting the County Council to discharge its responsibilities.

Investment management training

96. The County Council is also required by regulations to disclose its processes for ensuring officers are well-trained in investment management.

97. Treasury management is a specialised area requiring high quality and well trained staff that have an up to date knowledge of current issues, legislation and treasury risk management techniques.

98. Officers who attend the Treasury Management Panel are senior qualified finance professionals. Treasury practitioners attend regular CIPFA and treasury consultant training seminars throughout the year and undertake a My Performance Conversation assessment each year through which training needs are identified.

99. Member training is also important to introduce treasury concepts. The need for training events will be kept under review with more sessions arranged in the future if necessary.

Policy on the use of financial derivatives

100. Local authorities have previously only made use of financial derivatives embedded into loans and investments (e.g. those embedded in LOBO loans). With the introduction of the General Power of Competence in the Localism Act 2011, a lot of uncertainty around the use of standalone derivatives (e.g. swaps, forwards and futures) was removed. The County Council would only arrange standalone derivatives with an approved investment counterparty where it can be clearly demonstrated that they reduce financial risk.

MRP Strategy 2016/17

101. The County Council are also legally obliged to have regard to government guidance issued in February 2008 concerning the Minimum Revenue Provision (MRP) policy. MRP is where the County Council must make an annual revenue provision for the repayment of debt (also referred to as the Capital Financing Requirement or CFR). The MRP policy must be submitted to the full Council for approval prior to the start of the financial year to which the provision will relate. The policy for 2016/17 is summarised below and shown in full at **Appendix 8**.

102. Following guidance issued in 2007/08 regarding the Minimum Revenue Provision (MRP), it is proposed to continue the agreed policy as follows:
   - The major proportion of the MRP for 2016/17 will relate to the more historic debt liability that will continue to be charged at the rate of 4%, in accordance with the recommendations and intent of Option 1 of the guidance.
   - Further amounts of new capital expenditure may continue to be charged at the rate of 4%, and added to the above mentioned base CFR amount, up to an amount equivalent to the County Council's annual Supported Capital Expenditure (Revenue) allocation.
   - Certain expenditures reflected within the debt liability at 31 March 2016 will under delegated powers be subject to MRP under Option 3.
   - With regards to loans granted by the County Council no MRP will be charged on them. The MRP will be equated to the principal repayment of the individual loans.

103. In practical terms, this approach means that capital expenditure funded from supported borrowing (that is, supported by government grant) will be repaid at 4%. However, expenditure funded from unsupported borrowing will be repaid at a rate which matches the useful lives of those assets funded. This will result in a saving for the authority as the debt can be spread over a longer period of time, for example 60 years where a building has been funded from unsupported borrowing (that is, supported by the County Council). The MRP Policy statement for 2016/17 is shown at **Appendix 8**.

Appendix 1

Equalities implications: There are no equalities implications.

Legal implications: Approval of Prudential Indicators and an Annual Investment Strategy is necessary in order to meet the requirements of the Local Government Act 2003.

Resource and value for money implications: All resource implications are covered in the body of this report which links to the County Council's MTFS.

Risk implications: Risk is inherent in treasury management and is dealt with throughout the report.

Climate change implications: There are no direct climate change implications arising from treasury and investment strategy decisions.

Health impact assessment screening: There are no health impact assessment implications arising from this report.

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List of background papers

1. Treasury Management in the Public Services: Code of Practice (CIPFA) (2011)
2. Prudential Code for Capital Finance in Local Authorities (CIPFA) (2011)
3. Local Authorities (Capital Finance and Accounting) Regulations 2003
4. Local Government Investments - Guidance under Section 15(1) of the Local Government Act 2003 issued by the Secretary of State
5. Local Government Act 2003 - Guidance issued under section 21(1a) (re MRP policy)

Appendix 2

Cabinet – 20 January 2016 - Investment categories authorised for use 2016/17

Investment	Specified*	Non-Specified	Comments
UK Government - Debt Management Account Deposit Facility (DMADF) (regulation investment)	**unlimited**	**n/a**	6 months maximum available
UK Government - Treasury Bills (T-Bills) (regulation investment)	**unlimited**	**n/a**	6 months maximum available
UK local authorities term deposits (regulation investment)	**unlimited**	**£45m across these categories**	Up to 40 years in duration (non-specified)
UK Government – Gilts	**unlimited**		
Money Market Funds	✓	**n/a**	50% of total investments in this category. Lower of 0.50% of MMF size or 10% of all investments per MMF
Term deposits with banks and building societies	✓	×	50% of total investments in this category. Lower of 5% (unsecured) or 10% (secured) of total investments or £30m per counterparty
Certificates of deposit (banks / building societies)	✓	**Maximum £20m per investment category and £50m in total across all categories**	Up to 5 years in duration (non-specified)
Bonds issued by Multilateral Development Banks	✓		
Collective Investment Schemes	×		
Covered Bonds	✓		
Repos (repurchase agreement)	×		

** Up to 12 months*

Appendix 3

Cabinet – 20 January 2016

Risk Assessment – Investments

Risk Heading	Risk Description	Relevance to Investment	Key Control	Assessment	Approved Investment Strategy (AIS)
Security	A third party fails to meet its contractual obligations (counterparty risk).	Crucial that money invested is returned (principal and interest).	Relies on credit management policy including; credit risk, duration of investment and amount as well as an ongoing review of the credit environment. Prudential Limit on investment over 1 year as well as limits on non-specified investments.	**LOW**	Use of the instruments and banks identified within the AIS reduces this risk to a low level. In addition the long-term investments with other local authorities has reduced security risk further and the borrowing strategy keeps cash balances low. With the exception of regulation investments with the UK Government and local authorities counterparties have a maximum investment limit. Overall this remains a low risk strategy.
Liquidity	Cash is not readily available when it is needed.	Cash is invested daily so the availability of cash from investment is fundamental to providing liquidity.	Managed through detailed cash flow forecast and investment in highly liquid funds – but can also borrow temporarily (and Local Authorities are a good credit risk if lent money).	**LOW**	Fixed term deposits have a relatively short maximum duration of up to 12 months; this contributes to high liquidity. Same day access accounts are held as follows: • All MMF's • Lloyds Banking Group • Santander • Barclays Cash flow plans are completed annually and regularly updated. The long-term investments with other local authorities have reduced liquidity but these can be transferred if funds need to be raised. Overall liquidity risk is considered low.

Appendix 3 (continued)

Risk Heading	Risk Description	Relevance to Investment	Key Control	Assessment	Approved Investment Strategy
Interest Rate	Unexpected reduction in Interest rate.	Reduces the return on investment and reduces the level of reserves.	Can reduce risk by: A) netting off investment against borrowing to reduce net exposure B) investing for longer periods. Controlled through the overall strategy.	**LOW**	Investments will be mainly short-term, of up to 12 months maximum – this does not protect against an interest rate reduction or falls in the market generally. The long-term investments made with other local authorities reduce this risk as the rates are fixed for a long period of time.
Interest Rate	Unexpected increase in interest rates.	In order to take advantage of the unexpected return would need to keep investment short term and increase the amount of cash invested (e.g. by not using cash in lieu of borrowing).	Controlled through the overall strategy.	**MEDIUM**	Current policy allows upturns to be taken advantage of as investments are not fixed for very long periods. Upturns are possible in the medium term. The long–term investments made with other local authorities increase this risk as the rates are fixed for a long period of time.
Market	Unexpected need to liquidate market instrument quickly and accept 'price on the day'.	Only relevant if invest in market instruments (e.g. CD's, gilts, covered bonds).	Limit investment in market instruments or alternatively have capacity to borrow to avoid need to liquidate. Controlled by limits on non specified investments.	**LOW**	It is proposed to hold these types of investments to maturity to mitigate this risk.

Appendix 3 (continued)

Risk Heading	Risk Description	Relevance to Investment	Key Control	Assessment	Approved Investment Strategy
Refinancing risk	Maturing transactions cannot be renewed on similar terms.	Reflected in the term (duration) of investments if everything invested shorter term has a high refinancing risk.	Proportion of investments maturing in the future.	**LOW/ MEDIUM**	The current policy is to invest in the relatively short-term. There is an increased risk with this strategy due to frequent 'refinancing' but this is expected to be advantageous in a rising interest rate environment. The long–term investments made with other local authorities has reduced this risk as they are for an extended period of time reducing the need to refinance a proportion of the investment portfolio. Using cash to fund borrowing (the proposed borrowing strategy) reduces this risk as the overall exposure to short term interest rates is less.
Regulatory and legal risk	Rules governing local government investment powers are changed or amended without notice.	Investment powers are granted through statute and guidance.	None	**LOW**	The current policy of using cash in lieu of borrowing reduces the County Council's dependency on interest receipts. In the past these were generated by using the full range of powers granted to local authorities. This is not the case now; the AIS is low risk and uses liquid and conservative investment instruments. The long-term investments made with other local authorities have increased this risk as they are for an extended period of time. Within the contracts for these investments is the ability for the County Council to force an early repay or transfer which contributes to overall this risk still being considered low.

Appendix 4

Cabinet - 20 January 2016

County Council lending list – December 2015	
	Time Limit
Regulation investments	
DMADF account	6 months
UK Government T-bills	6 months
UK local authority	12 months
Banks and building societies	
Barclays	100 days
HSBC	6 months
Lloyds / Bank of Scotland	100 days
Nationwide	100 days
Santander	100 days
MMF	
Black Rock	same day
Insight	same day
Federated	same day
Standard Life	same day
State Street (SSGA)	same day

Appendix 5

Cabinet – 20 January 2016

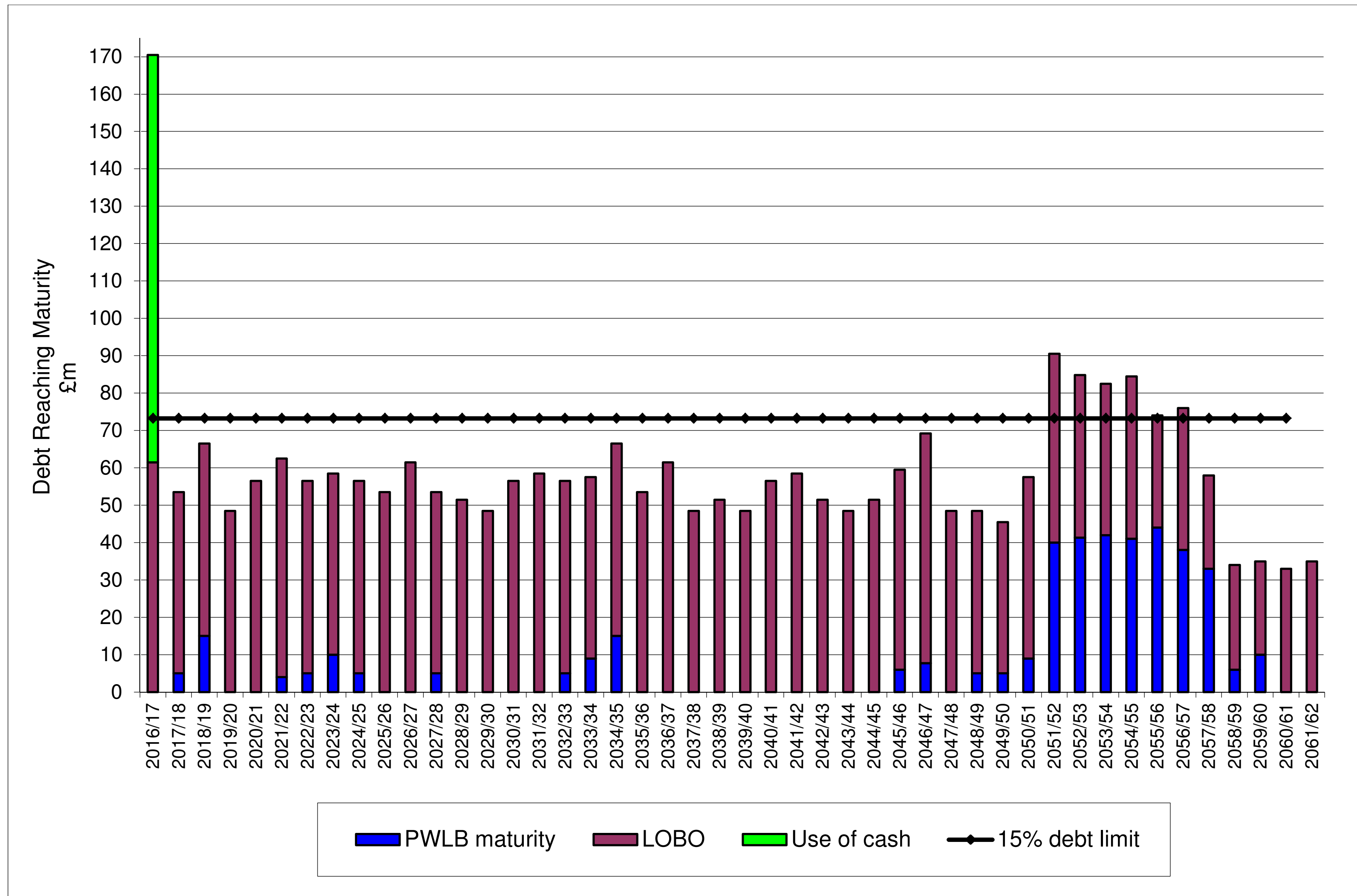
Prudential Indicators for Treasury Management

Indicator	Estimate 2016/17	Estimate 2017/18	Estimate 2018/19	Estimate 2019/20	Estimate 2020/21
1.CIPFA Code of Practice for Treasury Management in the Public Services	The County Council has adopted the CIPFA Code of Practice on Treasury Management (2011 version).				
This indicator identifies whether an authority has adopted CIPFA's Code of Practice for Treasury Management in the Public Services.					
2. External Debt	£m	£m	£m	£m	£m
Authorised Limit for borrowing	671	665	661	650	639
Authorised Limit for other liabilities	238	240	241	243	245
TOTAL	**909**	**905**	**902**	**893**	**884**
Operational Boundary for borrowing	556	568	567	548	548
Operational Boundary for other liabilities	238	240	241	243	245
TOTAL	**794**	**808**	**808**	**791**	**793**
External Loans	**518**	**513**	**498**	**498**	**498**
The Authorised Limit is the maximum level of external borrowing which should not be exceeded. It is linked to the estimated level of borrowing assumed in the capital programme. *The Operational Boundary represents the Director of Finance and Resources estimate of the day to day limit for treasury management borrowing activity based on the most likely i.e. prudent but not worst case scenario.* *"Other liabilities" relate to PFI schemes which are recorded in the County Council's accounts.*					
3.Interest Rate Exposures					
a. Upper Limit (Fixed)	£596m	£591m	£586m	£575m	£564m
b. Upper Limit (Variable)	(£180m)	(£185m)	(£190m)	(£195m)	(£205m)
Upper limits of fixed and variable borrowing and investments are required to be set. The effect of setting these upper limits is to provide ranges within which the County Council will manage its exposure to fixed and variable rates of interest. Negative figures are shown in brackets; these relate to the" high- point" of investments at a variable rate which are not offset by variable borrowings. The exposure to variable rate movements has been reduced by the use of cash in lieu of borrowing.					
4.Maturity Structure of Borrowing	Upper Limit	Lower Limit			
See **Appendix 6**					
This indicator relates to the amount of loans maturing in specified periods. The overarching principle is that steps should be taken from a risk management point of view to limit exposure to significant refinancing risk in any short period of time. The c County Council currently applies the practice of ensuring that no more than 15% of its total gross fixed rate loans mature in any one financial year. *Because this is a complex situation for the County Council, involving PWLB loans, LOBO loans with uncertain call dates and the use of internal cash, specific indicators have not been set. Instead the County Council will manage its exposures within the limits shown on the graph at **Appendix 6**. This graph shows all LOBO call options on a cumulative basis; in fact the actual pattern of repayment, although uncertain, will not be of this magnitude.*					
5.Upper limit for total principal sums invested for over 364 days (from maturity)					
This limit has been set at the total amount that could be invested in non-specified investments as per the County Council's policy (see paragraph 64) which is the maximum that could be invested for 1 year or over.	£95m	£95m	£95m	£95m	£95m
6. Borrowing in advance of need (Maximum debt)	100%	100%	100%	100%	100%
This indicator sets the maximum loans as a proportion of the borrowing need. In 2016/17 the strategy is not to borrow in advance, hence the indicator is set at 100%.					

Appendix 6

Cabinet – 20 January 2016

County Council maturity structure of debt



Appendix 7

Cabinet – 20 January 2016

Risk Assessment – Borrowing Strategy

Risk Heading	Risk Description	Relevance to Borrowing	Key Control	Assessment	Borrowing strategy
Security	A third party fails to meet its contractual obligations (i.e. counter party risk).	Unlikely that there is a failure between the agreement to borrow and sums being received a few days later. However, if we borrow in advance we must invest until this is needed and this increases exposure to investment risk.	Usually borrow from the Government (PWLB) and maximum 2 day gap between agreement to borrow and receipt of money.	**LOW**	Use of cash to fund borrowing reduces this risk further i.e. less money is held with banks and third parties as a result (see investment risk assessment).
Liquidity	Cash is not readily available when it is needed.	Only borrow for capital – usually borrow from Government (PWLB) with no limits other than the County Council agrees the borrowing is affordable. See legal and regulatory risk below.	Prudential rules on borrowing and consideration of whether Government is secure.	**LOW**	Use of cash to fund borrowing increases this risk as liquidity is reduced when borrowing is avoided. However, the County Council is able to borrow money temporarily using the money markets should it need to, so the overall risk remains low.
Interest Rate	Unexpected reduction in short term Interest rates.	Depends on the mix between fixed rate borrowing and variable rate borrowing Higher exposure to variable rate borrowing helps the budget.	The control is set out below.	**LOW to MEDIUM**	Pursuing a strategy of using cash reduces the overall net exposure to sudden interest rate falls.
Interest Rate	Unexpected increase in short term interest rates.	Mix of variable and fixed rates – Lower exposure to variable rate borrowing helps the budget.	Limit variable rate borrowing to a relatively small proportion (e.g. 20%) excluding cash.		20% limit provides a suitable risk control.

Appendix 7 (continued)

Risk Heading	Risk Description	Relevance to Borrowing	Key Control	Assessment	Borrowing strategy
Market	The market value of a loan changes substantially (i.e. how much is the borrowing strategy exposed to long term interest rate change).	How much risk is built into the maturity profile of the loans structure. LOBO's (17% of all loans) are the only 'market instrument' in borrowing terms currently used.	See alternative methodology using graph in **Appendix 6.** This is inversely linked to refinancing risk below.	**MEDIUM**	Use of cash will shorten the duration of the loan portfolio and reduces this risk. Without the use of cash this risk assessment would probably be high.
Refinancing risk	Maturing transactions cannot be renewed on similar terms.	Need to avoid a high level of borrowing over a short period where you are exposed to high interest rates.	The County Council has a policy of limiting maturing loans to 15% of the portfolio (including LOBO's) See graph in **Appendix 6.** This is inversely linked to market risk above.	**MEDIUM**	Using cash to fund borrowing potentially increases the refinancing risk. LOBO's increase refinancing risk (as the option to exercise the repayment trigger is held by the borrower). Without the use of cash this risk assessment would probably be low.
Regulatory and legal risk	Rules governing local government borrowing are changed or amended without notice, this has happened in the recent past.	Local government heavily reliant upon PWLB; cost and ability to reschedule / manage loans are determined by the Government. The Government could close the PWLB and force local authorities to use market loans for all new borrowing.	Market loans will be evaluated and taken if these are good overall value and dilute reliance on the PWLB. This risk cannot be managed in any other way.	**MEDIUM**	LOBO's are held and these diversify loans away from the PWLB. Use of cash means that PWLB loans are not being taken. If the PWLB was closed to new business then market loans would be the only option.

Appendix 8

Cabinet – 20 January 2016

Minimum Revenue Provision (MRP) Policy Statement

Introduction

Capital expenditure is expenditure on assets which have a life expectancy of more than one year e.g. buildings, vehicles, machinery etc. It would be impractical to charge the entirety of such expenditure to revenue in the year in which it was incurred therefore such expenditure is spread over several years in order to try to match the years over which such assets benefit the local community through their useful life.

The manner of spreading these costs is through an annual Minimum Revenue Provision (MRP), which was previously determined under Regulation, and will in future be determined under Guidance.

The Government issued guidance which came into force on 31 March 2008 which requires that a Statement on the County Council's policy for its annual MRP should be submitted to the full Council for approval before the start of the financial year to which the provision will relate.

The guidance offers four main options under which MRP could be made (for information these are detailed over the page), with an overriding recommendation that the County Council should make prudent provision to redeem its debt liability over a period which is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits.

MRP Policy Statement 2016/17

The County Council implemented the new MRP guidance in 2009/10, and will assess their MRP for 2016/17 in accordance with the main recommendations contained within the guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003.

The major proportion of the MRP for 2016/17 will relate to the more historic debt liability that will continue to be charged at the rate of 4%, in accordance with the recommendations and intent of Option 1 of the Guidance.

Further amounts of new capital expenditure may continue to be charged at the rate of 4%, and added to the above mentioned base Capital Financing Requirement (CFR) amount, up to an amount equivalent to the County Council's annual Supported Capital Expenditure (Revenue) allocation.

Certain expenditures reflected within the debt liability at 31 March 2016 will under delegated powers be subject to MRP under Option 3.

Estimated life periods will be determined under delegated powers. To the extent that expenditure is not on the creation of an asset and is of a type that is subject to estimated life periods that are referred to in the guidance, these periods will generally be adopted by the County Council. However, the County Council reserves the right to determine useful life periods and prudent MRP in exceptional circumstances where the recommendations of the guidance would not be appropriate.

Appendix 8 (continued)

Asset lives will be assessed on a basis which most reasonably reflects the anticipated period of benefit that arises from the expenditure. Also, whatever type of expenditure is involved, it will be grouped together in a manner which reflects the nature of the main component of expenditure.

With regards to loans granted by the County Council no MRP will be charged on them. The MRP will be equated to the principal repayment of the individual loans.

Option 1: Regulatory Method

Under the previous MRP regulations, MRP was set at a uniform rate of 4% of the adjusted CFR (i.e. adjusted for “Adjustment A”) on a reducing balance method (which in effect meant that MRP charges would stretch into infinity). This historic approach must continue for all capital expenditure incurred in years before the start of this new approach. It may also be used for new capital expenditure up to the amount which is deemed to be supported through the SCE annual allocation.

Option 2: Capital Financing Requirement Method

This is a variation on option 1 which is based upon a charge of 4% of the aggregate CFR without any adjustment for Adjustment A, or certain other factors which were brought into account under the previous statutory MRP calculation. The CFR is the measure of an authority’s outstanding debt liability as depicted by their balance sheet.

Option 3: Asset Life Method.

This method may be applied to most new capital expenditure, including where desired that which may alternatively continue to be treated under options 1 or 2.

Under this option, it is intended that MRP should be spread over the estimated useful life of either an asset created, or other purpose of the expenditure. There are two useful advantages of this option: -

- Longer life assets e.g. freehold land can be charged over a longer period than would arise under options 1 and 2.
- No MRP charges need to be made until the financial year after that in which an item of capital expenditure is fully incurred and, in the case of a new asset, comes into service use (this is often referred to as being an ‘MRP holiday’). This is not available under options 1 and 2.

There are two methods of calculating charges under option 3:

a. equal instalment method – equal annual instalments,
b. annuity method – annual payments gradually increase during the life of the asset.

Option 4: Depreciation Method

Under this option, MRP charges are to be linked to the useful life of each type of asset using the standard accounting rules for depreciation (but with some exceptions) i.e. this is a more complex approach than option 3.

The same conditions apply regarding the date of completion of the new expenditure as apply under option 3.