

## RESERVES & BALANCES

### General Reserves

- 1.1 Local authorities are legally required to set a balanced budget and the chief finance officer has responsibility to report should serious problems arise (including in relation to the adequacy of reserves).
- 1.2 Under provisions introduced by the Local Government Act 2003, the level and use of reserves must be formally determined by the Council, informed by the judgement and advice of the chief finance officer. When calculating the budget requirement, the chief finance officer must report to Members on the adequacy of reserves. There are also now reserve powers for the Secretary of State to set a minimum level of reserves. External auditors are responsible for reviewing and reporting on financial standing but are not responsible for recommending a minimum level of reserves.
- 1.3 The Council needs to consider the establishment and maintenance of reserves as an integral part of its medium term financial planning. Reserves are held for three main purposes:
  - § As a working balance to help cushion the impact of uneven cash flows and avoid unnecessary temporary borrowing – this forms part of a general reserve.
  - § As a contingency to cushion the impact of unexpected events or emergencies, including budget overspends – this also forms part of a general reserve.
  - § To hold funds for specific purposes or to meet known or predicted liabilities – these are generally known as earmarked reserves. Schools' balances and insurance reserves are examples of these.
- 1.4 In order to assess the adequacy of general reserves, account needs to be taken of the strategic, operational and financial risks facing the authority. The level of general reserves is also just one of several related decisions in the formation of a medium term financial strategy and the budget for a particular year. Factors affecting judgements about reserves include the key financial assumptions underpinning the budget and an assessment of the Council's financial health, including:-
  - § Overall financial standing (level of borrowing, Council Tax collection rates, auditors' judgements, etc.)
  - § The track record in budget management.
  - § Capacity to manage in-year budget pressures and savings.
  - § The strength of financial information and reporting arrangements.

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§ The external financial outlook.

- 1.5 There is therefore no 'correct' level of reserves. Furthermore a particular level of reserves is not a reliable guide to the Council's financial health. It is quite possible for reserves to increase but for financial health to deteriorate, if for example, the authority's risk profile has changed. As a general rule thumb, therefore, reserves need to be higher as financial risk increases, and may be allowed to become lower if risk reduces.
- 1.6 Financial reserves also have an important part to play in the overall management of risk. Councils with adequate reserves and sound financial health can embark on more innovative programmes or approaches to service delivery, knowing that if the associated risks do materialise the Council has sufficient financial capacity to manage the impact. Conversely, Councils with inadequate reserves can either find it more difficult to introduce change, or in extreme cases can be forced to develop very high-risk service strategies simply in order to restore their financial health.
- 1.7 General reserves are projected to stand at £20.6m as at 31<sup>st</sup> March 2011.
- 1.8 The authority is currently projecting an over spend of approximately £1.1m on service budgets in 2010/11. These overspends can probably be attributed in part to the general tightening of the Council's resources and this in turn increases the risk that unforeseen pressures may cause more temporary over spends in future years.
- 1.9 The Council continues to face a range of uncertainties which carry attendant financial risks.
- 1.10 The Council is undertaking a substantial change programme to deliver the savings required over the forthcoming period and described in more detail below. This will involve major remodelling of services, which will have up-front costs that the Council will need to control, and improvement projects will need to be delivered on time to avoid cost overruns and a shortfall in savings required to balance the budgets. These factors point to the need for a solid financial position to underpin the risks involved.
- 1.11 The first Local Government financial settlement since public austerity measures were introduced earlier in the year has now been announced. This confirms that for each of the years 2011/12 and 2012/13, Tower Hamlets will face having to make General Fund revenue savings in excess of £30m each year. This is around five times the level of any single year's savings delivered over recent years. The authority remains at the grant floor, however the population of the authority is expected to grow substantially, and any additional costs arising will need to be met from savings. A healthy level of reserves would enable the Council to plan for these savings and increase the chances that they can be met from efficiencies, avoiding sudden cuts in spending.

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- 1.12 Grant figures have only been announced for the two years 2011/12 -2012/13, and the Government has said it will review the local government finance system before grant figures for 2013/14 onwards are announced. This introduces considerable uncertainty, and the concern that the weighting of grant settlements towards the areas of greatest need will be reduced, with detrimental effects to Tower Hamlets. The Spending Review confirms that while 2013/14 may be a more benign year, further substantial local government cuts will be required in 2014/15. Beyond that no further figures have been announced. The Medium Term Plan and the level of reserves needs to set so as to avoid over-dependence on income streams that could be temporary.
- 1.13 Economic risk continues, manifesting itself primarily in low interest rates (which restrict the Council income from investments) and high inflation. However, the UK economy remains at risk of a 'double-dip' recession and the public finances are already severely in deficit as a consequence of the cost of extra public borrowing to stimulate the banking sector and the impact on tax revenues of the last recession. This has a number of potential effects for the Council;
- The Local Government Finance Settlement confirms that the squeeze on public spending which feed directly through to grant cuts for Tower Hamlets from 2011/12 at least up to and including 2014/15.
  - A general economic downturn may place extra demands on some services putting upward pressure on costs, and a reduction in income from charges that are linked to economic activity, such as planning and building control fees. Poorer general economic conditions could also make other debts harder to collect.
  - In a bid to stimulate credit, the Bank of England has drastically reduced interest rates. The Council has around £100m invested at any one time and reductions in interest rates impact directly upon income to the Council.

All of these factors tend to increase risk to the authority and should be taken into account in setting the level of reserves for 2011/12 and the medium term.

- 1.14 Against this background, the chief financial officer has considered whether to change the current advice to the Council that reserves need to be maintained at between 5- 7.5% of budget requirement and in view of the risks and uncertainties facing the authority it would seem prudent to maintain reserves at the upper end of the range for the time being. For this reason, the main report recommends an allocation to general reserves of £3.0m as part of the budget setting for 2011/12.

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### **Insurance Reserve**

- 1.15 The Financial Outlook and Review identified continuing pressure on insurance costs to meet both higher numbers of claims payments and higher external insurance premiums. The Council self-insures a substantial proportion of its insurable risks and an external actuarial review of the level of internal insurance reserves is commissioned at regular intervals.
- 1.16 Contributions to the insurance reserve are made by all Directorates from their budgets based on their relative size, risk profile, and level of claims, representing the equivalent of a 'premium'.
- 1.17. The value of the Council's insurance reserves and provisions was £31.2m at the end of 2009/10. A contribution of £500,000 to the Insurance Reserve is recommended for 2011/12.

### **Opportunity Costs**

- 1.18. When a decision is made to set resources aside against risks, it is important to consider the opportunities that are foregone and to balance this against the risk. The allocation of resources to reserves temporarily denies the authority the opportunity to spend this money. It is therefore important that reserves are held at a level that takes account of risks and that the reserves strategy is neither reckless nor risk averse. However, the ability to set money aside in reserves allows the authority to plan with more certainty and thus to take more short term risks than it would do if, for example, it had no balances or reserves to fall back on. There is also a risk that if insufficient reserves are carried to ride out unforeseen circumstances, the Council may be forced into urgent action to deliver savings which is more likely to have an impact on front-line services and incur additional costs.

### **Improvement & Efficiency Reserves**

- 1.19. The costs of implementing the Council's programme of efficiencies and improvements to deliver the substantial level of savings required will in itself be considerable. The Council has planned well and has established reserves from which funding to deliver the necessary changes can come, although the total cost at this stage has not been determined.
- 1.20 Costs may include, for example;
- Cost of programme and project management
  - Investment in new technologies
  - Costs of buying the Council out of existing contracts with suppliers and with staff.

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- 1.21 In the current year's budget (2010/11) the Council is setting aside £2.9m to establish an Improvement Reserve and in addition annual contributions of £0.689m to the Efficiency Reserve will substantially cover the costs of the Programme Management Office.
- 1.22. The costs of delivering savings arising from reducing budgets in the HRA and Schools also potentially fall to be met by the Council. Both the HRA and schools are supported corporately by the Council's central support services. There are also a number of front line services, especially environmental services, which provide support to Council tenants and therefore charge costs to the HRA, and a number of services within Children, Schools and Families which rely on contributions from school budgets. The majority of the costs of these services would need to be saved, although any costs associated with downsizing these services would need to be borne by the General Fund. Any ongoing costs which could not be saved would need to be met on an ongoing basis by the Council.

### **Parking Control Account**

- 1.23 The Parking Control Account (PCA) is ringfenced. The surplus can only be used for reinvestment within the service and for highways and transport initiatives. Tower Hamlets uses the surplus for a variety of measures relating to street works and transportation including to part fund the cost of the concessionary fares scheme which forms part of the Communities, Localities and Culture Directorate budget.

### **Schools' Reserves**

- 1.24 Schools' reserves represent unapplied revenue resources accumulated by schools with delegated spending authority. These totalled £19.1m at 31<sup>st</sup> March 2010. Schools' reserves are technically earmarked reserves of the Council but are controlled by schools and are not available to the Council for other purposes.

### **Capital Programme**

- 1.25. The Council receives monies under agreements entered into under Section 106 of the Town and Country Planning Act 1990. These agreements specify the purposes to which the monies can be applied. Unapplied sums are held in reserve until such time as they are applied.

### **Service Specific Earmarked Reserves**

- 1.26 A number of earmarked reserves are held to meet specific service objectives or fund potential liabilities which do not qualify as provisions for accounting purposes. The principal ones provide for:-

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- § Balances of government grants which have been allocated for particular purposes but are being spent over more than one year.
- § The carry-over of budgetary underspends from one financial year to the next.

Use of these reserves is subject to specific Cabinet approval. The nature of these reserves means they are not generally available to support the Council's medium term financial strategy.

**Sensitivity Analysis**

The assumptions built into the budget and Medium Term Financial Plan all contain a measure of estimation, and where events differ from assumption, the risk falls to the Council's budget.

The following table shows how assumptions made in this budget process would affect the budget if they proved to be incorrect. This gives a guide to the kind of risks which need to be allowed for in considering the level of reserves or contingencies made available as part of this exercise.

Scenario	Estimated annual financial impact	
	(% age of estimated balances) £000s (£19.5m)	
Inflation – cost of an additional 0.5% pay rise for all staff	750	(3.8%)
Inflation – price inflation 0.5% higher than forecast.	800	(4.0%)
Committed growth 10% higher than forecast	500	(3.2%)
Interest rates – average investment rate in 2010/11 is 1% less than estimate.	Rates currently at 0.5%- risk negligible	
10% Of projected savings not delivered	3,000	(15.4%)
Budget requirement overspent by 1%	3,147	(16.1%)
For each £1m that the cost of implementation of improvement and efficiency programme exceeds expectation.	1,000	(5.1%)