Appendix 1

Assessment of Level of Reserves

1 Introduction

Each year, reviewing the level of reserves the Council holds is an important part of the budgetary process. The review must be balanced and reasonable, factoring in the current financial standing of the Council, the funding outlook into the medium term and beyond, and most importantly, the financial risk environment the Council is operating in.

2 Background

The Chartered Institute of Public Finance and Accountancy (CIPFA) recommend that the following factors should be taken into account when considering the level of reserves and balances:

- Assumptions regarding inflation and interest rates
- Estimates of the level and timing of capital receipts
- The capacity to manage in-year budget pressures and strategy for dealing with demand and service delivery in the longer term
- Strength of financial reporting and ability to activate contingency plans if planned savings cannot be delivered
- Risks inherent in any new partnerships, major outsourcing arrangements and major capital developments
- Financial standing of the Authority (level of borrowing, debt outstanding, use of reserves etc.)
- The Authority's record of budget and financial management including robustness of medium-term plans
- Virement and year-end procedures in relation to under and overspends
- The availability of reserves and government grants/other funds to deal with major unforeseen events
- The general financial climate including future expected levels of funding
- The adequacy of insurance arrangements

It should be made clear that the assessment of the adequacy of reserves is subjective. There is no 'right' answer as to the precise level of reserves to be held. There is also no formula approach to calculating the correct level; it is a matter of judgement, responsibility for which lies with the Council's Section 151 Officer.

3 Spending Round and Local Government Finance Settlement (LGFS)

The government's spending plans for 2020-21 were announced on 4th September 2019. For local government (and many other public services) this amounted to a one-year settlement, with a repeat of 2019-20 grants plus an additional £2.9bn (6%) from Council Tax increases, inflationary uplifts to business rates and an additional £1bn government grant to support social care spending pressures.

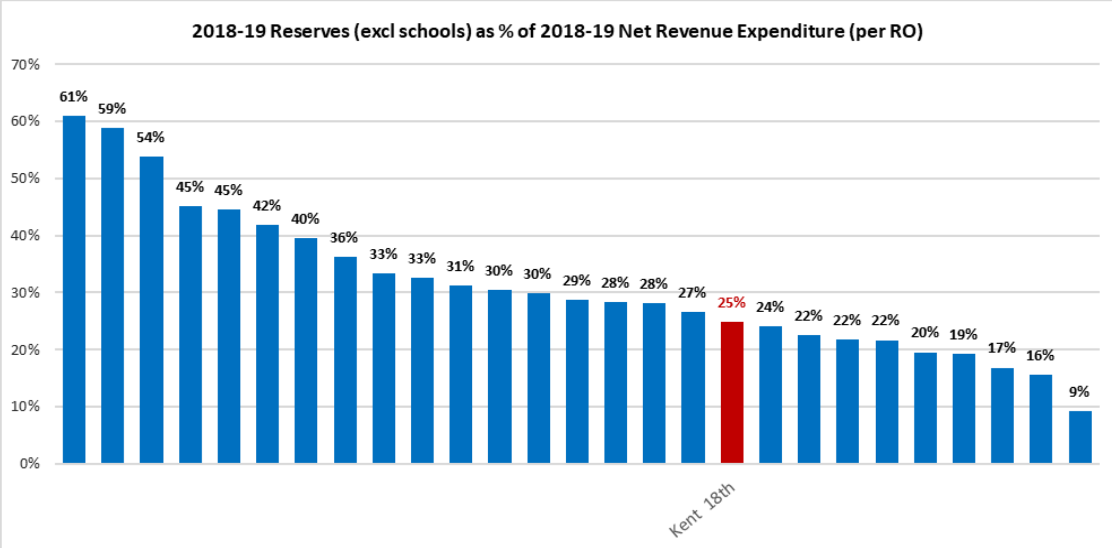
A technical consultation on the Local Government Finance Settlement was launched on 3rd October 2019. This included detailed proposals on the allocation of Revenue Support Grant, social care and other grants, and Council Tax referendum principles. The outcome from this consultation has not been published in time for the Draft Budget, and, at the time of drafting this report, the provisional local government finance settlement had not been published.

The Draft Budget has been prepared based on an estimate of the likely settlement, provisional Council Tax base estimates and assumptions on Council Tax increases in line with the presumed referendum principles. The assessment of the reserves is made against the background of these estimates, including the reduced risk from a better than expected 2020-21 settlement compared to the forecast in the 2019-22 MTFP, and the heightened medium-term uncertainty arising from only having a one-year settlement and potential changes in central government policy following the 12th December general election. This assessment has not materially changed following the provisional Local Government Finance Settlement announcement on 20th December or notification of provisional tax base and collection fund estimates from districts.

4 Comparison with other County Councils

Each council must make its own decisions about the level of reserves they hold, taking into account all of the issues referred to in Section 2 above.

A graphical analysis of the 2018-19 reserves for county councils is shown below. Kent is ranked 18th out of 27 county councils in terms of the percentage of reserves held (Rank number 1 being the highest level of reserves as a percentage of annual net revenue expenditure). This is the same ranking from last year despite an increase in the overall reserves of £27.6m compared to 2017-18. Kent has used some of its earmarked reserves to support the revenue budget in recent years but has also been able to set aside additional reserves to offset higher financial risks, particularly in 2018-19 from better than expected additional business rates from the retention pilot and roll-forwards approved at the end of the year. The Council has maintained a general reserve at approx. 4% of net revenue budget. The overall picture is that total reserves have been relatively stable at around an average of £200m in most years and £223.5m on 31st March 2019 (25%) but this is below the average of other county councils.

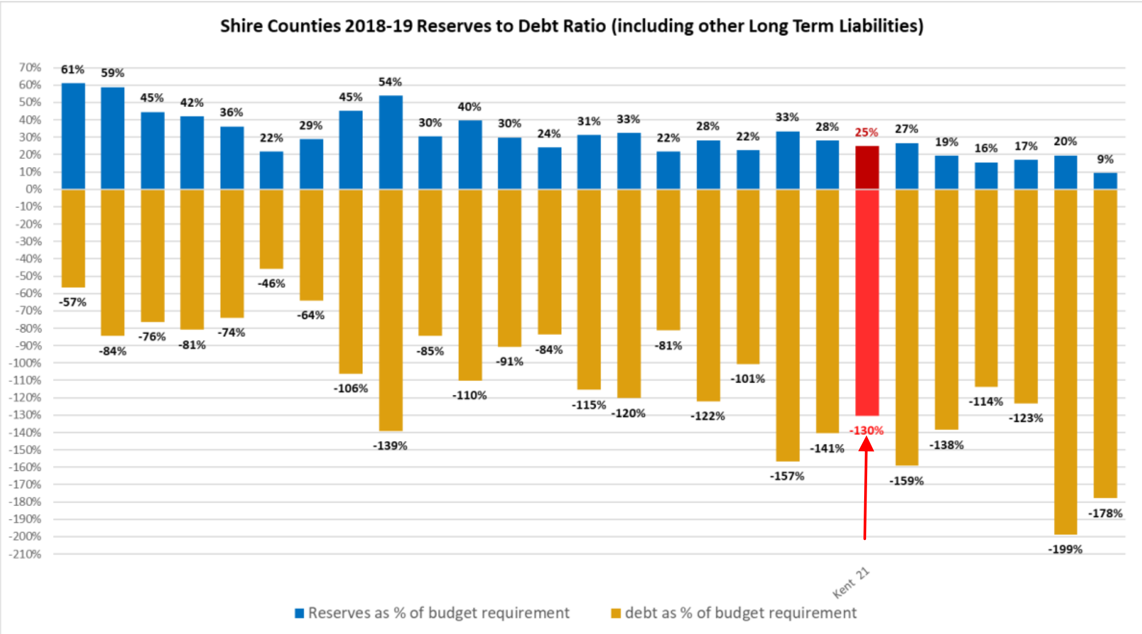


There is a wide range of reserves held as a percentage of net revenue spend; the lowest Authority at 9%, up to the highest at 61%. The Council's figure is 25%. This figure of 25% is made up of the General Reserve of £37.1m and Earmarked Reserves (including Public Health and trading surpluses but excluding Schools, Capital Receipts and Capital Grants unapplied) of £186.4m, totalling £223.5m. Details of all the Council's reserves can be found in the 2018-19 Statement of Accounts, which includes a summary of all usable reserves in note 23 on page 84, and details of all the earmarked reserves in note 25 on pages 93-97.

It is important to consider reserves alongside borrowing to fund the capital programme. Capital spending can be funded from borrowing to protect levels of reserves, or alternatively reserves can be used as a substitute to reduce the need for borrowing. The graph below shows the percentage reserves to percentage debt ratio, with the Council ranked 21st out of the 27 Counties (Rank number 1 being the highest percentage of reserves compared to percentage borrowing i.e. most resilient). This year the calculation has changed to include other long-term liabilities as well as borrowing to be consistent with the gross external debt position used by CIPFA in their Financial Resilience index. This index is an analytical tool designed to provide councils with a clear understanding on their position in terms of financial risk. The index is made up of a set of indicators, which can be used to compare against similar authorities. As a result, the Council has moved from 20th to 21st in the rankings. This position reflects the relatively high levels of historic external debt of £906.2m at 31st March 2019, despite the Council's more recent approach to rely on internal borrowing.

There is little that can be done in the short term to affect borrowing levels as most debt is long-term with significant early repayment penalties which would far exceed the benefits of redeeming debt. The Council will continue with the policy of supporting capital spending with internal borrowing rather than external debt whilst the Council has sufficient cash balances, but the continuing need to finance capital expenditure with borrowing presents a significant risk to the level of reserves and financial resilience of the Council.

The Council's borrowing costs have been capped at a maximum of 15% of net revenue budget in recent years (and have remained under that cap), and have stabilised overall borrowing during that time. Consideration is being given to applying a further cap based on the pressure of interest costs on the revenue budget to support borrowing.



5 Financial Resilience

Following well publicised financial difficulties in some authorities, and the heightened risk of more councils getting into financial difficulties over the coming years, there has been a much greater emphasis from government on the financial resilience of councils. As part of this, CIPFA has reviewed its range of guidance, tools and services to promote better financial management and to provide early warning systems. Part of this package has been the development of a financial resilence index. This tool is not a performance measure of service outcomes or quality, nor a comment on the quality of leadership. It aims to be an authorative measure of a council's financial resilience drawing on published information. It is designed as a dashbord warning indicator and not a full diagnostic tool.

The tool is based on the following eleven measures:

1. Reserves sustainability measure (the number of years it will take for a council to deplete their reserves if they continue to use them at the same rate as the average of the last three years)
2. Level of reserves
3. Change in reserves
4. Interest payable as a proportion of net revenue expenditure
5. Gross external debt

6. Social care ratio (proportion of net revenue spending accounted for by children's social care and adult social care)
7. Fees and charges to service expenditure ratio (sales, fees and charges as a proportion of gross service expenditure)
8. Council Tax requirement to net revenue expenditure ratio
9. Growth above baseline (the difference between the baseline funding level and retained rates income, over the baseline funding level)
10. Auditors VFM judgement
11. Children's Social Care judgement (Ofsted rating for children's social care)

The financial resilience index based on 2018-19 outturn has very recently been published and it is currently being analysed to determine what the indicies mean for the Council's reslience. In future this will sit alongside the newly released CIPFA Financial Management Code to support good practice in the planning and execution of sustainable finances.

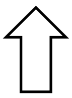
The initial overall assessment is that the Council is not in imminent danger of financial failure, but it is in the lower half of the resilience range, and therefore the Council cannot be complacent and must continue to maintain financial rigour.

The Council needs to remain vigilant, particularly in relation to accumulated debt and associated financing costs.

6 Analysis of Risk

Listed in Section 2 of this appendix are the factors that CIPFA recommend should be taken into account when considering the level of reserves and balances. Below, each of those factors is given a 'direction of travel' indicator since last year's budget was set. An upward direction means an improved position for this council (i.e. the risk is less than it was last year).

- Assumptions regarding inflation and interest rates:



Inflation has been on a general continual downward trend since its peak of 2.8% in Autumn 2017 (barring the occasional seasonal fluctuation) and at the time of setting the 2020-21 budget is below the Government target of 2%. Forecasts suggest further falls in the rate of inflation for the remainder of 2019 and remaining below the 2% target throughout much of 2020. The medium-term forecast is still slightly above the target. Interest rates are largely determined by the Bank of England base rate which has remained at 0.75% since August 2018. The Bank of England has indicated the rate may have to be reduced if economic growth continues to be weak but could rise if growth improves as predicted. Overall in the short term the lower forecast rate of inflation reduces the Council's risk especially if interest rates rise a little. Longer term, inflation at or close to the 2% target and low interest rates result in a broadly neutral impact.

- Estimates of the level and timing of capital receipts:

  The Council's reliance on capital receipts is significant in order to part fund the capital programme. Delivery of receipts against the target in the programme has fallen behind in recent years necessitating additional short-term borrowing/use of reserves.

- The capacity to manage in-year budget pressures and strategy for dealing with demand and service delivery in the longer term:
  Although 2018-19 was the 19th consecutive year that the Council has ended the year with a small net surplus, and the 2019-20 forecast is better than at the same time in recent years, concern remains about the capacity to deal with in-year pressures and longer term trends. In spite of the better than estimated settlement for 2020-21, the additional funding is still not sufficient to cover all forecast spending pressures, although it does represent a marked shift from previous years and provides added short term security which offsets the longer term uncertainty. The Council has had to find alternative ways to resist some of the pressures and still needs to find additional savings and income to balance the budget. As each year passes and this trend continues it becomes ever harder to resist pressures or find savings/income despite the overall funding increasing. The Council has less and less spend that can be de-commissioned at short notice. The longer-term trends for demand-led services are leading to rising costs. The lack of future government spending plans makes it impossible to forecast potential funding with any degree of accuracy to determine whether there will be sufficient funding to cover these rising cost drivers such as demographic trends, market pressures or cost pressures from inflation.

- Strength of financial reporting and ability to activate contingency plans if planned savings cannot be delivered:

  There is confidence in the validity of financial reporting and reporting has been enhanced to better focus on the major factors affecting financial performance. Some progress towards enhancing outcomes based budgeting within the Council has been made but there is scope for further improvement. The are still some areas of spending that can be changed at short notice if required without compromising either the Council's statutory responsibilities or strategic objectives. Although these have reduced in recent years, the better settlement for 2020-21 means the risk is no greater in the short term.

- Risks inherent in any new partnerships, major outsourcing arrangements and major capital developments:

  The financial difficulties in the health sector mean there are risks in relation to the partnership arrangements with NHS partners in the county. The returns from some of the Council's trading companies have not been as good or have taken longer to be generated than originally estimated in business cases. There is also a real risk that retendering of major contracts could result in higher prices due to market conditions. There are also significant concerns about the Council's ability to continue to sustain a capital programme with competing demands to tackle statutory responsibilities and make infrastructure improvements. In the longer term both these objectives cannot be delivered with an increasing reliance on borrowing.

- Financial standing of the Authority (level of borrowing, debt outstanding, use of reserves etc.):

  The planned use of corporate reserves to support the 2020-21 revenue budget has been limited to a small number of specific spending pressures pending the identification of longer-term sustainable alternatives. This is an improvement on previous years where reserves have been used to balance the overall budget. Some directorate reserves have also been released in the 2020-21 proposed budget following the announcement of the continuation of grants for 2020-21 which were previously identified as at risk. Although reserves at the end of 2018-19 were higher than forecast when the 2019-22 MTFP was presented, the forecast for the end of 2019-20 per the half year monitoring of reserves is that they are expected to reduce to the level previously anticipated for 31 March 2020. Whilst the plan is to use reserves in 2020-21 that are no longer required for the purpose they were set up for, the use of these reserves will impact on future resilience indices even though the Council's actual resilience is no weaker. The overall level of reserves is more stable in comparison to other authorities, although remain relatively low. Consequently, the general financial health of the Council remains fairly static, however there is no room for complacency.

  The level of borrowing to support previous capital investments remains relatively high compared to other counties. Much of the accumulated debt is long term with only 15% due to mature over the next 5 years. The debt represents a combination of loans taken out under the previous "supported borrowing" regime and more recent loans under the "prudential regime". In recent years the Council has been able to use cash reserves to support the capital programme (internal borrowing) rather than increasing external debt as this represented a lower overall financing cost. However, the Council's ability to finance future capital spending from borrowing remains a significant concern. Should the Fair Funding review proposals be implemented, this will be better reflected in future settlements including the restoration of revenue for legacy capital financing of supported borrowing.

- The Authority's record of budget and financial management including the robustness of medium-term plans:

  This continues to be excellent with effective financial management resulting in nineteen consecutive years of underspend up to 2018-19. The additional funding for social care announced in the Spending Round, together with the continuation of the adult social care Council Tax precept for a further year has contributed towards funding rising social care demands and costs, although there continues to be significant concern about the viability of social care funding over the medium to long term and thus the sustainability of the market. The ability to continue to deliver an underspend or a balanced budget becomes increasingly more difficult with rising demands and insufficient, short term funding.

- Virement and year-end procedures in relation to under and overspends:

  The Council continues to adhere to sound financial governance and virement procedures set out in its financial regulations. The Council continues to have a good record of closing its accounts in a timely manner including agreeing rollovers for over and underspends.

- The availability of reserves and government grants/other funds to deal with major unforeseen events:

  There are three major concerns in this area which could impact on the Council's reserves and financial resilience.

  The first, and by far the most significant, is the overspending and accumulated deficit on the High Needs Block of the Dedicated Schools Grant (DSG). This relates to spending to support children and young people with Special Educational Needs and Disabilities (SEND). Since the introduction of the Children and Families Act 2014, the Council has seen an unprecedented rise in the number of children and young people assessed for Education and Health Care Plans (EHCPs). The high needs funding within the DSG has not kept pace resulting in in-year overspends and an accumulated deficit on the unallocated DSG reserve. This is a national problem but has been particularly acute in Kent and a number of other large county councils. To date the government has not provided councils with sufficient funding and have not introduced structural reforms to eliminate the overspends or repay the deficits. They have also not provided satisfactory arrangements for the treatment of deficits.

  The second major concern in this area is the grant funding available to prepare for BREXIT or to deal with significant disruption in the event of a disorderly withdrawal. Whilst additional funding has been allocated to all councils, with extra funding for councils with major ports, this has not been sufficient for the Council to cover additional costs and without further funding these costs will need to be met from the Council's reserves.

  The third major concern is a long standing issue with grant funding for unaccompanied asylum seeking children and care leavers. Whilst the Council has had some success in negotiating sufficient grant with the Home Office for under 18s, the funding for care leavers and those staying in care beyond 18 has been insufficient and if unresolved will continue to put pressure on the Council's reserves.

- The general financial climate:

  The current Spending Round only covers 2020-21. There are no indicative government spending plans beyond this or the provisional settlement for local government for 2020-21. Reasonable estimates for 2020-21 have been calculated as the basis for a draft budget but this severely limits the Council's ability to make meaningful medium-term multi year financial plans. This shortening of medium-term financial planning horizons for local government is one of the reasons which has prompted the CIPFA resilience indices and the new Financial Management Code. 2020-21 will be the first year since 2013-14 that the Council has been unable to produce meaningful multi-year plans as although spending trends can be forecast with sufficient accuracy, the delay to the full Spending Review, Fair Funding Review and additional business rate retention means likely funding cannot be predicted with any accuracy. This means it is impossible to predict whether funding will be sufficient to cover rising demands and costs and whether the Council will continue to need to find savings and to what extent, to compensate for real-terms reductions in funding.

- The adequacy of insurance arrangements:

  The Council's insurance policies were reviewed in January 2016, insuring the same levels of risk as previously, albeit at a higher premium. Since then the Council's exposure to risk and levels of insurance reserves have been reassessed and a higher level of excess has been accepted on some policies in return for a lower premium. Evidence to date is that this has reduced the net cost to the Council.

Of the eleven factors, one has shown an improvement from twelve months ago, seven are relatively unchanged, and three have deteriorated. No weighting has been applied to the individual factors, but the general financial risk to the Council should now be regarded as increased compared with a year ago, which in turn, was increased from the year before, so the cumulative effect can be seen.

Only the general reserves of £37.1m (as at 31st March 2019) are available to the Council to offset any in-year overspends and these are largely unchanged from the previous year. However, these can only be used once.

The overall conclusion is that the Council has an increased risk profile since the 2019-20 budget was approved, and on a like-for-like basis the Council will have a similar level of earmarked reserves available during the year. This means the Council is marginally less resilient than before, but this is not a cause for concern at this stage. Whilst no immediate action is required, the Council's resilience will continue to be monitored and the trend will need to be reversed as much as possible in the medium term.

7 The detail of the Council's reserves

The Statement of Accounts that is produced each year details **Earmarked Reserves** and explains why these reserves are held. There will continue to be draw-down and contributions to these reserves in line with the patterns of expenditure anticipated when the reserves were created. There council's reserves policy and the reserves held will be reviewed during 2020-21 to ensure the policy and the reserves are held corporately to support the Council's strategic objectives.

A review of the earmarked reserves, in light of the forecast funding estimates has resulted in a proposal within the 2020-21 budget to:

- drawdown £8.4m from specific directorate earmarked reserves to cover individual service pressures (including release of reserves where winter pressures grant has now continued);
- net drawdown £1.3m from corporate reserves to fund specific one-off pressures until sustainable alternatives can be found;
- drawdown £3.2m from corporate reserves to help fund the costs of the Learning Disability, Mental Health & Physical Disability residential care retender.

In addition, there is a net drawdown from corporate reserves of £1.2m within the 2019-20 base budget which will continue in 2020-21 which comprises a £2.5m drawdown from the Kingshill smoothing reserve and a repayment of £1.3m of previous "loans" from long term reserves. Therefore, the overall proposed use of reserves in the draft 2020-21 budget is £14.1m. The budget also assumes reduced contributions to reserves of £2.5m. These reserves/contributions are either no longer needed (e.g. Directorate specific reserves to offset potential grant reductions which have now not occurred following the rollover settlement), or were created for exactly this situation or a one year contribution holiday can be taken where risks and the potential call on reserves have been reduced or eliminated.

8 Role of the Section 151 Officer

The duties of the Council's Section 151 Officer include the requirement 'to ensure that the Council maintains an adequate level of reserves, when considered alongside the risks the Council faces and the general economic outlook'. The reserves that this council will hold as at 1 April 2020 are, in the opinion of the Section 151 Officer, adequate.