ESSENTIAL REFERENCE PAPER C

Stress testing the MTFP: The Council's ability to withstand significant external shocks

It is axiomatic that the MTFP is based on less than full knowledge of the future. There will be "events" which cannot be predicted or the impact of which cannot be quantified. It is important to consider the Council's ability to withstand any such events. Following the crisis in financial markets in 2008 major banks and financial institutions have been subject to stress tests to see how they would cope with disruption in financial markets including being subject to loss of value of some of their assets.

Below is set out a similar but internal assessment of the Council's financial position. The Councils external auditors looked at the financial resilience of the Council in 20ll (see Audit Committee 21 September 2011 agenda item 7) covering a wider range of topics than covered here and gave a positive report. A similar external review will be undertaken for 2011/12.

External shocks can be divided between scenarios which trigger unavoidable spending from demand or price pressures and those arising from unforeseen shortfalls in income and might include any of the following:

- The UK being subject to a significant economic downturn such that public spending might be subject to further substantial cuts.
- A loss on investments arising from failure of one or more banks
- The relocalisation of business rates at cost to the Council
- Failure of a major supplier
- A natural disaster
- Unforeseen additional take up of council tax benefit
- Prolonged pay and/or price inflation above expectation
- Investment returns running below forecast
- Costs arising from litigation

The Council seeks to mitigate the risk of some of the above – for example by insurances, its prudent approach to treasury management. However, none of the mitigation measures can offer a 100% guarantee the Council will not be subject to a significant financial shock. The comments here are therefore not about likelihood but only about ability to cope should the “what if?” happen. The commentary on the robustness of estimates speaks to likelihood and quantifies the impact of a variance from assumptions. Individual cost impacts are of a lesser order than the more extreme scenarios considered here which is indicative of the Council’s ability to deal with concurrent lesser order variations from expectations.

The Council’s budget requirement for 2012/13 is £15.1m. For the purpose of stress testing the impact of the event(s) is set at “major”- level 1 = 10% of the requirement and “severe” - level 2= 20% of the requirement i.e. £1.5m and £3.0m
The tools to cope with such an event:

- Spendable reserves
- Borrowing and capitalisation including access to immediate cash
- The Bellwin formula
- Emergency increases in fees and charges
- Emergency reduction in spending
- Council tax
- Pooling of risk

Spendable Reserves

The use of reserves is a potential response to meet a none continuing shock and potentially to buy time to make adjustment to spending if the shock is of a continuing nature.

The Reserves Policy approved in September 2011 set a minimum balance of £3m and a ceiling of £7.4m. The projected balance at March 2012 is £7.2m and the MTFP assumes no change over the period to March 2016. Earmarked reserves might be redirected in the short term providing another £2.7m of cover over the period of the MTFP.

The September refresh of the MTFP benchmarked the Councils reserves against similar Councils. At £10.3m at the date of comparison the Council fell into the bottom end of a group of 54 district council with 136 councils below this group with lesser reserves and 11 in higher groups with higher reserves- the Council would therefore be in the upper middle quartile.

Reserves are adequate to meet

- Up to 2 level 2 events
- 1 level 2 events and up to 2 level 1 events
- Up to 4 level 2 events

A one off call on reserves of £3m would reduce cash balances and return on investments. By the end of the MTFP period investments are assumed to be achieving a 3% return. To offset this loss of income savings of an additional £90k per year would need to be identified.

However, prior to a continuing call on reserves other options as set out below would be applied.

If the event was of a continuing nature the implications would be much more challenging and as noted above a call on reserves used to implement longer term changes. The current MTFP includes a range of savings and to reduce spending by another £3m per year would be extremely difficult being equivalent to over 25% of payroll costs. In such a scenario the council would have to look to a combination of :

- Targeted reductions in staffing
- Renegotiations of terms and conditions
- Significant increases in fees and charges
- Renegotiation of major contracts
- An exceptional increase in council tax

At this stage the benefits of more detailed financial contingency planning in applying the above tools to meet such a challenge is not considered cost effective as no contingency plan can anticipate all circumstances which might be in place. The circumstances are likely to trigger a business continuity event or emergency planning event and contingency planning is focused in these areas of service delivery.

Borrowing and Capitalisation

The council has a negative Capital Finance Requirement which within the constraints of the Prudential Code permits borrowing to meet capital expenditure in response to shocks. In extremis the Council might seek approval to charge revenue cost to capital to spread the cost.

Bellwin Scheme

This refers to the scheme by which DCLG will meet the uninsurable costs of immediate response to an emergency such as caused by bad weather.

The threshold above which grant becomes payable is 0.2% of net revenue expenditure (£30k for East Herts) after which 85% of costs are recoverable. This “insurance policy” is limited to costs of immediate response and not to recovery i.e. costs incurred (within two months of an incident)

• *by a local authority in England on, or in connection with, the taking of immediate action to safeguard life or property or to prevent suffering or severe inconvenience, in its area or among its inhabitants;*
• *as a result of the incident(s) specified in the scheme which involved the destruction of or danger to life or property.*

Emergency Increases in Fees and Charges

The Council accelerated some of its 2011/12 budget measures during 2010 in response to the contribution required from local authorities towards short term savings required by the incoming government.

The Council has therefore demonstrated its ability to respond promptly when required to meet unforeseen financial pressures.

Fees and charges which are subject to the Council’s discretion raise income of about £4m per year. A 10% across the board increase would generate an extra £400k per year.

Emergency reductions in spending

The Council cannot instantly reduce much of its spending.

Payroll is a significant cost and it takes time to implement staffing reduction if legal challenges to dismissal are to be avoided and changes to terms and conditions by negotiation or imposition are protracted. Not filling vacancies has limited impact when turnover is low.

Contractual payments for outsourced services, rents, business rates, utility costs, licences, postal costs make up a further tranche of spending not able to be turned off at short notice.

Exceptional council tax increase

A 1% increase in council tax generates about £93k per year (about the same as a the loss of investment income following a single level 2 event).

The Council's planning is based on increases well within any limit which would trigger a council tax referendum. It would therefore likely be well placed to absorb the impact of a continuing event by an increase in the council tax by an additional 1% to 2,5% if other measures did not offset the impact.

Pooling of risk

The Council will explore risk pooling in respect of business rates as part of risk mitigation.

Liquidity and Access to Financial Markets

The Treasury Management Strategy ensures the Council always has ready access to cash with 50% or so of investments currently in realisable short term UK treasury bills and other investments in short dated bank deposits. A £10m structured deposits is the sole illiquid investment.

The Council's major debtors are council tax payers and businesses for business rates and adequate provision is made for bad debts. These are subject to ongoing monitoring and rates of collection remain high.

The Council has no requirement to refinance outstanding debt and capital expenditure will be financed by reduction in investments rather than external borrowing.

The Council is therefore well placed to withstand short term lack of liquidity in financial markets.