

CIPFA\

CIPFA Financial Resilience Index

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Financial resilience is the ability, from a financial perspective, to respond to changes in delivery or demand without placing the organisation at risk of financial failure. Without resilience, the essential public services that our communities depend upon would be at risk.

For this reason, it is important that the sector strengthens its financial resilience where it can and the Index is just one tool designed to support that ambition.

CIPFA's Financial Resilience Index¹ is a comparative analytical tool that supports good financial management and provides a high-level, common understanding within a council of their financial position based on a range of measures associated with financial risk.

We hope to encourage discussion and debate about public finances to improve understanding and appreciation. This December 2022 Resilience Index looks at data from 2021/22 and has been influenced by the pandemic, increasing inflationary pressures and significant uncertainty affecting local authority funding.

Overview of the financial context for local authorities in England

It remains difficult to assess and predict the uncertain nature of how COVID, its legacy and inflationary pressures will impact local government. The pandemic has caused extraordinary financial costs to local government and the effects of inflation on council budgets, along with cost pressures, have continued to be felt into 2022/23 with little sign that these will ease.

Some service demands were suppressed during lockdowns, with pent-up demand now surfacing, particularly in adult and children's services. This demand and the expenditure needed to meet it has in many cases been merely delayed, not removed from the system. Most authorities have recognised and adjusted their budgets accordingly where possible.

Councils continue to support their local communities through the current cost of living crisis. The extra government funding and support provided to date has been crucial but sector stakeholders recognise it has been short term in nature.

Recent analysis estimates that the dramatic increases in inflation and energy costs during this year has added £2.4bn in extra costs on to the budgets councils set in March 2022 and a funding gap rising to £3.4bn in 2023/24 and £4.5bn in 2024/25.² This position and these services are not sustainable without significant additional sources of income for local authorities.

To cover this shortfall, the Resilience Index reflects the fact that some local authorities have strengthened their reserve position.

While the short-term picture based on the increases in reserves may appear to suggest that local government finances are sustainable, we remain concerned with the medium and longer term outlook, which largely remains unsettled, uncertain and more risky.

Government should continue to monitor the situation both in the short and long term, providing vital support to councils when needed.

Key messages from the Resilience Index

- Increase in the reserves held by local authorities at 31 March 2022.
- A large part of these increased reserves will have been earmarked for distribution in 2022/23 and beyond as part of the financial strategy to plan for an increasingly uncertain future.
- Many councils will be using reserves to fund the unforeseen additional costs of inflation and energy increases as well as additional service demand since their budgets were set in March 2022.
- A significant proportion of council budgets are spent on social care services (for both adults and children) with amounts still increasing within certain types of authority.
- Interest payments (to fund borrowing and capital expenditure) continue to place financial pressure on other council services with increases evident in parts of the sector.
- Continuing delays in the implementation of the government's long planned reforms to fair funding, business rates and social care and significant uncertainties about public spending beyond 2025 exacerbate risk and uncertainty and are likely to increase the need to hold reserves to strengthen financial resilience.

1 The December 2022 Index uses figures from the 2021/22 DLUHC revenue and expenditure outturn data return (RO).

2 LGA.

Challenges of audit

2021/22 represents the second financial year that external auditors provide a narrative judgement on local authority's arrangements for delivering value for money judgement, rather than a simple 'qualified' (negative) or un-qualified (positive) opinion.

In addition, due to continuing challenges, there have been significant delays in the completion and publication of local authority external audits, with 88% of audits missing the statutory deadline for 2021/22 one % lower than the previous year but still higher than the 55% in 2019/20.

Therefore, the December 2022 Resilience Index signposts readers to the local authority website to locate the most up-to-date position and judgement from their external auditor.

Headline indicators

While all the indicators within the resilience index are measures of financial risk, we would consider that three are particularly relevant:

- Reserves
- Social care ratio
- Debt and interest payable

Reserves

CIPFA has always been very clear on the importance of reserves, and it is vital that any discussion is based on a true understanding of the nature of those reserves.

The Resilience Index uses three different indicators to look at reserves:

- Reserves sustainability measure
- Level of reserves
- Change in reserves

The reserves sustainability measure provides a measure of how long in years it will take for a council to run out of their reserves if they continue to use them as they have and is represented as a year figure.

The level of reserves is perhaps the simplest reserves indicator and compares the current level of reserves to the council's net revenue expenditure.

Finally, the change in reserves identifies the change in reserves over a three-year period using figures from the current year and those from the previous three years.

This year's analysis of the data from the Resilience Index has shown that reserves have grown between 2020/21 and 2021/22; however, this hides a very complicated picture where short term must not deflect attention from medium and longer-term concerns.

Funding from central government for COVID related expenditure (including grants for local businesses and the Contain Outbreak Management Fund) are still being used by local authorities, and these are reflected in reserve figures but will gradually get depleted.

The reserve landscape also shows the increase in earmarked reserves as local authorities have funds reflecting the specific purpose to which they would be applied. Categories could include planned capital expenditure, budget stabilisation or contractual risk.

Identifying and managing funding in this way is good financial management.

The table below shows at a national level across England earmarked reserves rose more steeply than unallocated reserves.

Reserves (£'000)	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Earmarked	12,098	12,967	13,920	15,799	24,595	25,734
Unallocated	3,059	3,164	3,195	3,191	3,934	3,973
Total	15,157	16,131	17,115	18,990	28,529	29,707

Authorities excluded if data unavailable for any year period.

While reserves are higher than previous years providing financial sustainability for the majority in the short term, the issue is the medium and longer term. Services where demand due to Covid has been suppressed may continue to see costs increase and overall demand especially in areas such as adult and children’s social care are expected to rise.

Understanding reserves

Graph 1: Reserves and as a proportion of net revenue expenditure 2021/22 only³

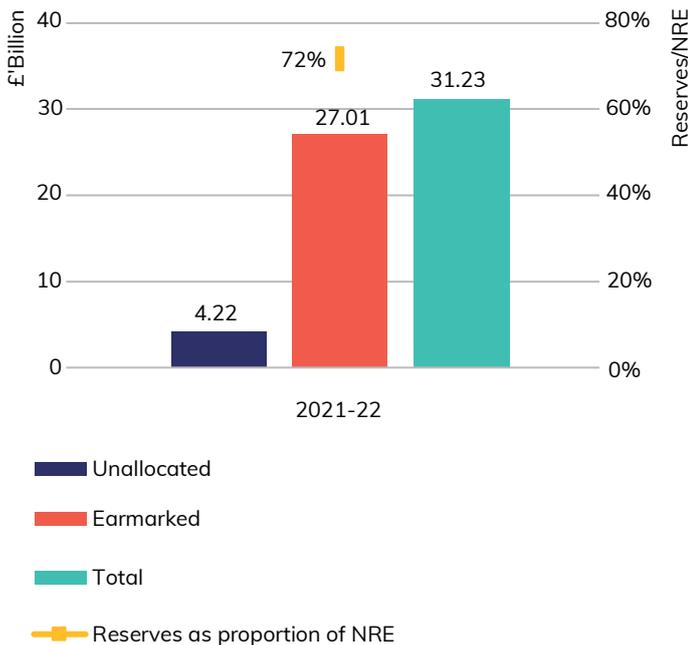


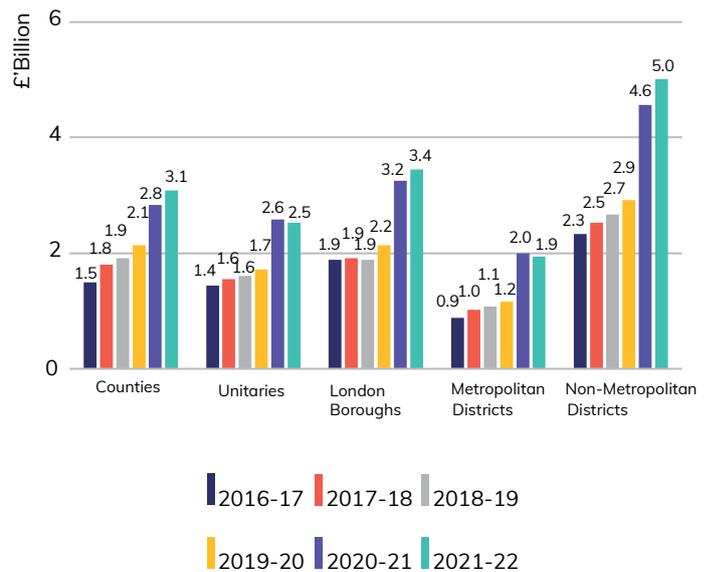
Chart 1 shows the difference between earmarked and unallocated reserves held by local authorities. Earmarked can be held for a variety of reason and Local Authorities may hold significant numbers of individual reserve pots including planned capital, contractual obligations, or budget stabilisation.

³ The £31bn may differ from other national figures as it excludes those local authorities whose data was not available at the time and no estimate was provided.

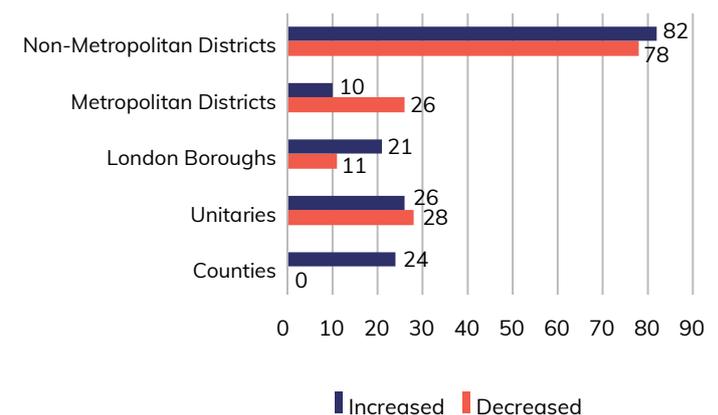
A more detailed breakdown can be found in the RO form⁴ and the announcements made in the Local Government Finance Policy Statement⁵ indicates further work will be carried out in this area.

Graphs 2 and 3 below show a more detailed picture of reserves reflecting at a national level the pattern across the different types of Local Authority.

Graph 2: Reserves by authority type 2016/17 to 2021/22



Graph 3: Number of authorities whose reserves increased/decreased between 2020/21 and 2021/22

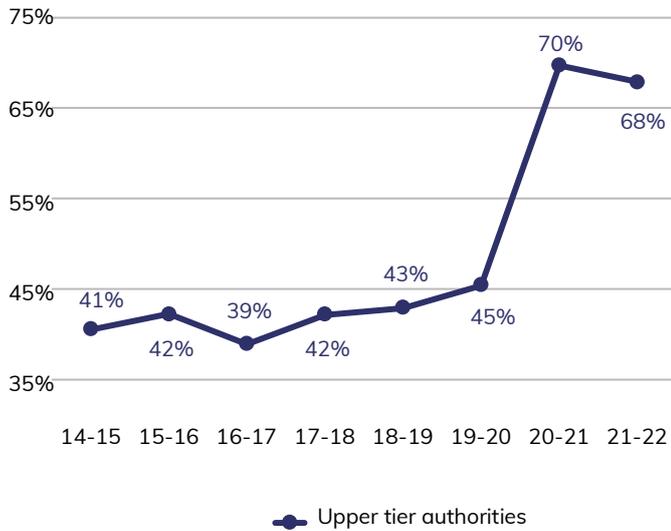


It may be of interest to note that while the total amount of reserves has increased in 2021/22 as Graph 4 shows at a national level reserve as a proportion of net revenue expenditure has marginally decreased.

⁴ www.gov.uk/government/collections/local-authority-revenue-expenditure-and-financing#2021-to-2022

⁵ www.gov.uk/government/publications/local-government-finance-policy-statement-2023-24-to-2024-25

Graph 4: Reserves as proportion of net revenue expenditure



CIPFA continues to consider that reserves are essential to a local authority’s financial resilience as, unlike central government, they cannot borrow money over the medium-term, other than for specific functions, and they are required to balance their budgets on an annual basis.

Local authorities generally hold reserves for three purposes:

- working balance to help cushion the impact of uneven cash flows
- contingency to cushion the impact of unexpected events or emergencies
- building up funds to meet known or predicted requirements – often referred to as earmarked reserves.

With continuing funding pressures and uncertainty the ability of local authorities to manage unexpected expenditure in-year is essential. It may be counter intuitive, but at a time of increased uncertainty, the role of reserves becomes more important and the need for adequate levels of reserves has increased.

While reserves are an essential dimension of resilience, they are not the only one. Resilience also includes indicators of financial standing; the predictability, buoyancy and diversity of income streams; cost and demand pressures and management and governance judgements of auditors and regulators.

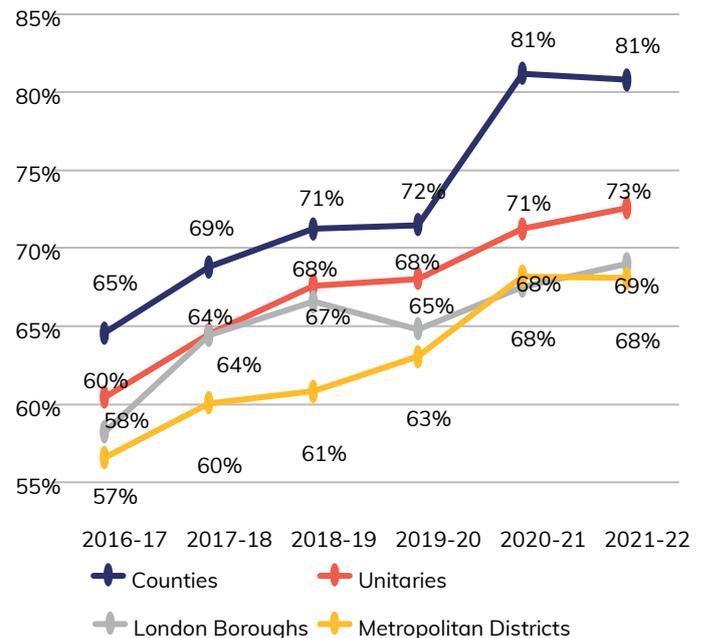
Social care ratio

This indicator reflects the fact that the greater the proportion of the local authority budget that is used for social care, the less funding there is for other services. Increased demand will therefore reduce the flexibility of the council’s budget, making it more vulnerable to financial challenge.

The December 2022 Resilience Index shows the local authorities with the highest level of spending as a % of their net revenue expenditure. Additional funding has been provided in the financial settlement in 2023/24, but the delays to the reforms mean that there is still considerable financial pressure and risk attached to this area of service delivery.

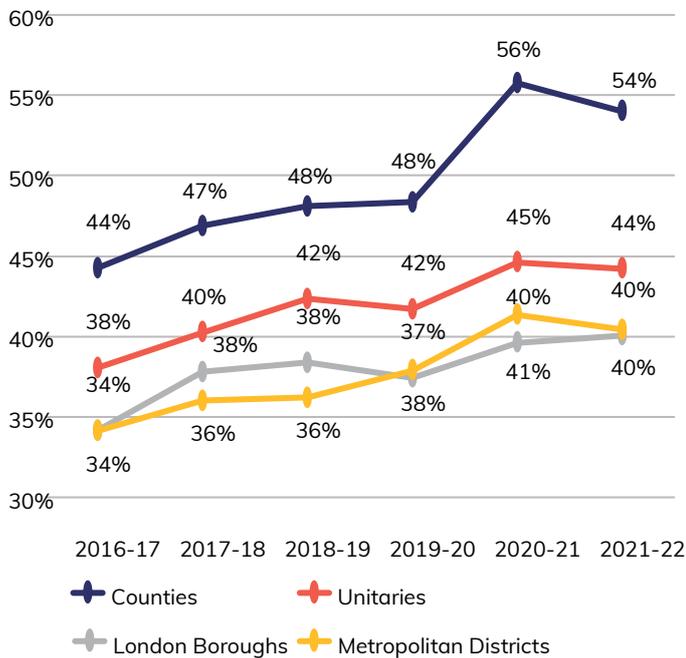
The graphs⁶ below show the high % of net revenue expenditure that is used to support this service area. Increasing costs and capacity issues will add to costs of this service in the coming years.

Graph 5: Social care as proportion of net revenue expenditure

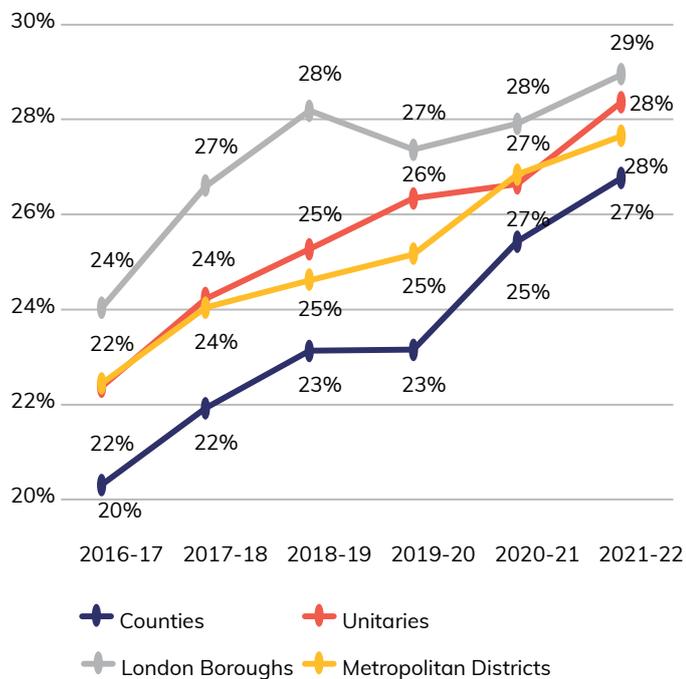


6 Rounding may impact the calculation of the figures.

Graph 6: Adult social care as proportion of net revenue expenditure



Graph 7: Children’s social care as proportion of net revenue expenditure



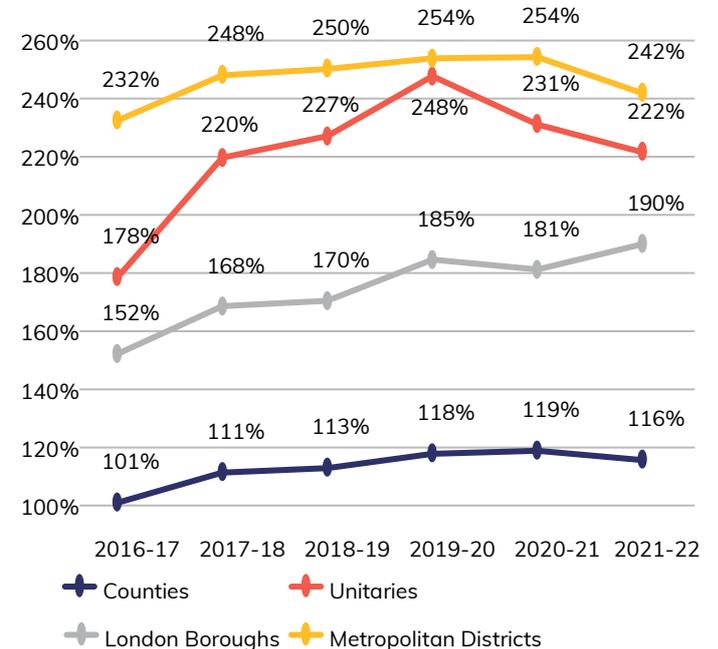
External debt and interest

The Prudential Code⁷ is clear that local authorities should borrow within their means and minimum revenue provision ensures that there is suitable debt cover. This indicator does not show how an authority will repay the debt but shows the gross external debt level and compares to other similar authorities.

While the level of debt itself does not indicate immediate risk, it is an area that may limit the flexibility of a local authority to remain financially resilient. Substantial debt must be monitored, and effective risk management must be evident as part of good governance.

Graph 8 below takes the gross external debt figure and sets it into the context of net revenue expenditure across the different types of authority. It indicates that the average gross external debt when calculated in this way has reduced for the majority of the councils, indicating that fewer councils were borrowing in 2021/22, which may reflect changes in guidance but may also be caused by other external factors such as COVID or inflationary pressures.

Graph 8: External debt as percentage of net revenue expenditure

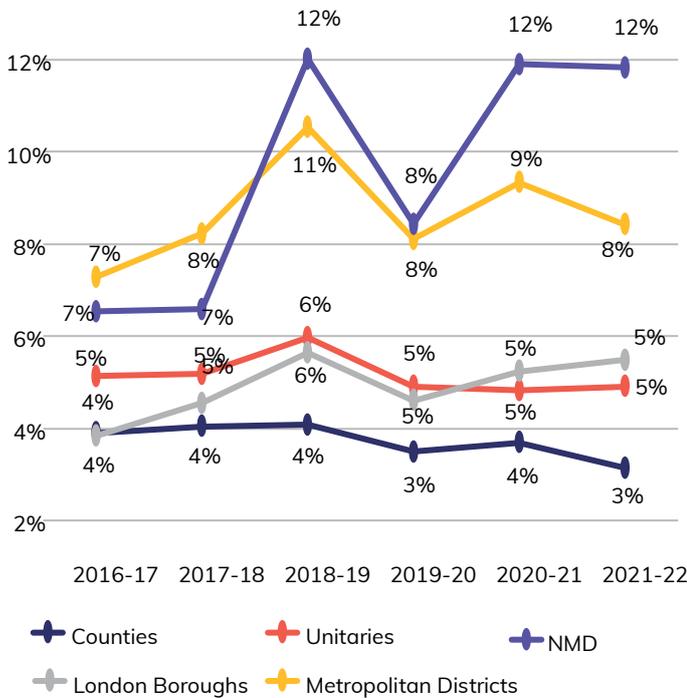


7 CIPFA Prudential Code 2021. www.cipfa.org/policy-and-guidance/publications/t/the-prudential-code-for-capital-finance-in-local-authorities-2021-edition

While total debt has reduced and stabilised, the cost of borrowing is rising due to increases in interest rates. The Resilience Index considers the amount of interest that is currently payable as a proportion of net revenue expenditure as a good indicator of financial stress. Irrespective of other requirements, interest must be paid, and therefore if interest rates rise, additional money will need to be found.

While it is recognised that many authorities will have set interest rates over the longer term, any vulnerability to rate changes is a risk. The chart below reflects the fact that non metropolitan districts appear to have had an increase in the amount of interest paid as a % of net revenue expenditure, while other types of authority have remained more stable.

Graph 9: Interest payable as proportion of net revenue expenditure⁸



Conclusion

The picture for local authority finances remains very unclear. Levels of reserves have risen; however, there is an explanation for this and one that also underlines the short-term nature of the change.

Social care expenditure remains a dominating factor for many authorities, limiting the flexibility of an authority to deliver other non-statutory services. Increases in interest rates are likely to provide additional pressure on council budgets.

CIPFA would argue that for authorities to remain financially stable, it is important for them to be able to plan in the medium and longer term, with sufficient funding. Longer term settlements are the most effective way to ensure value for money and the most effective use of public money.

While the Financial Resilience Index can shine a light on areas of possible risk to generate a local discussion, it is essential that a national conversation on funding remains a priority.

⁸ the data excludes non mets who are statistical outliers



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