HEALTH PROFESSIONS COUNCIL (HPC)

RESERVES POLICY
(Revised October 2005)

1 INTRODUCTION

HPC commenced operations on 1st April 2002 inheriting the net assets and reserves of the Council for Professions Supplementary to Medicine (CPSM).

In the HPC Balance Sheet, Net Reserves are comprised of the sum of Investments, Bank Balances and Cash, less Loans. At June 05, Net Reserves were £2.45M and budgeted Reserves for March 2006 are £5.45M (after loan repaid in full).

A private meeting of the Council in October 2004 ratified the September 2004 proposed policy that sufficient Reserves should be held to cover three months overheads.

2 RESERVES POLICY

2.1 **That HPC maintain a Reserves level that is a MINIMUM of three average months budgeted operating expenses[1] and a MAXIMUM of the sum of the following three sub-policies (£600k + £880k + £2,570k = £4,050k).**

2.2 **That HPC maintain sufficient Reserves to fund the replacement of assets (purchased or leased) that are used in the business for ongoing operations.**

By definition, assets have a useful economic life greater than one year. They are depreciated over their useful life e.g. four years for most computer assets. If HPC needs to replace those assets at the end of their economic life to at least maintain existing services and service levels, sufficient reserves must be built up to do so. As HPC grows in size, the investment in assets increases, so the level of Reserves must increase to ensure the assets can be replaced.

Ignoring Land and Building assets, and assuming replacement cost = historical cost of purchase, the average annual replacement cost of Computer assets (4 yr life) = £507k. Likewise, the average annual replacement cost of Office assets/equipment = £93k. Collectively, this totals £600k.

2.3 **That HPC maintain sufficient Reserves to refund a minimum of 20% Registrant Income received in advance.**

Because HPC collects renewal fees in advance and because renewal fees make up most of the HPC's income, reserves will typically include a significant proportion of income received in advance.

[1] The existing policy (3 months overheads) needs to be changed to *three average months budgeted operating expenses*, since the monthly timing of some expenditure (projects) is uncertain. Based on 05/06 budgeted operating costs, three average months operating costs is £2.57M.

The income received in advance is held in the HPC Balance Sheet as a liability, since it is repayable to creditors (including Registrants) if HPC ceased to be a going concern. If one of the Health Professions changed its Regulator from HPC to another Regulator, HPC would need to have sufficient Reserves available to refund the fees collected in advance.

The average level of income received in advance (deferred income) between April 05 and March 06 is projected as £4.4M, ranging from a low of £3.1M in July to a high of £5.6M in March 06. 20% of £4.4M = £880k.

2.4 **That sufficient Reserves be held to preserve operating flexibility within the business to handle external "shocks".**

HPC develops annual and Five Year Plans based on the most likely and agreed targets for the business. However, some external events may arise with rapid and significant impacts on HPC operating activities that are outside the plans. Examples include; lost legal cases, legislative penalties and costs imposed on HPC by central government agencies, the unanticipated withdrawal of a profession and/or sector-restructuring.

If HPC has a significant level of Reserves built up, these will in the short term provide "bridging finance" to handle such "shocks". A significant level of Reserves also generates income (interest income etc) to help "smooth out" and delay Registrant fee price increases.

A default value for "shocks" provision could be three average months operating costs i.e. £2.57M.

2.5 **That the Reserves Policy be viewed in the context of the Five Year Financial Plan "bottom line" surpluses/deficits and the Investments Policy.**

Arguably, the Reserves policy both influences and is influenced by the Five Year Financial Plan. To elaborate, if high Reserves levels are to be built up or maintained, this will drive the need to increase fee income (find more fee-paying Registrants and/or raise fee prices). Similarly, if a Five Year Plan is agreed, Reserves levels will be an output of this. If those levels conflict with the prevailing Reserves policy, the policies will need to change, to produce an alignment.

Reserves levels will also be a function of volatility in the value of the things comprising those reserves. Regarding relative volatility (uncertainty) over the next 12 months, share, bond and property market values are considerably more volatile than fee income, especially fee income relating to the existing professions that HPC regulates.

Ignoring property investment and assuming the loan is repaid soon, then at the time of writing, the market value of investments approximately matches the value of bank and cash funds directly managed, while projected surpluses in the latest Five Year Plan remain modest. This means that it is desirable for Reserves levels to be significant, simply because the volatile value of the Investments portion of Net Reserves is such a large proportion of the total value.

Regarding the relationship between the Reserves Policy and the Investments Policy, in the medium term, if fees are not able to rise to offset cost increases, but ongoing compliance with the agreed Reserves policy is maintained, then investment returns need to rise. However, higher investment returns will typically involve incurring increased investment risk (more value volatility and/or greater potential for losses).

Finally, it is worth noting that if HPC's underlying cash-flows become highly volatile, then either HPC needs an overdraft[2] (indicative interest rates are about 2 percentage points about the Bank of England base rate), or the Reserves "buffer" in the absence of a bank overdraft, needs to be correspondingly higher.

3 BENCHMARKING

In future, it may be useful to benchmark HPC's Reserves levels in the context of the Health Regulator sector, for example converting the Reserves level to a ratio, such as % of annual operating expenses, % of annual income and comparing the ratios across the sector using public information.

4 REPORTING

Net Reserves levels are not explicitly reported as such in the HPC Balance Sheet produced on a monthly basis. Such reporting could be easily provided and also reported relative to three average months budgeted operating expenses, if the Committee would find this information useful.

[2] If there was a £150k bank overdraft facility created costing 6.5% per annum and HPC had say £100k go on overdraft for three months per annum (not necessarily continuously), the interest cost would be £1,625. Alternatively, if no overdraft facility, but a£100k "buffer" balance effectively kept in the lower yielding but immediately available Business Reserve account, the loss of interest (4.5% money market rate less 2.5% business reserve rate received) over a full year is £2000.