



**Government Finance Officers Association**

# **Reserve Policies**

Section 4

# Agenda

- General fund reserves
  - About reserve policies
  - Sizing your reserve
  - Key policy elements
- Reserves in other funds

# About a Reserve Policy

- Corner stone of financial flexibility
  - Buffer shocks
  - Manage risk
- Policy is essential to:
  - Define amount to hold in reserve
  - Describe purpose of reserves

# Reserves v. Fund Balance

- Fund balance
  - An accounting term for the difference between assets and liabilities
- Reserves
  - A budget/policy term referring to resources set aside to provide a buffer against risk
  - May only refer to a portion of fund balance

# GASB 54 and Reserve Policy

- 5 categories of fund balance
  - Non-spendable fund balance
  - Restricted fund balance
  - Committed fund balance
  - Assigned fund balance
  - Unassigned fund balance
- The last three are “unrestricted fund balance” and are typically the subject of a policy

# Reserve Key Questions

- These questions should guide the discussion resulting in policy language
- ? What is the right level of reserves?
- ? What factors influence the "right" level of reserves?
- ? What are the most important elements of a reserve policy?
- ? What is the right financial strategy for using reserves for budgetary stabilization?
- Let's look at each...

# The Right Level of Reserves?

- How to measure?
  - Reserves as a percent of
    - Regular revenues or...
    - Regular expenditures
  - Choice depends upon which is more predictable

## City of Redmond - 8. Reserve Fund Policies

- a. The City will maintain General Operating Reserves at a level equal to at least 8.5% of the total General Fund budgeted **revenue**, excluding the beginning fund balance, development review revenue, and any significant one-time revenue. A separate reserve shall be established for development review services and economic stabilization.

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# The Right Level of Reserves?

- What does GFOA recommend?
  - As a baseline for the general fund:
    - 16% of regular operating revenues
    - 2 months of regular operating expenditures
  
- S&P's views on available reserves
  - Low: Below 0%
  - Adequate: 1%-4%
  - Good: 4%-8%
  - Strong: 8%-15%
  - Very strong: Above 15%



# Factors Influencing the “Right” Level?

- GFOA recommendation = a baseline
  - Often a great place to start the conversation
- Need to adjust based on local conditions
- Conduct an analysis
  - Catalogue major influencing factors
  - Analyze past experience on factors
  - Judge implications for reserves

# Risk Factors to Consider

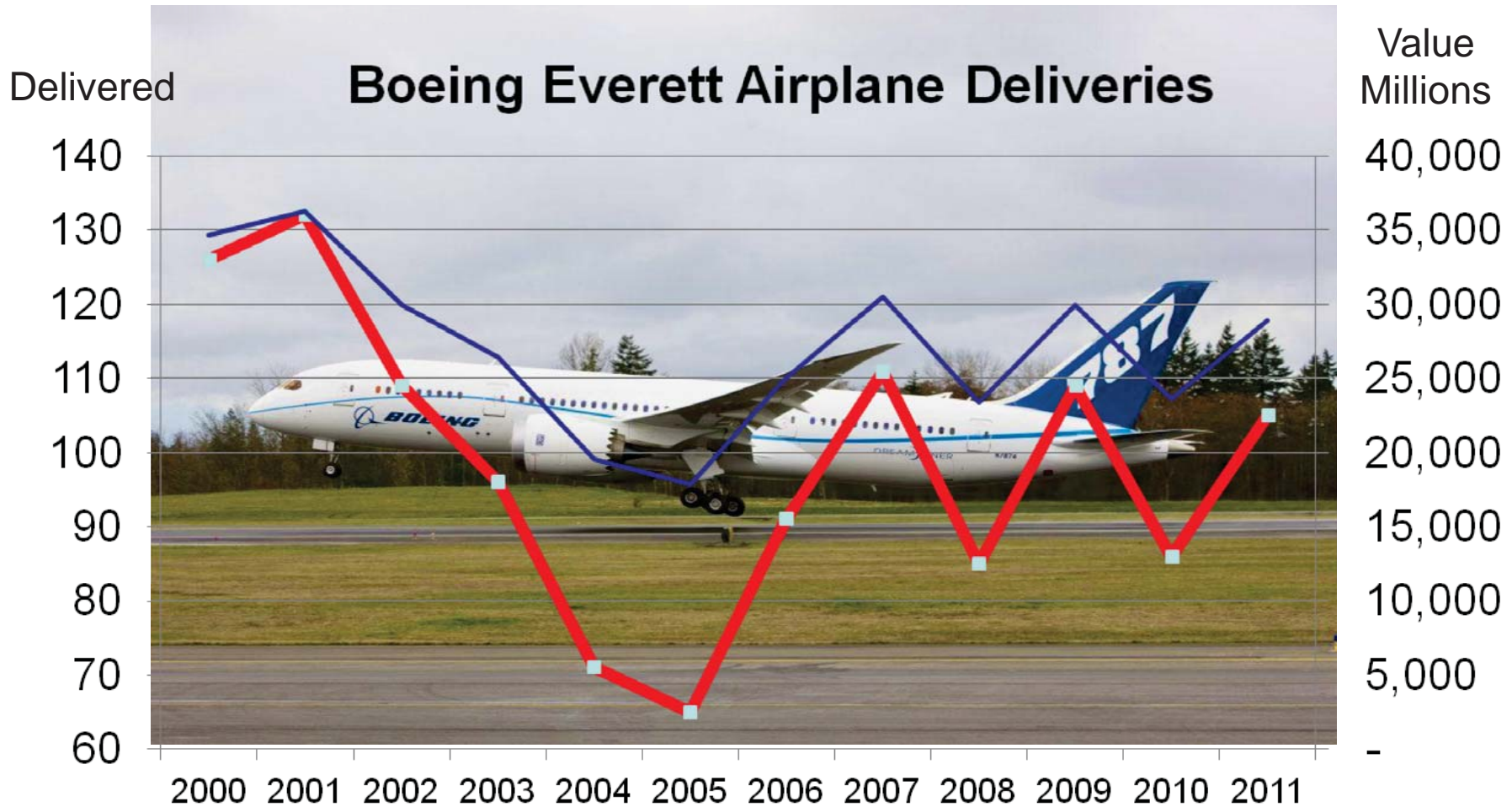
- Vulnerability to Extreme Events & Public Safety
- Revenue source stability
  - Types of revenue
  - Concentration in tax base
- Expenditure volatility
  - Look for spikes from unusual, non-recurring circumstances

# City of Everett, WA Policy

- Fund Balance is defined as the excess of assets over liabilities, which is an unreserved, undesignated resource that remains part of the General Government budget. The City desires to maintain a prudent level of financial resources to guard its citizens against service disruption in the event of unexpected temporary revenue shortfalls or unanticipated and extraordinary one-time expenditures. The Fund Balance has been accumulated to meet this purpose, to provide stability and flexibility to respond to unexpected adversity and/or opportunities. The long-term target is to maintain a rolling beginning fund balance equal to 20% of operating revenues.
- The City's goals are to maintain annual expenditure increases at a conservative growth rate and limit expenditures to anticipated revenues. Revenues in excess of operating expenditures, ("Surplus Funds"), may be transferred to a Capital Reserve, Long Term Obligation, or Debt Service Fund. Capital projects, Street Overlays and Motor Vehicle replacements may be funded from Capital Reserve funds.
- The decision to retain a fund balance of 20% of operating revenues stems from the following considerations:
  - This amount, in combination with the Rainy Day Fund, provides adequate funding to cover approximately three months of operating expenses.
  - It provides the liquidity necessary to accommodate the City's uneven cash flow, which is inherent in its periodic tax collection schedule.
  - It provides the liquidity to respond to contingent liabilities.

# City of Everett, WA Policy

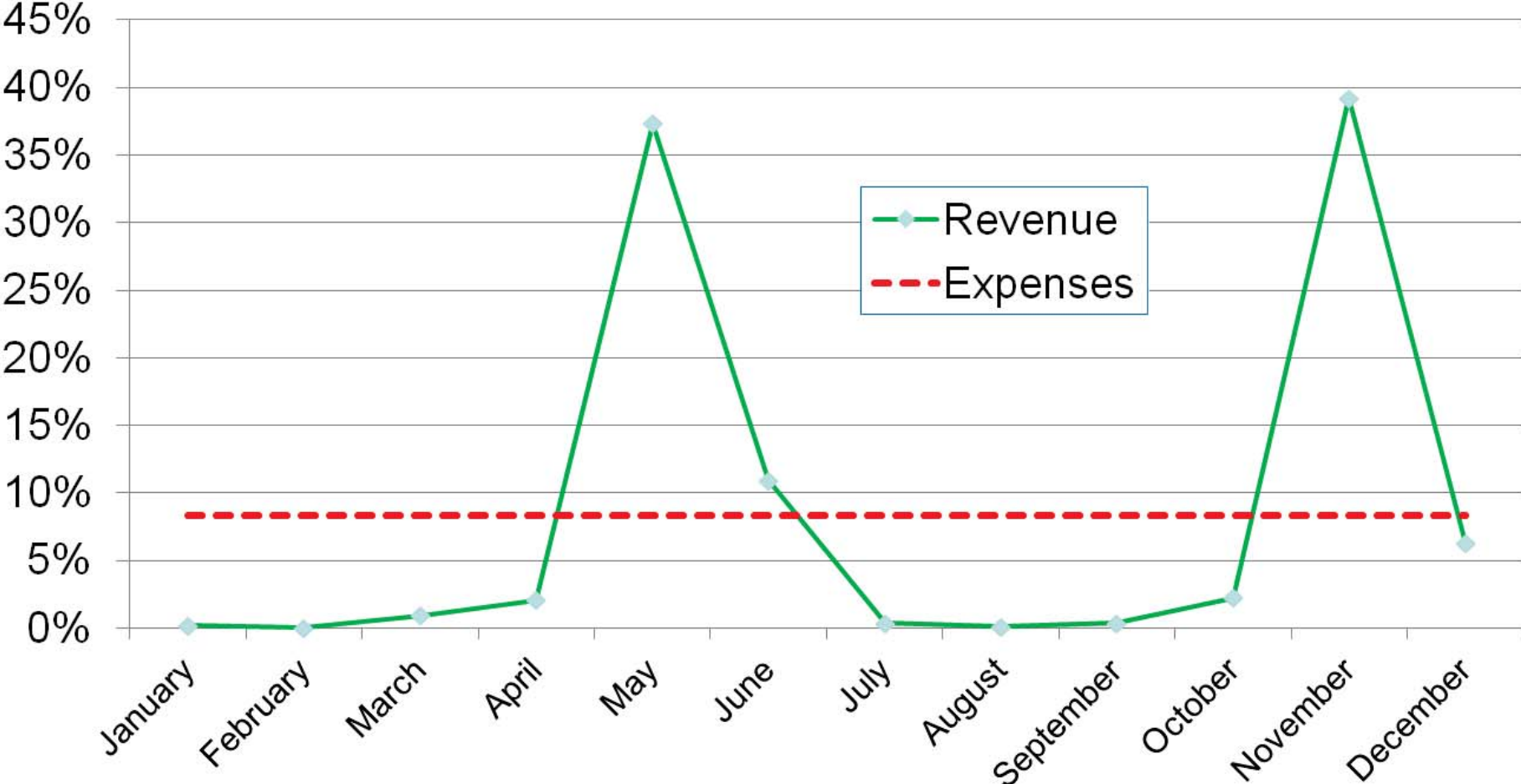
- Why this policy in Everett?



# Risk Factors to Consider

- Leverage
  - Debt – is use of debt part of your financial resiliency strategy?
  - Maintenance / replacement
- Budget practices
  - Large contingencies reduce need for reserves
- Liquidity
  - What does the cash flow curve look like?
  - Are reserves needed for working capital?

# Snohomish County Fire District Cash Flow



# Risk Factors to Consider

- Other funds' dependency
  - Are other operations outside the fund subsidized by the fund?
  - If so, is the fund also seen as a “backstop” against risk?
  
- Growth
  - High growth may require higher reserves
  
- Capital projects
  - What is the expectation of using reserves for capital projects?

# Other Drivers to Consider

- Government size
- Management plan
- Borrowing capacity
- Public perception
- Labor Issues
- Political Support
  - Is there a level of reserves that resonates?
  - Can elected officials be engaged in the analysis?



# Most Important Policy Elements?

- Reserve target levels
  - Consider breaking into subcategories
  - Key word: ***credibility***
- How to reach target levels
  - Broad guidance in policy
  - Use a long-term financial plan for more specifics

# Most Important Policy Elements?

- Conditions for use of reserves
  - Use of Reserves
  - Authority to Use Reserves
  - Replenishment of Reserves
  - Excess Reserves

# Targets

- Louisville Metro
  - Between one and two months of monthly average current year general fund budgeted expenditures
- Portland
  - 5% (of revenues) emergency reserve & 5% counter-cyclical reserve
- Minneapolis
  - 15% of the following year's revenue budget amount

# Other Policy Examples

- Authority to use (Portland)
  - The City Manager makes recommendations to the Finance Committee of the City Council on use
- Replenishment (Portland)
  - Restore the fund balance in upcoming budget cycles in such amounts as deemed prudent under then-existing economic conditions
- Excess reserves (Minneapolis)
  - Hold if contingencies warrant, move to other funds if needed, or spend on approved special projects

# Using Reserves for Stabilization?

- Describe how reserves fit into “bridging” strategy
- Have a credible fund balance policy
- Get skilled at distinguishing between one-time and permanent decreases
  - If it is permanent, how long is the downturn expected to last?
- Develop a replenishment strategy for after it is used
  - How will it be replenished?
  - By when will it be replenished?

# Using Reserves

## Key Policy Questions to Ask

- How will fund balance compare to policy standards as a result of the use?
  - What vulnerabilities does it leave to other risks?
- How soon can balances be built back up?
- What other mitigation tools might eliminate the need to use fund balances?



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# **Reserves in Other Funds**

# Reserves in Governmental Funds

- Fund balance doesn't have same risk-mitigating role
  - Special revenue. Intent of fund is show funds are spent for intended purpose
  - Debt service. Debt liability not report in fund, so fund balance analysis is not meaningful
  - Capital projects. Presumed that all funds will eventually be spent on the project
  - Permanent funds. Presumed that all funds will eventually be spent on intended purpose



# Reserves can Still Play a Role

- Target level of reserves.
  - Not to manage risks but to better accomplish fund purpose
- Maximum level of reserves.
  - Define the maximum allowable fund balance
- Source of funding.
  - Relevant were target has been set but there is no natural source of funding

# Reserves in Internal Service Funds

- Target reserves should be a function of the liabilities the fund is subject to
  - Minneapolis, Minnesota: *Self-Insurance Fund shall maintain a cash balance equal to the unpaid claims payable amount on its balance sheet plus 10% of the annual department operating budgets within the fund. Net assets within the fund should not fall below zero.*
- Address how reserves will be funded
- Address use of reserves, especially for self-insurance
- Address what happens to excess reserves

# Reserves in Enterprises

- Reserves help manage risk
- Use “working capital” instead of “fund balance”
- GFOA recommends 45 days as a bare minimum amount of working capital
- Start with an assumption of 90 days and adjust based on relevant risks

# Enterprise Risks

- Support from general govt. Is the enterprise “backstopped” by the govt?
- Cash cycles: Are there big ups and down in cash?
- Customer concentration: Is there heavy reliance on few customers?
- Demand: Is demand steady or volatile?
- Control of rates: Can the enterprise set rates relatively freely?
- Expenditure volatility. What is the exposure to extreme events?
- Debt. Does debt constrain financial flexibility?

# Take-Aways

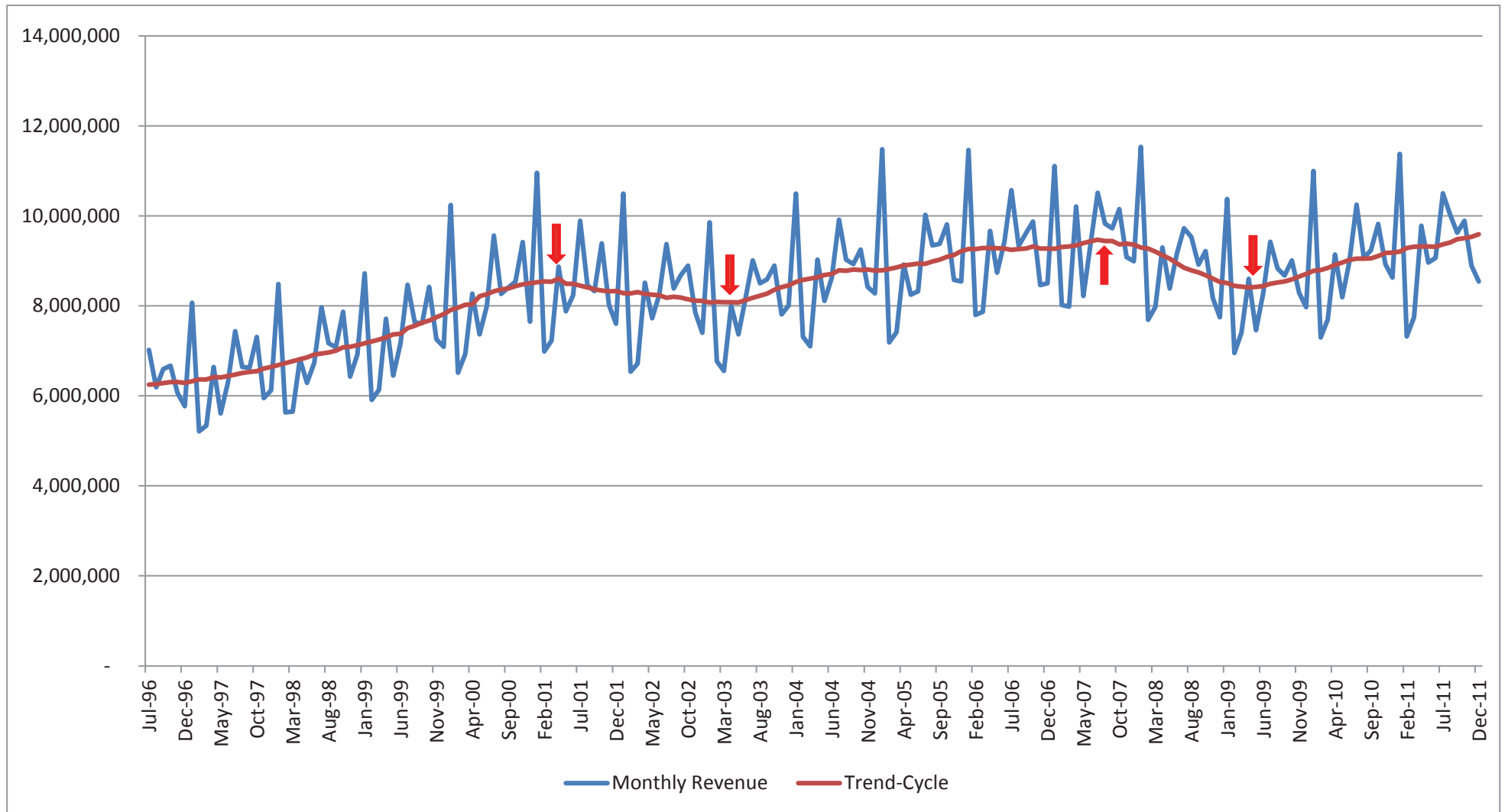
- Reserves are critical to financial planning
  - Flexibility
  - Risk mitigation
- A policy defines a target level and what reserves can be used for
- Analyze the risks you face to define your target



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# **Case Study on Determining Reserve Levels**

## Sales Tax Monthly Revenue and Trend Cycle



*The City has experienced two major downturns in the sales tax trend-cycle. The first one started in April 2001 and lasted until May 2003. The trend-cycle declined 6.6% over 25 months. The second started in July '07 and lasted until April'09. The trend-cycle declined 11.2%.*



# Risk Profile for Bridges

Consequence of Failure	Probability of Failure				
	1	2	3	4	5
5	34 Assets \$97,543,123.50	6 Assets \$14,341,650.00	8 Assets \$17,801,817.00	1 Asset \$1,544,010.00	No Assets N/A
4	39 Assets \$25,177,155.00	7 Assets \$6,959,355.00	No Assets N/A	2 Assets \$1,772,910.00	2 Assets \$1,633,935.00
3	48 Assets \$18,897,532.50	5 Assets \$3,852,240.00	4 Assets \$1,345,308.00	2 Assets \$412,344.00	No Assets N/A
2	64 Assets \$13,759,009.50	14 Assets \$5,716,803.00	7 Assets \$711,121.50	1 Asset \$741,195.00	3 Assets \$1,353,675.00
1	104 Assets \$20,381,443.50	35 Assets \$8,967,537.00	13 Assets \$2,933,257.50	9 Assets \$889,242.00	77 Assets \$1,090,359.00



# Triple-A Approach to Uncertainty

- **Accept.** Accept that we are subject to uncertainty, including events that we haven't even imagined.
- **Assess.** Assess the potential impact of the uncertainty. Historical reference cases are a useful baseline.
- **Augment.** The range of uncertainty will almost always be greater than we assess, so we should augment that range.
  - Historical reference cases provide a baseline, but that baseline may not be adequate.

# The Results

- \$13M for sales tax economic uncertainty
- \$7.5M for economic uncertainty in other revenues
- \$6.25M for pension payment uncertainty
- \$5.25M for critical bridge failure and \$11.6 million critical storm sewer replacement, for a total of \$16.85 million.
- \$5-7.5M for extreme events
- \$2-4M for expenditure spikes from law suits

# Group Discussion

- What are the biggest risks you face that drives reserve levels? What strategies might you use to help your organization accept uncertainty?
- How might you assess the level of uncertainty?
- What other risk mitigation approaches might you consider, besides reserves?