Setting Reserve Policies – and Living Within Them

What Reserves Do – and Don't

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Strong reserves reflect ability to manage risk, not fiscal strength. Reserves – whether large or small – do not per se reflect on an agency's financial capacity or underlying fiscal strength. There are much better indicators than fund balance for this; most notably the ability over time for ongoing revenues to adequately meet day-to-day service needs, capital improvement goals and debt service requirements.

Then what does retaining a prudent level of fund balance reflect? It measures an agency's ability to manage risk. How much can things adversely turn out differently than "usual?" And how much fiscal capacity (measured in time) does the organization think is prudent in developing and implementing plans to respond to unexpected circumstances?

For organizations with a high tolerance for risk, small reserve levels will work. When adverse circumstances hit, just close fire stations and libraries right away; and start laying-off employees by the next payroll. For those with a lower tolerance for risk, strong reserves will allow for breathing room in responding to one-time circumstances or developing longer-term strategies for closing the gap between revenues and expenditures.

The following are four suggested steps in setting reserve policies and living within them.

1. Assess Risk in Determining Reserve Policy

The first step in assessing an appropriate reserve level is to assess fiscal risks, which likely fall into seven categories:

Economic. How dependent are the agency's key revenues on local economic performance? And how dependent is it on the fortunes of a few key tax or rate payers – or are revenue sources broadly distributed? In short, are all of the agency's revenue "eggs in one basket?" And if so, how large and strong is the basket? Stated simply, how stable or volatile are your key revenue sources?

Cash Flow. What cash resources does an agency need in balancing when it receives key revenues and when it incurs expenses? For example, in California, most local agencies must operate for six months before receiving their first installment of property tax revenues; and for many, this is a key revenue source. This requires each agency to review its own unique circumstances in evaluating "lumpy" receipts and disbursements, as well as cash flow commitments from and to other funds. In short, every agency has a different cash flow story to tell.

Expenditure Flexibility. How much of an agency's costs are relatively "fixed" or ongoing, like debt service and regular staffing; versus more flexible costs like capital projects or other "one time" costs? The more "flexible" an agency's costs, the more flexibility it will have in not disrupting day to day services in responding to adverse circumstances, while it figures out a longer term strategy.

Reliance by Other Funds. How dependent are other funds on the General Fund?

General Contingencies for "Extreme Events." What is the likelihood of a major, unanticipated cost?

Disasters. What is the likelihood (and frequency) of natural or human disasters like floods, fires or earthquakes in increasing response and recovery costs, or reducing revenues?

Stability of State Local Government Relationships. How likely is it that the federal or state government will structurally change revenue sources or no longer allow an agency to set a key fee or a tax that it has relied upon for many years? Or charging agencies for services that the state or federal agency has traditionally provided at no cost?

The Power of Policies

One of the most powerful aspects of fiscal policies is making tough decisions easier when adverse circumstances arise by articulating your values before they are placed under stress.

This means that identifying when it is appropriate to use reserves is a critical component of an effective policy. If you have been successful in building reserves at policy levels (or beyond), there will be calls from many places to use them when adverse circumstances arise - when your fiscal condition improves. Being forearmed with "when" will help you respond to these pressures.

Placed in context, over the past thirty years, even in adverse local economic circumstances, State budget takeaways have consistently been the largest single fiscal threat to local government in California.

2. What's the Right Amount?

In comparing reserve levels between government agencies, it is important to recognize that "one size does not fit all." In short, other than having a reserve at all, there is no "right" level: it depends on the circumstances in each agency.

GFOA Structured Assessment Tool. Because of this, beyond generally addressing the risk factors above, for many years there wasn't really a satisfactory response to "how much" other than saying "it depends."

However, the Government Finance Officers Association of the United States and Canada (GFOA) recently developed an excellent analytical resource in translating these conceptual risks into specific reserve targets. It does this by creating a structured assessment of the risk factors facing each agency. It looks at eight risk factors (like those above); asks questions about them; and based on the agency's situation, assigns a score to each risk category on a scale of 1 (low risk) to 5 (high risk). The tool then provides suggested reserve levels based on the total score (along with adjustments for other factors such as population). This straight forward spreadsheet tool (no special software required) is available on-line at no cost from the GFOA on its web site at:

http://gfoa.org/financial-policy-examples-general-fund-reserves

For those with a lower tolerance for risk, strong reserves will allow for breathing room in responding to one-time circumstances or developing longer-term strategies for closing the gap between revenues and expenditures.

3. Using Reserves

Along with setting minimum reserve policies, agencies should also consider adopting policies for when the use of reserves below policy targets is appropriate.

There are several circumstances where doing so makes sense. For example, reserves are often referred to as "rainy day funds," so it makes sense to use them when it rains – at least, when it rains unexpectedly. For rain that can be reasonably expected every year, however, it doesn't make sense to use reserves.

This surfaces the second point about the use of reserves: you can only spend them once. And accordingly, they should ideally only be used for one-time purposes. This could include serving as a bridge in tough times as part of a multi-year strategy to close a systemic gap in bringing operating costs in line with lower ongoing revenues (the "new normal").

However, smart agencies will strongly resist using reserves to fund operating costs – let alone operating cost increases, such as labor agreements.

4. Restoring Reserves to Policy Minimums

Agencies should also consider setting policies for how reserves should be restored to policy levels after they've been used for appropriate purposes. In recognition that as things improve, there will be a legitimate public policy interest in restoring/improving service levels and funding capital projects, an example might be:

- Restore reserves to policy levels within 5 years.
- And as revenues improve, split the improved financial condition evenly ("50/50") between services and reserve restoration.

SUMMARY

Reserves act as an insurance policy – a risk management tool. Accordingly, in setting appropriate reserve policies, an agency should ask itself:

- What risks are we exposed to?
- And how much risk are we willing to take when adverse circumstances emerge?

After setting minimum reserve policies based on this assessment, effective reserve policies will then identify when it is appropriate to use reserves and strategies for restoring them to policy levels when they have been drawn-down for these appropriate policy reasons.

Knowing how other agencies answer these questions can be helpful; but ultimately, each agency needs to be guided by its own facts and circumstances.

Bill Statler served as the Director of Finance & Information Technology for the City of San Luis Obispo for 22 years and for 10 years prior as finance officer for the City of Simi Valley. Bill has also played a large leadership role in the municipal finance profession. He served on the Board of Directors of the League of California Cities in 2009-10 and as President of the League's Fiscal Officers Department in 2002-03. He was President of CSMFO in 2001 and served on its Board of Directors and as a Chair and Senior Advisor on several committees. Additionally, he served as a member of the California Committee on Municipal Accounting and on the GFOA's Budget and Fiscal Policy Committee. After 37 years of public service, Bill retired from the City of San Luis Obispo in May 2010. In the "third act" of his career, Bill continues to be deeply involved in the municipal finance profession as a consultant, trainer and writer, including co-authoring the Guide to Local Government Finance in California, published by Solano Press Books in July 2012.