



**Implementing
a Risk-Based
Reserve Strategy
in Colorado Springs**

BY ELIZABETH FU



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In fall 2013, *Public Sector Digest* featured an article on the City of Colorado Springs, Colorado, and its approach to analyzing reserves based on risk factors. The city wanted to maintain emergency reserves in an amount that was specific to its circumstances. By working with the Government Finance Officers Association (GFOA) and *Public Sector Digest*, it identified target reserve levels, as well as ways to support and maintain its overall reserve strategy.

Much has happened in the two years since the reserve planning began. This article provides an overview of the initial risk-based reserve analysis, as well as a progress report on how the reserve has been used and current reserve levels.

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THE INITIAL ANALYSIS

In 2011, Colorado Springs began the process of determining how much money it should maintain in reserve. General standards were considered, including GFOA’s best practice¹ of maintaining no less than two months (or 16 percent) of regular general fund operating revenues or regular general fund operating expenditures in the city’s “unrestricted”² portion of the general fund. At the same time, Colorado Springs hoped to find a dollar figure tailored to its circumstances. The city was sensitive to the argument that while reserves provide a government with the ability to respond to and buffer against uncertainty and risk, excessive reserves could be used for additional services or even be returned to citizens (e.g., through lower taxes).

GFOA conducted a review of the risk factors that generally influence the amount of reserves a municipal government should hold.³ (A risk is defined as the probability and magnitude of a loss, disaster, or other undesirable event.⁴) Working with the city, these risk factors were then classified as primary (volatility of sales tax revenue; the potential for the city’s storm sewer and bridge infrastructure to fail; and the city’s vulnerability to extreme events such as wildfires, floods, and, to a lesser extent, snowstorms) or secondary (cash flow and the potential for unexpected spikes in expenditures). GFOA then analyzed the city’s level of exposure to these risks

in order to calculate a customized target reserve level for the city’s general fund. The results of the analysis recommended approximately \$54 million (or 25 percent) of the 2012 budget’s general fund revenues dedicated to reserves — \$27 million dedicated to budgetary uncertainty and \$27 million for emergencies.⁵

IMPLEMENTING THE RESERVE STRATEGY

When the city presented the recommended target to the mayor and city council, it was well received. This was in large part due to a transparent, research-based assessment of Colorado Springs’ risks. The mayor became a champion for meeting the reserve target level and the city became committed to achieving the reserve target of 25 percent of general fund expenditures to hedge against risks.

That year, the city set aside an amount equal to approximately 19.3 percent of its general fund expenditures in reserves. In 2012, the city’s “unrestricted” fund balance reached 22.7 percent. Previously, from 2005 to 2010, the city had between 7.9 percent and 15.8 percent in an “unreserved” fund balance — meaning resources that do not have any external legal restrictions or constraints for appropriation purposes.⁶

Exhibit I: Target Reserve Levels

Budget Uncertainty Reserve

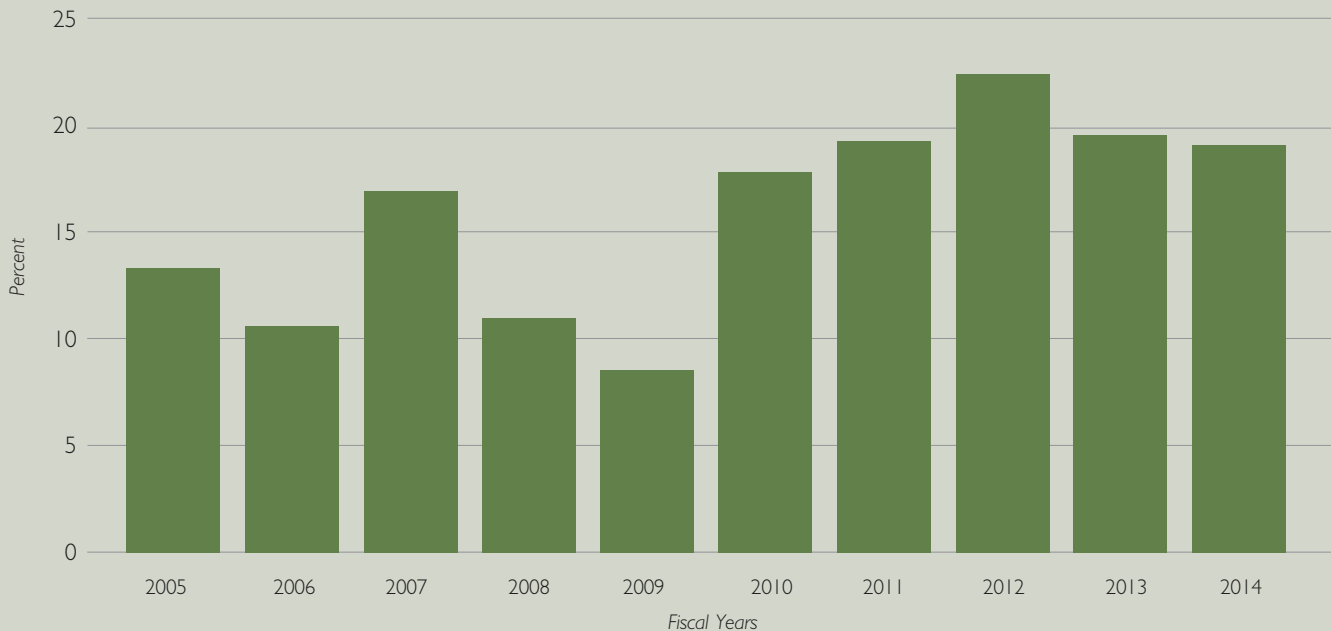
	\$13 million for sales tax economic uncertainty
+	\$7.5 million for economic uncertainty in other revenues
+	\$6.25 million for pension payment uncertainty
=	\$26.75 million (or about 12.5%) of general fund revenues*

Emergency Reserve

	\$16.85 million for critical infrastructure needs (\$5.25 million for critical bridge failure and \$11.6 million for critical storm sewer replacement)
+	\$5-\$7 million for extreme events
+	\$2-\$4 million for expenditures spikes from lawsuits
=	\$27.85 million (or about 12.5%) of general fund revenues*

*Based on Colorado Springs’ 2012 budget

Exhibit 2: General Fund Reserve as a Percentage of General Fund Expenditures (2005-2014)



*Estimated figures. Source: City of Colorado Springs, CO

The reserves quickly proved to be a prudent choice. After GFOA conducted its analysis, the city experienced two wildfires, one of which created flooding issues and damaged the storm water infrastructure. With a reserve fund at over 20 percent, the city was able to tap into reserve funds to help pay for infrastructure replacement — a success that redoubled the city’s commitment to maintaining its reserves. In 2013, Colorado Springs maintained 19.6 percent of general fund expenditures, and estimates for 2014 place that figure around 18.0 percent. Whenever the reserve falls below 25 percent, the city works toward replenishing the fund as quickly as possible.

OTHER RISK-MANAGEMENT METHODS

While the framework for GFOA’s analysis focused on using reserves to manage risk, it also encouraged the city to think about other risk-management methods. GFOA identified strategies such as enhanced sales tax monitoring and development of an infrastructure maintenance/replacement schedule, as well as policies on user fee cost recovery, volatile revenue, short-term borrowing, and grants as mechanisms to help support the city’s overall general fund reserve policy.

Colorado Springs has implemented some of these secondary risk-management strategies. The clearest example is the city’s approach to capital assets. Prior to the analysis, the most recent review of its capital improvement plan was conducted in 2007-2008. After the analysis, Colorado Springs took a more comprehensive and forward-looking approach. The city reviewed its infrastructure needs and what could be funded. It involved stakeholders and the public to prioritize the city’s needs, unconstrained by funding availability. The result of this process was the release of Colorado Springs’ five-year funded prioritized capital improvement plan in 2013. The plan includes anticipated needs over a five-year period and a ten-year period.

As part of the city’s recent capital improvement planning process, Colorado Springs also adopted strategies to help alleviate the need to retain risk. For example, from the financing perspective, the city is developing funding strategies to address the backlog of capital needs. It is also considering ways to reduce long-term maintenance and operating cost through low-impact, low-energy approaches to renovations and infrastructure development.

GFOA conducted a review of the risk factors that generally influence the amount of reserves a municipal government should hold.

CONCLUSIONS

According to the city's chief financial officer, the reserves are higher than they would have been if it had not been for the risk-based analysis. Further, the city now thinks about risk in a more holistic way. Conversations are ongoing because risk-based analyses are not meant to be static. Circumstances change. One example is how new legislation can impact the city's budget; policy changes may necessitate an update.

Vulnerabilities change over time. Still, risk is uncertain only in its particulars; eventually some difficulty will be encountered, and reserve funds will need to be drawn upon. Maintaining ample reserves will help make sure your government can focus on coping with the crisis, rather than scrambling to find funds. ■

Notes

1. "Appropriate Level of Unrestricted Fund Balance in the General Fund," a GFOA best practice.
2. "Unrestricted" is an accounting term that includes fund balances that do not have constraints placed on their use by an outside entity (e.g., a bond covenant might restrict the use of some portion of fund balance to debt service) and that are spendable (e.g., do not represent inventory or other non-liquid assets). "Unrestricted" funds may still have constraints placed upon their use, but these constraints would be created by the municipal government itself.
3. The risk factors and basic review method were developed and published in Shayne C. Kavanagh's *Financial Policies* (Chicago: Government Finance Officers Association, 2012).
4. Definition of risk taken from Douglas W. Hubbard, *The Failure of Risk Management: Why It's Broken and How to Fix It* (Hoboken, New Jersey: John Wiley and Sons, Inc., 2009).
5. The city's primary concern was the volatility of sales tax income, and its most important vulnerability in this area would be an economic downturn. The two major asset classes deemed to have the greatest associated risk were bridges and storm sewers, and the city is subject to extreme events that pose significant threat to life and property, particularly wildfires and floods.
6. Prior to 2011 the City reported on its "unreserved fund balance." In 2009 the Governmental Accounting Standards Board (GASB) issued *GASB Statement No. 54: Fund Balance Reporting and Governmental Fund Type Definitions* to amend fund balance reporting from the availability of fund resources for budgeting purposes to a clearer classification of funds "based primarily on the extent to which a government is bound to observe constraints imposed upon the use of the resources reported in governmental funds."

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For more information about the initial study, see *A Risk-Based Analysis of General Fund Reserve Requirements*, GFOA, May 2013, at gfoa.org/research-reports.

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