Building a Risk-Based Reserves Policy

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What Are Reserves For?

Four ways to think about reserves

1. **Savings** made up of all the surpluses and deficits have accumulated over the years

2. What we are **worth**– everything we own (assets) less everything we owe (liabilities)

3. In a for-profit company they would be the **shareholders'** funds

4. The amounts **saved** in previous years to cover uncertainty and risk and future plans

Manage Fluctuations

- Reserves allow us to manage fluctuations in the financial cycle:-

  - Fundraising is skewed across the year

  - Large donations are highly unpredictable

  - Grant payments can vary

Make future plans

- Reserves allow us to plan into the future:

    - We can **designate** surpluses to be spent on special projects or activities

    - We can **invest** reserves so that we can get investment income

    - We can take more risks in our future plans as we have a **cushion** if things go wrong

Manage and Embrace Risks

- Reserves allow us to manage risks:

  - We can deal with **crises** as they arise

  - We can use reserves to increase our **risk appetite**

  - We use reserves to cover **existing risks**

    - This is what a Risk-based Reserves policy does explicitly

Risk-based Reserves Approach

How to use reserves to manage liquidity

- We need reserves to manage Risks and **liquidity**
  - We need enough money in the bank at the beginning of the **year** to see us through to the end of the year
  - We need enough money in the bank at the beginning of the **month** to see us through to the end of the month
  - We need to ensure that we can cover planned deficits and other **cash demands** such as grants, trade creditors
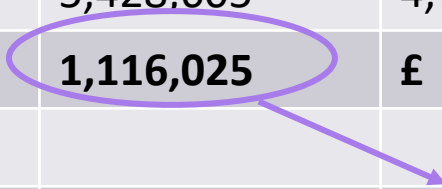
How to use reserves to manage liquidity

- We need to put aside some reserves to manage **liquidity**

- If your **cash flow forecasts** are good enough use them, otherwise take a **simple** approach:

  - Look at the **biggest gap** between highest and lowest bank balance over each of the last three years

  - Add any **planned deficit**

Liquidity Requirement

Bank Balance £s	2018/19	2019/20	2020/21
Highest	4,984,670	6,544,630	5,340,835
Lowest	4,529,787	5,428,605	4,778,901
Gap	**454,883**	**1,116,025**	**£ 561,934**
Planned Deficit			£ 956,000
Liquidity Requirement			**£2,072,025**

How to use reserves to manage risks

- Update the **risk register** every quarter

- Estimate a **cost** for each risk should the risk **materialise**

- The cost consists of:

    - The **immediate losses** from the risk materialising

    - The **cost of adjustment** if the risk has a long-term impact

- Looking specifically at the impact on **free/unrestricted** reserves.

- NB Some risks covered from **restricted** funds

How to use reserves to manage risks

- We cannot reserve for all the **long-term impact** of risks materialising

- Our free reserves give us the capacity to absorb losses and **adjust** to a new affordable structure

- When a risk **materialises** it may take some time to identify it, and to understand its impact.

- We will then need **time** to adjust to the new level of income. And incur costs in doing so.

- SO We need free reserves to cover for **immediate** losses AND to cover the cost of **adjustment**

Weighting Our Risks

We weight our risks

- As not all risks will happen at once we look at the **likelihoods** of the risks arising in the year ahead

- We then **weight** the risk to reflect the likelihood. So if a risk has a 25% likelihood of occurring then we multiply the cost by that amount

Risk Likelihood

- We look at the **inherent** likelihood – if we take no action

- We look at the **residual** likelihood – if we take the mitigating action

- By multiplying the cost of the risk by the inherent likelihood and the residual likelihood we calculate a **price** for the risk

- At Stroke we use the **average** of the inherent and residual risks, you could use the residual risk.

Pricing Our Risks

We price our risks

- The cost of the risk is £1,000,000

- The inherent likelihood is 50%

  - So the inherent price is £500,000

- The residual likelihood is 10%

  - So the residual price is £100,000

- We price the risk at the average of the two

  - So the price of this risk in **£300,000**

- This is the amount that we reserve for that risk

Calculating Our Risk Reserve Requirement

- Once we have the price of every risk we **add them up**

- We them **round** to the nearest £500k

  - This is so that we only worry about **major** fluctuations

  - Also recognise that these are **estimates**

  - Currently totals **£7.0m**

- And we also add the **liquidity** requirement – currently £2.0m

- Risk-Reserves Calculation is **£9.0m**

Using Our Reserves

Steering in the Right Direction

- The Three Year Financial Plan sets our overall direction:

£000s	2021/22	2022/23	2023/24
Free Reserves	*10,800*	*12,056*	*14,633*
Reserve Requirement	9,000	9,000	9,000
Excess reserves available	1,800	3,056	5,633

- In this case we can see that our free reserves are expected to be at the lowest **£1,800k in excess** of our requirement.

- If reserves are deficient we would have to generate surpluses over the three years to meet our requirement.

Steering in the Right Direction

- If reserves are in surplus, trustees can agree various courses of action:

  - Increase expenditure

  - Designate Funds

  - Keep the reserves as they are to allow for more investment income

  - Increase the risk on the investment portfolio in order to improve the returns

Advantages and Disadvantages

Disadvantages of the Model

- But…

- There is a lot of estimation involved:

  - Cost

  - Likelihood

- You might find that you are back to three to six months anyway

- Difficult to estimate unknown risks

- Depends on quality and scrutiny of Risk Register and financial plans

Advantages of the Model

- We have a more rational basis for calculating reserve requirements

- We explicitly link the risk register to three year plans

- We have a better idea of how much reserves we need and can rationalise these

- We are explicitly aware of the risks we cannot cover should our reserves be deficient

- If a risk materialises we have the resources to protect the organisation and to rebuild if necessary

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