

The Last Line of
Financial Defense? **Internal Loans in
Emergency Situations**

By Shayne Kavanagh
and Elizabeth Fu

General fund reserves are one of local governments' primary resources for responding to unexpected financial losses, such as those brought about by natural disasters or man-made extreme events. However, it is neither practical nor desirable for a government to accumulate enough reserves to respond to every possible contingency it might face — that would simply not be affordable for most communities. Therefore, governments should consider other having financial risk management tools at their disposal, beyond reserves (e.g., insurance). One such instrument is internal borrowing.

Many, or perhaps most, local governments divide their financial resources into various funds. Fund accounting has its advantages, including a better ability to isolate the assets needed to achieve a particular public purpose. But this isolation also works against optimal risk management. Just as a larger insurance pool will usually be better off than a smaller pool, a government will be better able to respond to risk if it can bring all of its resources to bear. A strong internal borrowing policy can deal with risk by providing many of the benefits of pooling financial resources while avoiding the problems of comingling monies that fund accounting is intended to solve.

Internal borrowing should be considered if a government finds itself confronted with an emergency that exhausts its reserves. The government will need to access money from somewhere, but there may be better options than internal loans in this kind of extreme circumstance.

Ideally, the Federal Emergency Management Agency (FEMA) or state resources would fill the gap. However, the number of disasters has been increasing (see Exhibit 1) much faster than the rate of population growth. Research also shows a trend of significantly increasing aggregate financial losses from disasters.¹ As a result, one might question whether FEMA or state governments will have the financial wherewithal to keep pace. In fact, many local government finance officers have already experienced long delays between when a disaster occurs and when financial support from FEMA arrives.

If FEMA assistance may not be as reliable as it once was, perhaps private markets could provide a source of capital.

Unfortunately, accessing private capital in the aftermath of a disaster presents problems:

- External lenders may be wary of a government's ability to repay, especially if the disaster impaired the tax base.
- The borrowing would take place under harrowing circumstances, compromising the government's ability to negotiate optimal terms.
- Many forms of external borrowing require satisfying extensive legal requirements, but time is usually of the essence after a disaster.
- The government would probably incur extraordinarily high interest costs, given the conditions under which the borrowing would likely take place.

Given these limitations, internal borrowing may be the best tool for a bad situation. This article outlines an approach to internal borrowing that could guide a government in using this tool responsibly in tough circumstances. These guidelines could be used to develop a policy that "prepositions" a government's approach to internal borrowing, so it is ready when the time comes.

INTERNAL BORROWING AND RISK MANAGEMENT

Decision makers need to understand the role of internal borrowing in risk management. If reserves are a primary tool for managing risk, then internal borrowing is the backup plan. If reserves prove insufficient to deal with an extraordinary emergency situation,

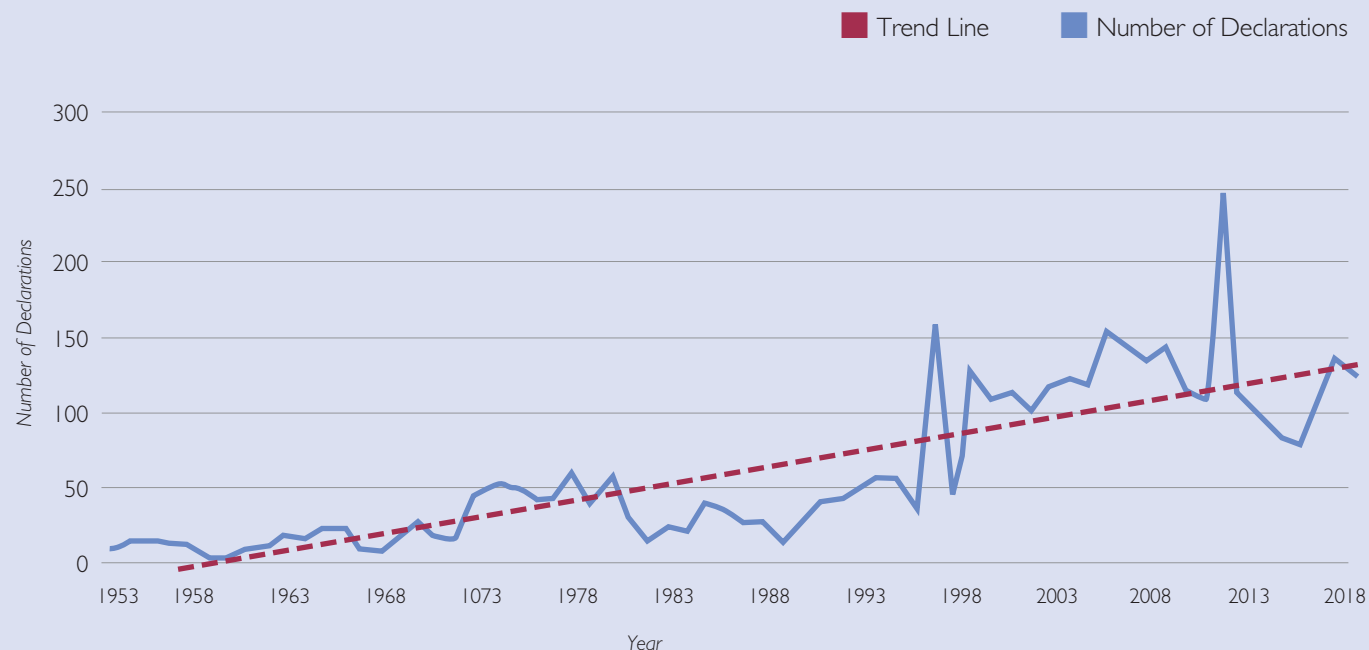
internal borrowing may become necessary.

Like a good reserve policy prohibits the use of reserves to pay for ongoing expenditures, a policy on internal borrowing might clarify that internal borrowing is not a tool for addressing long-term cash flow problems. For instance, if a natural disaster destroys a major source of sales tax revenue, then an internal loan should not be used to prop up the services that had relied on those sales taxes. Internal borrowing could have a role in rebuilding, but the budgeting and financial planning process should be used to find an affordable service level for the community over the long term.

If internal borrowing is appropriate, a local government should clarify who is authorized to do so, and in what

Fund accounting has its advantages, including a better ability to isolate the assets needed to achieve a particular public purpose. But this isolation also works against optimal risk management.

Exhibit I: Number of U.S. Presidentially Declared Disasters



amounts. For example, an appointed CFO might be authorized to make internal loans up to a certain dollar amount. The aftermath of a disaster is a stressful time, so a government should plan for the constraints before a disaster occurs. A good place to start is the terms of the loan.

TERMS OF THE LOAN

Internal loans are usually most appropriate as a short-term mechanism to bridge a financing gap. Therefore, a policy on internal loans might limit loans to short-term use. “Short term” could be defined as three to six months, or even up to a year. For example, if a critical piece of infrastructure is heavily damaged or destroyed by a natural disaster and the local government wants to begin the process of rebuilding as soon as possible, an internal loan could be used to get the project underway, until the government can arrange more traditional long-term financing. Federal treasury regulations allow local governments to repay this internal loan with the proceeds from the issuance of long-term debt, so long as the project costs

were incurred 60 days before the local government issued tax exempt debt and the costs covered by the internal loan were eligible expenses. A “reimbursement resolution” can be passed by the governing board as well. This adds more formality to reimbursing the internal loan with long-term debt proceeds. A reimbursement resolution could even to extend the time period for coverage beyond 60 days. This would allow a local government to start rebuilding right after a disaster, using an internal loan, and then repaying the loan with proceeds for long-term debt.

This is not to say a longer-term internal loan is never acceptable. There may be a good reason to make a longer-term loan. For example, perhaps one fund needs to buy an asset that is

too expensive to fit in the operating budget, but not expensive enough to justify the extra costs of securing external financing. In this case, it could be better for another fund to loan the money. For a longer-term internal loan, the terms of repayment become particularly important to make sure the loan is administered responsibly.

Internal borrowing should be considered if a government finds itself confronted with an emergency that exhausts its reserves.

A good place to start when setting the terms for any internal loan is your local government's existing investment policy and strategy for idle cash. An internal loan can be looked at as an investment for the fund making the loan, so it should be treated as such. The interest rate should be comparable to what the fund would otherwise receive for different types of investments it would otherwise make with its idle cash, and the loan should be compatible with the lender fund's liquidity strategy. For example, investment policies sometimes define a maximum duration for investment vehicles, and an internal loan should respect these limits as well.

Internal loans are usually most appropriate as a short-term mechanism to bridge a financing gap. Therefore, a policy on internal loans might limit loans to short-term use.

That said, a case could be made for making an internal loan on more favorable terms than the government would expect from an outside investment, especially in an emergency situation. A government should start the conversation by considering the rate of return for an investment with similar duration and risk characteristics to compensate the lending fund for foregone investment earnings. The government can then decide where more favorable terms might be appropriate.

CANDIDATES FOR MAKING THE LOAN

Some funds are better able to make loans than others. Of course, a fund must have the resources available to make a loan — but beyond this basic qualification, other factors might influence the viability of a fund to be a lender for an internal loan.

- **Need for Liquidity.** Funds that need rapid access to their available cash may not be good lenders; funds with a longer investment horizon on their use of idle resources may be better. For example, internal service funds often accumulate resources to fund non-current liabilities. Funding non-current liabilities is a good practice to ensure that a government is paying the true cost of doing business and not shifting costs to future generations. However, the accumulated monies are often not needed right away and could therefore be used for an internal loan.
- **Effect of Restrictions on the Use of Funds.** Monies are often placed in a separate fund because of restriction on their use. Funds with inflexible restrictions on their resources (e.g., restrictions placed by an outside entity) may not be good candidates to be a lender. An exception to this guideline might be if the intended use of the loan is consistent with the nature of the restrictions on the funds in question. If there are no restrictions, or the restrictions are self-imposed by the government, then those funds may be better candidates.
- **Ability to Survive a “Default.”** Given that we are discussing internal loans in the context of extreme circumstances, we must consider the possibility that the borrowing fund may not be able to pay back the loan.

Borrowing from FEMA: The Community Disaster Loan Program²

A borrowing strategy that local government can explore in the event of a presidentially declared disaster is FEMA's Community Disaster Loan program. The program offers affected local governments direct loans to keep providing essential services or to expand essential services to meet disaster-related needs. To be eligible, a local government must demonstrate that it has sustained a loss of more than 5 percent of tax and other revenues for the current or subsequent year as a result of a presidentially declared disaster.³

Loans are available to local governments from the end of the FEMA incident period through the end of the following fiscal year. The loan amount is capped by one of the following: 1) cumulative estimated revenue loss for the fiscal year of the disaster and subsequent three years; 2) 25 percent of the local government's approved operating budget for the fiscal year in which the disaster occurred or the subsequent fiscal year; or 3) \$5 million.

The loan term is five years, which can be extended to 10 years. The interest rate on the loan is determined by the Secretary of the Treasury.

For example, perhaps FEMA reimbursement is taking even longer than expected, or the tax base does not recover. If a default would endanger a fund's ability to provide services critical to the health and safety of community, then that fund may not be the best choice for a lender.

- **Political Viability.** Some funds may meet the technical criteria described above for making an internal loan, but a loan wouldn't feel right to the public. Self-supporting enterprise funds might fall into this category. These funds are intended to provide a self-contained, business-like service to the public, so they might not approve if the fund were to make internal loans to other areas of government. For example, if an enterprise has enough idle cash to make loans, does that mean it has been charging its customers too much?

CONCLUSIONS

Reserves are one of a government's primary tools for dealing with unexpected financial effects caused by emergency situations. It is possible, though, that a reserve could prove

Some funds are better able to make loans than others. Of course, a fund must have the resources available to make a loan — but beyond this basic qualification, other factors might influence the viability of a fund to be a lender for an internal loan.

insufficient to deal with an extreme situation, in which case a government may need to consider an internal loan to enable a timely and decisive response to the situation — in a safe and responsible manner. ■

Notes

1. Information and exhibit on trends in disasters are from: Vera Brusentsev and Wayne Vroman. "Disasters in the United States: Frequency, Costs, and Compensation, W.E. Upjohn Institute for Employment Research, 2017.
2. Refer to the Federal Emergency Management Agency for additional and updated information on the Community Disaster Loan Program. ([fema.gov](https://www.fema.gov)).
3. "What is the Community Disaster Loan (CDL) Program?" U.S. Federal Emergency Management Agency, February 5, 2019.

SHAYNE KAVANAGH is GFOA's senior research manager. He can be contacted at skavanagh@gfoa.org. ELIZABETH FU is a senior manager at GFOA. The authors would like to acknowledge the following GFOA members for their valuable assistance: Jay M. Goldstone, policy advisor, GFOA Debt Policy Committee; Cory Kampf, chief finance office, Finance and Central Services Division manager, Anoka County, Minnesota; Dan Matusiewicz, finance director and treasurer, City of Newport Beach, California; and Kenton Tsoodle, assistant city manager, City of Oklahoma City, Oklahoma.

