GENERAL FUND
RESERVE POLICY REPORT

January 2022

William C. Statler

Fiscal Policy ■ Financial Planning ■ Analysis ■ Training ■ Organizational Review

General Fund Reserve Policy Report

TABLE OF CONTENTS

124 Cerro Romauldo Avenue
San Luis Obispo, CA 93405
805.544.5838 ■ Cell: 805.459.6326
bstatler@pacbell.net
www.bstatler.com

William C. Statler

Fiscal Policy ■ Financial Planning ■ Analysis ■ Training ■ Organizational Review

City of Carpinteria
GENERAL FUND RESERVE POLICY REPORT

The purpose of this report is to review the City's current reserve policy for "Financial and Economic Uncertainty" and make recommendations for change as appropriate. Provided in Appendix A is the recommended General Fund reserve policy for this purpose, which covers six key areas:

- Sets the minimum reserve target (retains the current policy of 40% of expenses, with added guidance on the "base" this applies to).
- Identifies when it is appropriate to use reserves below the target amount.
- Provides a strategy for restoring the reserve if it falls below the target minimum.
- Presents guidelines for accounting and financial reporting of the reserve.
- Discusses other areas where the Council may decide to set reserve amounts.
- Compares actual versus target.

As noted above, the current policy is 40% of expenses. Based largely on the structured approach developed by the Government Finance Officers Association of the United States and Canada (GFOA) in assessing risk factors, the proposed policy retains this target, but clarifies the basis as 40% of operating, debt service and subsidy transfers.

PROPOSED POLICY OVERVIEW

Minimum Reserve Target

The recommended policy retains the target minimum unrestricted General Fund balance for "Financial and Economic Uncertainty" at 40% of operating, debt service and subsidy transfers. This is largely based on the structured assessment methodology for setting reserve levels developed by the GFOA in considering a city's exposure to the following eight fiscal risk factors, which are discussed in greater detail later in this report:

- Vulnerability to extreme events and public safety concerns
- Revenue source stability
- Expenditure volatility
- Leverage, such as unfunded pensions and asset maintenance
- Liquidity (cash flow)

- Dependence of other funds on the General Fund
- Growth: revenue and expenditure imbalance
- Unfunded high priority capital projects

Depending on the results of this assessment, the GFOA methodology provides recommended targets ranging from a minimum of 16.6% of expenditures (60 days cash flow) to circumstances where more than 35% might be warranted. Based on the City's circumstances, the GFOA's structured methodology recommends a target in excess of 35%. Accordingly, in light of the recent pandemic as well as past natural disasters, economic downturns and State takeaways, this report recommends retaining the 40% target with a clarified base and scope (including cash flow and contingencies) as follows.

> *The City will strive to maintain a minimum General Fund unrestricted balance (less encumbrances and reappropriation carryovers) of at least 40% of operating and debt service expenditures plus subsidy transfers to other funds for fiscal stability, cash flow and contingencies such as economic downturns, catastrophic events and unforeseen operating or capital needs. This target is based on financial management best practices and industry standards, including the risk assessment methodology for setting reserve levels developed by the Government Finance Officers Association of the United States and Canada.*

Policy Title Change. To better reflect its scope, this report recommends revising the reserve policy title to: *Reserve for Fiscal Stability, Cash Flow and Contingencies*.

Accounting for the Reserve

As noted in the sidebar, under generally accepted accounting policies, General Fund balances are classified into the following categories:

- Non-spendable
- Restricted
- Unrestricted
  - Committed
  - Assigned
  - Unassigned

While categorizing fund balance as non-spendable or restricted is generally clear between cities, the classification of the unrestricted fund balance between committed, assigned and unassigned amounts varies between cities based on their budget and fiscal policies.

General Fund Balance Classifications

Under generally accepted accounting principles set by the Government Accounting Standards Board (GASB) in Statement No. 54, General Fund balance is classified into five components:

- ***Non-Spendable.*** Amounts that are not in spendable form, such prepaid items or inventories.
- ***Restricted*****.** Amounts subject to *externally* enforceable restrictions imposed by outside third parties.
- ***Committed.*** Amounts whose use is constrained internally by the agency itself for specific purposes set by the governing body.
- ***Assigned.*** Amounts intended for specific purposes as determined by the governing body or others it has formally designated.
- ***Unassigned.*** Residual classification of spendable amounts available for other purposes.

The City currently categorizes its reserve for “financial and economic uncertainties” as “committed” in its audited financial statements. Other cities might consider this as “assigned” or “unassigned.” This purpose falls into a category that GASB calls “revenue stabilization, working capital needs, contingencies or emergencies;” and unless they are specifically classified as restricted or committed, GASB 54 states that they “… should be reported as unassigned in the general fund.”

As the City’s current reserve policy (adopted by Resolution 5786 in April 2018) calls for categorizing this reserve as “committed,” it meets the GASB criteria.

Setting the Base

The City’s current policy sets the “base” for the target as “General Fund expenses.” This report recommends being clear on the base, since “expenses” may be subject to changing interpretations. While the difference in result is likely to be insignificant, for clarity and transparency in calculating the reserve, a minor change in the base is recommended to “operating and debt service expenditures plus subsidy transfers.”

Current General Fund Reserve Policy

The current policy was adopted by the Council in April 2018 and addresses a wide range of issues related to General Fund reserves. In addition to setting the 40% target for fiscal stability, it also establishes two other reserves, each at $1 million:

- General Reserve
- Major Asset Replacement and Repair Reserve

As noted above, this report focuses solely on the 40% target: no other changes in the current policy are recommended.

If the Council concurs with the recommended changes, staff will return for Council approval a resolution amending the policy as set forth in Appendix A.

The City’s current policy is on the City’s web site at: https://carpinteriaca.gov/wp-content/uploads/2020/01/admin-services_Reserve-Policy-and-Resolution.pdf

Other Policy Provisions

- ***Purpose of reserves.*** Reserves exist for a reason. The proposed policy sets forth those purposes in accordance with the risk assessment methodology developed by the GFOA. (These are consistent with the City’s current policy.)

- ***Other Assignments/Commitments.*** The recommended policy makes it clear that the Council may make other assignments or commitments of General Fund balance in addition to the 40% reserve target, which the Council has done (such as the General and Major Asset Replacement and Repair Reserves). It also is clear that the target is after any assignments or commitments for appropriation carryovers and encumbrances.

- ***Guidance on when it is appropriate to go below the minimum target***. The proposed policy sets forth the circumstances where taking reserves below the target minimum balances would be appropriate in accordance with its purpose.

- ***Restoring the reserve if it falls below the target minimum***. The proposed policy provides for restoring reserves to policy levels within five years; and as revenues versus expenditures begin moving in a positive direction, allocating at least 50% to restoring the reserve.

Including the Reserve Policy in the Budget Document

Having a clearly fiscal policies has its greatest value during the budget preparation, review and adoption process. For this reason, it makes sense to include key fiscal and budget policies in the Budget document. The City currently includes several key significant accounting policies in its budget document. This report recommends including the recommended reserve policy as well. In this case, the policy should be compared with the budgeted ending fund balance.

DISCUSSION

The Power of Fiscal Policies

As we know from experience over the past 25 years, with the recessions and recoveries of 1992-94, 2003-05, the Great Recession beginning in 2008 and the economic downturn resulting from Covid-19 protection measures: good times come and go. *But an organization's values shouldn't*. And that's what fiscal policies are all about: articulating your financial management values before they are placed under stress.

Stated simply, clearly articulated policies – and being guided by them – are the best way of ensuring long-term fiscal health. While the strength of the local economy and related General Fund revenues are important, no city is immune from economic downturns. In navigating tough fiscal times, effective financial management is the most critical factor for long-term fiscal success; and clearly articulated policies provide an essential framework and foundation for effective decision-making.

Fiscal policies are important in both good times and bad. The roots of fiscal adversity for most governments take hold in the good times, by making commitments that are not sustainable. They rarely surface in the "bad" times, when most agencies act on the "First Rule of Holes" (when you find yourself in one, stop digging).

They are both preventative and curative:

- Clearly articulated policies – and following them – help prevent problems from arising in the good times.

- And provide more effective responses when the inevitable bad times occur.

They are most powerful when put in place before the need for them arrives, recognizing that not all financial decision-making situations can be reasonably anticipated.

Policies should be set based on where the agency wants to be, which may not be where it is today. However, setting the course for where it wants to be, significantly enhances its ability to get there. Accordingly, each policy should include a brief "compliance status." And if it is not there yet, the policy should provide the agency's plan for getting there.

Policies Versus Plans. Planning is essential for success. However, plans change over time as actual results replace assumptions. But fiscal policies are the "north star" guiding the preparation of plans. They help making tough decisions easier by articulating values before they are put under stress by adverse circumstances. An organization can reasonably do something else, but policies are a powerful starting point for asking: but for "this" unexpected circumstance, what would we have otherwise done?

Lastly, of all the fiscal policies that cities should set, minimum reserve targets are among the most important.

Prudent Reserves Reflect Ability to Manage Risk, Not Fiscal Strength Per Se

Reserves – whether large or small – do not per se reflect on a city's financial capacity or underlying fiscal strength. There are much better indicators than reserves 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.

Stated simply, reserves are a risk management tool: how much can things go differently than the organization otherwise thought they would before it must take corrective action? Reserves can also serve as a bridge to the future, providing time to develop and implement thoughtful solutions where projected gaps are systemic.

Typical risks that reserves help mitigate include economic uncertainties, such as downturns in the economy and external revenue hits (like State takeaways); responding to local disasters; contingencies for unforeseen operating or capital needs; strategic opportunities; and cash flow. And more recently, Covid-19 adds pandemics to the mix.

What's the Right Amount? This depends on each agency's unique fiscal circumstances and capacity for risk. In answering this question, there are two sources to consider:

- Rating agency recommendations.
- GFOA structured assessment approach.

❶ Rating Agency Recommendations

All three of the major rating agencies – Moodys, Standard and Poors and Fitch – identify reserve policies as one of their most important factors in assessing an agency's financial management and assigning bond ratings. While they do not provide recommended minimums, they are interested in their basis and the agency's track record in following them.

❷ GFOA Structured Assessment Methodology

The GFOA has developed a structured assessment methodology for setting reserve levels in considering an agency's exposure to the following eight fiscal risk factors:

1. ***Vulnerability to Extreme Events and Public Safety Concerns.*** Major extreme events the community could reasonably be subject to and the likelihood and potential magnitude of loss for each event.

2. ***Revenue Source Stability.*** Volatility of each major revenue source based on factors such as past experience and trends with that revenue, characteristics of the tax or rate payers, state or federal revenue takeaways and economic factors.

3. ***Expenditure Volatility.*** Spikes in expenditures, usually arising from special, non-recurring circumstances such as lawsuits; critical special projects without a funding source; or new state or federal spending requirements and unfunded mandates.

4. ***Leverage.*** Common examples include unfunded pensions and unfunded asset, as well as outstanding bonded indebtedness and compensated absences. Is the source of leverage very large? Does it have an off-setting funding source or asset?

5. ***Liquidity (Cash Flow).*** Intra-period cash imbalances, such as property taxes that are only received at two major points during the year (December and June).

6. ***Dependence of Other funds.*** Are there other funds that have a significant dependence on the General Fund?

7. ***Growth.*** Is significant growth a realistic possibility in the next three to five years? This includes assessing likely potential marginal costs associated with serving new growth compared with marginal revenues and resulting gaps.

8. ***Capital Projects.*** Are there high priority projects without a funding source, where reserves may be looked to as a funding source?

As discussed in greater detail in Appendix B, the methodology uses a scale of 5-1 in assessing how important reserves are in mitigating each risk:

5: Very important
4: Important
3: Neutral
2: Unimportant
1: Very unimportant

Since there are eight mitigation factors, total scores will range from 8 (the least risk) to 40 points (greatest risk). Along with these eight risk factors, the methodology also considers:

- City size (assumes larger cities have more mitigation strategies than smaller ones)
- Other reserve/contingency funds
- Borrowing capacity

Depending on the results of this assessment, the GFOA methodology provides recommended targets ranging from a minimum of 16.6% of expenditures (60 days cash flow) to circumstances where more than 35% might be warranted.

The following summarizes the GFOA's rating scale.

GFOA Reserve Rating Scale

Rating	Target Minimum General Fund Reserve
8 -16	Minimal risk to retain through reserves. Consider target equal to the GFOA minimum recommended reserve of 16.6% (two months cash flow) of revenues/expenditures.
17-24	Low to moderate level of risk to retain through reserves. Consider reserve target of 17% to 25%.
25-31	Moderate to high level of risk to retain through reserves. Consider reserve target of 26% to 35%.
32-40	High level of risk to retain through reserves. Consider reserve target greater than 35%.

As detailed in Appendix B, the City's rating under this methodology is 32, which indicates that the target minimum should be more than 35%.

Six of the assessment factors were largely responsible for this rating:

- Extreme events
- Liquidity/cash flow (30% needed to cover lowest point during the year)
- Unfunded capital projects
- Revenue stability
- Expenditure volatility
- Dependence of other funds on the General Fund

The other two factors (leverage and new development/growth) were not significant in this rating.

ALTERNATIVES

Setting the Minimum Target Reserve at Lower or Higher Amounts than 40%

Based on the results of the GFOA structured assessment methodology, the risks facing the City support a reserve in excess of 35% compared with the current target of 40%.

Mitigating Cash Flow with TRANS

A possible mitigation for cash flow needs (or responding in the short term to other risks) is the use of Tax and Revenue Anticipation Notes (TRANS).

TRANS are short-term borrowings by local government agencies who are not able to meet their cash flow needs during the year. They are typically issued early in the fiscal year and repaid before year-end.

At one time, many TRANS were issued as an investment strategy since the proceeds could be invested at higher yields than their tax-exempt interest rate. However, this favorable variance between interest costs and yields has not been the case since the Great Recession.

Stated simply, while incurring debt to meet cash flow needs is an option, it is preferable to avoid it if possible. Moreover, TRANS are not free: there are financing and interest costs in issuing them.

Appendix C provides a cash flow analysis for the General Fund, which shows the need for 30% to cover the lowest point in the fiscal year (May) before the receipt of the second installment of property tax revenues (the City's most important General Fund revenue source). However, there are four other months with significant cash flow shortages (October, November, March and April) ranging from 21% to 28%.

However, the Council is the ultimate “decider” in balancing risks and reserves. Stated simply, the City’s fiscal resources do not exist to amass large fund balances but rather, to deliver important services that help make Carpinteria a good place to live, work and play. On the other hand, prudent reserves are essential in helping assure stability in the delivery of services.

Accordingly, the Council could reasonably set reserves at levels that are lower or higher than retaining the current target.

Lower Target than 40%. Given other reserves established by the City, it might be reasonable to lower the minimum reserve policy to 35%. However, the current pandemic combined with past challenges with floods, economic downturns, unexpected costs and State takeaways, argue for setting the target above 35%, which is reinforced by the GFOA methodology.

Higher Target than 40%. Based on surveys provided on the California Society of Municipal Finance Officers’ web site as well as other studies, there are many cities in California that have minimum target reserve policies of 50% or higher, including:

- La Canada Flintridge: 125%
- Millbrae: 89%
- Cupertino: 82%
- Stanton: 75%
- La Palma: 60%
- Burlingame: 65%
- Gilroy: 51%
- Mountain View: 51%
- Brisbane: 50%
- Camarillo: 50%
- Laguna Nigel: 50%
- Lomita: 50%
- Malibu: 50%
- Mission Viejo: 50%
- Moraga: 50%
- Rancho Palos Verdes: 50%
- San Ramon: 50%

Accordingly, given the many uncertainties ahead, and especially in light of the pandemic (which after a number of ups and downs is far from over), a target higher than 40% would also be reasonable.

Segregating the Reserve into Separate Components

Like the current policy, the recommended policy sets a unified reserve target of 40% to meet the aggregate of the risks it is intended to meet. Some cities segregate this reserve into the separate factors that they are intended to mitigate. However, since not all factors are likely to come into play at the same time, a unified target makes sense: “pooling” serves to lower the overall reserve amount that might otherwise be needed to meet each of the risk factors individually. Moreover, budgeting and accounting for the reserve is simpler and more straightforward, as is communicating its purpose to the community and organization.

Note: While cash flow also plays an important role in setting the minimum reserve target, if the 40% target and other reserves are maintained, they should also cover cash flow needs. However, this is another reason for setting a unified target rather than segregating it.

Setting the Base

As noted above, the City's current policy sets the "base" for the target as "General Fund expenses."

However, other "base" options used by California cities include:

- Total expenditures and uses (operating, debt service and capital expenditures, and transfers out).
- Operating expenditures only.
- "Normal" annual expenditures (thus including operating costs, less one-time costs such as special studies and plans; debt service; some "normal" capital costs; and transfers out, less any one-time purposes).
- Other combinations of expenditures and uses.
- Revenues rather than expenditures.

Where the base is narrower (such as just operating expenditures), the same target percentage will result in a smaller reserve; conversely, where the base is broader (including capital, debt service and/or transfers), the same target percentage will result in a larger reserve.

In the case of the City, it makes sense to include operating and debt service costs as well as subsidy transfers as the base.

- ***Operating costs*** are included in the base in virtually all cities, which makes sense: this is the "core" cost base of city services that is most at risk; and while sensitive to economic changes and community needs (up or down), it is relatively stable from year to year. While it is possible that there may be significant one-time costs included in the operating budget, adjusting for this is not recommended: the difference is likely to be immaterial and, more importantly, transparency in calculating the reserve target will be enhanced by "keeping it simple."

- ***Debt service costs*** are also ongoing contractual obligations (until the principal balance is paid-off); accordingly, it makes sense to include this in the target base as well. While the City does not currently have any General Fund debt service costs, this could change in the future. Accordingly, to be proactive in accounting for this possibility, it makes sense to include this as part of the base.

- ***Subsidy transfers*** are also ongoing commitments, and as such, should be included in the target base.

On the other hand, capital projects can vary from year-to-year, and the reserve should be relatively stable. Accordingly, capital outlay expenditures and transfers-out for CIP projects are excluded. And since they are internally determined, other transfers-out are also excluded.

CONCLUSION

Establishing a reserve policy – and being guided by it – is among the most important of the City's fiscal policies in mitigating financial risks. Based on the results of the GFOA structured assessment methodology, this report recommends that the minimum reserve target continue to be set at 40% (but on a slightly revised base of operating and debt service expenditures plus subsidy transfers).

William C. Statler

Fiscal Policy ■ *Financial Planning* ■ *Analysis* ■ *Training* ■ *Organizational Review*

APPENDIX

A. Proposed Amendment to General Fund Reserve Policy
B. General Fund Reserve Risk Factors: GFOA Structured Assessment Methodology
C. Cash Flow Analysis