City of Pacific Grove

General Fund Reserve Policy

January 17, 2018

William C. Statler

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

The Power of Policies

- Good times come and go.
- But your values shouldn’t.
  - And that’s what fiscal policies are all about.

Plans and Policies

- Plans are good.
  - General Plans (and Elements)
  - Facility Master Plans (Pavement, Parks, Bicycles, Water, Sewer)
  - Long-Term Forecasts
  - Multi-Year Budgets
    - Operating and CIP
- Policies are better.

Fiscal Health

- … is a lot like your personal health — it’s not what you live for . . . . but it’s hard to enjoy your life without it.
- And like personal health, fiscal health is rarely luck.

Fiscal Policies

- The best way to ensure your long-term fiscal health.
  - Local economy important
    - And no one is immune from economic downturns.
  - But not the most critical feature . . . financial management counts!
    - Just Think: Orange County
- Important in both good times and bad

When do fiscal challenges arise?

- Roots of fiscal adversity for most governments take hold in the good times, by making commitments that are not sustainable
- Rarely in the bad times, when most agencies act on the “First Rule of Holes”
  - When you find yourself in one, stop digging.

Both Preventative and Curative

- Clearly articulated policies help prevent problems from arising in the good times.
- And help respond to bad times when they do occur.

Take on momentum of their own

- What's the most frequent answer to the question: "Why do we do it this way?"
- Provide continuity as elected officials and staff change.
- Most powerful when it put in place before the need for them arrives.

An Example of the Power of Policies

Fund Balance Survey: 1996

City	Policy?	If Yes, Description	Actual
Arroyo Grande	No		1%
Atascadero	No		1%
Grover Beach	Yes	20% of operating	20%
Morro Bay	Yes	27.5% of operating	15%
Paso Robles	Yes	15% of operating	13%
Pismo Beach	No		-14%
San Luis Obispo	Yes	20% of operating	21%

Situation Ten Years Later

Based on Adopted 2006-07 Budget

City	Policy?	If Yes, Description	Actual
Arroyo Grande	Yes	20% of Operating	20%
Atascadero *	Yes	Narrative Assessment	44%
Grover Beach	Yes	20% of Operating	23%
Morro Bay	Yes	27.5% of Operating	14%
Paso Robles	Yes	15% of Operating	39%
Pismo Beach	Yes	15% of Operating	15%
San Luis Obispo	Yes	20% of Operating	21%

* *Actual Shown as Percent of Operating Budget*

Plans Versus Policies

- Plans change over time as actual results replace assumptions (like, as soon as the laser jet ink is dry).
- But policies:
  - Are your “north star” guiding preparation of plans.
  - Help making tough decisions easier by telling you what your values are before they are put placed under stress by adverse circumstances.
  - You might actually do something else, but they are a powerful starting point:
    - *But for “this,” I would do . . . what?*

High-Level Fiscal Policies

- Balanced Budget (and what this means)
- Multi-Year Budgets
- Staff vs Council Budget Authority
- Revenue Management
- User Fees
- Enterprise Funds:
  - Do they subsidize the General Fund?
  - Does the General Fund subsidize them?
- Financial Reporting
- Revenue Earmarking
- Investments
- Appropriations Limit
- <u>Minimum Fund Balance</u>
- CIP Management
- Capital Financing & Debt Management
- Human Resources
- Contracting-Out
- Productivity

Where to Start

- What credit rating agencies recommend
- What other agencies do: using benchmarks
- GFOA Best Practices

FitchRatings

Important Fiscal Management Policies

- Very Significant
  - Fund balance policy
  - Debt affordability policy
- Significant
  - Pay-as-you-go capital financing
  - Multi-year forecasting
  - Quarterly reporting
  - Quick debt retirement
- Influential
  - Contingency plans
  - Non-recurring revenue policy
  - Depreciation of fixed assets (GASB 34 implementation)
  - 5 Year CIP integrating operating cost impacts
  - GFOA financial reporting award
  - GFOA budgeting award

STANDARD & POOR'S
RATINGS SERVICES

Top Ten Financial Management Practices

- Established budget reserve
- Regular economic and revenue reviews
- Prioritized spending plans and established contingency plans
- Formal capital improvement plan
- Long-term planning
- Debt affordability model
- Pay-as-you-go financing
- Multi-year financial plan
- Effective management and information systems
- Well-defined and coordinated economic development plan

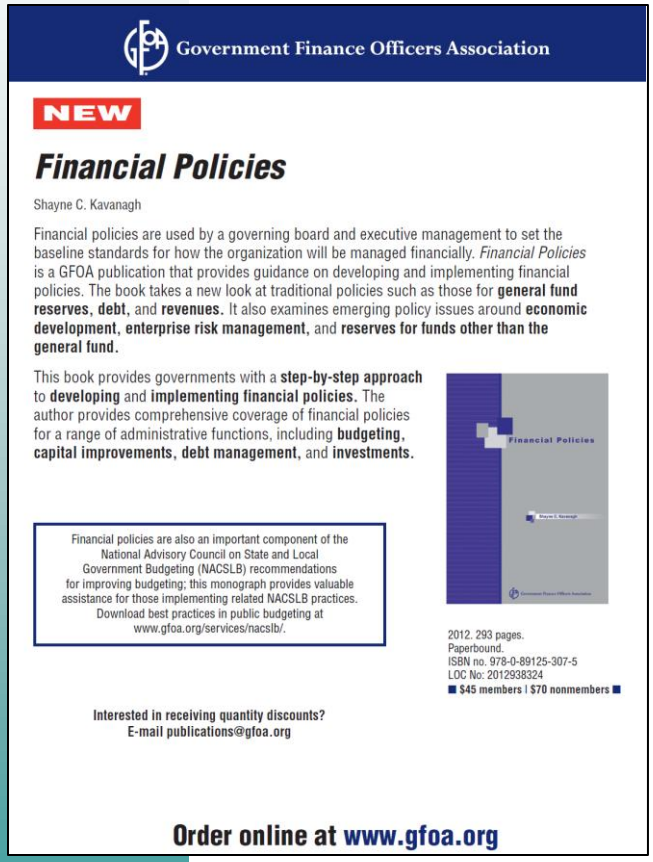
Benchmarking: Keys to Success

- Clear on “measures”
  - Meaningfully
  - Available
  - Credible
    - Audited financial statements
- Benchmark agencies
  - Form of government
  - Population size
  - Demographics
  - Geography and weather
  - Economy
  - Community characteristics: Central City? Suburb? Rural?
  - Revenue mix
  - Scope of services

Key Caveat

- Be informed by what others are doing but not driven by it.

GFOA Best Practices



Government Finance Officers Association

NEW

Financial Policies

Shayne C. Kavanagh

Financial policies are used by a governing board and executive management to set the baseline standards for how the organization will be managed financially. *Financial Policies* is a GFOA publication that provides guidance on developing and implementing financial policies. The book takes a new look at traditional policies such as those for **general fund reserves, debt,** and **revenues.** It also examines emerging policy issues around **economic development, enterprise risk management,** and **reserves for funds other than the general fund.**

This book provides governments with a **step-by-step approach** to **developing** and **implementing financial policies.** The author provides comprehensive coverage of financial policies for a range of administrative functions, including **budgeting, capital improvements, debt management,** and **investments.**

Financial policies are also an important component of the National Advisory Council on State and Local Government Budgeting (NACSLB) recommendations for improving budgeting; this monograph provides valuable assistance for those implementing related NACSLB practices. Download best practices in public budgeting at www.gfoa.org/services/nacslb/.

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GFOA Best Practices identify specific policies and pr
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recognized goal.

GFOA Advisories identify specific policies and proced
exposure to potential loss in connection with its finan
interpreted as GFOA sanctioning the underlying activit

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Reserve Policies

- Why reserves are important
- Reserve policy elements
- Evaluating policy options

Reserves are about managing risks

- 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.
    - Much better indicators than fund balance for this, most notably ability over time for ongoing revenues to adequately meet day-to-day service needs, capital improvement goals and debt service requirements.

The Short Story

- Reserves are a risk management tool
  - How much can things go differently than you thought they would before you have to take corrective action?
  - Bridge to the Future: Provide time to develop and implement thoughtful solutions.

Typical Risks

- Economic uncertainties
  - Local disasters
  - Downturns in the economy
  - External revenue hits (State takeaways)
- Contingencies for unforeseen operating or capital needs
- Strategic opportunities
- Cash flow

What’s the right amount?

- It depends …
  - Your unique fiscal circumstances.
  - Capacity for risk.

Reserve Policy Elements

1. Define what the reserve is.
2. Set minimum General Fund reserve target
   - Use GFOA's structured approach for assessing eight risk factors
   - Benchmark with comparable agencies
3. Identify when it's appropriate to use reserves below the target amount.
4. Set policy for restoring the reserve when it falls below the target minimum.
5. Compare actual versus target.

❶ Defining Reserves

- General Fund Balance (GASB 54)
  - Nonspendable
  - Restricted
  - Unrestricted
    - Committed
    - Assigned
    - Unassigned

Reserve Definition Concepts

- Operating Reserve
  - Economic uncertainties
  - Contingencies for unforeseen operating or capital needs
  - Strategic opportunities
  - Cash flow

Typically "Unassigned"

- Other Reserves
  - Insurance
  - Fleet replacement
  - Equipment/IT replacement
  - Facilities
  - Encumbrances/ carryovers
  - Unfunded pension and OPEC obligations

❷ Setting the Reserve Target

- Benchmark Analysis
- GFOA Structured Assessment

Benchmark Analysis

- Benchmark City Selection Criteria
  - Similar population: between 7,500 and 25,000 population (Pacific Grove: 15,498)
  - Coastal location
  - Tourism important component of local economy
  - Distinct sense of place
  - Similar scope of services
  - Reputation for being well-managed and using “best practices”

Selection Summary

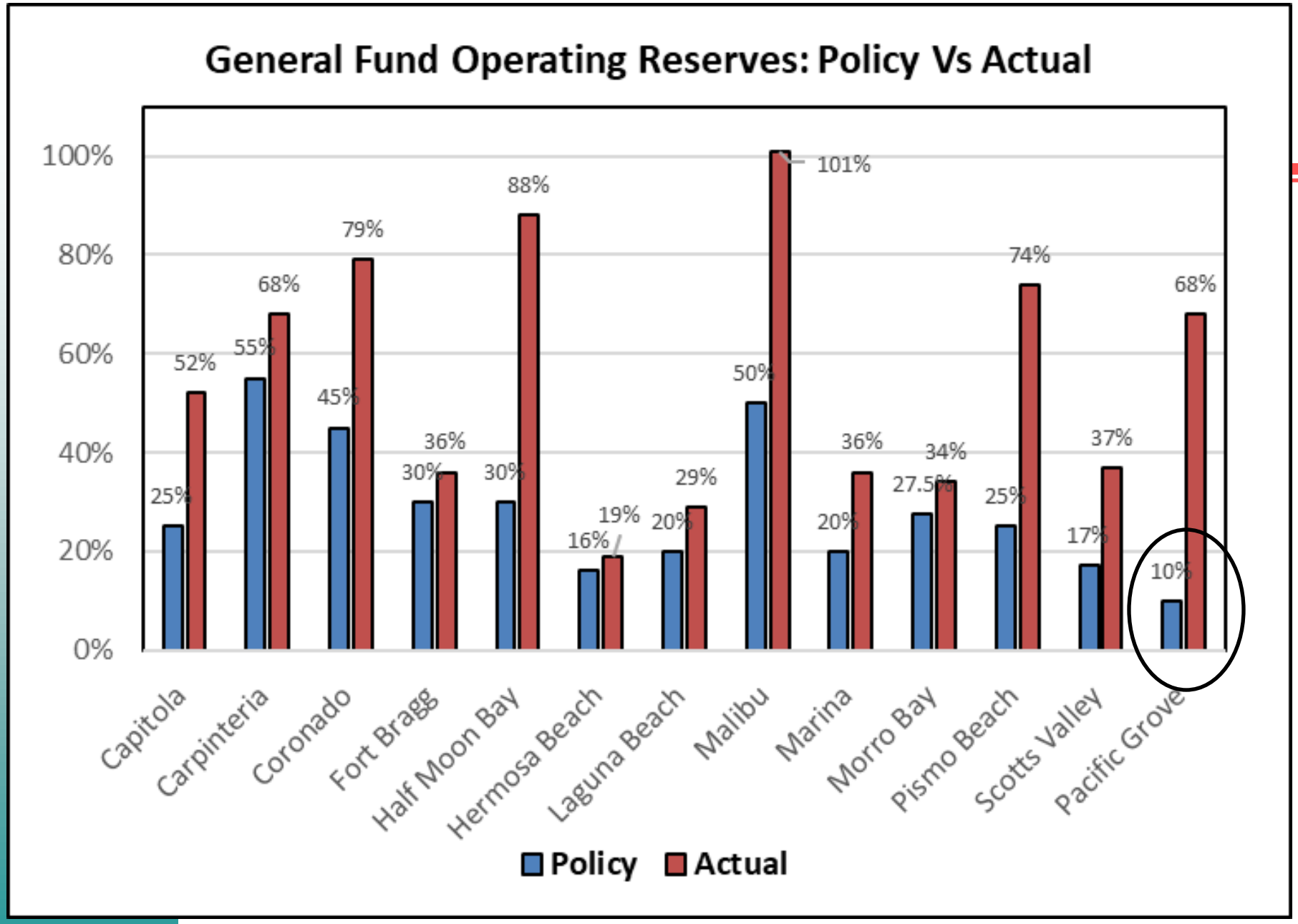
Cities in California	482
7,500 to 25,000	129
Coastal	36
TOT Ratio at Least 10%	18

Benchmark Cities

- Capitola (10,162)
- Carpinteria (13,943)
- Coronado (24,453)
- Fort Bragg (7,772)
- Half Moon Bay (12,591)
- Hermosa Beach (19,616)
- Laguna Beach (23,505)
- Malibu (12,742)
- Marina (21,528)
- Morro Bay (10,762)
- Pismo Beach (8,247)
- Scotts Valley (12,163)

Reserve Policy vs Actual

- “Operating” reserve policies range from 16% to 55% of expenditures or revenues (excluding “other reserves”)
  - All have “other reserves”
- All meet the policy minimum
  - Actual reserves range from 19% to 101%


General Fund Operating Reserves: Policy Vs Actual
100%
80%
60%
40%
20%
0%
25%
52%
55%
68%
45%
79%
30%
36%
30%
88%
16%
19%
20%
29%
50%
101%
20%
36%
27.5%
34%
25%
74%
17%
37%
10%
68%
Capitola
Carpinteria
Coronado
Fort Bragg
Half Moon Bay
Hermosa Beach
Laguna Beach
Malibu
Marina
Morro Bay
Pismo Beach
Scotts Valley
Pacific Grove
Policy
Actual

GFOA Structured Assessment

- Assesses risks based on eight factors
- Mitigation scale: 5-1
  - 5: Very important
  - 4: Important
  - 3: Neutral
  - 2: Unimportant
  - 1: Very unimportant

8 to 40 Points

- Vulnerability to extreme events and public safety concerns
- Revenue source stability/volatility
- Expenditure volatility
- Unfunded liabilities
- Liquidity (cash flow)
- Dependent funds
- Growth/new development
- Unfunded high priority capital projects

Other Factors

- City size
- Other reserve/contingency funds
- Borrowing capacity
- Benchmark results

GFOA Assessment

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%-25%.
25-31	Moderate to high level of risk to retain through reserves. Consider reserve target of 26 - 35%.
32 - 40	High level of risk to retain through reserves. Consider reserve target greater than 35%.

Pacific Grove Assessment "Score"

- Overall Score: 33
  - GFOA recommendation: greater than 35%
- Key Assessment Factors
  - Exposure to extreme events
  - Revenue stability
  - Expenditure volatility
  - Cash flow
    - 20% needed to cover low points in November and May
  - Unfunded liabilities
  - Unfunded CIP projects

❸ When do you use "the minimum?"

- Rainy day fund – so must be appropriate to use when it rains ***unexpectedly***
- When is that?
  - One-time use
    - Forecast shows short-term gap
    - Unexpected expenditure or revenue shortfall
  - Forecast shows structural gap
    - Strategic bridge to the future

When you shouldn't …

- For rainy days that can be reasonably expected
- Avoid use for *long-term* gap-closing strategies
  - Actual is invariably worse the forecast
  - Sooner you get to the bottom the sooner you can begin re-building
    - Five-year rebuilding plan or five-year "death by a thousand cuts" program?

❹ Restoration Policy

- When reserves fall below minimum targets, what's the strategy for restoration?
- Example:
  - Restore to policy level within 5 years.
  - As revenues improve, 50/50 split between services and reserve restoration.

❺ Policy Versus Actual

- Set policies based on where you want to be – which may not be where you are today.
  - Clearly stating where your agency wants to be (versus where it may be today) significantly enhances your ability to get there.
- Consider following each policy with a brief "compliance status"
  - In compliance: reserve policy versus actual (budget ending reserves)
  - In progress: what's the plan for getting there?

Last thoughts on the importance of reserves

Pacific Grove Recommendations

Target Minimum Fund Balance

- Reserves for Fiscal Stability, Cash Flow and Contingencies
  - The City will strive to maintain a minimum unassigned General Fund balance of at least 40% of operating and debt service expenditures for fiscal stability, cash flow and contingencies. This is based on the risk assessment methodology for setting reserve levels developed by the GFOA.

Reserve Restoration

- Whenever the General Fund unassigned fund balance falls below this target, the City will strive to restore reserves to this level within five years.
- As revenues versus expenditures improve, the City will allocate at least half to reserve restoration, with the balance available to fund outstanding liabilities, asset replacements, service levels restoration, new operating programs or capital improvement projects.

Use of Reserves

- Circumstances where taking reserves below policy levels would be appropriate include responding to the risks that reserves are intended to mitigate, such as:
  - Meeting cash flow needs during the fiscal year.
  - Closing projected short term revenue-expenditure gap.
  - Responding to unexpected expenditure requirements or revenue shortfalls.
  - Making investments in human resources, technology, liability reductions, economic development and revenue base improvements, productivity improvements and other strategies that will strengthen City revenues or reduce future costs.
  - Where a forecast shows an ongoing structural gap, in providing a strategic bridge to the future.

When reserve use should be avoided

- City should avoid using reserves to fund ongoing costs or projected systemic “gaps.”
- Stated simply, reserves can only be used once, so their use should be restricted to one-time (or short-term) uses.

Other Assignments

- The Council may also commit or assign specific General Fund balance levels above the reserve target for future purposes such as capital projects, unfunded liabilities, fleet and equipment replacements, insurance and other long-term goals that it determines to be in the best interests of the City.

Net of Commitments and Restrictions

- In addition to the 40% target, fund balance levels will be sufficient to meet funding requirements for:
  - Programs or projects approved in prior years which are carried forward into the new year.
  - Debt service reserve requirements.
  - Commitments for encumbrances.
  - Other restrictions, commitments or assignments required by contractual obligations, state law or generally accepted accounting principles.

Policy vs Actual

- Proposed Policy
  - 56.6% based on audited results for FYE June 30, 2017
  - 40.4% based on 2017-18 Budget

Options

- Set target reserve at lower or higher amounts
  - Minimum of 35% recommended.
  - Based on benchmark results and lack of other reserves, 50% could be supported.
- Show reserve as “Committed or Assigned”
  - GAAP indicates should be classified as “unassigned.”
- Segregate the reserve into separate components:
  - Cash Flow: 20%
  - Fiscal Stability: 10%
  - Contingencies: 10%
- Calculate reserve requirement on operating costs only

Questions?