GENERAL FUND RESERVE POLICY UPDATE

RECOMMENDATION

It is recommended that the City Council adopt a resolution to approve a revised City Council Policy No 700-4 “Reserve - General Fund” and change the title to “Reserve and Fund Balance Policy - General Fund”. It is further recommended that the City Manager be authorized to take appropriate and necessary action to carry out the purpose and intent of the resolution.

Summary

The City Council policy regarding General Fund reserve levels is out of date and should be updated to reflect best practices and the City’s circumstances after Bankruptcy. Pursuant to Section 1903 of the City Charter and Chapter 19.03 of the Stockton Municipal Code, the Council is required to adopt a reserve policy that is intended to prudently protect the fiscal solvency of the City. The current City Council policy "Reserve Policy - General Fund" (Attachment A) was adopted in 2006, and has not been updated since the City entered the severe fiscal crisis and completed the Bankruptcy process. During the Bankruptcy, Council adopted Annual Budgets with reserves that were consistent with the Court approved Plan of Adjustment. While appropriate at the time due to the severe fiscal crisis, it is now recommended that an updated Reserve and Fund Balance Policy - General Fund be adopted by resolution to guide development of the Fiscal Year (FY) 2016-17 Annual Budget. As measured by the need to file Bankruptcy, recommended industry benchmarks and Council practice during the Bankruptcy, the current reserve policy of 10 percent is inadequate. The recommended policy (Attachment B) would maintain a 17 percent operating reserve and establish additional reserves for known contingencies, unforeseen revenue changes, infrastructure failures, and catastrophic events. Additionally, the new reserve policy would establish an automatic process to deposit one-time revenue increases and expenditure savings into the reserves. These new policies are consistent with the Government Finance Officers’ Association (GFOA) best practice recommendations and Governmental Accounting and Standards Board (GASB) guidance.

DISCUSSION

Background

Pursuant to Section 1903 of the City Charter and Chapter 19.03 of the Stockton Municipal Code, the Council is required to adopt a reserve policy that is intended to prudently protect the fiscal solvency of the City. The current City Council policy "Reserve Policy - General Fund" (Attachment A) was adopted in 2006. The purpose of the current policy is to establish a minimum level of unreserved (“unassigned” in accounting terms) fund balance to be maintained in the General Fund. The unreserved fund balance was meant to address financial risk associated with natural and man-made disasters (Catastrophic Reserve), and economic uncertainties (Economic Contingency/Budget...
Uncertainty Reserve). The minimum level of each reserve allocation was to be five percent of the annual General Fund appropriations and transfers out for a total of 10 percent. As measured by the need to file Bankruptcy, recommended industry benchmarks and Council practice during the Bankruptcy, the current reserve policy of 10 percent is inadequate.

Additionally, the current policy was adopted in 2006 and has not been updated since. In 2009, the GASB issued guidance for Fund Balance Reporting and Governmental Fund Type Definitions in Statement No. 54. This Statement provides direction regarding fund balance reporting that is meant to provide better transparency and understanding. Specifically, GASB Statement No. 54 clarifies existing governmental fund type definitions, establishes a hierarchy based on fund constraints and distinguishes between restricted reserves and unreserved fund balance. The fund balance classification approach in Statement No. 54 requires governments to classify amounts consistently, and provide users the information necessary to understand the nature of the restrictions placed on the funds. The current City Council policy was developed prior to the GASB Statement No. 54 guidance, and should be updated to reflect the most recent accounting standards.

Beyond GASB compliance, a review of GFOA best practices, case studies and other cities provided further guidance regarding the establishment of appropriate reserve policies. Appropriate reserve levels should consider the City’s circumstances, operational needs, known contingencies, infrastructure conditions and potential catastrophes that could require investment of personnel and infrastructure. The current circumstances of Stockton are a direct result of the fiscal crisis and ensuing bankruptcy. Significant reductions were made to address the City’s fiscal realities, resulting in annual ongoing reductions of over $90 million and 300 positions. As a result, only essential core services remain and Council has heard repeated public comment regarding service deficits in public safety, libraries and community services for example. Additional reductions are not a realistic protection against economic uncertainties, infrastructure failures or catastrophes.

Furthermore, the salary and benefit reductions implemented during the bankruptcy have negatively affected the recruitment and retention of staff. Although hiring is at its fastest pace in years, particularly in law enforcement where it is at the fastest pace ever, staff from the City of Stockton are regularly recruited to other municipalities with better compensation packages. Because the City is a direct service provider to the residents of Stockton, the inability to recruit and retain staff at all levels has a direct effect on the level and quality of services provided. As the City is on the cusp of entering the next round of labor negotiations, it is prudent to set aside additional funds to address employee compensation in the current market conditions.

The City addressed known pension and Other Post-Employment Benefits during the Bankruptcy. The City remained current on its obligations to the California Public Employee Retirement System (CalPERS) throughout, and eliminated retiree health care benefits during the Bankruptcy. Discontinuing retiree health care eliminated a $540 million unfunded liability for the City. However, the CalPERS Board has begun conversations regarding the sustainability of the pension fund and is considering making changes in the future to lower investment risk and better ensure the funds ability to meet its obligations. The potential for a future decrease in the CalPERS discount rate (assumed rate of return) is a known risk that has emerged since Bankruptcy began.

During the Bankruptcy, the City negotiated a lease for City Hall operations to be relocated to 400 E. Main Street in downtown Stockton. Originally, the City planned to own this building but was unable to meet its payment obligations to maintain ownership during the fiscal crisis. An eight year lease, with
potential extensions of up to four years, was negotiated as part of the Court approved Plan of Adjustment. There are no plans for the future location of services maintained in City Hall beyond the current 8 year lease.

There are additional infrastructure considerations beyond the location of City Hall. The City currently has $720 million worth of buildings and improvements, machinery and equipment, governmental infrastructure and construction in progress. This amount does not include full cost of replacement valuation or the cost to maintain and upgrade physical assets owned or maintained by the City. However, the history of poor economic conditions and fiscal crisis diminished the amount of resources invested in the regular maintenance of these assets. The Annual Budget for FY 2015-16 included $1.1 million in Capital Improvement Projects and $500,000 in maintenance funding. An amount well below the amount needed to address the current deferred maintenance estimate of approximately $970 million. The Public Works Department (PWD) is completing an assessment of all City facilities to document current condition and validate repair and maintenance needs. Given the large amount of deferred maintenance, the City is carrying an elevated level of risk associated with the potential failure of City facilities and equipment. While budgeting for the full cost of the deferred maintenance is beyond the City’s means, it is appropriate to establish a specific reserve to address the cost of restoring services as a result of failure.

City facilities and equipment are also susceptible to potential catastrophes. Unlike the increased risk of failure due to the lack of maintenance, natural and man-made events represent additional risks. Potential earthquakes, floods or fires, such as the one recently experienced under the Wilson Way overpass, result in immediate costs for personnel and repairs to restore services. These unusual but potentially significant risks are in addition to the assumed risk from lack of investment in maintenance. Regardless of the potential for reimbursement from federal, state or insurance sources, there is an immediate need to address a catastrophe and return services to normal operations. Furthermore, certain catastrophic failures may not be eligible for reimbursement.

As witnessed during the Great Recession, City revenues can vary dramatically. Research by the GFOA demonstrates that revenues from sales, property and utility user taxes are directly related to broader economic factors that are beyond the control of individual cities. Consequently, there is inherent risk in not being able to control these economic trends. Changes in direction of the economy and the ensuing changes in revenues are distinct from the need for operational reserves in the form of a Working Capital Reserve. Working Capital is meant to offer protection against normal fluctuations in timing of receipt of revenues or unforeseen expenditures. A risk-based Revenue reserve protects against economic downturns that will reduce the overall level of revenues anticipated in near-term and foreseeable future. During the Great Recession, the City saw an overall decline in revenues of 19 percent.

The final category of risk-based reserves are contingencies related to the City’s self-insurance programs, including workers’ compensation and litigation. The City’s General Liability Fund and Workers’ Compensation Fund are internal service funds. City programs are charged annual contributions through rates based upon five years of historical losses. The Fund pays for self-insured losses (e.g. property damage, litigation and settlement payments) up to $1 million per occurrence, and for excess insurance coverage purchased through joint powers authority pools. By its nature, the Fund is a reserve for the City’s self-insured liabilities related to tort and workers’ compensation claims. During the Bankruptcy, the filing of tort claims was restricted per the Court and unsecured claims were paid at a discounted rate and litigation was suspended. With the City’s exit from
bankruptcy both the number of claims and the amount of claims is anticipated to increase.

The current policy does not specify a funding mechanism for either the Catastrophic Reserve or the Economic Contingency/Budget Uncertainty Reserve. The reserve targets are to be accomplished by maintaining a sufficient level of unreserved fund balance. The policy does acknowledge that full funding of reserve targets does not happen immediately, and will occur over time. Establishing a mechanism to provide incremental funding for working capital, known contingencies, and risk-based reserves would be prudent.

Proposed Reserve and Fund Balance Policy

It is recommended that the Reserve Policy - General Fund be updated to reflect current accounting standards, the City’s current circumstances, known contingencies, infrastructure conditions and potential catastrophes. Compliance with GASB Statement No. 54 will necessitate accounting changes to more accurately reflect Council action to establish reserve funds and restrict funds accordingly. The reserves proposed herein would be committed or assigned for the purposes of each specific reserve, and would not be available for any other purpose without Council action to revise the policy or remove a specific commitment. Because the purposes of each reserve are clearly identified, it is intended that the reserves would be used when such a circumstance presents itself. Two categories of priorities will enable the appropriate tracking of Known Contingencies and Risk Based reserves. Council action regarding these reserve categories will require majority action for the Known Contingencies, which is consistent with other budget actions, and super majority of 6 out of 7 Council members for the Risk Based reserves which is consistent with the existing Council policy and in relation to catastrophic events.

Working Capital and Known Contingencies

Reserves for Working Capital and Known Contingencies are recommended to be the first priorities given the need to maintain operations. Working Capital is the category of reserve meant to ensure the continued daily operation of government. This reserve accommodates normal fluctuations in the timing of revenues and unforeseen operational costs. To establish the appropriate level for this category the GFOA recommended minimum level of two months of operational cost was used. This would be the equivalent of approximately 17 percent of the General Fund operating budget, or $33 million. The GFOA standard has been the benchmark utilized by the City to evaluate the reserve levels during the Bankruptcy, and the Council approved a reserve equivalent to 20 percent in adopting the FY 2015-16 Annual Budget. This unassigned reserve would be maintained as a constant percentage and adjusted annually based on the General Fund operating budget. However, this benchmark is not specific to Stockton and does not account for a number of known issues. In addition to the Working Capital reserve, additional reserves are recommended for Known Contingencies.

The Known Contingency reserve would support fiscal sustainability and would commit or assign funds to be used later when sufficient detail is known to appropriately budget for the expenditures. Along with the Working Capital reserve, this reserve would be a first priority for reserve funding. It is recommended that the Known Contingency reserve include amounts to address staff recruitment and retention, future CalPERS costs and City facilities. The Known Contingency reserve target would be an additional $15.4 million, and would be evaluated annually.
Labor was a valued partner during the Bankruptcy as demonstrated by the overall level of cooperation and sacrifice made. As the City recovers from Bankruptcy, an analysis of market conditions is being completed consistent with the Council Strategic Priority to address Staff Development. As other municipalities and jurisdictions continue to provide compensation increases to staff, it is prudent to set aside funds in a reserve to achieve the City’s goal of being at the median of the market for staff compensation. It is not appropriate to budget these costs as the City and its Labor partners are just beginning negotiations for future contracts, and restricting funds in a reserve is more appropriate. Failure to address staff recruitment and retention issues could compound existing staff vacancies and related service delivery deficiencies. This reserve may be used for ongoing costs and would be evaluated annually.

Since the Bankruptcy began, CalPERS initiated discussion of investment changes that would improve the funds ability to meet its future obligations. CalPERS is contemplating modifications to the investment policies to increase the level of certainty that future returns will occur as predicted. Such modifications to reduce the risk of uncertainty would also lower the anticipated rate of investment return. Lower rates of return will increase the obligations of participating agencies. Because CalPERS has not provided final information regarding whether or how this change will occur, it is not possible to budget this cost and it is more appropriate to begin reserving funds for this purpose. Staff recommends reserving funds for this cost and evaluating annually based on the latest information from CalPERS.

The final item recommended to be used for the Known Contingency reserve is City facilities. During the Bankruptcy, the City negotiated a lease for operations to be located at 400 E. Main in downtown Stockton. Originally, the City planned to own this building but was unable to meet its payment obligations to maintain ownership during the fiscal crisis. An eight year lease, with potential extensions of up to four years, was negotiated as part of the Court approved Plan of Adjustment. The City must begin planning for the continued operation of City services beyond the current lease term. Creating and funding a reserve for this purpose would provide protection against future increases in lease costs or borrowing costs if a facility is renovated, purchased or constructed. It is anticipated that funds would be reserved each year for eight years commensurate with the term of the base lease for 400 E. Main.

Risk Based Reserves

The City currently has $720 million worth of buildings and improvements, machinery and equipment, governmental infrastructure and construction in progress. This amount does not include the full cost of replacement valuation or the cost to maintain and upgrade physical assets owned or maintained by the City. The total deferred maintenance backlog is estimated to be $970 million. Establishing a reserve target equivalent to two percent of the deferred maintenance backlog is recommended to protect against facility and equipment failure. The Infrastructure Reserve target would be $19.4 million. Additionally, establishing a reserve equivalent to two percent of the total asset value is recommended to protect against potential catastrophes resulting from extreme events. The Extreme Events reserve target would be $14.4 million. Both targets would be evaluated annually based on the latest facility assessment information and asset inventory.

The City revenues are susceptible to broader economic forces beyond the control of the City. A Revenue Volatility reserve would protect against significant and unanticipated decreases in any of the City's major revenue sources. Significant or unanticipated revenue downturns could in turn have
dramatic effect on already reduced service levels. To establish an appropriate reserve target, Stockton’s experience during the Great Recession was analyzed. The City experienced an overall reduction in revenues of 19 percent, and based on current revenue projections, a reserve target at this level would be $30.5 million. The reserve target would be evaluated annually based on changes in revenues.

The proposed Contingent Liabilities reserve target is estimated to be $7.9 million. This reserve would provide protection against increases in the number and amount of claims filed against the City. Based on claims history, a reserve target of $6.4 million for litigation is warranted and an additional amount of $1.5 million is recommended for unforeseen liabilities.

As described above, the circumstances of the City warrant reserve levels well beyond best practice minimum levels. The inability to make further reductions, the underfunding of capital asset repair and maintenance, recognized facility needs, labor realities and significant risk contingencies all necessitate adequate planning and preparation to ensure the financial solvency of the City consistent with Charter requirements. Additionally, the City must establish and account for these reserves in a manner that is consistent with GASB Statement No. 54 and restrict funds for specific purposes rather maintain a large unassigned General Fund balance. It will take time to achieve full funding of the recommended $120 million target reserve levels, but it is prudent to establish and begin funding reserves for operations, known contingencies, unforeseen revenue changes, infrastructure failures, and catastrophic events.

Reserve Fund Resources

To establish the reserve funds described above the reserve target will be established as part of the annual budget process and funds appropriated through Council approval of each General Fund Annual Budget. An amount equal to two months or 17% of expenditures and transfers-out will be unassigned for working capital needs. The remaining reserve will be committed or assigned to Priority I, Known Contingencies and Priority II, Risk-Based Reserves in the Fiscal Sustainability Fund (previously the Bankruptcy and Sustainability Fund). These reserves will be established by Council action and are consistent with the proposed Reserve and Fund Balance Policy - General Fund, GASB Statement No. 54, and GFOA best practices. It is anticipated that the combination of the General Fund unassigned fund balance and the balance of the previous Bankruptcy Fund will fully fund the Working Capital and Known Contingency reserves in the first year. The balance of available resources, one-time current year savings, would be applied to funding the Risk-Based Reserves and one-time Council priorities consistent with the allocations outlined in the policy for future funding. Of these remaining available funds, 95 percent would be allocated to the various Risk-Based reserves on a proportionate basis, and five percent would be available for one-time Council priorities. Going forward, the amended policy establishes an incremental funding mechanism for reserves. The policy dedicates unanticipated nonrecurring revenues, unspent and unencumbered appropriations and released prior year encumbrances to reserve targets and one-time Council priorities.

The proposed funding sources above do not represent resources diverted from other needs in the annual budget process. For instance, unanticipated nonrecurring revenues are not part of a structurally balanced budget and the retention of such monies in reserves should have no impact on ongoing operations. Similarly, unspent and unencumbered appropriations having been neither spent nor encumbered provide a funding source that would not reduce ongoing operations. Of course, Council would also continue to have the ability to allocate funds toward the reserve targets annually.
during the budget development process when balancing current and future needs of Stockton residents.

FINANCIAL SUMMARY

Adoption of the amended Reserve and Fund Balance Policy - General Fund would affect the FY 2015-16 Annual Budget, as amended, and proposed budgets in future years. The reallocation of existing reserves and dedication of unspent nonrecurring funds in future years will have no effect on ongoing operations. This policy will establish a working capital reserve to meet the minimum GFOA recommended level of 17 percent and restricted reserves for Priority 1 Known Contingencies. In addition, available one-time revenues and expenditure savings will be allocated to one-time Council priorities and dedicated Risk-Based reserves. This proposed Reserve and Fund Balance Policy-General Fund reflects best practices, complies with GASB Statement No. 54, and addresses the City’s circumstances after Bankruptcy.

Attachment A - City Council Policy 700-4, Reserve Policy - General Fund
Attachment B - Recommended City Council Policy 700-4, Reserve and Fund Balance Policy - General Fund