THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: November 3, 2015 **IBA Report Number:** 15-41

Budget and Government Efficiency Committee Date: November 9, 2015

Item Number: TBD

Options for Increasing the City's General Fund Reserve

BACKGROUND

General Fund Reserve and Excess Equity

In FY 2014, the Mid-Year Budget Monitoring Report identified a budgetary General Fund, fund balance surplus over and above the 14% reserve level established by the City's Reserve Policy. This budget surplus was described as "Excess Equity" and defined as "spendable and unrestricted fund balance that is not otherwise assigned to General Fund Reserves and is available for appropriation." At the time, our Office suggested that maintaining fund balance on top of the City's reserve levels was fiscally conservative and seemed appropriate, but we recommended that the Chief Financial Officer (CFO) return to Committee with an update of the City's Reserve Policy that included a definition of Excess Equity, the timing of when Excess Equity projections are reported to Council, and how Excess Equity may be appropriated. These changes were requested by the Budget and Government Efficiency Committee (B&GE) on May 22, 2014, and were included in the Reserve Policy when it was subsequently reviewed and approved by the City Council.

Some questions still remained about Excess Equity however, including the appropriate amount to retain in spendable and unrestricted fund balance. In our Office's review of the Mayor's FY 2016 Proposed Budget we offered a recommendation to help address these questions by proposing an Equity Reserve equal to 1% of General Fund revenues[1], to be calculated in the same manner as the City's 14% General Fund reserve requirement. At the time the Equity Reserve was proposed, 1% of General Fund Revenues was projected to be approximately equal to the estimated Excess Equity: $11.3 million. This amount of Excess Equity has since grown to $30.6 million as derived from the recently released FY 2015 Year-End Financial Performance Report. Our Office

[1] The addition of a 1% Equity Reserve would have increased the General Fund reserve to a total of 15% of operating revenues.

proposed the Equity Reserve in order to provide a reasonable cushion for potential variances in revenue and expenditure projections, and limited its uses to one-time capital improvements or for funding other City reserves.

This reserve suggestion offered by the Office of the IBA served as an alternative to the proposal that was subsequently put forward by the Mayor in his May Revision: an irrevocable Pension Payment Stabilization Reserve Trust (PPSRT) that would serve as a source of funds for any unexpected increases to the City's pension payment. While all Councilmembers favored increasing the City's General Fund reserves as noted in their final Budget Priorities memoranda, they held differing viewpoints on the reserve amount, its uses, or the mechanism. Several Councilmembers raised concerns about approving an appropriation for the proposed PPSRT in June without a corresponding policy, and when the City Council adopted the FY 2016 Budget they unanimously agreed to keep the funds proposed for a PPSRT in Excess Equity until a discussion could be held at B&GE about the purpose and use of a new reserve or trust.

At the October 2015 B&GE meeting the CFO presented an update to the City's Reserve Policy to include a Pension Payment Stabilization Reserve. The IBA supported the addition of this Reserve as we noted that the concept of an irrevocable trust had been dropped and our suggestions for clarifying and defining the Policy, including the ability of Council to propose using the Reserve, had been added. We also noted that it is prudent to identify a source of funds for unanticipated changes to the City's Actuarially Determined Contribution (ADC) pension payment such as investment losses or changes to economic assumptions made by the San Diego City Employees' Retirement System (SDCERS). A majority of B&GE members raised a concern about the narrow use of the Reserve for unexpected pension payments only. They noted that the Reserve, as defined, lacked flexibility, that the proposed amount was not associated with any benchmarks or professional standards, and they questioned whether to create a separate pension reserve or broaden the scope of the City's General Fund Reserve. Committee members approved a motion that directed staff and our Office to research the option of increasing the City's currently established General Fund Stability Reserve and to present the findings at a subsequent B&GE meeting.

DISCUSSION

To respond to the Committee's request, we have reviewed information on best practices relative to City reserve levels along with rating agency comments regarding our current reserves and budgetary performance from recent Rating Update Reports. We have also provided several General Fund Reserve scenarios for your consideration based on this information and other factors. Based on our review and in response to the Committee's request, we have suggested an option for increasing the General Fund Stability Reserve for Committee consideration, and have compared this with the Mayor's Pension Payment Stability Reserve proposal. Finally, we have provided suggested revisions to our current Reserve Policy should the Committee wish to consider this option.

Best Practices and Rating Agency Comments

Government Finance Officers' Association (GFOA) "Best Practice" on "Appropriate Level of Unrestricted Fund Balance in the General Fund"

The 2009 GFOA policy statement regarding cities' reserve levels calls for maintaining a minimum reserve equal to two months of operating expenditures or operating revenue which equates to an approximate 16.7% reserve. Our current General Fund Reserve (the Emergency Reserve and the Stability Reserve) equals 14% of the last three years average of annual audited General Fund operating revenues and is estimated at $158.7 million for FY 2016. Increasing our reserve to two months of revenues or 16.7%, consistent with GFOA guidelines, would require an additional allocation of $30.6 million for a total General Fund Reserve of $189.3 million.

Standard and Poor's (S&P) Assessment Guidelines for Reserve Levels

In their credit rating assessments of cities, S&P considers reserves of 8-15% to be "strong" and any amount over 15% to be "very strong".

Moody's November 12, 2014 report "Anatomy of Successful US Cities"

In this report Moody's found that 34 of the largest US cities (including San Diego) have either "improved or maintained their credit quality… since the onset of the Great Recession". Of the factors contributing to this, Moody's identified that successful cities had strong financial management which supported revenue growth and improved reserve positions. According to this report, by 2013 the 34 successful cities' average median reserves had grown to 18.6% of operating revenues, up from the 14.5% in 2008.

Recent Ratings Update Reports for the City of San Diego from Moody's, S&P, and Fitch

In updating the City's credit ratings for the issuance of lease revenue bonds, Moody's, S&P, and Fitch released reports on November 12, 2014; March 24, 2015; and March 25, 2015 respectively. All three reports spoke to the City's improved financial position, increasing the City's reserves to 14%, strong fiscal management, conservative financial policies, and strong financial disclosure practices. The reports also noted some of the City's credit challenges with Moody's addressing the City's current reserve level:

Moody's: "Key Credit Challenge: While reserves have improved, overall reserve position falls below median for the current rating category. What Could Cause the (City's) Rating to Go Up?: Significant growth in City reserve position."

S&P: "The stable outlook reflects our view of the city's very strong economy and strong budgetary flexibility which is supported by very strong management conditions. We could consider raising the rating if budgetary performance improves to a level we consider strong, coupled with no deterioration in other factors."

Fitch: "While the City faces sizable capital pressures and some uncertainty related to pension litigation, the ability of the city's current administration and management team to continue to achieve stable-to-positive financial operations, coupled with greater clarification on capital and litigation issues, could lead to an upgrade of the credit over the next few years."

Increasing our reserves would likely be seen by the three rating agencies as a favorable action, all other factors remaining equal. The GFOA and S&P guidelines make a case for considering increasing our reserves slightly above 14%, as does Moody's "Anatomy of Successful US Cities" report which found that as of 2013, 34 of the largest US cities averaged a median reserve of 18.6% of operating revenues, up from 14.5% in 2008.

That being said, it is important to highlight the very positive comments from all three of the rating agencies about the City's strong financial management, the increase to our General Fund reserve, and our improved financial position. Recent upgrades in the City's credit ratings issued by S&P (FY 2014) and Moody's (FY 2015) referenced the City's financial management as well as our improving and diverse economy and low debt burden as reasons for the change.

Also for Committee consideration, it has been the City's practice to pay our full pension ADC for the past 11 years. With or without a new or increased reserve, the City would continue this practice of making our annual ADC payments a top priority for funding in the annual budget process. Any additional reserve funds that Council should choose to allocate, however, would serve as a cushion against the budgetary impact of **unexpected** changes to the ADC and provide greater certainty that service reductions would not be necessary to fund these increases.

General Fund Reserve Scenarios

Attachment 1 provides a comparison of five reserve scenarios based on 1) the City's current reserve policy, 2) the Mayor's Pension Payment Reserve, 3) S&P Assessment Guidelines, 4) GFOA Guidelines, and 5) an Office of the IBA Suggested Option. Table 1 in the attachment shows the basis used for calculating each of the scenarios, the percent of operating revenues achieved, the total General Fund reserve amount, and the increased funding needed to meet the proposed reserve level over our current reserve. Table 2 shows the amount of Excess Equity that would remain for each scenario after funding the proposed reserve level based upon the most recent Excess Equity estimate provided in the FY 2015 Year-End Performance Report.

As shown in Table 2, increasing our reserve to two months of operating revenue consistent with GFOA guidelines would result in a 16.7% reserve and require an allocation of $30.6 million for a total reserve of $189.3 million. No funds would remain in Excess Equity based on current estimates under this scenario which raises a concern for us as we believe it is prudent to maintain a small amount of Excess Equity this early in the fiscal year.

Alternatively, if the Committee is interested in increasing the existing reserve, we would suggest increasing our General Fund Reserve from 14% to 16%—a reserve level very close to the GFOA guideline—with the Stabilization Reserve increasing from 6% to 8% and the Emergency Reserve remaining at 8%. An increase to 16% General Fund reserves would require an additional $22.7 million, for a total reserve of $181.4 million, and would leave an estimated $7.9 million available in Excess Equity to provide a cushion for any unexpected revenue and expenditure changes in the current fiscal year.

Comparing Pension Reserve Proposal and Stability Reserve Proposal

The table below compares various factors of the two different approaches that are under consideration for increasing our reserves. This increased funding level will be used to cushion the budgetary impact of unexpected changes to the City's future pension ADC payments.

	Pension Reserve Proposal	**Stability Reserve Option**
Total Amount	$21.2 million	$22.7 million
Source	$16.3 million – General Fund (Excess Equity) $4.9 million – Enterprise Funds	$22.7 million – General Fund (Excess Equity) No Enterprise Funds
Mechanism	Create separate reserve	Increase existing Stability Reserve from 6% to 8%, for a total General Fund Reserve of 16%
Amount of Excess Equity Remaining	$14.3 million	$7.9 million
Formula	8% average of the last three years' ADC	16% of the most recent three years' average of annual audited General Fund revenues (includes 8% Emergency Reserve and increased 8% Stability Reserve)
% of General Fund Operating Revenues	15.4%	16%
Uses	1. Unexpected pension ADC increases as defined in the City's Reserve Policy	1. Unexpected pension ADC increases as defined in the City's Reserve Policy 2. Mitigate financial risk due to revenue shortfalls or unanticipated critical expenditures 3. Critical capital or operating needs

Key Components of Suggested Option for Increasing the Stability Reserve

The following key components for increasing the Stability Reserve are suggested if the Committee is interested in pursuing this option:

A. Increase the General Fund Reserve from 14% to 16%, maintaining the Emergency Reserve at 8% and increasing the Stability Reserve from 6% to 8%, for a total General Fund reserve of $181.4 million.
B. Transfer $22.7 million from fund balance to the Stability Reserve leaving $7.9 million in Excess Equity for operational fluctuations (based on current estimates).

C. Revise the Stability Reserve Section of the Reserve Policy to include unanticipated changes in annual ADC payments as an eligible and appropriate use of the Stability Reserve in order to avoid service reductions[2].
D. Include language in the policy which clearly defines unanticipated changes to the ADC as presented in the Pension Payment Stabilization Reserve proposal[2].
E. Strengthen the replenishment language in the Stability Reserve Policy in the event the fund is reduced below policy levels, to require the Mayor prepare a plan for replenishment of the fund no later than one year from the reserve action. Current language states the Mayor will do so "as promptly as conditions warrant"[2].
F. Make the primary purpose of the Stability Reserve more transparent by clarifying that the Stability Reserve may also be used as a source of one-time funding for critical capital or operating needs[2].

CONCLUSION

Based on our projected strong Excess Equity position of $30.6 million at year-end, double what was projected in June 2015, and the City's desire to prepare for unanticipated pension ADC increases, this is an opportune time to consider increasing our reserves.

Both methods—either increasing the City's General Fund Stabilization Reserve or creating a new Pension Payment Stabilization Reserve—are prudent and increase the City's General Fund reserve. Both would achieve the intended purpose of identifying a source of funding for unexpected changes in the City's pension ADC payment, while helping to avoid service reductions. Both approaches would move the City closer to meeting GFOA best practices for the City's General Fund Reserve by increasing an already very healthy reserve level, and both would likely be viewed as favorable by the rating agencies.

Increasing the existing Stabilization Reserve could provide greater budgetary flexibility over the course of time while the Pension Reserve could provide certain benefits by being restricted to one specific use. Perspectives differ and sound arguments exist, pro- and con-, regarding fund flexibility versus fund specificity. Clear policies on use and fund replenishment could address concerns of either proposal.

We have prepared potential revisions to the City's Reserve Policy should the Committee wish to pursue the option of increasing the City's General Fund Stability Reserve; these revisions are presented in Attachment 2 for Committee consideration. Potential Reserve Policy revisions for a Pension Reserve were previously presented to B&GE by the CFO in October.

[2] See Attachment 2 for proposed updated policy language. Please note that this language has not yet been reviewed by the City Attorney's Office.

Andrea Tevlin
Independent Budget Analyst

Christiana Gauger
Fiscal & Policy Analyst

Lisa Byrne
Fiscal & Policy Analyst

Attachment 1:	General Fund Reserve Scenarios
Attachment 2:	Reserve Policy: General Fund Reserve Policy Section

General Fund (GF) Reserve Scenarios

TABLE 1

Source	Basis	% of GF Oper Revenues	Total GF Reserve Amount (FY 2016)	Increase Over Current Reserve Amount
Current Policy	14% of GF Revenues	14.0%	$ 158.7	$ N/A
Mayor's Pension Payment Stabilization Proposal [1]	8% Average of Past 3 ADCs	15.4%	174.6	16.3
Standard & Poors (S&P) Assessment Guidelines [2]	15% of GF Revenues	15.0%	170.0	11.3
GFOA Guidelines [3]	2 Months GF Revenues	16.7%	189.3	30.6
IBA Option	16% of GF Revenues	16.0%	181.4	22.7

[1] This proposal is to establish a separate reserve from the Emergency and Stabilization Reserves that comprise the currently existing General Fund Reserves.

[2] For S&P assessments, reserves of 8-15% are considered "strong" and those greater than 15% are considered "very strong". The IBA proposed a 1% increase to the current 14% GF reserve policy in April 2015 (in the IBA review of the FY 2016 Proposed Budget).

[3] GFOA recommends a minimum of 2 months of operating revenues or expenditures, which is approximately 16.7%.

TABLE 2

Source	Basis	Current Estim. Available Excess Equity	Increase Over Current Reserve Amount	Excess Equity Remaining After Increase of Reserve
Current Policy	14% of GF Revenues	$ 30.6	$ -	$ 30.6
Mayor's Pension Payment Stabilization Proposal[1]	8% Average of Past 3 ADCs	30.6	16.3	14.3
Standard & Poors (S&P) Assessment Guidelines[2]	15% of GF Revenues	30.6	11.3	19.3
GFOA Guidelines[3]	2 Months GF Revenues	30.6	30.6	-
IBA Option	16% of GF Revenues	30.6	22.7	7.9

CITY OF SAN DIEGO, CALIFORNIA

COUNCIL POLICY

CURRENT

SUBJECT: RESERVE POLICY

POLICY NO.: 100-20

EFFECTIVE DATE: July 17, 2014

BACKGROUND:

A key attribute of a financially stable organization is appropriate reserves. Strong reserves position an organization to weather significant economic downturns more effectively, manage the consequences of outside agency actions that may result in revenue reductions, and address unexpected emergencies, such as natural disasters, catastrophic events caused by human activity, or excessive liabilities or legal judgments against the organization. In concert with the budgetary and fiscal policies adopted by the City Council, including "Structural Budget Deficit Elimination Guiding Principles" (R-305615), "City Council Budget Policy 000-02" and the "Mid-Year Budget Authority Ordinance" (O-20084), the City's Reserve Policy serves as the policy framework to deploy City resources to meet the City's financial commitments and address unexpected future events in a fiscally prudent manner.

PURPOSE:

The City's Reserve Policy documents the City's approach to establishing and maintaining strong reserves across the spectrum of City operations, including General Fund, risk management and enterprise operations. The policy is designed to:

- Identify City operations and functions for which reserves should be established and maintained, considering risks to the operation from unexpected events and the availability of other resources to address such events, and the volatility of expenditures and revenues of the operation;

- Establish target reserve levels and the methodology for calculating reserve levels;

- Provide a time-frame for meeting reserve targets, using a phased approach where necessary so that reserve goals are balanced appropriately with current budget availability; and

- Establish criteria for the use of reserves and the process to replenish reserves.

RESERVE POLICY:

General Fund Reserve Policy:

The General Fund[1] is the main operating fund that pays for general services provided by the City, such as public safety, parks, and library services. The General Fund accounts for all general revenues of the City not specifically levied or collected for other City funds and for expenditures related to the delivery of the City's general services.

The General Fund Reserve Policy incorporates the requirements of the City Charter and is consistent with the City Council policies regarding the use of one-time and ongoing sources of revenue to fund City services.

The City's General Fund Reserves shall be comprised of two separate Reserves. These Reserves will be considered together when calculating the total General Fund Reserve balance.

Emergency Reserve

An Emergency Reserve will be maintained for the purpose of sustaining General Fund operations in the case of a public emergency such as a natural disaster or other unforeseen catastrophic event. The Emergency Reserve will not be accessed to meet operating shortfalls or to fund new programs or personnel. This reserve may be expended only if an event is determined to be a public emergency by a two-thirds vote of the City Council, when such expenditures are necessary to ensure the safety of the City's residents and their property. In the event this reserve is reduced below the amount established by this policy, the Mayor shall prepare a plan as promptly as conditions warrant to replenish the Emergency Reserve balance to the policy level.

Stability Reserve

A Stability Reserve will be maintained to mitigate financial and service delivery risk due to unexpected revenue shortfalls or unanticipated critical expenditures. The purpose of this reserve is to provide budgetary stabilization and not to serve as an alternative funding source for new programs. The Stability Reserve may be used as a source of one-time funding for critical capital or operating needs. This reserve may also be used to mitigate service delivery risk due to unanticipated increases in the annual pension payment, the Actuarially Determined Contribution (ADC), and will serve as a funding source if the ADC unexpectedly increases year-over-year as

[1] For the purpose of this policy, the General Fund is the operational fund as presented in the City's annual budget document. Financial statements prepared on a GAAP basis include these funds, as well as other funds that do not meet the criteria to be classified as special revenue, capital project, or debt service funds, pursuant to Government Accounting Standards Board (GASB) Statement No. 54.

calculated in the most recent Actuarial Valuation Report produced by the San Diego City Employees' Retirement System's actuary. An unexpected ADC increase is defined as the difference between the total change in the ADC and the expected change in the ADC as provided in the *Change in the ADC Table* of the Report.

~~-~~Recommendations to appropriate from the Stability Reserve will be brought forward by the Mayor and will require approval by a majority of the City Council. In the event this reserve is reduced below the amount established by this policy, the Mayor shall prepare a plan ~~as promptly as conditions warrant~~ no later than one year from the reserve action, to replenish the Stability Reserve balance to the policy level.

General Fund Reserve Calculation and Measurement

Total General Fund Reserves consist of the total of the Emergency Reserve and the Stability Reserve. The target level for total General Fund Reserves shall be ~~14~~16% of the most recent three-year average of annual audited General Fund operating revenues[1]. ~~-~~The Emergency Reserve shall be set at a target level of 8%, and the Stability Reserve shall be set at a target level of ~~6~~8%.

Excess Equity

Excess Equity is spendable and unrestricted fund balance that is not otherwise assigned to General Fund Reserves and is available for appropriation. Excess Equity is most commonly a non-recurring source of revenue. Consistent with City Council Budget Policy (Policy No. 000-02) and the use of one-time and ongoing revenues, Excess Equity will be appropriated primarily for unanticipated circumstances, such as a General Fund revenue shortfall affecting programs included in the current year budget or for one-time priority expenditures. Recommendations for the use of Excess Equity may be brought forward by the Mayor and will require approval by a majority of the City Council.

The Quarterly Budget Monitoring Reports provide an estimate of Excess Equity based on the projected activity from operations during the fiscal year; however, unrestricted fund balance is not determined until the City closes its books as of June 30. In the May Revision of the annual budget, the Mayor may propose to budget any projected excess equity as a contingency to fund the General Fund Reserves, Risk Management Reserves~~,~~ or for a priority one-time capital need. The transfer would occur after the fiscal year close is completed and the budgeted Excess Equity amount is determined to be available in fund balance above the ~~14~~16% General Fund reserves.

City Charter

City Charter Section 91 requires the City to create and maintain a “General Reserve Fund” to meet the cash obligations of the City for the first four months, or other necessary periods of each fiscal year prior to the collection of taxes. It further stipulates the fund may be expended only in the event of a public emergency by the affirmative vote of two-thirds of the City Council. This requirement is met through the City’s pooled investment fund and when necessary cash borrowing through the sale of Tax and Revenue Anticipation Notes.

[1] For purposes of this policy, target reserve balances are based on operating revenues as presented in the General Fund Budgetary Schedule of Revenues, Expenditures and Changes in Fund Balance in the Required Supplementary Information section of the Comprehensive Annual Financial Report. These revenues are from recurring revenue sources that support operations, and exclude other financing sources.

Attachment 2

CURRENT

Summary

Total General Fund Reserves will be based on, and reconciled to, the General Fund fund balance. The sum of the Emergency Reserve, Stability Reserve, and amounts determined to be Excess Equity shall equal the sum of unrestricted fund balance and amounts restricted for the purpose of maintaining the Emergency Reserve.