

Study Session

Risk-based Reserves Assessment & Recommended Funding Mechanics

June 10, 2014



Introduction

- Reserves are critical to the overall health, agility and stability of any government
- An interdepartmental team lead by the Finance Department contributed to a Risk-Based Assessment of the City's Reserve Requirements and policies
- The resulting report shows: while rebuilding Vallejo's reserves, steps could be taken to adjust policy to better prepare for future irregularities & aid in avoiding cutbacks to integral City services in the future

Discussing ‘Proper’ Reserve Levels

- Government Finance Officers Association (GFOA) recommended:
 - a “baseline”/minimum of 16% of regular operating revenues; to cover 2 months of operating expenditures
- Standard & Poor’s (S&P) view on available reserves:
 - Good: 4-8% -- Strong: 8-15% -- Very Strong 15%+ calculated on either revenues or expenditures.
- GFOA newest (2012) proposed approach is to conduct an analysis to measure risk and adjust Reserve levels based on local conditions accordingly

GFOA's Risk Factors to Consider

1. Revenue source stability

Consider: Economic downturn leading to declining home prices; rising unemployment; and therefore reduced tax revenues

2. Expenditure volatility

Consider: Rising costs associated with employee retirement expenses and known future CalPERS cost increases

3. Vulnerability to Extreme Events & Litigation Risks

Consider:

- Infrastructure failure risks; a risk increased with reduced levels of spending on infrastructure repairs and upkeep
- Cases of costly extreme event: natural disaster, act of terror, etc.

How things are done today ...

- The City operates a single Reserve for the General Fund
- Current reserve *target* is 15% of expenditures as unassigned General Fund balance (the City is *estimated to be at 9.1%* as projected for June 30, 2014)
- This Reserve acts as a general Reserve to cover all potential risks & issues that arise
- This reserve was drained to a low of 1% at the end of FY2007-2008

Changes Suggested & The New System



The New Risk-Based Reserve Layout

- General Fund Reserves goal change:
 - Funding goal reduced from a 15% ‘catch-all’ to 8.333% to cover one month’s expenditures
 - Provides “baseline liquidity”, ensuring operational costs are covered
- Four additional, more specific Risk Reserves are created, tailored to specific issues & risks:
 - 1. Contingent Liability Reserve
 - 2. Revenue Volatility Reserve
 - 3. Infrastructure Failure Reserve
 - 4. Extreme Event Reserve
- Liability Stabilization Reserve

The 4 Risk Based Reserves:

1. Contingent Liability Reserve

- Money to covers *specific* liabilities identified & foreseen by the City
- Examples: USPS relocation expenses; litigation & tort costs related to cases not covered by the City’s self-insurance program

2. Revenue Volatility Reserve

- Covers significant & unanticipated decreases in City revenue streams that could impact City service levels
- This “Revenue Volatility” reserve would allow the City to continue operations uninterrupted while analyzing the impact of significant changes in revenue, providing the City with invaluable time to plan and react to the changing circumstances

The 4 Risk Based Reserves:

3. Infrastructure Failure Reserve

- To cover costs should a major failure of City infrastructure occur
- Example: bridge or pedestrian overpass failure; gas line failure

4. Extreme Events Reserve

- Designed to cover costs for four weeks, should a catastrophic event happen within the City, at which point FEMA & State reimbursement funds should be available
- Examples: earthquake, act of terror

Liability Stabilization Reserve

- Funds landing in this Reserve would pool and then be used with Council's approval to pay-down debts and liabilities in order to reduce ongoing costs
 - Example: making a supplemental payment to PERS or the OPEB trust; paying off bonds or other debts
- Not Risk-Based
- This Reserve is designed to catch surplus funds *after all other Reserves are fully funded*

The Water Fund ...

This new structure would be duplicated to cover the Water Fund as well. The main Operating Reserve target set at 12.3% (to cover 45-days short-term operating costs) and then the four new risk-based Reserves:

- 1. Contingent Liability Reserve
- 2. ~~Revenue Volatility Reserve~~ Rate Stabilization Reserve*
- 3. Infrastructure Failure Reserve
- 4. Extreme Event Reserve

*Water Fund uses 'Rates' as their revenue-word, so the fund naming would reflect that, as it would be used to smooth over periods when rates were unstable.

The City's Self-Insurance Fund

- The City's Self-Insurance Fund pays for self-insured losses:
 - Property damage claims, worker's compensation claims, litigation & settlement payments, etc.
 - Excess insurance is carried for covered claims that exceed the City's self-insured retention level of \$500,000
- **50%** - Current. The fund is funded at a 50% 'Confidence Level', which is the minimum permitted under Generally Accepted Accounting Principles (GAAP)
- **75-85%** - Best practice as recommended by industry experts. The City's actuary's recommend Confidence Level
- **80%** - The Target. Going forward the plan would be to increase the fund to the 80% Confidence Level

Funding the New Reserve System



Where does the money come from?

- Funding was chosen based on sources having the least impact on City operations or services, and without the need to create new revenue sources
- “Slow & Steady” approach. *It will take time* to fill Reserves to their new levels, but funding would become automated based on City Council policy
- ‘Reallocating’ or ‘shifting’ funds that were unexpected or unused while maintaining a balanced budget

Four sources of funds ...

1. Unanticipated nonrecurring revenues

- “onetime funds” / “windfalls”
- Revenues not expected and not recurring
- Examples: Settlements in the City’s favor (Property Tax Fee Settlement FY2012-2013); Changes in law resulting in lump payments to the City (elimination of Redevelopment Agencies statewide)
- 50% (minimum) would go toward filling Reserves; the remainder would be available as part of the budget process. This would not preclude allocation of the second 50% to reserves as well.

Four sources of funds ...

2. Unspent and unencumbered appropriations

- “Unspent budget”
- At year-end, ‘savings’ from the final-adjusted budget (less encumbrances) and final audited expenditures in the General Fund
- 100% would go toward filling Reserves

3. Release of prior year encumbrances

- “unspent prior year budgeted program or service”
- Currently, these funds can ‘roll over’ onto next year’s budget & if not used in the subsequent year they are “released”
- 100% would go toward filling Reserves

4 . Annual budget authorizations

- City Council allocations toward the City’s reserves, such as the Measure B fund allocation

Filling Reserves in Order of Risk ...

As each Reserve reaches the proper level, the funds then flow into the next tier of Reserve(s) in order:



By The Numbers ...

| Proposed Reserve Targets | | | | |
|---|---------------------|-------------------|-------------------|-------------------|
| | Self-Insurance | | | |
| | <u>General Fund</u> | <u>Fund</u> | <u>Water Fund</u> | <u>TOTAL</u> |
| Baseline Liquidity/Operating Reserves: | | | | |
| Working Capital | 6,103,000 | | 3,671,000 | 9,774,000 |
| Funding to actuarially-recommended 80% Confidence Level | | 17,779,000 | | 17,779,000 |
| Subtotal, baseline liquidity/operating | <u>6,103,000</u> | <u>17,779,000</u> | <u>3,671,000</u> | <u>27,553,000</u> |
| Risk-based Reserves: | | | | |
| Contingent Liabilities | 2,624,000 | | 4,500,000 | |
| Revenue Volatility / Rate Stabilization | 8,666,000 | | 3,636,000 | 12,302,000 |
| Infrastructure Failure | 3,006,000 | | 4,388,000 | 7,394,000 |
| Extreme Events | 2,210,000 | | 5,720,000 | 7,480,000 |
| Subtotal, primary risks | <u>16,056,000</u> | <u>-</u> | <u>18,244,000</u> | <u>27,176,000</u> |
| Grand total | <u>22,609,000</u> | <u>17,779,000</u> | <u>21,915,000</u> | <u>54,729,000</u> |
| As a percentage of exp (see below) | 30.3% | N/A | 54.1% | |

This chart is included in the staff report on page 5

How to Access the Reserve Funds ...

- The Contingent Liability Reserve
 - Is directly reserved for specific, identified & foreseen uses
 - Resolution required to access the funds
- The 4 Risk-Based Reserves
 - Are directly reserved for specific but unforeseen risks
 - Require specific triggers to access the funds (Exhibit B, Schedule 2)
 - Resolution not required if triggers are met; approval of use by City Manager required, w/ subsequent ratification by City Council
- The Liability Stabilization Reserve
 - Is pooled money for paying down liabilities & debts
 - Resolution required to access the funds

Conclusion



Why the change?

A Risk-Based approach to Reserves:

- acknowledges risks
- looks at more factors and hedges against more problem issues; better representing the potential issues Vallejo could face
- sets aside funds for specific usages/problems; this allows staff to more quickly move into action once a risk becomes a reality
- allows for regular updating, re-evaluation & fine-tuning of Reserve targets and amounts; i.e. as the USPS relocation issue is resolved, that amount can be pulled from the equation
- more specifically lays out how funds will be allocated to Reserves, ensuring a constant flow to keep them replenished
- good business practice as recognized by the GFOA, and among factors considered by credit rating agencies & investors when assessing credit-worthiness

Next Steps

- Staff is requesting input from City Council on the findings and recommendations found in the report
- If approved, staff would formalize a revised Reserves Policy and propose to Council for adoption at a future Council meeting
- The proposal would be expected to contain the amended goals for the General Fund reserve (15% to 8.333% change); the establishment of the framework for the Reserves; mechanisms for diverting funds to those Reserves

Questions / Comments

