OPEN SESSION
AGENDA ITEM

54-144 MAY 2018
F&P COMMITTEE ITEM III.D.

DATE: May 17, 2018

TO: Members, Finance and Planning Committee

FROM: Kevin Harper, Interim Chief Financial Officer

SUBJECT: Reserve Policy Revision Regarding Client Security Fund and Lawyer Assistance Program Funds and Related Budget Amendment

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EXECUTIVE SUMMARY

This agenda item seeks to implement a recommendation from The State Bar of California 2018 Client Security Fund (CSF) Report; Board of Trustees approval is sought to modify the State Bar Reserve Policy to exclude CSF application payouts from the reserve calculation. Doing so will result in an additional $1.5 million being made available for 2018 CSF application payments.

In addition, this agenda item addresses the Lawyer Assistance Program (LAP) Fund balance, which was at 159% as of December 31, 2017, and is projected to total 154% by the close of this calendar year.

BACKGROUND

At its February 1, 2016, meeting, the Board of Trustees adopted a Reserve Policy. That policy requires a Minimum Target Reserve level of two months of operating expenses (17%) for all funds and requires a spend down plan when reserves remain greater than 30 percent for longer than six consecutive months. At its March 7, 2016, meeting, the Board of Trustees modified the Reserve Policy to exempt all grant-related funds (Grants Fund, Legal Services Trust Fund, Equal Access Fund, Justice Gap Fund, and Bank Settlement Fund) from the Minimum Target Reserve requirements.

DISCUSSION

Client Security Fund

The CSF reimburses clients who have lost money or property due to theft by a California lawyer. As of December 31, 2017, the CSF had 3,431 applications pending for processing, totaling approximately $52.3 million. The CSF is financed by a mandatory licensing fee of $40 per active attorney and $10 per inactive attorney. These fees generate approximately $8 million of revenue per year.

Staff believes that the calculation of reserves in accordance with the Reserve Policy should be based on operating expenses excluding application payouts. This would represent the true costs of administering the CSF program. This is consistent with the Board's previous decision to exclude grant-related funds from the Minimum Target Reserve requirements. Disbursement of CSF application payouts is always limited by the amount of revenue available, so there is no need to permanently retain 17% of these payouts as a reserve.

Excluding CSF application payouts from the reserve calculation will allow the disbursement of an additional $1.5 million of application payouts in 2018, while maintaining the newly defined reserve at 30 percent. The Reserve Policy is proposed to be amended to reflect this revised interpretation of the calculation of CSF reserves. A new sentence is proposed to be added to the Reserve Policy stating:

> "For purposes of the Minimum Reserve Target, operating expenses of the Client Security Fund shall exclude application payouts."

A redline version of the revised policy is included as Attachment A and a clean copy of the revised policy is included as Attachment B.

The following table shows the calculation of CSF reserves using amounts in the 2018 amended budget (in thousands):

Per 2018 Amended Budget	
Revenues	$ 7,977
Application Payouts	(7,400)
Expenses	(856)
Indirect Costs	(785)
Subtotal Expenses	9,041
Excess of Expenses Over Revenues	(1,064)
Projected Reserves 1/1/2018	3,089
Projected Reserves 12/31/2018	$ 2,025
Projected Reserves 12/31/2018	$ 2,025
Operating Expenses as Previously Calculated	9,041
Reserves as Previously Calculated	22%
Restatement of CSF Reserves	
Projected Reserves 12/31/2018	$ 2,025
Operating Expenses as Proposed*	941
Reserves as Previously Calculated	215%

* Operating expenses as proposed are total expenses as shown above less application payouts of $7.4 million and the portion of indirect costs applicable to those payouts of $700,000. The needed reserve for CSF per the proposed revision would be $282,000 ($941k x 30%).

If the Board approves this revision to the CSF reserve policy, it allows disbursement of additional $1.7 million of additional costs in 2018, representing the difference between the current projected reserve at December 31, 2018 of $2.0 million and the needed reserve under the proposed methodology of approximately $.3 million. Staff proposes to amend the 2018 budget to add this $1.7 million to CSF expenses. $1.5 million of the budget amendment is for application payouts and $.2 million for additional indirect costs, as follows:

	Amended Budget	***Proposed Amendment***	***Revised Budget***
Revenues	$ 7,977	$ -	$ 7,977
Application Payouts	(7,400)	(1,500)	(8,900)
Expenses	(856)		(856)
Indirect Costs		(200)	(985)
Excess of Expenses Over Rev	(1,064)	$(1,700)	(2,764)
Projected Balance 1/1/2018	3,089		3,089
Projected Balance 12/31/2018	$2,025		$ 325

Lawyer Assistance Program

The 2018 Final budget adopted by the Board in January 2018 projected a reserve of $3.5 million (154%) for LAP as of December 31, 2018. The LAP Fund has had a balance in excess of the 30% reserve cap since the Reserve Policy was adopted in February 2016. New statutory provisions enacted January 1, 2018, allow for the transfer of surplus LAP funding to the CSF. Such transfers are to be governed by a policy that takes into account the needs of the LAP program; an item on the Board's May 18 agenda outlines that proposed policy, and provides the Board with options regarding a current year transfer from the LAP to the CSF. Implementation of the Board's Reserve Policy as related to the LAP program should be governed by the LAP transfer policy being considered by the Board. As such, although staff is bringing the LAP excess reserve issue to the Board's attention, no action is sought or requested independent from the Board's consideration of the broader issues at its meeting on May 18.

FISCAL/PERSONNEL IMPACT

Increase in the 2018 Client Security Fund budget of $1.7million, $1.5 million of which will be used for application payouts.

RULE AMENDMENTS

None.

BOARD BOOK AMENDMENTS

Main Section 4, Tab 4.1, Article 1, Section 3, Page 8

STRATEGIC PLAN GOALS & OBJECTIVES

Goal: 3. Improve the fiscal and operational management of the State Bar, emphasizing integrity, transparency, accountability, and excellence.

Objective: d. Reallocate funds to support the discipline system based on expenditure review, revenue enhancement measures, implementation of the Bar's reserve policy, and other reengineering efforts.

RECOMMENDATION

It is recommended that the Finance and Planning Committee approve the following resolution:

> **RESOLVED**, that that the 2018 Budget be amended to increase the budgeted expenses of the Client Security Fund by $1,700,000.
>
> **FURTHER RESOLVED**, that the Reserve Policy be revised to add the following sentence to Section C of the Reserve Policy:
>
> > "For purposes of the Minimum Reserve Target, operating expenses of the Client Security Fund shall exclude application payouts."

ATTACHMENT(S) LIST

A. Reserve Policy, with proposed revision – redline version

B. Reserve Policy, with proposed revision – clean version

Attachment A

RESERVE POLICY

A. DEFINITION AND CLASSIFICATION OF RESERVES

1. **Working Capital.** In accordance with best practices, State Bar reserves are defined as working capital (current assets less current liabilities). Since the State Bar uses Enterprise Fund accounting for its financial operations in accordance with Generally Accepted Accounting Principles (GAAP), working capital is the financial measure that most closely matches the concept of "fund balance" in the Governmental Funds and what is typically meant by the concept of "reserves" in a budgetary policy context. This is also the financial measure recommended by the Government Finance Officers' Association of the United States and Canada (GFOA) as a "best practice" in setting reserve policies for Enterprise Funds (web site link): www.gfoa.org/determining-appropriate-levels-working-capital-enterprise-funds

2. **Classification of Reserves.** The Governmental Accounting Standards Board (GASB) is responsible for establishing "GAAP" for state and local governments in the United States. For Governmental Funds, GASB Statement No. 54 adopted in 2009 requires that Fund Balance be classified into five components: non-spendable, restricted, committed, assigned and unassigned. While these classifications are only used for Governmental Funds and are not applicable to Enterprise Funds (in fact, there is no discussion under GAAP of the concept of "fund balance" or reserves for Enterprise Funds), they nonetheless provide a useful framework for assessing the State Bar's reserves. Accordingly, reserves will be classified within each fund (where applicable) as follows:

   a. ***Non-Spendable.*** Amounts that are not in spendable form, such prepaid items or inventories. (The State Bar does not currently have any reserves that would be classified as non-spendable.)

   b. ***Restricted.*** Revenues where the use is subject to *externally* enforceable restrictions imposed by outside third parties.

   c. ***Committed.*** These are outstanding obligations for contractual or policy commitment for programs or projects approved in prior fiscal years that are carried forward into the new year. They are typically composed of two types:

      - Encumbrances: unfilled purchase orders and outstanding contractual obligations at year-end. Since these commitments were made during the fiscal year, adequate resources should be available at year-end to cover them and carryover balances into the new fiscal year.

      - Policy Commitments: Balances formally set aside by the Board in order to fund future projects based on adopted plans.

   d. ***Assigned.*** Minimum reserve targets established based on assessing risks in accordance with the structured assessment methodology developed by the GFOA (see Section C), after addressing non-spendable, restricted and committed reserves.

e. ***Unassigned.*** Residual classification of spendable amounts available for other purposes. Under GASB Statement No. 54, unassigned fund balance should not be shown as a negative number. However, as noted above, GASB Statement No. 54 is only being used as a policy framework in assessing the State Bar's reserves. Accordingly, in the interest of policy clarity, where the State Bar's ending reserves are not sufficient to meet its non-spendable, restricted, committed and assigned amounts, the unassigned balance will be shown as a negative number in clearly disclosing how short reserves are in meeting policy goals.

B. ESTABLISHMENT AND CLASSIFICATION OF FUNDS

While usually created with the goal of improving accountability, the proliferation of funds often makes an agency's financial position and fiscal operations more confusing and less transparent. As such, in accordance with GAAP, the State Bar will limit the proliferation of funds and only establish separate funds where there are compelling policy reasons to do so. This approach will not only simplify accounting and financial reporting, but by focusing on meaningful resource restrictions and earmarking, it will improve accountability, transparency and understandability.

Program Funds

State Bar funds are organized into three Program Fund categories:

1. ***Restricted Funds.*** Using GAAP as the framework, "restricted" funds are those whose use is externally restricted via legislation, bond covenants or similar external restrictions. In short, to be classified as a "restricted" fund, the restriction must be externally imposed as set forth under GAAP. This this means that all special purpose assessments approved by the State Legislature, including voluntary ones, will be accounted for in a separate restricted fund. In the case of limited-term assessments that will expire at some point, the fund will be closed-out when the last assessment is received or all proceeds are used for designated purposes, whichever occurs last. Closed-out fund balances will typically be transferred to the General Fund; however, the Board will determine the disposition of any residual balances on a case-by-case basis. The following are Restricted Funds:

   a. Client Security Fund
   b. Elimination of Bias and Bar Relations Fund
   c. Equal Access Fund
   d. Justice Gap Fund
   e. Lawyer's Assistance Fund
   f. Legislative Activities Fund
   g. Legal Services Trust Fund
   h. Legal Specialization Fund
   i. Bank Settlement Fund[1]

[1] A new Fund to be established pursuant to the State Bar's receipt of $44 million in bank settlement monies to be used to support legal services in the areas of economic development and foreclosure prevention.

2. ***Special Revenue Funds.*** While these could be accounted for within the General Fund, there may be compelling policy reasons to account for the use of resources separately. In this case, separate "Special Revenue Funds" will be created, recognizing that in accordance with GAAP, these could have been accounted for within the General Fund. Board approval should be required to establish a Special Revenue Fund, with findings as to the fund purpose and why earmarking these resources is appropriate. The following are Special Revenue Funds.

   a. Admissions Fund
   b. Annual Meeting Fund
   c. Grants Fund
   d. Sections Fund

3. ***General Fund.*** All other revenues, expenditures and other uses will be accounted for in the General Fund.

C. MINIMUM RESERVE TARGET

The State Bar will maintain unrestricted, uncommitted reserves in its General Fund, and each fund within its Restricted and Special Revenue Program Funds, other than Excluded Minimum Target Reserve Funds, net of reserves that are non-spendable, restricted and committed, that equate to 2 months of operating expenses for the respective funds; this translates to a target minimum reserve level of 17 percent.

Excluded Minimum Target Reserve Funds include all grant-related Funds, specifically the Grant, Legal Services Trust, Equal Access, Justice Gap, and Bank Settlement Funds.

For purposes of the Minimum Reserve Target, operating expenses of the Client Security Fund shall exclude application payouts.

D. APPROPRIATE RESERVE USES

Circumstances where taking reserves below target minimum levels would be appropriate include responding to the risks that reserves are intended to mitigate, such as:

1. One-time uses in meeting cash flow needs; closing a projected short term revenue-expenditure gap; responding to unexpected expenditure requirements or revenue shortfalls; and making investments in human resources, technology, liability reductions, revenue base improvements, productivity improvements and other strategies that will strengthen State Bar revenues or reduce future costs.

2. Where a multi-year forecast shows an ongoing structural gap, in providing a strategic bridge to the future.

   Any expenditure that would cause the balance of the General Fund, or any fund within the Restricted or Special Revenue Program Funds, to fall to a level totaling 10 percent or less of recurring annual operating expenses, must be approved by the Board of Trustees.

E. FUND BALANCE SPEND DOWN WHEN RESERVES ABOVE POLICY LEVELS

Whenever reserve levels in the General Fund, or any fund within the Restricted or Special Revenue Program Funds, other than Excluded Excess Reserve Funds, surpass 30 percent, for a consecutive six month period, spend-down funding shall occur in accordance with the following principles:

1. Fund balance spend-down should be utilized to offset member dues and other assessments and use charges, where possible.

2. Fund balance spend-down should be used to advance strategic efficiency investments that will result in short- or long-term reductions in operating costs.

3. Fund balance spend-down should be used to bolster the Client Security Fund, where possible.

4. Fund balance spend-down should be used to increase legal services funding, where possible.

All spend-down in excess of $250,000 must be approved by the Board of Trustees.

Excluded Excess Reserve Funds include all grant-related Funds, specifically the Grant, Legal Services Trust, Equal Access, Justice Gap, and Bank Settlement Funds, and the Sections Fund.

F. **RESTORING RESERVES TO POLICY LEVELS**

Whenever reserve levels in the General Fund, or any fund within the Restricted or Special Revenue Program Funds, other than Excluded Minimum Target Reserve Funds, fall below the target minimum reserve level of 17 percent, the State Bar will strive to restore reserves to this level within five years. As revenues versus expenditures improve, the State Bar 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.

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