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# Rainy Day Funds? How to Determine Appropriate Reserve Amounts

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# Agenda

Importance

Metrics

How Much is Adequate?

Key Credit Factors

Drawing Down Reserves

Policies and Targets

# Why do reserves matter?

Revenue Volatility

Economic Events

Natural Disasters

Other Unexpected Outcomes

# What's the Metric?

Unrestricted fund balance as a percent of spending.

Other available restricted reserves. Are these available if needed and what is the requirement for replenishment?

Also look at condition of the other funds. Are there sizeable deficits in Internal Service Funds?

# How much is adequate?

No set fund balance prescription exists at any rating category.

Amount considered satisfactory varies based on such factors as economic or tax base concentration, revenue and/or expenditure volatility, and flexibility to adjust revenues and spending.

# Four key credit factors to consider:

- Economy
- Finances
- Debt
- Management

# Criteria Components are Interactive

## Debt and other long-term liabilities:

- Affordability of existing debt levels
- Future capital/debt needs - CIP
- Debt composition and amortization
- Pension and OPEB

## Economy:

- Employment Opportunities
- Employment Composition
- Education and income levels
- Quality of life attraction
- Tax base composition
- Top employers

## Finances:

- Revenue and Expense composition
- Structurally Balanced Operations
- Liquidity
- Reserve levels
- Contingency planning

## Management and administration:

- Most Subjective category
- Ultimately the most important
- Institutionalized and prudent policies
- Clear Vision
- Ability to adapt

# Stronger Credit Attributes

## Debt and other long-term liabilities:

- Debt per capita < \$2,000; debt to market value < 2%; low debt service burden < 5% of spending
- Modest future capital/debt needs; CIP updated regularly
- Rapid debt amortization , > 65% in 10 years
- Predominantly fixed-rate debt (< 15% variable rate)
- Consistent full funding of pension ARC (UAAL < 20%)
- Effective efforts to reduce OPEB liability

## Economy:

- Broad, diverse, stable economy
- Taxpayer concentration < 10% for top 10
- Consistent, moderate population and employment growth
- Major employer stability and diversity
- Robust wealth indicators
- Moderate tax burden relative to area and similar communities

## Finances:

- Diverse, stable, broad-based, flexible sources of operating revenues
- Ample ability to adjust spending without undue service impacts
- Consistently positive operating margins
- Consistently sound reserve levels
- Substantial available liquidity without borrowing

## Management and administration:

- Highly efficient decision-making process
- High performing elected officials, management
- Good management-labor relations
- Financial management: prudent policies consistently followed; conservative budgeting process; regular financial management reviews; contingency planning; long-term planning; timely reporting



# Midrange Credit Attributes

## Debt and other long-term liabilities:

- Debt per capita \$2,000 - \$4,000; debt to market value 2% - 5%; debt service burden 5% - 10% of spending
- Manageable future capital/debt needs; periodic CIP
- Moderate debt amortization , 40% - 65% in 10 years
- Mostly fixed-rate debt (15% - 25% variable/short-rate)
- Consistent full funding of pension ARC (UAAL < 30%)
- Some efforts to reduce OPEB liability

## Economy:

- Fairly diverse economy
- Taxpayer concentration 10% - 15% for top 10
- Stagnant or rapidly growing population
- Moderately diverse employment base with some concentration
- Sound wealth indicators

## Finances:

- Somewhat concentrated operating revenue with some flexibility to increase
- Some ability to adjust spending (potential service and timing impacts)
- General trend of positive operating margins
- Satisfactory reserve levels with some fluctuation
- Sound available liquidity with limited borrowing

## Management and administration:

- Efficient decision-making process
- Satisfactorily performing elected officials, management
- Reasonably productive management-labor relations
- Financial management: reasonable policies usually followed; realistic budgeting process; able to make midyear adjustments; timely reporting

# Weaker Credit Attributes

## Debt and other long-term liabilities:

- Debt per capita > \$4,000; debt to market value > 5%
- High debt service burden > 10% of spending
- Large future capital/debt needs; no published CIP
- Slow debt amortization, < 40% in 10 years
- Predominantly fixed-rate debt (> 25% variable-rate)
- Inconsistent full funding of pension ARC (UAAL < 30%)
- Limited efforts to reduce OPEB liability

## Economy:

- Small, limited, or concentrated economy
- Taxpayer concentration > 15% for top 10
- Declining or extremely rapid population growth
- Industry or employer dominance
- Below-average wealth indicators

## Finances:

- Severely limited revenue flexibility; revenue declines
- Little spending flexibility
- Trend of negative operating margins
- Low reserve levels without replenishment plans
- Low liquidity; reliant on short-term borrowing (< 15% of general fund receipts)

## Management and administration:

- Cumbersome decision-making process
- Unsatisfactorily performing elected officials, management
- Problematic management-labor relations
- Financial management: non-existent or inconsistently followed policies; optimistic budgeting process; inflexible budget adjustment process; inadequate reporting

# Weaknesses in one credit factor may offset strengths in another and vice versa

In general, more volatile financial profiles dictate the need for larger financial cushion that will give the entity time to react to a downturn

- Revenue raising flexibility and expenditure reduction flexibility are also important considerations for general fund balance reserves.

Credit concerns over high dependence in sales tax revenue may be offset by strong reserve levels.

Credit concerns over a very high pension obligation without the full funding of requirements may offset the strength of very high reserves.

# Drilling Down on Drawing Reserves

Reason for use? One time capital outlays or recurring operating expenses?

Was it planned?

If use is to offset decline in revenue, what is the entity doing to restore balanced operations (expenditure flexibility)?

What is the plan to replenish the reserves?

Did reserves drop below policy or targets?

# Formal Policies or Targets

Established reserves that benefit from automatic funding mechanisms and clear restrictions on use are the strongest credit features.

Fund balances that have been maintained consistently over time are also viewed positively.

Segregated funds that are available, or could be made available (by council or board action) for general expenditures are considered additional financial flexibility.

Fitch views reserve levels in light of any legal or statutory limitations and takes into account other efforts to maintain an operating cushion where reserve levels are restricted.

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