County of Fairfax, Virginia

MEMORANDUM

DATE: February 17, 2015

TO: Board of Supervisors

FROM: Edward L. Long Jr.
County Executive

SUBJECT: Strengthening County Reserves

At the November 25, 2014, Budget Committee meeting and again during the Board of Supervisors meeting on January 13th, the Board discussed the need to shore up County reserves in response to concerns from the rating agencies. I have summarized below the state of our reserves and recommendations for moving forward. I will discuss these recommendations at one of our scheduled Budget Committee meetings in more detail and can respond to questions by the Board.

Reserves are an essential part of strong financial management for municipal governments. They provide the County with options and alternatives to respond to unanticipated issues or events and serve as a buffer against emergencies or significant changes in revenues or unforeseen and emergency expenditures. The size of reserves and controls over them are dependent on many factors including the volatility and diversity of the revenue base, a jurisdiction's flexibility and willingness to reduce expenditures quickly and the external risks that may threaten the financial stability of a region. Sufficient reserve levels are also an essential part of the credit rating evaluation methodology utilized by the rating agencies. Despite a slight improvement in County reserve levels in FY 2014, the credit rating agencies still contend that the County reserves are not sufficient, especially when compared to other triple-A jurisdictions. As the Board is aware, the triple-A is extremely valuable not only as an indication of the County's strong financial management policies but also as it saves the County money on bond sales and allows ready access to the credit markets. The triple-A rating is synonymous with Fairfax County nationwide and must be maintained.

COUNTY POLICIES

The County has established two general reserves, the Managed Reserve and the Revenue Stabilization Fund, which together are equal to five percent of General Fund disbursements. The Managed Reserve is maintained at two percent of General Fund disbursements and provides for temporary financing of critical unforeseen disbursements of a catastrophic emergency nature. Fortunately, a withdrawal has never been made from the Managed Reserve. The Revenue Stabilization Fund is maintained at a target level of three percent of General Fund disbursements. The Revenue Stabilization Fund permits an orderly adjustment to changes resulting from

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curtailment of revenues during significant and rapid deterioration of the local economy. In order to make a withdrawal from the fund, projected revenues must reflect a decrease greater than 1.5 percent from the current year estimate, withdrawals must not exceed one-half of the fund balance in any fiscal year, and withdrawals must be used in combination with spending cuts or other measures. The County's available General Fund balance as of June 30, 2014, which includes the Managed Reserve and the Revenue Stabilization Fund as well as year-end encumbrances and other reserves like the Sequestration Reserve, was $302.2 million, or 8.4 percent of General Fund revenues and transfers in.

In addition, balances and reserves exist outside of the General Fund that could be used for General Fund expenditures if an extreme emergency arose. These include reserves for vehicle and technology hardware replacement, as well as reserves held for self-insurance losses based on an actuarial analysis as required by GAAP. Including these reserves, the County's total available fund balance as of June 30, 2014 was $451.8 million, or 12.5 percent of General Fund revenues and transfers in, as shown in the table below.

	$ in Millions
General Fund:	
Committed Fund Balance (Primarily Managed Reserve and Revenue Stabilization)	$220.6
Assigned Fund Balance (Encumbrances)	29.4
Unassigned Fund Balance	52.2
Total General Fund Available Fund Balance	**$302.2**
Non-General Fund:	
Community Services Board Reserves	$12.2
Elderly Housing Fund Reserves	2.7
Helicopter, Ambulance, Police Specialty, Large Apparatus and Vehicle Replacement Reserves in Vehicle Services Internal Service Fund	34.9
Technology Hardware Reserve in Technology Infrastructure Internal Service Fund	10.0
Outstanding Liability Reserve in County Insurance Internal Service Fund	47.2
Catastrophic Reserve in County Insurance Internal Service Fund	12.6
Litigation Reserve in County Insurance Internal Service Fund	30.0
Total Non-General Fund Available Fund Balance	**$149.6**
Total Available Fund Balance	**$451.8**

The table above displays all reserves and fund balances that have been recognized by the bond rating agencies as being available for operating purposes. In addition to these balances, the County holds multiple other reserves that are not available for General Fund use. These include reserves that are generated through taxes or fees for specific purposes, such as pest management, sewer service, and refuse disposal, as well as funds held in trust to pre-fund employee retirement benefits.

WHAT RESERVE LEVELS ARE RECOMMENDED

The Government Finance Officers Association (GFOA) provides concrete guidance on the appropriate size of reserves, recommending that the General Fund available fund balance be maintained at a minimum of two months, or 16.7 percent, of operating revenues or expenditures. GFOA recommends establishing a target level of fund balance at or above this minimum based

on factors including the predictability of revenues, the volatility of expenditures, the amount of exposure to one-time outlays, and the requirements of and resources available in other funds. However, GFOA notes that the appropriate level of fund balance for states and large local governments may be lower than the recommended two-month minimum, as larger jurisdictions tend to have more diversified revenues and expenditures, and are better able to predict contingencies.

The three bond rating agencies all include available fund balance as a significant factor in their ratings. Cash balance, a related measure, is also included. The rating agencies review reserve policies, the actual fund balance and trends in the fund balance in light of the jurisdiction's exposure to risk and financial volatility as well as its flexibility and demonstrated willingness to adjust revenues and expenditures when necessary. While specific information on the ratios used by Fitch to evaluate fund balances is not available, the criteria and weightings for Moody's and Standard & Poor's are presented below.

- MOODY'S
  Fund balance and cash balance each account for 15 percent, or a combined 30 percent, of the total rating criteria for Moody's. Moody's recognizes that smaller balances may be carried by jurisdictions with significant revenue-raising flexibility, while jurisdictions with exposure to substantial risks require larger balances. Moody's measures both fund balance and whether the level of reserves is increasing with budgetary growth. A fund balance in excess of 30 percent of General Fund revenues is required to achieve the highest score within this component of Moody's rating criteria.

- STANDARD & POOR'S
  Fund balance and cash balance each account for 10 percent, or a combined 20 percent, of the total rating score for Standard & Poor's. Standard & Poor's score may be increased by qualitative factors, such as fund balance projections for the current and following years, as well as the capacity and willingness to reduce spending or increase taxes. A fund balance in excess of 15 percent equates to a rating of Very Strong, the highest score in this category.

RESERVE POLICIES AND PRACTICES IN REGION

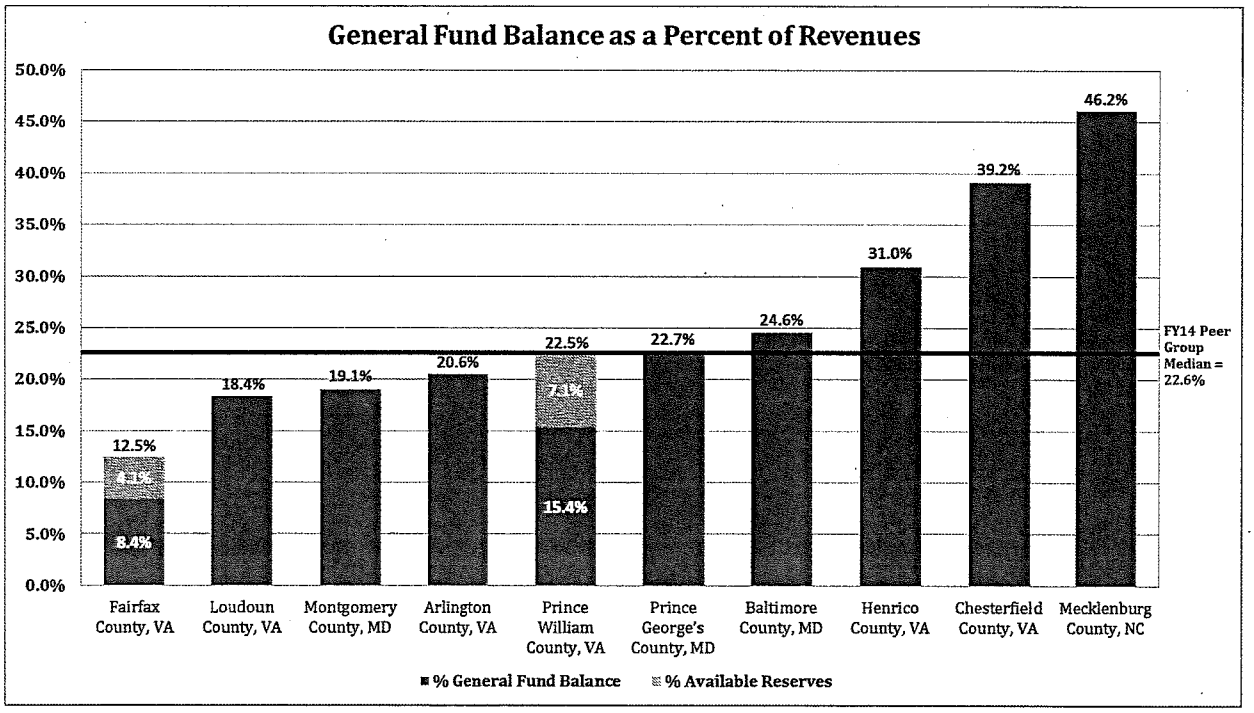
The reserve and fund balance policies and practices of other highly-rated jurisdictions have also been reviewed. Staff researched balance policies and the actual reserves of other triple-A jurisdictions including those in our region. The table below provides a comparison of Fairfax County to a select group of peer jurisdictions. Most of these jurisdictions are located near Fairfax County, and all have received triple-A ratings from all three bond rating agencies. All of these jurisdictions have established a minimum fund balance policy ranging from 5 to 15 percent of revenues or expenditures. These fund balance policies typically apply to the level of general reserves held in the General Fund, specifying the level of funding to be held in unassigned fund balance or in a named reserve such as a revenue stabilization reserve or a contingency reserve. In addition to the balances required by their fund balance policies, unspent funds fall to fund balance at the end of the fiscal year and these jurisdictions may have additional reserves. Therefore, actual available balances are higher and range from 18.4 percent to 46.2 percent, with a median balance of 22.6 percent. In sum, the County's reserves in practice are the lowest of

these comparator jurisdictions. In addition, the County's reserve policy is among the lowest. Moody's further validated this point in their most recent report to the County noting "we will continue to monitor the County's ability to increase reserves to levels more in-line with like-related entities."

Comparison of Reserve Policies and Actual Balances	Fund Balance Policy	Available General Fund Balance
Mecklenburg County, North Carolina[1]	8.0%	46.2%
Chesterfield County, Virginia	8.0%	39.2%
Henrico County, Virginia	15.0%	31.0%
Baltimore County, Maryland	7.0%	24.6%
Prince George's County, Maryland	5.0%	22.7%
Prince William County, Virginia[2]	8.5%	22.5%
Arlington County, Virginia	5.0%	20.6%
Montgomery County, Maryland[1]	10.0%	19.1%
Loudoun County, Virginia	10.0%	18.4%
Fairfax County, Virginia[2]	5.0%	12.5%

[1] Fund balance policy for Mecklenburg County, NC, requires that total fund balance be maintained at 28% of actual revenue, and that unassigned fund balance be maintained at 8% of actual revenue. Fund balance policy for Montgomery County, MD, applies to unrestricted fund balance. Fund balance policies for all other jurisdictions listed apply to the unassigned fund balance or to a named reserve such as a revenue stabilization reserve or contingency reserve.

[2] Available Balances for Fairfax County and Prince William County include General Fund Available Balance and Non-General Fund balances that have been identified as being available for General Fund use. Available Balance for all other jurisdictions is based on total General Fund balance, excluding nonspendable balances, as published in most recent available CAFR documents.



RECOMMENDATIONS

As a result of this review, as well as discussions with rating agencies and the County's financial advisor, the following policy changes and implementation steps are recommended that would

increase the County's total reserve policy from the 5 percent that is currently required to 10 percent. Specifics include:

1. Ensure that FY 2015 CAFR balances are consistent with FY 2014 levels: This will require replacing funds used from the litigation reserve prior to the end of the fiscal year. Moody's again reiterated this point in their recent report stating "any additional declines in the County's reserves could result in additional negative pressure" on the County's bond rating. As a result, staff will be including in the *FY 2015 Third Quarter Review* a number of adjustments to replenish the litigation reserve as necessary. Staff will examine capital and debt funds to reallocate available balances to the litigation reserve. The projected FY 2015 year-end available balance cannot fall below the FY 2014 level of 12.5 percent.

2. Increase Existing Reserves: Staff recommends that the Board adopt policies to increase the target balance of the Managed Reserve from 2 percent to 4 percent of General Fund disbursements, and increase the target balance of the Revenue Stabilization Fund from 3 percent to 5 percent of General Fund disbursements.

3. Establish a New Reserve: Staff recommends that the Board create a new reserve with a target balance of 1 percent of General Fund disbursements, for the purpose of allowing strategic investment in economic development opportunities that are identified as priorities of the Board. This reserve would be funded after funding has been accumulated to increase the Managed Reserve and Revenue Stabilization Fund to their new target levels. Criteria on how this reserve could be utilized will be established after further discussion with the Board.

4. Adjust and reaffirm the County's Ten Principles of Sound Financial Management when the Board adopts the Budget in April: This will send a clear message to the rating agencies of the County's commitment to sound financial management and the resolve to make the difficult financial decisions.

Implementation:

1. Discuss these recommended actions during our scheduled budget meetings on the FY 2016-FY 2017 Multi-Year Budget Plan.

2. Funding of increased reserves to be provided by:
   a. Any one-time revenue (insurance reimbursements, significant refund revenue based on state audit, etc.)
   b. 40% of year-end balances not required for critical purposes
   c. Savings from bond refundings and other one-time savings
   d. Consolidation of existing balances
   e. Budget funds for reserve when available

3. Demonstration of the Board commitment to our reserves by an immediate deposit into the Revenue Stabilization Fund to increase its level as part of the *FY 2015 Third Quarter Review*.

4. Review allocation and presentation of available balances as presented in the CAFR to consolidate balances so they can be included in the reserve calculations and methodologies used by the rating agencies. A review of some of the practices of other jurisdictions indicates that some funds that the County now holds in reserve in non-General Fund accounts are reflected in the available reserves in other jurisdictions. An example of such a County non-General fund reserve is the funding the County holds in the self-insured health benefits fund where approximately two months of premiums are identified in reserve. This funding could be moved and captured as an available fund balance. This would not require a new policy as the reserves are already identified but would require some change to budget and financial reporting practices. Staff will review other available reserves to see whether a recast as available fund balance is possible.

The work of identifying, funding, and accumulating reserves will be ongoing and take time. A prudent plan is essential to preserving the County's triple-A rating which has significant benefit to County services and priorities. Staff will provide the Board with draft policy statements to implement these strategies as part of the FY 2016 budget adoption process.

I look forward to discussing these recommendations with the Board. Maintaining the triple-A rating is critical to the County's financial foundation and economic success. If you have any questions please give me a call.

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