Response to Questions on the FY 2009 Advertised Budget Plan

Request By: Supervisors Gross and Hudgins

Question: Provide more information on the Revenue Stabilization Fund.

Response: See attached memorandum from the County Executive on the Revenue Stabilization Fund.

County of Fairfax, Virginia

MEMORANDUM

DATE:

TO: Board of Supervisors

FROM: Anthony H. Griffin
County Executive

SUBJECT: Revenue Stabilization Fund

On September 13, 1999, the Board of Supervisors established a Revenue Stabilization Fund (RSF) to allow the County to adjust to changing economic conditions with a measured response that would not require sudden and drastic reductions to County and School programs. The County's RSF is targeted at three percent of General Fund disbursements. Funding for the reserve was made available from non-recurring balances identified at quarterly reviews. The Reserve was not fully funded until the *FY 2006 Third Quarter Review*, nearly seven years after its inception.

The RSF is maintained in addition to the two percent Managed Reserve at a level sufficient to permit orderly adjustment to changes resulting from the curtailment of revenue. Based on current Board Policy, use of the RSF should only occur in times of <u>severe</u> economic stress. Accordingly, a withdrawal from the RSF will not be made unless the projected revenues reflect a decrease of more than 1.5 percent from the current year estimate (approximately $50 million), any such withdrawal may not exceed one half of the RSF fund balance in that year and withdrawals from the RSF shall be used in combination of spending cuts or other measures.

Maintaining sufficient levels of unreserved fund balance is critical for several reasons. Unreserved fund balance provides a source of internal liquidity to help smooth out the seasonality of public sector cash flows. Unreserved balances also provide resources for contingencies such as unanticipated requirements, unexpected changes in State or Federal polices, significant losses in revenues based on economic factors or the impact of natural or manmade disasters. In addition, credit rating agencies have repeatedly stressed the maintenance of adequate reserves as a benchmark measure of economic and credit strength. An appropriate level of unreserved fund balance is an essential credit factor because it better insures the timely and full payment of debt obligations, enhances financial flexibility to handle unforeseen events and demonstrates the commitment of the jurisdiction to the principles of sound financial management.

The Government Finance Officers Association (GFOA) recommends, at a minimum, that general-purpose governments, regardless of size maintain unreserved fund balance in their

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General Fund of no less than five to 15 percent of regular General Fund operating revenues or of no less than one to two months of regular General Fund operating expenditures.

The County's Revenue Stabilization Fund has been cited as an important factor in numerous credit rating reports done on the County by the three rating agencies. As late as January 2008, Moody's noted the RSF, "The County continues its practice of strong budgetary control of spending and a conscientious reliance on a number of self-imposed financial and debt management guidelines. The County board has required the maintenance of General Fund reserves in the 4% to 5% range. While this is modest on a percentage basis, Moody's believes that the County's consistent history of meeting its budget and monitoring its budget on a monthly basis, as well as its maintenance of undesignated reserves, render this amount satisfactory."[1] Both Standards & Poor's and Fitch rating agencies have also made notice of the reserve and the Board's policy for withdrawal of funds. All the rating agencies have noted that consistently strong financial management has been a key factor in assessing the strength of Fairfax County.

A number of questions have been raised about the Revenue Stabilization Reserve. I have summarized staff responses to these questions below.

1. Are there legal impediments to modification of the criteria established for the County's Revenue Stabilization Fund?

According to the County Attorney, there is no legal restriction that would prohibit the Board from modifying the previously adopted criteria.

2. Since its inception, have County revenues been below estimates to such an extent that the Revenue Stabilization Reserve would have been triggered?

No. In FY 2002, actual General Fund revenues were 0.23% below the FY 2002 Adopted level. During that year, the County reduced its revenue estimates as part of the Midyear and Third Quarter Reviews for a total reduction of 0.8 percent.

However, revenue projections were reduced from the Adopted Estimate by more than 1.5 percent during a Quarterly Review two times since FY 1990. This occurred in FY 1991 and FY 1992.

3. How do other Triple AAA counties compare in terms of reserves?

When compared to other AAA jurisdictions, the County ranks among the lowest for maintaining an adequate fund balance. In a recent Moody's review of 44 Moody's AAA-rated counties, the average balance maintained was 16.9 percent. It should be noted that the comparable figure for Fairfax County would be approximately nine percent as this data

[1] Moody's Investor Services, January 4, 2008.

includes all of the undesignated fund balances as a percentage of projected revenues and transfers in to the General Fund.

In 2005, Standard and Poor's noted that the average unreserved general fund balance for the 'AAA' counties is 29% of expenditures, while the median is 18.5%. Fairfax County was at the very bottom of the range in this analysis with a 6.2% reserve which accounted for the County's managed reserve, the Revenue Stabilization Fund and balances remaining at year end. The credit agency highlighted the stability of the balances among the 'AAA' counties which remained virtually unchanged from the 2002 report, noting "this is even more impressive when considering that the latest figures capture the effects of the recession."[2]

There are a number of Triple AAA counties that have established very similar rainy day reserves. For example, Baltimore County, Maryland has an established Revenue Stabilization Reserve Account (RSRA), which serves as a hedge against major revenue shortfalls and other fiscal emergencies. Baltimore County's Account has a target rate of **five percent** of General Fund revenues and if a deficit exists, use of the funds requires approval by the County Executive and the County Council. In FY 2007, the Account was equal to approximately $78 million or roughly 4.9 percent of General Fund revenues. Use of the RSRA requires the approval of the County Executive and the County Council.

Montgomery County, Maryland has a Revenue Stabilization Fund that is very similar to Fairfax County. Montgomery County's Fund has the purpose of coping with unanticipated revenue shortfalls or unexpected expenditure requirements. According to the Fund Reserves Policy, Montgomery County must maintain a budgeted total reserve, comprised of an Operating Margin Reserve and a Revenue Stabilization Fund that is equal to at least **six percent** of total resources. The RS Fund may be used only when economic conditions have met two of the following criteria: General Fund revenues are two percent lower than projected, residents' unemployment has worsened for six consecutive months, the local index of economic indicators have decreased for three months or decided otherwise by six or more council members. The 2009 Montgomery County budget presentation stated that the RS Fund has a projection of $119,648,000 for the upcoming fiscal year. This projected amount combined with the Operating Margin Reserve maintains the reserves at the policy level of six percent.

Another Triple AAA county that has a fund similar to the RSF in Fairfax is Chesterfield County, Virginia. Chesterfield County uses its undesignated fund balance to cope with unexpected financial problems or emergencies where the Board of Supervisors approves all uses of the fund. The fund has a target rate of **seven and one-half percent** and a floor of five percent of General Fund expenditures; however, in FY 2006 the fund exceeded the target with $71 million or approximately 11 percent of General Fund expenditures in reserve. In FY 2007, the fund was utilized and depleted to $46 million or approximately seven percent,

[2] Standard & Poor's Ratings Direct, "The 2005 Annual Review of 'AAA' Rated US Counties, October 5, 2005.

although it still stayed above the floor of five percent. Currently the fund is equal to 7.09 percent of General Fund expenditures, or approximately $48 million.

4. What has been the savings to the County as a result of its Triple AAA rating from all three rating agencies?

On January 15, 2008, Fairfax County sold General Obligation and Refunding Bonds to Bank of America at the interest rate of 3.77 percent. An amount of $234.475 million in Aaa/AAA/AAA rated general obligation bonds was sold. The 3.77 percent interest rate is the fourth lowest interest rate achieved by Fairfax County since the first AAA was awarded by Moody's Investors Service in 1975. This very low interest rate reflects a number of favorable factors. Timing the sale for January allows the County to take advantage of a period of low supply. This year the advantage was enhanced by the recent volatility in the bond markets resulting from the subprime mortgage losses which created more demand for high quality investments. As a natural AAA credit, Fairfax County can be expected to be a market leader. The value of maintaining the AAA cannot be more evident than completing a highly successful sale in a turbulent market.

Proof of the favorable reception of these bonds in the market place is borne out by the fact that this interest rate represents a differential of 44 basis points under the Bond Buyer Index, which stood at 4.21 percent on January 11, 2008. There were 8 bids submitted with a high bid of 3.797 percent. This is a very narrow margin of difference between the low bidder and the high bidder with the high bidder off the mark by only 2.7 thousandths of a percent or 2.7 basis points with one basis point equal to one hundredth of a percentage point (0.01%).

It should be noted that since 1978, the County has saved approximately $251.21 million on bond sales due to its Triple A rating on new public improvement bonds. Including refunding sales, the County has saved over $351.67 million as a result of the AAA rating.

5. What actions have been taken relative to the Commonwealth of Virginia's rainy day fund and what has been the reaction of the credit agencies to these actions?

The General Assembly established Virginia's Revenue Stabilization Fund in 1993. The fund consists of an amount not to exceed ten percent of the Commonwealth's average annual tax revenues derived from taxes on income and retail sales. As laid out in Article X of the Virginia Constitution, the General Assembly may appropriate an amount for transfer from the fund to compensate for no more than one-half of the difference between the total General Fund revenues appropriated and a revised General Fund revenue forecast presented to the General Assembly prior to or during a subsequent regular or special legislative session. In practice, the transfer from the fund is not possible unless General Fund revenue estimates are two percent or more lower than the budgeted revenues and no more than one half of the balance of the Revenue Stabilization Fund may be used in any one fiscal year. The actual balance of the State's Revenue Stabilization Fund is $1.2 billion as of March 2008.

Actions necessary as part of the 2002-2004 biennium included drawing down reserve funds. The Revenue Stabilization Fund was drawn down significantly in FY 2002 and FY 2003. In September 2003, Moody's Investor Services placed the Commonwealth of Virginia's General Obligation bond rating with a negative outlook and added it to the Watch List for possible downgrade. Stating the Watch List action was promoted by fiscal pressures brought on by a weak economy and a significant revenue shortfall, the credit agency noted the Revenue Stabilization Fund withdrawals stating, "slow economic and fiscal recovery coupled with increasing spending requirements for Medicaid and other programs will likely compete with the need to replenish reserves and restore structural balance in the near term."[3] Virginia's rating was removed from Watch List for possible downgrade in May 2004 as a result of actions taken in the FY 2004-2006 biennium to constrain spending and increase recurring revenue. In addition, the State committed to replenishing its reserves.

As part of the FY 2008-2010 biennium budget, the General Assembly approved a net withdrawal from the State's Revenue Stabilization Fund of nearly $300 million.

6. What factors should be considered in utilizing the Revenue Stabilization Fund?

Size of Reserve: As noted earlier, the County's combined RSF and managed reserve at 5 percent is relatively low when compared to other Triple AAA categories or GFOA recommended practices for jurisdiction of any size. Our current RSF fund is fully funded at $101 million. For perspective, the average bi-weekly County payroll is approximately $34 million, excluding fringe benefits. The Schools monthly payroll is approximately $130 million, excluding fringe benefits. At this level, the Revenue Stabilization Reserve would be available to fund less than one month of salaries for both the County and School systems.

The importance of having a sufficient reserve was reinforced in 2005 with the devastating impact that Hurricanes Katrina and Rita had on the Gulf Coast, and particularly in the City of New Orleans where over half of the municipal workforce and virtually all of the 7000 school district employees were laid off, with most services suspended as insufficient reserves were available to meet payroll requirements. In times of crisis, residents look to government at the federal, state and local levels to meet their needs. Ongoing County services will be essential should a significant catastrophe befall our region. In the words of Mayor Capitano of Kenner, Louisiana, in his September 2005 State of the City Address, "The progress we have made since [Katrina] is nothing short to miraculous. But I can tell you that it really wasn't a miracle, but careful planning which enabled us to move so quickly and efficiently in this recovery process. It started with the bold move of our city council last year… in returning all surplus funds to our general fund to boost that emergency account we call the rainy day fund. Well that rainy day came…it was called Katrina… and without that reserve of $4.6 million that we had in the bank leading up to Katrina… we would have been in a world of hurt…unable to make payroll like other communities. During the past two weeks alone, we have incurred over $500,000 in overtime- essential overtime. In addition, we have the funds to pay those 16 work crews that

[3] Moody's Investor Service, Rating Update, September 4, 2003

have been clearing the debris … and while we will be reimbursed by FEMA, we don't know when the check will come."[4] To add some perspective, the City of Kenner's total General Fund budget in 2005 was $50.1 million; Kenner's rainy day fund at the time was equal to about nine percent of its total budget.

Definitions of when it is truly "raining" differ, but it is clear that funding must be available for disaster recovery or other emergencies.

Likelihood that Reserve Will Be Replenished Quickly: The RSF required nearly seven years of contributions in order to be fully funded. Given the current forecasts for the General Fund over the next several years, it seems unlikely that the reserve would be able to be replenished quickly. Balances made available as part of the FY 2007 Carryover were used to fund the FY 2009 budget and any balances that may result at the end of FY 2008 will be limited and will be necessary to hold for FY 2010 requirements.

Clearly any action to use the Revenue Stabilization Fund should be accompanied by the establishment of a mechanism to replenish the reserves once they have been drawn upon. This reserve replenishment process is essential but will limit future years flexibility. A written replenishment policy provides some assurances to investors that the rebuilding of the reserve is a priority and will be balanced when conditions improve against other budget requirements.

Recurring Nature of Required Use: The funds in the RSF represent one-time, non-recurring funds that must be used to address longer term recurring issues. If those funds were used for recurring expenditures, the County would create an even large structural imbalance in the budget. At best, the RSF should serve as a temporary stop gap measure in an emergency situation until more dramatic and long term actions can be considered.

cc: Fairfax County School Board
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[4] Mayor Capitano State of the City Address, City of Kenner, Louisiana, September 15, 2005.