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Banking & Advisory Group

In Consideration of a Fund Balance Policy©

FUND BALANCE POLICY AND THE RATING PROCESS

While it is difficult to identify, with certainty, all of the aspects that affect the assignment of a bond rating our experience is that the rating evaluation process is comprised of the following factors:

Factors That Drive Rating Changes

Credit Factors	Potential Rating Change Driver
Economy	• Significant development in the local tax base driving continued growth in total property values. • Increased or decreased diversification of local tax base. • Loss of key industry or employer with no work-out plan.
Finances	• Expected augmentation (or loss) of financial flexibility. • Expectation that significant growth (or decline) of reserves will continue.
Debt	• Significant increase in debt obligations without correlating development to offset tax-base leveraging. • Utilization of debt structure not appropriately matched to asset's useful life.
Management	• Implementation of new strategies that are expected to augment (or detract) from operating flexibility. • Change in political environment that affects ability to react to unanticipated events.
Legal Security	• Indenture for non-tax backed debt; Regulatory agency permission; Financial flexibility: Unlimited, Limited or Restrictive.

Financial analysis involves a great deal more than just reviewing year-end financial statements. Although statements of operating results and year-end financial position are important, they reflect only a snapshot of time. These indicators only have analytic significance when placed in a proper context. For example, a large budget surplus may appear impressive, but could actually have negative implications if it results from a municipality's inability to execute certain spending programs, or results in taxpayers' taking legislative action to limit taxation. Conversely, a planned drawdown of a prior surplus (particularly to fund one-time expenditures such as capital or prior year's projects) may not signify fiscal problems. In fact, an established trend of financial performance and control is more important to the analytical process than year-end figures alone. Budgetary planning and projecting, in conjunction with daily spending control, as well as an issuer's policies on spending growth, use of surplus, and shortfall contingency plans are all incorporated into the credit analysis.

However, the rating review process *specifically emphasizes* a municipal government's ability to bridge the timing differences between its receipts and its disbursements ... as a measure of its liquidity vis-à-vis ability to meet its obligations in a timely manner. The fund balance position is a measure of an issuer's financial flexibility to meet essential services during periods of limited liquidity. *The rating agencies consider an adequate fund balance to be a credit strength.*

This is based primarily on conservative business practices, that ongoing expenditures be financed by recurring revenues! Normal costs should be covered from basic revenues, without reliance on one-time assessments or fees; analysts expect any unexpectedly increased costs to be quickly addressed through internal resources. The level of fund balance is related to the likelihood of drawing upon these accumulations. Generally, a fund balance > 5% of the budget is deemed prudent. A smaller balance may be justified by a long-term trend of annual budget surplus, while a larger balance may be warranted, particularly if budget revenues and expenses are economically sensitive or other- wise not easily forecasted. While positive operating results and a large fund balance provide financial strength, a planned drawdown of balances and actual performance consistently close to original budget estimates are *evidence of strong management control*. Prudent management will also insure that the investment of cash balances is done carefully and conservatively. For example, Moody's Investors Service states:

> "One financial statistic that is key to evaluating financial strength is the General Fund balance as percent of revenues. This ratio provides a measure of the financial reserves potentially available to fund unforeseen contingencies. The level of fund balance should be related to the likelihood that such reserves will be needed, as well as the issuer's revenue raising flexibility. Larger balances may be warranted if budgeted revenues and expenditures are economically sensitive and therefore not easily forecasted. Moody's likes to see a General Fund balance sufficient to address *normal* contingencies which, as a general guideline, is typically *between* 5-10% of annual revenues [emphasis added]. It is important to emphasize, however, that the appropriate level of fund balance varies depending upon the particular issuer and its respective operating environment. Moody's examines a range of other financial data, such as annual growth in revenues and expenditures; the amounts of and reasons for interfund transfers; primary revenue sources and expenditures items; the composition of assets and liabilities; cash position; and actual financial performance relative to budget." (*The Determinants of Credit Quality*, Moody's Investors Service – November 1999)

In addition to quantitative factors, *qualitative* information weighs heavily in credit analysis. In fact, the whole concept of credit ratios/benchmarks cannot quantifiably measure management factors, administrative characteristics and other structural issues facing a government entity, by their inherent subjective nature, that can be overriding factors in a rating. Management can contribute significantly to many of the individual credit benchmarks and can positively impact

ratings in a number of ways. Conversely, the lack of strong management is usually a significant factor in a weakened credit profile. As displayed in the introductory chart, management is a major focus of credit evaluation. To a large extent the economy will determine a rating category but management will be one of the deciding factors in the final rating. The management or administrative structure of a government will move a rating up or down probably more significantly and swiftly than any other element of a credit review. For example, in Standard & Poor's top 10 list of *Best Management Practices Make a Difference* (Standard & Poor's – June 5, 2000), the #1 item is:

"1. *Establishing or enhancing rainy day /budget stabilization reserves.*

A *formalized* financial reserve policy is a consistent feature of most of Standard & Poor's highly rated credits. It has been standard operating procedure for some governments for decades. Others focused attention on this immediately following the early 1990s recession when it was a challenge to set aside the money. Many state and local governments are just starting to focus more attention here after seven or more years of steady economic expansion. Some important considerations when establishing a reserve are:

- What the government's cash flow/operating requirements are;
- The historical volatility of revenues and expenditures through economic cycles;
- Will the fund be a legal requirement or an informal policy;
- Under what situations can the reserves be drawn down; and/or
- Will there be a mechanism to rebuild reserves once they are utilized."

In Summary

Both rating agencies believe that careful, *institutionalized policies*, contribute to an issuer's ability to withstand unforeseen downturns without compromising recurring structural balance (annual revenues equal to or greater than annual expenditures). And, that cautious financial policies enable local issuers to maintain or build their reserves and invest in technologies which, in turn, support more timely and accurate accounting, reporting, and oversight procedures.

Because the rating agencies focus on expected financial trends and anticipated fiscal flexibility (often determined by state legislation and type of governmental unit), they do not prescribe that cash or fund balance be augmented to a particular level prior to a rating upgrade. However, they do focus on factors that result in a particular level of reserves with careful scrutiny placed on an issuer's expected ability to maintain the higher level of financial cushion in the future. It is our experience that, to the extent that reserves are bolstered and are expected to be maintained (and should the prior financial position have detracted from other favorable credit fundamentals), a rating upgrade may be rewarded.

In summary, as previously alluded to administrative factors are perhaps the most difficult credit fundamentals to assess because they are not easily quantifiable. An evaluation of management is, however, crucial because ultimately it will be management's responsibility to seize upon economic opportunities, adopt a budget, and take corrective action as may be necessary, to realize targeted results. Despite the qualitative nature of a management assessment, there are a number of elements that are regarded as indicators of management strength which are important to an analyst's ... or an investor's ... evaluation. They are: an issuer's organization; division of responsibilities; professional qualifications; and, sufficiency of power to perform its functions.

A formalized Fund Balance Policy is an indication of "good" Management. It also exists as a positive discipline ... that may be politically hard to implement when most needed!