A Local Government Guide to Financial Policies
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Financial Policy Overview
Financial Policy Overview

- Most local government decisions are ultimately driven by an entity’s financial position.

- Effective financial policies, which are ideally adopted by a legislative body, help guide decision making and are essential to a local government’s long-term fiscal health.
  - Financial policies help to provide stability and continuity over the years as staff and elected officials turn over by establishing benchmarks against which a local governments can measure performance.

- According to GFOA, “Financial policies provide written guidance for financial decision making and set strategic intent for financial management and are central to a strategic, long-term approach to financial management.”

Source: GFOA and MRSC Websites
Importance of Financial Policies
Importance of Financial Policies

- Institutionalizes good financial management practices;
- Clarifies strategic intent for financial management;
- Defines boundaries;
- Supports good bond rating and lowers borrowing costs;
- Promotes long-term strategic thinking;
- Manages risks to financial condition; and
- Complies with established public management best practices.

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**THERSE SHALL BE A REVIEW OF THE CITY'S FINANCIAL POLICIES EVERY FOUR YEARS AT THE SEATING OF A NEW CITY COUNCIL.**

**DEBT AND FINANCIAL ADMINISTRATION POLICIES**

**EFFECTIVE DATE:** JULY 1, 2015

1. The City will not use long-term borrowing to finance current operations or normal maintenance.

2. Capital projects financed through the issuance of bonds and capital lease purchases shall not be financed for longer than the expected useful life of the improvements.

3. The City will not issue tax or revenue anticipation notes to fund governmental operations.

4. The City will not issue bond anticipation notes (BANs) for a period longer than two years after the completion of a project. If the City issues a BAN for a capital project, the BAN will be connected to a long-term bond or redeemed at its expiration, but will not be rolled over.

5. The City will strive to increase its reliance on current revenue to finance its capital improvements. The City is committed to finding a significant portion of capital improvements on a "pay-as-you-go" (PAYGO) basis. Therefore, the City will strive to increase each year the percentage of its capital improvements financed by current revenues.

6. The City will pursue a policy of designating excess General Fund balance over the target ratio amount of fifteen percent of undesignated fund balance for the purpose of providing PAYGO funding for the Capital Improvement Program.

7. The City will not use General Fund equity to finance current operations. The City's General Fund equity balance has been built over the years to provide the City with sufficient working capital and enable it to finance unforeseen emergencies without borrowing. Use of General Fund equity shall be done in accordance with the provisions of the Financial Administration Policies contained herein.

8. The City Code requires that the Water and Sewer Enterprise Funds debt service will be self-supporting. A formal rate study will be done every ten years, or as may be required by any Trust Indenture the City enters into in connection with Revenue Bonds, to ensure that the rates and fees will be sufficient to cover the debt service requirements as well as the operating costs. Additionally, rates and charges will be reviewed annually during the budget process to ensure ongoing compliance with formal rate studies.

Source: GFOA Website
Rating Agency Views on Financial Policies

- All three national rating agencies have recently revised their criteria for rating general obligation bonds and have put a greater emphasis on financial policies and long-term planning.

- It is important for local governments to have a good understanding of how their fiscal policies align with rating agency expectations to ensure assignment of the best credit rating.

- While rating agencies won’t be prescriptive on policies, they can provide general feedback on how policies compare to other peers.
  - If a policy revision is being considered, reaching out and communicating with the rating agencies before adoption can be beneficial.

- If a policy is adopted, the rating agencies want to ensure that policy can met and maintained.
  - If a local government falls outside its policy threshold, ratings agencies like to see an established plan (best if within written policy) for regaining compliance with current policy.
Types of Financial Policies
Types of Financial Policies

- Financial policies can include a wide-variety of topics, but some should be considered more essential to a local government’s financial health.

- According to GFOA, below is a list of financial policy categories that all local governments should consider adopting:

<table>
<thead>
<tr>
<th>1) Fund Balance/Reserves</th>
<th>6) Accounting, Auditing, and Financial Reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>2) Debt Management</td>
<td>7) Operating Budget</td>
</tr>
<tr>
<td>3) Investments</td>
<td>8) Procurement and Purchasing</td>
</tr>
<tr>
<td>4) Capital Improvement Planning</td>
<td>9) Risk Management</td>
</tr>
<tr>
<td>5) Long-Term Financial Planning</td>
<td>10) Economic Development</td>
</tr>
</tbody>
</table>

- Over the next few slides, we will discuss the policies on the right-hand side of the table in more detail, as these tend to be the policies that the rating agencies focus on during their credit reviews.
Fund Balance / Reserve Policy

- A fund balance policy should establish minimum levels for designated funds to ensure stable service delivery, meet future needs, and protect against financial instability (revenue shortfalls and unanticipated expenditures).

**Fund balance is most important rating factor, so ensuring a strong reserve position is critical to maintaining high-grade credit ratings.**

- When establishing a reserve policy, the policy should focus on the following:

  - **Scope and Purpose**
    - Need to identify what funds will be included and what purpose are the reserves intended for

  - **Appropriate Fund Balance Level**
    - Adequacy of fund balance should take into account each government’s unique circumstances including predictability of revenues and volatility of expenditures; exposure to significant one-time outlays; support of other funds outside the General Fund; impact on bond rating; and extent of commitments and assignments of fund balance.
    - GFOA recommends that local government maintain no less than two months of regular General Fund operating revenues or expenditures for unrestricted fund balance.

  - **Use and Replenishment of Funds**
    - Policy should define conditions under which fund balance can be utilized, and if fund balance falls below policy level, a plan to replenish it (typically 1-3 year period).
Fund Balance / Reserve Policy (Continued)

- Fund balance policies typically range between 10%-20% of revenues/expenditures.
  - Policies below the 10% threshold don’t hold as much weight in rating committee.

- While below national medians for available fund balance, Virginia local governments are known for strong reserve levels, policies, and overall financial management. These factors support the high-grade credit ratings that are prevalent within the Commonwealth.

| National City Median Available Fund Balance | 33.5% |
| Virginia City Median Available Fund Balance  | 23.1% |
| National County Median Available Fund Balance| 31.7% |
| Virginia County Median Available Fund Balance| 21.0% |

- There can be many variations on how a fund balance/reserve policy can be set-up, from the fund balance designation to the naming convention for that policy.
  - While the structure of the fund balance policy will be noted by rating committee, no single structure is better than the other.
  - The most important aspects are that a local government has a fund balance policy that they are meeting/exceeding, expecting to remain in compliance with in the near-term, and what total available reserves are compared to peers.

Source: Moody’s MFRA Database
Rainy Day Fund would only be used for extreme one-time situations and would require super-majority vote of governing body before it could be utilized.

– If Rainy Day Fund fell below policy, a plan for replenishment within three years would need to be drafted.

Budget Stabilization Fund acts as first line of defense to balance a budget or address an immediate need, but is not meant to be a source of recurring revenue.

Capital reserve allows government to set-aside extra funds to support ongoing reinvestment and maintenance of capital infrastructure.
The amount of debt a local government issues is another important factor in measuring its financial health.

- Issuing debt obligates a local government to pay debt service over 20 years or more, and as a result can have a significant impact on that government’s fiscal condition for an extended period of time, ultimately limiting funding available for other operating purposes.

According to GFOA, debt management policies are written guidelines and restrictions that affect the amount and type of debt issued by a government, the issuance process, and the management of a debt portfolio,

- These policies help to articulate a local government’s goals with respect to debt; enhances a government’s ability to make decisions on issuing debt; exhibits a commitment to long-term financial planning that will ensure sound fiscal health; and most importantly demonstrates to the rating agencies that debt obligations are being well managed and met.
When establishing a debt management policy, the policy should focus on the following:

- **Scope and Purpose**
  - Provides overall goal that local government would like to achieve by adopting debt management policy.

- **Uses of Debt**
  - Outline when it is appropriate to utilize debt and for what purposes.
  - Consider Capital Improvement Plan to demonstrate commitment to long-term planning.

- **Types of Debt Permitted**
  - Outline types of short and long-term debt that are permitted to be issued, what each type can be utilized for, and when it is appropriate to issue each form of debt.
  - This includes the permitted use of variable rate debt and derivatives, as this exposure is assessed by rating agencies during credit reviews.

- **Debt limitations**
  - States typically establish legal debt limits on the type and amount of debt that can be issued by local governments.
    - The Commonwealth has a legal debt limit of 10% of assessed valuation for cities, and no limit for counties although all General Obligation debt must be approved by voters.
  - Local governments can also implement debt policies of their own that are more conservative than state-established policies.

Source: GFOA and MRSC Websites
Debt Management Policy (Continued)

– **Debt Structure and Repayment**

  • Policy should speak to repayment terms, desired pay-out ratio, and debt service structure (level debt service vs. level principal).

– **Debt Issuance Practices**

  • For more frequent issuers, it is also helpful to include established practices for the following:
    - Selection and use of professional service providers (bond counsel, municipal advisor, underwriter)
    - Selection of sale method (competitive vs. negotiated)
    - Issuance of refunding bonds (typically 3% threshold)
    - Credit Ratings

Source: GFOA and MRSC Websites
Key Debt Ratios

- While there are several different ratios/metrics that can be tracked to evaluate a government’s debt profile, four are generally regarded industry-wide (including rating agencies) as Key Debt Ratios that should be included in financial policies:

1. Debt vs. Assessed Valuation

- This key ratio answers the **“Can I Borrow This?”** question. It is commonly utilized by the rating agencies as a measure of capacity and is more realistic/practical than the legal debt margin.

- Debt vs. Assessed Valuation policies typically range from 2% to 4%.

- Local governments in Virginia have higher debt vs. assessed value metrics, as they are responsible for operating schools, whereas most cities and counties across the nation do not have that responsibility.

<table>
<thead>
<tr>
<th></th>
<th>National City Median Debt vs. Assessed Value</th>
<th>1.2%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>National County Median Debt vs. Assessed Value</td>
<td>0.6%</td>
</tr>
<tr>
<td></td>
<td>Virginia City Median Debt vs. Assessed Value</td>
<td>2.4%</td>
</tr>
<tr>
<td></td>
<td>Virginia County Median Debt vs. Assessed Value</td>
<td>1.6%</td>
</tr>
</tbody>
</table>
2. Debt Service vs. Expenditures

- This key ratio measures **Debt Affordability**, i.e. how much of the annual budget is spent to pay for debt, and can show how much additional revenue needs to be raised to pay for new debt being considered. However, it is more commonly used by the rating agencies as a measure of capacity. It answers the “**Can I Afford This?**” question.

- The medians for both Virginia cities and counties remain below the industry standard 10% policy.

<table>
<thead>
<tr>
<th></th>
<th>National City Median Debt Service vs. Exp.</th>
<th>Virginia City Median Debt Service vs. Exp.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>9.5%</td>
<td>8.1%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>National County Median Debt Service vs. Exp.</th>
<th>Virginia County Median Debt Service vs. Exp.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>7.9%</td>
<td>8.2%</td>
</tr>
</tbody>
</table>

3. Payout Ratio

- Payout Ratio remains a relevant indicator of a healthy debt profile, though it does not reflect upon the ability of a locality to borrow debt or whether doing so is affordable.

- Virginia counties approximate the national payout ratio median, while Virginia cities remain slightly below.

<table>
<thead>
<tr>
<th></th>
<th>National City Median Payout Ratio</th>
<th>Virginia City Median Payout Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>83.4%</td>
<td>75.6%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>National County Median Payout Ratio</th>
<th>Virginia County Median Payout Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>80.1%</td>
<td>79.0%</td>
</tr>
</tbody>
</table>
4. Fixed Cost Burden

• Like Debt Service vs. Expenditures, this is a Key Ratio that measures overall **Financial Flexibility** and answers the “Can I Afford This?” question. However, it provides a more comprehensive review of a government’s fixed cost burden by including Pension and OPEB contributions, in addition to debt service.

• Keeping fixed costs below 20%-25% of expenditures is most optimal, once a local government pierces this threshold, fixed costs can be considered outsized and could have potential rating implications.
  
  o According to Moody’s, median fixed costs for the 50 largest local governments totaled 23% of budget
  
  o Virginia’s total fixed costs tend to be below the 20% target threshold.
  
  o An example of the fixed cost calculation can found below.

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Debt Service</th>
<th>Pensions</th>
<th>OPEB</th>
<th>Total Fixed Costs</th>
<th>Operating Expenditures</th>
<th>Fixed Costs as % of Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>$4,731,084</td>
<td>$1,548,865</td>
<td>$1,960,823</td>
<td>$8,240,772</td>
<td>$94,639,337</td>
<td>8.7%</td>
</tr>
<tr>
<td>2014</td>
<td>4,605,951</td>
<td>1,620,731</td>
<td>1,575,207</td>
<td>7,801,889</td>
<td>85,426,752</td>
<td>9.1%</td>
</tr>
<tr>
<td>2015</td>
<td>4,956,326</td>
<td>1,672,143</td>
<td>900,832</td>
<td>7,529,301</td>
<td>83,342,515</td>
<td>9.0%</td>
</tr>
<tr>
<td>2016</td>
<td>3,975,985</td>
<td>1,538,515</td>
<td>900,832</td>
<td>6,415,332</td>
<td>84,796,736</td>
<td>7.6%</td>
</tr>
<tr>
<td>2017</td>
<td>3,974,056</td>
<td>1,345,022</td>
<td>1,273,835</td>
<td>6,592,913</td>
<td>85,434,994</td>
<td>7.7%</td>
</tr>
</tbody>
</table>

• As this is a fairly new concept looked at by the rating agencies, not many local governments have adopted policies to reflect this metric to date.

  o Although those fixed costs policies that have been adopted have been well-received by the agencies.
Investment Policies

- Every local government that invests its excess funds has an investment policy, but some are more formal and well-developed than others.

  - Establishing a written investment policy can help establish financial security.

- GFOA stated that an investment policy describes parameters for investing government funds and identifies the investment objectives, preferences or tolerance risk, constraints on the investment portfolio, and how the investment program will be managed and monitored.

  - An investment policy enhances the quality of decision making and demonstrates a commitment to the fiduciary care of public funds.

- A good investment policy will identify the people who are empowered to make investment decisions on behalf of the local government; what dealers/institutions are authorized to be used; the types of securities that can be invested in; a diversification strategy; benchmarks by which to measure investment performance; and a reporting/oversight structure.

- Once established, it is important to send a copy of your investment policy or include in rating presentation, as agencies will request during their credit review.

Source: GFOA and MRSC Websites
Long-Term Financial and Capital Planning

- According to GFOA, long-term financial planning uses forecasts to assess future financial capacity so that strategies can be developed to achieve long-term sustainability in light of the government’s service objectives and financial challenges.

- During credit rating reviews, analysts will inquire if a local government maintains a long-term financial plan and will typically request a copy of those projections.
  
   – Ensures that management is bring proactive and thinking long-term.
     
     • Typically look for a plan that is at least five years in length.
   
   – Verifies that financial forecasts are credible and in line with historical performance.

- Long-term financial planning also includes maintenance of a Capital Improvement Plan with a similar time horizon.
  
  – This plan should outline capital projects with estimated costs and proposed methods of financing.

  – Since ratings are forward-looking, analysts need to understand the future capital needs and the potential impact any additional debt will have on key debt metrics.

- The long-term financial and capital plans should be updated on an annual basis during the budget process.
Policies for Enterprise Funds

- As with the General Fund, adopting specific financial policies for enterprise funds will be considered a management strength during a credit rating review.

- Two of the most common policies that are adopted to measure the financial health of an enterprise system include the following:

  1. **Debt Service Coverage**
     - Indicates the financial margin to meet current total annual debt service with current revenues available for debt service.
     - Average debt service coverage is typically between 1.5x and 2.0x for internal policies (on par with national medians below), while the average indenture coverage covenants for stand-alone systems tend to be less restrictive (around 1.2x).

     |                          | Water System Only | Sewer System Only | Water & Sewer System Only |
     |--------------------------|-------------------|-------------------|---------------------------|
     | National Debt Service Coverage Median | 2.1x              | 1.9x              | 2.1x                      |

  2. **Days Cash on Hand**
     - Indicates financial flexibility to pay near-term obligations.
     - Moody’s considers between 150 and 250 days in the “Aa” category and above 250 days in the “Aaa” category of liquidity within their Municipal Utility Scorecard.

     |                          | Water System Only | Sewer System Only | Water & Sewer System Only |
     |--------------------------|-------------------|-------------------|---------------------------|
     | National Days Cash on Hand Median | 382 days          | 565 days          | 399 days                  |

Source: Moody’s Municipal Utility Methodology and Medians Report
Two additional metrics that could be included in financial policies for enterprise systems include:

3. Net Debt to Operating Revenues

- Indicates system’s overall leverage and fixed costs.
- Moody’s considers between 2.0x and 4.0x coverage in the “Aa” category and below 2.0x in the “Aaa” category of their Municipal Utility Scorecard.

<table>
<thead>
<tr>
<th></th>
<th>Water System Only</th>
<th>Sewer System Only</th>
<th>Water &amp; Sewer System Only</th>
</tr>
</thead>
<tbody>
<tr>
<td>National Debt Service Coverage Median</td>
<td>2.0x</td>
<td>2.5x</td>
<td>2.1x</td>
</tr>
</tbody>
</table>

4. Asset Condition

- Indicates condition of utility’s capital assets which determines its ability to comply with environmental regulations and continue delivering adequate service with existing resources.
- Moody’s considers between 12 and 25 years in the “A” category and between 25 and 75 years in the “Aa” category of their Municipal Utility Scorecard.

<table>
<thead>
<tr>
<th></th>
<th>Water System Only</th>
<th>Sewer System Only</th>
<th>Water &amp; Sewer System Only</th>
</tr>
</thead>
<tbody>
<tr>
<td>National Debt Service Coverage Median</td>
<td>31 years</td>
<td>30 years</td>
<td>27 years</td>
</tr>
</tbody>
</table>

Implementing long-term financial and capital planning, as well as consistent rate studies to support current rates, are additional policies that are seen as a credit strength.
Implementation of Financial Policies
Implementation of Financial Policies

- After the scope of a local government’s financial policies has been finalized, the next step is to draft the policies in written form for approval by the elected body.
  
  – Can be helpful to have a third-party assist in developing and presenting the new/revised policies to the governing body.

- After adoption, management should ensure that policies are circulated and communicated to staff, as well as easily accessible for future reference.

- Policies should be reviewed regularly to ensure continued compliance and assess whether any policy updates are required.
  
  – Reviewing on an annual basis along with budget process is most ideal. A majority of governments include a summary of the financial policies within the budget document.

- As mentioned previously, if a local government is thinking of implement a new policy or changing an existing policy, it is always beneficial to reach out to the rating agencies beforehand.
Questions?

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