CITY OF MILWAUKEE
COMPTROLLER

Fund Balance Policy

Background

- The City is at risk of being downgraded to “BBB” from the level of “AA” where the City was rated by two of three rating agencies prior to 2019.
- Steady drawdowns on the Tax Stabilization Fund (TSF) have depleted reserves, which is one of the main areas of focus for the rating agencies.
- Downgrades to the City’s ratings increase the cost of borrowing. Higher interest expense results in fewer resources for General Fund expenditures.
- To avoid downgrades to the City’s ratings, it is recommended the City replenish the TSF.
- Establishing a Fund Balance Policy would help ensure that the balance of the TSF is not further reduced, allowing it to grow to more prudent levels.

Milwaukee Ratings History

- The rating agencies use fund balance in their evaluation of the City's bond ratings.
- The below table shows the City's general obligation bond ratings for the past 10 years.

Year	S&P	Moody's	Fitch	Unassigned TSF as % of GF Exp.
2012	AA	Aa2	AA	5.49%
2013	AA	Aa2	AA	9.66%
2014	AA	Aa3	AA	6.97%
2015	AA	Aa3	AA	8.52%
2016	AA	Aa3	AA	9.14%
2017	AA	Aa3	AA	7.23%
2018	AA	A1	AA	5.50%
2019	AA-	A1	AA-	2.40%
2020	A	A2	AA-	0.97%
2021	A	A2	AA-	2.45%

Ratings Downgrades shown in red.

S&P Global Quantitative Framework

- S&P Global uses a quantitative framework as the starting point for their general obligation ratings. Categories are assigned scores, which are then weighted to arrive at an initial Indicative Rating.

Category	Weight
Institutional Framework	10%
Economy	30%
Management	20%
Liquidity	10%
Budgetary Performance	10%
Budgetary Flexibility	10%
Debt & Contingent Liabilities	10%

- The Fund Balance Policy would directly impact the Budgetary Flexibility and Management scores, as well as indirectly impacting the Budgetary Performance score.
- Approximately 15% of the Indicative Rating score is directly tied to the TSF balance (the Management score includes other factors beyond fund balance).

Rating Agencies Negative Outlook

- All three major rating agencies (S&P Global, Moody's, and Fitch) have the City of Milwaukee on a Negative Outlook, which indicates a significant chance that future ratings downgrades may occur.
- S&P Global:
  - "If the city reverses its trend of operational imbalances and sustains it in addition to maintaining a higher level of available reserves, we could revise the outlook to stable."
- Moody's:
  - "The negative outlook reflects the city's narrow available reserves that could further deteriorate due to ongoing budget deficits."
- Fitch:
  - "The Negative Rating Outlook is due to the city's long-term structural budget gap, with the city relying on appropriations from its tax stabilization fund in recent years to balance the budget."

Downgrade Implications

- S&P Global has indicated that they might place a rating cap on the City in addition to a downgrade.
  - "If the city cannot address its continued budget shortfalls quickly, either through significant expenditure reductions or higher revenue, we could lower the rating, potentially by multiple notches. In addition, if the city continues to experience operational deficits, and, in our view, fails to execute its plan to address these imbalances, a determination of structural imbalance could be made, leading to a rating cap of 'BBB+'."
- It is currently estimated that a one "notch" downgrade would cost the City $100,000 in additional interest per bond issue per year, assuming annual issuances of $100 million.
  - $1,000,000 of additional interest per year after 10 years (when the majority of the City's outstanding debt will have been issued at the new rating).
- It is currently estimated that a rating cap of 'BBB+' would cost the City $200,000 per bond issue per year.
  - $2,000,000 of additional interest per year after 10 years.

Downgrade Implications (continued)

- The City has historically borrowed approximately $100 million per year on a long-term basis and $300 million per year on a short-term basis for the City and MPS RANs.
- The City's RAN ratings are currently the highest obtainable short-term ratings.
  - The short-term ratings are tied to the City's long-term ratings.
  - Additional downgrades to the City's long-term ratings would also lead to corresponding downgrades in the short-term ratings.
- The additional interest cost on the RANs could be another $400,000 per year if the City's short-term ratings were downgraded.
- If both the short-term and long-term ratings were downgraded, it is currently estimated that up to $2,400,000 of additional interest (RANs plus long-term debt) could be incurred per year after 10 years.

Why is Fund Balance Important?

- Adequate levels of fund balance help to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenditures) and to ensure stable tax rates.
  - In a levy-limited environment, healthy fund balances can limit or prevent programmatic budget cuts.
- GFOA recommends that governments establish a formal policy on the level of unrestricted fund balance that should be maintained in the general fund.
- The adequacy of unrestricted fund balance in the general fund should take into account each government's own unique circumstances.
  - Governments that are more dependent on volatile revenue sources should maintain a higher level in the unrestricted fund balance.
- The potential impact on the entity's bond ratings and the corresponding increased cost of borrowed funds should be considered when implementing a fund balance policy.

Existing Fund Balance Policy

- 304-29 of the City of Milwaukee Code of Ordinances governs the TSF. Current provisions are:
  - Maximum Ceiling on the TSF is equal to 5% of the current year, total Common Council controlled budget.
    - $77,620,850 in 2021 ($1,552,416,989 x 5%).
  - No Minimum Floor on the TSF.
  - Draws are limited to 50% of the unallocated portion of the TSF.

Proposed Fund Balance Policy

- Proposed Fund Balance Policy:
  - Maximum Ceiling on the TSF of 15% of general fund expenditures.
    - $103,624,500 in 2020 ($690,830,000 x 15%).
  - Minimum Floor on the TSF of 10% of general fund expenditures.
    - $69,083,000 in 2020 ($690,830,000 x 10%).
  - Draws that would reduce TSF below the minimum are not allowed.
  - <u>No requirement to levy to replenish TSF</u>.
    - Organic growth to build TSF over time.

Summary

- The City is at risk of being downgraded to “BBB” from the level of “AA” where the City was rated a few years ago.
- Further downgrades will result in significant increases in interest expense, and less available for General Fund expenditures.
- The declining balance of the TSF has been a significant factor in the City’s ratings.
- Establishing the proposed TSF balance requirement of 10% of General Fund expenditures could stabilize the City’s ratings.
- Adhering to the proposed Fund Balance Policy for several years could result in upgrades of the City’s ratings, reducing interest expense and making more resources available for General Fund expenditures.