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DOES MONTGOMERY COUNTY NEED HIGH RESERVES TO STAY AAA?

BY MARC JOFFE

Montgomery County government has maintained the highest credit rating for decades, a point of pride for elected officials. In a press release celebrating its 50th year of Moody's Aaa ratings, County Executive Marc Erlich stated:

> *Wall Street's watchdogs have once again found our local economy and County management practices as amongst a handful of the very best in the country. Out of more than 3,000 counties in this nation, Montgomery County is one of approximately 50 with a Triple-A bond rating from all three credit agencies. This mark of financial stability for more than three decades is a testament to consistent excellent financial stewardship, smart choices, and strategic investments. This bond rating saves our taxpayers millions of dollars in lower interest rates and demonstrates to the financial community that purchasing Montgomery County bonds is a wise investment. These funds are needed to continue to strengthen our County's economy, create jobs and expand opportunities for our residents.*

County Council President Gabe Albornoz attributed Montgomery County's strong ratings to policies that enabled its government to maintain a robust level of reserves, even through the COVID-19 pandemic. Those policies include a "fund balance reserve target of 10 percent." But there's a cost to keeping a high level of reserves. Those balances ultimately come from taxpayers and sustaining them when spending is at a high level means governments often must raise tax rates or at least avoid lowering them.

If Montgomery County holds larger reserves than needed to retain its top credit ratings (Aaa from Moody's and AAA from S&P and Fitch), it is imposing an unnecessary cost on taxpayers. The County could get the same prestige and low interest rates without holding onto money taxpayers could otherwise use. That begs the question of whether, and if so, how much, Montgomery County could lower its reserves without being downgraded.

Since credit ratings are not determined using a mechanistic, fully transparent procedure, we cannot answer this question precisely, but we can get some insight from rating agency publications and the finances of comparable counties.

THE MANY FACTORS THAT DRIVE RATINGS

Rating agencies consider several factors besides reserves when assessing local governments. According to methodology documents published by Moody's and S&P, both firms use scorecards to develop their ratings. The scorecard assigns weights to various factors analysts consider during the ratings process.

Both Moody's and S&P assign a 30% weighting to local economic performance factors that only affect indirectly a county's budgeting process. Moody's considers median household income, property values and economic growth in determining its economy score. S&P's economy assessment is primarily driven by "effective buying income" (defined as personal income less taxes) which may be adjusted based on economic diversification, the local unemployment rate, and demographic trends.

County government policies usually have little impact on the economic factors rating agencies consider unless they raise issues such as potentially driving away individuals and businesses or otherwise dampening economic activity. For example, excessively high property tax rates could depress real estate values and potentially deter new construction, which could adversely affect economic activity and hence the metrics rating agencies evaluate.

The fact that 70% of the S&P and Moody's rating calculations is driven by factors unrelated to reserves suggests there are many variables on the rating scorecard that can make up for a less-than-stellar fund balance.

Both agencies assign a 10% weight to the county's institutional framework, which, according to S&P:

> *[A]ssesses the legal and practical environment in which the local government operates and is typically considered a governance credit factor. Accordingly, all governments of the same type within the same state receive the same score. Since state constitutions and state laws generally dictate the terms under which local governments may operate, the score reflects these state-specific elements.*

Since the institutional framework is controlled at the state level, county reserve policy has no effect on this component.

Moody's and S&P weigh the remaining factors differently. Moody's assigns a 30% weight to long-term debt (including unfunded pension and other post-employment benefit obligations) and fixed costs. S&P assigns a 20% weight to its evaluation of the government's management and a 10% weight to debt service costs as a percent of expenditure.

For both agencies, that leaves just 30% of the ratings scorecard for financial ratios affected by available reserves. In S&P's case, reserves are included in the government's budgetary flexibility score which accounts for 10% of the overall rating. S&P also considers deficits (which affect future reserve balances) and cash available for debt service. Since reserves often take the form of cash there should be a correlation between fund balances and reserves.

Moody's includes the reserve balance as well as net current assets (i.e., the difference between current assets and current liabilities) in a ratio that accounts for 20% of the overall score. The remaining 10% uses a liquidity ratio based on the government's unrestricted cash, which should correlate with the reserve balance.

The fact that 70% of the S&P and Moody's rating calculations is driven by factors unrelated to reserves suggests there are many variables on the rating scorecard that can make up for a less-than-stellar fund balance. Since Montgomery County benefits from relative affluence, strong growth and management discipline, it should be able to retain the AAA/Aaa ratings with more modest reserves.

HOW LOW CAN RESERVES GO?

Analysts measure a government's reserve position in a variety of ways. So-called "rainy day funds" are a specifically allocated part of a government's reserves, but the definition will include other cash and current assets that are not directly obligated but could readily be converted into cash.

One common measure involves adding up available balances on a government's audited financial statement and dividing that total by its expenditures. In a government financial statement, fund balances are the difference between current assets and current liabilities reported on the entity's Governmental Funds Balance Sheet. The Government Accounting Standards Board (GASB) requires governments to allocate their reported fund balances across five categories: non-spendable, restricted, committed, assigned and unassigned. Funds in the first two categories are legally constrained, and thus are usually not considered to be available for spending needs. Instead, analysts look at the last three categories (committed, assigned, and unassigned) and often focus just on the government's general fund.

The Government Finance Officers Association (GFOA) recommends governments maintain available general fund balances of at least two months' expenditures, implying a general fund balance ratio of 16.67%. As the accompanying table shows, Montgomery County is well above that level and could carry a significantly lower balance without violating the GFOA recommended best practice. The table includes four peer counties in Maryland and northern Virginia, all of which carry AAA/Aaa ratings from S&P and Moody's.

S&P, which unlike Moody's publishes discrete fund balance thresholds in its methodology, gives its highest factor score to governments that maintain at least a 15% fund balance ratio, which is slightly below GFOA's recommendation. Going above 15% does not affect the factor score but S&P does assign a higher rating to governments that achieve and maintain a 75% available fund balance ratio separate from the scorecard calculation. Montgomery and peer counties get S&P AAA ratings based on the scorecard calculation alone and thus do not need to maintain such an extraordinarily high reserve level to receive top ratings.

Montgomery County's fund balance ratio of 29.37% is well above the 10% level required to be included in the county's Revenue Stabilization Fund (RSF). In the audited financial statements, the RSF balance is included in the County's General Fund Committed Balance. The assigned and unassigned balances are additive to that.

General Fund Balance Ratios, June 30, 2022

Source: Annual Comprehensive Financial Reports

	A	B	C	D	(A + B + C) / D
	GENERAL FUND COMMITTED BALANCE	GENERAL FUND ASSIGNED BALANCE	GENERAL FUND UNASSIGNED BALANCE	GENERAL FUND EXPENDITURES	GENERAL FUND BALANCE RATIO
ANNE ARUNDEL COUNTY, MD	0	278,740,469	247,385,055	1,774,461,644	29.65%
BALTIMORE COUNTY, MD	0	83,683,000	704,414,000	2,288,066,000	34.44%
FAIRFAX COUNTY, VA	532,150,215	47,493,932	154,902,645	4,009,467,455	18.32%
MONTGOMERY COUNTY, MD	699,495,564	85,111,637	188,531,200	3,313,758,341	29.37%
PRINCE GEORGE'S COUNTY, MD	300,856,150	89,389,101	336,615,709	2,081,539,677	34.92%

In addition, the County's method for calculating RSF is different than the ratio calculation method used above. The County's code requires the RSF to be 10% of Total Governmental Fund Revenues (plus revenues received by the county college and public schools) rather than the General Fund Expenditure amounts shown in the table. Since local governments typically balance their budgets, the difference between revenues and expenditures is usually small. But the use of a broader base is significant. During FY 2022, Montgomery County collected and spent over $1 billion of revenue in special funds for grants, housing, capital projects, and other purposes. Ten percent of these additional revenues is included in the RSF which further increases the county's General Fund Balance Ratio.

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Montgomery County's reserve requirement is more stringent than the other local counties. Fairfax County also uses a 10% factor, but it only applies to General Fund expenditures, not other spending categories. Baltimore County has the same policy. Prince George's County has two reserve requirements that total 7% of General Fund expenditures. Anne Arundel County does not appear to have a formal fund balance or reserve policy.

CONCLUSION

Given its strong economy, Montgomery County does not need high reserve balances to maintain the highest credit ratings. While we cannot be sure what magnitude of balance drawdown would affect the AAA/Aaa rating, it would probably have to be quite large.

Finally, in light of the other cash cushions on the County's balance sheet, a policy of maintaining 10% of total governmental fund revenues in the RSF seems excessive.

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