New England Public Policy Center
at the Federal Reserve Bank of Boston

neppc@bos.frb.org
600 Atlantic Avenue
Boston, MA 02210
617-973-4257

MEMO

September 25, 2005

This memo is preliminary in nature and subject to revision and review. Any views expressed are not necessarily those of the Federal Reserve Bank of Boston or the Federal Reserve System.

To: Representative Norman Majors, New Hampshire House of Representatives
From: Darcy Rollins, Policy Analyst
Re: Evidence and Analysis of the Relationship of Rainy Day Funds and Municipal Bond Ratings

Since budget stabilization funds, also known as rainy day funds, have the potential to aid states in weathering periods of fiscal stress, they may reduce the default risk associated with state-issued debt and improve bond ratings and reduce borrowing costs. This memo provides a summary of evidence supporting this theory and reviews recommendations for improving the effectiveness of rainy day funds.

Evidence from Bond Rating Agencies

A review of criteria for rating general obligation debt published by bond rating agencies suggests that the depth of rainy day fund reserve does impact bond ratings.

In examining the ability of municipal and state governments to repay tax-secured debt, Standard & Poor's considers fund-balance levels, including the availability of unencumbered reserves or contingency funds. In 1999, Fitch Ratings studied municipal debt defaults and concluded that management practices were more important in predicting favorable credit performance than previously thought. Fitch identified several preferred management practices and said on record that issuers who incorporate multiple best practices could see a positive difference – "of one to three rating notches above the ratings of similar issuers that do not incorporate such practices". The first best practice listed in the report was "Fund Balance Reserve Policy/Working Capital Reserves". Fitch's explicitly states that "…maintaining an operating reserve or rainy day fund is perhaps the most effective practice an issuer can use to enhance its credit rating" and notes that the appropriate size of a reserve depends on the variability of the state's revenues and expenditures.

Similarly, Moody's Investor Services identifies establishing fund balance policies as a critical component of strong municipal management. Moody's specifically states that "…externally, reserves tend to be viewed favorably by investors, rating agencies and local banks with which a municipality does business, thus benefiting ratings and decreasing the potential need for external liquidity sources." The firm also recommends that municipalities establish a plan for when and how to use the reserves, including a fund balance target level and a minimum level to maintain. And while Moody's does not require a specific level of fund balances, the firm provides a guideline of undesignated reserves that equal one to two months of operating expenses or 5% to 10% of annual revenues.

Evidence from the News

Press releases and newspaper articles from different parts of the country suggest that rainy day funds are important to public sector bond ratings. A September 12, 2002 press release from the Office of Governor Pataki of New York asserted that Standard and Poor's high rating ("AA") of the city that year was due in part to the existence of its rainy day fund. The release notes that Governor Pataki created the state's first reserve fund, and increased reserves to nearly 6 percent of the State's Budget prior to 2001. In Nevada, a news article reported that the state's lack of reserves was identified as a key concern during meetings between the State Treasurer and bond rating agencies. Nevada had used $135 million worth of its $136 million emergency fund the previous fiscal year and had not replaced the funds. A 1998 press release from the State Comptroller of Illinois office announced the introduction of legislation to establish a rainy day fund. The release quoted the Comptroller as saying that "The lack of such a fund has been cited in the past by bond houses as one reason to downgrade the state's bond rating."

Empirical Evidence

Past empirical papers have studied the effect of various fiscal institutions on state general obligation bond yields; few papers have investigated the impact of rainy day funds on state and municipal bond rating. The exception is a recent paper (Wagner 2004) published in the National Tax Journal. The paper focuses explicitly on state-level debt financing. The author found that, compared to states without budget stabilization funds, the typical state experiences nearly a 10 basis point reduction in long-term bond yields following the implementation of a rainy day fund. However, the structure of a state's rainy day fund deposit and withdrawal rules is found to be more critical in affecting borrowing costs than the mere existence of a fund. The author also briefly reviews earlier research [(Eichengreen (1992), Goldstein and Woglom (1992), Bayoumi et al. (1995), Lowry and Alt (2001), and Poterba and Rueben (1999)] which found evidence that strict balanced budget rules (meaning those that require end–of–the–year fiscal adjustments to avoid a budget deficit) reduce bond yields between five and 15 basis points.

Improving Rainy Day Fund Effectiveness

In a 2003 paper, "Heavy Weather: Are State Rainy Day Funds Working", the Center on Budget and Policy Priorities (CBPP) contends that most state rainy day funds were not adequate to address budget gaps during the 2002-2003 fiscal crisis, and expressed concern about the 5 percent guideline that many states use as a limit for the level of total state spending directed to rainy day funds. CBPP notes that bond rating agencies have also questioned the adequacy of the 5 percent benchmark level: "Standard and Poor's considers total general fund balances (including rainy day funds) of 15 percent or more to be "strong," while balances of 5 percent or less to be "low" for local government tax-backed general obligation bond ratings." CBPP asserts that states should set a target level for the size of the fund that is at least 10 to 15 percent of the budget and give serious consideration to making additional deposits into the fund above the 15 percent level.

In addition to increasing the percent of state funding directed towards rainy day funds, CBPP suggests that state policymakers should including rainy day fund appropriations in the budget and that access to the rainy day funds should be through the normal appropriation process. Further, state rainy day fund policies should not include a replenishment rule, which CBPP believes creates a disincentive for using the fund and can lead to rainy day fund deposits competing with other programs for scarce resources in poor economic times. Despite CBPP's concern about the structure of rainy day funds the paper concludes that, if properly designed, rainy day funds can be an important policy option for policymakers.

Resources

2004 State Debt Medians. *Moody's Investor Services.* April 2004.

"Governor: S&P Lauds State's Response to 9/11 Fiscal Challenges: Wall Street Agency Reaffirms New York State's Highest Credit Rating in 23 Years" *Press Release: New York Office of the Governor.* September 12, 2002.

"The Twelve Habits of Highly Successful Finance Officers: Management's and Disclosure's Impact on Municipal Credit Ratings." *Fitch Ratings. Public Finance Criteria Report.* November 2002.

Standard and Poor's 2005 Public Finance Criteria

The Six Critical Components of Strong Municipal Management: Managerial Methods to Promote Credit Enhancement. Moody's Investor Services. March 2004.

Wagner, Gary A. The Bond Market and Fiscal Institutions: Have Budget Stabilization Funds Reduced State Borrowing Costs? *National Tax Journal.* Vol. LVII, No. 4, December 2004.

Zahradnik, Bob and Ribeiro, Rose "Heavy Weather: Are State Rainy Day Funds Working?" *Center on Budget Policy and Priorities.* May 13, 2003. http://www.cbpp.org/5-12-03sfp.htm

New England Public Policy Center
Federal Reserve Bank of Boston
P.O. Box 55882
Boston, MA 02205

617.973.4257
neppc@bos.frb.org
http://www.bos.frb.org/economic/neppc/