LYNNWOOD
CITY COUNCIL
Finance Committee

Date: **Thursday, May 23, 2019**
Time: **3:00 PM**
Place: **City Hall Conference Room #4**

3:00 PM **A** Finance Committee Meeting (agenda attached)

Adjourn

Memorandums for Future Agenda Items:

Memorandums for Your Information:

Contact: Council Office (425) 670-5011

Lynnwood City Council
Finance Committee Meeting
Thursday, May 23, 2019
City Hall Conference Room #4
Time: 3:00pm

AGENDA ITEMS:

Call to Order

1) **Recap of the PFM (*our Financial Advisors*) Webinar on Recession Readiness ~** *Sonja Springer, Finance Director.*

2) **Closing Comments**

Adjournment

Recession Readiness

Budget Stress Testing and Action Plans for Fiscal Sustainability

May 2019

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Today’s Presenters

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President of PFM Group Consulting LLC

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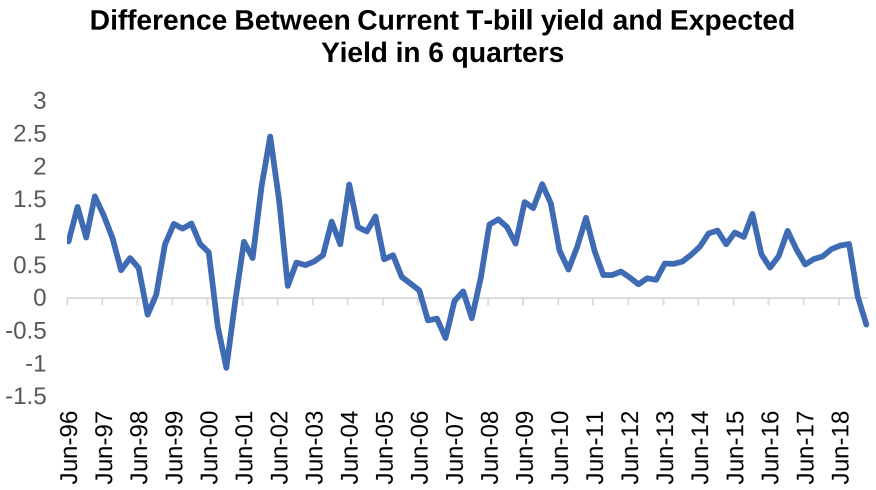
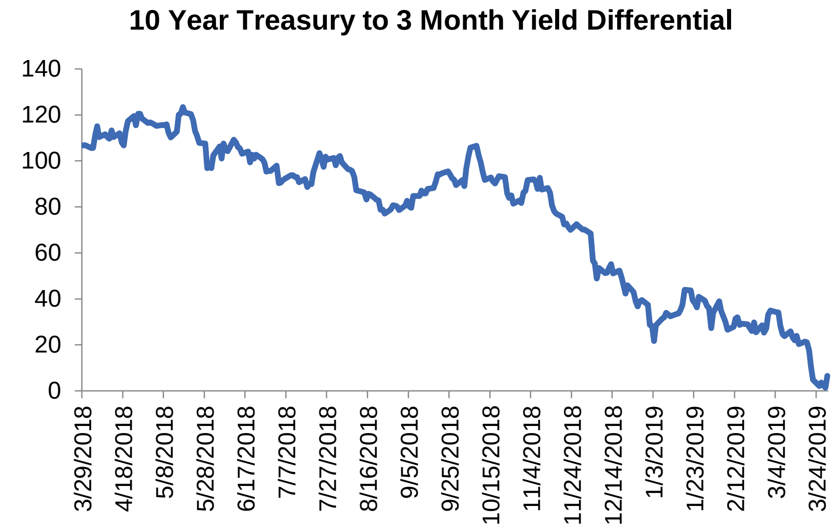
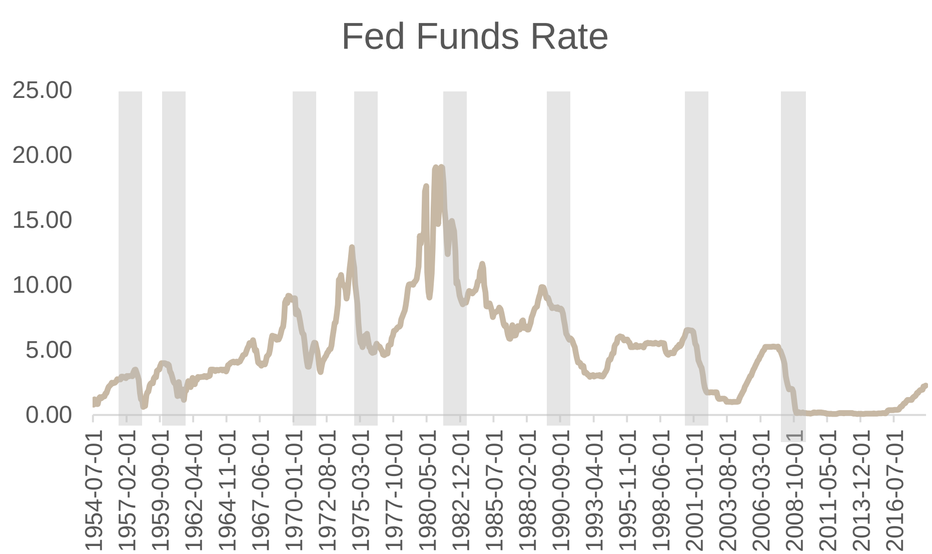
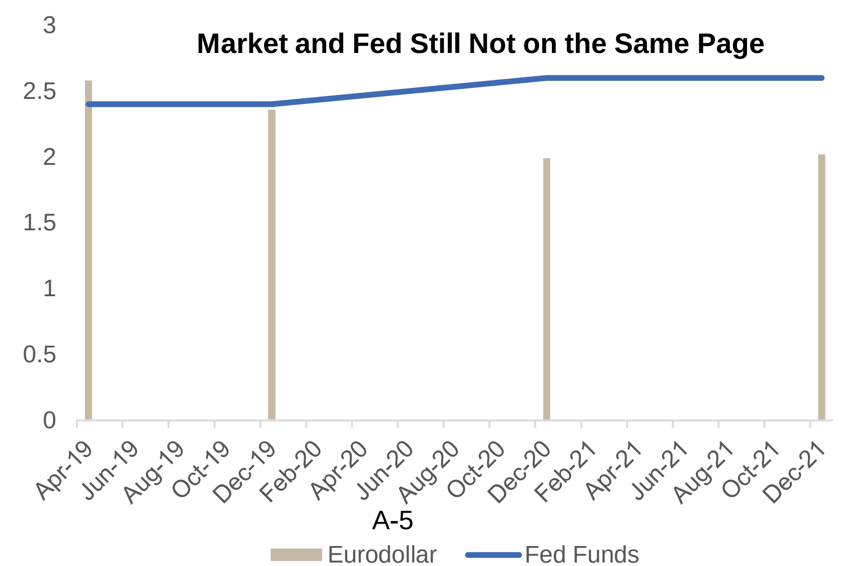
Are we heading for a recession?



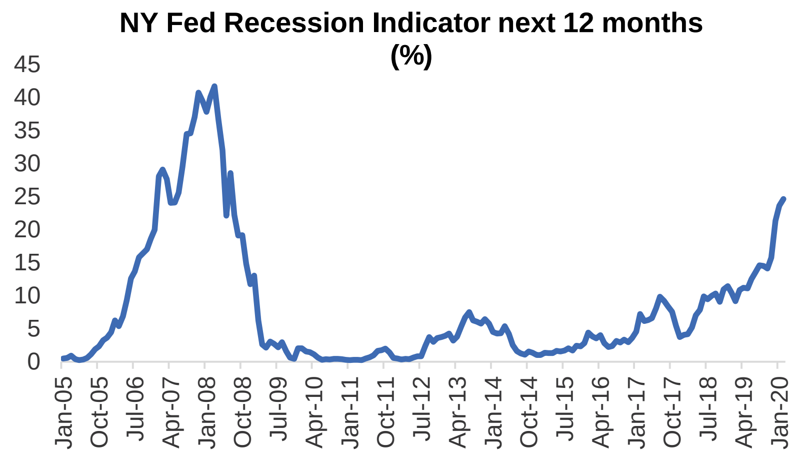


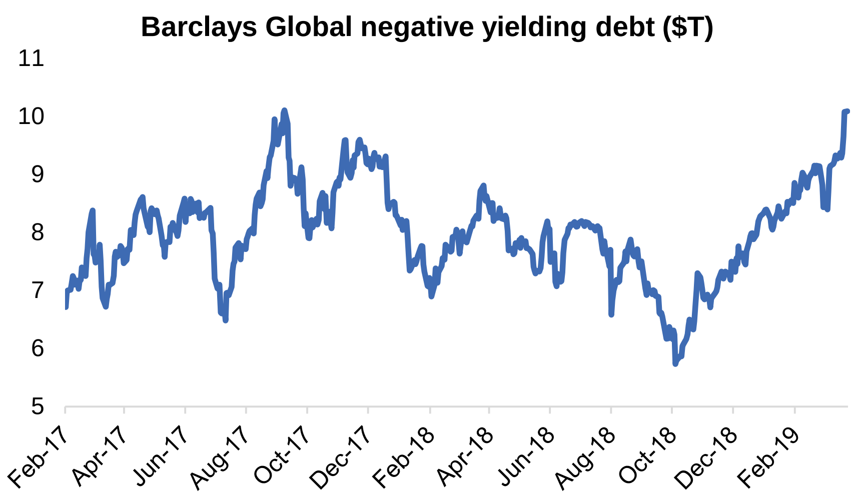


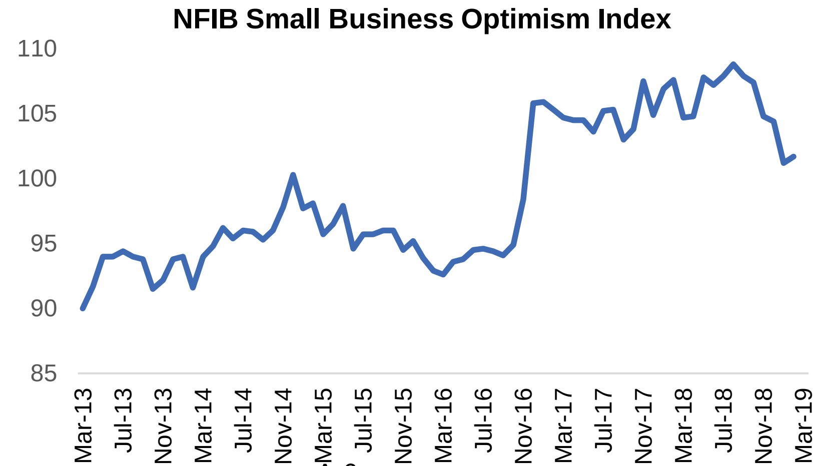


Source: Bloomberg, FRED

Business Confidence Has Weakened Over the Last 12 Months







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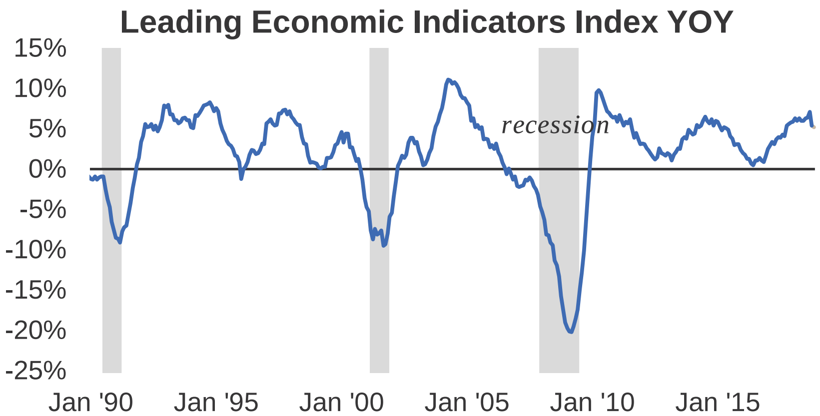
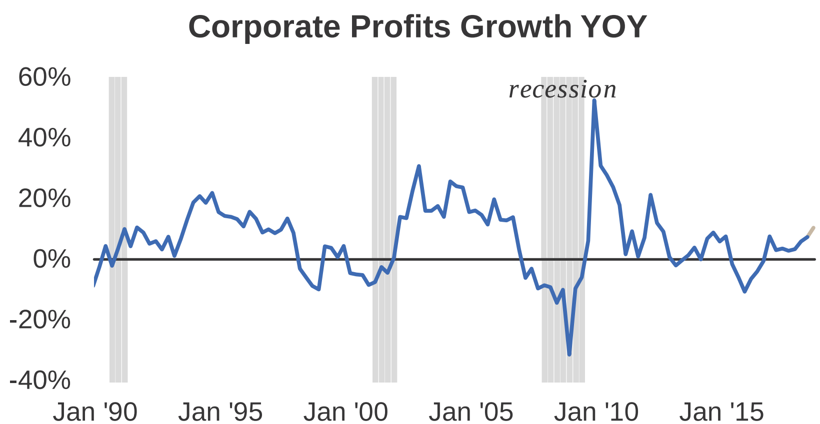
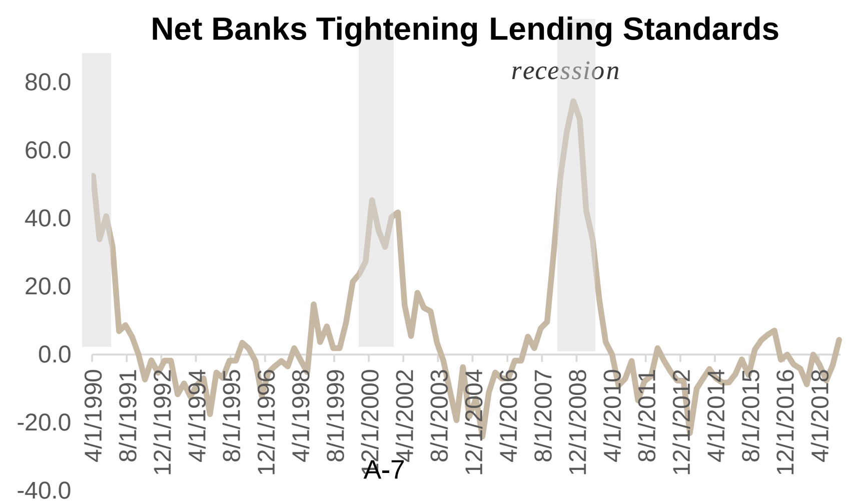
Source: Bloomberg, New York Federal Reserve, FRED

Economic Indicators Do Not Currently Predict Impending Recession







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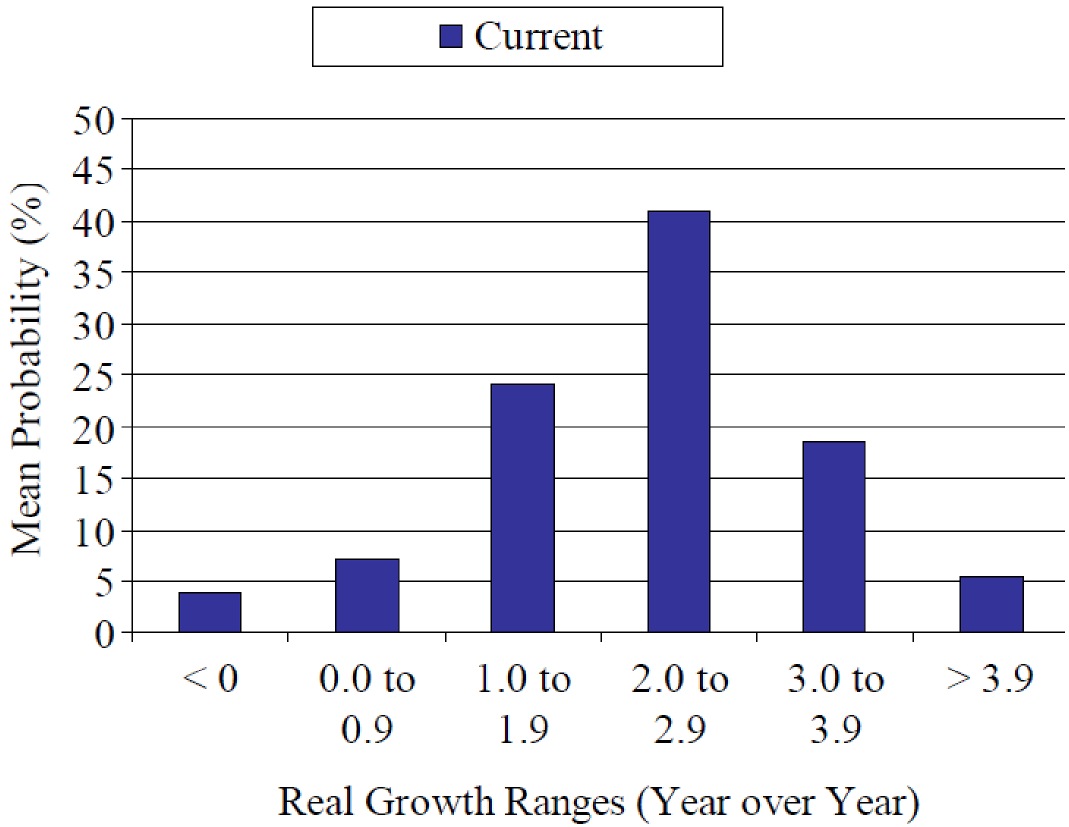
Source: Bloomberg, FRED

Where we are now: three (3) premises

Survey of Professional Forecasters

Mean Probabilities for Real GDP Growth



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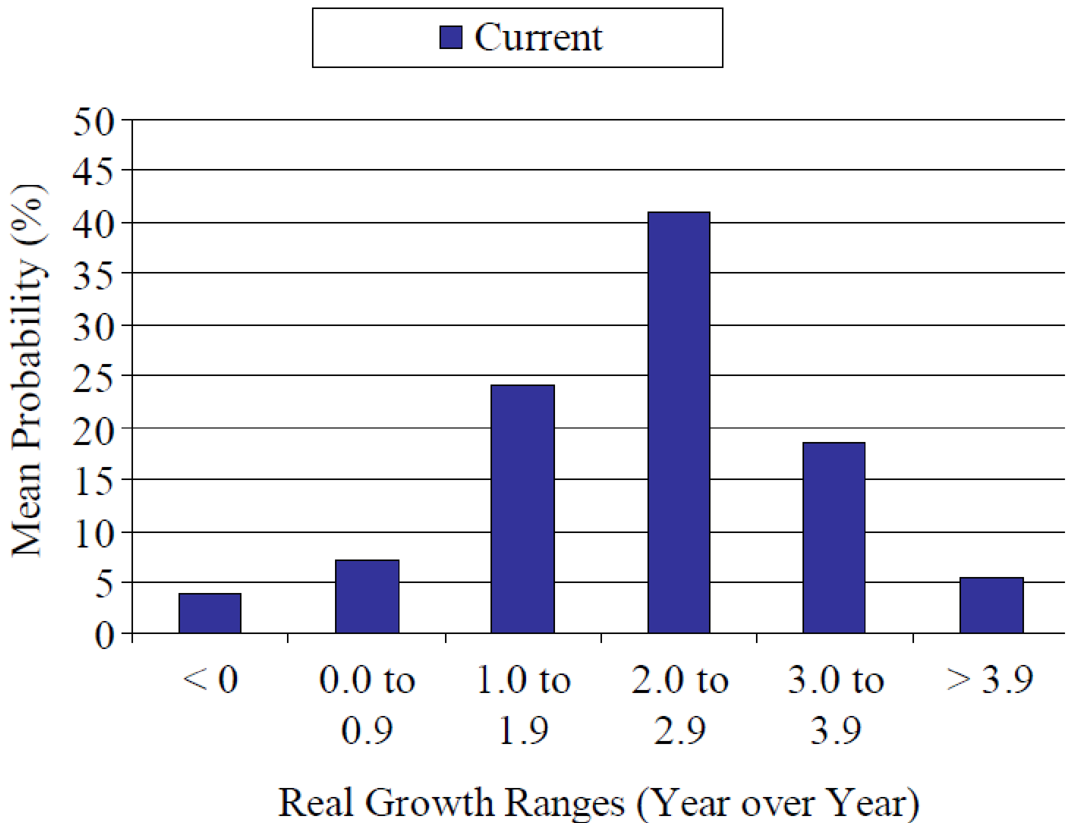
Source: Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters

Survey of Professional Forecasters

Mean Probabilities for Real GDP Growth in 2009



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Actual Real GDP Growth for 2009:
-2.5%

Source: Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters (February 12, 2008); U.S. Bureau of Economic Analysis, Real Gross Domestic Product [GDPC1], retrieved from FRED, Federal Reserve Bank of St. Louis

1. The Start of the Next Downturn is Now Closer Than the End of the Last One

- As of May 2019, we have nearly completed the tenth year of the expansion phase of the current business cycle, starting after the recession bottomed out in June 2009: **119 months and counting**
- Average 1945-2009 (prior 11 cycles): **58.4 months**
- Average 1854-2009 (prior 33 cycles): **38.7 months**
- Range since 1854: 10 to 120 months

Last Five Expansion Phases (trough to peak)	Duration
November 2001 – December 2007	73 months
March 1991 – March 2001	120 months
November 1982 – July 1990	92 months
July 1980 – July 1981	12 months
March 1975 – January 1980	58 months

Source: National Bureau of Economic Research (NBER)

2. Structural Fiscal Challenges Persist

- Public sector fiscal challenges are not just cyclical, and few public employers will simply grow their way out of such pressures

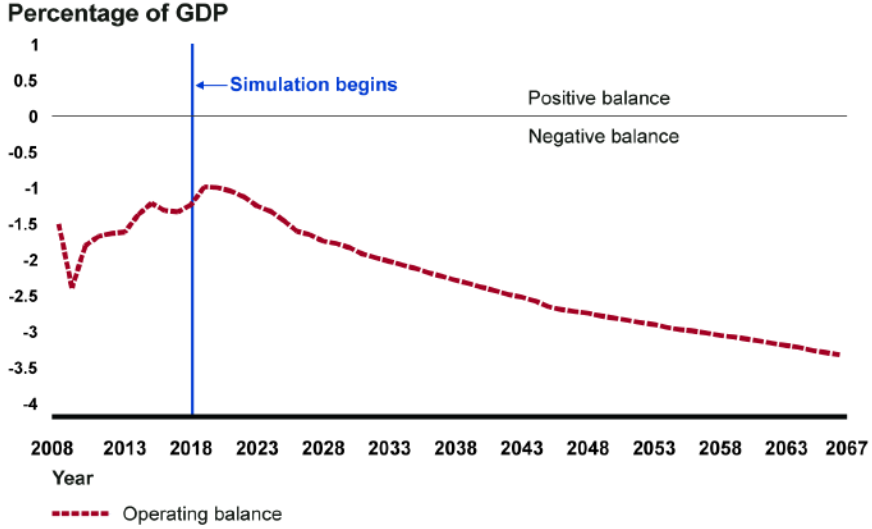
- The U.S. Government Accountability Office (GAO) has developed a simulation model for the state and local sector as an entirety, projecting significant fiscal gaps absent corrective action, due largely to:

  - Flat revenues as % of GDP

  - Healthcare and retiree costs rising faster than the overall economy

- GAO calculated that closing the structural fiscal gap would require action equivalent to a **[14.7% reduction]** in state and local government recurring expenditures every year

State and Local Government Sector Operating Balance as a Percentage of Gross Domestic Product (GDP), 2008 through 2067



Source: GAO analysis of data from the Agency for Healthcare Research and Quality, Bloomberg, the Board of Governors of the Federal Reserve System, the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, the Bureau of Economic Analysis, the Bureau of Labor Statistics, the Census Bureau, the Centers for Medicare & Medicaid Services, the Congressional Budget Office, and the Federal Reserve Bank of St. Louis. | GAO-19-208SP

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Source: United States Government Accountability Office, "State and Local Governments' Fiscal Outlook: December 2018 Update"

3. Pent-up Demands Have Surfaced

- **From the workforce**, to make up for containment and concessions during the downturn as the labor market has since heated up
- **From the public, operating departments, and elected officials** to restore and enhance services
- **To address deferred and growing infrastructure needs**
- **To meet changing IT demands** (mobility, access) and opportunities

Managing competing expectations and goals from operating departments, labor, Councils/Boards, and the public – while positioning for long-term fiscal stability – is a major challenge and concern for public sector finance officers in this period of recovery and growth

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Summary: Where We Are

1. The start of the next downturn is now closer than the end of the last one

2. Structural fiscal challenges will persist

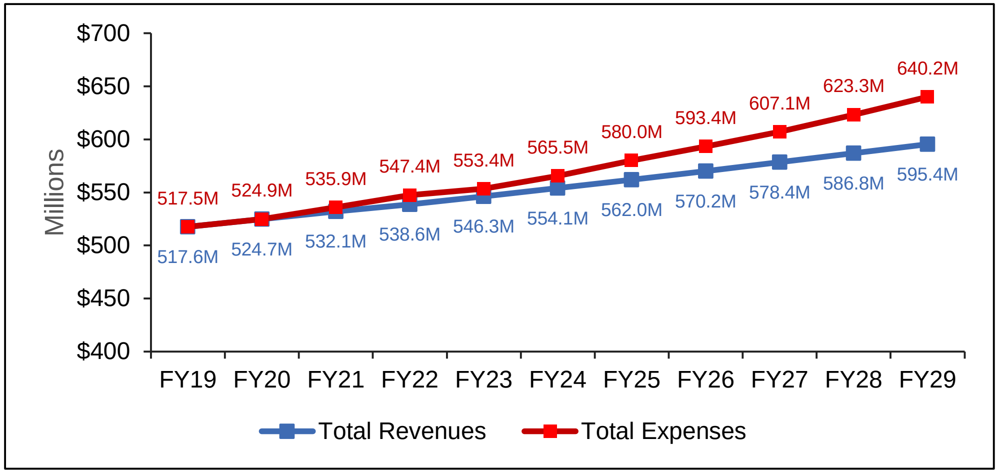
3. Pent-up demands have surfaced

Stress Testing

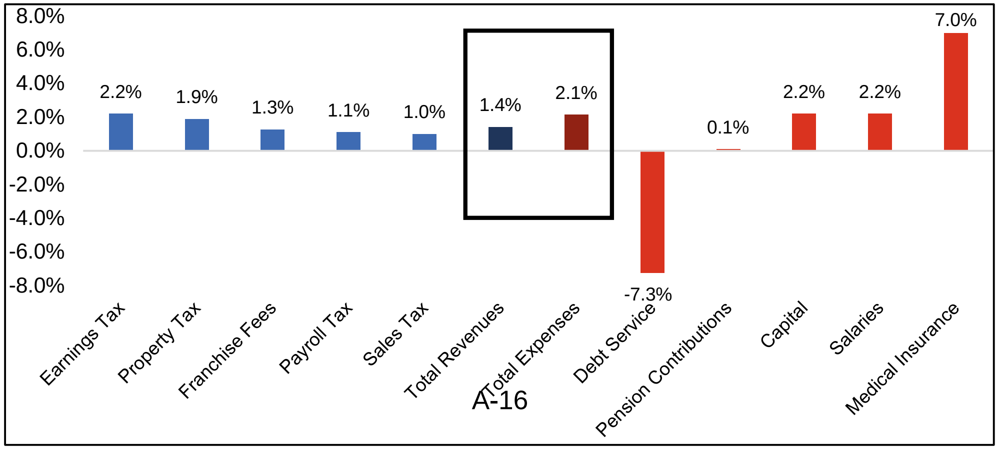
Step One: Baseline Long-Range Financial Plan

- Recognized best practice: 5-10 year **long-range financial plan** to create a framework for fiscal sustainability
- Evaluate key budget drivers and policy parameters through a **baseline** analysis
- Focus on recurring revenues and expenditures and structural budget position ("carry forward")
- Assess and address liabilities and long-term needs (e.g. infrastructure, unfunded retiree benefits, tax policy)
- Develop strategies to bend the curves, close any gaps, and carve out new resources
- Communicate the plan and gain buy-in from all levels of the organization

General Fund Projections: FY2019-FY2029



Projected CAGR for Major Budget Drivers: FY2019-FY2029



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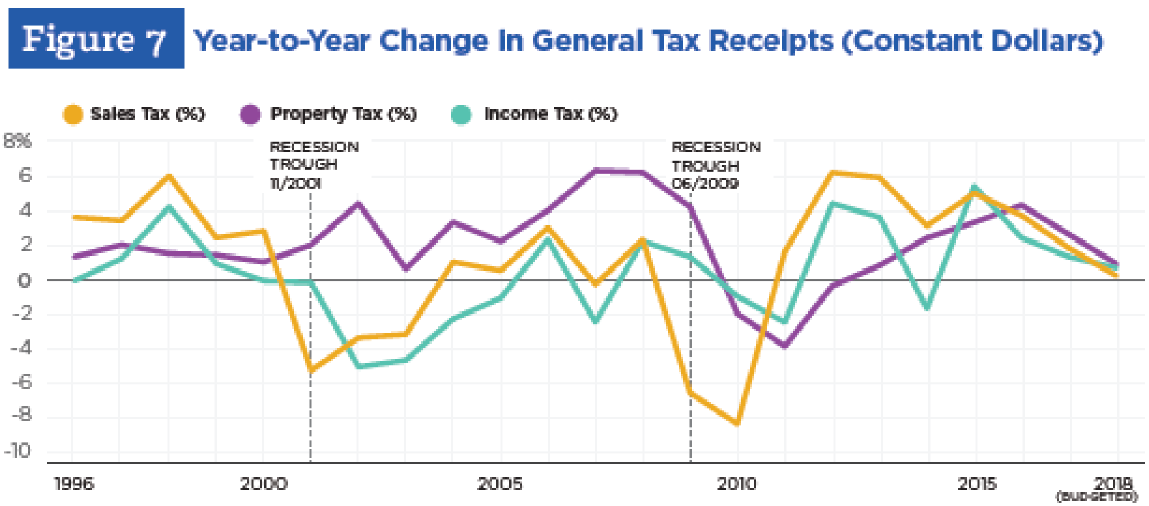
Step Two: Stress Test

- **Stress test** the plan under alternative economic scenarios, and to provide **"pre-mortems"** on what could go wrong without preventative measures
  - Revenue sensitivity
  - Expenditure sensitivity and fixed cost constraints
  - Debt and capital program considerations
- What scenarios?
  - Moderate or "typical" recession?
  - Great recession or worse?
  - Multiple scenarios?

Stress Test: Revenues

- Evaluate and forecast key revenue streams under alternative economic scenarios
- Both the degree of sensitivity to the economy **and** timing of impacts can vary across revenue types based on a range of local factors
- Examples:
  - Timing of payment
  - Reassessment practices
  - Laws and practices with regard to tax caps and credits
  - Tax base and industry mix / concentration
  - Character of the community (e.g., built out or developing)



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Source: National League of Cities, "City Fiscal Conditions" (2018)

Stress Test: Revenues

- **Common revenue streams to watch:**
  - Sales taxes
  - Income / wage taxes
  - Business taxes
  - Intergovernmental revenues not under direct local control
  - Property taxes (maybe)
  - Real estate transfer taxes (definitely)
  - Development related fees

Stress Test: Revenues

- **Projection issues:**
  - Do you already (and/or overlapping levels of government) already have forecasting models for major revenue streams driven by economic assumptions?
  - What was your experience during prior downturns?
    - Has your community and economic base changed significantly since those prior recessions? If so, what does that change imply?
    - Have your tax/fee rates and rate structures changed since your last downturn, and what does that imply?
  - Could collection/payment rates decline?
  - Will public resistance to otherwise routine rate adjustments (and/or demand for tax breaks) likely intensify during tough times?
  - For intergovernmental revenues, how is the fiscal structure for the other level of government (e.g. state) aligned with the economy in terms of the potential severity and timing of pressures? Are the revenues formulaic or discretionary? What is the history, if any, during prior downturns?

Stress Test: Operating Expenditures

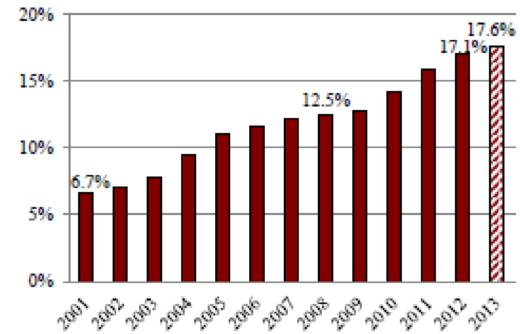
Total Expenditures = Fixed Costs + [Level of Service * Cost Per Unit of Service]

- **How would your service demands change in a recession?**
  - Greater demand for social services and safety nets
  - Some growth-related service pressures might decline (e.g., building permit inspections)
  - Are certain discretionary services and studies likely to go on hold?
- **How might costs per unit of service change?**
  - Wage pressures could moderate. How much flexibility (If under collective bargaining, when do contracts expire? Are there reopeners?)? How to address and present?
  - Healthcare inflation? Workers' compensation?
  - Are any major contracted services coming up for bid? Is that just a general concern or are there economic sensitivities with the pricing?
- **What are your fixed costs?**
  - Are they truly fixed? Even if not economically sensitive, are the prospective trends clear?

Stress Test: Operating Expenditures – Pension Contributions

- **Declining pension investment returns would increase employer contributions (eventually)**
  - Reduced assets, or even just shortfalls relative to the assumed return, will increase a plan's unfunded liability
  - In turn, a larger unfunded liability will mean bigger amortization payments on top of the normal costs for current service
  - Impact and timing will depend on multiple factors, for example: smoothing method for investment returns, AVR lag to budget year, amortization method (open/closed, level dollar or level % of pay) and period, potentially offsetting changes in payroll growth, etc.
  - Overall, however, the economic downturn was a major driver of rising pension costs in the wake of the Great Recession
  - Today, some plans/systems are already under sharp pressure due to other factors (e.g. CalPERS) and many remain underfunded

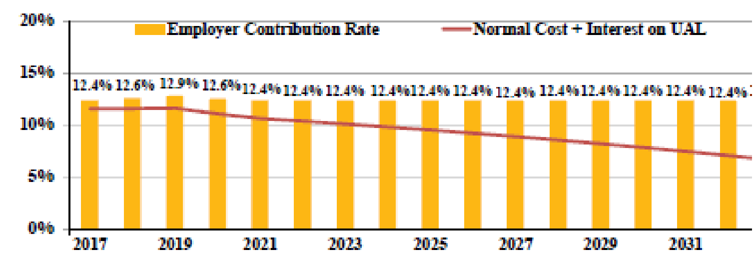
FIGURE 4. ANNUAL REQUIRED CONTRIBUTION AS A PERCENT OF PAYROLL, FY 2001-2013

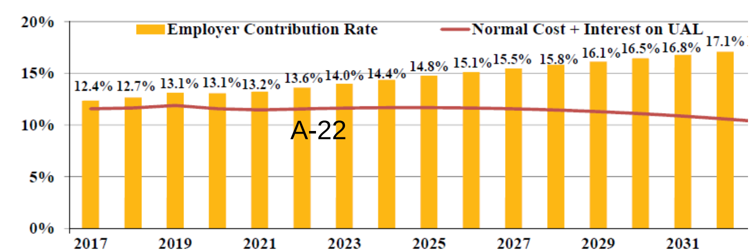


Note: 2013 involves projections for about one-third of plans.
Sources: Various 2013 actuarial valuations; and PPD (2001-2013).

Source (Figure 4): Center for Retirement Research at Boston College, "The Funding of State and Local Pensions" 2013-2017 (June 2014)

Sample Plan Impacts: 6.0% Annual Returns Instead of 7.5%





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Stress Test: Retiree Benefits and Other Non-Debt Liabilities

- Pension funded ratio, pension health relative to the plan sponsor's finances and economic base, actuarial risk, benefit design
- Other Post-Employment Benefit (OPEB) funding, benefit design and risk exposure
- Other non-debt liabilities, such as:
  - Internal service fund condition
  - Workers' compensation reserves

Is 80% the Right Number?

"The funded ratio is most meaningful when viewed together with other relevant information. Other factors that might be considered in assessing the fiscal soundness of a pension plan include:

- Size of the pension obligation relative to the financial size (as measured by revenue, assets, or payroll) of the plan sponsor.
- Financial health (as measured by level of debt, cash flow, profit or budget surplus) of the plan sponsor.
- Funding or contribution policy and whether contributions actually are made according to the plan's policy.
- Investment strategy, including the level of investment volatility risk and the possible effect on contribution levels.

Each of these factors should be examined over several years and **in light of the economic environment**."

Source: "The 80% Pension Standards Myth," American Academy of Actuaries, Issue Brief, July 2012 [emphasis added]

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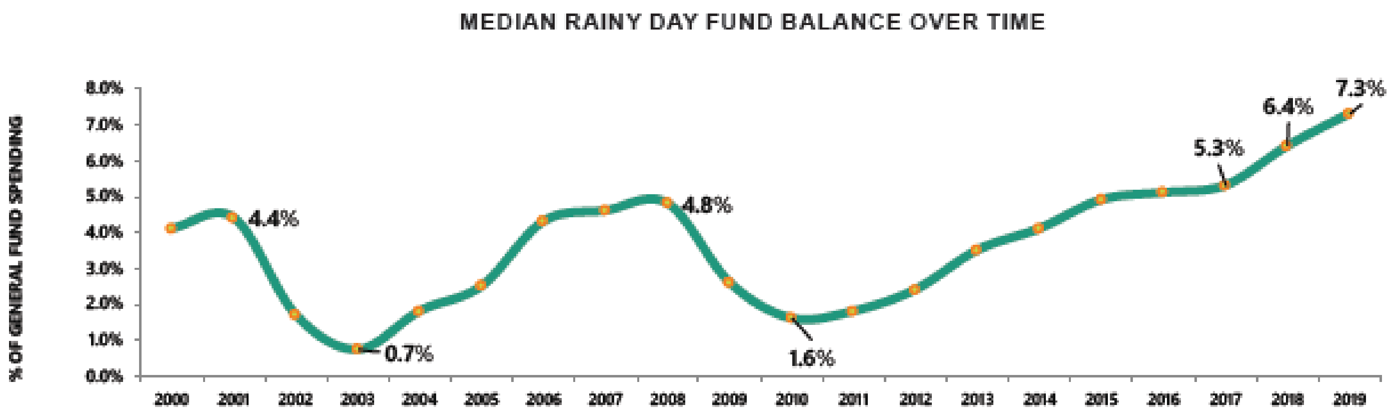
Stress Test: Capital and Debt

- Re-evaluate CIP needs
  - Assessment of needs to identify what might be deferred vs. critical / mandated
  - Evaluation of historical programmed vs. actual expenditures
- Related capital needs (if not in CIP): fleet, equipment
- Potential issues to review with your Municipal Advisor:
  - Outstanding debt schedule and future capacity
  - Assumptions for borrowing costs during economic downturn:
    - New debt issued
    - Variable rate exposure, if any
  - Mix of debt vs. pay-go capital funding

Action Plans for Sustainability

So You Have a Stress Test: Now What?

- **Calibrate and size reserve needs**
  - Existing policy
  - Current reserve levels
  - Risk-based resizing based on exposure analysis?



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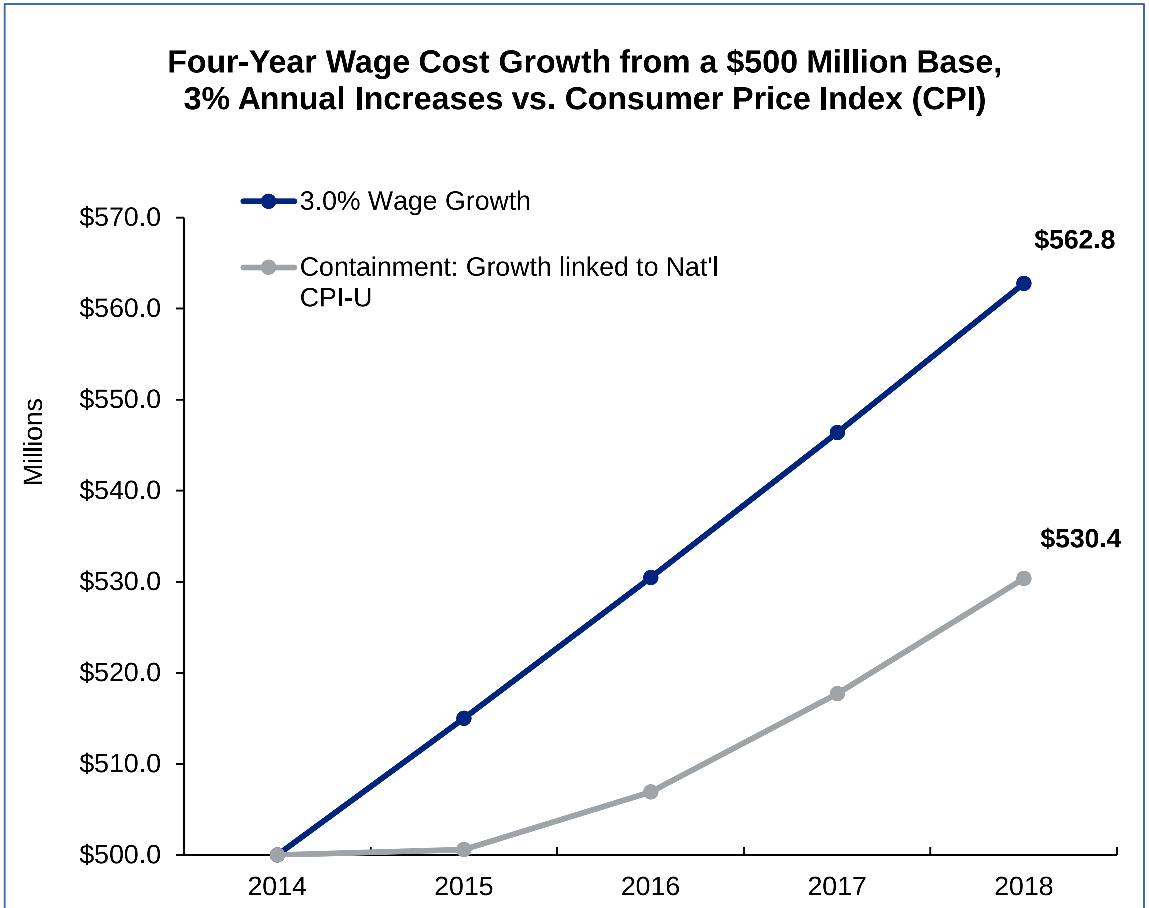
So You Have a Stress Test: Now What?

- **Establish spending parameters for addressing pent up demands**
  - Workforce agreements / policies
  - New services
- **Communications and buy-in**



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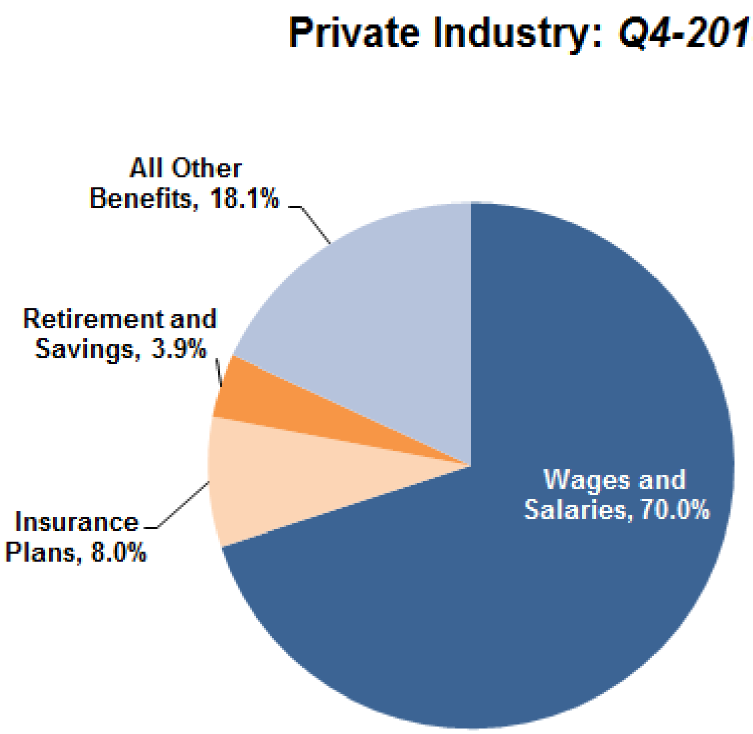
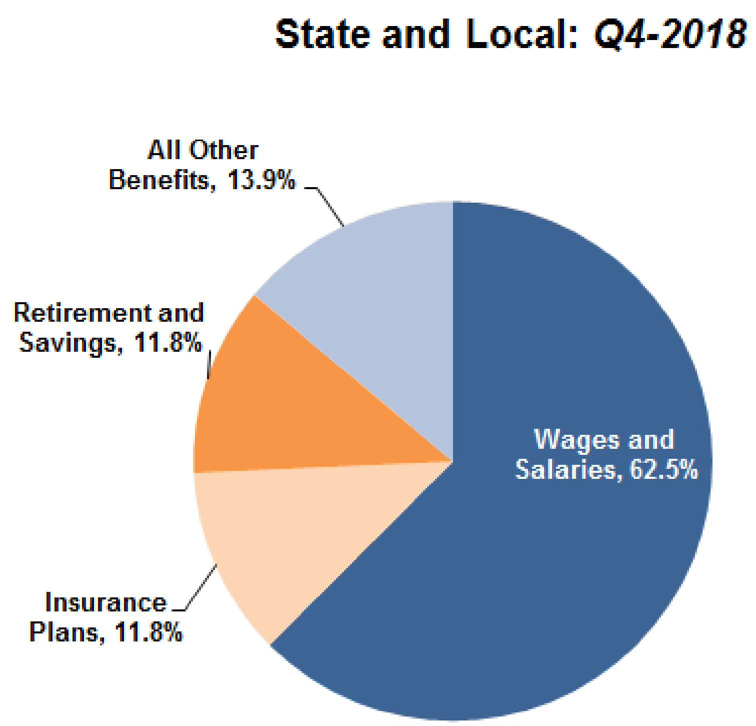
Source: CPI growth rates from the Bureau of Labor Statistics, CPI-All Urban current series, 2014 Annual to 2018 Annual, not seasonally adjusted

Action Plan: Revenue Positioning

- **Tax incentives review**
- **Non-tax revenue updates**
  - Keep pace with cost of service
  - Consider special funds for volatile service areas with self-sustaining revenues (e.g., permitting)
- **Tax policy analytics**
  - Establishment of a mechanism to buffer volatile revenues
    - City of Oakland, Commonwealth of Massachusetts
  - Review of tax structure
    - Revenue diversification
    - Exemptions (e.g. sales tax)

Action Plan: Total Compensation Portfolio





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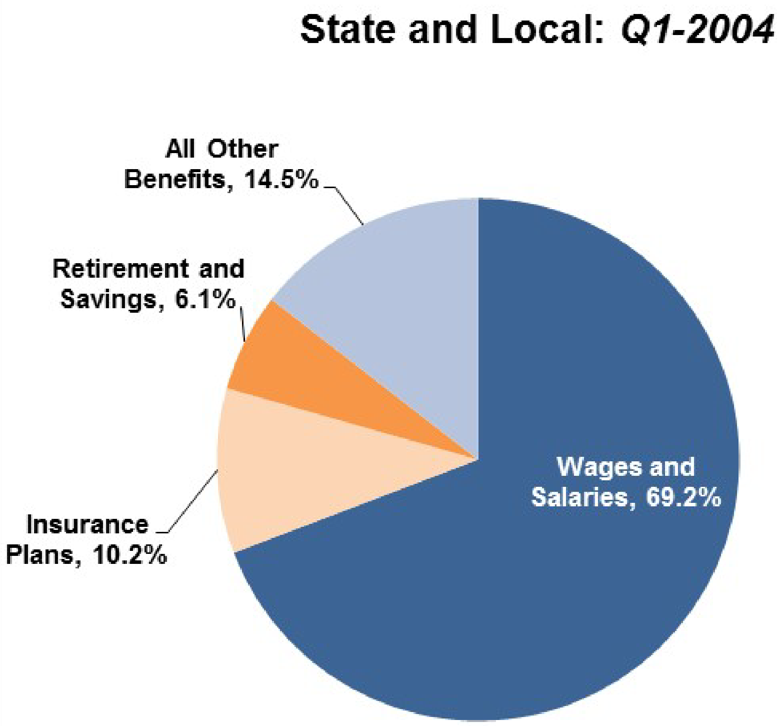
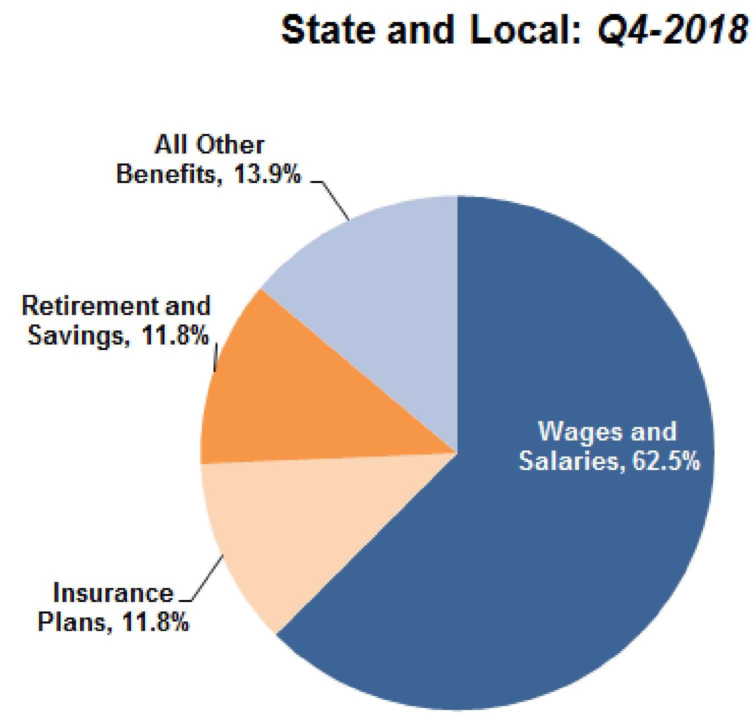
Source: Bureau of Labor Statistics, Employer Costs for Employee Compensation

Action Plan: Rebalancing the Compensation Portfolio





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Action Plan: Employee Compensation

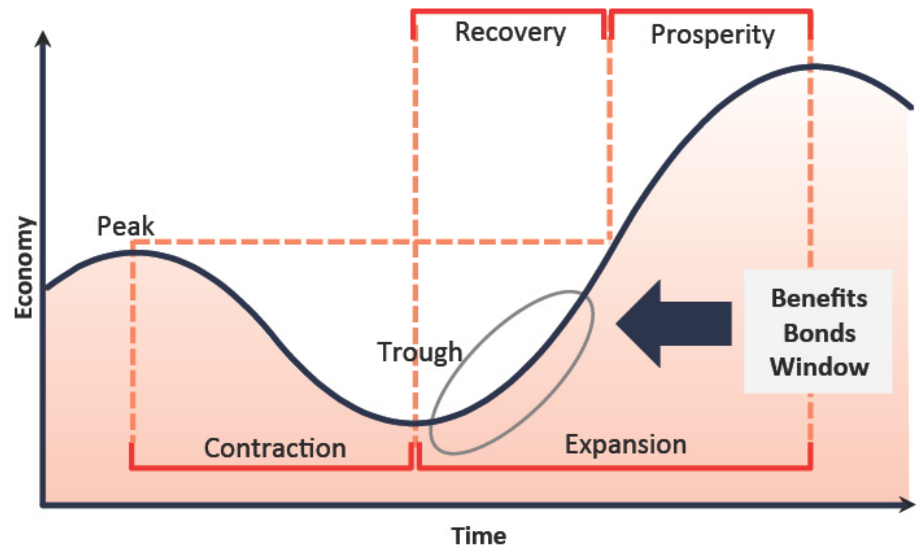
- **Use current pay flexibility**, as available, toward adopting/negotiating:
  - More affordable health benefit programs and structures
  - Paid leave and schedule reforms
  - Work rules
  - Retiree benefit restructuring / cost-sharing
- **Goals:**
  - More competitive pay to recruit and retain quality employees
  - A more efficient (smaller) workforce through attrition
  - Less exposure to future benefit cost growth

Action Plan: Non-Personnel Expenditures

- **Develop options for future savings:**
  - Agency performance reviews
  - Policy reviews: e.g., criminal justice
  - Explore alternative service delivery
- **Invest in productivity gains:**
  - Energy efficiency
  - Fleet
  - Technology
  - Productivity Bank?

Action Plan: Retiree Benefit and Other Non-Debt Liabilities

- Retiree benefit liability management?
  - Benefit change?
  - Buyouts?
  - De-risking (actuarial assumptions)
- Stabilization fund (Section 115)?
- OPEB trust/policy?
- Pension funding?
  - POBs?
  - Asset sales/concessions
  - Financial engineering
    - Internal loans
    - Asset-in-Kind (AIK) transfers
- Fully fund, as needed and applicable, other reserves and special funds:
  - Worker's compensation
  - Internal services



Action Plan: Capital and Debt

- Invest now in infrastructure renewal and replacement
- Consider CIP process improvements to increase rate of spend-down and increase impact with debt incurred
- Again, explore internal “investment” opportunities with operating budget savings (e.g., energy efficiency, fleet modernization)
- Plan for capital investment during a downturn? Construction costs may be favorable, rates may be lower, local economy may benefit from the stimulus activity
- Potential issues to review with your Municipal Advisor:
  - Diversification of debt to de-risk portfolio (e.g., fixed vs. variable rate debt, exposure to liquidity providers and counterparties)
  - Permitted structure of new debt issuances (e.g., slower repayment of debt)
  - Timing of debt incurrence (e.g. use of interim financing tools and/or cash)
  - Debt refinancing guidelines
  - In light of options identified above, debt policies and flexibility included therein

Recession Readiness Checklist

Recession Readiness Checklist

Stress Test

- ❑ Baseline long-range forecast
- ❑ Select a downturn scenario
- ❑ Analyze revenue impacts
- ❑ Analyze expenditure impacts
- ❑ Understand fixed cost trends
- ❑ Review liabilities
- ❑ Review CIP/debt

Action Plan for Sustainability

- ❑ Calibrate and size reserve needs
- ❑ Establish future spending parameters
- ❑ Revenue positioning
- ❑ Employee compensation rebalancing
- ❑ Develop efficiency/policy options
- ❑ Invest in productivity
- ❑ Liability management
- ❑ Liability funding
- ❑ CIP/Debt Strategy
- ❑ Other?

❑ Communication and Stakeholder Buy-in

Questions?

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