REPORT TO COUNCIL
City of Sacramento

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INFORMATION
October 14, 2008

Honorable Mayor and
Members of the City Council

Title: Economic Update

Location/Council District: Citywide

Recommendation: Receive and file. As requested at the September 23, 2008 City Council meeting, this is a report back on the recent economic developments and the financial impacts to the City of Sacramento. The Background section of this report provides a brief summary of the events leading up to the credit crisis; the bulk of the message will be delivered verbally, along with a slide presentation.

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Department: City Treasurer

Division: City Treasurer

Organization No: 05001011

Description/Analysis

Issue: The housing and credit crises, as well as increasing unemployment, have and will continue to have significant negative impacts on the City and city residents. Tighter credit will curtail economic recovery and expansion. We should not expect property tax and sales tax revenue growth over the next several fiscal years.

Policy Considerations: The City Charter requires the City Treasurer to make periodic reports to City Council regarding the status of the City's cash and investments. Given the current economic crisis and its direct impact on the City of Sacramento it is prudent to expand the discussion to financial matters beyond cash and investments and to provide comments to the Mayor and City Council.

Environmental Considerations:

California Environmental Quality Act (CEDA): Under the California Environmental Quality Act (QEDA) guidelines, continuing administrative activities do not constitute a project and are therefore exempt from review.

Sustainability Considerations: There are no sustainability considerations applicable to this action.

Commission/Committee Action: None.

Rationale for Recommendation: The economic crisis currently enveloping the City, the Sacramento region, and the nation, is having and will continue to have significant negative fiscal and human impacts on the City, its residents, and businesses. It is important for Sacramento's leadership to be fully informed of the continuing financial challenges and constraints upon operations and fiscal planning.

Financial Considerations: This report is for information only and no action is being requested. However, the current economic crisis and its unfolding have created a period of fiscal stress on the City. Rising unemployment, declining real estate values, reduced taxable sales, tighter, even unavailable credit, will place real and challenging fiscal constraints on the City in the next several years. This information and monitoring of these trends is being coordinated with the City Manager. The City Manager's Office will recommend appropriate actions for consideration and implementation in the very near future during the FY 2009 mid-year review process or as part of the FY2010 budget development process.

Emerging Small Business Development (ESBD): Because this transaction does not involve the purchase of goods or services for the City, ESBD efforts are not applicable.

Respectfully Submitted by:

Russell T. Fehr
City Treasurer

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Attachment 1

Background Information:

The crisis-level economic conditions in the national and global economies are having and will continue to have significant impacts on the City of Sacramento and the Sacramento region. The further deterioration of the housing market, escalating unemployment, waning consumer confidence, and the lack of credit and liquidity in markets due to financial institution failings and asset write downs have significant negative impacts on the City of Sacramento. In summary, those impacts include:

- Decline in Investment earnings as a result of national and global markets.
- Continued decline in property and sales tax revenue due to impacts of the economic crisis.
- Tightened access to affordable credit for both the City and businesses, thus delaying economic development projects and making those projects more costly.

We believe the recessionary conditions will continue for an extended period of time as government, business, households, and individuals will be forced to depend less on credit to fund services, operations, and lifestyles.

<u>How did we get here?</u>

During the past decade several trends have converged to create the economic crisis and chaos in the global market. The basic cause was the creation of a very large amount of bad debt; much of this bad debt was created in the recent real estate boom and during the inevitable downturn following the boom.

It is well documented that a perfect storm was created when in 2003, in an effort to deter recession, the Federal Reserve reduced the federal funds rate to 1%. Additionally, changes in federal legislation deregulated what turned out to be very risky trading and products offered by banking institutions. Coupled with the lowest rates in 45 years, this resulted in over inflated housing market that was funded by exotic loan structures made to individuals that prior to this could neither afford nor qualify. Wall Street in turn packaged these loans and sold the products to large pension funds and insurance companies who desired high yields and sustained cash flow.

To make these securities more marketable and expand the pool of potential investors – these securities were rated by the top three rating agencies, Moody's, Standard & Poors, and Fitch. For those failing to receive the "AAA" rating, there was another option – insurance. Monoline insurance, so called because it had one line of business, began in the early 1970's as a guarantee for municipal bonds. Issuers of debt could purchase the credit rating of the monoline insurers, essentially risk free, or so was thought at the time. The monoline insurers began to guarantee these new securitized derivative products, and by 2007 had given their financial guarantee to over $2.4 trillion in asset backed securities.

Due to the inevitable decline in real estate values after the boom, in 2006 unsound lending practices caught up to both the borrower and the lender. Variable rates were resetting, deferred payments were becoming due and many sub-prime borrowers began to default on their mortgages. While many convinced themselves the initial warning signs were limited to the sub-prime market, by mid- 2007, several large funds began disclosing their exposure to mortgage-backed securities. By mid 2008, most of the large global financial institutions had reported significant losses and we witnessed many fail or acquired by other financial institutions. Additionally, we saw the Federal government take over of Fannie Mae and Freddie Mac, the two largest mortgage lenders in the United States.

The U.S. was not alone in this crisis as the downward spiral affected large financial institutions on a global scale leading to mutual distrust in the global market for interbank loans, which meant credit was difficult to get for many banks. By September 2008, the situation had deteriorated to a point where the entire banking system was on the verge of collapse; at that time, the U. S. Treasury put forth a $700 billion stabilization plan.

Current Status

In order to address this financial meltdown, the Emergency Economic Stabilization Act of 2008 was signed into law on October 3, 2008. In short, the Act authorizes the U. S. Secretary of the Treasury to spend up to $700 billion to purchase distressed assets from the balance sheets of major lending institution thereby freeing up banking reserves to allow banks to make loans to stimulate the economic growth. The purchase of mortgage backed securities is intended to reduce uncertainty of the value of remaining assets, and restore confidence in the credit markets.

How Does this Impact the City and Our Local Economy?

The economy of the City and of the Sacramento region is impacted by

- Declining real estate market values
- Increasing unemployment
- Declining economic activity
- Declining consumer confidence; and
- Restricted credit

Property Tax

After years of very strong property tax revenue growth, the City should expect reductions in property tax revenue in FY2010 and FY2011 due to the local real estate market and credit conditions.

From 1998 through 2005 the region, like the rest of the nation, experienced a period of growth as interest rates were low, making borrowing easy. Building was booming, real estate prices were increasing rapidly and the pressure was on the average citizen to invest in real estate - now! The low rates and the amount of liquidity in the market place, gave rise to loosened qualifying standards and creative financing mechanisms. The initial impact of this building/buying frenzy was an escalation in property values.

In the past three years, property values in the City of Sacramento have declined by more than $10 billion. The declines have resulted in the Assessor making a Proposition 8 reduction of the tax roll values for properties sold in the past several years. The credit crisis has since tightened lending standards, which makes it more difficult to buy, sell, and develop real estate and while the Emergency Economic Stabilization Act may help to provide some relief through improving liquidity, it is projected to have little impact on the near term market values or reduce inventory of properties on the market.

Sales Tax

The American economy is largely consumer and consumption based, and as such has been significantly impacted by the credit crisis, the housing crisis, stock market reductions, and the overall impact on consumer confidence. As liquidity in the financial market place has ceased, it has had a direct trickle down affect to our local economy. Financing for new development has stalled resulting in stagnant job growth, increased unemployment, decreased consumer spending, severe restrictions on credit and tightened lending standards; all resulting in decreased sales and property tax growth. Taxable sales within the City and the Sacramento region have been in decline since mid-2006. It is anticipated that consumer spending, which accounts for two-thirds of the U.S. economy, will remain sluggish as credit tightens and job losses escalate. This is threatening retail sales going into the holiday season, the largest source of revenue for most retailers. The National Retail Federation has forecast the worst holiday season since 2002, during a period that accounts for 20 percent to 35 percent of a retailer's annual revenue.

How Does It Affect the City of Sacramento?

The City's past conservative practices in the areas of cash management, debt issuance, and investment practices have resulted in the City having reduced exposure to adverse conditions affecting many other State and local governments. However, as previously stated the overall global and national economic conditions will have direct and indirect impacts on the City as we grapple with reduced revenues, as well as the financial impacts to our residents.

Cash

The City currently averages $580 million in cash balance from General Fund, as well as the Enterprise funds. With revenue and expenditure budgets at $965 million, the viability of maintaining a healthy cash balance hinges on practicing conservative budget principles by matching expenditures to actual revenues. It should be noted that the City proactively manages its finances and cash flow on a daily basis and does not borrow for cash flow purposes.

Investments

The City managed treasury pools (the City's is commonly referred to as Pool A), are prudently invested with minimal market risk to principal. The City's funds are invested in permissible investments under California Government Code 53601 which include government notes and investment grade corporate bonds – all of which have significantly reduced earnings in the current market environment.

In addition to the treasury pools, the City invests funds for the Sacramento City Retirement System (SCERS). Due to the extreme market conditions in 2008, it is anticipated that earnings will be significantly below actuarial targets. This will require increased City contributions in future years.

Debt

Due to conservative and prudent practices the City secured debt has minimal exposure to the on-going financial crisis. With one exception, all of the City's debt is fixed rate, therefore unlike most jurisdictions, we have not had to go to market in an attempt to take out any variable rate debt. The one exception is the loan to the Kings, which has a 10-year overlying fixed rate swap with no basis risk; the Kings have always been current with their quarterly payments.

As previously reported to City Council, while the rating on several of our bond issues has been lowered from "AAA" as a result of rating downgrades of the monoline insurers (due to their exposure in insuring the asset backed securities as described above), at this time there are no actions the City needs to take. The City has potential impact through an investment agreement with AIG associated with a bond reserve account. AIG was recently been downgraded, again due to exposure to asset backed securities, triggering termination clauses in the agreement that is highly likely to result in a reduction in investment earnings and higher net debt service payments to be made by the City.

While the City is not liable for the debt, there has been an upswing in delinquency rates the past two years for land-secured debt (i.e. Mello-Roos). At this time the City has not had to draw on any bond reserve accounts and has been fortunate in that the debt not covered by the County's Teeter Plan has been quickly paid once notification of foreclosure notice has been sent.

Debt and Economic Development

In addition to the reduction in actual property and sales tax revenues, the City should not look for Economic Development programs to assist in getting over this downturn. Paramount to this is what we anticipate to be continuing restrictions on credit availability. While the Treasurer's Office continues to work on and support City projects, as well as other economic development projects, under the current budget and economic climate it is not a good time for the City to borrow money. Despite the push for municipal bond rating reform, borrowing at this time is likely to impact the City's AA credit rating, thus making future borrowings more difficult and expensive. This threat to the credit rating is due to the current economic impact on the City revenues, the resulting budget pressures, and the high (nearly 8%) General Fund debt ratio. Secondly, due to the liquidity issues in the market place many financings nationwide are being placed on hold as they are not marketable, particularly those that are development dependent. This is immediately recognized in the recent media attention on the difficulty the State of California is having with selling bonds.

Where do we go From Here?

The economic crisis, rooted in housing and credit, is having a direct impact on the City's two major revenue sources: property taxes and sales tax. Unfortunately, the financial challenges will continue to impact the City for several years. Recovery and future expansion will occur when the current negative trends are reversed: employment increases, credit is available, housing values stabilize, and taxable sales increase.

At all levels in the nation, governments, companies, households, and individuals have been spending at levels not supported by current revenues and income, and closing the gap with debt/credit or the use of savings/reserves. Climbing out of the economic crisis will require this trend to be reversed; spending must fall below income and the difference applied to debt reduction and increasing savings. This has obvious impacts on governmental budget and resource allocation decisions. The recessionary conditions will continue for an extended period of time as government, businesses, households, and individuals will be forced to depend less on credit to fund services, operations, and lifestyles.

The challenging financial conditions create real constraints; adapting to these constraints is critical and will continue to be a painful reality in operations and fiscal planning for years to come.

Attachment 2

The Economic Crisis and Its Impacts on the City of Sacramento

City Treasurer's Office

October 14, 2008

Report to Mayor & City Council

- Charter requires City Treasurer to make periodic reports to the City Council regarding status of City's cash & investments
  - Such a report is appropriate in the current circumstances
- Given the economic crisis gripping the nation, I am expanding my comments to other aspects of the City's finances

Sources

- County Assessor
- State Board of Equalization
- Published & Public Data
- Published & Broadcast--Articles, Commentaries, Editorials
- Published & Public Economic Forecasts
- Conversations with Public & Private Sector Finance Professionals

Acknowledgements

- City Manager
- City Treasurer's Office
- City Finance Department

- *City Treasurer is solely responsible for content and comments*

Economic Crisis Impacts on City

- The severe economic crisis gripping the nation and the world is having, and will continue to have, significant negative impacts on the City, its residents, its businesses, and its economic development/prosperity program

Why High Level of Concern

- Decline in housing values
- Increasing unemployment
- Slowing economic activity
- Very tight, even unavailable credit
- Declining City property tax & sales tax revenues
- Multi-year economic downturn ahead

Economic Crisis

- Root cause was creation of very large amount of what has turned out to be bad debt
- Relaxed credit standards, low interest rates & lax regulation
- The bad debt was packaged & sold as investments
  - Mortgages
  - Credit cards
  - Other loans

Housing Crisis

- Significant increase in housing values between 1998 and 2005
- Significant increase in volume of housing sales, both existing housing & new housing
- Inevitable decline in market value & sales volume at end of boom cycle

Housing Crisis Compounded

- Some banks, mortgage providers & homebuilders took risky and irresponsible measures to extend housing boom
- False sense of value
  - Sub prime mortgages compound situation
    - Long term unaffordable
    - More mortgage backed investments created
    - Unsophisticated homebuyers lured into ruin
    - Irresponsible homebuyers took on debt beyond their means

Housing Crisis Impacts

- Nationwide--housing values decline by $4 trillion to $6 trillion
- In City of Sacramento property values decline by more than $10 billion
- Banks, investment funds & individual investors who purchased or issued mortgage backed investments have lost trillions with losses continuing

Credit Crisis

- The housing & other bad debt losses of financial institutions & investors worldwide have created the credit crisis
- Major bank failures
- Investors are afraid to invest—risk adverse
- Banks are afraid to lend
- Borrowers are unable to borrow
- Economic activity coming to a standstill
- Much tighter lending standards when current panic ends

Consumer Confidence

- American economy largely consumer & consumption based
- Decline in housing values & investments has resulted in massive losses of wealth & equity
- Credit standards will be tighter in future
- Need to pay down debt
- Weak holiday sales expected

Regional Economic Landscape

- Increasing unemployment
- 3 years of declining real estate values
- Foreclosures at all time high
- 2 years of Citywide & Regional reductions in taxable sales
- Severe restrictions in availability of credit & tighter lending standards

City's Economic Trajectory

- 2005 Continuing Growth
- 2006 Slowing Growth
- 2007 No Growth
- 2008 Economic Decline
  - Real estate values fall
  - Taxable sales fall
  - Employment declines
  - Credit evaporates

Impacts on City Finances

- Not all immediate bad news
  - Past conservative practices in areas of cash management, debt issuance & investment practices provided reduced exposure to adverse conditions
- Continuing declines in major tax revenues
- Threat to City's credit rating should borrowing be attempted
- Delays in economic development program

Cash

- The City's cash and cash flow is proactively managed on daily basis
- City does not borrow for cash flow purposes
- No current cash flow crisis such as occurring with State, other governments & many businesses

Investments

- Treasury Pools
  - Investments prudent with minimal market risk
  - Investments consistent with State investment regulations
  - Low interest earnings due to low return on government notes & investment grade corporate bonds
- SCERS Retirement Fund
  - Earnings below actuarial targets due to market conditions
  - Increasing City contributions in future years

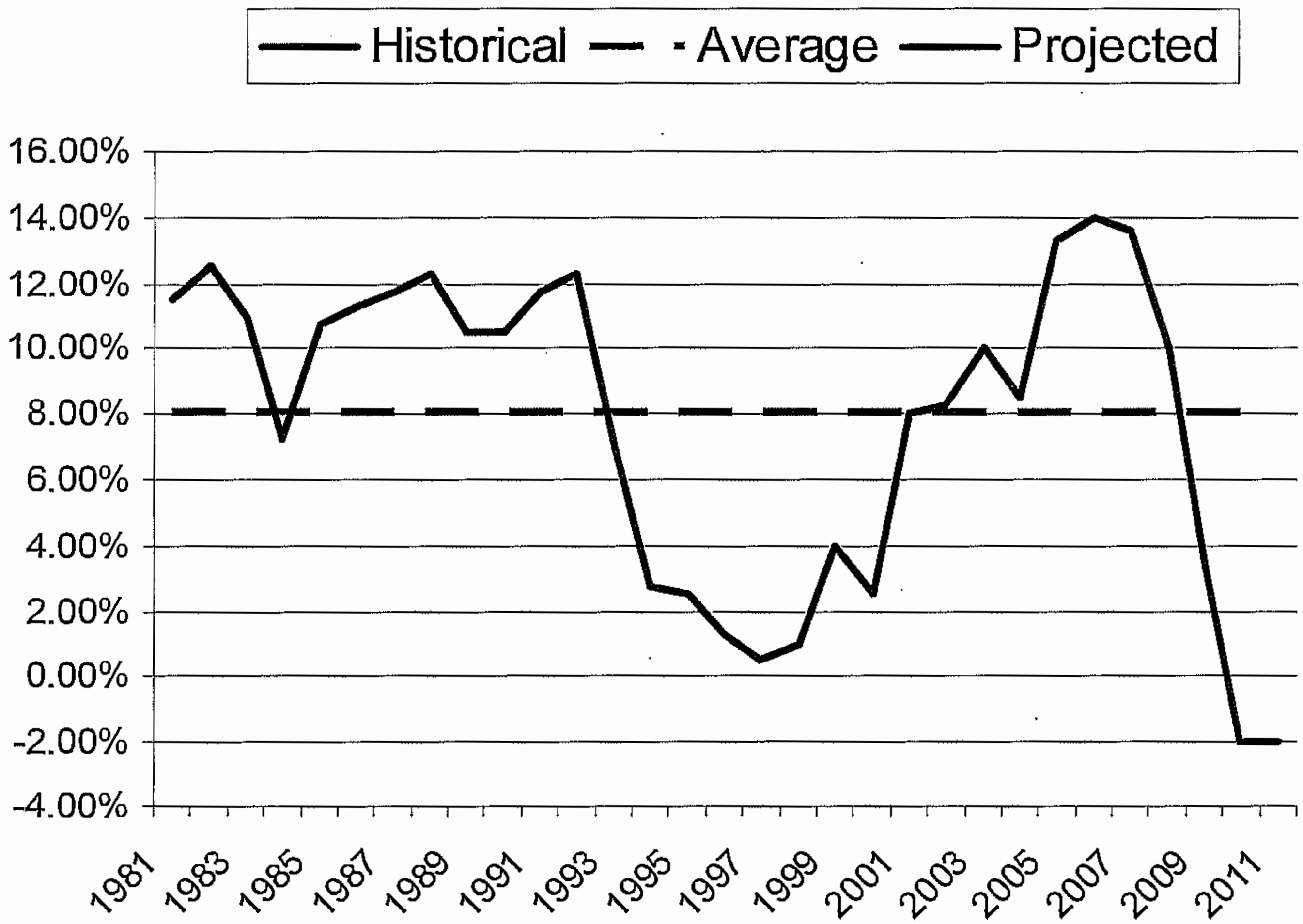
Debt

- All City debt is fixed rate
  - No variable rate exposure
  - Little exposure to bond insurance provider downgrades
- Debt Status
  - Current AA & A ratings for debt issues & master lease program
  - High General Fund debt ratio restraint on future borrowing
  - Limited capacity for debt service savings through refinancing

Property Taxes

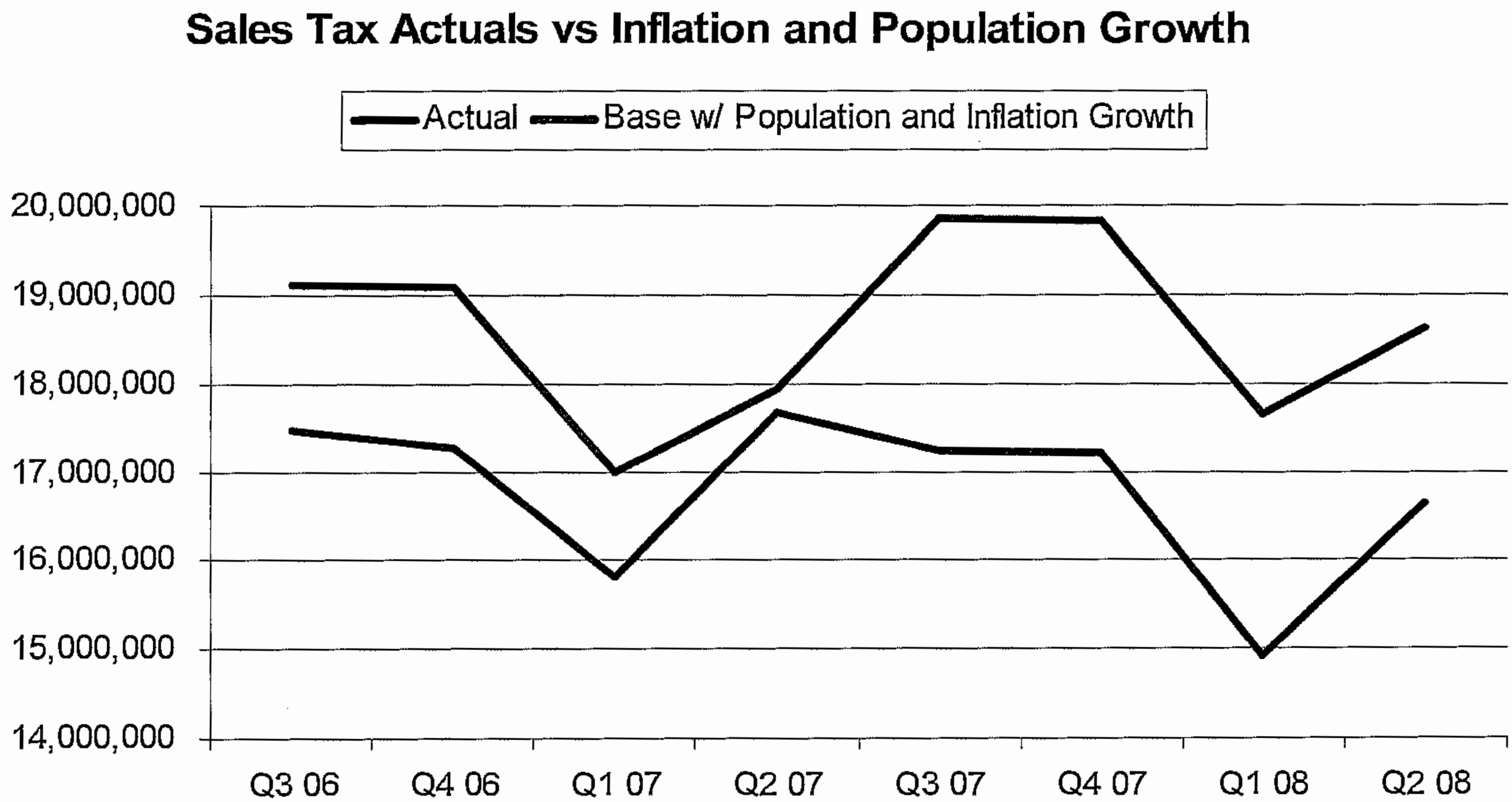
- A 20% to 30% reduction in property values having impact on property tax revenue
- Typical sale is a foreclosed home resulting in market value reduction
- Trend continuing
- Tighter credit standards
- High inventory
- Reductions in FY2010 & FY2011

Property Tax Growth 1981-2011



Sales Tax

- Rising unemployment
- Consumer confidence falling
- Businesses closing
- Tighter credit
- Need to pay down debt
- Weak holiday sales expected


Sales Tax Actuals vs Inflation and Population Growth
Actual
Base w/ Population and Inflation Growth
20,000,000
19,000,000
18,000,000
17,000,000
16,000,000
15,000,000
14,000,000
Q3 06
Q4 06
Q1 07
Q2 07
Q3 07
Q4 07
Q1 08
Q2 08

Debt & Economic Development

- Current AA credit rating at risk should City attempt to borrow under current conditions
- Project types currently deemed more risky & speculative
  - Financing dependent on future housing development
  - Revenue generating facilities & projects such as parking garages, theaters, retail

Project Funding

- Tighter Credit Anticipated
  - City borrowing will be more costly & restricted when credit crisis abates
  - Much tighter standards for revenue bonds with much higher revenue coverage required
  - Tighter credit standards also apply to the City's private sector partners in economic development & job creation
- Projects deferred if funding too expensive or even unavailable

Recovery

- National & Local
  - Increasing employment
  - Availability of credit
  - Housing market stabilization
    - Inventory reduction
      - Foreclosures & short sales
      - "Ready" new housing
      - Deferred resales
  - Taxable sales increase
  - Non-residential development

Conclusion

- Consensus that recovery will take several years, at best
- City planning & actions will be constrained by new economic realities
- Economic development, critical to City's future, challenged by current economic environment