City of Culver City, California

City Council Agenda Item Report

Meeting Date: 10/13/08	Item Number: A-1
AGENDA ITEM: Discussion of Current Economic Conditions and Effects on Culver City, and Input to Staff as Deemed Appropriate.	
Contact Person/Dept.: Jeff Muir, CFO	Phone Number: (310) 253-5865
Fiscal Impact: Yes [X] No []	General Fund: Yes [X] No []
Public Hearing: [] Action Item: [X]	Attachments: []
Public Notification: Master E-Mail Notification List (10/09/08)	
Department Approval: Jeff Muir (10/09/08)	City Attorney Approval: Carol Schwab (by H. Baker) (10/09/08)
Chief Financial Officer Approval: Jeff Muir (10/09/08)	City Manager Approval: Jerry B. Fulwood (10/09/08)

RECOMMENDATION:

Staff recommends the City Council receive and file a brief report on current economic conditions and how they may affect Culver City, and provide input to staff.

BACKGROUND:

At the joint meeting of the City Council and Redevelopment Agency on October 6, 2008, the City Manager briefly described some proactive steps the City would be taking to protect itself from the current conditions that exist in the economy and financial markets. In order to weather these economic conditions and attempt to prevent deeper cuts in the future, the City Manager informed the City Council of the following actions that are being taken:

- Implementation of an immediate hiring freeze, excluding Public Safety positions. All vacant positions will be reviewed on a case-by-case basis with the City Manager.
- Cessation of overtime, excluding Public Safety or emergency situations. All exceptions to be reviewed by the City Manager.
- Assessment of current usage of part-time and contract employees.
- Assessment of current usage of consultants.

The City Manager also informed City Council that a more comprehensive memo would be issued detailing these actions, and that the Finance Department was in the process of putting together a budget review based on the first quarter of the fiscal year as well as updating the Comprehensive Financial Report. After some initial comments and questions by City Council, it was agreed that since this item was not agendized, it would be most prudent to add it to the next agenda so that City Council could have discussion and provide any information requests or questions to staff. This written report will provide only some basic information of the current economic conditions and how they might affect Culver City. Staff anticipates bringing the first quarter budget report and updated Comprehensive Financial Plan back in November.

Economic Update

One year has made a significant difference in the economic reality and outlook faced by the entire nation. The dramatic shift in the housing market has been the driving force in the economic downturn that has occurred. Over the last few years, a huge number of "unconventional" mortgages were offered to borrowers who may not have otherwise qualified for or been able to afford a conventional loan. An unconventional loan offers creative financing terms that allow the borrower to pay only interest, or offers a very low "teaser" interest rate (i.e. subprime loan) for a specified term, typically 1 to 7 years. When the initial term expires, the loan typically resets to a more conventional principal and interest payment at a higher interest rate. The idea behind these types of loans is that the home will increase in value enough to allow the borrower to refinance, or the borrower's income will increase enough to cover the more conventional terms. The success of these loans is highly dependent on continuous large increases in home values.

Unfortunately, as large numbers of these loans began to reset, home values were not increasing sufficiently to allow borrowers to refinance to a fixed rate loan. As a result, many borrowers experienced significant increases in their monthly mortgage cost, to the point that they could not afford to make the payment. An increase in foreclosures flooded the real estate market with supply, causing home prices to fall even further. The decline in prices resulted in even more foreclosures as the number of borrowers that were unable to refinance increased. It has been a vicious cycle that has led to an all-time record number of homes in foreclosure status.

The number of foreclosures has had such a devastating impact on financial institutions because they began experiencing huge losses on their investments in sub-prime mortgages (called mortgaged back securities). As a result of the losses, banks do not have nearly as much capital for new loans, and have become wary of giving new loans without putting a significant burden on the prospective borrower to document their financial stability. In fact, the borrowing restrictions have gotten so burdensome and the amount of capital banks have available to lend has gotten so short, that many lending markets are currently non-existent (this has been referred to as the "credit crunch").

Additionally, the losses experienced by the financial institutions heavily invested in mortgage backed securities have been so severe, that a number of companies that were previously thought to be financially infallible (e.g. AIG, Lehman Brothers, Bear Stearns, Washington Mutual, Indymac Bank, etc.) have filed for bankruptcy, been taken over by the government, or have been forced to merge with other institutions for pennies on the dollar. The federal government has recently pushed through legislation to provide $700 billion to failing banks to try to keep the U.S. economy from plunging even further into a hole.

All of this has had a devastating impact on consumer confidence and the stock market (the Dow Jones has declined by nearly 3,000 points in the last month, from 11,500 in the beginning of September to 8,500 and falling). Most recently, this financial crisis has spread to the world markets with many European banks experiencing solvency troubles and big losses in the Asian stock markets. Many economists are new predicting that this will be a prolonged economic contraction that will last a year or longer.

DISCUSSION:

While there have certainly been economic ups and downs during the last ten to fifteen years, the housing crisis which has precipitated the collapse of the financial markets has placed the economy in ‘uncharted waters’. While there was some debate over the past year as to whether the country was entering a recession, based on recent events it is becoming widely accepted that we are entering a recessionary period that could last for some time. It is necessary for Culver City to react now in order to avert its own potential financial disaster. During the last few years the City has seen growth and development. This recession and tightening of the credit markets, though, will continue to affect everyone: governments, large and small businesses, developers, individuals, etc.

The credit crunch during September intensified to the point where Lehman Brothers filed for bankruptcy protection, Washington Mutual was bought by JP Morgan/Chase, AIG needed an $85 billion dollar line of credit from the Federal Reserve (and has subsequently requested an additional $23 billion infusion from the US Treasury), and the government fast-tracked a comprehensive bailout plan that provides support to the overall market. To make matters worse, the outlook for the U.S. economy is beginning to deteriorate at an increasing rate. Second quarter Gross Domestic Product (GDP) growth has been revised downward from 3.3 percent to 2.8 percent. More alarming is that GDP growth is projected to be 1.0 percent in the third quarter and 0.2 percent in the fourth. While the U.S. economy is not yet technically in a recession, which is defined as two consecutive quarters of negative growth, there is a 43 percent chance it will be in the next six months, according to Moody's.

Culver City's revenue streams are being affected by these conditions, and the likelihood is that it will get worse before it gets better. Below are a few of Culver City's major General Fund revenue sources and how they can be affected by an economic downturn:

Sales Tax

Sales Tax represents about 20% of the City's General Fund revenues. Specific Sales Tax data lags receipts by about six months. Based on our most recent information from our Sales Tax consultant, the first quarter of 2008 was down 5% compared to the same quarter in 2007. It is likely we will see larger declines as data comes in for the subsequent quarters based on the negative events that have occurred in the marketplace. The budget estimate of Sales Tax for FY 2008/09 is $17.8 million. Coming in only 5% under for the year would be a $900,000 loss compared to budget.

Utility Users Tax (UUT)

UUT represents about 17% of the General Fund revenues for FY 2008/09, or about $14.5 million. As economic conditions tighten, individuals become more apt to take steps to reduce utility consumption to reduce related costs. This can have an effect on the City's tax receipts. Staff will provide information on our UUT trend in the quarterly budget update.

Business Tax

Business Tax represents about 12% of the General Fund revenues for FY 2008/09, or about $10.15 million. Receipts from this category were strong in FY 2007/08, and can be partly attributable to strong staff oversight and increased compliance from business. Funding is included in the FY 2008/09 budget for a business tax audit, which is anticipated to identify further non-compliant businesses in the city and should then bring in additional tax receipts. Since the Business Tax is often based on gross sales receipts, Business Tax revenues generally mirror the trend in Sales Tax revenues. Despite increased oversight and compliance, there is the possibility of this revenue category seeing a dip due to lower sales volume or companies going out of business.

Property Tax

Culver City is a "low property tax" city and only receives 10.5% of the 1% property tax rate paid by property owners, which equates to only about 3.5% to 4.5% of General Fund revenues, on average. Fortunately, Culver City has not seen a significant drop in this category the last few years, and has not experienced the severe mortgage and foreclosure meltdowns felt by other locales. The adopted revenue projection for FY 2008/09 is $3.94 million. This amount has subsequently been adjusted by our property tax consultant, HdL, and will be further addressed during upcoming finance presentations.

Major Development Taxes and Fees

FY 2007/08 saw some major development activity get underway, including the Westfield Shopping Mall and Sony. Combined Commercial Industrial Development Tax from these two sources alone was close to $2 million for FY 2007/08. Building, electrical and plumbing permits, plan check fees, and other related fees and charges saw dramatic increases related to this development also. Projections for FY 2008/09 include $1.18 million in Commercial Industrial Development Tax and approximately $500,000 in related fees and charges. Due to the current economic climate and the difficulty for commercial development in securing financing, it is extremely possible the projects these revenues were based on will be significantly delayed. Further developments are also slated to begin in FY 2009/10, and the budget projections for that fiscal year will need to be revisited depending on how the current business climate shakes out over the next several months.

Interest Income

Culver City maintains an investment portfolio in order to achieve earnings on idle cash balances. The portfolio includes balances maintained in passbook accounts or money market accounts to cover immediate obligations, in highly liquid pooled investment accounts through the California Local Agency Investment Fund, in federal agency issues and in medium term corporate notes. The collapse of several significant companies in the financial sector has placed some exposure on the City and Redevelopment Agency portfolios.

The City holds a $1 million corporate note from Lehman Brothers, which is now in the process of bankruptcy liquidation. We have joined a working group with other agencies similarly positioned to work collectively in identifying options to recover as much of this investment as possible. The City and Agency also hold several notes from AIG wholly owned subsidiaries: Bear Stearns and Merrill Lynch. Bear Stearns was bought out by J.P Morgan, and Merrill Lynch by Bank of America, so the prognosis for these notes is strong as long as the parent companies remain so. It is important to note that these medium term corporate notes were AAA rated at the time of purchase. Based on market conditions we see yields being lower than anticipated during the budget process, and could see lower than expected investment income in the coming years. Staff is closely monitoring this situation and will keep the City Council informed.

State Budget Issue

After 85 days after the beginning of the State's fiscal year on July 1, the state budget was finally adopted. At the time of its adoption, cities escaped relatively unscathed, and relatively little city funding was used to balance it. Transportation is expected to lose $1 million in STA funding for FY 2008/09. The Redevelopment Agency will also have $2.26 million taken away in FY 2008/09 to help balance the state budget.

With the recent announcement of an imbalance already of $4.6 billion for FY 2008/09 and the need of $7 billion in cash just to pay bills, it is now uncertain if the state will come back and shift, divert, or takeaway funds from local governments. Staff will be watching closely for any developments on this critical issue, and report any information to City Council and the City Manager.

PERS

The City of Culver City, like most local government agencies in California, contracts with CalPERS for pension system operation and administration. CalPERS holds and invests pension payments from local agencies, and is one of the largest pension systems in the country. As of July 31, 2008, the CalPERS investment portfolio market value was $235.9 billion. According to the CalPERS website, the investment portfolio market value as of October 8, 2008 was $198.3 billion. During the last stock market incident surrounding the 'dot com' collapse and then September 11th, CalPERS saw three years of negative earnings. This resulted in dramatic increases in required pension contributions from local agencies. As a result of the outcry from contracting agencies, CalPERS instituted a 'smoothing' formula to avoid huge ups and downs in required contributions. If CalPERS sustains huge losses in its portfolio, we can expect higher contributions in the future, but likely not of a magnitude seen earlier in the decade.

FISCAL ANALYSIS:

There is no fiscal impact from this report. As mentioned previously in the report, Staff will return with a detailed budget update based on results through the first quarter, and update the Comprehensive Financial Plan with these results and revised future assumptions.

ATTACHMENTS:

None

MOTION:

That the City Council:

Receive and file this report and direct Staff as deemed appropriate.