

Housing Market Downturn + Sub-Prime Mortgage Implosion = Financial Management Issues for Cities

The bursting of the housing bubble coupled with the sub-prime lending implosion is no longer news to most of us. What may become news is their subsequent impact on cities. As this market situation has unfolded, its impact in one or more forms has taken on greater dimensions and expanded to most cities.

One broad measure of the extent of impact is the mortgage foreclosure rate on all housing. A recent Kansas City Star article stated that the national foreclosure rate in August 2007 was one filing for every 510 households. Missouri ranked 18th, with 3,079 foreclosures, or one in every 842 households. Kansas was 37th, with 428, or one in every 2,795 households. These figures are a bellweather of the total housing market, both in the supply and demand for housing.

First, the housing industry retrenchment can take on one or more of the following forms, depending on the city:

- Reduced permit activity affecting annual operating budgets
- Delinquencies in special assessment payments and connection fees affecting the ability to fund debt service on city infrastructure investment
- Historic inflationary increases in tax base falling off, leading to higher property tax rates

Second, the collapse of the sub-prime mortgage lending market is having the following direct and indirect effects on cities:

- Upward pressure on most all interest rates, particularly at the lower credit quality levels
- Tightening of mortgage lending standards for buyers affecting access to the housing market

Third, the combination of these two market events may raise a number of issues for your city either in the near term or over time:

- Will the sale price of housing be temporarily reduced or remain at a different plateau?
- Will the affordability of housing, sale price and borrowing rate consume a larger share of an individual's budget?
- Will single-family housing development change to a degree which impacts local government's infrastructure investment and housing use mix?
- What do all of these factors mean in terms of municipal financial management?

As with all economic events, individual cities are impacted to a greater or lesser degree and over a shorter or longer time period. Those fully-developed cities may have little immediate impact, but should instead focus on the housing market ripple effect as the normal inflation in the value of their housing stock levels off or falls. The impact on growing cities may be more extensive where investments in infrastructure expansion have been made, including staff directly related to building permit activity.

Let's briefly look at each of the above factors and how they might impact your city, as well as how you should potentially position your management processes to anticipate those situations. We will start with the two factors bearing the greatest potential of impacting the most cities.

Two Factors having the Greatest Potential of Impacting Most Cities:

- Interest Rates
- Tax Base

All cities have witnessed a change in the interest rate market. This is good news if you are investing money, but not such good news if you are borrowing money. The sub-prime market situation has already caused upward pressure on most interest rates, including the municipal bond market. This situation is still unfolding as first the direct lenders were impacted, then the institutions that lent them money. Through it all, the ultimate investors are wondering how this is going to shake out. When the investors get nervous, interest rates go up.

From a city management perspective, a revisiting of the immediate borrowing needs may be required to ensure both the demand for the investment and its interest cost are still advisable.

An open question is 'to what extent and for how long will the tax bases of cities be adversely impacted?' The majority of housing market segments are experiencing some level of downward pressure. As individuals generally use the equity from their existing residence to move up in the market, falling sale prices and a general slowing down of sales prohibit these individuals from moving up to higher valued homes. This slackening in demand coupled with more stringent mortgage lending practices impacts other housing market segments.

Many cities need to anticipate their property tax position moving forward. For a considerable period, a good number of communities have witnessed substantial ongoing growth in their tax bases, often fueled by their residential sector. This situation has permitted them to keep tax rates lower while still generating the same or increased tax revenues. If a city's residential sector does not continue to grow at recent historical rates, and the city wants to continue to generate the same tax dollars, then tax rates must increase. These rate increases would come at a time of flattening property valuations and greater shares of income being spent on housing related costs.

Factors More Localized to Cities Experiencing Growth:

- Building Permit Revenues and Inspection Expenditures
- Debt Repayment
- Infrastructure Expansion

Now let's look at those factors which may be more localized to those cities which have greater investments in new growth.

Generally, a growing city's current operating budget anticipates building permit revenues and inspection department expenditures. In many cities, building activity has fallen off over the past year, as have the related permit revenues. This situation raises the issue of if, and how, the upcoming operating budget should be changed on both financial sides.

From a management perspective, any decision should consider both immediate and long-term budget scenarios. If building activity levels have fallen off, what do you know of the size and timeframe of this condition moving forward? Training staff is an investment which pays off over time. Terminating such staff for smaller, short-term market situations may not be prudent over a longer term. Conversely, in times of difficult budget choices with reduced inspection revenues, the reduction of positions is an area of review. In either case, the structure of your city's operating budget should easily identify growth-related revenues and expenditures so that in uncertain markets the dual impacts can be readily considered.

Most growing cities have existing and planned future investments in infrastructure expansion – roads, utilities, treatment plants, etc. This area raises the most potential for significant, long-term financial impact because of the dollar magnitude of funding outstanding debt obligations and the costs of new investments. These growth-related capital and debt requirements are often funded by single or combination special assessments, connection fees, excise taxes/impact fees, property taxes and utility user fee revenues. The first three revenues relate to specific properties as they develop, while the second two revenue sources are drawn from all tax payers or utility customers.

The financial viability of growth related special assessments, excise taxes/impact fees, and connection fees is directly linked to the sale and development of properties. As lots are developed, excise taxes, impact fees and connection fees are received and the risk of special assessment delinquencies is reduced. The city is in actuality partnered with the housing market in their complementary investments. As the supply of available lots grows, in many cases the lot price will fall. The developer's or builder's financial viability will in turn be impacted, as will their ability to make timely payment of special assessments. With more available lots, the decisions on future city infrastructure expansion become more critical as the overall municipal financial exposure relates to all development areas.

Missouri and Kansas cities often make available assessments, excise taxes, impact fees, property taxes and/or utility user fees for debt repayment. As the risk of assessment delinquencies or delays in fee revenues grows, so does the exposure for increases in supplemental property taxes or higher user fees.

Many cities have already taken steps to reduce their risk exposure through development agreements relating to timely payment of assessments and fees. Cities should continue to explore with their attorneys viable means of similar risk mitigation tools.

From a city management perspective, quality information on its local development market and the ongoing position of its revenue sources for debt service is essential. Information on the lot supply, the pace of new construction, the type of new construction, and whether single or multi-family is extremely important for gauging your ability to repay

existing debt obligations, as well as if and when new investments should be made. For those cities sensing potential future shortfalls, the gathering and reporting of this information should be formalized and become part of any related decision-making process with the governing body. As the housing situation for a given city may take some time to unfold, the financial impacts may also take a period of time to be realized. Faced with uncertainty, communities should have monitoring systems to determine if, and to what extent, your city's financial situation may be impacted so that if necessary, you have enough time to plan for corrective actions.

Summary

Whether your city has yet to be affected or not, the housing market and sub-prime lending situations are having financial impacts on communities across Missouri and Kansas. The keys to successfully managing those factors affecting your city are based in the established standards of good management: specifically, information, discussion, planning and flexibility.

Your city will be better positioned if you engage now in planning for any potential impacts. Fruitful discussions follow from a review of solid information covering both your private market and the status of your public financial resources. These discussions should result in an assessment of if the city is at risk and, if so, in what areas, to what extent, and over what timeframe. If appropriate, the city should develop a plan to anticipate its future options and potential courses of action. As conditions will change over time, your city should have ongoing information resources available to decision-makers. This information and planning becomes a context for immediate decisions, for example:

- Should we plat new subdivisions?
- Should we expand our road program?

This context is crucial to your longer term decisions to align financial operations, debt and capital planning activities with the city's financial commitments.

The partnership between the private development market and municipalities has always existed. The period of economic expansion has been long lasting with many benefits for both parties. Now the broad downturn presents potential issues which are new to many city officials. Their reliance on sound management and governing skills will work well for them during the changing private market environment.