

**CITY AND COUNTY OF SAN FRANCISCO
BOARD OF SUPERVISORS
BUDGET AND LEGISLATIVE ANALYST**

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To: Supervisor Dean Preston
From: Fred Brousseau, Director of Policy Analysis
Budget and Legislative Analyst's Office
Re: Update to our July 2020 report on Municipal Bank Issues and Options
Date: October 29, 2021



Recap of July 2020 BLA report on creating a public bank

In our July 2020 report, "Municipal Bank for San Francisco: Issues and Options for Consideration"¹ we provided two primary options for consideration by the Board of Supervisors of the City and County of San Francisco to create a publicly owned lending institution, or Municipal Financial Corporation (MFC). One option was to create a depository MFC; the second option was a non-depository institution.

A depository MFC is a traditional bank, able to issue liabilities against itself as a counterpart to the issuance of loans and to accept incoming payments, or deposits, to customers' accounts. As with all banks, a depository institution created by the City and County of San Francisco would be subject to approval and ongoing regulation by state and federal banking oversight agencies. As of 2019, local governments in California are explicitly allowed by State law to create and operate public depository institutions.

A non-depository MFC, by contrast, would not take traditional customer deposits so would have to fund its lending operations through borrowing funds on the private markets, generally through the issuance of debt securities. All payments received from other parties, and payments made by the non-depository would be cleared and settled through a partner depository bank. A non-depository would not be subject to the same State and federal regulations as a depository MFC.

In our July 2020 report, we recommended that the City and County of San Francisco (the City) consider establishing a non-depository MFC, at least initially, to slowly build up its portfolio of loans and successful operations while keeping its operating costs low. While prudent and cost-effective operations would still be necessary, a non-depository MFC would have additional operating flexibility and cost savings opportunities in that it would not be providing an array of banking services to the public and would not be subject to the regulatory requirements of state and federal agencies including the Federal Deposit Insurance Corporation (FDIC). We also presented the idea in our July 2020 report that, over time, as the non-depository institution's assets grow and financial position strengthens, the City could consider

¹ Budget and Legislative Analyst, Policy Analysis Report for Supervisor Sandra Lee Fewer, "Municipal Bank for San Francisco: Issues and Options for Consideration". July 24, 2020.

converting the MFC into a depository institution to achieve additional growth and impact and to provide a higher level of service.

Whichever type of MFC the City chooses to create, we recommended that the City use a portion of its \$11 billion Investment Pool (value at the time of our report) along with some General Fund appropriations to capitalize and fund the MFC. We recommended this approach so that the MFC could quickly achieve the scale and impact consistent with the City's policy objectives: providing low-cost loans to the community, particularly to address local needs such as affordable housing, providing loans to communities underserved by traditional banks, and extricating itself from the business and lending practices of many large financial institutions.

Along with investment instruments such as U.S. Treasury notes, bankers' acceptances, and state and local agency bonds, State law allows cities and counties to place its investment pool funds in commercial paper, debt securities, or other obligations of a public bank, defined as a traditional depository institution.² However, there is no counterpart provision in State law allowing a jurisdiction's investment pool funds to be invested in a non-depository MFC. Because of the absence of such a provision, our July 2020 report included a recommendation to place a designated amount from the City's Investment Pool funds in a conduit entity, separate from the MFC. State law authorizes placing investment pool funds in bonds or notes issued by state agencies or local government jurisdictions such as the City and County of San Francisco. In our July 2020 report, we assumed City Investment Pool funds placed in the conduit entity (a bond issuing state or local agency) would in turn be used to purchase securities from the MFC to provide funding from which it would originate loans. The conduit entity could be a local or State body that issues debt.

City Attorney opinion

In a memo released on June 29, 2021, the City Attorney's Office states that State law would bar the City and County of San Francisco from setting up a special-purpose, publicly-owned conduit entity to channel Investment Pool funding to a non-depository Municipal Financial Corporation. The City Attorney's Office has concluded, subsequent to the issuance of our July 2020 report, that State law, particularly Sections 53601 and 57600 of the California Government Code, would in fact disallow the conduit funding mechanism.

We welcome the City Attorney's clarification on this matter. At the same time, it is important to stress the City Attorney's revised position does not change our proposed approach to any of the fundamental issues we sought to address in our report or in our recommendation to initially create a non-depository MFC. If the newly created San Francisco Reinvestment Working Group determines that it wants to pursue the non-depository MFC option, but not use of a conduit, it could pursue one of at least two alternatives. The first alternative would be to establish a partnership with an existing bank that would serve the same role as the conduit: receiving Investment Pool monies and providing interest earnings to the City. This partner

² California Government Code 53601(r).

bank could then purchase debt securities from the MFC which would serve as the source of the MFC's funding to originate loans.

A second alternative would be for the Reinvest in SF Working Group and/or City officials to advocate at the state level for the Government Code to be amended to allow Investment Pool funds to be invested in non-depository institutions as is now allowed for depository MFCs. These two options are discussed further below.

The Reinvest in SF Working Group may seek out other opinions and information about using a conduit, identify other funding approaches, or may choose to pursue the depository MFC approach, in which case the issue would be moot. Separate from the issue of MFC funding mechanisms, this memo reiterates the key issues we believe must be considered, and the rationale underlying our July 2020 report's recommendations.

The need for a stable, low-cost source of funding

Creating a publicly-owned financial institution able to supply low cost, long-term credit to support affordable housing investment, lending to small businesses, and infrastructure development requires a low-cost, stable funding base. The reason is self-evident – lower funding and operational costs can be directly passed through to borrowers in the form of lower interest rates. In addition, it is critical this funding base is stable, and is not subject to unpredictable and volatile funding run-offs.

We identified two potential funding sources in our July 2020 report that satisfy these criteria. The first is the City Investment Pool, a portion of which we recommend be used for either a depository or a non-depository MFC. The second source, deposits from households, businesses, public entities, and nonprofit organizations, only applies to a depository MFC that would provide the standard range of banking services. When combined with Investment Pool monies, deposits would enable the MFC to build up an even larger deposit base to support the bank's lending operations.

There are definite advantages to the depository route to forming a public bank. This option is explicitly authorized under State law (California Government Code Sections 53601(r) and 57600) and the Treasurer is authorized to purchase debt securities issued by the MFC depository, obviating the need for any workaround via conduit funding or another means. Moreover, State law imposes no limitation on the amount of Investment Pool funds that can be directly invested in debt securities of a public bank. Nor is there any explicit limitation regarding the term (time to maturity) of these investments, provided they are consistent with the prudent exercise of the Treasurer's fiduciary responsibilities as per the terms of Section 53601. We recognize the language of Section 53601 provides the Treasurer with discretion about which of the State-permitted investment instruments to use, but ruling out use of Investment Pool funds cannot be justified on the basis of any explicit legal or fiduciary prohibition.

There are certain risks and disadvantages to initially seeking to create a depository MFC. For one, a *de novo* public bank would require but might not be granted regulatory approval by the FDIC. In addition, a depository will have significantly higher startup and ongoing operating costs, and hence may not be the optimal choice when evaluated in terms of the ability to provide longer-term, below market rate credit. For these reasons, we continue to favor launching the MFC as the non-depository if a means for doing so can be found that is permissible under current State law.

Alternatives to conduit mechanism

State law prohibits using Investment Pool monies to directly fund a non-depository MFC. Should the Reinvest in SF Working Group conclude there are advantages to establishing a non-depository prior to incorporation as a state-chartered, FDIC insured depository, it will be necessary to find a “workaround” funding mechanism that the Working Group concludes is not precluded under current State law.

As mentioned above, a possible alternative funding mechanism would be for the City to use some of the funds in the Investment Pool to purchase medium-term notes issued by a depository partner to the MFC. The MFC’s affiliated depository would in turn lend these funds to the MFC via purchase of the MFC’s debt securities, providing funding to support the non-depository MFC’s lending activities. The partner depository would pay interest earnings to the City and earn transaction fees for playing this role.

This mechanism has a similar structure and objective as the City or state-sponsored conduit entity detailed in our July 2020 report. The difference is that Investment Pool monies would be used to purchase debt securities (medium terms notes) issued by an FDIC-insured depository (the MFC’s partner bank). Provided this satisfies the requirements of Section 53601(k) regarding placement of Investment Pool funding in medium term debt securities, the MFC’s partner banking entity will need to have a grade A or higher credit rating from a nationally recognized statistical ratings organization. With that in place, upwards of 30 percent of Investment Pool monies would be legally eligible for the purchase of such securities. Given the City Attorney’s recent opinion that the conduit mechanism would violate the legislative intention of Section 53601, we recommend the Reinvest in SF Working Group request clarification regarding the legal viability of this alternative funding option.³ We believe this alternative may not evoke a similar prohibition, but defer to the City Attorney or other legal advisers to the Working Group on this question.

Another alternative for the Reinvest in SF Working Group to pursue, also mentioned above, is for the City to lobby the State legislature for an amendment to the California Government Code to allow Investment Pool funds to be invested in publically owned non-depository MFCs in the same way that they are now allowed to be invested in public banks.

Why the BLA recommends the Reinvest in SF Working Group explore the option of launching the MFC as a non-depository

If an alternative approach to funding a non-depository MFC cannot be devised, the City will need to establish a depository MFC and seek state and federal authorization from the Department of Business Oversight and the FDIC.

One of our primary reasons for recommending a non-depository MFC is that the costs and time required of setting up and operating a publicly-owned depository bank are significantly higher than for a non-depository. We discuss this issue at length in various sections of our July 2020 report (see pp. 38-40 of our July 2020 report). Higher operational costs will need to be passed forward in the form of higher interest rates to borrowers. Trade-offs exist between the pursuit of the pathway to incorporation explicitly authorized by the State, and the desire to create an institution that can provide long-term, below market rate credit.

³ Our report recommended the City set up a public owned dedicated special purpose conduit entity that would sell long-term bonds to the City Treasury, and pass these funds through to the MFC.

A second consideration is that seeking “out of the gate” FDIC approval for a de novo public banking institution may carry some risk as the FDIC may not be inclined to approve such a bank without a track record. Though the financial liability incurred by the FDIC from insuring a public bank would be negligible, the FDIC may also be concerned that, in agreeing to provide insurance to a publicly-owned depository, it would become the MFC’s resolution agent in the event of insolvency.

The FDIC may be more favorably inclined towards an institution with a prior record of successful performance. If the applicant is operating a non-depository MFC and providing clear and tangible benefits to the community, the FDIC may be more favorably inclined to provide deposit insurance. The probability of FDIC approval will increase to the extent the MFC has an acceptable business plan and competent and financially astute management with substantial banking experience. In that case the FDIC may very well grant its regulatory imprimatur on a de novo public banking entity.

Opportunity and constraints imposed by California Government Code Section 57600

California Government Code Section 57600 explicitly prohibits a public bank from providing a full complement of banking services to businesses and households. To accept deposits from sources other than the City, a public bank must have a partnership agreement with at least one local credit union or community bank, according to State law. In the absence of such an operating agreement, a public bank is explicitly barred under the provisions of Section 57604 from offering retail banking services, and is restricted to offering loans to the local public entity, infrastructure and housing loans, wholesale loans, participation loans, and retail products that are not currently provided by an existing local financial entity.

These regulatory provisions constrain the ability of a depository MFC to reach the \$2 billion funding threshold that we modeled in our July 2020 report solely through the acceptance and issuance of deposits. The Reinvest in SF Working Group must be fully cognizant of such limits, and recognize that access to a large and stable funding base will require either the use of the Investment Pool, or reliance on funding secured through the private capital market and partnership with a local credit union or community bank.

Establishing the MFC as a limited, special purposed depository

Should the Reinvest in SF Working Group conclude the most viable pathway is to launch a state-chartered publicly owned depository, we recommended a middle ground approach in our July 2020 report.⁴ The primary function of this limited depository would be to allow the Treasurer to use Investment Pool monies to purchase the MFC’s debt securities. To establish this entity, the Treasurer would transfer a modest sum of funds currently held on deposit at one of the City’s private banks on the order of \$10 million to the MFC depository, who would hold these funds with the Federal Reserve.⁵

However, the majority of the MFC’s banking transactions - accepting and disbursing payments, holding inventories of government securities, and executing interbank settlements - would be handled through the MFC’s primary partner bank. We recommend this initial arrangement if the depository option is selected by the Working Group to minimize the MFC’s startup and operating costs, thereby allowing the MFC to provide credit at the lowest rate to borrowers consistent with sound lending practice. Moreover,

⁴ See Budget and Legislative Analyst, “Municipal Bank for San Francisco: Issues and Options for Consideration”. July 24, 2020, pp. 9, 34-39, and Appendix A.

⁵ Because this would qualify as a public deposit, it will fall under the collateralization requirements as set out in Section 53651 of the California Code.

provided the partner bank qualifies as a “local financial institution”, this arrangement has the additional advantage of allowing the MFC to provide a full range of banking services through partnership agreements with existing community banks and credit unions, as per the terms of Section 57600.⁶

As with our non-depository approach, the objective for setting up a limited, special purpose depository is to minimize startup and operating costs. This approach would also allow the depository MFC to access funding directly from the Investment Pool. The Reinvest in SF Working Group should note that Section 53601(r) does not impose any limitations on the total amount of Investment Pool funds that can be lent to a public bank, or the term (time to maturity) of these investments.

Can the MFC rely on private market funding alone?

Parties opposed to the use of Investment Pool monies are likely to urge the Reinvest in SF Working Group to examine alternative sources of market-based funding. Options include Socially Responsible Investment Funds (or ESG), philanthropic foundations, other public agencies, and pension funds. While such sources could bolster the MFC’s assets, we are skeptical the MFC would be able to provide low-cost, long-term credit at sufficient scale to make an impact if forced to rely solely on the private capital market without support from the Investment Pool.

The rates of return demanded by private investors – including ESG funds, et al - are likely to be prohibitive. A public bank is a novel and ‘untested’ investment. Moreover, the liabilities of the MFC would have a limited, or non-existent, secondary re-sale market – this is certainly the case if the MFC originates loans at below market rates. For these reasons, fund managers are likely to demand a premium on MFC notes over and above the prevailing market rates on securities with similar maturities. This undermines the ability of the MFC to provide below market rate lending. For these reasons, we believe that primary reliance on the private capital markets is not a viable funding strategy.

If use of Investment Pool funding for the MFC is categorically ruled out (the final decision on how these funds are used is in the hands of the Treasurer, in accordance with the City Charter⁷), the Reinvest in SF Working Group will need to find a way through what appears to be a difficult impasse. It will need to solicit ideas from informed sources for alternative means through which the MFC can obtain sufficient funding to achieve the objectives of providing stable, longer-term below market rate credit. As detailed in our July 2020 report, we believe it is possible to responsibly safeguard the City financial interests in all circumstances short of a catastrophic system-wide financial collapse.

⁶ During the drafting of our report, we had multiple conversations with an FDIC-insured bank with the requisite technical capacities whom expressed interest in exploring such a partnership arrangement with a City-owned public bank.

⁷ San Francisco Charter Section 6.106.

Insulating the Investment Pool against losses

Pursuant to State law, the overarching concern of the City Treasurer is to ensure that participants that hold funds in the Investment Pool do not incur any losses. The Treasurer's concern in this regard would be the same in the case of either the non-depository or depository variant. Our report addresses this risk by requiring the MFC to have a (minimum) capital-to-asset ratio of 15 percent, which is nearly double the level at which the FDIC defines a bank as being "well-capitalized". With capitalization set at 15 percent, the MFC we proposed could withstand losses of a magnitude comparable to those experienced by US banks during the 1929-1932 Great Depression.

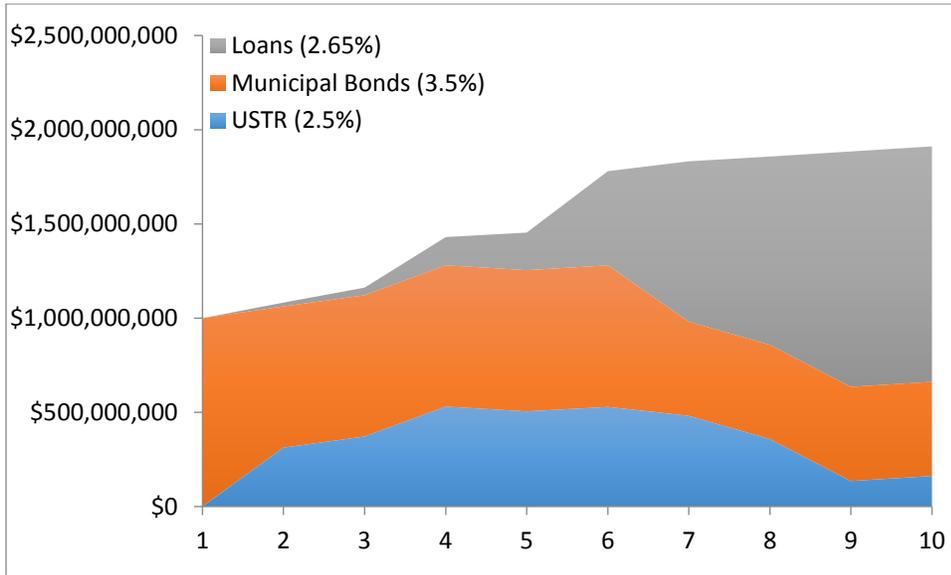
The Treasurer, as fiduciary agent, has the prerogative to state that he or she will not contemplate any exposure of the Investment Pool to potential losses, and may urge the Reinvest in SF Working Group to explore alternative sources of private market finance. However, in our view, it is possible to create a capital buffer that will effectively insulate the Investment Pool against losses under all but the most catastrophic scenarios. Given this, we conclude that the benefits of investing in the creation of assets with tangible economic and social benefits to the City's residents would be greater than holding the vast majority of the City surpluses in U.S. Treasury notes and bonds. A systemic financial crisis of the magnitude required to destroy a well-managed financial institution with a 15 percent capital buffer (or greater) would certainly trigger massive federal and central bank intervention. If the federal government and Federal Reserve are unwilling, or unable, to come to the rescue in the event of a catastrophic financial meltdown, holding \$1.5 billion in liquid U.S. Treasury notes is unlikely to provide much consolation.

Gradual phase-in and slow ramp-up of MFC's lending operations

As mentioned above, our July 2020 report recommends the MFC begin with a very moderate set of demonstration lending projects, and slowly scale-up its lending programs over the first 5 to 7 years of operation.

Our proposed ramp-up timeline is shown in Exhibit 1. The vast majority of the MFC's assets are held in U.S. Treasury notes and municipal bonds during the first five years of operation. Only in year six does the MFC begin to rapidly expand its lending operations. This provides the Treasurer and the City ample opportunity to assess the viability of Investment Pool funding. At any time over the initial five to seven years of operation, the majority of any Investment Pool funds that have been lent to the MFC can be rapidly "unwound" or taken back. To do so, the Treasurer would simply need to request repayment, and the MFC would sell U.S. Treasury notes and municipal bonds and return funds back to the Investment Pool.

Exhibit 1: Growth over time of MFC loan portfolio



We believe our proposed models balance the need to address the question of how to provide a stable, long-term, below market rate funding source, while recognizing and mitigating risk, and allowing the Treasurer ample discretion in the execution of his or her fiduciary duties.

Project staff: Karl Beitel, Fred Brousseau