ANALYSIS OF MUNICIPAL BANK FOR SAN FRANCISCO: ISSUES AND OPTIONS FOR CONSIDERATION

Policy Analysis Report to Supervisor Sandra Lee Fewer

Presentation to:

BUDGET AND FINANCE COMMITTEE

BOARD OF SUPERVISORS
CITY AND COUNTY OF SAN FRANCISCO

October 7, 2020

Scope and Objectives of BLA report

- Review results of Municipal Bank Task Force report.
- Outline alternative model(s) that achieves profitability in a shorter time period with:
  - Ability to extend long-term loans at below market rates.
- Consider risk management to address CA Government Code Section 53600.5: safeguard principal, meet liquidity needs, achieve a return on funds.

Public banks

- Created and owned by a public entity rather than private owners. Public funds may provide capital and funding.
- Mission diverges from maximizing shareholder value to fulfilling certain economic and social policy objectives.
- Separate legal entity with its own board of directors and bylaws and its own staff, separate from the City and its governing bodies.
- The Board of Supervisors could provide general direction and policy objectives for the institution such as originating loans to create more affordable housing and providing loans to local communities underserved by traditional banks.
- State law amended in 2019 allows local government entities to create public banks and investment of surplus funds in public bank obligations.

Capitalization vs. Funding

Capital/capitalization Funds a financial institution such as a Municipal Financial Corporation (MFC) receives from investors as it starts operations, and which it retains to serve as a buffer to absorb potential losses.

Funding Mechanisms to support the MFC's lending operations. These are liabilities, either in the form of demand, time, and saving deposits or funds borrowed through the issuance of debt securities or IOUs of varying maturity.

2 types Municipal Financial Corporations (MFC)

<u>Depository bank</u>

Creates money (deposits) through new lending activity.

Can provide full range of bank services: checking, time, & savings deposits, disbursement, cash/treasury management.

Has access to Federal Reserve Bank clearinghouse and settlement services.

Higher operating costs than non-depository.

Regulated by FDIC and California Department of Business Oversight.

<u>Non-depository</u>

Loans must be funded through the issuance of debt securities.

All payments and transactions cleared and settled through a correspondent depository bank.

More limited funding sources compared to depository.

Generally lower operating costs than depository; can be passed through as lower rates on loans.

Not regulated by FDIC.

Municipal Bank Task Force Report: 3 Options

- Non-depository that funds loans through the sale of debt securities (Model 1.0).
- Two variants of a depository, both of which serve as the City's primary banking agent (a public depository) (Models 2.0 and 3.0).
- Both depository and non-depository models lend at around 5% for real estate; 2.5 – 15% for small business.
- Total assets at year 10 are $1.1 bn. (all models).

Task Force model issues

- Depository models do not achieve profitability until at least thirty years from the point of commencing operations (non-depository: 10 years).
- High costs of operating public depository.
- Funding depository would be problematic under AB 857, which could place limits on a public bank's ability to accept deposits from non-public entities.
- Non-use of Investment Pool (IP) increases funding costs and subjects MFC to risk of funding runoff.
- Term matching of assets and liabilities - limitation on housing loans consisting of 3-5 year mezzanine debt in Model 1.0 to match maturities on loans to maturities on debt securities.
- Limited impact on affordable housing.

BLA models: non-depository and depository

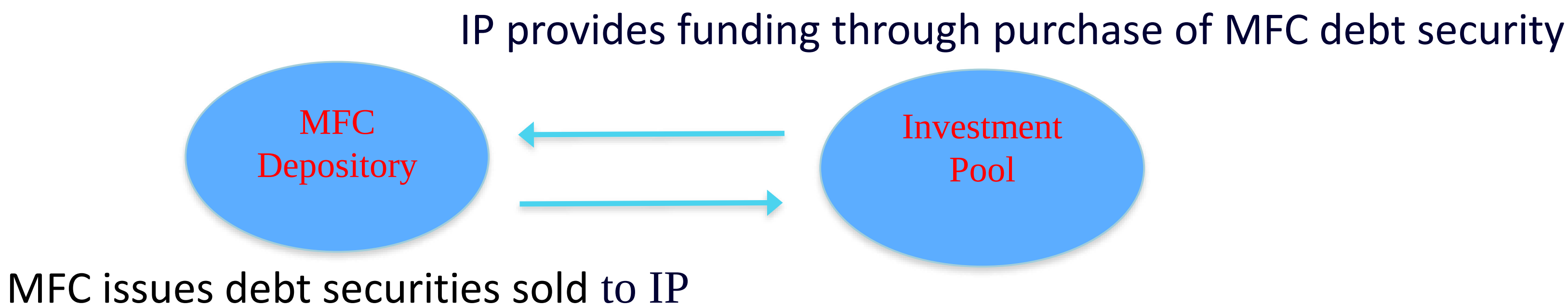
- Illustrative, not definitive. Other hybrid funding and lending models possible.
- Use City resources to keep costs and interest rates low.
- Address risk management to ensure safety, liquidity, and yield (CA Gov't. Code 53600.5).
- Depository variant is limited, low overhead special purpose MFC; would not provide banking services to the City.
- Achieve profitability immediately (vs. Task Force models).
- Able to originate loans at lower interest rates than Task Force models.

Conclusion: Both variants feasible and could operate profitability. However, we recommend that the City, at least initially, establish a non-depository MFC with advantages of:

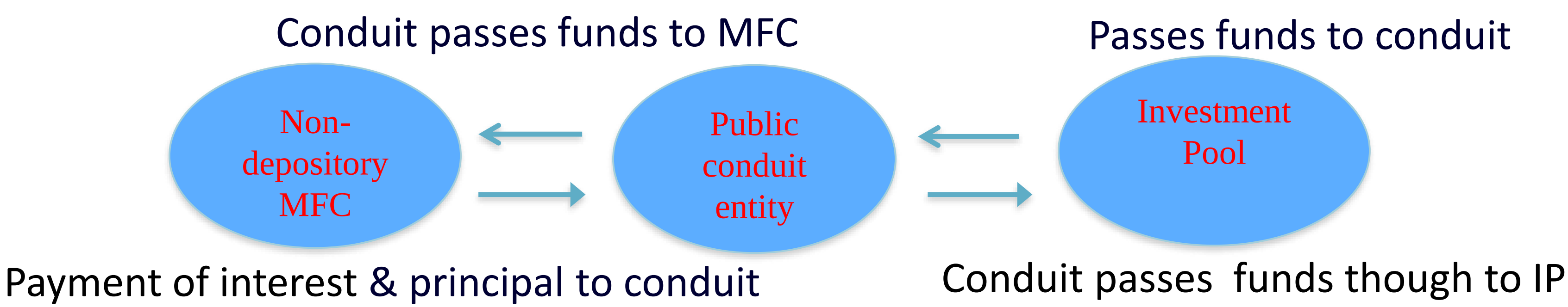
1) lower operating costs compared to a depository bank,
2) no FDIC approval to operate.

Funding using Investment Pool

Depositories: Use of Investment Pool is authorized under State law



Non-depositories: need for alternative to allow Investment Pool to fund MFC



Pro-forma: BLA preferred non-depository model

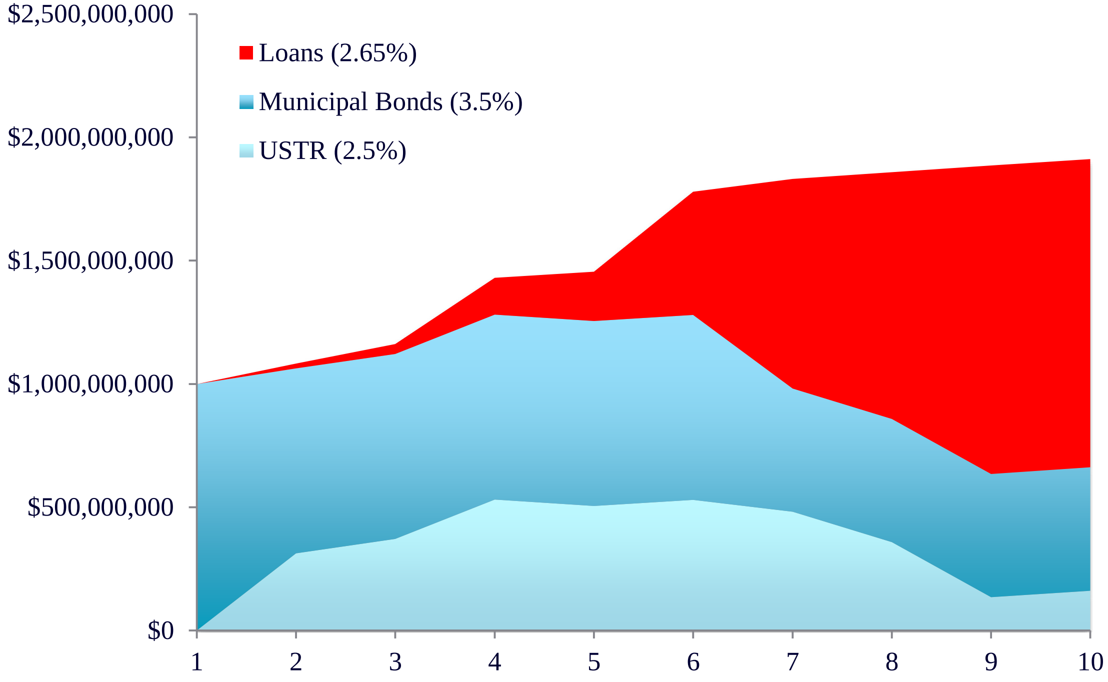
- **Capitalized by**: Investment Pool interest earnings, General Fund appropriations, and interest earnings over 3 years = $136.2 million.
- **Funded by**: Investment Pool $1 bn. at Year 1, or 10% of funds moved from current instruments to MFC + GF appropriations. Over first 5-6 years of operations, these commitments could, if necessary, be rapidly scaled down if City needed funds returned. Investment Pool invests $1.5 bn. by Year 10.
- **By Year 10:** MFC assets of approximately $2 billion:
  - loan portfolio: of $1.25 billion.
  - $750 mn. held in liquid U.S. Treasury notes and municipal securities.
  - significant impact on local housing provision, small-business credit, and (as a supplemental source) infrastructure financing.

Key points: How BLA non-depository MFC would function

- **Phased-in approach**: demonstration loans funded initially, ramping up over the first five years of operations.
  - Keeps Investment Pool funds liquid.
- **Does not offer traditional banking services**, thus lowering costs and allowing loans at lower rates.
- Cultivates and enters into **lending agreements with a network of affiliated institutions:** local and regional credit unions, banks, loan funds, and Community Development Financial Institutions (CDFIs).
- All profits retained and reinvested in the MFC; builds up robust buffers to protect the City's financial commitments.

Portfolio composition, first 10 years of operation

MFC non-depository



Key Measures: MFC non-depository

Interest rates	
MFC earnings on USTRs and municipal bonds	2.5%
Interest rate on loans	2.65%
Interest paid to IP	0.5%

Measure	MFC-Year 10	Industry standard
Return on Equity	9.3%	11.4%
Return on Assets	1.4%	1.3%
Capital to Asset ratio (risk-weighted)	14.5%	6.0-8.0%

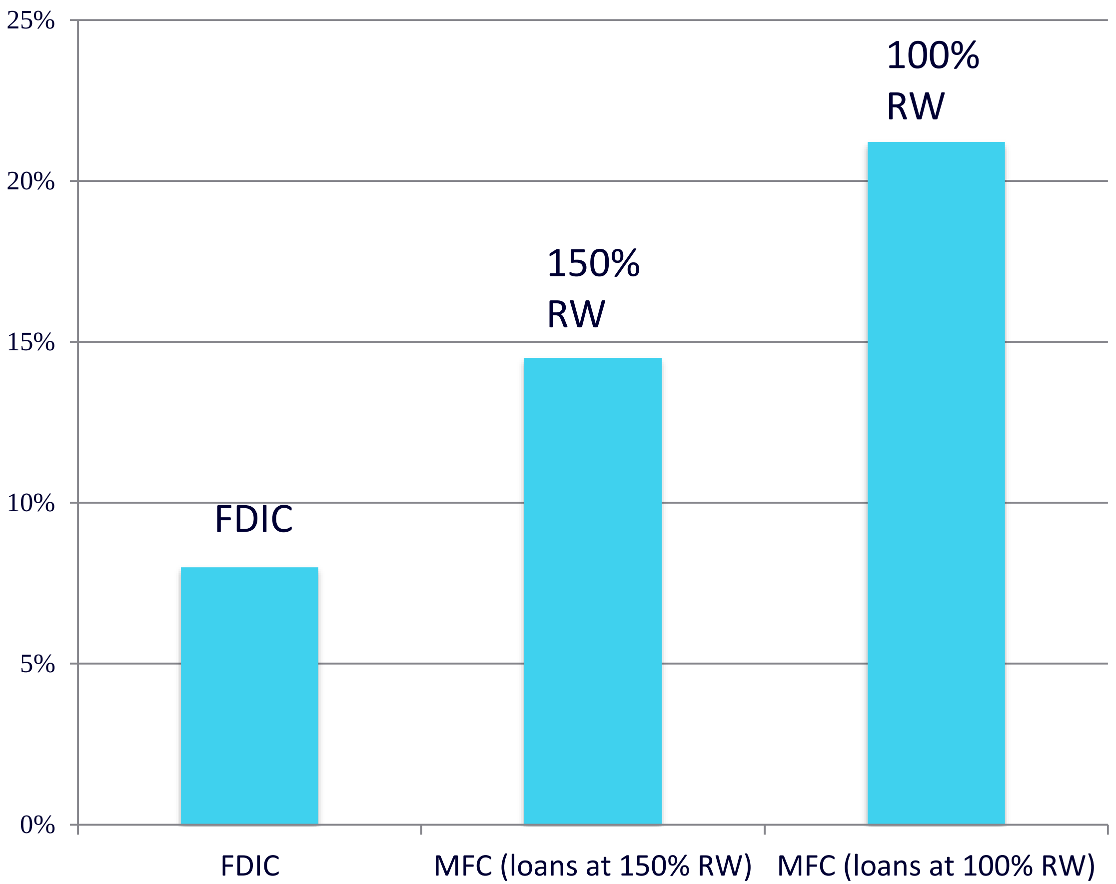
Addressing risks

Risks	Remedies
▪ Credit risk *(high rate of loan defaults)* ▪ Interest risk *(maturity mismatch: long-term loans vs. short-term funding)* ▪ Rollover, or refunding, risk *(creditors demand full cash redemptions, not rollovers)* ▪ Liquidity risk *(runoffs)*	▪ High capital-to-asset ratio ▪ Rigorous & consistent underwriting standards ▪ Long-term, low-cost funding commitment from IP ▪ $750 mn. of funding committed from IP can be withdrawn on 3 day notice

Credit risk

- Impossible to completely eliminate all credit risk from any loan portfolio.
- MFC is designed to withstand a prolonged period of heavy losses.
- Depending on structure, MFC could absorb complete write-offs of 24 - 40% of loan portfolio before any losses incurred by IP.
- Unlikely the MFC would be exposed to defaults at a level that would impose losses on the Investment Pool.

Capital-to-asset ratios at 2 risk weights

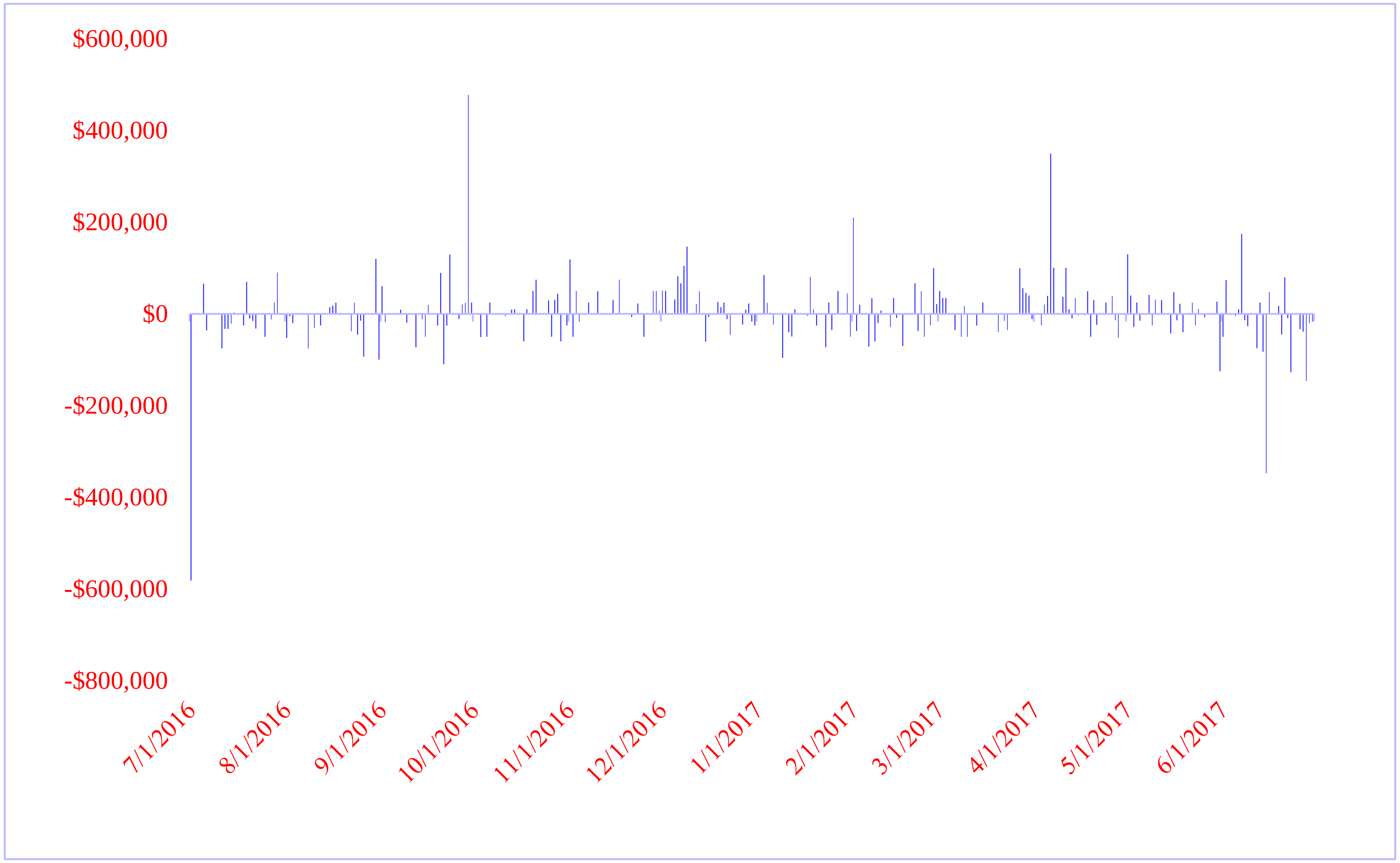


Liquidity Risk

- MFC has approximately 62.5% of total assets in form of long-term loans.
- Surpluses held in the Investment Pool generally invested in short-term, liquid instruments.
- These securities can be sold, and proceeds transferred to City bank account to cover expenditures.
- Using monies from Investment Pool to purchase longer-term MFC liabilities means $750 mn., or 50% of IP funding commitment becomes illiquid over the near term – are not available for immediate recovery.
- BLA model allows $750 mn. to be recovered on short-term notice. 12.5% of GF surplus in IP is short-term illiquid.

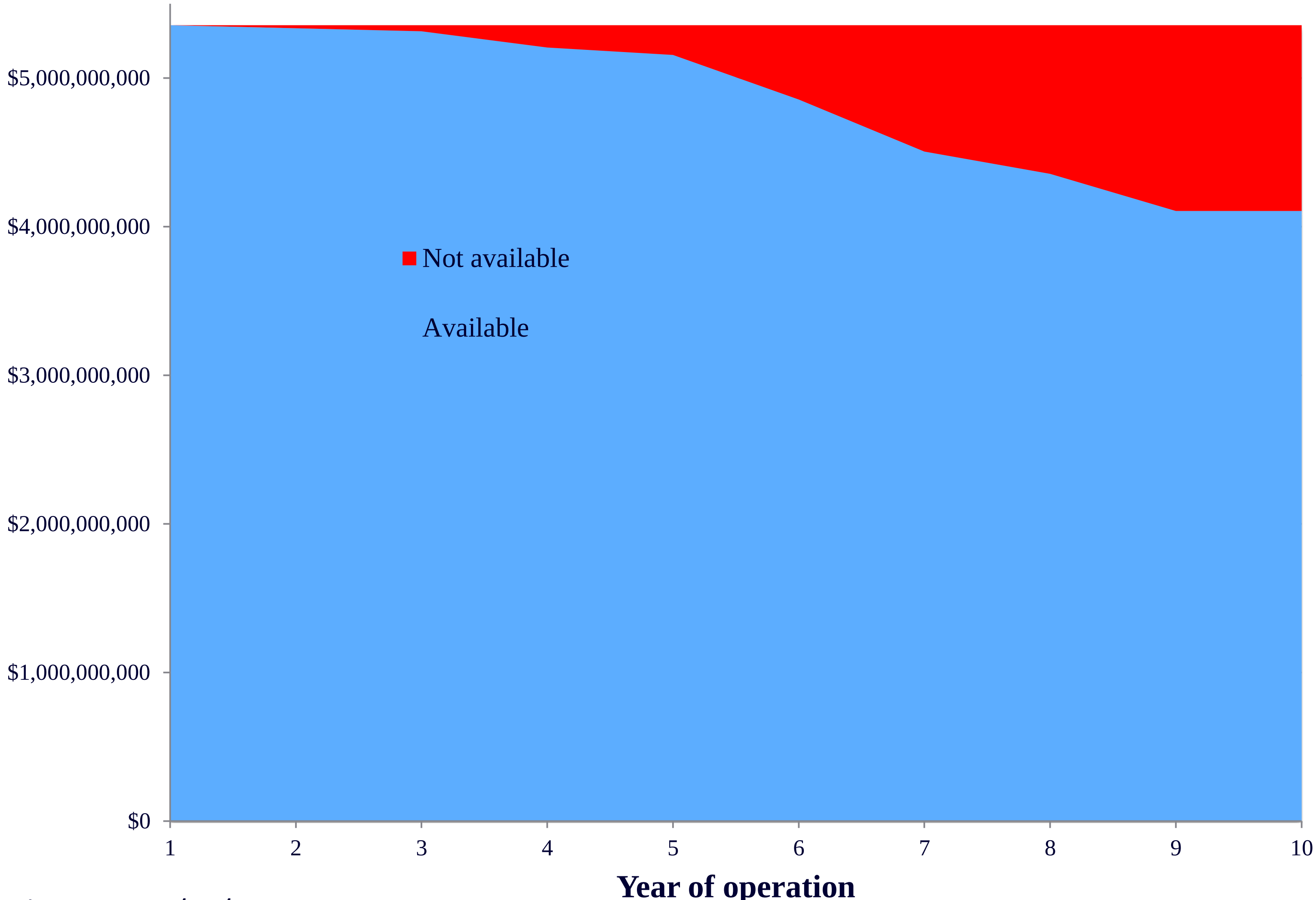
Daily Variance, FY 2016–17

Additions and withdrawals from Investment Pool, in $1,000s



Source: Treasurer–Tax Collector

Investment Pool, General Fund only, available for immediate withdrawal



Based on CAFR 6/30/19

Policy options

1. Establish, fund, and staff an Implementation Working Group to oversee the development of a business plan for a City municipal financial corporation (MFC).
2. Implementation Working Group should design three initial lending programs to determine viability focused on: 1) property acquisition for affordable housing, 2) small business lending, and 3) infrastructure financing.
3. Mandate Implementation Working Group to assess the viability of developing a wholesale distribution network.
4. If the City should decide, after an initial period of successful operation of demonstration lending projects, to scale up its funding commitments, we recommend the City initially do so by committing additional monies from the Investment Pool to fund the lending activities of a *non-depository* MFC. Consider a depository subsequent to this after several years of operation.

Questions and comments

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