**File No.** 210078 **Committee Item No.** 1
**Board Item No.** ______

# COMMITTEE/BOARD OF SUPERVISORS

AGENDA PACKET CONTENTS LIST

**Committee:** Government Audit and Oversight **Date:** June 3, 2021
**Board of Supervisors Meeting:** **Date:** ______

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**Prepared by:** John Carroll **Date:** May 28, 2021
**Prepared by:** John Carroll **Date:** ______
**Prepared by:** John Carroll **Date:** ______

1 [Administrative Code - San Francisco Reinvestment Working Group]

2

3 **Ordinance amending the Administrative Code to establish the San Francisco**
4 **Reinvestment Working Group to submit business and governance plans for a non-**
5 **depository Municipal Finance Corporation and for a Public Bank to the Board of**
6 **Supervisors and to the Local Agency Formation Commission.**

7

8 NOTE: **Unchanged Code text and uncodified text** are in plain Arial font.
9 **Additions to Codes** are in *single-underline italics Times New Roman font*.
**Deletions to Codes** are in ~~*strikethrough italics Times New Roman font*~~.
10 **Board amendment additions** are in double-underlined Arial font.
**Board amendment deletions** are in ~~strikethrough Arial font~~.
11 **Asterisks (* * * *)** indicate the omission of unchanged Code subsections or parts of tables.

12

13 Be it ordained by the People of the City and County of San Francisco:

14 Section 1. Chapter 5 of the Administrative Code is hereby amended by adding Article
15 XVI, consisting of Sections 5.16-1 through 5.16-7, to read as follows:

16 ***SEC. 5.16-1. CREATION OF SAN FRANCISCO REINVESTMENT WORKING***
17 ***GROUP.***

18 *The Board of Supervisors hereby establishes the San Francisco Reinvestment Working Group*
19 *("Working Group").*

20 ***SEC. 5.16-2. FINDINGS AND PURPOSE.***

21 *(a) California Assembly Bill 857, the Public Banking Act, effective January 1, 2020, authorizes*
22 *local agencies to create public banks for the purposes of achieving cost savings, strengthening local*
23 *economies, supporting community economic development, and addressing infrastructure and housing*
24 *needs for localities.*

25

1 *(b) A San Francisco Public Bank would create a fiscally safe and sound institution to invest*
2 *public funds in a manner that aligns with the values and interests of the City, including investments in*
3 *City residents, businesses, and sectors that serve the public good and that are underserved or unserved*
4 *by the existing financial industry.*
5 *(c) The City and County of San Francisco has a population of over 800,000 residents who,*
6 *through decades of public elections, have repeatedly prioritized local control, transparency, and*
7 *economic opportunity as valued pillars of public interest. These interests would be served by*
8 *sustainable and responsible community investments that promote economic security, housing*
9 *affordability, environmental sustainability, and general wellbeing for all San Franciscans, guided by*
10 *the creation of lending priorities focused on those objectives.*
11 *(d) The complexity of establishing a public bank requires focused, sustained planning and*
12 *interim steps to ensure ongoing viability.*
13 *(e) This complex task is a valuable one, as City government banking services are provided by*
14 *large national banks that invest in sectors that may harm San Francisco residents or contradict the*
15 *City's values. These banks continue to resist pressure from national movements to have their*
16 *investments reflect values of transparency, environmental responsibility, and social justice, and they*
17 *have been criticized for racially-biased predatory lending and foreclosures and for investments in fossil*
18 *fuels, weapons, and private prisons.*
19 *(f) Traditional financial institutions' executive compensation and employee incentive programs*
20 *often are dissociated from the external or public effects of their investment policies, in some cases*
21 *causing significant financial harm to customers and shareholders.*
22 *(g) While a Public Bank will require planning and investment of public funds, it can create*
23 *significant long-term benefits for the City, which include allowing local tax dollars to be invested in*
24 *local priorities while still ensuring the safety and preservation of capital, liquidity to meet City cash*
25 *flow needs, and return on investments.*

1 *(h) A Public Bank can and should balance both fiscal solvency and investments in residents,*
2 *businesses, and sectors that reflect San Francisco values, advancing issues of social, economic, gender,*
3 *racial, and environmental equity, among others.*
4 *(i) The long-term financial and social well-being of the City requires sustainable and equitable*
5 *economic growth locally, nationally, and internationally, which in turn requires equitable and*
6 *transparent financial investment and opportunity.*
7 *(j) Increasing interest among municipalities and regions across California and the United*
8 *States in public bank formation provided the impetus for the enactment of the Public Banking Act,*
9 *Assembly Bill 857.*
10 *(k) The Budget and Legislative Analyst of the Board of Supervisors has produced reports*
11 *regarding banking, community supportive banking options, and public banking, including on the*
12 *following subjects: "Community Supportive Banking Options," September 8, 2011 (Updated);*
13 *"Community Supportive Banking Options 2017 Update," November 27, 2017; "Large Bank Social*
14 *Responsibility Screening," May 19, 2017; and "Municipal Bank for San Francisco: Issues and Options*
15 *for Consideration," July 24, 2020. These reports are on file with the Clerk of the Board of Supervisors*
16 *in File No. 210078.*
17 *(l) In 2017, in response to Resolution No. 152-17 urging the formation of a Municipal Bank*
18 *Feasibility Task Force to research the viability and advisability of a Public Bank, Treasurer Jose*
19 *Cisneros formed such a group. After 18 months of work, it produced a report entitled, "Municipal*
20 *Bank Feasibility Task Force Report," dated March 2019, which analyzed three models: (1) a lending*
21 *entity focused on investments in affordable housing and small business lending to achieve community*
22 *goals; (2) a bank that performs the City's cash management and other banking needs, allowing the City*
23 *to divest from large commercial banks; and (3) a bank that combines these functions. A copy of said*
24 *report is on file with the Clerk of the Board of Supervisors in File No. 210078.*
25

1 ***SEC. 5.16-3. DEFINITIONS.***

2 *For the purposes of this Article XVI, the following terms shall have the following meanings:*

3 *"Local Enterprise" means small businesses, nonprofits, cooperatives, and community land*

4 *trusts that operate primarily in San Francisco.*

5 *"Municipal Finance Corporation" ("MFC") means a non-depository lending corporation that*

6 *is wholly-owned by the City.*

7 *"Public Bank" means a City "public bank" as defined by California Government Code Section*

8 *57600(b)(1), as may be amended from time to time.*

9 ***SEC. 5.16-4. POWERS AND DUTIES OF THE WORKING GROUP.***

10 *(a) Not later than one year from the date of the first Working Group meeting, the Working*

11 *Group shall submit to the Board of Supervisors and to the Local Agency Formation Commission a*

12 *business and governance plan for establishing and operating an MFC, which shall address the MFC's*

13 *planned lending services, prioritizing investment in affordable housing production and preservation,*

14 *Local Enterprise, and public infrastructure; organization and management; financial projections; and*

15 *funding requirements; and which may include recommendations for modifications of City laws and*

16 *regulations.*

17 *(b) Not later than one year from the date of the first Working Group meeting, the Working*

18 *Group shall submit to the Board of Supervisors and to the Local Agency Formation Commission a*

19 *business and governance plan for the MFC to become a Public Bank, which plan shall:*

20 *(1) meet the elements required in a business plan to be submitted as part of a public*

21 *bank license application to the California Department of Financial Protection and Innovation;*

22 *(2) include a study that meets the requirements of California Government Code Section*

23 *57606(a) for state-chartered public banks and, at the discretion of the Working Group, may address the*

24 *elements set forth in California Government Code Section 57606(b);*

25

(3) *incorporate the following time objectives: the MFC applying for a public bank license within three years of its establishment, and becoming operational as a Public Bank within five years of its establishment; and the Public Bank providing comprehensive banking services to the City within five years of its becoming operational;*

(4) *establish lending priorities that promote economic security, affordability, environmental sustainability, and general wellbeing for all San Franciscans, which shall:*

(A) *prioritize investment in affordable housing production and preservation with a focus on: housing to meet the needs of low-income households (as set forth in Planning Code Section 415) and Social Housing Developments (as defined in Administrative Code Section 10.100-78(e)) for households earning up to 80% of Area Median Income; Local Enterprise; and public infrastructure;*

(B) *evaluate implementing additional lending programs investing in public lands, zero-emission renewable energy systems, energy efficiency upgrades, student loans, and sustainable food systems, and foreclosure prevention/homeowner assistance; and*

(C) *prohibit lending for market-rate housing and for lending that conflicts with the City's values, which shall include, but not be limited to, predatory lending; lending for fossil fuels, tobacco, firearms, and weapons; and lending to businesses with a record of labor law violations, prisons, and detention centers;*

(5) *recommend a governance and regulatory structure of a Public Bank that encompasses compliance with legal requirements, ethical standards, lending priorities, and standards for transparency, community oversight, and accountability;*

(6) *make recommendations for modifications of City laws and regulations, which may include draft legislation or regulations;*

(7) *make recommendations whether to establish and operate the Public Bank in partnership with other California cities, counties, or other local agencies, or to include other*

*California cities, counties, or other local agencies in the capitalization or as customers of the Public Bank;*

*(8) make recommendations for capitalization and loan funding of at least $300 million, from sources including but not limited to appropriations from the Treasurer's Investment Pool, the General Fund, and budget surpluses; and*

*(9) address any other matter the Working Group deems appropriate in light of its purposes.*

*(c) The Working Group may in its discretion incorporate the analysis of the Municipal Bank Feasibility Task Force Report into the plans required under subsections (a) and (b).*

***SEC. 5.16-5. MEMBERSHIP.***

*(a) The Working Group shall consist of nine members as follows:*

*(1) Seats 1-3 shall be held by technical experts in financial institutions, each of whom shall have expertise in at least one of the following: Community Development Financial Institutions; credit unions, as defined in Section 165 of the California Financial Code; small banks or intermediate small banks, as defined in Section 25.12(u) of Title 12 of the Code of Federal Regulations; bank or lending entity formation or business planning; or financial institution regulatory compliance.*

*(2) Seats 4-7 shall be held by community representatives, each of whom shall have a commitment to economic, gender, and racial justice; a commitment to serving low-income communities, communities of color, immigrant communities, and organized labor; and experience in at least one of the following: affordable housing financing or policy; Local Enterprise lending; consumer or student lending; or environmental justice, with experience in areas such as zero-emission renewable energy sources, energy efficient building design, or sustainable food systems.*

*(3) Seat 8 shall be held by the Controller or the Controller's designee.*

*(4) Seat 9 shall be held by the Treasurer or the Treasurer's designee.*

*(b) The Board of Supervisors shall appoint Seats 1-7.*

1 ***SEC. 5.16-6. ORGANIZATION AND OPERATIONS.***

2 *(a) Each appointing authority shall name its appointees within 30 days of, and the Working*
3 *Group shall convene within 60 days of, the effective date of this Article XVI. The Working Group shall*
4 *meet at least once per month.*

5 *(b) Subject to the fiscal and budgetary provisions of the Charter, subject to the approval of the*
6 *Local Agency Formation Commission, and consistent with the Local Agency Formation Commission's*
7 *special studies authority under state law, the Local Agency Formation Commission shall provide*
8 *administrative and clerical support for the Working Group for the preparation of the plans required*
9 *under subsections (a) and (b) of Section 5.16-4.*

10 *(c) Subject to the fiscal, budgetary, and civil service provisions of the Charter, subject to the*
11 *approval of the Local Agency Formation Commission, and consistent with the Local Agency Formation*
12 *Commission's special studies authority under state law, the Local Agency Formation Commission may*
13 *hire and make available to the Working Group an outside consultant or consultants with expertise in*
14 *drafting business plans for the establishment of California banks, community engagement, or the*
15 *establishment of public governance models to draft the plans required under subsections (a) and (b) of*
16 *Section 5.16-4. All policy decisions and recommendations for such plans shall be under the direction*
17 *and for the approval of the Working Group. The Local Agency Formation Commission shall provide*
18 *support and facilitation in accordance with state law.*

19 *(d) The Working Group may request information from other technical advisors as needed, such*
20 *as experts in municipal ownership and financing, student lending, affordable housing, sustainable*
21 *agriculture loans, renewable energy, or public infrastructure.*

22 *(e) Members appointed to Seats 1-7 shall serve at the pleasure of the Board of Supervisors and*
23 *may be removed by the Board at any time. Each member in Seats 1-7 may remain on the Working*
24 *Group until its termination under Section 5.16-7, unless removed by the Board. Any vacancy in Seats 1-*
25 *7 shall be filled by the Board.*

1 *(f) Designees in Seats 8 and 9 are members of the Controller's Office and Treasurer's Office*
2 *respectively and serve in lieu of the Controller and Treasurer respectively. The Controller, as to Seat*
3 *8, and the Treasurer, as to Seat 9, may change the designee at any time or serve in the seat at any time.*
4 *(g) Members appointed to Seats 1-7 shall serve without compensation from the City. Members*
5 *serving in Seats 8 and 9 shall receive their regular salaries for time spent on the Working Group*
6 *because they are serving in an official capacity as representatives of their departments.*
7 *(h) The Working Group shall elect a Chairperson, Vice Chairperson, and other such officers as*
8 *it deems appropriate from its members and may establish bylaws and rules for its organization and*
9 *procedures.*
10 *(i) All recommendations of the Working Group shall be made pursuant to a vote or votes of the*
11 *majority of the Working Group.*
12 *(j) Any member, including the Chairperson or the Vice Chairperson, who misses three regular*
13 *meetings of the Working Group within a six-month period without the written approval of the*
14 *Chairperson, or the Vice Chairperson in case of the Chairperson's absence, at or before each missed*
15 *meeting shall be deemed to have resigned from the Working Group 10 days after the third unapproved*
16 *absence. The Working Group shall inform the Clerk of the Board of Supervisors of any such*
17 *resignation as to Seats1-7, and the Controller or Treasurer respectively as to Seat 8 or 9, in the case of*
18 *a designee to Seat 8 or 9.*
19 ***SEC. 5.16-7. SUNSET DATE.***
20 *This Article XVI shall expire by operation of law, and the Working Group shall terminate,*
21 *eighteen months from the Article's effective date. Upon expiration of this Article, the City Attorney*
22 *shall cause it to be removed from the Administrative Code.*
23
24 Section 2. Effective Date. This ordinance shall become effective 30 days after
25 enactment. Enactment occurs when the Mayor signs the ordinance, the Mayor returns the

ordinance unsigned or does not sign the ordinance within ten days of receiving it, or the Board of Supervisors overrides the Mayor's veto of the ordinance.

APPROVED AS TO FORM:
DENNIS J. HERRERA, City Attorney

By: /s/
LISA POWELL
Deputy City Attorney

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FILE NO. 210078

# LEGISLATIVE DIGEST

[Administrative Code - San Francisco Reinvestment Working Group]

**Ordinance amending the Administrative Code to establish the San Francisco Reinvestment Working Group to submit business and governance plans for a non-depository Municipal Financial Corporation and for a Public Bank to the Board of Supervisors and to the Local Agency Formation Commission.**

## Existing Law

California Assembly Bill 857, the Public Banking Act, effective January 1, 2020, authorizes local agencies to form State-licensed public banks.

## Amendments to Current Law

This ordinance creates the San Francisco Reinvestment Working Group, which, within one year of its first meeting, must submit to the Board of Supervisors (Board) and the Local Agency Formation Commission (LAFCO), a business and governance plan to establish a non-depository lending corporation wholly-owned by the City, designated as the "Municipal Finance Corporation" or MFC.

Also within one year its first meeting, the Working Group must submit to the Board and LAFCO a separate business and governance plan for the MFC to become a state-licensed public bank. Among other requirements, this plan must include the business plan elements required for a State public bank license; a study required to apply for a State public bank license; and lending priorities. The plan must recommend a governance and regulatory structure for the Public Bank; modifications to City laws and regulations; and whether the City should partner with another local agency in the establishment and operation of a public bank.

The ordinance (and hence the Working Group) sunsets 18 months from its effective date.

## Background Information

In 2017, in response to Resolution No. 152-17, Treasurer Jose Cisneros formed a Municipal Bank Feasibility Working Group, which produced a report in March 2019 that analyzed three potential models for public banking: 1) a lending entity focused on investments in affordable housing and small business lending; 2) a bank that performs the City's cash management and other banking needs; and 3) a bank that combines these functions. The Working Group created by this ordinance will build on the work of the earlier task force.

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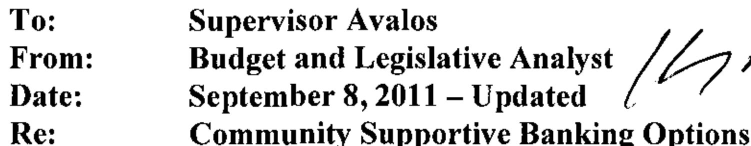
# CITY AND COUNTY OF SAN FRANCISCO
# BOARD OF SUPERVISORS
## BUDGET AND LEGISLATIVE ANALYST

1390 Market Street, Suite 1150, San Francisco, CA 94102
(415) 552-9292 FAX (415) 252-0461

**LEGISLATIVE ANALYST REPORT – Updated**

**To:** Supervisor Avalos
**From:** Budget and Legislative Analyst
**Date:** September 8, 2011 – Updated
**Re:** Community Supportive Banking Options



## Summary of Requested Action

Your office requested that the Budget and Legislative Analyst research options for ways that the City may invest its funds in community-supportive banking institutions, including those that invest more in local small businesses, single family homeowners and community development. Your office asked us to report on a variety of municipal banking options, including private, credit union and public banking systems, with a focus on any examples of existing public banks in other jurisdictions (specifically, the Bank of North Dakota).

## Executive Summary

- The Office of the Treasurer and Tax Collector is responsible for the banking and investment activities of the City and County of San Francisco and must abide by local, state and federal law in carrying out its duties. The City's monies are divided into two categories: (1) the cash that is used for ongoing expenditures including City and County employee salary expenditures, residing in bank accounts, and (2) all other funds that are not necessary for short-term use, invested in the Treasurer's Investment Pool. The City currently uses the services of three banks for its short-term cash banking needs, and many banks, brokers and dealers for its investment activities.
- The primary impediment to the City and County of San Francisco creating a public bank is California Government Code Section 27003, which states that "a county shall not, in any manner, give or loan its credit to or in aid of any person or corporation." Therefore, should the City and County of San Francisco choose to pursue the public bank option, a change in State law would be required. Beyond the legal impediment, the City would need to invest significant resources to capitalize the bank and build the human resource and technological capacity to operate a large financial institution. However, as demonstrated by the Bank of North Dakota, which is the only public bank in the United States, several potential benefits might be obtained through the establishment of a public bank, including (a) the creation of a new revenue-stream for local government without raising taxes, (b) decreased borrowing costs and increased credit stability for local government, and (c) increased support for small businesses and any number of community development programs.
- If a public bank were to be established, or if any other option presented in this report were to be pursued, the City and County of San Francisco would be required to comply with California Government Code Section 27000.5, which states that "the primary objective of the

county treasurer or the board of supervisors, as the case may be, shall be to safeguard the principal of the funds under the treasurer's or the board's control." This means that protecting the safety of public funds must always be the first priority in investment decisions and that consideration of liquidity, return on investment, or other priorities is subjugated by the requirement that county officials must protect principal. Therefore, investing in credit unions or community development banks (beyond the $250,000 per institution insured by the Federal Deposit Insurance Corporation) would only be allowable through a formal appropriation of funds to a program by the Board of Supervisors. Per California Government Code Section 27000.5, the Office of the Treasurer and Tax Collector would not be authorized to make such investments with the Treasury Funds.

- The City has several options available should it choose to increase its support of small businesses, single family homeowners and community investment. These options, and follow up recommendations for each, are as follows:

**Option 1. Invest funds in local credit unions or community development banks that provide a minimum level of investment in City community development and improvement efforts**

*Recommendations to pursue this option:*

1. Request the Office of the Treasurer and Tax Collector evaluate the viability of the 17 San Francisco-based credit unions reported by the National Credit Union Administration, any other credit unions operational in San Francisco, and qualified community development banks to ascertain which, if any, would be suitable for City time deposit business based on the institutions meeting a minimum level of investment in City community development and improvement efforts.
2. Unless evidence of additional suitable security is provided by any such institutions, the investment per institution must be limited to $250,000, the maximum insured by the FDIC.

**Option 2. Expand existing City community development programs**

*Recommendations to pursue this option:*

3. Request information from appropriate City departments on the results of existing community investment programs, both those operated directly by the City and those operated in conjunction with partner financial institutions, to assess which programs are suitable for additional appropriation of City funds. Examples of such programs are the Surety Bond Financing Assistance program and the Kindergarten to College program.
4. Request the Office of the Treasurer and Tax Collector to incorporate an element related to community investment into its upcoming competitive Request for Proposals to obtain banking services such that banks doing business with the City would be required to fulfill a defined community investment component such as the Kindergarten to College program or the Bank on San Francisco program.

**Option 3. Create a community investment program by appropriation of funds**

*Recommendations to pursue this option:*

5. Request the Office of the Treasurer and Tax Collector to evaluate and report back to the Board of Supervisors on the viability of and risk associated with the City operating a direct loan-making initiative such as an "Office of Community Investment", including recommendations for which City Department should administer the program and which City Department should provide oversight of this function.
6. Based on the results of the Treasurer and Tax Collector's report, request the City Attorney to prepare legislation for consideration by the Board of Supervisors that: defines the level of funding to be appropriated for the Office of Community Investment; defines targeted small business and community member clients; sets loan-making criteria; and creates an operational plan for establishing the Office of Community Investment.

**Option 4. Support Assembly Bill 750 which would create a task force to study the viability of creating a State Bank and existing efforts in California to establish a state bank** ***[September 8, 2011 update: AB 750 was "held under submission" in the State Senate Appropriations Committee on August 25, 2011, indicating limited political viability without new levels of support or interest.]***

*Recommendations to pursue this option:*

7. Obtain from the legislative sponsors of AB 750 all related information about AB 750 and inquire about ways the City may actively support such legislation and benefit from advocating for the passage of AB 750 which is currently pending before the State legislature.
8. If the information gathered on AB 750 and the potential benefits to the City's community development efforts from creation of a state bank are determined to be worthwhile, request the City Attorney to prepare legislation for consideration by the Board of Supervisors to express support for such legislation and establish a process for City staff to follow up and report back to the Board of Supervisors on their involvement and the progress of AB 750.

**Option 5. Join efforts to establish a Bay Area network of public banks**

*Recommendations to pursue this option:*

9. Contact representatives of the Public Banking Institute, the nonpartisan research and advocacy organization that is organizing a steering committee of Bay Area stakeholders interested in establishing a regional public bank, to determine if participation in this effort would be beneficial to the City.

**Option 6. Establish a San Francisco public bank**

*Recommendations to pursue this option:*

10. Request the Treasurer and Tax Collector submit a report on the viability and estimated costs and benefits of establishing a public bank in San Francisco. The information to be provided should include:

    - detailed estimates of the costs to the City of operating the bank, including consideration of the cost of human resources and technological systems that would be required;
    - an examination of the legal hurdles and required steps to effectuate a change in State law;
    - an assessment of the financial risk to the City and options to address that risk;
    - options for meeting the 10 percent capital reserve requirement imposed on banks by the Federal Reserve Bank;
    - a preliminary time-line for establishing the bank and meeting all regulatory requirements; and,
    - the potential benefits that would accrue to the City and as well as to the City's residents and businesses, including an assessment of the value of more stable access to lower cost credit and an estimate of the potential revenue that could be generated for the City and County of San Francisco.

## CITY AND COUNTY OF SAN FRANCISCO CURRENT BANKING ARRANGEMENTS

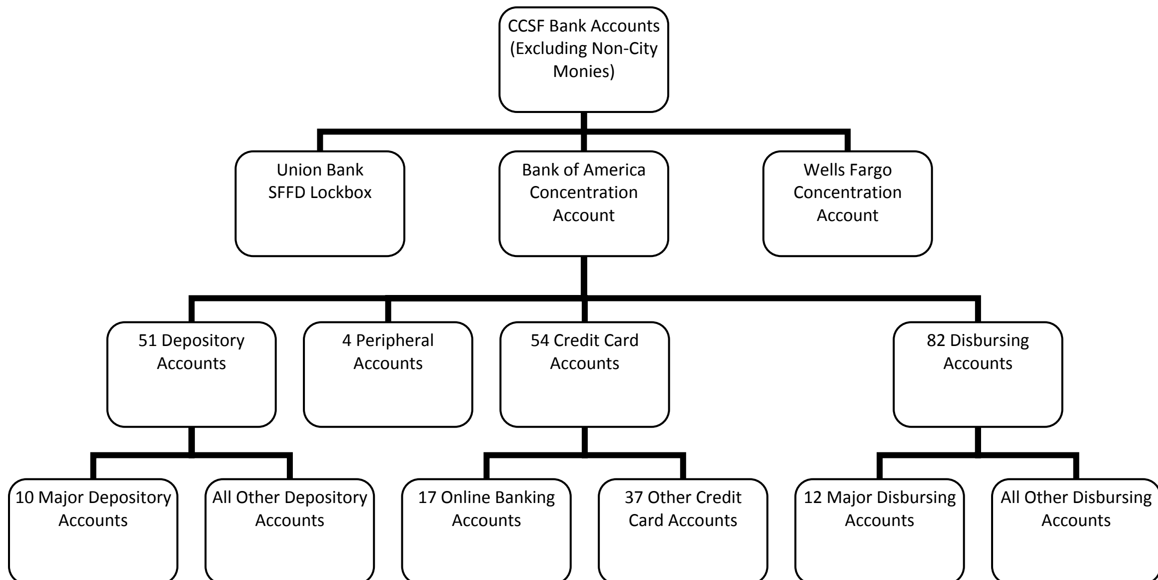
The City's monies are divided into two categories: (1) the cash that is used for frequent expenses like payroll, residing in bank accounts, and (2) all other funds that are not necessary for short-term use, invested in the Treasurer's Investment Pool. Each of these two categories of funds are described in more detail below.

*Cash Bank Accounts*

The City's cash for short-term use such as payroll and operations is held in bank accounts with the following institutions: Bank of America, Union Bank, and Wells Fargo Bank. The balance of cash held in these accounts as of the most recent audited financial statements (June 30, 2010) was $406,479,000[1].

As shown in Exhibit 1 below, the City's bank account structure includes a total of 194 accounts[2], including 82 disbursing accounts, 54 credit card accounts, 51 depository accounts, and four peripheral accounts, in addition to the primary Union Bank Lock Box Account, the Bank of America Concentration Account, and the Wells Fargo Concentration Account.

**Exhibit 1**
**City and County of San Francisco**
**Bank Accounts Structure**




Total of 194 Accounts
Data as of 02/04/2011

Source: Request for Proposals for Treasury Management Consulting Services (Attachment 4), Office of the Treasurer & Tax Collector.

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[1] The Comprehensive Annual Financial Report of the City and County of San Francisco, Notes to the Basic Financial Statements, Note (5)(a) Cash, Deposits and Investments Presentation (page 59).
[2] As of February 4, 2011.

According the Office of the Treasurer and Tax Collector, the City has had its current banking relationships with Bank of America, Union Bank, and Wells Fargo for more than ten years. The City developed relationships with these three banks over time, as the City's service needs as well as the services offered by the individual banks changed. As Exhibit 1 above shows, the City's banking needs involve many different services which, in recent years at least, were only obtainable by engaging with multiple banks.

In 2011 and 2012, the Office of the Treasurer and Tax Collector will conduct a search for banking services providers. On March 24, 2011, the Office of the Treasurer and Tax Collector issued a request for proposals (RFP) for Treasury Management Consulting Services. The chosen consultant will work with the Treasurer-Tax Collector to assist in the selection and establishment of one or more banking and/or merchant card services contracts. As of the date of this report, the consultant had not yet been chosen. The Treasurer-Tax Collector expected to complete the entire banking and/or merchant card services contract selection process by approximately August 2012.

*Invested Funds – Pooled Fund*

Funds that are not needed for short-term operational use are invested in the Treasurer's Pooled Fund Portfolio. These funds are invested in accordance with California Government Code Sections 27000-27013 and the City and County of San Francisco Investment Policy, which is adopted by the Treasury Oversight Committee.

As of July 31, 2011, the Pooled Fund Portfolio had a balance of $3,959,950,813 in market value. Exhibit 2 below, an excerpt from the Pooled Fund's July 2011 Investment Report, shows the values of each of the different types of investments in the portfolio, broken out by par value, book value, and market value. The City's securities are held by Citibank, its custodian bank, and several brokers, banks and dealers are used in the buying and selling of securities.

**Exhibit 2**

**City and County of San Francisco**

**Pooled Fund Portfolio Statistics**

For the month ended July 31, 2011

| | |
|---|---|
| Average Daily Balance | $3,959,950,813 |
| Net Earnings | $4,222,406 |
| Earned Income Yield | 1.26% |
| Weighted Average Maturity | 840 days |

| Investment Type ($ million) | Par Value | Book Value | Market Value |
|---|---|---|---|
| U.S. Treasuries | $ 450 | $ 451 | $ 456 |
| Federal Agencies | 2,513 | 2,522 | 2,545 |
| TLGP | 671 | 683 | 681 |
| Public Time Deposits | 10 | 10 | 10 |
| Negotiable CDs | 150 | 150 | 150 |
| Commercial Paper | 50 | 50 | 50 |
| Total | $ 3,844 | $ 3,866 | $ 3,891 |

Source: Office of the Treasurer & Tax Collector July 2011 Investment Report.

## BACKGROUND ON SPECTRUM OF COMMUNITY-SUPPORTIVE BANKING

A commercial bank is a for-profit financial institution that is owned by private investors and is organized to provide return to its investors. A commercial bank may offer some of the same services as a credit union, community development bank or other type of financial institution, and may even be chartered or supervised by some of the same regulatory entities, but the profit-generating purpose of commercial bank distinguishes it from financial institutions that include a community- or member-supportive mission.

### Definition of other types of banking institutions

- Publicly-owned Bank

  A financial institution owned by a public entity. The only example of a publicly-owned bank in the U.S. is the Bank of North Dakota, which is described in detail below.

- Community Development Bank

  A mission-driven private financial institution that provides financial services to individuals, businesses, and communities underserved by traditional financial institutions. Authorized by the Community Development, Credit Enhancement, and Regulatory Improvement Act of 1994, key attributes of these institutions are defined in the authorizing law as follows:

  > (i) has a primary mission of promoting community development;
  >
  > (ii) serves an investment area or targeted population;
  >
  > (iii) directly, through an affiliate, or through a community partnership, provides development services and equity investments or loans;
  >
  > (iv) maintains, through representation on its governing board or otherwise, accountability to residents of its investment area or targeted population; and
  >
  > (v) is not an agency or instrumentality of the United States, or of any State or political subdivision of a State.

  The Community Development, Credit Enhancement, and Regulatory Improvement Act of 1994 established the Community Development Financial Institutions Fund (CDFI Fund), which was created for the purpose of promoting economic revitalization and community development through investment in and assistance to community development financial institutions (CDFI's). Administered by the U.S. Office of the Treasury, the CDFI Fund operates several programs whereby monetary awards and the allocation of tax credits support qualifying CDFI's in their economic, business, and community development goals.[3] Only certified CDFI's may access CDFI Fund awards. According to the CDFI Fund, CDFI's include regulated institutions such as community development banks and credit unions, and non-regulated institutions such as loan and venture capital funds,

[3] Overview of What We Do, Community Development Financial Institutions Fund, U.S. Department of the Treasury.

provided they meet the community development criteria spelled out above.[4] Since a CDFI may take these various forms, there are multiple federal regulators of these institutions. For example, a credit union seeking CDFI funds would need to meet the certification and regulatory requirements of the CDFI Fund of the U.S. Department of the Treasury in addition to those of the Federal Deposit Insurance Corporation and National Credit Union Administration if it is a federal credit union, or the California Department of Financial Institutions if it is a state-charted financial institution.

According to the U.S. Treasury's CDFI Fund website, 61 awards totaling $377.4 million have been granted to 17 different CDFI's in San Francisco since the establishment of the Fund in 1996. These awards ranged in size from $11,000 to $50 million, with the average award amounting to $6.2 million and the median award amounting to $860,000 and were awarded to a variety of types of CDFI's, including commercial banks, credit unions, venture funds and other community loan funds. Among the 17 awardees were Citibank, Northeast Community Federal Credit Union, Pacific Community Ventures, and Northern California Community Loan Fund, to name a few. While the 17 awardees may not represent the total number of certified CDFI's in San Francisco, the award information does indicate that a broad array of types of financial institutions have sought and secured funding from the CDFI Fund.

- Credit Union

A credit union is defined as a nonprofit cooperative financial institution owned and run by its members. While they offer many of the same banking services, including checking and savings accounts and loan services as commercial banks, their organizational structure differs from commercial banks. Commercial banks are corporations owned by private investors and organized to return profit to investors, while credit unions are cooperatively owned by members, or depositors, who share in the benefits accrued by the credit union. Credit unions are intended to provide their members with a safe place to save and borrow at reasonable rates. They are governed by volunteer boards that are elected by the members.

Like commercial banks, credit unions in the U.S. may elect to be chartered either on the federal or state level. Credit unions may be chartered and supervised on the federal level by the National Credit Union Administration (NCUA), an independent federal agency, or on the state level by the state's regulatory body overseeing credit unions. In California, the Department of Financial Institutions (DFI) oversees state-chartered credit unions. The statutory definition of a credit union provided by California Financial Code Section 14002 is similar to the NCUA definition but does not include the word "nonprofit".

- Other Vehicles

Other, more specialized financial vehicles exist for community development purposes, including community development loan funds, and community development venture capital funds.

[4] CDFI Certification, Community Development Financial Institutions Fund, U.S. Department of the Treasury.

**Banking in San Francisco**

Table 1 below shows the number and asset size of commercial banks and credit unions in California, by federal or state-chartered status, as reported by the California Department of Financial Institutions. As the table shows, there are 188 state-chartered commercial banks in California with approximately $250 trillion in assets, and 49 national commercial banks in California with approximately $175 trillion in assets. There are 160 state-chartered credit unions in California with approximately $73 trillion in assets and 271 federal credit unions in California with approximately $56 trillion in assets.[5] The Department of Financial Institutions also reports on 11 other categories of financial institutions including industrial banks, trust companies, international banks and money transmitters.

**Table 1:**

**Number and Asset Size of Commercial Banks and Credit Unions in California**

| | | Commercial Banks | Credit Unions |
|---|---|---|---|
| State-Chartered | Number (%) | 188 (79.3%) | 160 (37.1%) |
| | Assets (%) | $250 billion (58.8%) | $73 billion (56.6%) |
| | Average Assets | $1.3 billion | $456.3 million |
| Federal or National | Number (%) | 49 (20.7%) | 271 (62.9%) |
| | Assets (%) | $175 billion (41.2%) | $56 billion (43.4%) |
| | Average Assets | $3.6 billion | $206.6 million |
| Total State-Chartered and Federal or National | Number | 237 | 431 |
| | Assets | $425 billion | $129 billion |
| | Average Assets | $1.8 billion | $299.3 million |

Source: California Department of Financial Institutions, Financial Institution Overview as of March 31, 2011.

As shown in the table, most (79.3 percent) commercial banks established in California choose to operate under a state charter, but the average size of those banks ($1.3 billion) is less than half the size of the average national bank ($3.6 billion). This reflects the likelihood that larger national banks operate in multiple states and seek more streamlined regulatory requirements than holding multiple state charters would allow. The opposite pattern is exhibited by the credit unions, the majority (62.9%) of which are federally chartered. The average size of the federally credit unions ($206.6 million) is less than half the average size of the state-chartered credit union ($456.3 million).

## PERTINENT REGULATORY FRAMEWORK AND REQUIREMENTS

**Regulation of banks and credit unions**

Financial institution regulation in the U.S. is complex and involves several entities and options. Generally, a financial institution based in California will be subject to the oversight of two or

[5] Financial Institution Overview, as of March 31, 2011, California Department of Financial Institutions, available at: http://www.dfi.ca.gov.

more regulatory agencies. Known as a “dual chartering system,”[6] or a “dual banking system,” financial institutions in the U.S. may elect to be chartered on either the state or federal level. Generally, if a bank expects to keep its business in a single state, it may choose to seek a state charter, since, as described below, state bank regulatory agencies may provide some benefits to charter holders. Conversely, if a bank’s business proposal involves expansion into multiple states, it may prefer a single regulatory framework and opt for a national charter. If a bank or credit union opts not to seek a state charter, it is considered a “national” institution, and it will be subject to oversight by one federal regulator, its “primary regulator.” If a bank or credit union elects to be a “state-chartered” institution, it will be subject to regulation by both the State of California and a federal regulator, as described in more detail below. As shown above in Table 1, a large majority, approximately 79 percent, of commercial banks established in California choose to operate under a state charter. By contrast, only 37 percent of credit unions established in California choose to operate under a state charter. However, commercial banks with greater assets generally operate under federal charters to allow for interstate banking and local regional banks with smaller asset bases tend to operate under State charters.

The California Department of Financial Institutions (DFI) oversees the operation of California's state-chartered financial institutions, including banks, credit unions and several other types of financial institutions. The DFI asserts that there are several advantages to seeking a state-charter, including greater access to itself as the regulator than institutions would have with the federal regulators, lower fees and assessments, streamlined examination processes, and director training opportunities, among others.[7] If a bank obtains a state charter from DFI, its primary federal regulator would then be either the Federal Reserve Bank (for state-chartered banks that are members of the Federal Reserve System) or the Federal Deposit Insurance Corporation (for state-chartered banks that are not members of the Federal Reserve System). If a bank chooses not to obtain a state charter from DFI, it would be known as a “national bank” and would be regulated by the Office of the Comptroller of the Currency.[8]

## Regulation of the Treasury of the City and County of San Francisco

The Office of the Treasurer-Tax Collector is responsible for the banking and investment activities of the City and County of San Francisco. The Treasurer-Tax Collector must carry out these responsibilities in accordance with federal, state and local law and policies, as outlined in this section.

California Government Code Sections 27000-27013 define the roles and responsibilities of county treasurers in receiving and safely keeping counties’ money. Section 27000.5 defines the relative importance of the three primary objectives that a county treasurer and/or board of supervisors must effectuate in all investment practices:

> When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, the primary objective of the county treasurer or the board of supervisors, as the case may be, shall be to safeguard the principal of the funds under the treasurer’s or the board’s control. The secondary

[6] “The Dual Chartering System and the Benefits of the State Charter,” California Department of Financial Institutions, available at: http://www.dfi.ca.gov.
[7] “Advantages of State Charter,” California Department of Financial Institutions, available at: http://www.dfi.ca.gov.
[8] *The Federal Reserve System: Purposes and Functions*, The Federal Reserve Board, available at www.federalreserve.gov.

> objective shall be to meet the liquidity needs of the depositor. The third objective shall be to achieve a return on the funds under his or her control.

This three-tiered hierarchy is commonly known in the investment field as "SLY," which stands for Safety, Liquidity, Yield. The fundamental meaning of Section 27000.5 and the SLY concept is that protecting the safety of public funds must always be the first priority in investment decisions and that consideration of liquidity, return on investment, or other concerns is subjugated by the requirement that county officials protect principal.

In addition to state and federal law, the City and County of San Francisco Office of the Treasurer and Tax Collector abides by its own set of investment policies approved by the Treasury Oversight Committee[9] and adopted by the Office in January 2011.[10] Reflecting the three-tiered Safety-Liquidity-Yield hierarchy required by California Government Code Section 27000.5 (shown above), the Section 1.0 ("Policy") of the Investment Policy states:

> It is the policy of the Office of the Treasurer & Tax Collector of the City and County of San Francisco (Treasurer's Office) to invest public funds in a manner which will preserve capital, meet the daily cash flow demands of the City, and provide a market rate of return while conforming to all state and local statutes governing the investment of public funds.

Section 4.0 ("Objective") of the Investment Policy specifies the priority order of these three objectives:

> The primary objectives, in priority order, of the Treasurer's Office's investment activities shall be:
>
> 4.1 Safety: Safety of principal is the foremost objective of the investment program. Investments of the Treasurer's Office shall be undertaken in a manner that seeks to ensure the preservation of capital. To attain this objective, the Treasurer's Office will diversify its investments.
>
> 4.2 Liquidity: The Treasurer's Office investment portfolio will remain sufficiently liquid to enable the Treasurer's Office to meet cash flow needs which might be reasonably anticipated.
>
> 4.3 Return on Investments: The portfolio shall be designed with the objective of generating a market rate of return without undue compromise of the first two objectives.

Section 13.0 ("Social Responsibility") of the Investment Policy outlines socially responsible investment goals that should be used "in addition to and subordinate to" the objectives set for the Section 4.0 when investing in corporate securities and depository institutions. While these provisions effectively express the City's preference that socially responsible investments be made when safe and otherwise prudent, the primacy of the safeguarding requirement may in practice significantly limit socially responsible investment options available to the Office of the Treasurer and Tax Collector. The two primary Subsections are shown below:

> 13.1 Social and Environmental Concerns
> Investments are encouraged in entities that support community well-being through safe and environmentally sound practices and fair labor practices. Investments are encouraged in entities that support equality of rights regardless of sex, race, age, disability or sexual orientation. Investments are discouraged in entities that manufacture tobacco products, firearms, or nuclear weapons. In addition, investments are encouraged in entities that offer banking products to serve all members of the local community, and investments are discouraged in entities that finance high-cost check-cashing and

[9] The Treasury Oversight Committee was established by the San Francisco Board of Supervisors in Ordinance No. 316-00. The five-member committee is charged with reviewing and monitoring the Treasurer's Investment Policy and overseeing an annual audit of the Treasurer's Office.

[10] Chapter 10 of the Administrative Code includes Article X "Financial Policies" which, at the time of this report, included only a section on reserve policies.

deferred deposit (payday-lending) businesses. Prior to making investments, the Treasurer's Office will verify an entity's support of the socially responsible goals listed above through direct contact or through the use of a third party such as the Investors Responsibility Research Center, or a similar ratings service. The entity will be evaluated at the time of purchase of the securities.

13.2 Community Investments
Investments are encouraged in entities that promote community economic development. Investments are encouraged in entities that have a demonstrated involvement in the development or rehabilitation of low income affordable housing, and have a demonstrated commitment to reducing predatory mortgage lending and increasing the responsible servicing of mortgage loans. Securities investments are encouraged in financial institutions that have a Community Reinvestment Act (CRA) rating of either Satisfactory or Outstanding, as well as financial institutions that are designated as a Community Development Financial Institution (CDFI) by the United States Treasury Department, or otherwise demonstrate commitment to community economic development.

## PUBLICLY-OWNED BANKS & THE BANK OF NORTH DAKOTA

### Bank of North Dakota

There is only one example of a publicly-owned bank in the U.S. The Bank of North Dakota (BND) was founded in 1919 as part of populist response to problems in the agricultural industry including farmers' poor access to credit. BND was charged with "promoting agriculture, commerce and industry" in North Dakota.

Today, BND, which is overseen by the Industrial Commission of North Dakota, partners with more than 100 other North Dakota financial institutions to, in essence, serve as a central bank with a focus on financing economic development. BND is authorized to make both "direct" loans to individuals and "participation" loans to "lead" financial institutions such as regional or community banks, savings and loans, or credit unions. By practice BND makes very few direct loans to individuals.

All state funds are constitutionally required to be deposited into BND. As a result of the very large amount of money deposited by the state, private citizen deposits account for only a small portion (approximately 1.5 percent) of total deposits. At the end of 2010, BND was a $4.03 billion institution with capital of over $327 million, reflecting its approximate 8 percent capital reserve ratio.

Unlike commercial banks, BND is not insured by the Federal Deposit Insurance Corporation (FDIC). Instead, state law provides that all BND deposits are guaranteed by the full faith and credit of the State of North Dakota. It is a member of the Minneapolis Federal Reserve Bank. As such, it has the rights and responsibilities of other Federal Reserve Bank member banks, such as processing checks and carrying out other cash transactions, maintaining an approximate 8 percent reserve requirement, and meeting all safeguarding requirements of the Federal Reserve Bank[11].

Advocates of the public bank model point to positive government budget and economic outcomes in North Dakota and tout the Bank of North Dakota's role in influencing those

[11] Bank of North Dakota, BND Frequently Asked Questions, available at: http://www.banknd.nd.gov.

outcomes. For example, the Public Banking Institute (PBI) touts that the state of North Dakota has the lowest unemployment rate, at 3.2 percent[12], of any state in country, and during the recent recession was the only state to achieve a major budget surplus. Proponents argue that since BND does not rely on large national banks, it was not subject to dramatic decreases in access to credit that other states and local governments were affected by during the financial crisis. As such, BND was able to continue a stable flow of credit to its member banks, which in turn continued to extend credit to small businesses and other community members, all of which had the effect of sustaining the North Dakota economy. In April 2011, the BND reported its seventh straight year of record-breaking growth, with 2010 profits of $61.9 million, all of which belongs to the people of the State of North Dakota[13] and about half of which is returned to the State's General Fund each year.[14]

**Participation Banks**

In April 2011, Demos, a non-partisan public policy research and advocacy organization, released a study[15] of "partnership banks", or public banks that "act as a 'banker's bank' to in-state community banks and provide the state government with both banking services at fair terms and an annual multi-million dollar dividend." In essence, the term "partnership bank" used in the Demos report refers to the same model of a public bank that is exhibited by the Bank of North Dakota, though, as described above, the Bank of North Dakota also makes direct loans to individual customers (though this represents a small portion of their business). The study includes a review of the experience of the Bank of North Dakota and focused on several potential benefits of partnership banks, as follows:

- Create new jobs and spur economic growth. Partnership banks are participation lenders, meaning they partner with local banks to drive lending through local banks to small businesses.

- Generate new revenues for states directly, through annual bank dividend payments, and indirectly by creating jobs and spurring local economic growth.

- Lower debt costs for local governments. Like the Bank of North Dakota, partnership banks can get access to low-cost funds from the regional Federal Home Loan Banks. The banks can pass savings on to local governments when they buy debt for infrastructure investments. The banks can also provide Letters of Credit for tax-exempt bonds at lower interest rates.

- Strengthen local banks, even out credit cycles, and preserve competition in local credit markets. By purchasing local bank stock, partnering with them on large loans and providing other support, Partnership Banks would strengthen small banks.

- Build up small businesses. Partnership Banks would increase lending capabilities at the smaller banks that provide the majority of small business loans in America.

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[12] July 22, 2011 report for the month of June 2011, Bureau of Labor Statistics, U.S. Department of Labor.
[13] Ibid Industrial Commission of North Dakota.
[14] "Banking on America: How Main Street Partnership Banks Can Improve Local Economies", Demos, Jason Judd and Heather McGhee, April 21,2011.
[15] Ibid Demos.

**Recent Increase in Interest in State Public Banks**

In large part a response to the financial crisis of 2008-2009, twelve states, including California, considered a state bank proposal or study in 2010 and 2011.

On June 1, 2011, the California State Assembly approved Assembly Bill 750 to establish the "investment trust blue ribbon task force" to study the concept of a state bank for California. As of the writing of this report, the most recent action on AB 750 was on July 12, 2011 when the Senate referred the bill to the Committee on Appropriations. If AB 750 is enacted, the task force would "consider the viability of establishing the California Investment Trust, which would be a state bank receiving deposits of state funds." The text of the bill cites the following as potential benefits of a state bank:

(1) Supporting the economic development of California by increasing access to capital for businesses in the state;

(2) Providing financing for housing development, public works infrastructure, educational infrastructure, student loans, and community quality of life projects;

(3) Providing stability to the local financial sector;

(4) Reducing the cost paid by state government for banking services; and

(5) Lending capital to banks, credit unions, and nonprofit community development financial institutions to assist in meeting their goals of increasing access to capital and providing banking services.

The task force's report would be due to the Legislature by December 1, 2012.

In addition to California, in 2011 the states of Oregon, Washington, Massachusetts, Arizona, Maryland, New Mexico, and Maine considered legislation to form a state bank or to conduct a feasibility study on the matter. These states follow Illinois, Virginia, Hawaii and Louisiana, each of which considered similar bills in 2010. As of the date of this report, the status of the legislation in each of the 12 states is shown below in Table 2.

**Table 2:**

**Status of Recent Legislation to Establish a State Bank or State Bank Study Commission**

| | Bill Type | Bill Status | Last Action |
|---|---|---|---|
| Arizona | Establish State Bank | Held in Committee | 2/14/11 |
| California | Study State Bank | Passed Assembly; Pending in Senate Committee | 7/12/11 |
| Hawaii | Study State Bank | Passed House; Deferred by Senate Committee | 3/23/11 |
| Illinois | Establish State Bank | Did not pass House by end of session | 1/11/11 |
| Louisiana | Study State Bank | Passed House; Pending in Senate | 6/9/11 |
| Maine | Establish State Bank | Placed on file | 5/19/11 |
| Maryland | Study State Bank | Unfavorable reports in both houses | 3/18/11 |
| Massachusetts | Study State Bank | Passed; Study Commission convened and issued a report recommending against establishment of a State Bank. | 8/8/11 |
| New Mexico | Establish State Bank | Pending in Committee | 1/27/11 |
| Oregon | Establish State Bank | Pending in Committee | 1/21/11 |
| Virginia | Study State Bank | Tabled in Committee | 2/16/10 |
| Washington | Establish State Bank | Pending in Committee | 4/26/11 |

Source: Legislative databases of each of the 12 states.

There are no examples of a publicly-owned city or county bank in the U.S.[16]

[16] The Indianapolis Local Public Improvement Bond Bank is an instrumentality of the City of Indianapolis and was created for the purpose of buying and selling securities of the City of Indianapolis and Marion County, which have a combined form of government. However, its functions are limited to the buying and selling of bonds; it is not an example of the type of public bank discussed in this memorandum.

## POLICY OPTIONS

In order of increasing cost and difficulty of implementation, the following represent the primary policy options that decision-makers may consider as part of an analysis of banking options in the City and County of San Francisco.

**Option #1: Invest funds in local credit unions or community development banks that provide a minimum level of investment in City community development and improvement efforts**

| Costs / Impediments | Benefits |
|---|---|
| • The size of investment would be limited to a relatively small amount of money – $250,000 per institution, the maximum amount insured by the Federal Deposit Insurance Corporation – unless evidence of sufficient additional security is provided<br>• Would require some level of outreach to local credit unions and community development banks | • Could be implemented within existing institutional structures<br>• Would not require changing local or state policy<br>• Funds would be used to support small businesses, home-owners and other entities in the community, consistent with the member-serving mission of credit unions |

The Office of the Treasurer and Tax Collector has, in the past, invested small amounts of money in local credit unions via time deposits. These investments are limited to a maximum of $250,000 per financial institution, which is the maximum amount insured by the Federal Deposit Insurance Corporation (FDIC). Any amount above the amount insured by the FDIC would not meet the safety requirements of California Government Code Section 27000.5, according to the Office of the Treasurer and Tax Collector. While the commercial banks with which the City has banking relationships are also subject to the FDIC maximum of $250,000, the City's deposits exceed that limit because the City assesses the safety of those large commercial banks to be sufficient to meet the State safeguarding requirements based on evidence of security provided to guarantee larger deposits.

The City does not currently have any money invested in time deposits at credit unions or community development banks[17], but, according to the Office of the Treasurer and Tax Collector, it always considers proposals by local banks and credit unions within the limitations of local, state and federal law. The Office of the Treasurer and Tax Collector could conduct special outreach to credit unions or community development banks or otherwise encourage them to propose investment options. However, even if the City were successful in obtaining suitable proposals from local credit unions or community development banks, the total dollar amount that could be directed to those institutions would be relatively small, since there are only 17[18] San

[17] Community development banks are one type of community development financial institution that, by law, must direct some of its investments to underserved communities that may otherwise not have access to credit.
[18] The National Credit Union Administration reports 17 credit unions based in San Francisco; additionally, there are an unknown number of credit unions operational in San Francisco that are based outside of San Francisco.

Francisco-based credit unions operating within San Francisco and an unknown number of community developments banks[19]. The Office of the Treasurer and Tax Collector believes that it is unlikely that all or even many of the local credit unions would be well-poised to handle the City's business for time deposit investments. If the City were able to establish relationships with even 10 local credit unions for its time deposit business, this investment could amount to $2.5 million if the City invested $250,000, the maximum amount insured by the FDIC, in each institution. As of the June 30, 2011 pooled fund portfolio report (see Exhibit 2 above), the City had approximately $10 million, or 0.2 percent, of its $4 billion dollar portfolio in time deposits.

Separate from the money invested through the Treasurer's Pooled Fund, credit unions and many community development banks would not be a viable option for the City's short-term cash banking needs. According to the Office of the Treasurer and Tax Collector, there are no credit unions large enough to handle the City's volume of funds and transactions; they do not have the technological capacity to meet the City's needs. Therefore, the only viable option for placing City funds in with a credit union would be through the limited time deposit option described above. The same argument would likely apply to many community development banks.

**Recommendations**

1. Request the Office of the Treasurer and Tax Collector evaluate the viability of the 17 San Francisco-based credit unions reported by the National Credit Union Administration, any other credit unions operational in San Francisco, and qualified community development banks to ascertain which, if any, would be suitable for City time deposit business based on the institutions meeting a minimum level of investment in City community development and improvement efforts.
2. Unless evidence of additional suitable security is provided by any such institutions, the investment per institution must be limited to $250,000, the maximum insured by the FDIC.

[19] The U.S. Treasury does not maintain a separate inventory of community development banks. However, records of awards to these type of institutions indicate that 17 institutions in San Francisco qualified for federal funding since creation of a federal program to enhance community development investment.

**Option #2: Expand existing City community development programs**

| Costs / Impediments | Benefits |
| --- | --- |
| • Requires additional City expenditures | • Utilize and leverage existing infrastructure and programs<br>• Would not require effort to change state law<br>• Increase the impact of proven programs |

While California Government Code Section 27000.5 would not allow the City and County of San Francisco to invest its Treasury funds in credit unions, community development financial institutions, or other community-oriented investments beyond the time deposit option described in Option #1, the City may choose to appropriate funds to community investment programs. Any such appropriation could include grants or loans to community development financial institutions or other community organizations that support the City's goals of supporting small businesses, single family homeowners and community development. The City already does this through a variety of programs that it could choose to expand by appropriating additional funds to those programs. For example, the City operates multiple community development programs through the Office of Economic and Workforce Development, and support programs for small business through the Office of Small Business, any of which it could choose to expand.

Through the Human Rights Commission, the City offers the Surety Bond and Financing Assistance Program for small businesses engaging in contract work with the City. The program is designed to help certified Small or Micro Local Business Enterprise (LBE) contractors who are participating in City and/or Redevelopment construction projects obtain and/or increase their bonding and financing capacity.[20] This allows small businesses who would not otherwise meet the bonding requirements for City contractors to meet the requirements and compete for City construction jobs. In addition to financing services, the program also offers financial counseling, accounting, and third party funds administration services.

The program is currently funded at $5 million per year and is limited to construction contractors. The City could choose to expand the funding of the program to enable a greater number of small construction businesses to compete for City jobs and it could also expand the types of contractors to which it extends this program. Additionally, the City could explore offering a program like this for small businesses attempting to secure work with private entities other than the City and County of San Francisco.

Another approach to expanding existing programs would be to expand the partnership programs the City currently operates in conjunction with commercial banks. For example, the City's "Kindergarten to College" program, which seeks to open a savings account and provide a $50 seed deposit for every kindergartener in the City, is funded by a combination of City funds and philanthropic funds provided by a large commercial bank. That program could be expanded to

[20] Program Overview, Surety Bond and Financing Assistance Program for Certified Firms, Human Rights Commission website.

include a larger initial seed deposit, either by obtaining a larger financial commitment from the existing bank partner, or by recruiting other banks to participate in the program.

A second example of an existing program that depends on financial institution partnerships is the "Bank on San Francisco" program operated through the Office of Financial Empowerment within the Office of the Treasurer and Tax Collector. A consortium of 13 banks and credit unions brought together by the City, including both institutions that do business with the City and institutions that do not do business with the City, provide free banking services to individuals who may not otherwise have access to banking services either because of troubled financial history, lack of a social security number, or other factors. The program was established in 2005 as a joint effort of the Mayor and City Treasurer, who worked in conjunction with community organizations and the Federal Reserve Bank of San Francisco to develop the program and recruit financial institution partners.

**Recommendations**

3. Request information from appropriate City departments on the results of existing community investment programs, both those operated directly by the City and those operated in conjunction with partner financial institutions, to assess which programs are suitable for additional appropriation of City funds. Examples of such programs are the Surety Bond Financing Assistance program and the Kindergarten to College program.

4. Request the Office of the Treasurer and Tax Collector to incorporate an element related to community investment into its upcoming competitive Request for Proposals to obtain banking services such that banks doing business with the City would be required to fulfill a defined community investment component such as the Kindergarten to College program or the Bank on San Francisco program.

**Option #3: Create a community investment program by appropriation of funds**

| Costs / Impediments | Benefits |
|---|---|
| • Requires additional City expenditures | • Could define lending terms and take on greater levels of risk than state law allows for Treasury funds.<br>• Could set specific programmatic goals and target any population of individuals, small businesses, or neighborhoods.<br>• If structured as a profit-generating program, could potentially create a revenue stream for the City's General Fund. |

The City could appropriate funds for a new community investment program that would comply with California Government Code Section 27000.5, which requires the Office of the Treasurer and Tax Collector to safeguard the principal of the City's funds before advancing any other investment objectives, to a special community investment program or office that would make loans to small businesses and other community members. Such an approach could take the form of an "Office of Community Investment" that would define its programmatic and investment performance goals and set criteria for loan-making in accordance with those goals.

Since these funds would be appropriated for the specific purpose of the "Office of Community Investment," or another community investment program chosen and defined by the City, and not under the control of the Office of the Treasurer and Tax Collector, the funds would not be subject to the strict safeguarding requirements of California Government Code Section 27000.5. Therefore, the City could take on greater levels of risk with the appropriated funds than the Treasurer is allowed by state law to incur while investing Treasury funds, and there would be no need for the City to pursue any changes in state law in order to pursue this strategy.

A community investment program could potentially create a revenue stream for the City's General Fund or other purpose comprised of interest earnings from loans and other successful investments, much like the Bank of North Dakota. The City's risk exposure and its potential profit would be functions of both the loan-making criteria set by policy-makers and the amount of funds appropriated to the program. While such a program would not likely offer traditional banking services such as cash transaction or savings and checking accounts, its loan program may operate similarly to those offered by commercial banks or credit unions.

**Recommendations**

5. Request the Office of the Treasurer and Tax Collector to evaluate and report back to the Board of Supervisors on the viability of and risk associated with the City operating a direct loan-making initiative such as an "Office of Community Investment", including recommendations for which City Department should administer the program and which City Department should provide oversight of this function.

6. Based on the results of the Treasurer and Tax Collector's report, request the City Attorney to prepare legislation for consideration by the Board of Supervisors that: defines the level of funding to be appropriated for the Office of Community Investment; defines targeted small business and community member clients; sets loan-making criteria; and creates an operational plan for establishing the Office of Community Investment.

**Option #4: Support Assembly Bill 750 which would create a task force to study the viability of creating a State Bank and existing efforts in California to establish a state bank**

| Costs / Impediments | Benefits |
|---|---|
| • Unknown viability and likelihood of successfully emerging from the political process<br>• Lack of control over specific policy provisions<br>• Lack of opportunity to generate dividend revenue specifically for the City. | • Could cast support for AB 750 immediately and see report of the blue ribbon task force by December 2012.<br>• Would join an existing network of supporters<br>• In pursuing a state-based model, would follow an established example (North Dakota)<br>• Limited and shared risk<br>• Opportunity to access state letters of credit at reasonable rates not available through other banks, thereby helping the City to engage in infrastructure projects.<br>• Opportunity to access low-cost funds from the regional Federal Home Loan Banks through the state bank. |

If the City were interested in supporting existing efforts to create a public state bank for California, it could support Assembly Bill (AB) 750 and related efforts to establish a state bank. As described above, earlier this year the California State Assembly approved AB 750 to establish the "investment trust blue ribbon task force" to study the concept of a state bank for California. If AB 750 is passed by the Senate and enacted, the task force would "consider the viability of establishing the California Investment Trust, which would be a state bank receiving deposits of state funds" and report its findings by December 2012.

In addition to benefits that could accrue to the State of California, local governments could stand to benefit under a state-owned bank model. In North Dakota, local governments benefit from the Bank of North Dakota's lower cost funds. Local governments in North Dakota have access to more affordable terms on their letters of credit than they would have through large corporate banks. Letters of credit function like a co-signing agreement whereby the entity signing the letter of credit guarantees payment to the lender. They are an important source of credit for infrastructure projects that utilize bond financing. In North Dakota, the BND provides letters of credit to state and local governments as they seek bond financing for infrastructure projects, which, in turn, also supports higher employment rates in the broader economy[21].

[21] "Banking on America: How Main Street Partnership Banks Can Improve Local Economies", Demos, Jason Judd and Heather McGhee, April 21,2011.

## Recommendations

7. Obtain from the legislative sponsors of AB 750 all related information about AB 750 and inquire about ways the City may actively support such legislation and benefit from advocating for the passage of AB 750 which is currently pending before the State legislature.
8. If the information gathered on AB 750 and the potential benefits to the City's community development efforts from creation of a state bank are determined to be worthwhile, request the City Attorney to prepare legislation for consideration by the Board of Supervisors to express support for such legislation and establish a process for City staff to follow up and report back to the Board of Supervisors on their involvement and the progress of AB 750.

*September 8, 2011 update: On August 25, 2011, AB 750 was "held under submission" in the State Senate Appropriations Committee. While this indicates limited political viability, it may be that expressed public support from the City and County of San Francisco could regenerate momentum around the bill. City leaders would likely need to invest time and resources into efforts to raise support for the bill from other entities.*

**Option #5: Join efforts to establish a Bay Area network of public banks**

| Costs / Impediments | Benefits |
|---|---|
| • California Government Code Section 23007, which prohibits counties from giving or loaning their credit to any person or corporation; this option would require effectuating a change in state law.<br>• Risk associated with being first-in-the-nation to try the model; many unknowns | • Efforts already underway to establish a Bay Area network, with staff and organizational support of the Public Banking Institute<br>• Share the costs of establishing the capital reserve requirement<br>• Share the costs of complying with regulatory requirements<br>• Share the costs of building human and technological capital |

According to the Public Banking Institute (PBI), a non-partisan think-tank, research and advisory organization dedicated to exploring and disseminating information on the potential utility of publicly-owned banks and to facilitate their implementation, an effort led by PBI is currently underway to form a Bay Area steering committee that would study the feasibility of establishing a regional public bank for the nine-county Bay Area. Two preliminary concepts are proposed for review: (1) form a network of public banks, or (2) form one regional public bank with different funds for the different participating entities.

These efforts are still in the early stages and definition of mission, scope, and terms remains to be done. Learning more about these efforts or participating in early discussions with the PBI organization may be of interest to San Francisco policymakers interested in public banking.

**Recommendation**

9. Contact representatives of the Public Banking Institute, the nonpartisan research and advocacy organization that is organizing a steering committee of Bay Area stakeholders interested in establishing a regional public bank, to determine if participation in this effort would be beneficial to the City.

**Option #6: Establish a San Francisco public bank**

| Costs / Impediments | Benefits |
|---|---|
| • California Government Code Section 23007, which prohibits counties from giving or loaning their credit to any person or corporation.<br>• Risk associated with being first-in-the-nation to try the model; many unknowns<br>• Compliance with all regulatory requirements<br>• Meeting 10% federal capital reserve requirement[22]<br>• Recruiting and maintaining the human capital to run a large bank<br>• Building or acquiring the technological capacity<br>• Funding ongoing operational costs<br>• Long-term prospect | • Profits from bank operations stay with the City<br>• Rather than borrowing from larger state or national banks, the City as a "bank" could borrow from other banks at the Fed funds rate, which has a current target of 0-0.25%.<br>• Possibility of achieving positive economic and budgetary results such as those demonstrated in North Dakota.<br>o Low unemployment<br>o Budget Surplus<br>o Additional revenue stream for the City<br>• Possibility of notoriety for serving as a leader among cities, first-in-the-nation to try the model. |

In addition to the practical costs and challenges described below, there is a major legal impediment to the City and County of San Francisco establishing a public bank. California Government Code Section 23007 states "except as specified in this chapter, a county shall not, in any manner, give or loan its credit to or in aid of any person or corporation. An indebtedness or liability incurred contrary to this chapter is void." The Office of the Treasurer and Tax Collector interprets this to mean that the City and County of San Francisco could not lawfully establish and operate a public bank. Should the Board of Supervisors choose to pursue the public bank option, it would need to effectuate a change in California Government Code Section 23007. The costs of pursuing such a change in state law are unknown.

If the City were to succeed in changing state law, there are a number of other challenges it would face in establishing a public bank. First, it would have to go through the process of forming an entity that would apply to be recognized by either the California Department of Financial Institutions (DFI) and a primary federal regulatory agency, or just a primary federal regulatory agency. A bank establishing itself in California need not seek a state charter through the California DFI. However the DFI asserts that there are several advantages to seeking a state-charter, as described above.[23] If a bank obtains a state charter from DFI, its primary federal

[22] Reserve requirements are set by the Federal Reserve Bank and are subject to change. 10% is the rate applied, as of 12/30/10, to banks with over $58.8 billion in liabilities.
[23] "Advantages of State Charter," California Department of Financial Institutions, available at: http://www.dfi.ca.gov.

regulator would then be either the Federal Reserve Bank (for state-chartered banks that are members of the Federal Reserve System) or the Federal Deposit Insurance Corporation (for state-chartered banks that are not members of the Federal Reserve System).[24] If a bank chooses not to obtain a state charter from DFI, it would be known as a "national bank" and would be regulated by the Office of the Comptroller of the Currency.[25]

As shown in Table 1 of this report, a large majority, approximately 79 percent, of commercial banks established in California choose to operate under a state charter. If the City were to pursue state-chartered status, it would need to consult the DFI's "Guide for Groups Interested in Chartering a State Bank in California,"[26] which outlines the steps that parties interested in establishing a state-chartered bank in California must follow whether they elect to be a state member bank of the Federal Reserve Bank or choose the Federal Deposit Insurance Corporation as their primary federal regulator. In summary, the process requires an interested party to submit to the DFI a proposal and business plan for its proposed bank; request and attend pre-application meetings between all proposed directors of the proposed bank, representatives of the DFI and representatives of the Federal Reserve Bank and/or the FDIC; file a complete application to the DFI; and comply with field investigative activities during the application review period.

According to the DFI, in evaluating applications for a state charter, reviewers seek to ascertain:

a. That the public convenience and advantage will be promoted by the establishment of the proposed bank or trust company.

b. That the proposed bank or trust company will have a reasonable promise of successful operation.

c. That the bank is being formed for no other purpose than the legitimate objects contemplated by this division.

d. That the proposed capital structure is adequate.

e. That the proposed officers and directors have sufficient banking or trust experience, ability, and standing to afford reasonable promise of successful operation.

f. That the name of the proposed bank or trust company does not resemble, so closely as to be likely to cause confusion, the name of any other bank or trust company transacting business in this state or which had previously transacted business in this state.

g. That the applicant has complied with all of the applicable provisions of this division.

[24] As described earlier in this report, the Bank of North Dakota, the only example of a public bank in the U.S., is not insured by the Federal Deposit Insurance Corporation. Per state law, its deposits are guaranteed by the full faith and credit of the State of North Dakota. The Bank of North Dakota is a member of the Federal Reserve Bank of Minneapolis.

[25] *The Federal Reserve System: Purposes and Functions*, The Federal Reserve Board, available at www.federalreserve.gov.

[26] "Guide for Groups Interested in Chartering a State Bank in California," California Department of Financial Institutions, available at: http://www.dfi.ca.gov/cacharter/guide.asp

Additionally, the DFI states that, in reaching its decision, it considers:

a. The character, reputation, and financial standing of the organizers or incorporators and their motives in seeking to organize the proposed bank or trust company.

b. The need for banking or trust facilities or additional banking or trust facilities, as the case may be, giving particular consideration to the adequacy of existing banking or trust facilities and the need for further banking or trust facilities.

c. The character, financial responsibility, banking or trust experience, and business qualifications of the proposed officers of the bank or trust company.

d. The character, financial responsibility, business experience, and standing of the proposed stockholders and directors.

e. The adequacy of banking facilities to support its operations.

f. The adequacy of capitalization to support the projected volume and type of business.

g. The reasonableness to achieve and maintain profitability.

h. The viability of the Business Plan given the economic condition, growth potential, and competition of the proposed market area.

i. Whether the bank is free from abusive insider transactions and apparent conflicts of interest.

j. Other facts and circumstances bearing on the proposed bank or trust company and its relation to the locality as in the opinion of the commissioner may be relevant.

The City would be required to meet the Federal Reserve Board's capital reserve requirements, which vary based on the size of the depository institution. As of the date of this report the rate applied to institutions with liabilities of more than $58.8 million is 10 percent[27]. This means that the City would be required to keep 10 percent of its total funds, or approximately $408 million based on the $4.08 billion market value balance of the Treasurer's pooled investment fund as of June 30, 2011, in cash reserves.

As a variation on the public bank concept described above, the City could choose to design its public bank as "partnership bank" similar to the North Dakota model. Under this scenario, the City would not make direct loans to businesses or other individual community members. Rather, it would primarily provide "participation loans" to local partner financial institutions (commercial banks, credit unions, community development banks or other qualified institutions), which would then extend loans directly to small businesses and individuals. This option may require fewer administrative and operational costs than if the City were to provide direct loans and banking services to community members since it would harness the established systems and

[27] Reserve Requirements, in Monetary Policy of the Federal Reserve Board; available at: http://www.federalreserve.gov/monetarypolicy/reservereq.htm#table1

infrastructure of existing institutions. However, the City would still be required to meet regulatory requirements and build its own infrastructure as the "banker's bank."

## Recommendations

10. Request the Treasurer and Tax Collector to submit a report on the viability and estimated costs and benefits of establishing a public bank in San Francisco. The information to be provided should include:

   - detailed estimates of the costs to the City of operating the bank, including consideration of the cost of human resources and technological systems that would be required;
   - an examination of the legal hurdles and required steps to effectuate a change in State law;
   - an assessment of the financial risk to the City and options to address that risk;
   - options for meeting the 10 percent capital reserve requirement imposed on banks by the Federal Reserve Bank;
   - a preliminary time-line for establishing the bank and meeting all regulatory requirements; and,
   - the potential benefits that would accrue to the City and as well as to the City's residents and businesses, including an assessment of the value of more stable access to lower cost credit and an estimate of the potential revenue that could be generated for the City and County of San Francisco.

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

1390 Market Street, Suite 1150, San Francisco, CA 94102
(415) 552-9292 FAX (415) 252-0461


# Policy Analysis Report

To: Supervisor Fewer
From: Budget and Legislative Analyst's Office
Re: Large Bank Social Responsibility Screening
Date: May 19, 2017

## Summary of Requested Action

Your office requested that the Budget and Legislative Analyst report on social responsibility measures for the largest U.S. banks. Specifically, you requested that we report on (1) the gender and racial/ethnic composition of the banks' boards of directors; (2) lending practices; and (3) bank financing of the following: civilian firearms, tobacco, nuclear power, the Dakota Access Pipeline, and private prisons.

*For further information about this report, contact Fred Brousseau at the Budget and Legislative Analyst's Office.*

## Executive Summary

- Thirteen large banks were identified for this analysis of their performance against various social responsibility measures and their financing role in the Dakota Access Pipeline and the civilian firearms, tobacco, nuclear power and private prison industries.
- Eleven of the banks were selected for this analysis from the largest in the U.S., each with assets of $200 billion or more. Two additional banks were selected with assets under $200 billion, but with significant shares of the deposit market in California. Of the thirteen banks analyzed, seven participated in the Request for Proposal process for Banking & Payment Services for the City and County of San Francisco in 2012.
- The review of the performance of the thirteen analyzed banks measured against various social responsibility indicators showed that, overall, the banks performed worse than comparison benchmark institutions in the majority of cases. Specifically, the banks' performance was measured in the areas of:

    1. Board of directors diversity
    2. Percentage of loans made to small businesses
    3. Percentage of home loans to borrowers of color, low-income borrowers, and low-income neighborhoods

4. Percentage of loans for community development purposes such as affordable housing, community services, and economic development activities
5. Adoption of practices to limit the impact on low income customers of overdraft policies

Benchmark institutions for comparison to the thirteen banks varied by measure and consisted of all financial institutions, all large banks, or those with at least $1 billion in assets, all Fortune 500 companies, or for one measure where comparison data was not available from regulatory agencies, the aggregate results for the thirteen banks themselves.

- The results of our analysis of the thirteen banks' performance on various social responsibility measures are presented in Exhibit A.
- As shown in Exhibit A, the best results for the thirteen banks analyzed were achieved by two banks that exceeded the benchmark institutions' performance in five out of the eight measures evaluated. The remaining eleven banks only exceeded the benchmark institutions' performance on half of the measures or fewer.
- Measures for which a majority of the thirteen banks analyzed exceeded the benchmark institutions were on implementing best overdraft practices and making home loans to borrowers of color.
- Areas where the thirteen banks were below the benchmarks most frequently were in making home loans in low-income neighborhoods, making home loans to low-income borrowers, and making loans to small businesses.

**Exhibit A: 13 Banks' Performance on Social Responsibility Measures Relative to Benchmarks**

**(✓ = bank scored above benchmark)**

| Bank name | Board of directors | | Small business loans | Home loans | | | Community Development loans | Overdraft practices | Total measures above benchmark (out of 8) |
|---|---|---|---|---|---|---|---|---|---|
| | Female board members (%) | Board member of color (%) | % of total business loans | Borrowers of color (%) | Low-income borrowers (%) | Low-income neighbor-hood (%) | % of total loans | Pew best practices | |
| Benchmark | Fortune 500 | Fortune 500 | All large banks* | All instns. | All instns. | All instns. | Median of 13 banks | 45 largest banks | |
| Benchmark value | 20% | 15% | 15.3% | 19.9% | 28% | 13.5% | 0.8% | 0.85 | |
| **Bank of America** | ✓ | ✓ | | ✓ | | | | ✓ | **4** |
| **Bank of the West** | not available | not available | ✓ | | | | ✓ | ✓ | **3** |
| **BB&T** | | ✓ | ✓ | | | | ✓ | ✓ | **4** |
| **Capital One** | not available | not available | | ✓ | | | ✓ | | **2** |
| **Citibank** | ✓ | ✓ | | ✓ | | | ✓ | ✓ | **5** |
| **HSBC** | not available | not available | | ✓ | | | | ✓ | **2** |
| **JPMorgan Chase** | | | | ✓ | | | | ✓ | **2** |
| **PNC** | not available | not available | | | ✓ | ✓ | | | **2** |
| **SunTrust** | not available | not available | | | | | ✓ | | **1** |
| **TD Bank** | ✓ | not available | | | ✓ | ✓ | ✓ | | **4** |
| **U.S. Bank** | ✓ | ✓ | ✓ | | ✓ | | | ✓ | **5** |
| **Union Bank** | ✓ | ✓ | | ✓ | | | ✓ | | **4** |
| **Wells Fargo** | ✓ | ✓ | | ✓ | | | | ✓ | **4** |
| **Total** | **6** | **6** | **3** | **7** | **3** | **2** | **7** | **8** | |

*Large banks are those with at least $1 billion in assets.

- Filings with the U.S. Securities and Exchange commission show that the thirteen banks analyzed and their affiliates have all been active in financing one or more of the industries or business entities shown in Exhibit B. Each industry was analyzed based on the records of the top two or three publicly traded companies for each industry.

- The Dakota Access Pipeline is an entity, not an industry, owned by a consortium of companies including Energy Transfer Partnerships, Sunoco Logistic Partners, and Phillips 66, among others.
- Financing provided by the thirteen banks and their affiliates included in this analysis were lines of credit, loans and bond financings.

**Exhibit B: Industries and Business Entities Receiving Financing from 13 Analyzed Banks, 2010-2017**

| Bank Name | **Civilian Firearms** | **Tobacco** | **Nuclear Power Companies** | **Dakota Access Pipeline** | **Private Prison** | **Total Industries/ Entities Financed** |
|---|---|---|---|---|---|---|
| Bank of America | ✕ | | ✕ | ✕ | ✕ | *4* |
| Bank of the West | ✕ | | ✕ | ✕ | ✕ | *4* |
| BB&T | ✕ | | ✕ | | | *2* |
| Capital One | ✕ | | | | | *1* |
| Citibank | | ✕ | ✕ | ✕ | | *3* |
| HSBC | | ✕ | ✕ | ✕ | ✕ | *4* |
| JPMorgan Chase | ✕ | ✕ | ✕ | ✕ | ✕ | *5* |
| PNC | ✕ | ✕ | ✕ | ✕ | ✕ | *5* |
| SunTrust | | | ✕ | ✕ | ✕ | *3* |
| TD Bank | ✕ | | ✕ | ✕ | ✕ | *4* |
| U.S. Bank | ✕ | ✕ | ✕ | ✕ | ✕ | *5* |
| Union Bank | | | ✕ | ✕ | | *2* |
| Wells Fargo | ✕ | ✕ | ✕ | ✕ | ✕ | *5* |

*Project staff: Fred Brousseau, Christina Malamut, and Mina Yu*

## Overview

This report first presents social responsibility indicators related to bank practices and policies in five areas: (1) board of directors' gender and racial/ethnic diversity; (2) small business loans; (3) home loans to borrowers of color and low-income borrowers; (4) community development loans; and (5) overdraft policies for bank customers with checking accounts. Indicators were selected based on the Socially Responsible Banking & Payment Services Questions from the City and County of San Francisco's 2012 Request for Proposals (RFP) for Banking & Payment Services, as well as data availability. The second section provides information on bank financing of the following: civilian firearms, tobacco, nuclear power, the Dakota Access Pipeline, and private prisons.

The report reviews practices and financing at thirteen large banks, shown below in Exhibit 1. The banks include eleven of the thirteen banks[1] in the U.S. with more than $200 billion in assets, as well as two other large banks—Bank of the West and Union Bank—that have a considerable share of the deposit market in California (3.2 percent and 6.2 percent respectively) though their total assets are each less than $200 billion. Seven of the thirteen banks participated in the City's most recent RFP for Banking & Payment Services.[2] The City currently contracts with two of the banks for banking and payment services—Bank of America and U.S. Bank.

A bank is a financial institution that is licensed to make loans and receive deposits. This report's assessment of bank performance relative to various social responsibility measures focuses on commercial banks, which make loans to individuals and businesses, manage withdrawals, and receive deposits.[3] A bank holding company (BHC) controls one or more banks and typically owns multiple bank subsidiaries, as well as nonbanking entities that are engaged in activities such as securities dealing and underwriting, private equity, real estate, insurance, asset management, etc.[4] For example, Bank of America Corporation is a financial holding company[5] that owns the commercial bank, Bank of America[6]. In our analysis of bank performance relative to social responsibility indicators, we assess

[1] Bank of New York Mellon and State Street Bank and Trust Company were not included in this report because they do not offer retail banking services.
[2] Bank of San Francisco also participated in the most recent RFP but was not included in this report due to its size.
[3] Investment banks provide services such as underwriting and assisting with mergers and acquisitions for corporate clients.
[4] Avraham, Dafna, Selvaggi, Patricia, and Vickery, James. "A Structural View of U.S. Bank Holding Companies." The Federal Reserve Bank of New York Economic Policy Review. July 2012.
[5] Most BHCs are registered as financial holding companies (FHCs) which allow them to engage in financial activities such as securities underwriting and dealing, merchant banking activities, and insurance underwriting.
[6] Formally known as "Bank of America, National Association"

banks only since they are the entities most involved in making loans and other retail banking practices. In our analysis of financing of businesses in selected industries, we focus more broadly on commercial banks and their affiliates, such as bank subsidiaries or other entities owned by the same financial holding company, each explicitly identified.

**Exhibit 1: 13 Banks Covered in this Report**

| Bank name | Assets (Mil $) | CA deposit market share (%) | Branches in SF | Participated in 2012 CCSF Banking Services RFP |
|---|---|---|---|---|
| Bank of America | $1,659,793 | 21.7% | 42 | Yes |
| Bank of the West | 82,567 | 3.2 | 11 | Yes |
| Branch Banking & Trust (BB&T) | 217,378 | 0.0 | 0 | |
| Capital One | 279,255 | 0.0 | 0 | |
| Citibank | 1,356,393 | 4.2 | 25 | Yes |
| HSBC | 203,705 | 0.8 | 3 | |
| JPMorgan Chase | 2,118,497 | 9.4 | 42 | Yes |
| PNC | 357,859 | 0.0 | 0 | |
| SunTrust | 200,201 | 0.0 | 0 | |
| TD Bank | 264,438 | 0.0 | 0 | |
| U.S. Bank | 448,401 | 2.8 | 13 | Yes |
| Union Bank | 116,912 | 6.2 | 6 | Yes |
| Wells Fargo | 1,740,819 | 19.5 | 43 | Yes |

Source: Federal Reserve (assets), Federal Deposit Insurance Corporation (FDIC) (market share and branches); San Francisco Treasurer & Tax Collector (RFP participation)

## 1. Bank Practices Relative to Social Responsibility Indicators

This section presents data on social responsibility indicators related to board of directors' gender and racial/ethnic diversity, small business loans, home loans to borrowers of color and low-income borrowers, community development loans, and overdraft policies for bank customers with checking accounts. Specifically, we present data on eight indicators:

1. Percent of board of directors' members that are female
2. Percent of board of directors' members that are persons of color
3. Percent of total business loans that are small business loans, defined as loans with original amounts of $1.0 million or less, regardless of business size
4. Percent of home loans to borrowers of color
5. Percent of home loans to low-income borrowers
6. Percent of home loans that are for properties in low-income neighborhoods
7. Percent of total loans that are community development loans, defined in the Community Reinvestment Act of 1997 as loans that provide financing for the following: (1) affordable housing (including multifamily rental housing) for low-or moderate-income individuals; (2) community services targeted to low- or moderate-income individuals; (3) activities that promote economic development by financing small businesses or farms; or (4) activities that revitalize or stabilize low- or moderate-income geographies
8. Number of banking best practices in which the bank engages as identified in a Pew Charitable Trusts study, to minimize overdraft fees.

For each indicator, we compare the performance of the thirteen banks to each other as well as a relevant benchmark (e.g. the performance of all large banks).

### Board of Directors Diversity

This section describes the racial/ethnic and gender diversity of the boards of directors at the banks analyzed in this report and compares board diversity at these banks with that of all Fortune 500 companies. Some banks publish demographic information for their boards of directors in their annual proxy statements, while others do not. We gathered demographics data from the banks' annual proxy statements (when possible) as well as published studies and reports. However, gender diversity data was not available for five banks and racial/ethnic diversity data was not available for six banks. Board diversity data and sources are described in Exhibit 2 below.

**Exhibit 2: Board of Directors Diversity, 13 Analyzed Banks**

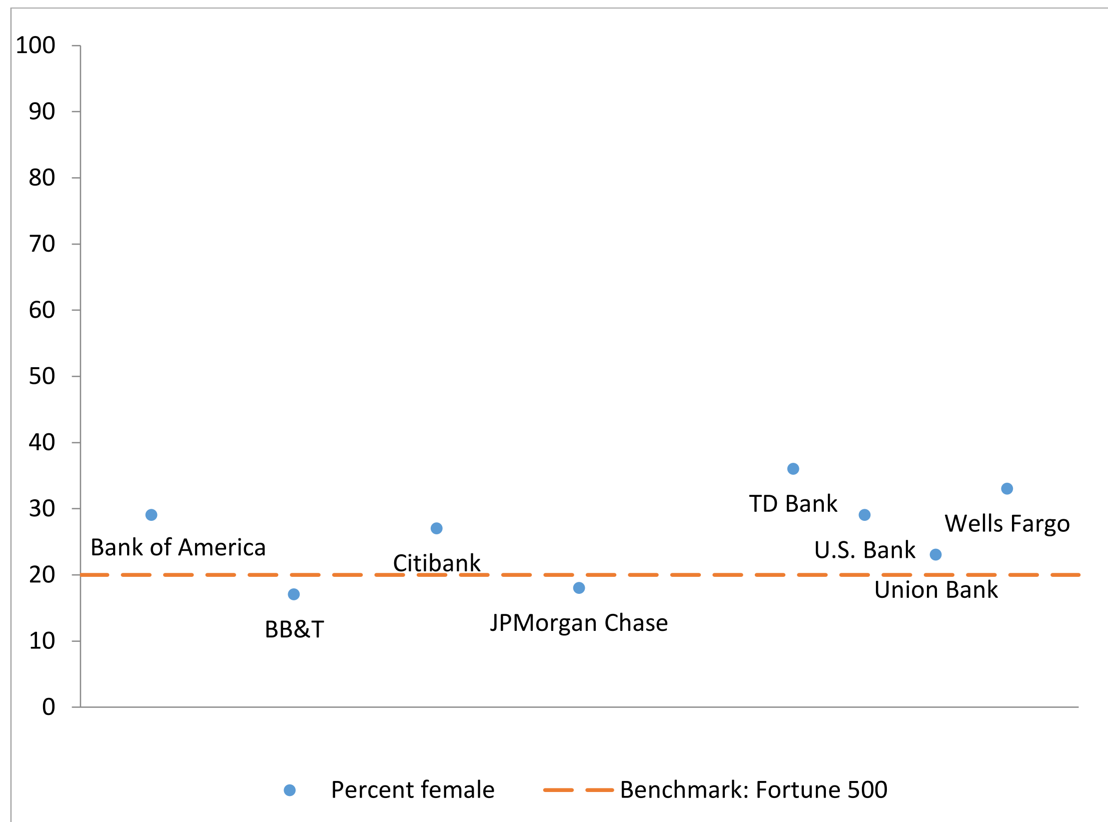
| Bank name | Percent female | Percent persons of color | Source | Year |
|---|---|---|---|---|
| **Benchmark:** All Fortune 500 companies | 20% | 15% | Deloitte report[7] | 2016 |
| Bank of America | 29% | 21% | Annual proxy statement | 2016 |
| BB&T | 17% | 22% | UNC study[8] | 2015 |
| Citibank | 27% | 20% | Annual proxy statement | 2016 |
| JPMorgan Chase | 18% | 9% | Greenlining Institute report[9] | 2012 |
| TD Bank | 36% | *not available* | Annual proxy statement | 2016 |
| U.S. Bank | 29% | 21% | Deloitte report | 2016 |
| Union Bank | 23% | 62% | Greenlining Institute report | 2012 |
| Wells Fargo | 33% | 27% | Annual proxy statement | 2016 |
| Bank of the West | *not available* | *not available* | | |
| Capital One | *not available* | *not available* | | |
| HSBC | *not available* | *not available* | | |
| PNC | *not available* | *not available* | | |
| SunTrust | *not available* | *not available* | | |
| Median: 13 Analyzed Banks | 28% | 21% | | |

In 2016, female board members represented just 20 percent of all boards of directors' members at Fortune 500 companies.[10] With a median of 28 percent female board members, six of the 13 large banks reviewed with available data had greater female representation on their boards of directors compared to Fortune 500 companies in aggregate: Bank of America, Citibank, TD Bank, U.S. Bank, Union Bank, and Wells Fargo. JPMorgan Chase and BB&T had less female representation on their boards compared to Fortune 500 companies—female board members made up 18 and 17 percent, respectively, of all board members. TD Bank and

[7] Deloitte, Catalyst, Diversified Search, The Executive Leadership Council, the Hispanic Association on Corporate Responsibility, and Leadership Education for Asian Pacifics, Inc. "Missing Pieces Report: The 2016 Board Diversity Census of Women and Minorities on Fortune 500 Boards." February 6, 2017.
[8] Director Diversity Initiative at University of North Carolina-Chapel Hill School of Law. *North Carolina Corporate Board Diversity 2015 Survey*. June 2016. <https://ddi.law.unc.edu/boarddiversity/>
[9] Vissa, Preeti. The Greenlining Institute. "Annual Bank Board Diversity Report 2012." February 2013. <http://greenlining.org/wp-content/uploads/2013/03/GI-BBD-layout-to-post.pdf>
[10] Deloitte, Catalyst, Diversified Search, The Executive Leadership Council, the Hispanic Association on Corporate Responsibility, and Leadership Education for Asian Pacifics, Inc. "Missing Pieces Report: The 2016 Board Diversity Census of Women and Minorities on Fortune 500 Boards." February 6, 2017.

Wells Fargo had the largest percentage (36 and 33 percent respectively) of female board members, as shown in Exhibit 3 below.

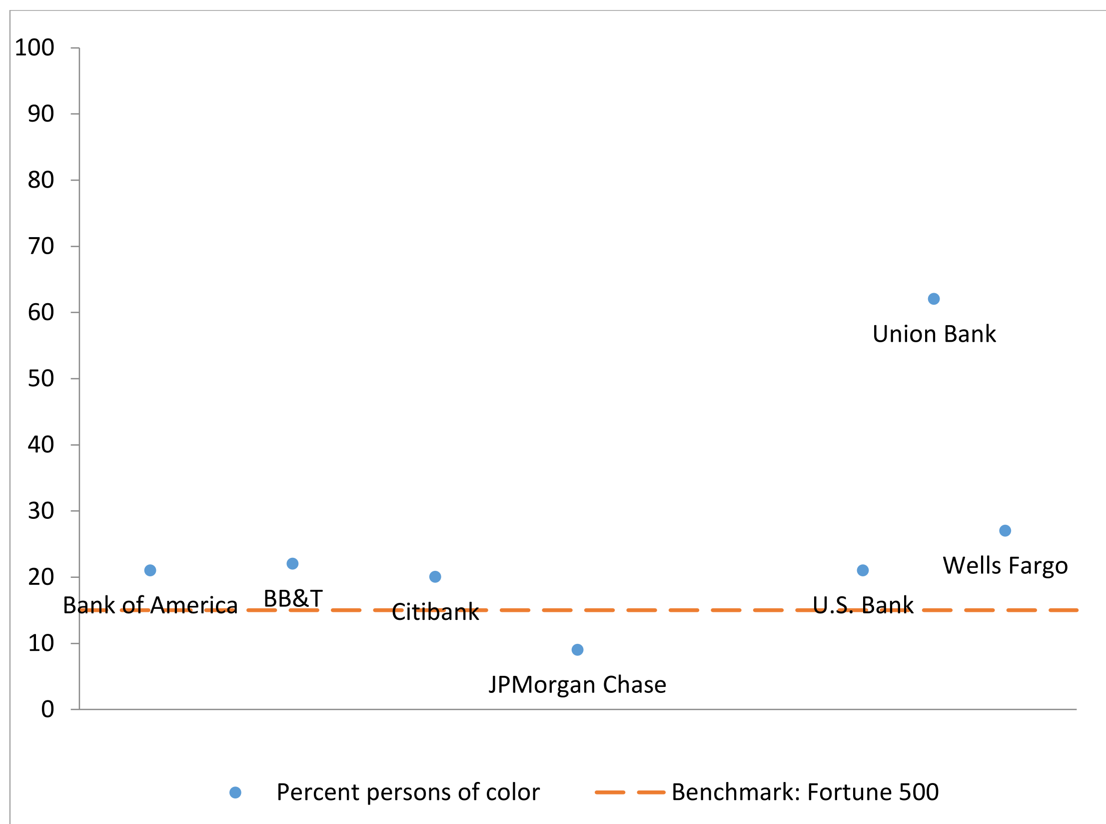
**Exhibit 3: Board of Directors, Percent Female, 13 Analyzed Banks**




Source: Annual proxy statements and reports described in Exhibit 2

In 2016, persons of color represented just 15 percent of all boards of directors' members at Fortune 500 companies. Six banks with available data had greater representation of persons of color on their boards of directors compared to Fortune 500 companies in aggregate: Bank of America, BB&T, Citibank, U.S. Bank Union Bank, and Wells Fargo. JPMorgan Chase had less representation of persons of color on their boards compared to Fortune 500 companies—persons of color represented nine percent of all board members. Union Bank had the largest percentage (62 percent) of persons of color among all board members, followed by Wells Fargo (27 percent), as shown in Exhibit 4 below.

**Exhibit 4: Board of Directors, Percent Persons of Color, 13 Analyzed Banks**




Source: Annual proxy statements and reports described in Exhibit 2

## Small Business Loans

Small business loans are defined as business loans[11] whose original amounts are $1.0 million or less, regardless of business size. In this section, we describe small business lending nationally in terms of number of loans and total amounts of loans using data from the Federal Deposit Insurance Corporation (FDIC) Call Reports for December 2016. We compare the banks' small business loans as a percentage of their total business loans to that of all large banks—defined as banks with at least $1.0 billion in assets at the end of 2016—based on previously

[11] Business loans include: (1) loans secured by nonfarm or nonresidential real estate; and (2) commercial and industrial loans.

established methodology.[12] Data on small business loans in the City and County of San Francisco can be found in the Appendix.

As of December 2016, the thirteen banks analyzed had a total of 10.9 million small business loans outstanding for a total of $152.4 billion in loans. This represented 10.8 percent of their total business loans, lower than the 15.3 percent rate for all large banks. Bank of America had the most small business loans outstanding (3.2 million), and Wells Fargo had the largest small business loan amount outstanding ($36.9 billion), as shown in Exhibit 5 below. Median amounts for the thirteen analyzed banks are also presented, again showing a lower rate of small business loans, at 12.5 percent, compared to the 15.3 percent benchmark rate for all large banks.

[12] Williams, Victoria. "Small Business Lending in the United States 2010-2011." Office of Advocacy of the U.S. Small Business Administration (SBA). July 2012.

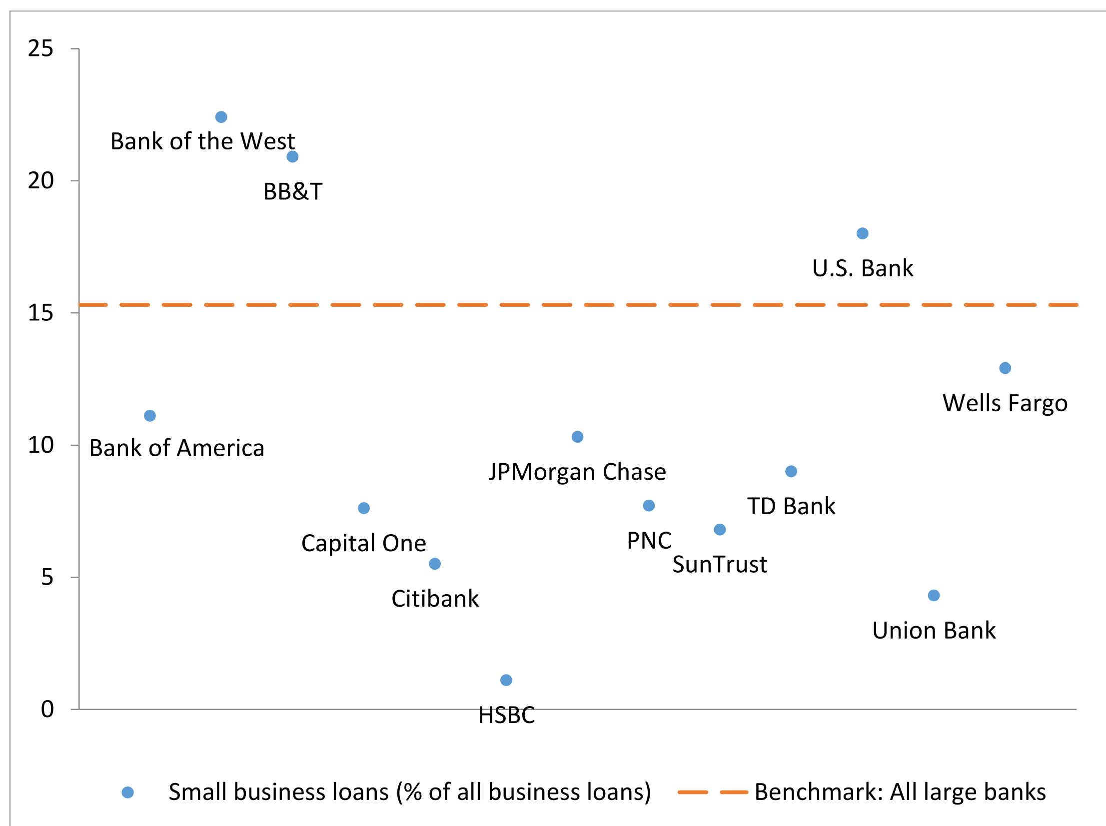
**Exhibit 5: Total Number of Small Business loans, 13 Analyzed Banks, December 2016**

| Bank name | Small business loans: Number of loans outstanding | Small business loans: Amount (000s) | Total business loans (000s) | Percent small business loans |
|---|---|---|---|---|
| **Benchmark**: All large banks* | 22,871,920 | $448,991,608 | $2,938,681,321 | 15.3% |
| Bank of America | 3,154,206 | $33,988,000 | $305,938,000 | 11.1% |
| Bank of the West | 42,290 | $5,305,879 | $23,660,872 | 22.4% |
| BB&T | 364,185 | $11,254,517 | $53,740,739 | 20.9% |
| Capital One | 290,739 | $2,975,807 | $39,095,368 | 7.6% |
| Citibank | 2,410,849 | $8,376,000 | $151,364,000 | 5.5% |
| HSBC | 2,929 | $429,013 | $37,465,555 | 1.1% |
| JPMorgan Chase | 2,151,629 | $19,282,000 | $186,743,000 | 10.3% |
| Union Bank | 153,294 | $1,258,916 | $29,085,090 | 4.3% |
| PNC | 254,749 | $7,217,815 | $93,999,842 | 7.7% |
| SunTrust | 32,706 | $3,892,024 | $57,642,410 | 6.8% |
| TD Bank | 74,664 | $4,664,744 | $51,652,740 | 9.0% |
| U.S. Bank | 1,099,082 | $16,776,329 | $92,964,332 | 18.0% |
| Wells Fargo | 898,199 | $36,962,000 | $287,074,000 | 12.9% |
| Total: 13 Analyzed Banks | 10,929,521 | $152,383,044 | $1,410,425,948 | 10.8% |
| Median: 13 Analyzed Banks | 290,739 | $7,217,815 | $57,642,410 | 12.5% |

Source: FDIC Call Reports, December 31, 2016
*All large banks are defined as those with assets of $1 million or more.

Small business loans made up a larger share of total business loans at three of the banks analyzed compared to all large banks—Bank of the West (22.4 percent), BB&T (20.9 percent), and U.S. Bank (18.0 percent). Small business loans made up a smaller share of total business loans at the remaining ten banks analyzed compared to all large banks. HSBC had the smallest share of small business loans as a percentage of total business loans in the group (1.1 percent). As shown in Exhibit 6, most of the thirteen analyzed banks were below the benchmark 15.3 percent small business loan rate for all large banks.

**Exhibit 6: Small Business Loans, Percent of Total Business Loans, 13 Analyzed Banks, 2016**




Source: Budget and Legislative Analyst calculation based on data from FDIC Call Reports, December 31, 2016
Note: The benchmark all large banks are those with assets of $1 billion or more.

## Home Loans to Borrowers of Color and Low-Income Borrowers

The Home Mortgage Disclosure Act of 1975 (HMDA) requires most mortgage lending institutions to disclose detailed information about their home-lending activity each year, including demographic information about loan applicants and census-tract designations of properties related to those loans. The Federal Reserve publishes an annual report based on HMDA data on residential mortgage lending demographics by institution type and provides institution level details for the top 25 mortgage lenders. Eight of the thirteen banks analyzed in this report are among the top 25 mortgage lenders. We pulled data from this Federal Reserve report and analyzed HMDA data for the remaining five banks, using the same methodology, and present three statistics in this section on home-purchase loan originations in 2015 for one-to-four family properties: (1) the percent of loans to borrowers of color; (2) the percent of loans to low-income borrowers; and (3) the percent of loans to low-income neighborhoods. We compare these measures for

individual banks with those at all mortgage lending institutions and at all large banks, for which aggregate records are available from the Federal Reserve report.

The thirteen banks analyzed made a total of 382,000 home-loans in 2015, and this represents approximately 12.2 percent of all home-loan originations in 2015. Originations and borrower demographic information are shown in Exhibit 7 below.

As can be seen in Exhibit 7, as a group, the thirteen analyzed banks made lower percentages of their loans to low income borrowers, with a median rate of 18.5 percent, than all large banks, at 23.7 percent, and all institutions, at 28 percent.

For loans to low-income neighborhoods, the thirteen banks analyzed were comparable to all large banks, with a median of 11.7 percent of their total loans going to low-income neighborhoods compared to 11.8 percent for all large banks, but had lower rates of such loans when compared to the 13.5 percent rate for all mortgage lending institutions.

**Exhibit 7: Home-Loan Originations by Race/Ethnicity and Income, 13 Analyzed Banks, 2015**

| Bank Name | Number of originations | Percent non-Hispanic white borrower | Percent borrower of color[13] | Percent race missing or joint[14] | Percent low-income borrower[15] | Percent low-income neighborhood[16] |
|---|---|---|---|---|---|---|
| **Benchmark:** All mortgage-lending institutions | 3,124,000 | 68.1% | 19.9% | 12.0% | 28.0% | 13.5% |
| All large banks | 929,000 | 69.6% | 17.9% | 12.5% | 23.7% | 11.8% |
| Bank of America* | 47,000 | 61.5% | 28.5% | 10.0% | 18.5% | 11.3% |
| Bank of the West | 2,000 | 70.5% | 17.2% | 12.3% | 20.3% | 10.8% |
| BB&T* | 19,000 | 69.6% | 10.8% | 19.6% | 26.9% | 12.5% |
| Capital One | 4,000 | 56.4% | 24.0% | 19.6% | 26.9% | 12.9% |
| Citibank* | 22,000 | 43.8% | 30.9% | 25.3% | 12.4% | 13.3% |
| HSBC | 1,000 | 24.8% | 27.3% | 47.9% | 9.9% | 10.8% |
| JPMorgan Chase* | 56,000 | 63.8% | 21.2% | 15.0% | 13.5% | 8.8% |
| PNC* | 20,000 | 62.9% | 15.2% | 21.9% | 34.8% | 14.4% |
| SunTrust* | 15,000 | 63.0% | 16.9% | 20.1% | 17.9% | 10.4% |
| TD Bank | 4,000 | 72.1% | 15.9% | 12.0% | 32.7% | 19.3% |
| U.S. Bank* | 32,000 | 68.6% | 12.1% | 19.3% | 28.3% | 11.7% |
| Union Bank | 4,000 | 51.5% | 29.0% | 19.5% | 6.9% | 12.6% |
| Wells Fargo* | 156,000 | 67.1% | 20.6% | 12.3% | 18.5% | 11.3% |
| Median: 13 analyzed banks | 19,000 | 63.0% | 20.6% | 19.5% | 18.5% | 11.7% |

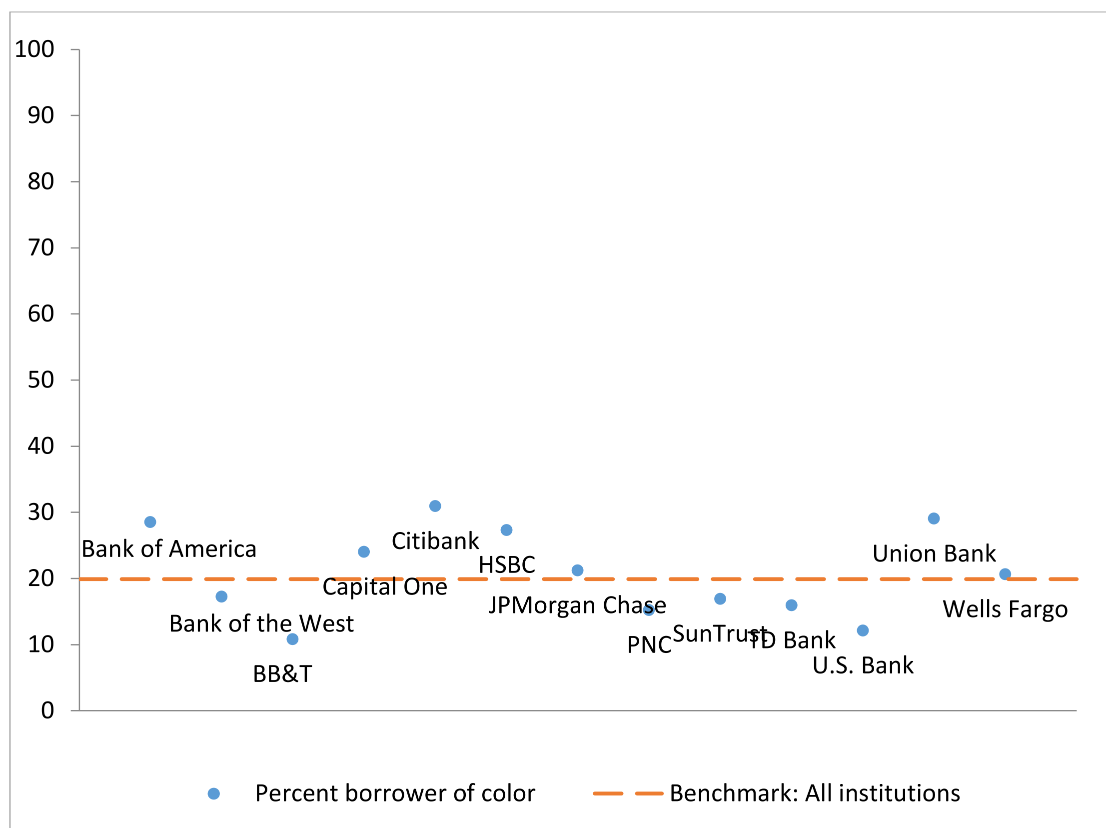
Source: Bhutta, Neil and Ringo, Daniel R. Federal Reserve Division of Research and Statistics. "Residential Mortgage Lending from 2004 to 2015: Evidence from the Home Mortgage Disclosure Act Data." Federal Reserve Bulletin Vol. 102, No. 6. November 2016; and Budget and Legislative Analyst calculations based on 2015 HMDA data.
*Top 25 lender in terms of total originations

[13] Borrowers of color include applicants that self-reported identifying as one or more of the following: Asian, Black or African American, Hispanic white, American Indians or Alaska Natives, Native Hawaiians or other Pacific Islanders.
[14] "Missing" refers to applications in which the race and/or ethnicity of the applicant(s) has not been reported. "Joint" refers to applications in which one applicant was non-Hispanic white and the other was a borrower of color.
[15] Low-income borrowers have income that is less than 80 percent of Area Median Family Income (AMFI).
[16] Low-income neighborhoods are census tracts with median family income that is less than 80 percent of AMFI.

Borrowers of color

Home loans to borrowers of color represented 19.9 percent of total home loans at all mortgage lending institutions. With a median rate of 20.6 percent, the thirteen analyzed banks were slightly above the rate for all mortgage-lending institutions and higher than all large banks, which had a lending rate to borrowers of color of 17.9 percent in 2015. Citibank made the largest percentage (30.9 percent) of loans to borrowers of color, and BB&T made the smallest percentage (10.8 percent) of loans to borrowers of color, as shown in Exhibit 8 below.

**Exhibit 8: Percent of Home Loans to Borrowers of Color, 13 Analyzed Banks, 2015**



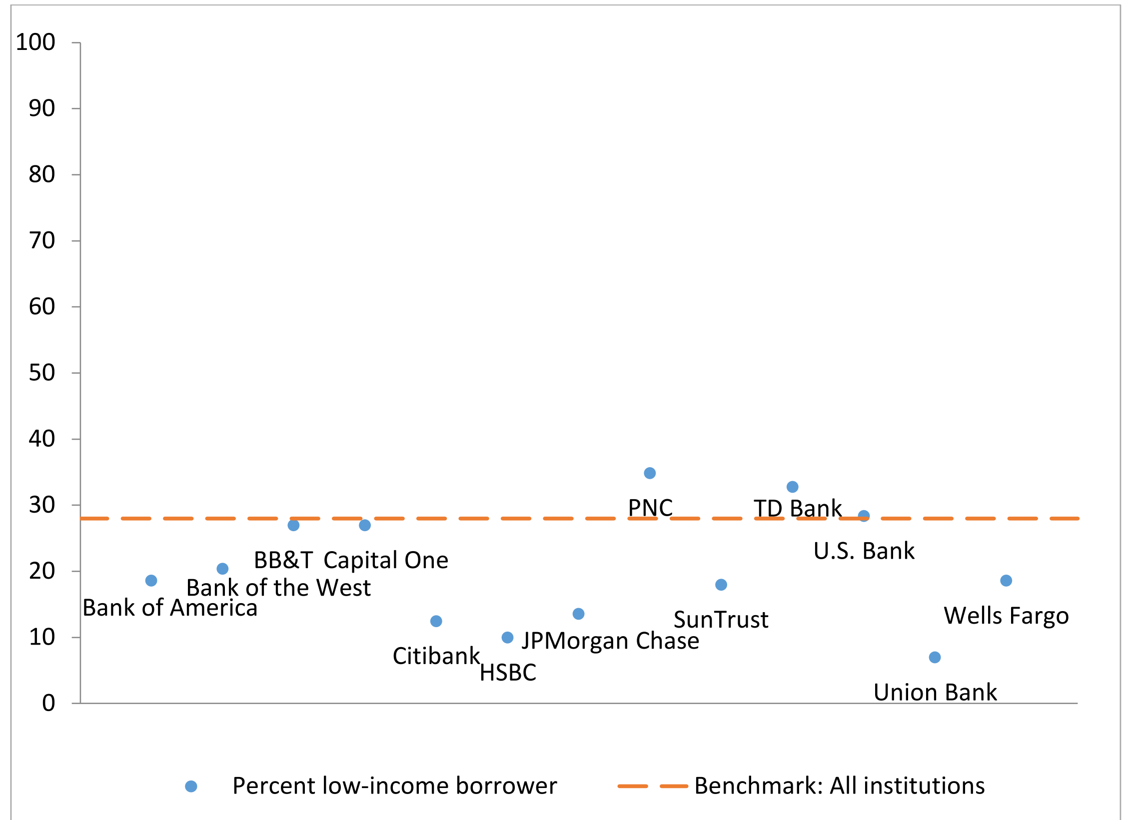

Source: Federal Reserve; Budget and Legislative Analyst Calculations based on 2015 HMDA data

Low-income borrowers

Home loans to low-income borrowers represented 28 percent of total home loans at all mortgage lending institutions but a median rate of only 18.5 percent for the thirteen banks analyzed. PNC and TD Bank made the largest percentage (34.9 and

32.7 percent respectively) of loans to low-income borrowers, and Union Bank made the smallest percentage (6.9 percent) of loans to low-income borrowers, as shown in Exhibit 9 below.

**Exhibit 9: Percent of Home Loans to Low-Income Borrowers, 13 Analyzed Banks, 2015**

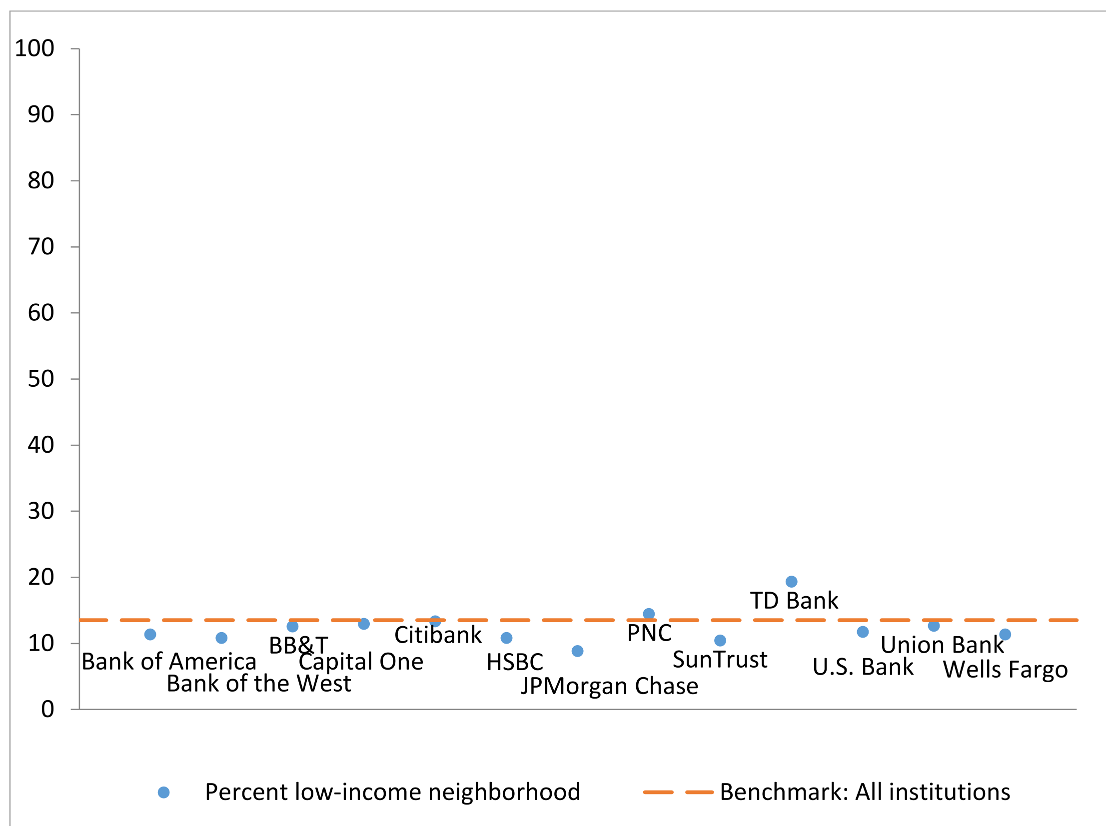



Source: Federal Reserve; Budget and Legislative Analyst calculations based on 2015 HMDA data

Low-income neighborhoods

Home loans for properties located in low-income neighborhoods represented 13.5 percent of total home loans at all mortgage lending institution compared to 11.7 percent at the median for the thirteen banks analyzed. TD Bank made the largest percentage (19.3 percent) of loans to low-income neighborhoods, and JPMorgan Chase made the smallest percentage (8.8 percent) of loans to low-income neighborhoods, as shown in Exhibit 10 below.

**Exhibit 10: Percent of Home Loans to Low-Income Neighborhoods, 13 Analyzed Banks, 2015**




Source: Federal Reserve; Budget and Legislative Analyst Calculations based on 2015 HMDA data

## Community Development Loans

The Community Reinvestment Act of 1997 (CRA)[17] requires that depository institutions report on the number and amount of community development loans originated in a given year. According to CRA regulations, community development is defined as:

- Affordable housing (including multifamily rental housing) for low-or moderate-income individuals;
- Community services targeted to low- or moderate-income individuals;

[17] The CRA, enacted by Congress in 1977, is intended to encourage banks to help meet the credit needs of the communities (including low-or moderate-income neighborhoods) in which they operate.

- Activities that promote economic development by financing small businesses or farms[18]; or
- Activities that revitalize or stabilize low- or moderate-income geographies.

In this section, we identify community development loans originated by the thirteen analyzed banks nationally in terms of number of loans and total amounts of loans, based on CRA reports for 2015. We compare the banks' community development loans as a percentage of total loans to the median of all thirteen banks analyzed.

In 2015, the thirteen banks analyzed originated 5,714 community development loans for a total of $32.9 billion in loans. JPMorgan Chase made the most community development loans (1,514), and Wells Fargo made the largest amount of community development loans ($5.6 billion), as shown in Exhibit 11 below.

Measured as a percentage of total loans, community development loans amounted to a median of 0.8 percent of all loans for the thirteen banks analyzed. As can be seen in Exhibit 11, community development loans were a higher or equal percentage of their total loans for seven of the thirteen banks analyzed; the six other banks analyzed were below that benchmark.

[18] "Small businesses or farms" must: (1) meet the size eligibility standards of the SBA's Development Company or Small Business Investment Company programs (13 CFR 121.301); or (2) have gross annual revenues of $1 million or less

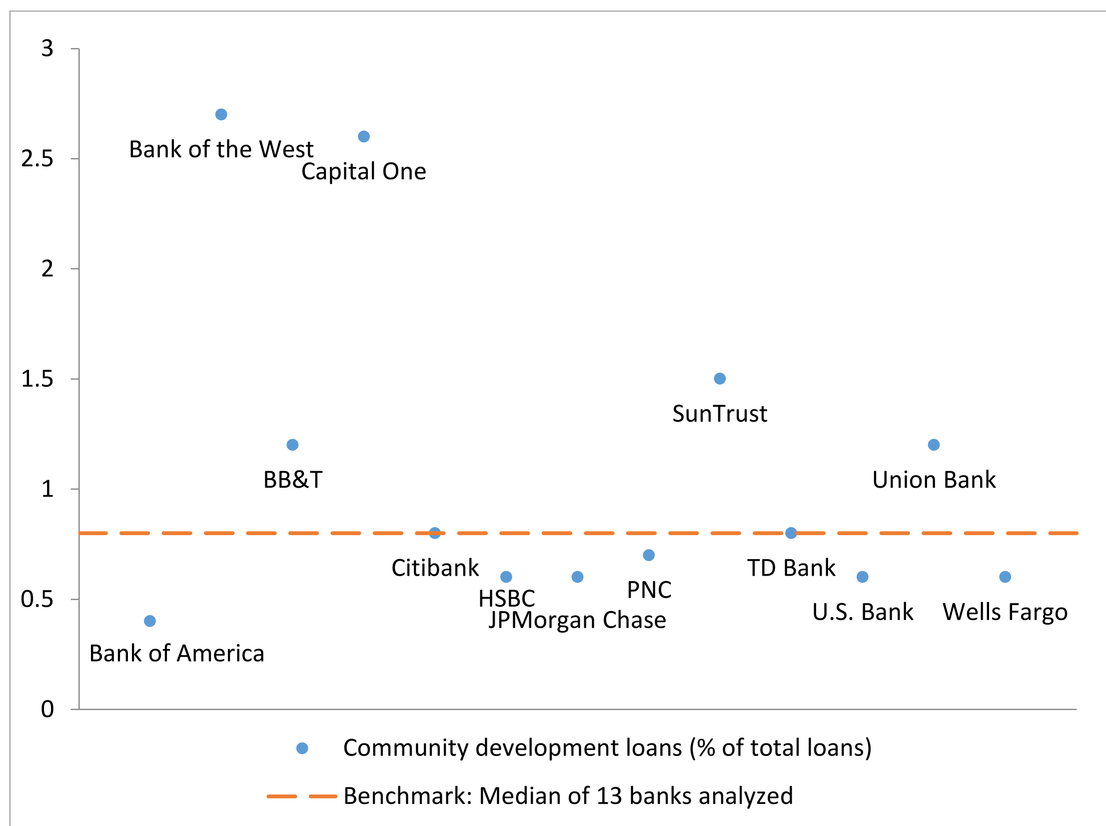
**Exhibit 11: Community Development Loans (in $000's), 13 Analyzed Banks, 2015**

| | Community development loans | | Total loans | Percent community development loans |
|---|---|---|---|---|
| **Bank name** | Number of loans | Amount (000s) | Amount (000s) | |
| Median: 13 Analyzed Banks | 327 | $1,665,216 | $152,527,050 | 0.8% |
| Bank of America | 482 | $3,791,799 | $879,724,000 | 0.4% |
| Bank of the West | 327 | $1,448,901 | $54,524,585 | 2.7% |
| BB&T | 423 | $1,665,216 | $133,613,811 | 1.2% |
| Capital One | 337 | $3,971,912 | $152,527,050 | 2.6% |
| Citibank | 344 | $4,528,704 | $586,959,000 | 0.8% |
| HSBC | 82 | $479,890 | $80,297,403 | 0.6% |
| JPMorgan Chase | 1,514 | $4,268,066 | $736,185,000 | 0.6% |
| PNC | 301 | $1,412,532 | $208,178,144 | 0.7% |
| SunTrust | 297 | $2,061,748 | $138,417,245 | 1.5% |
| TD Bank | 300 | $1,033,215 | $126,403,506 | 0.8% |
| U.S. Bank | 249 | $1,664,431 | $262,999,876 | 0.6% |
| Union Bank | 257 | $944,530 | $77,498,682 | 1.2% |
| Wells Fargo | 801 | $5,660,084 | 4888,911,000 | 0.6% |
| Total: 13 Analyzed Banks | 5,714 | $32,931,028 | $4,326,239,302 | 0.8% |

Source: FFIEC, CRA 2015 Disclosure Reports

Community development loans made in 2015 represented a median of 0.8 percent of all outstanding loans (in terms of loan amounts) that year for the thirteen banks analyzed in this report. Bank of the West and Capital One had the largest share of community development loans as a percentage of total loans in the group (2.7 and 2.6 percent, respectively). Bank of America had the smallest share of community development loans as a percentage of total loans in the group (0.4 percent).

**Exhibit 12: Community Development Loans, Percent of Total Loans, 13 Analyzed Banks, 2015**




Source: FFIEC, CRA 2015 Disclosure Reports

Affordable housing loans are included in the community development loan totals presented above but are not reported separately to bank regulators. Affordable housing loan totals reported by Affordable Housing Finance Magazine (AHF) for the top 25 lenders, including eight of the thirteen analyzed banks (or affiliates thereof), can be found in the Appendix.

## Overdraft Policies

Overdraft and transaction ordering processes can result in unexpected fees for bank customers with checking accounts, and customers that incur the most overdraft fees tend to have incomes below the U.S. average.[19] The Pew Charitable

[19] The Pew Charitable Trusts. “Consumers Need Protection from Excessive Overdraft Costs.” December 2016. <http://www.pewtrusts.org/~/media/assets/2016/12/consumers_need_protection_from_excessive_overdraft_costs.pdf>

Trusts developed a set of best and good practices that "reduce the incidence of overdrafts and eliminate bank practices that maximize overdraft fees". In 2015, Pew reviewed practices at 45 of the largest 50 banks in the U.S. to determine if the banks engaged in these best and good practices.[20] We present Pew's best practices below and show whether or not the banks analyzed engage in them (Pew's good overdraft practices can be found in the Appendix). We compare the number of best practices each bank engages in with the average number of the 45 large banks in Pew's report.

**Exhibit 13: Pew Charitable Trusts' Overdraft Best Practices**

| Best Practice | Description |
|---|---|
| No ATM overdrafts | Banks decline ATM withdrawals that would overdraw an account. |
| No debit point-of-sale overdrafts | Banks decline debit card point-of-sale transactions that would overdraw an account. |
| No high-to-low transaction reordering | Banks do not reorder transactions from high-to-low value. (Banks can generate more overdraft fees by reordering transactions and processing them from high-to-low value, compared to processing transactions chronologically for example.) |

Source: The Pew Charitable Trusts. "Checks and Balances: 2015 update." May 2015.

Of the 45 large banks that Pew reviewed, seven (15.6 percent) do not permit ATM overdrafts, seven (15.6 percent) do not permit debit point-of-sale overdrafts, and 24 (52.2 percent) do not reorder any transactions from high-to-low value. The thirteen banks analyzed had better rates of adherence to the No ATM Overdrafts and No Debit Point-of-Sale Overdraft practices, with 23.3 percent of the banks employing those policies but a worse rate of adherence to the No High-to-Low Transaction Reordering practice, with 46.2 percent of the thirteen banks employing that practice compared to 52.2 percent of the 45 banks reviewed by The Pew Charitable Trusts. Two of the thirteen banks analyzed in this report engage in all three best practices—Citibank and HSBC. Five banks do not engage in any of these best practices—Capital One, PNC, SunTrust, TD Bank, and Union Bank. The remaining banks—Bank of America, Bank of the West, BB&T, JPMorgan Chase, U.S. Bank, and Wells Fargo—engage in one of the best practices each, as shown in Exhibit 14 below.

[20] The Pew Charitable Trusts. "Checks and Balances: 2015 update." May 2015.

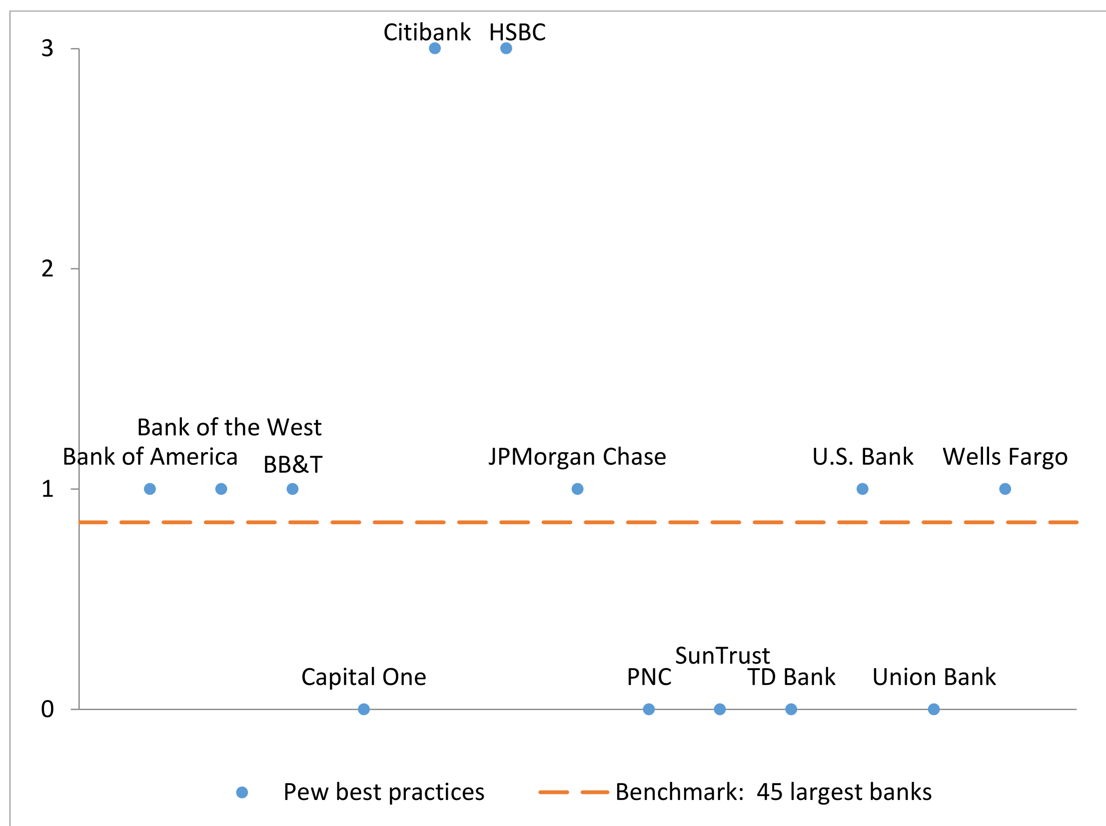
**Exhibit 14: Pew Charitable Trusts' Overdraft Best Practices, 13 Analyzed Banks, 2015**

| Bank Name | No ATM overdrafts | No debit point-of-sale overdrafts | No high-to-low transaction reordering | Total best practices |
|---|---|---|---|---|
| **Benchmark:** All 45 banks reviewed | 15.6% | 15.6% | 52.2% | 0.85 (avg) |
| Bank of America | | ✓ | | 1 |
| Bank of the West | | | ✓ | 1 |
| BB&T | | | ✓ | 1 |
| Capital One | | | | 0 |
| Citibank | ✓ | ✓ | ✓ | 3 |
| HSBC | ✓ | ✓ | ✓ | 3 |
| JPMorgan Chase | ✓ | | | 1 |
| PNC | | | | 0 |
| SunTrust | | | | 0 |
| TD Bank | | | | 0 |
| U.S. Bank | | | ✓ | 1 |
| Union Bank | | | | 0 |
| Wells Fargo | | | ✓ | 1 |
| Percentage of 13 analyzed banks with best practices | 23.1% | 23.1% | 46.2% | -- |

Source: The Pew Charitable Trusts. "Checks and Balances: 2015 update." May 2015.

On average, the 45 large banks that Pew reviewed engaged in 0.85 of the three best practices. The eight banks already mentioned that engaged in at least one of the best practices all exceed the average of all 45 banks, and the five banks that did not engage in any of the best practices are below the average.

**Exhibit 15: Total Best Overdraft Practices (Out of Three), 13 Analyzed Banks, 2015**




Source: The Pew Charitable Trusts. "Checks and Balances: 2015 update." May 2015.

## Summary: Social Responsibility Measures

The review of the performance of the thirteen analyzed banks measured against various social responsibility indicators showed that, overall, the banks performed worse than benchmark comparison institutions in the majority of cases. For some measures, however, the thirteen banks had better performance and for others, they were the same or worse.

Measures for which Thirteen Banks Analyzed Exceeded Benchmark Institutions

Eight of the thirteen banks analyzed in this report exceeded the benchmark value (0.85) for number of overdraft best practices, and seven exceeded the benchmark value (19.9 percent) for percent of home loans to borrowers of color. Additionally, most of the banks with data available had higher rates of representation of women and persons of color on their boards of directors compared to all Fortune 500 companies, as shown below in Exhibit 16.

Citibank and U.S. Bank exceeded the benchmark values for the most indicators (5 out of 8), and SunTrust exceeded the benchmark values for the fewest indicators (1 out of 8), but data was not available for SunTrust for two indicators (percent of board of directors' members that are women and percent of board of directors' members that are persons of color). Capital One, HSBC, JPMorgan Chase, and PNC could exceed benchmark values for the same number of indicators as SunTrust or fewer (2 out of 8)—depending on the gender and racial/ethnic composition of their (as well as SunTrust's) boards of directors.

Measures for which Thirteen Banks Analyzed were Lower than Benchmark Institutions

Eleven of the thirteen banks analyzed in this report fell below the benchmark value (13.5 percent) for percent of home loans to low-income neighborhoods. Ten fell below the benchmark value (28 percent) for percent of home loans to low-income borrowers, and ten fell below the benchmark value (15.3 percent) for percent of business loans that are small business loans.

JPMorgan Chase fell below the benchmark values for the most indicators (6 out of 8). However, Capital One, HSBC, PNC, and SunTrust could fall below benchmark values for the same number of indicators as JPMorgan Chase—SunTrust could fall below one more—depending on the gender and racial/ethnic composition of their boards of directors since data on the makeup of these banks boards of directors was not available.

Citibank and U.S. Bank fell below the benchmark values for the fewest indicators (3 out of 8). Bank of the West also fell below benchmark values for three indicators, but data was not available for two indicators (percent of board of directors' members that are women and percent of board of directors' members that are persons of color), as shown below.

**Exhibit 16: Bank Practices Above (or Equal to) Benchmark Values**

| Bank name | Board of directors | | Small business loans | Home loans | | | Community develop-ment loans | Overdraft practices | Total measures above benchmark (out of 8) |
|---|---|---|---|---|---|---|---|---|---|
| | Female board members (%) | Board member of color (%) | % of total business loans | Borrowers of color (%) | Low-income borrowers (%) | Low-income neighbor-hood (%) | % of total loans | Pew best practices | |
| Benchmark | Fortune 500 | Fortune 500 | All large banks | All instns. | All instns. | All instns. | Median of 13 banks | 45 largest banks | |
| Benchmark value | 20 | 15 | 15.3 | 19.9 | 28 | 13.5 | 0.8 | 0.85 | |
| Bank of America | ✓ | ✓ | | ✓ | | | | ✓ | **4** |
| Bank of the West | not available | not available | ✓ | | | | ✓ | ✓ | **3** |
| BB&T | | ✓ | ✓ | | | | ✓ | ✓ | **4** |
| Capital One | not available | not available | | ✓ | | | ✓ | | **2** |
| Citibank | ✓ | ✓ | | ✓ | | | ✓ | ✓ | **5** |
| HSBC | not available | not available | | ✓ | | | | ✓ | **2** |
| JPMorgan Chase | | | | ✓ | | | | ✓ | **2** |
| PNC | not available | not available | | | ✓ | ✓ | | | **2** |
| SunTrust | not available | not available | | | | | ✓ | | **1** |
| TD Bank | ✓ | not available | | | ✓ | ✓ | ✓ | | **4** |
| U.S. Bank | ✓ | ✓ | ✓ | | ✓ | | | ✓ | **5** |
| Union Bank | ✓ | ✓ | | ✓ | | | ✓ | | **4** |
| Wells Fargo | ✓ | ✓ | | ✓ | | | | ✓ | **4** |
| **Total** | **6** | **6** | **3** | **7** | **3** | **2** | **7** | **8** | |

## 2. Bank Financing of Other Industries/Entities

This section reports on financing of the following industries and business entities by the thirteen large banks analyzed for this report: civilian firearms, tobacco, nuclear power, the Dakota Access Pipeline, and private prisons. As shown in Exhibit 17 below, all thirteen banks in our study finance major public companies in the industries or entities examined.

**Exhibit 17: Bank Financing of Major Public Companies in Selected Industries or Entities Examined, 2010-2017**

| Bank Name | Civilian Firearms | Tobacco | Nuclear Power Companies | Dakota Access Pipeline | Private Prisons | Total Number of Industries Financed |
|---|---|---|---|---|---|---|
| Bank of America | ✕ | | ✕ | ✕ | ✕ | *4* |
| Bank of the West | ✕ | | ✕ | ✕ | ✕ | *4* |
| BB&T | ✕ | | ✕ | | | *2* |
| Capital One | ✕ | | | | | *1* |
| Citibank | | ✕ | ✕ | ✕ | | *3* |
| HSBC | | ✕ | ✕ | ✕ | ✕ | *4* |
| JPMorgan Chase | ✕ | ✕ | ✕ | ✕ | ✕ | *5* |
| PNC | ✕ | ✕ | ✕ | ✕ | ✕ | *5* |
| SunTrust | | | ✕ | ✕ | ✕ | *3* |
| TD Bank | ✕ | | ✕ | ✕ | ✕ | *4* |
| U.S. Bank | ✕ | ✕ | ✕ | ✕ | ✕ | *5* |
| Union Bank | | | ✕ | ✕ | | *2* |
| Wells Fargo | ✕ | ✕ | ✕ | ✕ | ✕ | *5* |

Sources: U.S. Securities and Exchange Commission 10-K, 10-Q, 8-K, and 424 filings

### Methods

Public companies in the industries and entities requested for review were selected based on market leadership, measured in sales production. For the selected companies, we reviewed U.S. Securities and Exchange Commission (SEC) Form 10-Ks from 2010 through 2017, the most recent Form 10-Qs, relevant Form 8-Ks, and all Form 424s available.

The SEC requires that Form 10-K reports be filed annually. These reports provide a comprehensive overview of a company's business and financial condition and include audited financial statements. The Form 10-Q is a quarterly filing required by the SEC that includes unaudited financial statements and provides a continuing

view of the company's financial position during the year. Form 8-K is the "current report" companies must file with the SEC to announce major events that shareholders should know about. The 424 is the prospectus form that a company must file if it has made significant changes to a previously-filed prospectus submitted as part of its registration statement. These required filings contain details on company financing sources including identification of financial institutions that provide lines of credit, loans and bond financing.

## Civilian Firearms

The Bureau of Alcohol, Tobacco, Firearms and Explosives reported 9.1 million firearms manufactured domestically in 2014.[21] Mother Jones magazine reported on the 10 largest gun manufacturers that produce the majority of firearms in the United States.[22] The three largest public civilian firearms domestic producers according to that article are Sturm Ruger, which manufactured 1.64 million firearms in 2014; Savage (Vista Outdoor), which produced 639,000 firearms in 2014; and Smith & Wesson (American Outdoor Brands Corporation), which produced 1.31 million firearms in 2014. Exhibit 18 below shows the banks financing these three civilian firearms producers, by financing type.

[21] "ATF Releases Annual Firearms Manufacturers and Export Report." Bureau of Alcohol, Tobacco, Firearms and Explosives. February 22, 2016. < https://www.atf.gov/news/pr/atfreleasesannualfirearmsmanufacturersandexportreport>

[22] Josh Harkinson. "Fully Loaded" Mother Jones. April 2016
< http://www.motherjones.com/politics/2016/04/fullyloadedtenbiggestgunmanufacturersamerica>

**Exhibit 18: Bank Financing of Major Civilian Firearms Producers, 2010-2017**

| | Sturm Ruger | Savage | | | Smith & Wesson | |
|---|---|---|---|---|---|---|
| **Bank Name** | ***Revolving Credit Line*** | ***Revolving Credit Line*** | ***Term Loans*** | ***Bonds*** | ***Revolving Credit Line*** | ***Term Loan*** |
| Bank of America | ✕ | ✕* | ✕* | | | |
| Bank of the West | | ✕ | ✕ | | | |
| BB&T | | ✕ | ✕ | | ✕ | ✕ |
| Capital One | | ✕ | ✕ | | | |
| Citibank | | | | | | |
| HSBC | | | | | | |
| JPMorgan Chase | | ✕ | ✕ | | | |
| PNC | | ✕ | ✕ | | | |
| SunTrust | | | | | | |
| TD Bank | | | | | ✕ | ✕ |
| U.S. Bank | | ✕ | ✕ | ✕ | | |
| Union Bank | | | | | | |
| Wells Fargo | | ✕* | ✕* | | ✕ | ✕* |

Sources: U.S. Securities and Exchange Commission 10-K, 10-Q, 8-K, and 424 filings
*Indicates affiliate entity

Sturm Ruger

Bank of America N.A. provided a revolving line of credit to Sturm Ruger of $25 million in 2007,[23] which was increased to $40 million in 2013.[24]

Savage (Vista Outdoor)

Bank of America provided a secured term loan of $350 million to Savage in 2014. In 2016, Savage received a secured loan in the amount of $640 million and a revolving credit line up to $400 million from the following institutions or their affiliates in our study: Merrill Lynch, Pierce, Fenner & Smith Incorporated[25], Bank of the West, BB&T, Capital One, N.A., JP Morgan Securities[26], JP Morgan Chase

[23] Credit Agreement, dated December 14, 2007, with Bank of America (SEC Form 8-k filed December 20, 2007)
[24] Fifth Amendment, dated February 14, 2013, to the Credit Agreement with Bank of America (SEC Form 8-k filed February 21, 2013)
[25] Merrill Lynch, Pierce, Fenner & Smith Incorporated and Bank of America NA are both subsidiaries of Bank of America Corporation.
[26] JP Morgan Securities is the wealth management business conducted by JP Morgan & Chase and is an affiliate of JP Morgan Chase Bank.

Bank, PNC, U.S. Bank NA, and Wells Fargo Securities[27] [28] U.S. Bank serves as the exchange agent and trustee for $350 million of 5.875% Senior Notes due in 2023 for Savage.[29]

Smith & Wesson (American Outdoor Brands Corporation)

Smith & Wesson entered into a credit agreement in June 2015 for a $175 million line of credit and a $105 million term loan. A second amendment increased the revolving line to $350 million with an option to add $150 million.[30] The following institutions in our study, or their affiliates, financed these loans: TD Bank NA, BB&T, and Wells Fargo Securities.[31] [32]

## Tobacco

In 2016, approximately 258 billion cigarettes were sold in the United States, and four companies accounted for approximately 92% of those sales: Reynolds American, Inc., Liggett (Vector Group Ltd.), ITG Brands, and Philip Morris USA (Altria Group, Inc.).[33] ITG Brands is not public and was thus excluded from our review. Exhibit 19 below shows the banks financing these three publicly traded tobacco producers.

[27] Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and is an affiliate of Wells Fargo Bank.
[28] Amended and Restated Credit Agreement, dated April 1, 2016 (SEC Form 8-K filed April 4, 2016)
[29] Prospectus (SEC Form 424 filed August 30, 2016)
[30] American Outdoor Brands Corporation (SEC Form 10-Q for quarterly period ended January 31, 2017)
[31] Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and is an affiliate of the Wells Fargo Bank.
[32] American Outdoor Brands Corporation Credit Agreement, dated June 15, 2015; Smith & Wesson Form 10-k 2016
[33] "Economic Trends in Tobacco." Centers for Disease Control and Prevention. March 3, 2017. <https://www.cdc.gov/tobacco/data_statistics/fact_sheets/economics/econ_facts/>

**Exhibit 19: Bank Financing of Major Tobacco Producers, 2010-2017**

| | Reynolds American | | Liggett | | Philip Morris USA | |
|---|---|---|---|---|---|---|
| **Bank Name** | ***Revolving Credit Line*** | ***Bonds*** | ***Revolving Credit Line*** | ***Bonds*** | ***Revolving Credit Line*** | ***Bonds*** |
| Bank of America | | | | | | |
| Bank of the West | | | | | | |
| BB&T | | | | | | |
| Capital One | | | | | | |
| Citibank | × | ×* | | | × | ×* |
| HSBC | | | | | | × |
| JPMorgan Chase | × | ×* | | | × | ×* |
| PNC | | ×* | | | | |
| SunTrust | | | | | | |
| TD Bank | | | | | | |
| U.S. Bank | | | | × | | ×* |
| Union Bank | | | | | | |
| Wells Fargo | | ×* | × | | | ×* |

Sources: U.S. Securities and Exchange Commission 10-K, 10-Q, 8-K, and 424 filings
*indicates affiliate entity

Reynolds American, Inc.

Reynolds American, Inc., entered into a credit agreement in 2014 with JPMorgan Chase and Citibank NA for a $2 billion revolving line of credit with the option to increase the line to $2.35 billion.[34] On September 12, 2013, $550 million of 4.85% Senior Notes due in 2023 and $550 million of 6.15% Senior Notes due in 2043 were issued by Citigroup[35], JP Morgan[36], Wells Fargo Securities[37], and PNC Capital Markets[38].[39] On June 29, 2015, $9 billion of Senior Notes at varying rates were

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[34] Reynolds American, Inc. (SEC Form 8-K filed December 18, 2014)
[35] Citigroup Global Markets Inc is an investment banking and financial advisory form and is a subsidiary of Citigroup Financial Products and an affiliate of Citibank.
[36] JP Morgan is the investment banking subsidiary of JP Morgan & Chase and an affiliate of JP Morgan Chase Bank NA.
[37] Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and is an affiliate of the Wells Fargo Bank.
[38] PNC Capital Markets offers investment banking and advisory services and is a subsidiary of PNC Holding and an affiliate of PNC Bank.
[39] Reynolds American, Inc. Prospectus Supplement (SEC Form 424 filed September 12, 2013)

issued by Citigroup[40], JP Morgan[41], Wells Fargo Securities[42], and PNC Capital Markets[43], among others.[44]

Liggett (Vector Group Ltd.)

Wells Fargo provided a revolving credit agreement to Liggett, although the amount and date of the agreement could not be identified. U.S. Bank served as the exchange agent for the following:

- $90 million of 11% Senior Secured Notes due in 2015,[45]
- $75 million of 11% Senior Secured Notes due in 2015,[46]
- $85 million of 11% Senior Secured Notes due in 2015,[47]
- $450 million of 7.75% Senior Secured Notes due in 2021,[48] and
- $235 million of 7.75% Senior Secured Notes due in 2021.[49]

Philip Morris USA (Altria Group, Inc.)

In August 2013, Altria Group, Inc. entered into a revolving credit agreement with JPMorgan Chase Bank and Citibank for up to $3 billion.[50] On May 2, 2011, $1.5 billion of 4.75% Notes due in 2021 were issued with Citi[51], Wells Fargo Securities[52], HSBC, and JP Morgan[53].[54] On August 6, 2012, $1.9 billion of 2.85% Notes due in 2022 and $90 million of 4.25% Notes due in 2042 were issued with JP Morgan[55], Citigroup[56], HSBC, Wells Fargo Securities[57], and U.S. Bancorp[58] as co-managers.[59]

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[40] Citigroup Global Markets Inc is an investment banking and financial advisory form and is a subsidiary of Citigroup Financial Products and an affiliate of Citibank.
[41] JP Morgan is the investment banking subsidiary of JP Morgan & Chase and an affiliate of JP Morgan Chase Bank NA.
[42] Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and is an affiliate of the Wells Fargo Bank.
[43] PNC Capital Markets offers investment banking and advisory services and is a subsidiary of PNC Holding and an affiliate of PNC Bank.
[44] Reynolds American, Inc. Prospectus Supplement (SEC Form 424 filed June 29, 2015)
[45] Vector Group Ltd. Prospectus (SEC Form 424 dated April 12 2011)
[46] Vector Group Ltd. Prospectus (SEC Form 424 dated May 6, 2010)
[47] Vector Group Ltd. Prospectus (SEC Form 424 dated May 6, 2010)
[48] Vector Group Ltd. Prospectus (SEC Form 424 dated April 26, 2013)
[49] Vector Group Ltd. Prospectus (SEC Form 424 dated June 29, 2016)
[50] Altria Group, Inc. Amended and Restated 5-Year Revolving Credit Agreement, dated as of August 19, 2013 (SEC Form 8-k filed August 23, 2013)
[51] Citi is a global bank and a subsidiary of Citigroup.
[52] Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and is an affiliate of the Wells Fargo Bank.
[53] JP Morgan is the investment banking subsidiary of JP Morgan & Chase and an affiliate of JP Morgan Chase Bank NA.
[54] Altria Group, Inc. Prospectus Supplement (SEC Form 424 dated May 2, 2011)
[55] JP Morgan is the investment banking subsidiary of JP Morgan & Chase and an affiliate of JP Morgan Chase Bank NA.
[56] Citigroup is the holding company of Citibank.

In April 2013, $350 million of 2.95% Notes due in 2023 and $650 million of 4.5% Notes due in 2043 were issued by HSBC, Wells Fargo Securities[60], Citigroup[61], JP Morgan[62], and U.S. Bancorp[63]. On October 28, 2013, $1.4 billion of 4% Notes due in 2024 and $1.8 billion of 5.375% Notes due in 2044 were issued by Citigroup[64], JP Morgan[65], U.S. Bancorp[66], HSBC, and Wells Fargo Securities[67].[68] Another $1 billion of 2.625% Notes due in 2020 were issued by Citigroup[69], JP Morgan[70], U.S. Bancorp[71], HSBC, and Wells Fargo Securities[72].[73] In 2016, $500 million of 2.625% Notes due in 2026 and $1.5 billion of 3.875% Notes due in 2046 were issued by Wells Fargo Securities[74], U.S. Bancorp[75], HSBC, Citigroup, and JP Morgan[76].[77]

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[57] Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and is an affiliate of the Wells Fargo Bank.
[58] U.S. Bank is a subsidiary of U.S. Bancorp, a financial holding company.
[59] Altria Group, Inc. Prospectus Supplement (SEC Form 424 dated August 6, 2012)
[60] Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and is an affiliate of the Wells Fargo Bank.
[61] Citigroup is the holding company of Citibank.
[62] JP Morgan is the investment banking subsidiary of JP Morgan & Chase and an affiliate of JP Morgan Chase Bank NA.
[63] Altria Group, Inc. Prospectus Supplement (SEC Form 424 dated April 29, 2013)
[64] Citigroup is the holding company of Citibank.
[65] JP Morgan is the investment banking subsidiary of JP Morgan & Chase and an affiliate of JP Morgan Chase Bank NA.
[66] Altria Group, Inc. Prospectus Supplement (SEC Form 424 dated April 29, 2013)
[67] Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and is an affiliate of the Wells Fargo Bank.
[68] Altria Group, Inc. Prospectus Supplement (SEC Form 424 dated October 28, 2013)
[69] Citigroup is the holding company of Citibank.
[70] JP Morgan is the investment banking subsidiary of JP Morgan & Chase and an affiliate of JP Morgan Chase Bank NA.
[71] Altria Group, Inc. Prospectus Supplement (SEC Form 424 dated April 29, 2013)
[72] Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and is an affiliate of the Wells Fargo Bank.
[73] Altria Group, Inc. Prospectus Supplement (SEC Form 424 dated November 10, 2014)
[74] Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and is an affiliate of the Wells Fargo Bank.
[75] Altria Group, Inc. Prospectus Supplement (SEC Form 424 dated April 29, 2013)
[76] JP Morgan is the investment banking subsidiary of JP Morgan & Chase and an affiliate of JP Morgan Chase Bank NA.
[77] Altria Group, Inc. Prospectus Supplement (SEC Form 424 dated September 13, 2016)

## Nuclear Power

The Nuclear Energy Institute, a lobbying group based in Washington DC, published a list of US nuclear operators, owners, and holding companies. We selected the top 3 megawatt producers for review: Exelon Generation Company, Tennessee Valley Authority, and Duke Energy Carolinas.[78] Exhibit 20 below shows financing institutions for these three major nuclear energy producers.

**Exhibit 20: Bank Financing of Top Nuclear Energy Producers, 2010-2017**

| | **Exelon** | **Tennessee Valley Authority** | **Duke Energy Carolinas** | |
|---|---|---|---|---|
| **Bank Name** | ***Bonds*** | ***Revolving Credit Line*** | ***Revolving Credit Line*** | ***Bonds*** |
| Bank of America | | × | × | × |
| Bank of the West | ×* | ×* | | × |
| BB&T | | × | | |
| Capital One | | | | |
| Citibank | ×* | | × | × |
| HSBC | | | | × |
| JPMorgan Chase | ×* | | × | × |
| PNC | | × | | |
| SunTrust | | × | | ×* |
| TD Bank | | | | ×* |
| U.S. Bank | × | | | ×* |
| Union Bank | | | × | ×* |
| Wells Fargo | ×* | × | × | × |

Sources: U.S. Securities and Exchange Commission 10-K, 10-Q, 8-K, and 424 filings
*indicates affiliate entity

Exelon Generation Company

In March 2017, JP Morgan[79] served as a joint book running manager, which is the underwriter who has primary control and responsibility for an initial public offering, for the issuance of $250 million of 2.95% Senior Notes due in 2020 and $500 million of 3.4% Senior Notes due in 2022 for Exelon.[80] In January 2015,

[78] "US Nuclear Operators, Owners and Holding Companies." Nuclear Energy Institute. <https://www.nei.org/Knowledge-Center/Nuclear-Statistics/US-Nuclear-Power-Plants/US-Nuclear-Operators,-Owners-and-Holding-Companies>
[79] JP Morgan is the investment banking subsidiary of JP Morgan & Chase and an affiliate of JP Morgan Chase Bank NA.
[80] Exelon Generation Company. Prospectus Supplement (SEC Form 424 dated March 7, 2017)

Citigroup[81] and JP Morgan[82] served as the co-managers for $750 million of 2.95% Notes due in 2020.[83]

In January 2013, U.S. Bank served as the exchange agent for $523,303,000 of 4.25% Senior Notes due in 2022 and $788,203,000 of 5.6% Senior Notes due in 2042.[84] In September 2010, Citi[85], BNP Paribas[86], and Wells Fargo Securities[87] financed the issuance of $550 million of 4.0% Senior Notes due in 2020 and $350 million of 5.75% Senior Notes due in 2014.[88] In 2009, JP Morgan[89] financed the issuance of $600 million of 5.2% Senior Notes due in 2019 and $900 million of 6.25% Senior Notes due in 2039.[90] Citi[91], BNP Paribas[92], and JP Morgan[93] financed $700 million of 6.2% Senior Notes due in 2017.[94]

Tennessee Valley Authority

In December 2016, the Tennessee Valley Authority (TVA)[95] entered into a $150 million Credit Agreement with SunTrust Bank as Administrative Agent and BB&T as a Lender.[96] TVA also entered into a $1 billion Credit Agreement in June 2012, where Bank of America NA served as a financier.[97]

In December 2012, TVA entered into a $1 billion credit agreement with Wells Fargo Bank NA and PNC Bank NA, among others.[98] In September 2015, TVA

[81] Citigroup is the holding company of Citibank.
[82] JP Morgan is the investment banking subsidiary of JP Morgan & Chase and an affiliate of JP Morgan Chase Bank NA.
[83] Exelon Generation Company. Prospectus Supplement (SEC Form 424 dated January 8, 2015)
[84] Exelon Generation Company. Prospectus Supplement (SEC Form 424 dated January 8, 2013)
[85] Citi is a global bank and a subsidiary of Citigroup.
[86] Bank of the West is a subsidiary of BNP Paribas (USA), a financial holding company.
[87] Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and is an affiliate of the Wells Fargo Bank.
[88] Exelon Generation Company. Prospectus Supplement (SEC Form 424 dated September 27, 2010)
[89] JP Morgan is the investment banking subsidiary of JP Morgan & Chase and an affiliate of JP Morgan Chase Bank NA.
[90] Exelon Generation Company. Prospectus Supplement (SEC Form 424 dated September 16, 2009)
[91] Citi is a global bank and a subsidiary of Citigroup.
[92] Bank of the West is a subsidiary of BNP Paribas (USA), a financial holding company.
[93] JP Morgan is the investment banking subsidiary of JP Morgan & Chase and an affiliate of JP Morgan Chase Bank NA.
[94] Exelon Generation Company. Prospectus Supplement (SEC Form 424 dated September 25, 2007)
[95] The Tennessee Valley Authority is a quasi-public corporation—i.e., it is a corporation whose stock is publicly traded that was started or backed by the government. It is a federally owned corporation created by congressional charter but run independently of the government, receiving no taxpayer funding and deriving its revenues from sales of electricity.
[96] Maturity Community Bank Credit Agreement, dated December 12, 2016, set to expire December 2019, with SunTrust Bank, BB&T, amongst others (Incorporated by reference to Exhibit 10.1 to TVA's Current Report on Form 8-k filed on December 15, 2016, File No. 00052313).
[97] $1,000,000,000 Spring Maturity Credit Agreement Dated as of June 25, 2012, among TVA, Bank of America and others (Incorporated by reference to Exhibit 10.1 to TVA's Current Report on Form 8K filed on June 28, 2012, File No. 00052313)
[98] On December 13, 2012, TVA entered into a $1,000,000,000 Winter Maturity Credit Agreement, set to expire December 2017, with banks including PNC and Wells Fargo Bank, which allows TVA to access up to $1,000,000,000 in either loans or letters of credit.

entered into a $1 billion Credit Agreement with BNP Paribas[99], BB&T, SunTrust Bank, and Wells Fargo Bank NA, among others.[100] TVA entered into a $500 million Credit Agreement with Bank of America NA.[101]

Duke Energy Carolinas

In 2011, Duke Energy Carolinas entered into a $6 billion credit agreement, later amended and increased to $7.5 billion[102], with Bank of America NA, Citibank NA, Bank of Tokyo Mitsubishi[103], Wells Fargo Bank NA, and JPMorgan Chase Bank NA.[104] In May 2011, Bank of America Merrill Lynch[105] and Wells Fargo Securities[106] financed $500 million of 3.9% Notes due in 2021.[107] In December 2011, JPMorgan[108], Citigroup[109], SunTrust Robinson Humphrey[110], Mitsubishi UFJ Securities[111], and U.S. Bancorp[112] financed $350 million of 1.75% mortgage bonds due in 2016 and $650 million in 4.0% mortgage bonds due in 2042.[113] In September 2012, U.S. Bancorp[114] co-managed the issuance of $650 million in bonds.[115] In March 2015, Bank of America Merrill Lynch[116], Citigroup[117], U.S.

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[99] Bank of the West is a subsidiary of BNP Paribas (USA), a financial holding company.

[100] On September 30, 2015, TVA entered into a $1,000,000,000 September 2020 Maturity Credit Agreement with BNP Paribas, BB&T, SunTrust Bank, and Wells Fargo Bank, amongst others. (SEC form 8-k dated June 5, 2015)

[101] $500,000,000 February 2020 Maturity Credit Agreement Dated as of August 7, 2015, among TVA, Bank of America, N.A., as Administrative Agent, Letter of Credit Issuer, and a Lender, and the Other Lenders Party Thereto (Incorporated by reference to Exhibit 10.1 to TVA's Current Report on Form 8K filed on August 7, 2015, File No. 00052313).

[102] On January 30, 2015, Duke Energy entered into an amendment to the $6,000,000,000 Credit Agreement, dated as of November 18, 2011 and as amended on December 18, 2013, with Wells Fargo Bank and others. The amendment was entered into primarily to increase the maximum aggregate borrowing amount available to the Borrowers to $7,500,000,000, and to extend the termination date of the facility from December 2018 to January 30, 2020. (incorporated by reference to Exhibit 10.1 of registrant's Current Report on Form 8K Filed on February 5, 2015, File Nos. 132853, 14928, 11232, 13543, 13382 and 13274).

[103] Bank of Tokyo Mitsubishi and Union Bank are both subsidiaries of Mitsubishi UFJ Financial Group, Inc., a financial holding company.

[104] On December 18, 2013, Duke Energy Corporation entered into an amendment to the $6,000,000,000 Credit Agreement, dated as of November 18, 2011, with Wells Fargo Bank, Bank of America, Citibank, JPMorgan Chase Bank, and the Bank of Tokyo Mitsubishi UFJ, Ltd. (incorporated by reference to Exhibit 10.1 to registrant's Current Report on Form 8K filed on November 25, 2011, File Nos. 132853, 14928, 11232 and 13543).

[105] Merrill Lynch is a subsidiary of Bank of America.

[106] Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and is an affiliate of the Wells Fargo Bank.

[107] Duke Energy Carolinas. Prospectus Supplement (SEC Form 424 dated May 16, 2011)

[108] JP Morgan is the investment banking subsidiary of JP Morgan & Chase and an affiliate of JP Morgan Chase Bank NA.

[109] Citigroup is the holding company of Citibank.

[110] SunTrust Robinson Humphrey provides investment banking services under SunTrust Banks, Inc.

[111] Mitsubishi UFJ Securities and Union Bank are both subsidiaries of Mitsubishi UFJ Financial Group, Inc., a financial holding company.

[112] U.S. Bank is a subsidiary of U.S. Bancorp, a financial holding company.

[113] Duke Energy Carolinas. Prospectus Supplement (SEC Form 424 dated December 5, 2011)

[114] U.S. Bank is a subsidiary of U.S. Bancorp, a financial holding company.

[115] Duke Energy Carolinas. Prospectus Supplement (SEC Form 424 dated September 18, 2012)

[116] Merrill Lynch is a subsidiary of Bank of America.

Bancorp[118], and HSBC financed the issuance of $500 million of 3.75% mortgage bonds due in 2045.[119] In March 2016, BNP Paribas[120], TD Securities[121], Citigroup[122], and HSBC financed the issuance of $500 million of 2.5% mortgage bonds due in 2023 and $500 million of 3.875% mortgage bonds due in 2046.[123] In November 2016, BNP Paribas[124] financed the issuance of $600 million in 2.95% mortgage bonds due in 2026.[125]

[117] Citigroup is the holding company of Citibank.
[118] U.S. Bank is a subsidiary of U.S. Bancorp, a financial holding company.
[119] Duke Energy Carolinas. Prospectus Supplement (SEC Form 424 dated March 9, 2015)
[120] Bank of the West is a subsidiary of BNP Paribas (USA), a financial holding company.
[121] TD Securities is part of the wholesale banking business of TD Bank Group.
[122] Citigroup is the holding company of Citibank.
[123] Duke Energy Carolinas. Prospectus Supplement (SEC Form 424 dated March 8, 2016)
[124] Bank of the West is a subsidiary of BNP Paribas (USA), a financial holding company.
[125] Duke Energy Carolinas. Prospectus Supplement (SEC Form 424 dated November 14, 2016)

## Dakota Access Pipeline

Food and Water Watch, a consumer rights group, published a comprehensive list of financiers of the Dakota Access Pipeline in September 2016. Dakota Access LLC, is owned by a consortium of companies, including: Energy Transfer Partners, Sunoco Logistic Partners, Phillips 66, Enbridge and Marathon Petroleum. Exhibit 21 below summarizes the financial institutions backing the pipeline through financing oil and gas infrastructure and through providing project level loans in the following ways:

- $2.5 billion revolving credit line to Sunoco Logistics
- $3.75 billion revolving credit line to Energy Transfer Partners
- $1.5 billion revolving credit line to Energy Transfer Partners
- $2.5 billion in project level loans to construct the Dakota Access Pipeline

**Exhibit 21: Bank Financing of Dakota Access Pipeline**

| **Bank Name** | ***Revolving Credit Lines*** | ***Project Level Loans*** |
|---|---|---|
| Bank of America | ✕ | ✕ |
| Bank of the West | ✕* | ✕* |
| BB&T | | |
| Capital One | | |
| Citibank | ✕ | ✕ |
| HSBC | ✕ | |
| JPMorgan Chase | ✕ | |
| PNC | ✕ | ✕ |
| SunTrust | ✕ | ✕ |
| TD Bank | ✕* | ✕* |
| U.S. Bank | ✕ | ✕ |
| Union Bank | ✕* | ✕* |
| Wells Fargo | ✕ | ✕ |

Source: Food & Water Watch. "Who's Banking on the Dakota Access Pipeline?" September 2016. <https://www.foodandwaterwatch.org/news/who%27s-banking-dakota-access-pipeline> Accessed April 28, 2017.
*indicates affiliate entity

## Private Prisons

The two largest private prison companies, Corrections Corporation of America (now CoreCivic) and GEO Group, were examined by *In the Public Interest* in November 2016. A summary of the extent to which they receive financing from the thirteen banks analyzed for this report and their affiliates is presented in Exhibit 22.

**Exhibit 22: Bank Financing of Largest Private Prisons, 2007-2015**

| | Corrections Corporation of America | | | GEO Group | | |
|---|---|---|---|---|---|---|
| **Bank Name** | ***Revolving Credit Line*** | ***Term Loan*** | ***Bonds*** | ***Revolving Credit Line*** | ***Term Loan*** | ***Bonds*** |
| Bank of America | ✕ | ✕ | ✕* | ✕ | ✕ | ✕* |
| Bank of the West | | | | ✕* | ✕* | ✕* |
| BB&T | | | | | | |
| Capital One | | | | | | |
| Citibank | | | | | | |
| HSBC | | | ✕ | | | ✕ |
| JPMorgan Chase | ✕ | ✕ | ✕* | ✕ | | ✕* |
| PNC | ✕ | ✕ | ✕* | | | |
| SunTrust | ✕ | ✕ | ✕* | ✕ | ✕ | ✕* |
| TD Bank | | | | | | ✕* |
| U.S. Bank | ✕* | | ✕* | | | |
| Union Bank | | | | | | |
| Wells Fargo | ✕ | ✕ | ✕* | ✕ | ✕ | ✕* |

Sources: U.S. Securities and Exchange Commission 10-K, 10-Q, 8-K, and 424 filings
*indicates affiliate entity

Corrections Corporation of America (now CoreCivic)

SunTrust, Bank of America NA, Wells Fargo Bank NA, JPMorgan Chase, PNC, and U.S. Bancorp[126] participated in the financing of a revolving line of credit of $900 million to the Corrections Corporation of America (CCA).[127] Bank of America NA, JPMorgan Chase Bank NA, SunTrust Bank, Wells Fargo Bank, and PNC participated in the financing of a $100 million term loan to CCA.[128] Wells Fargo Securities[129],

[126] U.S. Bank is a subsidiary of U.S. Bancorp, a financial holding company.
[127] CCA Second Amendment to Amended and Restated Credit Agreement, dated July 22, 2105
[128] CCA's Third Amendment and Incremental Term Loan Agreement, dated October 6, 2015
[129] Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and is an affiliate of the Wells Fargo Bank.

Bank of America Merrill Lynch[130], JP Morgan[131], SunTrust Robinson Humphrey[132], PNC Capital Markets[133], and U.S. Bancorp[134] participated in the underwriting of $250 million of CCA's 5.0% bonds due in 2022.[135] These banks, along with HSBC, also financed CCA's $325 million of 4.125% bonds due 2020 and $350 million of 4.625% bonds due 2023.[136]

GEO Group

Bank of America, BNP Paribas[137], JPMorgan Chase Bank, SunTrust Bank, and Wells Fargo Bank provided GEO Group $450 million in a revolving credit line, which was increased to $900 million in May 2016.[138] BNP Paribas[139], Bank of America, SunTrust Bank, and Wells Fargo Bank extended a loan of $300 million in 2013 to GEO Group.[140]

Bank of America Merrill Lynch[141], Wells Fargo Securities[142], SunTrust Robinson Humphrey[143], JP Morgan[144], BNP Paribas[145], and HSBC financed GEO Group's $350 million of 6.0% bonds due in 2026.[146] These banks, along with TD Securities[147], financed GEO Group's $250 million of 5.875% bonds due in 2024.[148] Wells Fargo Securities[149] and Bank of America Merrill Lynch[150] participated in the issuance of

[130] Merrill Lynch is a subsidiary of Bank of America.
[131] JP Morgan is the investment banking subsidiary of JP Morgan & Chase and an affiliate of JP Morgan Chase Bank NA.
[132] SunTrust Robinson Humphrey provides investment banking services under SunTrust Banks, Inc.
[133] PNC Capital Markets offers investment banking and advisory services and is a subsidiary of PNC Holding and an affiliate of PNC Bank.
[134] U.S. Bank is a subsidiary of U.S. Bancorp, a financial holding company.
[135] CCA's First Supplemental Indenture dated September 25, 2015 (SEC Form 424 dated September 21, 2015)
[136] CCA's Registration Rights agreement dated April 4, 2013
[137] Bank of the West is a subsidiary of BNP Paribas (USA), a financial holding company.
[138] GEO Group's Second Amendment No. 1 to Second Amended and Restated Credit Agreement, dated May 19, 2016
[139] Bank of the West is a subsidiary of BNP Paribas (USA), a financial holding company.
[140] GEO Group (SEC Form 10-Q for quarter ended June 30, 2016)
[141] Merrill Lynch is a subsidiary of Bank of America.
[142] Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and is an affiliate of the Wells Fargo Bank.
[143] SunTrust Robinson Humphrey provides investment banking services under SunTrust Banks, Inc.
[144] JP Morgan is the investment banking subsidiary of JP Morgan & Chase and an affiliate of JP Morgan Chase Bank NA.
[145] Bank of the West is a subsidiary of BNP Paribas (USA), a financial holding company.
[146] GEO Group (SEC Form 8-k filed April 18, 2016)
[147] TD Securities is part of the wholesale banking business of TD Bank Group.
[148] GEO Group (SEC Form 8-k filed September 25, 2014)
[149] Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and is an affiliate of the Wells Fargo Bank.
[150] Merrill Lynch is a subsidiary of Bank of America.

$250 million of 5.875% bonds due in 2022[151] and $300 million of 5.125% due in 2023.[152]

[151] GEO Group (SEC Form 8-k filed October 3, 2013)
[152] GEO Group (SEC Form 8-k filed March 19, 2013)

## Conclusion

None of the banks analyzed exceeded the benchmark values for all social responsibility indicators related to board of directors' gender and racial/ethnic diversity, small business loans, community development loans, home loans to borrowers of color and low-income borrowers, and overdraft policies for bank customers with checking accounts. Similarly, none of the banks fell below the benchmark values for all indicators. U.S. Bank exceeded the benchmark values for the most indicators (5 out of 8), and JPMorgan Chase fell below the benchmark values for the most indicators (6 out of 8).

All banks in our study finance major public companies in at least one of the industries or business entities examined, including: civilian firearms, tobacco, nuclear power, the Dakota Access Pipeline, and private prisons.

**Exhibit 23: Bank practices and financing summary**

| | Bank Practices | | | |
|---|---|---|---|---|
| **Bank name** | **Total missing** | **Total above or equal to benchmark** | **Total below benchmark** | **Total number of industries/ entities financed** |
| Bank of America | 0 | 4 | 4 | 4 |
| Bank of the West | 2 | 3 | 3 | 4 |
| BB&T | 0 | 4 | 4 | 2 |
| Capital One | 2 | 2 | 4 | 1 |
| Citibank | 0 | 5 | 3 | 3 |
| HSBC | 2 | 2 | 4 | 4 |
| JPMorgan Chase | 0 | 2 | 6 | 5 |
| PNC | 2 | 2 | 4 | 5 |
| SunTrust | 2 | 1 | 5 | 3 |
| TD Bank | 1 | 4 | 3 | 4 |
| U.S. Bank | 0 | 5 | 3 | 5 |
| Union Bank | 0 | 4 | 4 | 2 |
| Wells Fargo | 0 | 4 | 4 | 5 |

# Appendix

### Small Business Loans in San Francisco

In 2015, the banks analyzed made 13,006 small business loans for a total of $482.9 million in loans in the City and County of San Francisco according to Community Reinvestment Act (CRA) reports for 2015. Wells Fargo made the most small business loans (5,577) and the largest total amount of small business loans ($269.9 million) in the City, as shown in Exhibit 24 below.

**Exhibit 24: Small business loans in San Francisco, 2015**

| Bank name | Number | Amount (000s) |
|---|---|---|
| Average | 1,000 | $37,149 |
| Bank of America | 3,913 | 100,678 |
| Bank of the West | 112 | 13,984 |
| BB&T | 2 | 8 |
| Capital One | 7 | 86 |
| Citibank | 1,759 | 16,764 |
| HSBC | 40 | 1,361 |
| JPMorgan Chase | 127 | 26,179 |
| PNC | 5 | 1,430 |
| SunTrust | 1 | 470 |
| TD Bank | 2 | 240 |
| U.S. Bank | 1,295 | 25,243 |
| Union Bank | 166 | 26,553 |
| Wells Fargo | 5,577 | 269,939 |
| **Total** | **13,006** | **$482,935** |

Source: FFIEC, CRA 2015 Disclosure Reports

### Top 25 Affordable Housing Lenders

Eight of the thirteen banks analyzed in this report (or their affiliates) were among the top 25 affordable housing lenders in 2015 as reported by Affordable Housing Finance (AHF).[153] In 2015, Citi Community Capital[154], an affiliate of Citibank, was the top affordable housing lender and lent a total of $4.8 billion for affordable housing. Affordable housing loans for the top 25 affordable housing lenders are shown below. Note loan totals for bank affiliates may not be directly compared to the community development loan totals presented earlier in this report.

[153] AHF affordable housing loan totals are based on surveys of affordable housing lenders.
[154] Citi Community Capital is the community lending and investment arm of Citigroup, which owns Citicorp. Holding Co.

## Appendix

**Exhibit 25: Top 25 affordable housing lenders**

| Rank | Name | 2015 (in millions)** | 2014 (in millions)** |
|---|---|---|---|
| 1 | Citi Community Capital*[155] | $4,829.2 | $3,222.4 |
| 2 | Wells Fargo* | 3,020.8 | 2,788.4 |
| 3 | Bank of America Merrill Lynch*[156] | 2,573.0 | 1,750.0 |
| 4 | JPMorgan Chase Bank* | 1,406.0 | 1,287.0 |
| 5 | JLL Capital Markets | 1,052.0 | 748.5 |
| 6 | Capital One* | 864.0 | 1,315.0 |
| 7 | Berkadia | 760.0 | N/A |
| 8 | PNC Real Estate*[157] | 740.1 | 908.9 |
| 9 | U.S. Bank* | 725.0 | 690.0 |
| 10 | Pillar | 604.4 | 349.4 |
| 11 | Greystone Servicing Corp. | 582.4 | 505.0 |
| 12 | Prudential Mortgage Capital Co. | 565.6 | 518.8 |
| 13 | Walker & Dunlop | 557.0 | 588.1 |
| 14 | KeyBank Real Estate Capital | 555.0 | 364.0 |
| 15 | Red Capital Group | 553.8 | 375.1 |
| 16 | Red Stone Tax Exempt Funding | 538.0 | 475.0 |
| 17 | Stifel, Nicolaus & Co. | 525.0 | 415.0 |
| 18 | Rockport Mortgage Co. | 514.4 | 340.1 |
| 19 | RBC Capital Markets | 490.0 | 416.3 |
| 20 | SunTrust Community Capital*[158] | 450.0 | 437.0 |
| 21 | CBRE Capital Markets | 338.8 | 146.5 |
| 22 | Gershman Mortgage | 224.0 | 219.0 |
| 23 | Local Initiatives Support Corp. | 218.9 | 208.4 |
| 24 | Century Housing Corp. | 196.4 | 118.9 |
| 25 | Love Funding | 119.1 | 139.2 |

Source: Affordable Housing Finance Magazine
*Bank analyzed in this report or an affiliate thereof
**Totals include construction loans for affordable housing and permanent loans for 9% Low-Income Housing Tax Credit projects, Section 8 housing, and bond credit enhancement

[155] Citi Community Capital is the community lending and investment arm of Citigroup, which owns Citicorp. Holding Co.
[156] Total includes loans made by Bank of America and affiliate Merrill Lynch. Bank of America and Merrill Lynch are both subsidiaries of the financial holding company, Bank of America Corp.
[157] PNC Bank and certain affiliates do business as PNC Real Estate
[158] SunTrust Community Capital is a wholly owned subsidiary of SunTrust Bank.

# Appendix

## Pew Charitable Trusts Best and Good Overdraft Practices

**Exhibit 26: Pew Charitable Trust Overdraft Practices, 2015**

| | Best practices | | | Good practices | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **Bank name** | No ATM overdrafts | No debit point-of-sale overdrafts | No high-to-low transaction reordering | Limited high-to-low transaction reordering | Threshold amount to trigger an overdraft | No extended overdraft fee | Limited number of overdraft fees per day | **Total best practices** | **Total good practices** |
| All 45 banks reviewed | 16% | 16% | 53% | 84% | 69% | 42% | 91% | 0.85 (avg) | 2.86 (avg) |
| Bank of America | | ✓ | | ✓ | | | ✓ | 1 | 2 |
| Bank of the West | | | ✓ | ✓ | ✓ | | ✓ | 1 | 3 |
| BB&T | | | ✓ | ✓ | ✓ | ✓ | ✓ | 1 | 4 |
| Capital One | | | | ✓ | ✓ | ✓ | ✓ | 0 | 4 |
| Citibank | ✓ | ✓ | ✓ | ✓ | | ✓ | ✓ | 3 | 3 |
| HSBC | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | 3 | 4 |
| JPMorgan Chase | ✓ | | | ✓ | ✓ | | ✓ | 1 | 3 |
| PNC | | | | ✓ | ✓ | | ✓ | 0 | 3 |
| SunTrust | | | | | ✓ | | ✓ | 0 | 2 |
| TD Bank | | | | | ✓ | | ✓ | 0 | 2 |
| U.S. Bank | | | ✓ | ✓ | ✓ | | ✓ | 1 | 3 |
| Union Bank | | | | ✓ | ✓ | | ✓ | 0 | 3 |
| Wells Fargo | | | ✓ | ✓ | ✓ | ✓ | ✓ | 1 | 4 |

Source: The Pew Charitable Trusts. “Checks and Balances: 2015 update.” May 2015.

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

1390 Market Street, Suite 1150, San Francisco, CA 94102
(415) 552-9292 FAX (415) 252-0461

# Policy Analysis Report

To: Supervisor Fewer
From: Budget and Legislative Analyst's Office
Re: Community Supportive Banking Options 2017 Update
Date: November 27, 2017

## Summary of Requested Action

Your office requested that the Budget and Legislative Analyst research options for ways that the City may invest its funds in community-supportive banking institutions, including those that invest more in local small businesses, single family homeowners, and community development. Your office asked us to report on a variety of municipal banking options, including private, credit union, and public banking systems, with a focus on any examples of existing public banks in other jurisdictions.

*For further information about this report, contact Fred Brousseau at the Budget and Legislative Analyst's Office.*

## Executive Summary

- The City and County of San Francisco's use of banks is governed by its operational needs for banking services and State laws requiring that City and County funds are safely invested, remain relatively liquid, and produce a yield or return on funds it controls. The San Francisco Office of the Treasurer and Tax Collector has additional investment policies that address social responsibility matters to be applied in addition and subordinate to State requirements. The social responsibility policies encourage investments in entities that support safe and environmentally sound practices, fair labor practices, non-discriminatory practices, community economic development, and affordable housing, and have a demonstrated commitment to reducing predatory mortgage lending.

## Current City banking arrangements and policies

**City banking assets (6/30/16)**

Short-term cash accounts:

$228.6 million

# accounts: 183

Pooled Fund Portfolio:

$8.3 billion

- The City and County of San Francisco (the City) currently uses large national commercial banks for most of its banking services. While these banks all make loans and provide contributions to socially responsible initiatives such as small business loans and affordable housing programs, such activity is not their primary purpose and San Francisco is not their primary target for such efforts since they operate throughout the country and the world. However, the Office of the Treasurer and Tax Collector reports that using these large national commercial banks is necessary since they are unique in being able to provide all of the City's needed services and can ensure that the City's assets are safe.
- The Office of the Treasurer and Tax Collector has historically deposited a small amount of City funds in credit unions and community development banks that place a greater emphasis on social responsibility and local investment than the large national banks. However, insured funds in such institutions are limited to $250,000 per account so only City funds under that amount can be invested in any one institution, making widespread use of these institutions impractical for City financial operations. As of October 2017, the Office of the Treasurer and Tax Collector has initiated a new program that could result in up to $80 million in City funds being invested in San Francisco-based banks, credit unions, and community development banks within a year. This could result in a higher level of City funds deposited in credit unions and community development banks by October 2018.

## The banking industry has become more concentrated in recent years, particularly for large national commercial banks

- The number of banks and credit unions in California decreased between 2011 and 2014, with greater asset concentration in those that remain. State-chartered commercial banks decreased from 188 in 2011 to 135 in 2016, with average assets increasing from $1.3 billion to $3.3 billion. For large national commercial banks such as those used by the City for most of its banking services, the number of institutions decreased from 49 to 30 during the same period, and average assets increased from $3.6 billion to $8.8 billion. Credit unions have also experienced greater concentration, but at a much lower rate.
- The City currently has short-term accounts for funds used for frequent expenses such as payroll and a longer-term account, known as the Treasurer's Pooled Fund Portfolio, for funds that can be invested in longer-term instruments as they are not needed for short-term use. As of

June 30, 2016, the City had $228.6 million in short-term accounts and $8.3 billion in its Treasurer's Pooled Fund Portfolio.

**Alternatives for more City resources being used for loans to San Francisco small businesses, low-income residents, and for affordable housing and other community development initiatives**

**Options for City banking**

- Commercial banks
- Credit unions
- Community development financial institutions
- Public bank

- To use more of the City's financial resources in San Francisco for loans to small business, low-income residents and for affordable housing, other institutions and approaches for the City to consider include:
    - placing more City funds in credit unions or community development banks whose purposes are more consistent with serving underserved residents and community development initiatives,
    - expanding existing or establishing new City programs that serve these communities and purposes, and
    - creation of a municipal bank.
- Large commercial national banks currently serving the City do make loans to small businesses and support affordable housing. However, these are not their primary business lines and San Francisco is a small part of their national and international markets. As a result, the City's current banking arrangements are less likely to maximize the use of City funds for San Francisco community and economic development objectives.
- The Office of the Treasurer and Tax Collector points out that greater use of credit unions and community development banks has historically had limited application for the City because their deposits are only insured up to $250,000 and they are not able to provide the diverse mix of services that larger banks can provide. As mentioned above, a new program announced by the Office of the Treasurer and Tax Collector in October 2017 and described further in this report may change this pattern and allow for greater use of San Francisco-based credit unions and community development banks.
- The City currently has a number of programs and services with community development objectives directed to traditionally underserved populations. As of July 2017, these programs have approximately $86.0 million in loans outstanding. For FY 2016-17, the City has appropriated $3,771,663 for financial services for traditionally underserved populations and provided $756,000 in technical assistance services to small businesses in San Francisco. Such programs could be enhanced or added to though the level of funding that could be made available for such purposes from City funds

now deposited with the City's commercial banks could significantly expand funding available for such purposes.

**The City Attorney's Office has opined that previously reported legal impediments would not, in fact, prevent the City from creating a public bank**

- When the topic of the City creating a public bank was reviewed by the Budget and Legislative Analyst in 2011, we reported that the State law that prohibits counties from giving or loaning their credit to or in aid of any person or corporation[1] precluded the City from establishing a public bank. This conclusion was based on information and City staff representations available at the time. Since then, the City Attorney reviewed pertinent State codes in detail and concluded that, in fact, State law does not preclude the City from creating a bank as a separate legal entity.
- Key findings by the City Attorney's Office are that the State prohibition would not apply to the City creating a public bank because: 1) San Francisco is a charter city and county and the law applies to counties, 2) creation of a bank as a separate legal entity would remove the issue of the county giving or loaning its credit, and 3) a public bank serving a public purpose would be supported by case law.

**Though successful, the Bank of North Dakota is currently the only public bank in the U.S.**

**Snapshot: Bank of North Dakota**

- Created 1919
- Receives all State of North Dakota funds as deposits.
- 100+ community partner banks provide loans to local businesses
- Assets (2016): $7.3 billion
- Net Income (2016): $136 million

- The Bank of North Dakota is the only public bank operating in the U.S. at present. Created in 1919, all State of North Dakota funds are constitutionally required to be deposited in the bank. Private citizens may also make deposits in the bank but such deposits constitute a small portion of the bank's business. The Bank of North Dakota makes loans directly and partners with more than 100 other North Dakota community and regional financial institutions that provide loans to local businesses and citizens.
- According to its annual report for 2016, the Bank of North Dakota had assets of $7.3 billion, $136 million in net income, and achieved its thirteenth year of profitability. The Public Banking Institute reported that the State of North Dakota has had one of the lowest unemployment rates in the nation, and withstood the financial

[1] California Government Code Section 23007.

crisis of 2008 by having a steady flow of credit available to its member banks, which provided loans to small businesses and community members when it was difficult to obtain credit from many commercial banks.

**A number of cities and states are studying or considering legislation to create a public bank**

- A number of cities and states have shown interest in creating a public bank in recent years. The California State Assembly approved a bill in 2011 to establish a task force to study a state bank for California but the Governor did not sign the bill. Another bill was introduced in 2012 to establish a public bank, but was withdrawn before being considered by the State Assembly.
- Other cities considering creation of or feasibility studies for public banks over the last two years include Philadelphia, Santa Fe, and Oakland. Legislation to explore establishing public banks was passed in Philadelphia and Santa Fe, and the Oakland City Council is considering funding a feasibility study to establish a public bank.
- The states of Arizona, Vermont, Minnesota, New Hampshire, and Washington all have legislation pending to establish state banks. Recent proposals in Hawaii, Illinois, and Maine to establish state banks were not passed by their legislatures.

**Jurisdictions considering public banks, 2016 and 2017***

| Jurisdiction | Bill Status |
|---|---|
| Oakland, CA | Pending in Committee |
| Philadelphia, PA | Passed; Hearings held |
| Santa Fe, NM | Passed |
| Arizona | Assigned to committee |
| Hawaii | Deferred by committee |
| Illinois | Did not pass House by end of session |
| Maine | Did not pass |
| Minnesota | Pending in Committee |
| New Hampshire | Pending in Committee |
| Vermont | Pending in Committee |
| Washington | Pending in Committee |

*As of August 2017

**Creation of a municipal bank in San Francisco would require a number of key steps and investments to become operational**

- Key steps for the City to take to create a public bank would include:
    1. Creation of agreed upon goals and a founding policy statement by the Board of Supervisors and other City stakeholders including the Office of the Treasurer and Tax Collector and Mayor.
    2. Retention of staff and/or consultants to conduct detailed financial feasibility studies for the bank and create the administrative infrastructure of the bank.
    3. Appointment of an independent board of directors and creation of articles of incorporation.
    4. Development of a multi-year business plan to: identify amounts and sources of funds to capitalize the bank to meet its reserve requirements and cover ongoing operations, define its ongoing capital structure, determine whether or not to originate loans directly or to partner with other financial institutions, identify ongoing staffing needs and administrative costs, identify reserve requirements, and determine mechanisms for ensuring the bank's accountability and independence.
    5. Determination of whether to be charted by the State of California or the federal government and whether or not to become a Federal Reserve Bank member.
- Sources of funds possibly available for municipal bank capitalization include a General Fund appropriation such as from unassigned fund balance or other sources, monies legally available from other City funds, a City bond issue, and one-time funding from philanthropic organizations. An appropriation of funds without repayment requirements would be preferable; to the extent funds are provided as a loan subject to repayment by the new municipal bank, the less funding it will have available for originating loans and making investments to achieve its community and economic development goals.

**A municipal bank could potentially provide banking services for the cannabis industry in San Francisco**

- Twenty-six states, including California and the District of Columbia have legalized certain marijuana-related activities. Because marijuana is illegal at the federal level, many marijuana-related businesses do not have access to banking services and have to conduct all their business in cash.

- The Bank Secrecy Act of 1970 requires U.S. financial institutions to report suspicious activity that might signify money laundering to the U.S. government, including reporting on the financial activities of marijuana businesses. Because of this requirement, many banks do not accept marijuana-related businesses as customers.
- If the Board of Supervisors chooses to pursue a public bank, it could explore whether to make serving the cannabis industry one of its principles. This would require monitoring and reporting on those businesses for suspicious activity but would also provide access to banking services to an industry whose access is currently limited. Should the Board of Supervisors choose to pursue a public bank option, it should request an opinion from the City Attorney's Office on legal issues regarding serving the marijuana industry.

## Policy Options

In light of the information presented in this report, the Board of Supervisors could consider the following community supportive banking options in the interest of making more use of the City's funds to better achieve community and economic development goals:

1. Recommend to the Office of the Treasurer and Tax Collector more investment of City funds in local credit unions or community development banks whose loan and investment policies are more aligned with the City's City community and economic development objectives.
2. Support additional funding for expansion of existing City community development programs.
3. Take steps to establish a San Francisco public bank.
4. Request that the Office of the City Attorney assess the risk and legal issues associated with a San Francisco public bank serving the cannabis industry.

*Project staff: Fred Brousseau, Christina Malamut, and Mina Yu*

## Overview

This report describes City banking policies and practices and options for ways that the City could invest its funds in community-supportive banking institutions, with a focus on public banks. The report: (1) defines various community-supportive banking institutions and describes pertinent regulatory frameworks and requirements; (2) describes the City's current banking arrangements as well as current City programs that provide loans or banking services to San Francisco residents and small businesses; (3) presents information on the Bank of North Dakota, the only currently existing public bank in the U.S., as well as recent legislative efforts to establish public banks in other jurisdictions; (4) describes considerations for establishing a public bank in San Francisco, with a focus on implementation options; and (5) discusses issues pertaining to a San Francisco municipal bank serving the cannabis industry.

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## Background: Update to Legal Issue Pertaining to City Creation of Public Bank

This report is an update to a 2011 Budget and Legislative Analyst report on Community Supportive Banking Options.[2] Based on input from City officials at the time, the Budget and Legislative Analyst concluded in that report that the primary impediment to the City and County of San Francisco creating a public bank was

[2] Budget and Legislative Analyst Report to Supervisor Avalos: Community Supportive Banking Options, September 8, 2011, Updated.

California Government Code Section 23007, which states that "a county shall not, in any manner, give or loan its credit to or in aid of any person or corporation," and that a change in State law would be required for the City to create a public bank. At the time, the issue had not been researched by the City Attorney and, as is still the case today, no public bank had been created in California or by a city or county anywhere in the U.S. However, as a follow up to the 2011 Budget and Legislative Analyst report, the City Attorney's Office issued a memorandum on June 21, 2013, to then Supervisor John Avalos, opining that Section 23007 does not present a legal impediment for the establishment of a San Francisco public bank.

The key conclusion in the 2013 City Attorney opinion is that a court would likely conclude that California Government Code Section 23007 does not apply to San Francisco since it is a chartered city and county and the law is directed to counties. Further, the City Attorney pointed out that the City and County of San Francisco's charter supersedes its county powers, that creation of a bank as a separate legal entity from the City and County of San Francisco (the City) would further remove the applicability of Section 23007 to this situation since the law is directed to counties loaning their credit but not to banks used by counties, and that creation of a public bank would be permissible under case law if it served a public purpose.

## 1. Spectrum of Banking Options and Regulatory Frameworks

The following types of financial institutions could be used by the City and County of San Francisco to meet its banking needs: commercial banks, credit unions, community development banks, and public banks. Savings and loans are not included in this discussion as they offer more limited services to large institutional customers than commercial banks and because they are limited by law in that most of their loans must be residential. Excluding public banks, none of these types of financial institutions are structured or have the resources to both meet the City's banking needs and to maximize the investment of City deposits for community development, affordable housing, and related City public policy goals.

A public bank could be better equipped to meet the City's business needs and public policy goals, but, at present, only one public bank, the Bank of North Dakota, exists in the U.S. While the Bank of North Dakota has operated successfully and met its public policy goals since 1919, it would not likely be a feasible option for it to provide San Francisco's banking needs since its business operations and public policy goals are geared to the State of North Dakota.

## Commercial banks

Large national commercial banks provide most of the City's banking services at present. The Treasurer and Tax Collector's Office, which is responsible for selecting and overseeing the financial institutions that provide the City's banking services, has explained that the size and complexity of the City's banking needs, detailed further below, necessitate the use of larger commercial financial institutions. However, as described below, the Office of the Treasurer and Tax Collector has historically deposited a limited amount of City funds in a number of credit unions and community development banks, some of which have loan policies more aligned with community development goals such as serving small businesses, homeowners and other community development efforts in the City.

A commercial bank is a for-profit financial institution that makes loans and accepts deposits, is owned by private investors, and is organized to provide a financial return to its investors. A commercial bank may offer some of the same services as a credit union, community development bank or other type of financial institution, and may even be chartered or supervised by some of the same regulatory entities, but the profit-generating purpose of commercial bank distinguishes it from these other types of financial institutions that include a community- or member-supportive mission.

Commercial bank regulation in the U.S. is complex and involves several entities and options. Known as a "dual chartering system" or "dual banking system", banks in the U.S. may establish themselves as either national or state-chartered banks but, in either case, they must be overseen by at least one federal banking oversight agency. Choosing whether to be a national or state bank and whether or not to join the Federal Reserve System dictates the regulatory structure for banks, as follows:

- National banks are regulated by the Office of the Comptroller of the Currency within the U.S. Treasury Department. All national banks must become part of the Federal Reserve System, which involves meeting certain reserve requirements and being able to access services from the regional Federal Reserve Bank such as check processing, wire transfer services, and access to loan funds through the Federal Reserve's discount window.
- State banks are regulated by an agency in their state and have the option of joining the Federal Reserve System. Those that choose to join are overseen by a regulatory body in their state and supervised by the Federal Reserve Bank for their region. State banks that do not join the Federal Reserve System are subject to oversight by their relevant state agency and federal supervision by the Federal Deposit Insurance Corporation (FDIC).

These chartering and regulatory agencies ensure that the banks have the necessary capital, expertise, and systems to safely meet the public's banking needs. The various oversight agencies conduct examinations of the banks under their jurisdiction to continually monitor their operations and compliance with applicable banking laws.

Federal Reserve System membership requires that member banks contribute three percent of their capital to their regional Federal Reserve bank and another three percent to the national system. Depending on their level of asserts, they receive a dividend on their capital of six percent or a rate equal to the high yield of the 10-year Treasury note each year that their regional Federal Reserve Bank is profitable.

A bank operating or seeking to operate in multiple states may choose a national charter to have only one regulatory agency, rather than several state agencies with different rules, and to take advantage of Federal Reserve System services. Conversely, a bank operating or seeking to operate solely in one state may choose a state charter, and a single state and a single federal regulatory agency.

The State of California's Division of Financial Institutions within the Department of Business Oversight (DBO) oversees the operations of California's state-chartered banks as well as credit unions and several other types of financial institutions based in California. The DBO asserts that there are several advantages to seeking a State charter, including greater access to DBO's regulatory services than institutions would have with federal regulators, lower fees and assessments, streamlined examination processes, and director training opportunities, among others.[3]

### Credit Unions

A credit union is typically defined as a nonprofit cooperative financial institution owned and run by its members. While credit unions offer many of the same banking services as commercial banks, including checking and savings account and loan services, their organizational structure differs from commercial banks. Commercial banks are corporations owned by private investors and organized to return profit to investors, while credit unions are cooperatively owned by members, or depositors, who share in the benefits accrued by the credit union. Credit unions can focus their loans on specific geographic areas and/or types of

[3] "Advantages of State Charter," California Department of Business Oversight, http://www.dbo.ca.gov/cacharter/advantages.asp

loans such as home loans for low-income households. Credit unions are intended to provide their members with a safe place to save and borrow at reasonable rates. They are governed by volunteer boards that are elected by the members[4].

Like commercial banks, credit unions in the U.S. may elect to be chartered either on the federal or state level. Credit unions may be chartered and supervised on the federal level by the National Credit Union Administration (NCUA), an independent federal agency, or on the state level by the state's regulatory body overseeing credit unions. In California, the Credit Union Division of the California Department of Business Oversight oversees State-chartered credit unions. The statutory definition of a credit union provided by California Financial Code Section 14002 is similar to the NCUA definition but does not include the word "nonprofit".

Credit unions do not have the same objective as commercial banks of maximizing financial returns to investors. As of the writing of this report, the City had deposited a small amount of its funds in five credit unions. However, because deposits are insured at each institution for a maximum of only $250,000, City policy is to not invest more than $240,000 in any one institution. While San Francisco-based credit unions generally provide more loans to local residents and businesses for purposes aligned with community development objectives, depositing a large portion of City funds in credit unions would not be very efficient because the funds would have to be spread among many institutions. No City funds were deposited with credit unions as of August 2017.

### Community Development Banks

The City also deposits a limited amount of its funds in community development banks. As of August 2017, City funds were deposited in four community development banks.

A community development bank is a mission-driven private financial institution that provides financial services to individuals, businesses, and communities underserved by traditional financial institutions. Though not required, community development banks can be certified by the federal Community Development Financial Institution Fund within the U.S. Treasury Department pursuant to the Community Development Banking and Financial Institutions Act of 1994 (also called the Riegle Community Development and Regulatory Improvement Act of 1994). Certification entitles the community development bank to financial and technical assistance from the Community Development Financial Institution Fund

[4] California law does not allow members of credit union boards of directors to be paid, but this is not true in all states.

and other benefits such as access to the New Markets Tax Credit program, eligibility for partnerships with banks seeking Bank Enterprise Awards from the Fund, and greater stature when seeking grants and state and local funding. While there are many benefits to this federal certification, it is not required and community development banks can operate in the U.S. without it.

The Community Development Financial Institutions Fund (CDFI Fund) was created for the purpose of promoting economic revitalization and community development through investment in and assistance to community development financial institutions (CDFIs). Key attributes of Community Development Financial Institutions are defined in the Riegle Community Development and Regulatory Improvement Act of 1994 as follows:

i. has a primary mission of promoting community development;
ii. serves an investment area or targeted population;
iii. provides development services and equity investments or loans directly, through an affiliate, or through a community partnership;
iv. through representation on its governing board or otherwise, maintains accountability to residents of its investment area or targeted population; and
v. is not an agency or instrumentality of the United States, or of any state or political subdivision of a state.

The CDFI Fund operates several programs whereby monetary awards and the allocation of tax credits support qualifying CDFIs in their economic, business, and community development goals.[5] Only certified CDFIs may access CDFI Fund awards. According to the CDFI Fund, CDFIs include regulated institutions such as community development banks, commercial banks, credit unions, and non-regulated institutions such as loan and venture capital funds, provided they meet the community development criteria spelled out above.[6] Since a CDFI may take these various forms, there are multiple federal regulators of these institutions. For example, a credit union seeking CDFI funds would need to meet the certification and regulatory requirements of the CDFI Fund of the U.S. Department of the Treasury in addition to those of the Federal Deposit Insurance Corporation and National Credit Union Administration if it is a federal credit union, or the Division of Financial Institutions under the California DBO if it is a state-chartered financial institution.

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[5] Overview of What We Do, Community Development Financial Institutions Fund, U.S. Department of the Treasury.
[6] CDFI Certification, Community Development Financial Institutions Fund, U.S. Department of the Treasury. < https://www.cdfifund.gov/programs-training/certification/cdfi/Pages/default.aspx>

According to the U.S. Treasury's CDFI Fund website, 98 awards totaling $969.2 million have been granted to 22 CDFIs in San Francisco since the establishment of the Fund in 1996. These awards ranged in size from $11,000 to $85 million, with the average award amounting to $9.9 million and the median award amounting to $1.0 million and were provided to a variety of types of CDFIs, including commercial banks, credit unions, venture funds and other community loan funds. Among the 122 awardees were Citibank, First Republic Bank, Union Bank NA, Northeast Community Federal Credit Union, Pacific Community Ventures, and Northern California Community Loan Fund, to name a few. While the 22 awardees may not represent the total number of certified CDFIs in San Francisco, the award information does indicate that a broad array of types of financial institutions have sought and secured funding from the CDFI Fund.

## Public Banks

A public bank is a financial institution owned by a public entity such as a state, city or county. Unlike private banks owned by shareholders seeking the greatest financial returns on their investments, public banks need to earn a sufficient amount to cover their costs and originate new loans but do not operate to maximize profits. Public banks can thus charge more modest interest rates than private banks on loans, maintain a different customer risk profile, and return any profits to their founding entities such as the city, county, or state that established the bank rather than traditional shareholders. Public banks can also be the source of lower cost funding for large public sector capital and other projects that typically rely on issuing debt through private banks. Public banks could establish other objectives such as providing a greater portion of credit issued to underserved businesses and communities.

The only example of a publicly-owned bank in the U.S. is the Bank of North Dakota, which is described in detail below. Public banks are also functioning in other countries including Australia, Canada, Germany, and Switzerland.

## Other Vehicles

Other, more specialized financial vehicles exist for community development purposes, including community development loan funds, and community development venture capital funds. Further, public agencies can provide funding directly for community development purposes through appropriations of their own funds or, indirectly, through grant funds.

## 2. Banking Industry in California

Commercial banks operating in California and available to provide banking services to the City mirror the national industry trend of the concentration of assets in the hands of fewer and fewer institutions. Such concentration is particularly pronounced for national banks such as those that provide most of the City's banking services.

Exhibit 1 below shows the number and asset size of commercial banks and credit unions in California, by federal or state-chartered status, as reported by the California Department of Business Oversight. The Department of Business Oversight also reports on eight other categories of financial institutions including industrial banks, trust companies, international banks and money transmitters.

As of December 2016, there were 30 national commercial banks in California with approximately $263.4 billion in assets in California, or an average of $8.8 billion per institution, and 135 State-chartered commercial banks with approximately $435.6 billion in assets in California, or an average of $3.3 billion per institution. There were 137 State-chartered credit unions in California with approximately $102.4 billion in assets and 191 federal credit unions in California with approximately $74.3 billion in assets.[7]

As shown in Exhibit 1, the large majority of commercial banks (82 percent or 135 of 165 banks) established in California choose to operate under a State charter. By contrast, only 137 of 328 credit unions, or 41.8 percent, established in California choose to operate under a State charter. Commercial banks with greater assets generally operate under federal charters to facilitate interstate banking and, in some cases, to avail themselves of Federal Reserve System banking services. Local regional banks with smaller asset bases tend to operate under State charters.

[7] Financial Institution Overview, as of December 31, 2016, California Department of Business Oversight. <http://www.dbo.ca.gov/Publications/stats/overview/2016/Financial%20Institution%20Overview%2012%2031%2016.pdf>

**Exhibit 1: Number and Asset Size of Commercial Banks and Credit Unions in California, 2016**

| | Count | Assets in California | Average Asset Size per Entity |
|---|---|---|---|
| **National Commercial Bank** | 30 | $263.4 billion | $8.8 billion |
| **State-Chartered Commercial Bank** | 135 | $435.6 billion | $3.3 billion |
| ***Total banks*** | *165* | *$699.0 billion* | *$4.2 billion* |
| **State-Chartered Credit Union** | 137 | $102.4 billion | $747.5 million |
| **Federal Credit Union** | 191 | $74.3 billion | $389.1 million |
| ***Total: credit unions*** | *328* | *$176.7 billion* | *$0.5 billion* |

Source: California Department of Business Oversight, Financial Institution Overview as of December 31, 2016.

As shown above, most commercial banks established in California operate under a State charter, but the average asset size of these State-chartered commercial banks ($3.3 billion) is significantly less than the average asset size of the national commercial banks ($8.8 billion).

Exhibit 2 below shows that assets have become more concentrated in recent years for all four types of commercial banks and credits unions, with decreases in the number of institutions and increases in average asset size.

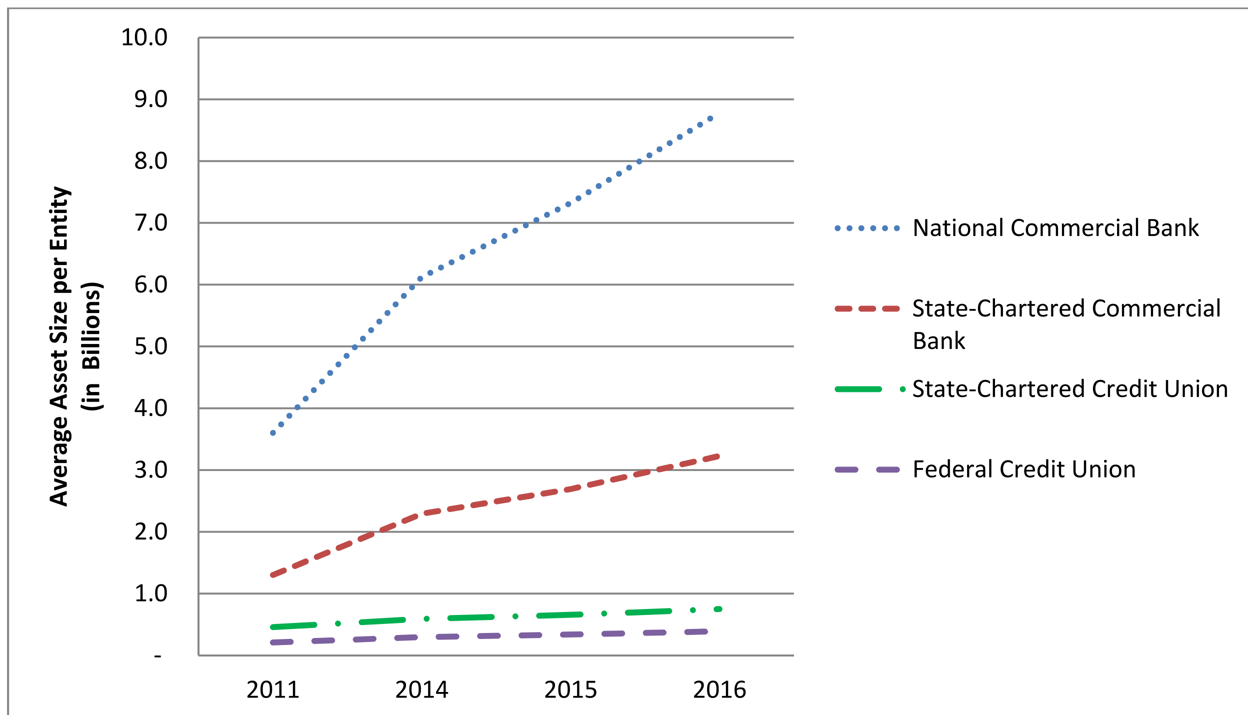
**Exhibit 2: Number and Asset Size of Commercial Banks and Credit Unions in California, 2011 and 2014-2016**

| | 3/31/2011 | 12/31/2014 | 12/31/2015 | 12/31/2016 |
|---|---|---|---|---|
| ***Counts*** | | | | |
| National Commercial Bank | 49 | 38 | 34 | 30 |
| State-Chartered Commercial Bank | 188 | 155 | 145 | 135 |
| State-Chartered Credit Union | 160 | 145 | 143 | 137 |
| Federal Credit Union | 270 | 220 | 205 | 191 |
| ***Assets*** | | | | |
| National Commercial Bank | $175.0 billion | $232.6 billion | $249.0 billion | $263.4 billion |
| State-Chartered Commercial Bank | $250.0 billion | $355.2 billion | $390.2 billion | $435.6 billion |
| State-Chartered Credit Union | $73.0 billion | $85.6 billion | $93.7 billion | $102.4 billion |
| Federal Credit Union | $56.0 billion | $65.0 billion | $69.1 billion | $74.3 billion |
| ***Average Asset Size per Entity*** | | | | |
| National Commercial Bank | $3.6 billion | $6.1 billion | $7.3 billion | $8.8 billion |
| State-Chartered Commercial Bank | $1.3 billion | $2.3 billion | $2.7 billion | $3.3 billion |
| State-Chartered Credit Union | 456.3 million | $590.7 million | $655.0 million | $747.5 million |
| Federal Credit Union | 206.6 million | $295.6 million | $337.0 million | $398.1 million |

Source: California Department of Business Oversight, Financial Institution Overview as of December 31, 2016 and March 31, 2011.
Note: Asset size is for assets recorded in California only.

Exhibit 3 below shows that average asset size increased for all types of commercial banks and credit unions between 2011 and 2016, but that this growth was most profound for the larger national commercial banks, or the types of institutions used for most City banking services as the Office of the Treasurer and Tax Collector reports such banks are more able to meet complex City banking needs and to provide adequate security for the City's funds deposited.

**Exhibit 3: Average Asset Size of Commercial Banks and Credit Unions in California, 2011 and 2014-2016**




Source: California Department of Business Oversight, Financial Institution Overview as of December 31, 2016.

## 3. Regulation of the Treasury of the City and County of San Francisco

The Office of the Treasurer and Tax Collector is responsible for the banking and investment activities of the City and County of San Francisco. The Treasurer and Tax Collector's Office must carry out these responsibilities in accordance with federal, State, and local law and policies, as outlined in this section.

California Government Code Sections 27000-27013 define the roles and responsibilities of county treasurers in receiving and safely keeping counties' money. Section 27000.5 defines the relative importance of the three primary objectives that a county treasurer and/or board of supervisors must effectuate in all investment practices:

> When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, the primary objective of the county treasurer or the board of supervisors, as the case may be, shall be to safeguard the principal of the funds under the treasurer's or the board's control. The secondary objective shall be to

> meet the liquidity needs of the depositor. The third objective shall be to achieve a return on the funds under his or her control.

This three-tiered hierarchy is commonly known in the investment field as "SLY," which stands for Safety, Liquidity, and Yield. The fundamental meaning of Section 27000.5 and the SLY concept is that protecting the safety of public funds must always be the first priority in investment decisions and that consideration of liquidity, return on investment, or other concerns is subjugated by the requirement that county officials protect principal.

In addition to State and federal law, the City and County of San Francisco Office of the Treasurer and Tax Collector abides by its own set of investment policies. These policies were approved by the Treasury Oversight Committee,[8] adopted by the Office in May 2016, and last amended in September 2017.[9] Reflecting the three-tiered Safety-Liquidity-Yield hierarchy required by California Government Code Section 27000.5 (shown above), Section 1.0 ("Policy") of the Treasurer and Tax Collector's Investment Policy states:

> It is the policy of the Office of the Treasurer & Tax Collector of the City and County of San Francisco (Treasurer's Office) to invest public funds in a manner which will preserve capital, meet the daily cash flow demands of the City, and provide a market rate of return while conforming to all state and local statutes governing the investment of public funds.

Section 4.0 ("Objective") of the Investment Policy specifies the priority order of these three objectives:

> The primary objectives, in priority order, of the Treasurer's Office's investment activities shall be:
>
> 4.1 Safety: Safety of principal is the foremost objective of the investment program. Investments of the Treasurer's Office shall be undertaken in a manner that seeks to ensure the preservation of capital. To attain this objective, the Treasurer's Office will diversify its investments.

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8 The Treasury Oversight Committee was established by the San Francisco Board of Supervisors in Ordinance No. 316-00. The five-member committee is charged with reviewing and monitoring the Treasurer's Investment Policy and overseeing an annual audit of the Treasurer's Office.

9 Chapter 10 of the Administrative Code includes Article X "Financial Policies" which, at the time of this report, included only a section on reserve policies.

> 4.2 Liquidity: The Treasurer's Office investment portfolio will remain sufficiently liquid to enable the Treasurer's Office to meet cash flow needs which might be reasonably anticipated.
>
> 4.3 Return on Investments: The portfolio shall be designed with the objective of generating a market rate of return without undue compromise of the first two objectives.

Section 13.0 ("Social Responsibility") of the Investment Policy outlines socially responsible investment goals that should be applied "in addition to and subordinate to" the objectives set for Section 4.0 when investing in corporate securities and depository institutions. While these provisions effectively express the City's preference that socially responsible investments be made when safe and otherwise prudent, the primacy of the safeguarding requirement may in practice significantly limit socially responsible investment options available to the Office of the Treasurer and Tax Collector. The two primary subsections on this topic are shown below:

> 13.1 Social and Environmental Concerns
>
> Investments are encouraged in entities that support community well-being through safe and environmentally sound practices and fair labor practices. Investments are encouraged in entities that support equality of rights regardless of sex, race, age, disability or sexual orientation. Investments are discouraged in entities that manufacture tobacco products, firearms, or nuclear weapons. In addition, investments are encouraged in entities that offer banking products to serve all members of the local community, and investments are discouraged in entities that finance high-cost check-cashing and deferred deposit (payday-lending) businesses. Prior to making investments, the Treasurer's Office will verify an entity's support of the socially responsible goals listed above through direct contact or through the use of a third party such as the Investors Responsibility Research Center, or a similar ratings service. The entity will be evaluated at the time of purchase of the securities.
>
> 13.2 Community Investments
>
> Investments are encouraged in entities that promote community economic development. Investments are encouraged in entities that have a demonstrated involvement in the development or rehabilitation of low income affordable housing, and have a demonstrated commitment to reducing predatory mortgage lending and increasing the responsible servicing of mortgage loans. Securities investments are encouraged in financial institutions that have a Community Reinvestment Act (CRA) rating of either Satisfactory or Outstanding, as well as financial institutions that are designated as a Community Development Financial Institution (CDFI) by the United States Treasury Department, or otherwise demonstrate commitment to community economic development.

## 4. City and County of San Francisco Current Banking Arrangements

The City's monies are divided into two categories: (1) the cash that is used for frequent expenses in the short-term like payroll, residing in bank accounts, and (2) all funds that are not necessary for short-term use, invested in the Treasurer's Pooled Fund Portfolio. Each of these two categories of funds is described in more detail below.

A portion of the funds from both categories could potentially be redirected to community development purposes, particularly if the City and County of San Francisco created a public bank. Rather than loans being made with City funds deposited with the national commercial banks providing banking services to the City, loans could be originated by a public bank targeting more San Francisco residents and businesses and community development objectives. Further, a greater portion of the funds in the Treasurer's Pooled Fund Portfolio could potentially also be targeted for such purposes, subject to all State laws and local investment policies.

Separate from or in addition to creation of a public bank, a greater share of City funds could be appropriated for existing or new City programs aimed at community development and affordable housing in San Francisco. Current City programs with such objectives are discussed in Section 5 of this report.

The structure of the City's banking arrangements is now presented for both demand deposits, or short-term bank accounts, and pooled investment deposits.

### Cash Bank Accounts

The City's cash for short-term use such as payroll and operations is held in bank accounts with the following institutions: Bank of America, Union Bank, and US Bank. The balance of cash held in these accounts as of the most recent audited financial statements (June 30, 2016) was $228,638,000.[10] The Treasurer and Tax Collector's Office projects an average balance of $137.8 million for FY 2017-18 allocated by bank as follows.

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[10] The Comprehensive Annual Financial Report of the City and County of San Francisco, Notes to the Basic Financial Statements, Note (5)(a) Cash, Deposits and Investments Presentation (page 62).

**Exhibit 4: Allocation of City's Short-Term Average Cash Balance, by Bank Projected for FY 2017-18**

| Bank | Amount |
|---|---|
| Bank of America | $130,000,000 |
| US Bank | $7,000,000 |
| Union Bank | $800,000 |
| Total | $137,800,000 |

Source: Treasurer and Tax Collector's Office as of October 2017

The Office of the Treasurer and Tax Collector's estimated annual FY 2017-18 costs for the three institutions providing banking services to the City are shown in Exhibit 5

**Exhibit 5: Estimated Annual FY 2017-18 Fees and Charges for Services Provided by the Three Banks Providing Short-term Cash Management Services**

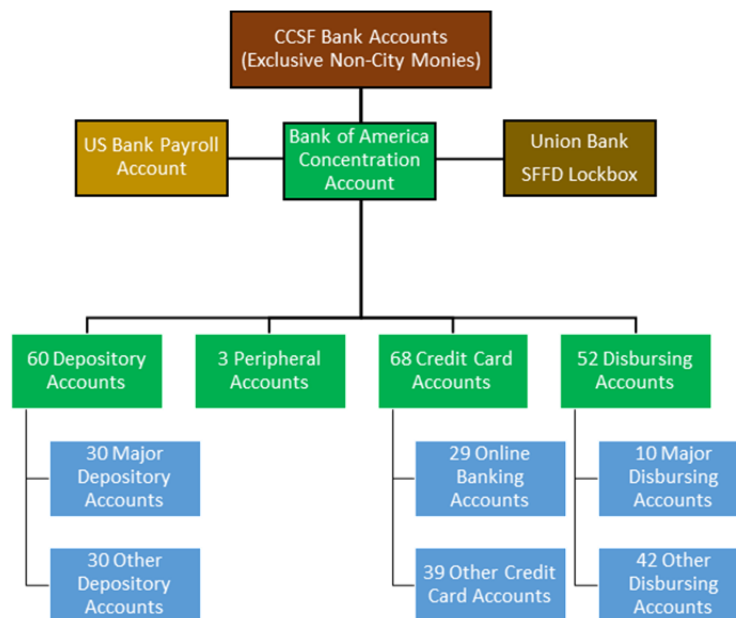
| Bank | Annual Fees |
|---|---|
| Bank of America | $780,000 |
| US Bank | $48,000 |
| Union Bank | $36,000 |
| Total | $864,000 |

Source: Treasurer and Tax Collector's Office as of October 2017

As shown in Exhibit 6 below, the City's bank account structure includes a total of 183 accounts,[11] including 52 disbursing accounts, 68 credit card accounts, 60 depository accounts, and three peripheral accounts, in addition to the primary Union Bank Lock Box Account, the Bank of America Concentration Account, and the US Bank Payroll Account. These accounts are organized to support City departments and their revenue tender type (cash, credit card, and check).

[11] As of May 10, 2017.

**Exhibit 6: City and County of San Francisco Bank Accounts Structure**




Total of 183 Accounts. Data as of May 10, 2017
Source: Office of the Treasurer & Tax Collector.

In 2011 and 2012, the Office of the Treasurer and Tax Collector conducted a competitive search for banking services providers. On March 24, 2011, the Office issued a request for proposals (RFP) for Treasury Management Consulting Services and selected US Bank for payroll, paycard, and purchasing card services.

## Invested Funds – Pooled Fund

Funds that are not needed for short-term operational use are invested in the Treasurer's Pooled Fund Portfolio. These funds are invested in accordance with California Government Code Sections 27000-27013 and the City and County of San Francisco Investment Policy adopted by the Treasury Oversight Committee. These funds include General Fund and other revenues in excess of short-term needs and bond fund proceeds for capital projects and other purposes that may span multiple years.

As of March 31, 2017, the Pooled Fund Portfolio had an average daily balance of $8,279,920,124. Exhibit 7 below, pulled from the Pooled Fund's March 2017 Investment Report, shows the values of each of the different types of investments in the portfolio, broken out by par value, book value, and market value. The City's securities are held by Citibank, its custodian bank, and several brokers, banks and dealers are used in the buying and selling of securities. Citibank's annual costs for

custodial services for the investment pool were $186,000 for FY 2017-18 as of October 2017. This amount is a combination of fixed fees and various fees charged for specific services when they are used, such as securities transactions.

**Exhibit 7: Pooled Fund Portfolio Statistics**

| City and County of San Francisco | | | | |
|---|---|---|---|---|
| **Pooled Fund Portfolio Statistics** | | | | |
| For the month ended March 31, 2017 | | | | |
| | | | | |
| Average Daily Balance | $8,279,920,124 | | | |
| Net Earnings | $6,712,212 | | | |
| Earned Income Yield | 0.95% | | | |
| Weighted Average Maturity | 428 days | | | |
| **Investment Type** | *($ million)* | **Par Value** | **Book Value** | **Market Value** |
| U.S. Treasuries | | $1,490.0 | $1,486.0 | $1,486.7 |
| Federal Agencies | | 4,355.9 | 4,355.5 | 4,353.8 |
| State & Local Government Agency Obligations | | 320.5 | 324.1 | 321.6 |
| Public Time Deposits | | 1.2 | 1.2 | 1.2 |
| Negotiable CDs | | 767.8 | 767.8 | 768.4 |
| Commercial Paper | | 940.0 | 935.5 | 938.6 |
| Medium Term Notes | | 92.9 | 93.1 | 93.0 |
| Money Market Funds | | 256.4 | 256.4 | 256.4 |
| Supranationals | | 180.0 | 179.9 | 180.2 |
| **Total** | | **$8,404.70** | **$8,399.50** | **$8,399.80** |

Source: Office of the Treasurer & Tax Collector March 2017 Investment Report.

The Office of the Treasurer and Tax Collector has historically invested small amounts of money in local credit unions via time deposits. These investments are limited by Office of the Treasurer and Tax Collector policy to a maximum of $240,000 per financial institution, which is just below the $250,000 maximum amount insured by the Federal Deposit Insurance Corporation (FDIC), and by the National Credit Union Administration (NCUA). Any amount above the amount insured by the FDIC/NCUA would not meet the safety requirements of California Government Code Section 27000.5, according to the Office of the Treasurer and

Tax Collector.[12] While the commercial banks with which the City has banking relationships are also subject to the FDIC maximum of $250,000, the City's deposits exceed that limit in those institutions because the Office of the Treasurer and Tax Collector assesses the safety of those large commercial banks to be sufficient to meet State Government Code safeguarding requirements based on evidence of the banks' security provided to guarantee larger deposits. To comply with State law, larger deposits are collateralized by the financial institution by putting securities in escrow with a custodian that exceeds the amount of the deposit. The concept is called "collateralization of public funds" and is mandated by State code. The Office of the Treasurer and Tax Collector only makes collateralized deposits with entities that meet these credit criteria.

As of August 2017, the City had deposits with the following four community development banks:[13]

- Trans-Pacific National Bank
- Bank of San Francisco
- Mission National Bank SF
- Preferred Bank LA

These deposits do not qualify as collateralized deposits and are thus limited to $240,000 per financial institution. No City funds were deposited with credit unions at the time this report was prepared.

As of October 2017 the Office of the Treasurer and Tax Collector reports that they are initiating a new program that will result in up to $80 million in Pooled Investment Fund monies being invested within the next year in San Francisco-based banks, credit unions, and community development financial institutions. The funds invested will be backed by a letter of credit from the Federal Home Loan Bank of San Francisco. If the full $80 million is so invested, this would represent an increase in City funds in local financial institutions, which could include credit unions and community development banks.

[12] CA Government Code 27000.5 states: "When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, the primary objective of the county treasurer or the board of supervisors, as the case may be, shall be to safeguard the principal of the funds under the treasurer's or the board's control. The secondary objective shall be to meet the liquidity needs of the depositor. The third objective shall be to achieve a return on the funds under his or her control."
[13] Community development banks are one type of community development financial institution that, by law, must direct some of its investments to underserved communities that may otherwise not have access to credit.

## 5. Funding for Community Development and Affordable Housing through Existing City Programs

In addition to the banking relationships described above, which indirectly make some City funds available for loans to San Francisco residents and small businesses, the City also provides loans directly and partners with non-profit organizations and financial institutions to provide loans and banking services to small businesses, low income residents, and others. Enhancement of existing programs and creation of other programs with similar objectives is another means the City could pursue to enhance goals such as community development and expanded affordable housing.

Current City programs that provide loans or that depend upon partnerships with financial institutions to provide loans or banking services are described below and summarized in Exhibits 8-10. As of the writing of this report, currently active programs have approximately $86.0 million in loans outstanding, while $756,000 was allocated in FY 2016-17 to organizations that provide technical assistance to small businesses and another $3,771,663 was provided through the Treasurer and Tax Collector's Office of Financial Empowerment and the Department of the Environment for financial services targeting populations traditionally underserved by financial institutions.

### City Programs that Provide Loans

The City directly funds loans for single family homeowners, including those purchasing their first home, and small businesses. Current loan programs funded by the Mayor's Office of Housing and Community Development (MOHCD) and the Office of Economic and Workforce Development (OEWD) are described below and summarized in Exhibit 8.

1. The **Downpayment Assistance Loan Program (DALP)**, administered by MOHCD, provides down payment assistance loans of up to $375,000 to low to moderate income[14] first time homebuyers purchasing a single family home in the City. These loans require no payments for 30 years. As of May 2017, the program had 1,189 loans outstanding with $82,171,256 disbursed. Funding is provided by a combination of sources including the City's Affordable Housing Fund and State and federal program funds.

[14] Low to moderate income is defined as less than or equal to 175 percent of Area Median Income (AMI). 175 percent of AMI in 2017 for a family of four is $201,800 as published by MOHCD.

2. The **First Responders Downpayment Assistance Loan Program (FRDALP)**, administered by MOHCD, provides down payment assistance loans of up to $375,000 to first time home buyers that earn up to 200 percent of Area Median Income (AMI)[15] and are active uniformed, sworn members of the San Francisco Police Department (SFPD), San Francisco Fire Department (SFFD), and Sheriff's Department. These loans require no payments for 30 years. As of May 2017, the program had 11 loans outstanding with $1,880,250 disbursed. Funding is from San Francisco's Housing Trust Fund.
3. The **Teacher Next Door Downpayment Assistance Loan Program (TND)**, administered by MOHCD, provides forgivable down payment assistance loans of up to $20,000 to first time home buyers that earn up to 200 percent of AMI and are active educators in the San Francisco Unified School District. As of May 2017, the program had 56 loans outstanding with $880,000 disbursed. Funding is from the City's General Fund and a 2015 general obligation bond.
4. The **Mortgage Assistance Loan Program (MALP)**, administered by MOHCD, provides loans of up to $50,000 to households that are earning up to 120 percent of AMI[16] and are behind on mortgage payments, homeowner association dues, or special assessments. As of May 2017, the program had just one loan outstanding with $33,400 disbursed. Funding is from San Francisco's Housing Trust Fund.
5. The **Small Business Revolving Loan Fund**, administered by TMC Working Solutions, a non-profit organization, provides up to $50,000 to start-up businesses and existing small businesses that are seeking capital to expand operations. As of April 2017, the small business revolving loan fund had 66 outstanding loans with $1,049,610 disbursed. Funding is from the City's General Fund, federal Community Development Block Grant monies, and other federal and private sources.

[15] 200 percent of AMI in 2017 for a family of four is $230,600 as published by MOHCD.
[16] 120 percent of AMI in 2017 for a family of four is $138,350 as published by MOHCD.

**Exhibit 8: Current Active City Loan Programs**

| Department | Program | Number of loans outstanding | Loan amounts outstanding as of April/May 2017 | Funding Source |
|---|---|---|---|---|
| Mayor's Office of Housing and Community Development | 1. Downpayment Assistance Loan Program | 1,189 | $82,171,256 | Affordable Housing Fund, Homeownership Assistance Loan Fund, Housing Trust Fund, CALHOME[17], HOME[18], 2015 GO Bond[19] |
| | 2. First Responders Downpayment Assistance Loan Program | 11 | $1,880,250 | Housing Trust Fund |
| | 3. Teacher Next Door Downpayment Assistance Loan Program | 56 | $880,000 | General Fund, 2015 GO Bond |
| | 4. Mortgage Assistance Loan Program | 1 | $33,400 | Housing Trust Fund |
| Office of Economic and Workforce Development | 5. Small Business Revolving Loan Fund *(administered by a nonprofit)* | 66 | $1,049,610 | General Fund, CDBGs[20], other federal and private sources |
| **Total** | | **1,323** | **$86,014,516** | |

Sources: Mayor's Office of Housing and Community Development (MOHCD), Office of Economic and Workforce Development (OEWD)

In addition to the active City loan programs shown above that are still issuing new loans, the City also manages outstanding loans for a few inactive programs that are no longer issuing new loans. The City Administrator's Office manages $50,000 in outstanding loans from the Nonprofit Performing Arts Loan Program. MOHCD manages $82,828,150 in outstanding loans from the following inactive loan programs: (1) Police in the Community Downpayment Assistance Loan Program

[17] The Community Development Financial Institutions Fund, administered by the California Department of Housing and Community Development
[18] The HOME Investments Partnerships Program, administered by the U.S. Department of Housing and Urban Development (HUD)
[19] In November 2015, San Francisco voters approved Proposition A, a $310 million General Obligation Bond for affordable housing.
[20] The Community Development Block Grant (CDBG) program is administered by HUD

($80,000 in loans outstanding); (2) Downpayment assistance loans issued by the former San Francisco Redevelopment Agency ($23,097,042 in loans outstanding); (3) the Residential Rehabilitation Loan Program ($8,154,376 in loans outstanding); and (4) the Seismic Safety Loan Program ($51,496,732 in loans outstanding). According to MOHCD, they are currently developing a new short-term loan fund to help property owners address code compliance violations.

### City Funding for Economic Development Service Providers that Provide Loans to Small Businesses

In addition to the various City loan programs described above, the City also supports economic development service providers that offer consulting and technical assistance to small businesses to access credit and debt. The City does not directly fund the service providers' community loan products or programs, and City funding may be used for a variety of services[21] including but not limited to loan packaging. These service providers and programs are described below and summarized in Exhibit 9.

1. The **San Francisco Small Business Development Center (SFBDC)** works with financial consultants to help small businesses package loan applications for crowdfunding and microloans to real estate acquisition financing from the U.S. Small Business Administration (SBA). The City provided $166,000 to support this program in FY 2016-17.
2. The **Mission Economic Development Agency (MEDA)** provides technical assistance and offers loans of up to $100,000 per borrower from their Adelante Fund. The City provided $125,000 to support this program in FY 2016-17.
3. The **Southeast Asian Community Service Center (SEACC)** provides consulting services and offers SBA microloans of up to $50,000 per borrower. The City provided $125,000 to support this program in FY 2016-17.
4. **Pacific Community Ventures** provides mentorship and financing from their Small Business Advising Integrated Lending (SAIL) Fund up to $50,000 per borrower. The City provided $50,000 to support this program in FY 2016-17.
5. The **Mission Asset Fund** offers lending circle financing of up to $2,000. The City provided $50,000 to support this program in FY 2016-17.

[21] Services may include marketing assistance, business plan assessment and review, financial consulting, legal assistance, human resources assistance, etc.

6. The **Emerging Business Loan Fund**, administered by Main Street Launch, a community development financial institution, provides loans ranging from $50,000 to $1 million. The City provided $200,000 to support this program in FY 2016-17.

7. The **Energy Watch Microloan Pilot Program**, also administered by the Mission Asset Fund, provides zero percent loans of up to $2,500 to small businesses that enroll in San Francisco Department of the Environment's (SFE's) Energy Watch Program. Loans are intended to cover the customer co-pay for energy efficiency projects. The City provided $40,000 to support this program in FY 2016-17.

**Exhibit 9: Service Providers Funded by the City that Provide Technical Assistance to Small Businesses**

| Department | Service Provider/Program | FY 2016-17 Funding Level | Funding Source |
|---|---|---|---|
| Office of Economic and Workforce Development | 1. San Francisco Small Business Development Center (SFBDC) | $166,000 | Community Development Block Grant (CDBG) |
| | 2. Mission Economic Development Agency (MEDA) | $125,000 | CDBG |
| | 3. Southeast Asian Community Service Center (SEACC) | $125,000 | CDBG |
| | 4. Pacific Community Ventures | $50,000 | CDBG |
| | 5. Mission Asset Fund (lending circle) | $50,000 | CDBG |
| | 6. Emerging Business Loan Fund *(administered by a CDFI)* | $200,000 | General Fund |
| Department of the Environment | 6. Energy Watch Microloan Pilot Program[22] *(administered by Mission Asset Fund)* | $40,000 | PG&E existing contract, through Department of the Environment |
| **Total** | | **$756,000** | |

Source: Office of Economic and Workforce Development, Department of the Environment

## Other Programs that Depend upon Relationships with Financial Institutions

The City's Office of Financial Empowerment (OFE), which is a division within the Office of the Treasurer and Tax Collector, and the San Francisco Department of the Environment (SFE) administer the following non-loan programs that depend upon relationships with financial institutions:

1. **Kindergarten to College**, administered by the Treasurer and Tax Collector's OFE provides college savings accounts containing $50 to every kindergartner in the San Francisco Unified School District, regardless of family income. The program is funded by a combination of City and philanthropic funds. The

[22] The pilot program was initiated in 2016 and received funding of $40,000 in FY 2016-17 through an existing contract with PG&E. The program will be extended in FY 2017-18 with $30,000 in funding through the same contract.

Office of the Treasurer and Tax Collector reports that Citibank was selected through an RFP process to provide the account structure for this program on a pro-bono basis.

2. **Bank on San Francisco**, OFE organizes banks and credit unions to increase access to affordable checking accounts for low-income San Franciscans. According to the Office of the Treasurer and Tax Collector, Bank on San Francisco has helped more than 75,000 low-income San Franciscans get a safe and affordable bank account and has helped reduce San Francisco's unbanked rate to roughly 2 percent.

3. **Smart Money Coaching**, administered by BALANCE, a non-profit counseling agency, provides financial coaching and access to financial products to clients currently receiving services from the Human Services Agency, MOHCD, HOPE SF public housing sites, and OEWD.

4. The **Loan Guarantee & Surety Bond Programs**, administered by Merriwether & Williams Insurance Services and sponsored by the Risk Management and Contract Monitoring Divisions of the Office of the City Administrator, aim to increase participation of Disadvantaged Business Enterprises[23] in City construction and public works projects by assisting contractors and subcontractors in accessing technical assistance, bonding and financing for City construction projects. Small businesses that may not otherwise have access to credit may borrow against an $8,000,000 revolving line of credit—guaranteed by the City—with Union Bank.[24] Funding for administrative and program costs[25]—totaling $1,062,363 in FY 2016-17—is from the operating budgets of General Fund and Enterprise Departments.

5. **GreenFinanceSF**, sponsored by the San Francisco Department of the Environment and administered by multiple third party partners, includes various Property Assessed Clean Energy (PACE) programs, which provide financing for energy improvements on commercial and residential properties that are paid back over time by the property owners. Program funding is provided by private PACE program administrators. Limited City staff funding to support residential sector roll-out and marketing support is from the City's General Fund.

[23] Disadvantaged Business Enterprises are small businesses owned by socially and economically disadvantaged individuals.
[24] The revolving line of credit was increased from $5,000,000 to $8,000,000 in October 2013.
[25] Program costs include fees associated with the $8,000,000 line of credit.

**Exhibit 10: FY 2016-17 Funding Levels for Other City Programs that Depend upon Relationships with Financial Institutions**

| Department | Program | FY 2016-17 Funding Level | Funding Source |
|---|---|---|---|
| Office of Financial Empowerment, Treasurer and Tax Collector's Office | 1. Kindergarten to College | $1,490,000 | City and philanthropic funds |
| | 2. Bank on San Francisco | $236,400 | City and philanthropic funds |
| | 3. Smart Money Coaching | $832,900 | City and grant funds |
| Risk Management Division, City Administrator's Office | 4. Loan Guarantee & Surety Bond Programs | $1,062,363 | Operating budgets of General Fund and enterprise departments |
| Department of the Environment | 5. GreenFinanceSF | $150,000 | General Fund[26] |
| **Total** | | **$3,771,663** | |

Sources: Treasurer and Tax Collector's Office, City Administrator's Office, Department of the Environment

## 6. The Bank of North Dakota: successful but currently the only public bank in the U.S.

There is only one publicly-owned bank in the U.S.: the Bank of North Dakota (BND). Founded in 1919 as part of the populist response to problems in the agricultural industry including farmers' poor access to credit, BND was charged with "promoting agriculture, commerce and industry" in North Dakota. BND's business model offers some useful ideas for how the City could approach creation and operation of a municipal bank.

Today, BND, which is overseen by the Industrial Commission of North Dakota, partners with more than 100 other North Dakota financial institutions to, in essence, serve as a central bank with a focus on financing economic development. BND is authorized to make both "direct" loans to individuals and "participation" loans to "lead" financial institutions such as regional or community banks, savings

[26] Department of the Environment received a one-time add back allocation of $100,000 for FY 2015-16 and $150,000 for FY 2016-17.

and loans, or credit unions. Most of its activity is for participation loans rather than direct loans.

All state funds are constitutionally required to be deposited into BND. As a result of the very large amount of money deposited by the state, private citizen deposits account for only a small portion of total deposits. In its 2016 annual report, BND reported assets of $7.3 billion, $136 million in net income, and its thirteenth sequential year of profitability.

Unlike commercial banks, BND is not insured by the Federal Deposit Insurance Corporation (FDIC). Instead, state law provides that all BND deposits are guaranteed by the full faith and credit of the State of North Dakota. It is a member of the Minneapolis Federal Reserve Bank. As such, it has the rights and responsibilities of other Federal Reserve Bank member banks, such as processing checks and carrying out other cash transactions, maintaining an approximate 10 percent reserve requirement (as of January 2017),[27] and meeting all safeguarding requirements of the Federal Reserve Bank.

Advocates of the public bank model point to positive government budget and economic outcomes in North Dakota and tout the Bank of North Dakota's role in influencing those outcomes. For example, in our 2011 report, we cited the Public Banking Institute (PBI) report that the state of North Dakota had the lowest unemployment rate, at 3.2 percent[28], of any state in the country, and that it was the only state to achieve a major budget surplus during the recession starting in 2007/2008.

North Dakota continues to have one of the lowest unemployment rates in the nation today.[29] Public bank proponents argue that since BND does not rely on large national banks, it was not subject to dramatic decreases in access to credit that other states and local governments were affected by during the financial crisis of 2008. As such, BND was able to continue a stable flow of credit to its member banks, which in turn continued to extend credit to small businesses and other community members, all of which had the effect of sustaining the North Dakota economy.

[27] Federal Reserve Bank, "Reserve Requirements." https://www.federalreserve.gov/monetarypolicy/reservereq.htm
[28] July 22, 2011 report for the month of June 2011, Bureau of Labor Statistics, U.S. Department of Labor.
[29] Bureau of Labor Statistics, "Unemployment Rates for States, Seasonally Adjusted." As of April 21, 2017.

## Participation Banks

In April 2011, Demos, a non-partisan public policy research and advocacy organization, released a study[30] of "partnership banks", or public banks that could "act as a 'banker's bank' to in-state community banks and provide the state government with both banking services at fair terms and an annual multi-million dollar dividend." In essence, the term "partnership bank" used in the Demos report refers to the same model of a public bank that is exhibited by the Bank of North Dakota, though, as described above, the Bank of North Dakota also makes some direct loans to individual customers, though this represents a small portion of their business.

The Demos study includes a review of the experience of the Bank of North Dakota and focused on several potential benefits of the partnership bank model for public banks, as follows:

- Creates new jobs and spurs economic growth. Partnership banks are participation lenders, meaning they would partner with local banks to drive lending through local banks to small businesses.
- Generates new revenues for establishing public entities directly, through annual bank dividend payments, and indirectly by creating jobs and spurring local economic growth.
- Lower debt costs for local governments. Like the Bank of North Dakota, partnership banks could get access to low-cost funds from regional Federal Home Loan Banks. The banks could pass savings on to local governments when they buy debt for infrastructure investments. The banks can also provide Letters of Credit for tax-exempt bonds at lower interest rates.
- Strengthen local banks, even out credit cycles, and preserve competition in local credit markets. By purchasing local bank stock, partnering with them on large loans and providing other support, partnership banks could strengthen small banks.
- Build up small businesses. Partnership banks could increase lending capabilities at the smaller banks that provide the majority of small business loans in America.

[30] Demos, "Banking on America: How Main Street Partnership Banks Can Improve Local Economies." Jadon Judd and Heather McGhee.

## 7. Efforts to Establish Public Banks in California and the U.S.

Since the financial crisis of 2008, multiple states and a few cities have considered legislation to establish a public bank or to conduct a feasibility study on establishing a public bank. A few jurisdictions have approved feasibility studies, but no legislative efforts to establish a public bank have passed since the Bank of North Dakota was founded in 1919. A common impediment to creation of public banks according to some analysts, are the startup costs and processes, which requires assembling initial equity or cash for startup operations and assembling and investing in banking, information systems and business expertise before the bank is established and able to earn revenue.[31,32]

Two California legislative efforts and recent efforts in other jurisdictions are described below.

### California Legislative Efforts

In 2011, the California State Assembly and Senate approved Assembly Bill 750 to establish the "investment trust blue ribbon task force" to study the concept of a state bank for California, but Governor Jerry Brown refused to sign the bill stating that creating a state bank was well within the scope of the banking committees in the State Senate and Assembly.[33]

If AB 750 had been enacted, the task force would have "consider[ed] the viability of establishing the California Investment Trust, which would be a state bank receiving deposits of state funds." The text of the bill cited the following as potential benefits of a state bank:

- Supporting the economic development of California by increasing access to capital for businesses in the state;
- Providing financing for housing development, public works infrastructure, educational infrastructure, student loans, and community quality of life projects;
- Providing stability to the local financial sector;
- Reducing the cost paid by state government for banking services; and

[31] Massachusetts "Report of the Commission to Study the Feasibility of Establishing a Bank Owned by the Commonwealth." August 8, 2011. <http://www.politico.com/states/f/?id=0000015b-5330-d932-a97b-f3fc404f0001>
[32] Updike, Katherine L. and Erickson, Christopher. "Public Banking Feasibility Study Final Report for the City of Santa Fe." January 2016. <http://www.santafenm.gov/document_center/document/4520>
[33] AB 750 Veto Message. <https://www.gov.ca.gov/docs/AB_750_Veto_Message.pdf>

- Lending capital to banks, credit unions, and nonprofit community development financial institutions to assist in meeting their goals of increasing access to capital and providing banking services.

In 2012 Assembly Member Hueso introduced another bill - this time to establish, not just to study, the viability of a public bank of California or the California Investment Trust through Assembly Bill 2500. He later withdrew that bill for unknown reasons.

### Recent Efforts in Other Jurisdictions

There have been recent legislative efforts in three cities and eight states to either study or establish a public bank. The Santa Fe City Council unanimously passed a resolution to create a Public Bank Task Force in April 2017 after a feasibility study found the establishment of a public bank to be feasible in January 2016. Santa Fe's Public Bank Task Force is charged with proposing governing policies for a Santa Fe public bank to the City Council.[34] The Philadelphia City Council authorized and held hearings regarding public banking in 2016, and the Oakland City Council was expected to vote in July 2017 on an ordinance to fund a feasibility study on establishing a public bank.

The states of Arizona and Vermont currently have legislation pending to study state banks, and Minnesota, New Hampshire, and Washington had legislation pending to establish state banks as of the writing of this report. Recent efforts in Hawaii, Illinois, and Maine to establish state banks did not pass.

[34] The Santa Fe New Mexican. "Local business in brief, May 2, 2017" May 1, 2017. Available at http://www.santafenewmexican.com/news/business/local-business-in-brief-may/article_8b88c4a9-8566-56a3-ba63-c4e80fc25252.html

**Exhibit 11: Public Bank Legislative Efforts in Other Jurisdictions**

| Jurisdiction | Bill Type | Bill Status | Last Action |
|---|---|---|---|
| Oakland, CA | Study Municipal Bank | Pending in Committee | 4/25/2017 |
| Philadelphia, PA | Hold hearings | Passed; Hearings held | 1/21/2016 |
| Santa Fe, NM | Study State Bank (Task Force) | Passed | 4/26/2017 |
| Arizona | Study State Bank (Task Force) | Assigned to committee | 2/9/2017 |
| Hawaii | Establish State Bank | Deferred by committee | 1/27/2016 |
| Illinois | Establish State Bank | Did not pass House by end of session | 1/10/2017 |
| Maine | Establish State Bank | Did not pass | 4/4/2017 |
| Minnesota | Establish State Bank | Pending in Committee | 3/9/2017 |
| New Hampshire | Establish State Bank | Pending in Committee | 2/21/2017 |
| Vermont | Study State Bank | Pending in Committee | 2/7/2017 |
| Washington | Establish State Bank | Pending in Committee | 4/24/2017 |

Source: Legislative databases of each of the 11 jurisdictions, as of July 2017.

## 8. Steps for Establishing a Municipal Bank in San Francisco

By becoming the depositary institution for the City and County of San Francisco's funds, a San Francisco municipal bank could make more funds available for loans to support affordable housing, local small business development, housing and other loans to underserved low-income households, and other community development efforts. Funds in the municipal bank could also be loaned and used as funding sources for City housing and infrastructure projects at lower financing costs than if such projects were to rely on debt issued through commercial banks. Depending on the bank's profitability, dividend payments could potentially be provided to the City as the primary shareholder.

Besides deposits of City funds, the municipal bank could also accept deposits from other municipalities, non-profit organizations and other depositors. The bank could potentially issue certificates of deposit and bankers acceptances which would serve as other funding sources.

As discussed earlier in this report, the City Attorney has reviewed key pertinent State laws and concluded that they do not preclude the City from creating its own bank. While there are a number of ways the City could structure its municipal bank, we have identified a number of legal requirements and business steps that

would likely have to be followed to establish a viable institution. Key sources for this information are the Roosevelt Institute's publication, "Municipal Banking: an Overview"[1], a report entitled "How to Start a Public Bank" prepared for the City of Oakland by Scott Baker, an affiliate of the Public Banking Institute, and other Public Banking Institute publications. Though established in 1919 and the only public bank in the U.S. at this time, a review of reports and information concerning the operations of the Bank of North Dakota were also reviewed and incorporated as appropriate.

Key steps for the City to take to create a public bank would include:

1. Creation of agreed upon goals and a founding policy statement by the Board of Supervisors and other City stakeholders such as the Office of the Treasurer and Tax Collector and Mayor.
2. Retention of staff and/or consultants to conduct detailed financial feasibility studies for the bank and create the administrative infrastructure of the bank.
3. Appointment of an independent board of directors and creation of articles of incorporation.
4. Development of multi-year business plans, including identification of sources of initial equity (cash for startup years), the ongoing capital structure, or sources or capital to cover ongoing operations and meet reserve requirements, determination of whether or not to originate loans directly or to partner with other financial institutions, identification of ongoing staffing needs and administrative costs, identification of reserve requirements, and developing a means of ensuring accountability and independence.
5. Determination of whether to be chartered by the State of California or the federal government and whether or not to become a Federal Reserve Bank member.

Each of the five steps above is now addressed.

Goals and Policies

Creation of goals and a founding policy statement for a City municipal bank would be a key starting point, with input from the Board of Supervisors, the Mayor, the Treasurer and Tax Collector, and other stakeholders. Creation of an entity legally separate from the City and County of San Francisco would also be a necessary

[1] Beitel, Karl, "Municipal Banking: an Overview", Roosevelt Institute, April 2016.

early step, with the City established as the primary shareholder to ensure that the institution remains committed to the City's municipal bank goals such as providing funding for community development needs. The founding of a separate banking entity would require authorization in the form of an ordinance adopted by the Board of Supervisors and/or a Charter amendment.

Hiring Staff

Banking, business and community development specialists would need to be hired and/or retained as consultants to, among other things, prepare feasibility studies and a business plan with multi-year financial scenarios to determine how the bank could become and remain profitable. This would require estimating the bank's assets, particularly the value and terms of loans that could be issued, required reserves, and liabilities such as deposits received. Startup and fixed costs would need to be identified, including staffing, information technology, office space requirements, and other operating costs.

Appointing Board of Directors

In order to ensure operational autonomy, an independent board of directors would need to be appointed to govern the bank, with a preliminary act of adopting articles of incorporation. Members would likely be appointed by the Board of Supervisors and Mayor but would thereafter need to have full autonomy in overseeing management and insuring that the bank continued to fulfill the goals set forth in the municipal bank's founding policy statement and the articles of incorporation. Board members should be selected according to criteria such as expertise, demonstrated commitment to the mission of the bank, and representation of constituencies typically excluded from decisions about public finance.

Multi-year Business Plan Preparation and Identification of Funding Sources to Capitalize the Bank

All banks need to maintain a certain level of capital to meet regulatory requirements and to be able to meet their operating costs. Since a new bank would not initially have sufficient funding for these purposes, sources of funding would need to be identified to capitalize the municipal bank. The exact amount of funding required for capitalization would need to be determined as part of a multi-year business plan for the municipal bank, particularly the projected timing of its volume of deposits, loans, and loan repayments.

Likely sources of cash for a municipal bank in San Francisco include a one-time appropriation from the City's General Fund, using a General Fund source such as

unassigned fund balance, and any legally available monies from other City funds. The City could also explore the possibility of issuing a bond, using the proceeds to capitalize the municipal bank. Issuing a bond would have to be weighed against the costs to the City of bond issuance and repayment vs. a one-time appropriation of funds. One-time donations from philanthropic or other organizations might also be available for startup purposes.

City funds used to meet the capitalization requirements of a municipal bank could be provided as a grant or a loan subject to repayment. To the extent any one-time funds used do not have to be repaid, such as those provided through an appropriation from unassigned fund balance, the faster the municipal bank could earn profits on the loans it originates. The banks net earnings could then be added to its capital, allowing expansion of its lending and investments. Repayment of initial funding, if necessary, would likely take a number of years.

Business plan decisions would include the extent to which the bank would originate loans directly or partner with existing credit unions and Community Development Financial Institutions (CDFIs), with the municipal bank's role being primarily to provide additional mission-consistent funding through participation lending. All lending activity would need to be subject to rigorous evaluation and public accountability to insure that credit issued is fully independent of political considerations and fulfills the public policy and business goals set out in the bank's founding policy statement.

The potential risks associated with a City municipal bank would need to be addressed by the bank's business plan and initial feasibility analyses. There would be some unknown risks associated with being the first in the nation to attempt to establish a municipal bank. The City would have to recruit human capital and build up the technology for this bank. There could be challenges at the outset meeting the 10 percent federal capital reserve requirement[36] and funding on-going operating costs, although the bank would have the advantage of being a depositary institution for the City's funds from the start.

Timing

It would likely take a few years to have a City municipal bank fully up and running and able to serve as the primary financial institution for the City's banking needs. Starting with its initial equity and making loans in its first year, the bank should be

[36] Reserve requirements are set by the Federal Reserve Bank and are subject to change. 10% is the rate applied, as of January 19, 2017, to banks with over $115.1 million in liabilities.

able to gradually build up its assets as loans are repaid with interest and new loans are originated. The City municipal bank would need a transition plan to begin accepting and managing deposits of City funds to ensure the bank's costs are covered and that all funds are available as needed for ongoing City operations. Within a few years, the municipal bank should be able to generate sufficient revenue to be able to cover its costs and serve as the primary financial institution for the City.

The Office of the Treasurer and Tax Collector has pointed out that State law requires that all local agencies can only deposit funds in institutions that have received a "satisfactory" rating in its most recent evaluation by its federal financial supervisory agency in meeting Community Reinvestment Act requirements.[37] Because a municipal City bank would be new, it would not have such an evaluation when it first starts. Other arrangements would need to be made, either through procedures in place for new banks by its supervisory agency or through arrangements negotiated by the new municipal bank. For example, the Office of Comptroller of the Currency in some cases allows banks to be rated based on their strategic plans.

Chartering and Federal Reserve Bank Membership Decisions

As stated above, an early decision that would need to be made in creating a San Francisco municipal bank would be whether to be chartered by the State or federal government. As discussed above in the section about the regulatory structure of banks, obtaining a State charter may be simpler and less costly than obtaining a federal charter and more appropriate given that a San Francisco municipal bank would assumedly not be interested in expanding nationwide. There are other implications for the chartering choice that the City would have to consider.

Under the country's "dual banking system", banks electing to be national are chartered by the federal Office of the Comptroller of Currency (OCC); state banks are chartered by the banking oversight agency in their state. In California, the bank oversight agency is the Department of Business Oversight (DBO). Whichever charter agency a new bank chooses, the chartering agency serves as its primary regulator, responsible for ensuring that the institution has sufficient capital and

[37] California Government Code Section 53635.2 requires this evaluation. The federal Community Reinvestment Act (CRA) was adopted in 1977 to prevent redlining and to help meet the credit needs of low- and moderate-income residents and communities. Pursuant to the Act, federal bank regulators must assess the record of each bank under its jurisdiction in adhering to the provisions of the CRA.

the management and technical expertise to meet their obligations and protect the public from unsound banking practices.

In addition to a chartering agency and primary regulator, all banks also have a secondary federal oversight agency. The secondary oversight agency for all national banks is the Federal Reserve Bank. Membership in the Federal Reserve Bank is also required of all national banks.

State banks have the option of joining the Federal Reserve Bank; if they choose to do so, the Federal Reserve Bank will serve as their federal oversight agency, secondary to their state oversight agency. The Federal Deposit Insurance Corporation provides federal oversight to state banks that do not choose to join the Federal Reserve Bank. Secondary federal oversight agencies supervise and examine the practices at banks under their jurisdiction in cooperation with the banks' primary regulators.

The Federal Reserve Bank also serves as the sole federal oversight agency for all bank holding companies. Banks that are owned by a holding company may choose the Federal Reserve Bank as their secondary regulator so that their entire organization is working with the a single agency as their secondary overseer.

Besides its oversight role, the Federal Reserve Bank offers services to its member banks, though nonmember banks are also able to use these services. The services include electronic payment services, both Automated Clearinghouse (ACH) and wire transfers (Fedwire), check clearing (crediting and debiting financial institutions for checks drawn on other institutions), and the provision of cash and coin. Banks can apply to the Federal Reserve Bank for a master account, which posts all of the bank's debit and credit transactions and maintains any reserve requirements.

As an alternative to obtaining their financial services and maintaining a master account with the Federal Reserve Bank, a financial institution can also obtain such services from bankers' banks or correspondent institutions or other private entities. Further, banks may choose to clear checks directly with each other rather than using the Federal Reserve Bank's check clearing services. However, such arrangements would be fairly restrictive for a bank's operations compared to having a master account through the Federal Reserve Bank.

Other aspects of Federal Reserve Bank membership include voting rights for some members of the board of directors for their area Federal Reserve Bank and a requirement that the banks purchase and hold stock in their local Federal Reserve Bank, with dividends paid based on the member bank's assets.

Based on the information above, a national charter does not appear to be needed for the City and its municipal bank since it is not likely that the bank would choose to become national, or have branches in other states. Membership in and oversight by the Federal Reserve Bank versus oversight by the Federal Deposit Insurance Corporation does not appear to have clear advantages or disadvantages for a City municipal bank. An approach to this choice could be based on municipal bank staff discussions with both federal agencies and an assessment of which agency would work best with the staff.

Use of Federal Reserve Bank services would offer some benefits to a municipal bank but, as mentioned above, these services could be obtained without Federal Reserve Bank membership. Finally, a City municipal bank would not likely be owned by a bank holding company so it would not have the incentive to join the Federal Reserve Bank to ensure coordinated secondary oversight by a single agency since the Federal Reserve Bank serves as the oversight agency to all bank holding companies.

### State of California Chartering Requirements

Assuming that the City's municipal bank would not have the goal of becoming a national bank and would therefore elect to be chartered by the State, it would need to meet the requirements imposed by the California Department of Business Oversight (DBO).

The DBO asserts that there are several advantages to seeking a State charter, as described above.[38] If a bank obtains a State charter from DBO, its primary federal regulator would then be either the Federal Reserve Bank (for State-chartered banks that choose to become members of the Federal Reserve System) or the Federal Deposit Insurance Corporation (for state-chartered banks that choose not to become members of the Federal Reserve System).[39] If the City chose not to obtain a State charter from DBO, it would have to obtain a charter to become a "national bank" from the Office of the Comptroller of the Currency.[40]

As discussed earlier in this report, a large majority, approximately 82 percent, of commercial banks established in California choose to operate under a State charter. If a City public bank were to pursue State-chartered status, it would need

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[38] "Advantages of State Charter," California Department of Financial Institutions, available at: http://www.dbo.ca.gov

[39] As described earlier in this report, the Bank of North Dakota, the only example of a public ban in the U.S., is not insured by the Federal Deposit Insurance Corporation. Per state law, its deposits are guaranteed by the full faith and credit of the State of North Dakota. The Bank of North Dakota is a member of the Federal Reserve Bank of Minneapolis.

[40] *The Federal Reserve System: Purposes and Functions*, The Federal Reserve Board, available at www.federalreserve.gov.

to adhere to the DBO's "Guide for Groups Interested in Chartering a State Bank in California",[41] which outlines the steps such banks must follow whether they elect to be a state member bank of the Federal Reserve Bank or choose the Federal Deposit Insurance Corporation as their primary federal regulator. In summary, the process requires an interested party to submit to the DBO a proposal and business plan for its proposed bank; request and attend pre-application meetings between all proposed directors of the proposed bank, representatives of the DBO and representatives of the Federal Reserve Bank and/or the FDIC; file a complete application to the DBO; and comply with field investigative activities during the application review period.

According to the DBO, in evaluating applications for a State charter, reviewers seek to ascertain:

a. That the public convenience and advantage will be promoted by the establishment of the proposed bank or trust company.
b. That the proposed bank or trust company will have a reasonable promise of successful operation.
c. That the bank is being formed for no other purpose than the legitimate objectives contemplated by this division.
d. That the proposed capital structure is adequate.
e. That the proposed officers and directors have sufficient banking or trust experience, ability, and standing to afford reasonable promise of successful operation.
f. That the name of the proposed bank or trust company does not resemble, so closely as to be likely to cause confusion, the name of any other bank or trust company transacting business in this state or which had previously transacted business in this state.
g. That the applicant has complied with all of the applicable provisions of this division.

Additionally, the DBO states that, in reaching its decision, it considers:

a. The character, reputation, and financial standing of the organizers or incorporators and their motives in seeking to organize the proposed bank or trust company.
b. The need for banking or trust facilities or additional banking or trust facilities, as the case may be, giving particular consideration to the

[41] "Guide for Groups Interested in Chartering a State Bank in California," California Department of Business Oversight. http://www.dbo.ca.gov/cacharter/guide.asp

adequacy of existing banking or trust facilities and the need for further banking or trust facilities.

c. The character, financial responsibility, banking or trust experience, and business qualifications of the proposed officers of the bank or trust company.
d. The character, financial responsibility, business experience, and standing of the proposed stockholders and directors.
e. The adequacy of banking facilities to support its operations.
f. The adequacy of capitalization to support the projected volume and type of business.
g. The reasonableness to achieve and maintain profitability.
h. The viability of the business plan given the economic condition, growth potential, and competition of the proposed market area.
i. Whether the bank is free from abusive insider transactions and apparent conflicts of interest.
j. Other facts and circumstances bearing on the proposed bank or trust company and its relation to the locality as in the opinion of the commissioner may be relevant.

## City Municipal Bank Ownership

Shares in the bank should be organized into various classes structured to ensure that the City remains the sole controlling interest through exclusive power to appoint the board of directors. Retaining exclusive power of appointment is essential to insuring continued fulfillment of the public purpose and objectives that motivated the establishment of the bank.

The City, as the ultimate controlling interest, could either own the bank in its entirety or sell non-controlling classes of shares to other investors. Owners of these subordinated share classes would be eligible to receive dividend payments, but would not exercise any controlling influence on bank policy or the selection of the board of directors. The City would at all times retain ultimate authority and oversight; any subsequent amendment or dilution of control could occur only through an ordinance whose ratification would also be subject to legislative approval by the Board of Supervisors.

## Reserve Requirements

**Capital Reserves:** The City would be required to meet the Federal Reserve Board's capital reserve requirements, which vary based on the size of the depository

institution. As of the writing of this report the rate applied to institutions with liabilities of more than $115.1 million is 10 percent[42]. This means that the City would be required to keep 10 percent of its total funds, or approximately $22.9 million based on the $228.6 million account balance in the City's short-term accounts as of June 30, 2016.[43]

## 9. Access to Bank Services for Marijuana-Related Businesses

Twenty-six states, including California, and the District of Columbia have legalized certain marijuana-related activities. Because marijuana is illegal at the federal level (as discussed below), many marijuana-related businesses in these states do not have access to bank accounts and have to conduct all business in cash. This lack of access to banking for marijuana businesses has served as an impetus for some public bank efforts in other jurisdictions, such as the City of Oakland. Relevant federal laws and guidance as well as recent efforts to provide access to banking services for marijuana-related businesses are discussed below.

### Controlled Substances Act

The Controlled Substances Act (CSA) makes it illegal under federal law to manufacture, distribute, or dispense marijuana. In response to changes in state law discussed above, U.S. Department of Justice Deputy Attorney General James M. Cole issued a memorandum in 2013 (the Cole Memo) to all U.S. Attorneys to provide guidance to federal prosecutors on marijuana enforcement under the CSA.[44] The Cole Memo emphasizes that marijuana distribution and sale is still illegal under federal law and directs federal attorneys and law enforcement to dedicate enforcement resources to persons or organizations whose conduct interferes with the following eight priorities:

1. Preventing the distribution of marijuana to minors;
2. Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;
3. Preventing the diversion of marijuana from states where it is legal under state law in some form to other states;

[42] Reserve Requirements, in Monetary Policy of the Federal Reserve Board; available at: http://www.federalreserve.gov/monetarypolicy/reservereq.htm#table1

[43] $228.6 million was reported in the Comprehensive Annual Financial Report for the City and County of San Francisco, FY 2015-16, Note (5)(a) Cash, Deposits and Investments Presentation.

[44] James M. Cole, Deputy Attorney General, U.S. Department of Justice, *Memorandum for All United States Attorneys: Guidance Regarding Marijuana Enforcement* (August 29, 2013), available at http://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf

4. Preventing state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;
5. Preventing violence and the use of firearms in the cultivation and distribution of marijuana;
6. Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;
7. Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and
8. Preventing marijuana possession or use on federal property.

Although guidance from the Department of Justice indicates that they will not go after marijuana-related businesses that operate legally under State law and do not implicate one of the Cole Memo priorities above, the Cole Memo could be revoked or altered by the Trump Administration (or any other administration).

## Bank Secrecy Act

The Bank Secrecy Act of 1970 (BSA) requires U.S. financial institutions to report to the federal government suspicious activity that might signify money laundering, tax evasion, or other criminal activities. Because the distribution and sale of marijuana is illegal under federal law, financial institutions are required to report the financial activity of marijuana-related businesses. The U.S. Treasury's Financial Crimes Enforcement Network (FinCEN) is responsible for the administration of the BSA and provides guidance for financial institutions seeking to provide services to marijuana-related businesses.[45] The FinCEN Guidance permits financial institutions to provide services to marijuana-related businesses that are operating in accordance with state laws and regulations. It also creates a three-tiered system for filing Suspicious Activity Reports (SARs) regarding marijuana-related businesses. Banks are required to use the following labels when filing SARs based on the bank's reasonable belief as to whether the businesses implicate one of the Cole Memo priorities:

- **Marijuana Limited**: the business does not implicate one or more of the Cole Memo priorities
- **Marijuana Priority**: the business does implicate one or more of the Cole Memo priorities

[45] Department of Justice and the Financial Crimes Enforcement Network division of the Treasury Department *FIN-2014-G001: BSA Expectations Regarding Marijuana-Related Businesses* (February 14, 2014), available at https://www.fincen.gov/sites/default/files/guidance/FIN-2014-G001.pdf

- **Marijuana Termination**: the bank has terminated the relationship with the business

In order to comply with the BSA, banks must conduct customer due diligence when deciding to open, close, or refuse any particular account or relationship. For marijuana-related businesses, key aspects of the due diligence process include verifying the business license and developing an understanding of the normal and expected activity for the business. Banks must monitor behavior on an on-going basis to identify red flags that may indicate that a business is engaged in an activity that implicates a Cole Memo priority. FinCEN identifies 11 scenarios that could raise a red flag, including being unable to provide state licensing documentation and seeking to conceal involvement in a marijuana-related business.

### Response to Federal Guidance

In Colorado and other states that have legalized certain marijuana-related activities, some community financial institutions have become more open to serving marijuana-related businesses in light of the guidance provided by the Department of Justice and FinCEN, but most large banks refuse to serve these businesses.[46] According to the California Bankers Association, U.S. Department of Justice and FinCEN guidance alone is not enough because the manufacture, distribution, and sale of marijuana is illegal under federal law, and "the only way to eliminate the risk of criminal prosecution for banks is if Congress changes federal statute."[47]

In May 2014, Colorado lawmakers authorized a credit union for the cannabis industry. However, the Federal Reserve Bank denied the credit union access to a master account, which is needed for electronic transactions between financial institutions, and the National Credit Union Administration refused to insure its deposits.[48]

The credit union sued the Federal Reserve Bank in federal court over the denial. The U.S. District Court for the District of Colorado dismissed the lawsuit, but, upon appeal, the 10th Circuit Court of Appeals vacated the district court's decision,

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[46] Quinton, Sophie. "Why Marijuana Businesses Still Can't Get Bank Accounts." *The Pew Charitable Trusts*. March 22, 2016, available at http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2016/03/22/why-marijuana-businesses-still-cant-get-bank-accounts

[47] California Bankers Association. "Frequently Asked Questions: Marijuana and Banking." Accessed on May 18, 2017. <http://www.calbankers.com/post/frequently-asked-questions-marijuana-and-banking>

[48] Quinton, Sophie. "Why Marijuana Businesses Still Can't Get Bank Accounts." *The Pew Charitable Trusts*. March 22, 2016.

allowing the credit union to reapply to the Federal Reserve Bank for a master account. However, in its decision, the appeal court stated that is decision relied on Fourth Corner's representation to serve marijuana-related businesses only when doing so was legal. Marijuana serving businesses are legal in Colorado but not under federal law so the decision does not clearly give the credit union authority to serve marijuana serving businesses as was its original intent.

This case could affect a City municipal bank's ability to obtain a master account and needed insurance if part of the bank's business plan is to serve marijuana serving businesses. This issue would require further legal analysis by the City Attorney or counsel to the separate bank entity when created.

After California voters approved Proposition 64 in November 2016, which legalized recreational marijuana use, State Treasurer John Chiang convened the Cannabis Banking Working Group. The Group is made up of representatives from law enforcement, regulators, banks, taxing authorities, local government, and the cannabis industry and is tasked with identifying practical ways to open access for marijuana-related businesses to the banking system.

Because marijuana is illegal under the Controlled Substances Act, banks could face criminal prosecution for serving marijuana-related businesses. However, guidance from the Department of Justice and FinCEN indicates that they will not go after banks that serve marijuana-related businesses that operate legally under State law and do not implicate one of the Cole Memo priorities, such as funding gang activity. Should the Board of Supervisors choose to pursue a public bank option, it should request an opinion from the City Attorney's Office on the legality and risks of serving the marijuana industry. A San Francisco public bank would have to comply with reporting requirements of the Bank Secrecy Act, and serving marijuana-related businesses would likely increase these compliance costs.

## Policy Options

In light of the information presented in this report, the Board of Supervisors could consider the following community supportive banking options in the interest of making more use of the City's funds to better achieve community and economic development goals:

1. **Recommend to the Office of the Treasurer and Tax Collector more investment of City funds in local credit unions or community development banks whose loan and investment policies are more aligned with the City's community and economic development objectives.**

   The Office of the Treasurer and Tax Collector has historically invested small amounts of money in credit unions and community development banks via time deposits. These investments are limited to a maximum of $240,000 per financial institution, which is just below the maximum amount insured by the Federal Deposit Insurance Corporation (FDIC) and by the National Credit Union Administration (NCUA). The Office of the Treasurer and Tax Collector announced in October 2017 a new program that could result in more City funds being deposited with San Francisco-based banks, credit unions and community development banks. The Board of Supervisors could request that when implementing this program, the Office of the Treasurer and Tax Collector specifically increase the level of investment in San Francisco-based credit unions and community development banks.

2. **Support additional funding for expansion of existing City community development programs.**

   As described earlier in this report, the City currently funds a variety of community development programs, including loans for single family homeowners and small businesses. As of the writing of this report, approximately $86.0 million in loans are outstanding from these programs for purposes such as home loans by low and moderate-income residents. Separately, $756,000 in funding was allocated in FY 2016-17 to organizations that provide technical assistance to small businesses and another $3,771,663 in funding was provided through the Treasurer and Tax Collector's Office of Financial Empowerment and the Department of the Environment for financial services targeting populations traditionally underserved by financial institutions.

   The Board of Supervisors could consider appropriating additional funds to expand these programs. For example, the Board could consider increasing the annual funding level for loans to single family homeowners and small businesses or expanding the Kindergarten to College program, which provides savings accounts for kindergartners in the San Francisco Unified School District, by increasing the initial seed deposit, either by obtaining a larger financial commitment from the existing bank partner, or by recruiting other banks to participate in the program. To determine which programs are suitable for additional appropriation of City funds, the Board could request

information from the appropriate City departments on the results of existing community investment programs.

### 3. Take steps to establish a San Francisco public bank.

The Board of Supervisors could consider establishing a public bank. A public bank could use its funding base to support affordable housing and large-scale infrastructure development in San Francisco. In addition, the bank could support economic development in low-income neighborhoods in partnership with local banks and credit unions that have established branches, relationships, and retail lending outlets. Establishment of a municipal bank would require creating a new legal entity separate from the City, meeting all State and federal legal requirements for creating and operating a bank, obtaining initial funding to capitalize the banks in its first years of operations, and investing in startup and ongoing information technology and human resources with banking and necessary legal expertise. As with any new business, there would be risks associated with the City creating a municipal bank, particularly since it would be the first in the nation.

### 4. Request that the Office of the City Attorney assess the risk and legal issues associated with a San Francisco public bank serving the cannabis industry.

While the manufacture, distribution and dispensing of marijuana is illegal under federal law, these activities are allowed by the State of California. However, because banks are regulated by both the federal and state governments, the industry as a whole has elected not to serve cannabis related businesses such as dispensaries, leaving them without banking services. The Board of Supervisors could request that the Office of the City Attorney investigate the risks and legal issues associated with a San Francisco municipal bank potentially providing banking services to cannabis-related businesses in San Francisco.

**CITY AND COUNTY OF SAN FRANCISCO**
**BOARD OF SUPERVISORS**
**BUDGET AND LEGISLATIVE ANALYST**
1390 Market Street, Suite 1150, San Francisco, CA 94102
(415) 552-9292 FAX (415) 252-0461


# Policy Analysis Report

**To:** Supervisor Sandra Fewer
**From:** Budget and Legislative Analyst's Office
**Re:** Municipal Bank for San Francisco: Issues and Options for Consideration
**Date:** July 24, 2020

## Summary of Requested Action

Your office requested that the Budget and Legislative Analyst address and report on certain aspects of the March 2019 Municipal Bank Feasibility Task Force Report, which was intended "to provide a thoughtful analysis of the costs and benefits of creating a municipal bank and to outline the policy and operational consideration should the City decide to proceed." You also requested assessments of alternative pathways to creating a municipal bank.

***For further information about this report, contact Fred Brousseau, Director of Policy Analysis, at the Budget and Legislative Analyst's Office.***

Note about impact of COVID-19

This report was mostly prepared prior to the known arrival of COVID-19 in California and the U.S. Since the pandemic has had a tremendous impact on public health and the economy of San Francisco, it could seem like an inopportune time for the City and County of San Francisco to consider creation of a municipal bank. The case could also be made that present circumstances highlight the need for such an institution, which could provide the City and its residents with an additional set of powerful tools to promote economic regeneration, and to address long-standing problems such as the multi-decade crisis of affordable housing, the need for a large-scale publicly financed energy transition, and providing credit to underserved communities.

There are multiple viable pathways to implementation for a City municipal financial corporation (MFC). In our view, all will involve City financial commitments to reduce risk and for the MFC to achieve success as soon as possible. This involves policy choices, and analysis of the costs and benefits of various policy tradeoffs. It would require a commitment of City resources in a time of projected shortfalls, but it could also provide assistance to those whose livelihoods or living situations have been adversely affected by the pandemic.

The BLA model outlined in detail in this report is not meant to be definitive, but rather is illustrative. The actual timing and level of funding commitments will need to be developed by an Implementation Working Group that we recommend to oversee the development of a specific business plan.

## Executive Summary

- A public bank is a bank owned by a public entity instead of private owners. Advocates of public banks believe such institutions would be able to use City funds, now deposited with traditional private sector banks, to better support policy objectives such as creating more affordable housing, investing in local small businesses and residents that may be underserved by traditional banks, and investing in environmentally sound local infrastructure projects.
- Toward the goal of a public bank in San Francisco, the Board of Supervisors created by resolution a Municipal Bank Feasibility Task Force in 2017, whose purpose was to "advise the Treasurer…the Mayor, the Board of Supervisors and relevant City Departments regarding the creation of a Municipal Public Bank."
- Issues raised in the past against creating a public bank have included cost, risk, and legal impediments. Concerns about legal impediments have since been disproven by the City Attorney and by changes in State law in 2019 that allows for creation of public banks and for local governments to deposit their funds in such institutions. In this report, we address costs and how risk to the City of funds invested in a municipal bank could be reduced through capitalizing the bank beyond the requirements of banking guidelines.

**What is a public bank?**

A bank that is created and owned by a public entity such as the City and County of San Francisco rather than private owners. Because of that, its mission can diverge from maximizing shareholder value to fulfilling certain economic and social policy objectives, while still operating as a profitable business.

If a public bank were created by the City, it would be a 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, however, 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 was amended in 2019 to allow local government entities to create public banks and to allow investment of surplus funds in certain instruments through a public bank.

**Depository vs. non-depository institution**

Referred to in this report as a municipal financial corporation (MFC), a public bank could be created in San Francisco as a non-depository or a depository institution. The latter would typically function as a full-service bank, accepting deposits from the institutions such as the City and County of San Francisco and the general public. A non-depository MFC would not take such deposits or provide a full complement of banking services but could still originate loans.

- The Municipal Bank Feasibility Task Force issued a report in 2019 containing an analysis of three options for creation of a municipal bank, or a municipal financial corporation as we refer to it in this report. The Task Force's three options were: 1) a non-depository model in which the institution makes loans but does not accept deposits or provide traditional banking services to customers, 2) a depository institution that would provide a full array of banking services including serving as the City's primary depository, and 3) a hybrid of the first two models.

- The Municipal Bank Feasibility Task Force estimated that their non-depository model would not become profitable until its tenth year of operations and that the second and third options would not achieve profitability for 30 and 60 years, respectively. Additionally, the banks would be structured and staffed at a level that we believe would hinder them from originating loans at sufficiently low interest to achieve a significant increase in affordable housing production or achieve other policy objectives of a municipal financial corporation such as more low-interest loans for populations often underserved by traditional banks.

**Capitalizing a public bank** Capitalization refers to the initial funding the bank would receive from its investors to start its operations and to serve as a buffer against losses.

**Funding a public bank** refers to a bank's proceeds from issuing debt securities or IOUs and/or deposits, all of which are used to originate loans.

**Differences between Municipal Bank Feasibility Task Force and BLA Public Banking Models**

- We have created a model for a municipal financial corporation (MFC) for San Francisco that achieves profitability sooner than assumed by the Task Force and is able to originate lower interest loans at a greater rate than assumed by the Task Force, thus enabling higher levels of affordable housing production or amounts available for loan recipients. The key differences between our models and those of the Task Force are:

  - The BLA model assumes that available City funds from the Investment Pool and other appropriations would be used to capitalize and fund a City MFC. The Task Force assumed that a City MFC would rely on private customer deposits and investments only and not use any City funds for capitalization or funding.

  - The BLA model assumes that $25 million in interest earnings on a portion of the City's approximately $5 billion General Fund balance would be allocated to the MFC for capitalization rather than being returned to the Investment Pool.

  - We also assume General Fund appropriations of $10 million, and $20 million in years two and three of the MFC's operation and an additional appropriation of General Fund surplus monies from the Investment Pool of $10 million each in year two and year three. These amounts, which total $80 million, could be increased or decreased at the discretion of the Board of Supervisors.

  - Finally, we assume additional *capitalization* funds would be realized by the MFC on its own investment earnings amounting to $27.1 million and $29.1 million in years

two and three of operations, respectively. Offsetting these earnings, MFC operations costs are assumed to be $9 million, $9.4 million, and $9.8 million in years one through three.

- All profits are retained and reinvested in the BLA model MFC. This will contribute to building up robust buffers to protect the City's financial commitments.

- We assume that a City MFC will achieve sufficient scale by year ten of full-fledged operations sufficient to have a significant impact on local housing provision, small-business credit, and (as a supplemental source) infrastructure financing.

- We further assume that *funding* for the MFC's loans would be initially provided by $1 billion from the General Fund portion of the Investment Pool. These funds would be used to buy debt securities from the MFC (or, due to current State law requirements, from a conduit entity issuing debt in the case of a non-depository MFC). While the City could recall these debt securities if it needed the cash, we show why it is very unlikely such funds would need to be recalled, and thus could be safely committed to financing long-term loans for purposes such as affordable housing and supporting local small businesses.

- With our model, the MFC would be profitable immediately at the point of commencing operations, due to the nature of the funding arrangements with the City. As stated above, the Task Force models assumed the MFC would not be profitable for between 10 and 60 years, depending on which of their three models is implemented.

- Our pro forma analysis of the BLA model non-depository MFC with capitalization and funding as specified above shows that the institution would have assets of approximately $2 billion by year 10 and a loan portfolio of $1.25 billion, with the balance held in U.S. Treasury notes and municipal securities.

- Our model calls for a phased-in approach to creation of a City MFC, with demonstration loans funded initially and ramping up over the first few years of operations. This approach would also provide opportunities for the City to retrieve funds allocated to the MFC at certain junctures in the first five years of its operations. The Task Force assumed the MFC would be fully operational from the outset.

- The BLA model assumes MFC operating costs in line with industry standards. The Task Force assumed the MFC's operating costs for a depository institution would be approximately double industry standards.

- The BLA model assumes that the MFC would cultivate and enter into lending agreements with a network of affiliated institutions composed of local and regional credit unions, banks, loan funds, and Community Development Financial Institutions (CDFIs). Through loan participations and MFC-led syndications, the MFC would redistribute federal and state credit guarantees to these partner institutions that would then be expected to issue low-interest loans to target clients consistent with

the MFC's mission. These arrangements would thus leverage the MFC's resources to an expanded loan pool. The Task Force model does not provide information on whether their proposed models include establishing and working with such networks.

- Our model for a City MFC includes both non-depository and depository variants. While we conclude that both are feasible and could operate profitability, we recommend that the City establish a non-depository MFC, at least initially, because it would have the advantages of: 1) lower operating costs compared to establishing a depository bank, particularly compared to providing all traditional banking services, thus allowing the non-depository to offer loans at lower rates; and 2) not requiring approval by the Federal Deposit Insurance Corporation (FDIC) to operate. This would make it less complex and costly to start a non-depository institution and would enable the MFC to focus on originating below market-rate loans for purposes such as affordable housing property acquisition, funding for small businesses, and other City policy objectives.

**Addressing Risks of a Municipal Financial Corporation**

- There are risks associated with the City establishing an MFC, whether depository or non-depository. Risks include credit risk, or the risk of loan defaults, as well as maturity mismatch, rollover, and liquidity risks. These risks could affect both the MFC and the City itself in the event the City needed to sell off its debt securities supporting the MFC due to a cash crisis.
- Our model is constructed such that the MFC's capital-to-asset ratio would far exceed the level at which the Federal Deposit Insurance Corporation (FDIC) defines a bank as "well capitalized." This is because we have assumed that City funding provided for capitalization will allow the MFC to create buffers against excessive loan defaults or other types of scenarios in which the MFC's assets are depleted due to demands by creditors or excessive mismatches between short-term liabilities and longer timer assets (maturity mismatch).

## Summary of Policy Options for the Board of Supervisors

1. Establish, fund, and staff an Implementation Working Group to oversee the development of a business plan for a City municipal financial corporation (MFC). This plan should address capitalization; funding through the Investment Pool; funding through private market sources; lending programs in areas related to housing, small business, and infrastructure investment; the creation of wholesale distribution markets; the nature of partnerships with local credit unions and community banks; liquidity; comprehensive strategies of risk management; and governance. The Implementation Working Group should have nine months to develop a business plan that will be submitted to the Board of Supervisors, which will then convene a vote to determine whether the City should move forward.

2. We recommend the Implementation Working Group design three initial lending programs to determine viability, one focused on property acquisition for affordable housing, one focused on small business lending, and one focused on infrastructure financing.

3. We recommend the Implementation Working Group be explicitly mandated to assess the viability of developing a wholesale distribution network, which will be critical to reaching the scale of operations required to support investment in new housing construction and a large-scale property acquisition program, given the extraordinarily high cost of developing or acquiring housing in San Francisco.

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. If, after some period of time, the City deems it desirous and advantageous to set up a depository bank, the non-depository MFC would provide the basis for seeking a state banking charter, that, if granted, would transform the MFC publicly owned depository able to offer a range of complementary banking services.

***Project staff: Karl Beitel, Fred Brousseau***

### Why we are recommending starting with a non-depository municipal financial corporation

As will be discussed in detail in the various sections below, there are advantages and drawbacks to the City establishing either a depository or non-depository public bank, or municipal financial corporation (MFC). In brief, a **depository bank** is able to issue liabilities against itself as a counterpart to the issuance of loans, and accept incoming payments, or additional deposits, made to customers' accounts. Depositories clear and settle payment orders (financial transactions between economic agents) and serve as the basic backbone of the monetary system upon which all other economic activities ultimately depend. As per the terms of AB 857, adopted by the California Legislature in 2019, local governments are authorized to form and operate public banks. The law specifically states that any publicly owned depository would fall under the regulatory jurisdiction of the Federal Deposit Insurance Corporation (FDIC) and the California Department of Business Oversight, and hence, under current law, could not be formed unless the FDIC is willing to approve the institution.

A **non-depository** MFC, by contrast, must fund its lending operations through borrowing funds on the private markets, generally through the issuance of debt securities. In the case of a non-depository MFC such as we are recommending for San Francisco, the MFC's issuance of debt securities would be sold to the City's Investment Pool. All payments received from other parties, and payments made by the non-depository would be cleared and settled through a depository bank.

A non-depository is less regulated, and formation does not require prior approval by either the FDIC or the California Department of Business Oversight. The non-depository thus has relative benefits such as lower operating costs - and the potential risks - entailed in being subject to lower levels of regulatory scrutiny.

Our recommendation is that the City first establish a non-depository MFC and defer the question of creating a depository bank during the first years of formation based on the following considerations.

First, provided the funding issues can be resolved (see section on funding below), a non-depository variant will have the capacity to originate loans and make investments on a scale that – in the first years of operations, would be fully on par with a depository institution. On the other hand, we conclude there would be limited ability to scale the MFC's lending operations if it commenced operations on day one as a depository bank.

Second, a non-depository option would have lower operating costs than a full-fledged depository bank. Lower costs can be passed through in the form of lower rates on loans.

By contrast, a full-fledged depository would need to hold a greater share of market-rate loans in its loan portfolio and would need to offer loans at a higher (average) rate. These factors would limit the ability of the depository variant to serve as a source of long-term below market rate credit. To the extent the City wants to support increased investment in property acquisitions, affordable housing development and local small businesses through the provision of low-cost credit, there are compelling reasons to opt for the non-depository variant.

Third, the non-depository MFC could provide the vehicle to scale up lending in areas such as small businesses, property acquisitions, and affordable housing. Doing so will necessitate the development of appropriate lending and underwriting standards, protocols insuring proper oversight of the MFC's lending programs, development of lending platforms, and the cultivation of partnerships with local credit unions, community development financial institutions (CDFIs), and community banks. In addition, a non-depository MFC would allow its management to set up wholesale loan distribution platforms (outlined below) to access additional (non-City) funding from other public sources, as well as the private market.

Finally, if the City were to initially opt for establishment of a depository at the outset of MFC operations, and the FDIC refused to approve the application for depository insurance, this could undermine the legitimacy of the concept. Opponents of the MFC could point to the FDIC refusal to grant regulatory imprimatur as evidence the MFC is fraught with unacceptable levels of risk. To be clear - FDIC refusal to insure a publicly owned depository bank is not prima facie evidence that the idea is not viable in an economic and business sense. Rather, the FDIC may be hesitant to grant approval given that doing so would require it to serve as the MFC's resolution agent in the event the MFC was to become insolvent. This could entangle the FDIC in a potentially contentious political process, made all the more uncertain given the lack of any prior history of resolution of a publicly owned depository bank. The FDIC has extensive powers, as resolution agent, to restructure a failed bank's existing business agreements, bring legal action to modify outstanding debt contracts, seek easement of legal claims for recoveries brought by creditors of the bank, liquidate assets, and sell the bank to private buyers - who could end up acquiring the MFC's assets at 'fire sale' prices. Exercise of such regulatory powers in the case of a publicly owned bank could bring the FDIC into direct conflict with the local government.

Should the City opt to transform the MFC into a publicly owned depository bank after its first few years of operations, we believe it is far more likely the application will be granted the regulatory imprimatur of the FDIC if the City was to approach the FDIC with a proposal to charter a de novo depository bank. At the present time, we are skeptical the FDIC would grant its imprimatur to an untested, de novo public banking institution with no

track record or history of successful management of lending operations.[1] This could change due to the overall context in which the FDIC would evaluate an application for a de novo banking license. In particular, if the State of California were to create a publicly owned lending institution, or if other states in the U.S. were to incorporate and operate public banks, this would enhance the legitimacy of public banking as a viable policy option. A probable effect would be to increase the likelihood the FDIC would grant approval of a banking license. However, none of these conditions exist at present. For these reasons, even if the City is committed, from inception, to the establishment of a City-owned depository, we believe the optimal pathway is to first set up a non-depository institution that will implement and scale up the core lending programs in areas such as affordable housing, infrastructure investment, and small business lending, and cultivate a network of supportive relations with local credit-granting institutions. Once this infrastructure is in place, the City could proceed with applying for a bank charter.

Should the City decide to opt for the depository variant, we recommend the depository be established as a special purpose bank. The MFC depository variant could provide basic banking services (depository, clearing and settlement, custodial services, underwriting of loans, and access to short-term lines of credit) to institutional depositors such as non-profits, unions, foundations, and small to medium sized businesses. For reasons we discuss below, we do not, at the present time, recommend the MFC depository variant be established with the intention of serving as a comprehensive public depository banking – i.e. a bank that would provide the full suite of bank and treasury management services. This would undermine the ability of the MFC to serve as a source of below market rate credit.

The main factor in favor of *initially* forming the MFC as a publicly owned depository bank is that a depository variant would be able to directly access funding from the Investment Pool. Specifically, California Government Code, Section 53601(r) now designates the purchase of debt securities issued by publicly owned depositories as a permissible use of surplus monies held in a local government's investment pool. However, under current State law, local governments may not, at present, use such funds to purchase debt securities issued by a non-depository MFC. This means that if the City was to apply for, and receive, a state banking charter, a depository MFC would be able to directly access funding by selling debt securities to the City Treasury, which could purchase such securities through reallocating a portion of monies current invested in U.S Treasuries and the debt securities of the federal housing agencies (FHLMC and FNMA).

[1] It is impossible to know with certainty how the FDIC would actually respond to an application to provide insurance to a de novo publicly owned depository bank. However, those advocating the depository option need to consider that the FDIC might be very hesitant to grant regulatory approval, as providing depository insurance and acting as the federal regulating agency will mean the FDIC must act as the MFC's resolution agent in the event the MFC becomes insolvent.

By contrast, this funding option is not available to a non-depository MFC. For this reason, barring a change in State law, various workaround solutions will need to be found to allow the City Investment Pool to purchase debt securities issued by the (non-depository) MFC. We have identified legally permissible options for how to do so, all of which involve the use of public conduit entities that would issue securities purchased by the Investment Pool, with the conduit entity in turn lending the proceeds from these sales at near zero cost to the MFC.

Given these complex tradeoffs, the recommended MFC Implementation Working Group will need to vet proposals for both the depository and non-depository variants in order to ensure that the City has maximum flexibility.

In the sections that follow we outline a framework within which the City can negotiate the complex issues involved in establishing, capitalizing, and funding an MFC. We begin with some general terminological clarifications. This is followed by a series of sections in which we lay out some of the basic components of our proposed model, such as sources of initial capital, how the Municipal Bank would establish its lending programs, partnership relations with local community based lending institutions, and supportive functions such as the formation of wholesale loan distribution platforms. We show how the Board of Supervisors could adopt a sequential, phased-in approach to ease concerns of over-extending the City's financial commitment in an uncertain and fraught financial and economic environment, and how the City commitment can be periodically assessed, and, if necessary, wound down during the initial stages of incorporation and operation.

This is followed by presentation of our pro forma analysis that demonstrates the economic viability of the BLA approach. We discuss options for how the MFC can establish and maintain a network of partner relationships with community lenders – credit unions, community banks, and CFDIs – with whom the MFC would enter into loan participations, syndication arrangements, and credit enhancements in order to leverage and maximize the impact of the MFC's own balance sheet. This is followed by a series of sections that address the nature of the City's current banking arrangements, use of the Investment Pool as a funding source, and risk management.

For this report, we were asked to review and comment on the Municipal Bank Feasibility Task Force Report released in 2019. Clearly, a significant amount of time and work was expended in the development and drafting of the Task Force Report. However, our conclusion is that the report does not achieve the Task Force's stated objectives of providing a framework for assessing the various issues that must be considered to determine whether to move forward with the formation of a municipal bank. Our overall conclusion is that the report includes estimates of costs of forming and operating a publicly owned depository bank that are higher than reasonable and does not present all viable options for capitalization. We have additional concerns that the report has not

demonstrated the viability of the proposed funding sources that are assumed to support the bank's lending activities. The Task Force Report does not provide an estimate of the actual numbers of additional housing units that could be funded through its proposed lending initiatives (our analysis has concluded that the volume of housing units that could be produced using the Task Force lending model are fairly negligible in terms of overall impact). The report does not explore non-conventional lending strategies of the type that we believe would be required for a public lending institution to serve as a source of long-term subsidized credit to support increased affordable housing and other policy objectives. For these reasons, we conclude the Task Force Report does not provide a comprehensive basis for further deliberation over the benefits, costs, and risks inherent in forming a municipally owned public bank. Our assessment of the Task Force report, and discussion of why it is viable to use unassigned fund balances held in the General Fund portion of the Investment Pool, are presented in Appendices A and B.

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## I. Terminology Clarifications and Some Overarching Considerations

The following terms are used throughout the report and are key to understanding the conclusions and proposals presented.

***Municipal Financial Corporation (MFC)***

*MFC* refers to any publicly owned lending institution and is the term used in this report instead of municipal bank. This is because the financial institution created by a municipality could be incorporated and operated as either 1) ***a depository bank*** or 2) ***a non-depository lending institution***. The primary difference is that the depository variant can accept deposits and would fall under the direct regulatory supervision of the Federal Deposit Insurance Corporation (FDIC), whereas a non-depository institution would not accept deposits and would not fall under the FDIC's regulatory jurisdiction.

Either a depository or a non-depository institution would exist as a separate legal entity created to receive funds from the City, as well as from other public and private entities, to be used to issue loans consistent with City policy objectives such as affordable housing, property acquisitions, infrastructure investment, and providing credit to small businesses.

***Capitalization* vs. *Funding***

A common confusion that arises in discussions regarding setting up and funding a publicly owned lending institution centers on the terms "capital," "capitalization," and "funding." These terms are often conflated, but in fact refer to distinct aspects of the formation and operation of the MFC.

***Capital/capitalization*** refers to monies a financial institution such as an MFC receives from investors as it starts operations, and which serve as a buffer to absorb potential losses.

***Funding*** refers to the mechanism used to support the MFC's lending operations. Funding appears on the balance sheet as a liability, or a claim on the MFC held by some other entity. These liabilities are either in the form of funds borrowed by the MFC through the issuance of debt securities or IOUs of varying maturity, or in the form of demand, time, and saving deposits.

**Considerations related to MFC capitalization**

There are various possible sources for capitalization. Our recommendation is that the City provide an initial commitment of money for capitalization by dedicating interest earning from securities currently held in the Investment Pool. Earnings that would otherwise

accrue to the City General Fund will be placed into a Capital Account set up under the auspices of the Controller and City Treasury. These interest earnings would be used to purchase shares — certificates of ownership — issued by the MFC and purchased by the Controller on behalf of the City.

We specifically recommend that $1 billion of the General Fund portions of surplus monies held in the Investment Pool be set aside and used to purchase the shares issued by the MFC. Assuming average interest earnings of 2.5 percent, this would provide $25 million in capitalization over the first year. (We note that the set aside during the initial year of using this mechanism for capitalization could be higher – for instance, $2 or even $3 billion). In addition, our pro forma model assumes the City commits one-time line item appropriations of $5, $10, and $20 million in year one through three from the time the MFC commences operation, and an additional $10 million supplement appropriations from the Investment Pool in year two and three to provide additional sources of capitalization.

At the end of year one of operations, the $1 billion of monies in the Investment Pool would be used to purchase debt securities issued by the MFC through a conduit funding entity. These funds would be transferred to the MFC and would be used to support loans and investments (see below), the earnings from which would be retained by the MFC and used for capitalization. At this point, the MFC would become a self-sustaining business enterprise.

We do not believe that sufficient capital could be raised from sources other than the Investment Pool quickly enough and in sufficient quantity to get the MFC to the desired scale of $2 billion (or greater) in assets by year 7-10 from the time of commencing operation.

Capital, once paid in, would not be returned to the City unless the MFC is sold to an outside acquirer, which we assume would be prohibited by the MFC's founding charter.

As the entity that initiates the formation of the MFC, and as the majority, or exclusive, owner of MFC shares, the City would acquire the power to determine the MFC's governance structure, the composition and methods of ongoing reconstitution of the Board of Directors, guidelines related to priority lending areas, and prohibited investments. However, the MFC should be run as a business, independent of the Board of Supervisors, the Mayor, and other City officials, with its own board of directors with their own bylaws, functioning consistent with the overall policy goals set by the Board of Supervisors.

In an economic sense, capital allows the MFC to absorb losses beyond those covered by loan loss reserve, i.e., by funds set aside to cover losses due to borrower default. This

provides protection to depositors and those that hold claims against the MFC's assets. All our models presented below assume the MFC maintains a very high ratio of capital to total assets, well in excess of the levels at which the FDIC defines a bank as being "well capitalized." Maintaining a very high ratio of capital to total assets is necessary to provide a robust degree of protection of any funds committed by the City, and to address the risks associated with the formation of a publicly owned lending institution that we recommend be initially funded wholly, or in large part, through public monies committed by the City.

***Funding the MFC's lending operations***

As noted, funding, as used in this text generally refers to the process through which the MFC obtains funds to operate through issuing various liabilities — debt securities and IOUs of varying maturities, in the case of the non-depository; and debt securities plus deposits in the case of the depository - to cover its operating costs, make loans, and acquire other assets.

Under our proposed approach, debt securities, or IOUs issued by the MFC would be purchased by the City through reallocation of some portion of funds currently under Treasurer management within the Investment Pool. The MFC could also sell debt securities to other public and private entities. The question of whether the MFC is established as a non-depository or depository institution is subordinate to the question of how the MFC can provide the requisite level of long-term below market rate credit. In either case (non-depository or depository), supporting an investment portfolio of upward of $2 billion – or greater – will require that the City provide a long-term funding commitment through the Investment Pool. Some portion of funds currently held in short-term, highly liquid credit instruments – i.e. USTR notes and the debt of federal housing agencies – will need to be reallocated and transformed into longer-term, illiquid, below market rate securities.

As opposed to capital, which, once committed, is not redeemable or returned to the City, funding the loan portfolio through debt (notes and securities) and time and saving deposits, creates liabilities for the MFC. Debt securities issued by the MFC - for instance, medium term notes or longer-term bonds – are required to be redeemed in full at some future date. Deposits can be withdrawn at any point, and hence require the MFC to be able to meet depositor payment orders on a timely basis through same day clearing and settlement arrangements. For this reason, prudent risk management involves some level of matching of the maturities of assets and liabilities.[2] All of our models are constructed

[22] Some balancing of the terms on assets and liabilities is necessary to prevent a funding runoff in the event holders of these debt securities demand cash redemption when the IOUs fall due. While it is typical in "normal" market conditions for shorter-term debt securities – e.g., commercial paper, short-term notes and bonds – to simply be rolled over at prevailing market rates at the time these obligations mature, holders of claims may demand cash redemption if they need to settle their own payment obligations, or under conditions of increased funding stress

to insure the MFC has a stable funding basis – all of which will necessitate the City providing the MFC with long-term funding commitments at below market interest rates.[3]

If the Investment Pool is ruled out as a funding source, we are skeptical as to whether there are ample alternative sources of low-cost, long-term financing that would allow the MFC to serve as a significant source of long-term, below-market-rate credit. Yet this is what is required to achieve any significant increase in lending for property acquisition and new development given the current price structure that characterizes San Francisco's land and real estate market.

We do *not* believe, nor are we asserting, that the Investment Pool is the only potential source for funding the municipal financial corporation's loan portfolio. We limit our report to extensive discussion of this funding mechanism to demonstrate the conditions that must be satisfied if the MFC is to serve as a source of long-term credit to support investment in housing, small business support, and infrastructure development. Recourse to private market funding sources, as advocated in the Task Force Report, will generally require the MFC to issue loans at higher interest rates, and with shorter maturities — i.e., the time from origination to repayment date. Our models are intended to highlight the City-provided funding commitments we believe mare required to meet the municipal financial corporation's economic and social policy objectives.

As a final preamble, we are not urging the City to adopt all of the specific proposals related to capitalization and funding that we discuss in detail in the following sections of this report. Our intention is to lay out, in clear terms, what will be required if the City deems it is in the public interest, after careful assessment of the costs and the risks, to create a publicly owned lending institution that can serve as a source of long-term, below-market-rate credit, with a particular emphasis on providing loans to support housing preservation and new development. Our models reflect the fact that, at present, it has become very costly to build new housing in the San Francisco market. Similarly, it has become extremely expensive to acquire existing housing units on the secondary resale market. For these reasons, debt financing of either acquisitions or new development will require creating an institution able to issue long-term loans at well below current market rates. This will in turn require identifying very low-cost funding sources. If the City wants to move forward with the formation of the MFC, we do not see readily available options at present other than the use of monies from the Investment Pool to finance low-cost credit facilities. This creates costs and risks that must be carefully assessed. We recommend that

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and a generalized increase in the precautionary demand for "cash," as typically occurs in any banking or financial crisis.

[3] Readers should note that if the MFC does not have a diversified deposit base, State law requires that a significant portion of its deposit liabilities must be collateralized by investments held in the form of liquid securities that can be liquidated as needed to allow the MFC to fulfill its obligations to other banks created when customers withdraw or spend down there existing deposits.

MFC the Implementation Working Group conduct a thorough evaluation of the models we have proposed as part of the attempt to develop a rigorous assessment of the benefits, costs, and risks.

## II. Summary of BLA Pro Forma Analysis

We here present a summary of the results of the pro forma analysis conducted to determine the economic viability of the various options for forming a Municipal Financial Corporation based on the following assumptions, most of which apply in the case of either the depository or non-depository institution:

- Capitalization occurs through the transfer of $1 billion in the City's Investment Pool assets to a Supplemental Reserve Account (SRA) in year one, with interest earnings on the account used to provide capitalization funds for the MFC. Assuming the securities held in the SRA earning 2.5 percent on average per year, this generates approximately $25 million by the end of year one that is transferred to a capital account and used to purchase MFC shares.

- Additional capital is provided through General Fund appropriations of $5 million, $10 million, and $20 million in years 1 through 3.

- Funding for the MFC is provided in year two through one of two mechanisms. If the MFC is incorporated as a non-depository, monies held in the SRA are used to purchase debt securities issued by a conduit financing entity, which would pass these funds onto to the MFC (by law, the conduit entity could be created by the City itself). If the MFC were incorporated as a depository, the Treasurer could use fund in the Investment Pool to directly purchase the MFC's debt securities (see discussion below). The MFC initially invests its funds in U.S. Treasury notes (USTR notes) and municipal securities. The liabilities issued by the MFC pay an average of 0.5 percent annual interest.

- The MFC funds its lending operations by selling its USTRs and municipal bonds and using the proceeds to finance loan originations. All profits are retained and re-invested.

- The MFC may sell non-voting "social dividend shares" to buyers willing to support the MFC's founding social and environmental objectives, which we estimate could raise $1.5 million in the initial five-year period. We also assume local foundations contribute $5 million in non-voting equity.

- The MFC is primarily funded through issue of liabilities purchased and held by the Investment Pool. Our model assumes the Investment Pool commits $1 billion in long-term funding beginning in year two by purchasing the MFC's debt securities, with total funding commitments rising to $1.5 billion by year ten.

- As it becomes fully operational, the MFC's assets consist of USTR notes that pay 2.5 percent, municipal bonds that pay an average rate of 2.5 percent, and loans issued at an average rate of 2.65 percent.

- In our estimates of risk-weighted capital-to-asset ratios, municipal bonds are risk-weighted at the FDIC standard of 20 percent. All loans issued by the MFC are assigned a 150 percent risk weight. This is the assignment made by the FDIC to "High Volatility Commercial Real Estate" loans, typically regarded as the most high-risk category of real estate.

- Our model assumes a gradual increase in the MFC's total loan portfolio. By the end of year 3, the MFC is assumed to have $50 million in loans. At year 5, total lending is assumed to have risen to $200 million. If a decision is made at that point to fully commit the City to the MFC's ongoing operations, lending is assumed to reach $1.25 billion is total credit outstanding by year ten. Lending could be increased at a faster rate, subject to loan demand, and risk considerations that might lead the MFC to limit any rapid increase in loan exposure.

- The MFC (non-depository) will maintain a staff of approximately 10 people over the initial demonstration period. At year five, additional staff is hired, with total staff assumed to be 25 full-time equivalent positions (FTEs). The assumed staffing level reflects the requirements of complexity in our proposed lending programs, the time required to develop partnership relationships, and the establishment of a wholesale loan sale platform.

### Non-depository model pro forma

Exhibit 1 presents rates of return for a non-depository MFC with certain assumptions about loan rates and the level of funding provided by the Investment Pool.

**Exhibit 1: Rates of Return on MFC non-depository, loans at 2.65 percent, $1.5 billion funding through Investment Pool**

| Year> | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Return on assets** | 1.60% | 1.63% | 1.66% | 1.70% | 1.69% | 1.53% | 1.47% | 1.44% | 1.40% | 1.40% |
| **Return on equity** | 76.19% | 30.72% | 17.37% | 18.61% | 15.88% | 15.13% | 13.01% | 11.47% | 10.12% | 9.33% |
| **Capital/Asset ratio (non-risk weighted)** | 2.10% | 5.31% | 9.57% | 9.12% | 10.64% | 10.08% | 11.27% | 12.56% | 13.80% | 14.98% |
| **Capital/Asset ratio (risk weighted)** | | 3,691.06% | 52.93% | 34.79% | 34.39% | 19.92% | 15.01% | 14.58% | 13.17% | 14.50% |

As shown in Exhibit 1, by year ten, the MFC (non-depository) achieves a return on equity of 9.33 percent. The return on equity subsequently stabilizes at, or very near, this level.[4] The return on equity is the basic measure of economic viability of our proposed funding and lending model. The 9.33 percent rate for year 10 is slightly lower than the average for banks insured by the FDIC, shown below in Exhibit 3.[5] The MFC (non-depository) achieves profitability immediately after commencing operations. This is due to relatively low overhead costs, the scale and timing of City-provided low-cost funding, and the fact that the MFC uses funding provided through the Investment Pool to engage in large-scale purchase of municipal securities.

The return on assets by year 10 is 1.40 percent, which is slightly above average rates for banks insured by the FDIC, as shown in Exhibit 3. The risk-weighted capital-to-asset ratio is 14.5 percent – note that this assumes all MFC loans are weighted by the highest risk weighting used by the FDIC in assigning risk weights to commercial real estate loans. This weighting overstates the actual risk level, so that the effective risk embedded in the MFC loan and investment portfolio is in fact far lower.

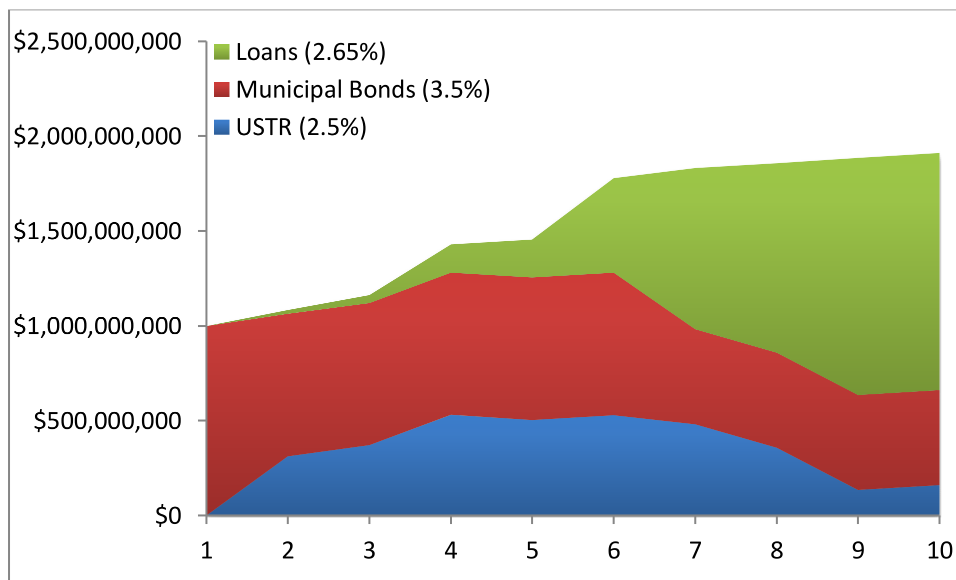
[4] The very high return in the initial years is due to very low costs, due to limited staffing, and the initially small amount of paid-in capital.

[5] **Equity** refers to assets that are not subject to encumbrance or *claims on the MFC held by other parties*. Deposits are an encumbrance on MFC assets (in the form of monies that can be withdrawn in full without prior notice). Debt securities are an encumbrance in that the MFC is obligated to redeem these notes in full at maturity. Equity is the residual difference between assets and external liabilities: **equity = assets – liabilities**. The return on equity (ROE) is the ratio of net earnings to equity, where net earnings are calculated as total revenue minus operating costs (primarily staffing costs in our models) and funding expenses - i.e. the interest paid on notes, bonds, and deposits that compose the MFC's funding base. Hence, **ROE = net earnings/equity.** The very high ROE shown in Exhibit 1 in the first year is due to very low operating costs, mostly due to reduced staffing. As the MFC scales up hiring, and begins to diversify its asset holdings, the ROE converges towards the long-term rate of 9.33 percent.

We assumed the highest risk-weighting factors in our pro forma to demonstrate that the MFCs' asset and liability structure is constructed to provide very stringent risk safeguards to the City's financial exposure. Even with the 'overweighting" of actual risk levels, the MFC's capital-to-asset ratio is well above the 8 percent ratio at which the FDIC defines a bank as being "well capitalized".[6]

Exhibit 2 shows our assumptions regarding the changing nature of the MFC asset portfolio over the first ten years of operation. We assume that, during the first three years, the vast majority of funding provided to the MFC via the Investment Pool is invested in USTR notes and municipal securities. Earnings are retained and used to provide funds for additional self-capitalization. We assume that over the first several years subsequent to incorporation, the MFC establishes several demonstration lending programs. At years 4-5, the MFC begins to expand the scale of its loan originations. Once sound underwriting and risk management practices have been established, and assuming the City, after year five, decides to fully commit to the MFC as an ongoing business concern, loans are rapidly increased over the next several years, reaching 1.25 billion by year ten. We note that these assumptions are made for illustrative purposes, and are consistent with our approach that would allow the City to unwind its funding commitments in full at any time over the first five years from commencement of operations should a decision be reached to not move forward (See section on "A Phased-in implementation Approach" below).

**Exhibit 2: Portfolio composition, MFC non-depository, first ten years of operation**




For comparison purposes, Exhibit 3 shows comparable data on return on equity, return on assets, and the capital/asset ratio for all FDIC-insured banks for the years 2001-2019.

[6] See FDIC, www.fdic.gov/regulations/capital/capital/index.html

Average return on equity in 2019 was 11.4 percent. This is higher than the projected 9.33 percent return on equity that we calculate for year 10 for the MFC (non-depository).

The return on assets for all banks insured by the FDIC is 1.29 percent, lower than the 1.4 percent rate for return on assets that we estimate for the MFC in year 10 of operations. The MFC has a more robust capital-to-asset ratio, at 14.5 percent a year as compared to 11.32 percent for the private banking industry – this despite the regulatory requirement imposed by the FDIC that banks increase capital to provide more robust buffers against which to absorb losses.

**Exhibit 3: Rates of return for FDIC-insured U.S. banks 2011 through 2019**

| | 2019 | 2018 | 2017 | 2016 | 2015 | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Return on assets** | 1.29% | 1.35% | 0.97% | 1.04% | 1.04% | 1.01% | 1.07% | 1.00% | 0.88% | 0.65% |
| **Return on equity** | 11.39% | 11.98% | 8.60% | 9.27% | 9.29% | 9.01% | 9.54% | 8.90% | 7.79% | 5.85% |
| **Capital/Asset ratio** | 11.32% | 11.25% | 11.22% | 11.10% | 11.24% | 11.15% | 11.15% | 11.17% | 11.16% | 11.15% |

Source: FDIC https://www.fdic.gov/bank/statistical/stats/

In our proposed capitalization and funding structures, at year ten the MFC could absorb a one-year loan loss write-down of 23 percent of all loans in the MFC loan portfolio before any losses would need to be passed on to the Investment Pool. This level of losses is comparable to what transpired in the U.S. Great Depression over the four-year interval spanning 1929 to 1933.[7]. As we show in our section on risk analysis, our model could withstand very heavy and prolonged losses, and thus provides very robust protection of the City's financial exposure.

**Depository model pro forma**

We here present the results of our pro forma analysis of a limited-purpose, publicly owned depository. In contrast to the Task Force models, our depository would not provide banking or treasury management services to the City. In our model, the depository may provide deposit accounts, short terms lines of credit, and overdraft services to entitles that are funded by the MFC, as well as banking services to institutions such as non-profit organizations, unions, foundations, and small to mid-sized businesses.

All the assumptions regarding the source and pace of the capitalization schedule, and the level and increase in funding provided through the Investment Pool are the same for the

[7] We note this is well in excess of losses that have been incurred by U.S. banks since March of 2020 – although these loan losses and write-offs against bank capital are certain to increase over the next year.

depository as with the non-depository option. We also assume that by year ten the MFC has deposit liabilities equal to $300 million.

With the depository model, staffing is increased from 25 to 35 FTEs, and we assume operating costs as a percentage of total assets are 2.07 percent. This is lower than the average operating costs as percentage assets for banks of equivalent size, which currently average is approximately 3 percent.[8]

For the depository model, we show the results of two pro forma analyses of estimated returns and capital-to-asset ratios achieved by year ten. In our first depository model, we assume, as with the non-depository variant, that the average rate of loans is 2.65 percent. Our second pro forma for a depository MFC presented in Exhibit 4 shows the results of a model where we assuming lending rates are increased to an average annual rate of 3.5 percent.

**Exhibit 4: Estimates of rates of return, MFC depository, lending at an average of 2.65 percent**

| Year> | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Return on assets** | 0.45% | 0.04% | -0.06% | 0.08% | 0.06% | 0.17% | 0.13% | 0.12% | 0.07% | 0.07% |
| **Return on equity** | 47.37% | 1.30% | -1.00% | 1.72% | 1.20% | 4.35% | 3.36% | 3.02% | 1.78% | 1.65% |
| **Capital/Asset ratio (non-risk weighted)** | 0.95% | 3.23% | 6.06% | 4.86% | 4.86% | 3.97% | 3.97% | 3.99% | 4.06% | 4.07% |
| **Capital/Asset ratio (risk weighted)** | | 3735.87% | 33.78% | 18.73% | 15.88% | 8.03% | 5.49% | 4.87% | 4.07% | 4.14% |

As seen in Exhibit 4, with lending rates set at 2.65 percent, return on equity for a depository MFC falls to a meager 1.65 percent compared to the 2019 average of 11.39 percent for banks insured by the FDIC, as shown in Exhibit 3. The capital-to-asset ratio for the depository MFC declines to 4.14 percent by year 10 as compared to the 2019 average of 11.32 percent for FDIC insured banks. This estimated rate for the MFC depository is below the level the FDIC determines that a bank has a risk of failure and will require corrective action to reduce exposures and boost various cash flow buffers and the bank's capital-to-asset ratios. Clearly, under these assumptions, the depository variant is not a viable institution.

If we assume the average rate on loans originated by the depository MFC is increased to 3.5 percent, the model achieves economic viability. The results are shown in Exhibit 4.

[8] We assume lower operating costs due to the lack of any retail banking presence, no branch offices, and the resultant reduction in staffing levels. In our pro forma banking model that issues loans at the same rate as the non-depository variant. Comprehensive historical data on U.S banks is available at https://banks.data.fdic.gov/explore/historical/?displayFields=STNAME%2CBANKS%2CASSET%2CDEP%2CEQNM%2CNETINC&selectedEndDate=2018&selectedReport=CBF&selectedStartDate=1934&selectedStates=0&sortField=YEAR&sortOrder=desc.

Given the assumption of very low costs of procuring funding through the City Investment Pool, the return on equity rises to 11.05 percent, which is nearly identical with the 11.39 percent average level in 2019 for U.S. banks insured by the FDIC as a whole. The risk weighted capital ratio is quite robust at 12.59 percent, above the 11.32 percent average in 2019 for U.S. banks as a whole, and nearly identical to the capital ratio achieved by the non-depository MFC.

**Exhibit 5: Estimates of rates of return, MFC depository, lending at 3.5 percent**

| Year> | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Return on assets** | 1.45% | 1.11% | 0.83% | 0.89% | 1.07% | 1.28% | 1.38% | 1.41% | 1.40% | 1.39% |
| **Return on equity** | 74.36% | 22.22% | 9.40% | 9.70% | 12.88% | 16.08% | 15.33% | 13.80% | 12.22% | 10.97% |
| **Capital/Asset ratio (non-risk weighted)** | 1.95% | 5.00% | 8.83% | 9.18% | 8.30% | 7.95% | 8.98% | 10.22% | 11.47% | 12.69% |
| **Capital/Asset ratio (risk weighted)** | | 3,644.65% | 48.86% | 29.94% | 27.37% | 15.45% | 11.74% | 11.63% | 13.24% | 14.85% |

Hence, the central tradeoff that must be contemplated by the City in opting for either the non-depository or depository MFC is whether the ability to take deposits creates long-term funding advantages that outweigh the higher operating costs associated with a depository, and hence the higher rate on loans that would need to be charged relative to the non-depository variety.

## III. Capitalization and Funding

In this section we discuss in greater detail some of the issues related to how to capitalize a non-depository MFC and fund its lending operations.

The primary purpose motivating the establishment of an MFC) is to provide long-term loans at below-market-rate interest to support investments in affordable housing, small business lending, infrastructure development, and other purposes consistent with City policy objectives in creating the MFC.

A major difference between the Budget & Legislative Analyst's models and those proposed in the Municipal Bank Feasibility Task Force Report is that BLA models receive a majority of their funding from the City's Investment Pool. The proposed funding structures set out by the Task Force Report limit the ability of the MFC to serve as a source of subsidized long-term credit. To the extent the City wants to utilize a municipally owned lending institution to originate long-term loans at below market rate to support affordable housing and infrastructure investment, it will be necessary either to use funds in the Investment Pool, or to identify other sources of stable, long-term, below-market-rate funding to support the MFC's lending initiatives.[9] The Task Force report does not identify how the MFC would acquire funding in sufficient volume and at low enough cost to support a robust below market rate interest loan program. Our belief is that there is low probability that such funding would be available at the level needed for the MFC to quickly start originating loans and achieving profitability without an extensive funding commitment from the City.

## A. Capitalizing the MFC

We recommend that the MFC be capitalized through a mixture of the following three sources: (1) a redirection of earnings on the City's Investment Pool that would be authorized by the Board of Supervisors as part of the Annual Appropriation Ordinance, (2) a series of Board-authorized appropriations from the Investment Pool, and (3) a series of annual line item appropriations as part of the Annual Appropriation Ordinance. Given that many of the issues involved are the same for a non-depository or a depository MFC, our recommended methods of capitalization are the same for either type of institution.

We recommend that establishment of the MFC occurs over two distinct phases of implementation. The first stage, which we refer to as the demonstration period, would span the first several years from the time the MFC commences operations. During this stage, the MFC would use the initial capital provided by the City to hire staff, and to set up and operate a set of demonstration projects to provide below market rate credit to support property acquisitions, affordable housing loans, credit to small business, and targeted infrastructure lending. This first phase would also involve the establishment of partnership relations with local community development financial institutions (CFDIs), community banks, and credit unions.

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[9] This is particularly the case for housing-related lending and investment, as the current cost of acquiring or developing affordable housing will necessitate that the MFC be able to make long-term loans at well below prevailing market rates. The Task Force models are all funded through tapping the private credit and capital markets, or through issuing certificates of deposit, and are thus exposed to risks of rising refinancing costs and funding runoffs. For this reason, the models outlined in the Task Force report must match the average maturities on loans to the maturities of the Task Force's proposed funding liabilities. This effectively prohibits longer-term lending and limits the ability of the Task Force models to provide loans at levels well below those prevailing on the private credit markets.

At the end of the first phase of its operations, the MFC would conduct an assessment to determine the viability and impact of the MFC's lending platforms and the benefits and costs to the City. As we show below, if a decision is made to not move forward with the MFC's operations, the majority of the capital and funding committed by the City can be unwound, and funds returned to the Investment Pool.

In the second phase of MFC operations, assuming the MFC has demonstrated the viability of its business operations, a decision can be made to fully commit to launching the MFC as an ongoing business concern. The City will waive the power to call in the capital already committed to the MFC. Any subsequent dissolution would require an ordinance authorizing liquidation of the MFC, and the return of all funds recovered from such liquidation back to the City.

**Option 1 for Capitalization: Establishment of a Supplemental Reserve Account within the Investment Pool to divert interest earnings into a capitalization account.**

This option involves establishing a separate accounting designation within the Investment Pool that we designate as the Supplemental Reserve Account (SRA). In the first year of operations, interest earnings on the portion of City funds held in the Investment Pool that are allocated to the SRA would be used to purchasing equity – shares - issued by the MFC. All funds allocated to the SRA will at all times remain as claims of the City on the Investment Pool.

This redirection of interest earnings, because it represents a deduction of (expected) revenues that would otherwise be allocated to the City General Fund, will require authorization by the Board of Supervisors as part of the annual budget appropriation.

**The Function and Rationale of the Supplemental Reserve Account (SRA)**

We are recommending creation of a Supplemental Reserve Account in the first year of MFC operations to require the Controller and Treasurer to formally recognize the MFC as an ongoing concern that is officially recorded and reported on the City's balance sheet. In effect, it would institutionalize the MFC and establish it as an ongoing concern in which the City has a vested interest. Without evidence of such a commitment, the MFC remains a purely theoretical concept, to which a serious City commitment could be indefinitely deferred.

In year one of MFC operations, the SRA would be structured as a separate sub-account inside the Investment Pool that would hold assets — securities —linked to the General Fund portion of funds under the Treasurer's fiduciary management. Beginning in year two, the SRA could be dissolved, and funds initially transferred to the SRA would be invested in the IOUs of the MFC's conduit entity. All interest earnings that had been

transferred to the MFC for capitalization through the SRA would at that time be returned in full to the City.

**Option 2 for Capitalization: Capitalization through one-time, line-item appropriations of General Fund revenues as part of the annual budget approval process**

The Board of Supervisors could approve a series of one-time appropriations of General Fund monies to capitalize the MFC. Our pro forma models assume annual authorization of funding appropriations of $5 million in year one, $10 million in year two, and $20 million in year three. These appropriations would occur at the discretion of the Board of Supervisors considering fiscal viability and existing policies that guide all budgetary approvals.

**Option 3 for Capitalization: Capitalizing the Municipal Financial Corporation through a supplemental appropriation of surplus monies from the General Fund portion of the Investment Pool**

This option involves using a supplemental appropriation to remove some portion of the Unassigned General Fund balance to provide funds that would be invested in shares of the MFC. Exercising this option requires that the City determines that the General Fund's overall financial position is sufficient to allow for such funding authorization. Prior to the onset of the global pandemic, this option would have been viable given the significant financial reserves accumulated by the City over the last decade. At the present time, the economic uncertainty makes short-term pursuit of this capitalization option less likely. However, we believe this option may again become relevant again for future consideration. We outline our rationale for why we think this is a viable capitalization source in greater detail in Appendix B.

## B. Funding the MFC's Lending Operations

In the approach we propose, already outlined in the prior section, the majority of the MFC's lending activity and security holdings would be funded through the City Investment Pool. Surplus Investment Pool monies currently invested in low yield USTR notes and Federal agency debts would be sold, and the proceeds used to purchase debt securities issued by the MFC. This would provide the MFC with resources needed to: 1) begin to originate loans; 2) cover operating costs, 3) pay nominal rates of interest on the funding committed by the City that would be passed back through the conduit entity, as explained further below.

The MFC's net earnings – profits - would be re-invested back into the MFC. This increases total equity, which could be leveraged to support additional lending. In this manner the MFC would establish itself as a self-capitalizing, self-sustaining business entity that, properly managed, would not impose any further financial encumbrance on the City.

At year two, our model assumes the City uses the $1 billion designated to the SRA to purchase debt securities issued by the MFC's conduit vehicle (see below). At this point, the SRA can be dissolved – all long-term City funding would be hereafter provided through reallocation of current City monies held under the fiduciary management of the Treasurer in the Investment Pool. The Treasurer would increase total holdings by $0.2 billion in year four, and an additional $0.3 billion in year five. Hence, at year five, the MFC will have received $1.5 billion in total City funding. To initiate this funding process, the Treasurer would liquidate the required amount of existing securities, and use the proceeds to acquire the IOUs of the conduit entity who in turn passes these proceeds onto the MFC.[10] The MFC would pay the City 0.5 percent annual rate of interest on monies lent by the City via the conduit entity.

Effecting these transfers thus does not require an appropriation; instead, an ordinance would request the Controller and Treasurer to transfer a portion of the securities currently held in the Investment Pool to the SRA, where they would retain their designation as "surplus monies not required for the immediate needs of the agency."

We reiterate that commitments of capital and funding from the Investment Pool would be structured such that, over the first several years of operation, these commitments could, if necessary, be rapidly scaled down. If at any point during the first several years of operations the City should desire, for whatever reason, to limit the City's exposure, this can be readily achieved by requiring the MFC to sell its USTR notes and municipal bonds and use the proceeds to retire loans provided by the City to the MFC via the conduit entity. Hence, the size of the *initial* Investment Pool funding commitment does not entail, over the several years from the time the MFC commences operation, any significant risk that losses would be incurred by the City, or that funds would be unavailable if needed to satisfy very high — and historically unprecedented - levels of Investment Pool withdrawals.

As we discuss in the following section, the Board of Supervisors should not conceptualize the capitalization and funding of the MFC over the first five years of operations as an "all-in", irreversible commitment that cannot be unwound if, for whatever reason, a decision is made at the end of the demonstration stage to not move forward. In the event such a determination is reached, the majority of funds committed over the initial five-year phase of operations can be recovered and returned in full to the Investment Pool. We discuss the process of unwinding the MFC in more detail below

[10] To avoid potential misunderstanding, note that the SRA is simply an internal accounting designation. All monies attributed to the SRA remain within the Investment Pool. All that is occurring is a change in the Investment Pool's asset composition, with holdings of USTR notes and agency securities being reduced to finance the purchase of the IOUs of the MFC's conduit funding entity.

In addition to large-scale commitments of long-term, low-cost funding through the Investment Pool, the MFC could potentially obtain additional funding by selling debt securities to mission-aligned investors such as philanthropic foundations, socially responsible investors, and pension funds, as well as to banks and credit unions that could use these purchases to satisfy federally mandated Community Reinvestment Act obligations. Funds would be used to support a scaling up of the MFC lending programs. Monies procured through the sale of debt securities to the Investment Pool would be used to support additional loan issuance. Funds not needed for new loan originations would be used to acquire municipal bonds — including the debt obligations of the City, other local municipalities, and enterprise agencies. Under our funding structure, we envision the portfolio of the MFC reaching a level of between $2 billion and $3 billion in total interest-earning assets by year ten from the date of commencing operations.

We acknowledge our proposed funding mechanisms create risks for the City. It is critical to guarantee the *surety* of any principal committed by the City and ensure the *liquidity* of the Investment Pool — i.e., the ability to meet any and all demands for withdrawal. Because risk management is of critical import, and is a complex topic, we devote a section of this report to extensive discussions of how the Municipal Financial Corporation's objectives can be achieved while providing sufficient safeguards for the City's funding commitment.

**Funding a Non-Depository MFC**

The provisions set forth in the recent State-level legislation AB 857 authorizes local governments to set up public banking institutions. As part of this legislation, Section 53601 of the California Government Code was amended to allow local governments such as municipalities to purchase medium-term notes and other debt obligations issued by a public banking institution. A public bank is explicitly designated as a depository institution subject to FDIC regulation. Unfortunately, Section 53601(r) does not apply to medium-term notes and other debt obligations issued by a non-depository Municipal Financial Corporation. If the City decides to move forward with the formation of a non-depository MFC and wants to reallocate Investment Pool monies to support its lending programs, it will be necessary to develop various workarounds to channel Investment Pool monies into a non-depository institution.

Under current provisions of the California Government Code, we believe there are two options through which the Board of Supervisors can act to provide funding to support the lending operations of a non-depository MFC: 1) funding via a conduit entity, and 2) using sweep arrangements to direct funds to the MFC.

## Option 1: Funding via conduit entity

Investment Pool monies can be channeled to a non-depository MFC for funding purposes through a public conduit entity issuing debt that would be purchased by the City Investment Pool. Section 53601(a) explicitly authorizes the Treasurer to invest surplus monies in bonds issued by the City and County of San Francisco. Section 53601(c) explicitly authorizes investment in the bonds or notes of any California state agency or enterprise of the State of California. This allows the state or City to function as a conduit entity by issuing debt at a very low, or zero, interest rate procured by the Investment Pool, with the conduit entity in turn transferring the proceeds to the MFC through the purchase of the latter's debt securities.

The sequence of the balance sheet transactions that would be required to fund the MFC's loans and operations through use of monies from the Investment Pool is shown in Exhibit 6. The initial position corresponds to the current situation, with approximately $5 billion in various General Fund placements in the Investment Pool (General Fund, special City funds, and internal service funds), and another $6 billion held on reserve by other participants in the Pool.

When the MFC issues new debt securities, or IOUs, they would be purchased by the conduit entity. The MFC would use the proceeds from these sales to the conduit entity to fund the MFC's loan originations. The final set of balance sheet positions at the completion of these funding transactions is also shown in Exhibit 6. The MFC has a $1.5 billion IOU owing to the conduit entity, which in turn has issued a long-term debt security purchased by the Investment Pool.

### Exhibit 6: Funding via Conduit

**1. Initial position**

| MFC | | Conduit entity | | Investment Pool (TTX) | |
|---|---|---|---|---|---|
| assets | liabilities | assets | liabilities | assets | liabilities |
| | | | | $11,000 mil (USTR and other authorized securities) | $5,000 mil (General Fund share of Investment Pool) |
| | | | | | $6,000 mil (share of other participants in Investment Pool) |

**2. After purchase of $1.5 billion of conduit-issued securities**

| MFC | | Conduit entity | | Investment Pool (TTX) | |
|---|---|---|---|---|---|
| assets | liabilities | assets | liabilities | assets | liabilities |
| | | $1,500 USTR notes (prior to purchase of MFC liabilities) | $1,500 bonds and securities | $9,500 mil (USTR and other authorized securities)<br>$1,500 mil Conduit entity securities | $5,000 mil (General Fund share of Investment Pool)<br>$6,000 mil (share of other participants in Investment Pool) |

**3. After funds lent out by MFC**

| MFC | | Conduit entity | | Investment Pool (TTX) | |
|---|---|---|---|---|---|
| assets | liabilities | assets | liabilities | assets | liabilities |
| $1,500 loans and investments | $1,500 in debt securities sold to conduit entity | $1,500 debt obligations of MFC | $1,500 bonds and securities | $9,500 mil (USTR and other authorized securities)<br>$1,500 mil Conduit entity securities | $5,000 mil (General Fund share of Investment Pool)<br>$6,000 mil (share of other participants in Investment Pool) |

Implementation of this funding system would require the City, or some other local or state government entity or agency to be willing to serve as the pass-through conduit entity.

We believe the most efficacious arrangement would be for the City to set up a legal entity that would issue liabilities to the Investment Pool, as authorized under the terms of Section 53601(a) of the California Government Code, and to pass these funds through to the MFC through the purchase of a long-term, below-market-rate debt security. This would allow for the term (the time to maturity) of the liability issued by the conduit and purchased by the Investment Pool, to match the loans made by the MFC. Rates paid to the Investment Pool by the conduit entity would be set at, or very near, zero to cover the costs of administrative staffing and an equivalent of 1.5 to 2 FTE positions that would be responsible for vetting the MFC's balance sheet and lending decisions on behalf of the Investment Pool.

This funding arrangement entails the conduit entity established by the City to transact the pass-through incurring a balance sheet liability in the form of a payment owing to the Investment Pool. To avoid any implied or actual commitment by the City to guarantee the liabilities of the MFC, these funding arrangements would need to include covenants to ensure that the conduit entity does not incur any financial obligation to the Investment Pool — i.e., in the event the MFC defaults on its IOUs held by the conduit entity, the latter is absolved of any direct financial liability to the City. Hence, any recourse by the Treasurer on behalf of the City would be limited to claims on the MFC that would be exercised via the conduit entity. Funds that could not be recovered from the MFC by the conduit entity

would be passed through as losses charged against the General Fund portion of the Investment Pool.[11]

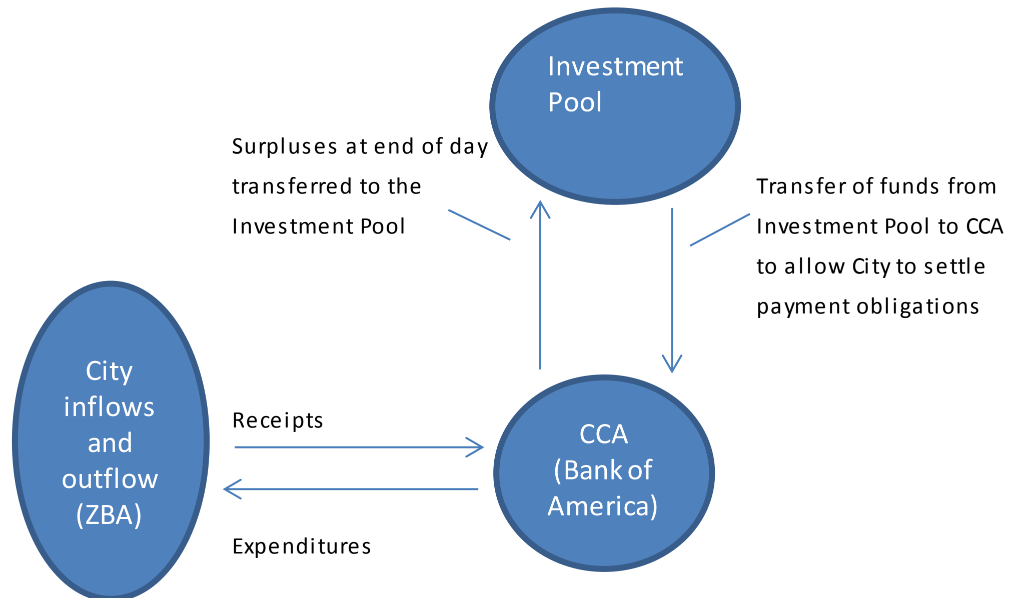
### Option 2: Using sweeping arrangements to re-direct funds to the non-depository MFC

Option 2 involves the creation of a funding mechanism that allows end-of-day balances in the City's Core Concentration Account (CCA — see Appendix D on the City's current depository banking arrangements) over the $130 million cap to be placed into a designated reserve in the Investment Pool subject to certain conditions being satisfied. The monies would be used to purchase equity or debt securities issued by the MFC, subject to a subsequent appropriation authorized by the Board of Supervisors.

Exhibit 7 shows a diagram of the current sweeping arrangements through which end-of-day surpluses in excess of the $130 million cap on the funds held overnight in the Core Concentration Account are swept into the Investment Pool and invested subject to the statutory provisions set out in California Government Code Section 53601(a)-(r). Alternatively, if a department needs to make a larger than normal payment — for instance, a bond repayment or a payroll disbursement — the Treasurer requires three days' notice, in order to sell assets from the Investment Pool and allow for the clearing and settlement of these trades, so that sufficient funds are available to allow the department to transact the required expenditure. In either case, at all times monies are held either as deposits in the Core Concentration Account, subject to the provisions of California Government Code Section 53651, or as surpluses in the Investment Pool, subject to the investment restrictions of Section 53601.

[11] We believe such provisions are allowable under Section 53601 of the California Government Code. Additional legal research would need to be conducted to determine whether inclusion of such covenants would limit the legal viability of this approach.

**Exhibit 7: Current sweeping of surplus monies into the Investment Pool**




CCA is "Core Concentration Account". Any end of day balances exceeding $100 mil are sweep into Investment Pool and invested in allowable assets as per CGC Section 53601. All funds in CCA are subject to collateralization provisions as set out in CGC Section 53651 and 53652.

As an alternative, the Board of Supervisors could modify the Administrative Code to require that all funds that are automatically transferred from the Core Concentration Account into the Investment Pool are placed into an MFC funding reserve once the maximum level of funds that may be placed into the General Reserve and the maximum amount of funds that may be placed into the Economic Stabilization Reserve and Budget Stabilization Reserve are met. Funds transferred to the MFC funding reserve will be available for investment in equity or debt issued by the MFC through an appropriation approved by a majority vote of the Board of Supervisors.

Once these funds are used to purchase MFC shares or debt securities, they would no longer be deposits of the City, and hence would no longer be subject to the collateralization requirements of Sections 53651 and 53652. Nor would these funds be within the Investment Pool, and hence their use would be fully exempted from the limitations of Section 53601(a)-(r). Moreover, these funds would no longer fall under the definition of “surplus,” as they would now be required to meet the immediate needs of the City, insofar as supporting the MFC is a Board- and voter-authorized policy priority.

### Should the City commit to using monies from the Investment Pool?

From the standpoint of funding the City-sponsored Municipal Financial Corporation’s lending programs and infrastructure investments, the singular overarching consideration regarding the design and construction of this institution is whether the City will commit

to the use of Investment Pool monies to fund the MFC's loan portfolio. We conclude there are several reasons why the Investment Pool is key to the success of an MFC for the City and County of San Francisco.

For one, we believe that the models presented in the Municipal Bank Feasibility Task Force Report will not attract funding at the projected levels. We do not believe there are grounds to assume private investors will buy market-rate Certificates of Deposit issued by a publicly owned depository bank projected to have annual losses stretching out over a time horizon of thirty years from the time of commencing operations. Similarly, we are concerned that the MFC would not find non-City ready buyers of its medium-term notes and other debt securities, which are the funding sources envisioned for the Task Force's non-depository institution (Model 1.0), and the blended variant (Model 3.0).

Second, the funding of the Task Force's Model 2.0 (depository MFC) through customer deposits and Certificates of Deposit could threaten to drain funding from local banks and credit unions. This would pose a major problem to implementation of either Model 2.0 or Model 3.0, which presumes the MFC has entered into partnerships with these institutions through a wholesale loan purchase program.

Third, the funding mechanisms proposed by the Task Force could evaporate in the context of a financial crisis. This is true for all the models proposed, which are vulnerable to large-scale funding runoff. Money market funding of any variety is highly unstable, as holders may demand cash redemption of debt securities when these notes come due. Nor is there any way to ensure demand for new debt issue. This could lead to severe liquidity problems, and, if prolonged, outright insolvency, as redemptions would need to be paid through a drawdown of the MFC's own equity.

Fourth, the means through which the Task Force report seeks to manage this source of funding volatility — matching the terms of assets and liabilities — while conforming to long-standing banking practice that seeks to match terms of assets and liabilities, rules out the long-term lending at subsidized rates that will be necessary if the MFC is to achieve a significant increase in the supply of long-term, permanently affordable, rent-controlled housing. As outlined in the Task Force report, the only real option for term matching under the assumption that the MFC is financed through the private money market is to issue short- to medium-term loans ("mezzanine debt") with terms that match the MFC's liabilities. As we show below, this form of lending, even under the most generous assumptions, will have very limited impacts in terms of increasing the supply of new affordable housing. In addition, it enforces the dependency of affordable housing production on investment decisions undertaken by private investors seeking the maximal rate of return on investment.

These problems all derive from the Task Force not considering use of funds in the City's Investment Pool to capitalize and/or fund the MFC. With this funding avenue ruled out, there are few options for creating a sufficiently large, stable, and low-cost funding base to support lending at the scale required to support a meaningful increase in local affordable housing investment. Without the Investment Pool, there is little alternative other than seeking to raise money through the issuance of debt on the private capital market. If the City adheres to this constraint, the primary means of providing funding to affordable housing and other social policy target investments is to pursue the option outlined in the Task Force report, namely for the MFC to provide subsidized credit to market-rate development, in return for which the City will be able to extract a small increase in project-specific affordable housing set-asides. Without considering use of the Investment Pool for a City-sponsored MFC, we do not believe the Board of Supervisors should move forward with an MFC as a means for increasing affordable housing investment, as the benefits are insufficient to justify the costs.

Any decision to use monies currently held in the Investment Pool contains risks. Moreover, California Government Code explicitly states that preservation of principal is an overarching consideration that is the responsibility of the agent that assumes fiduciary management of any municipality's surplus monies. This stipulation has been evoked by the Municipal Bank Feasibility Task Force to effectively rule out any discussion of whether the City could, in fact, engage in prudent financial management while using these funds to provide a stable source of long-term funding for a locally owned lending institution with a primary objective of increasing local investments in the area of affordable housing.[12]

The State Code specifies the low-risk, low-yield instruments in which Investment Pool monies can be invested. We believe our proposed approach would not violate these statutory requirements, and would allow the MFC to fulfill its policy objectives of providing low interest credit while remaining fully cognizant of its obligations to engage in prudent risk management to safeguard the City's funding commitment. We discuss these issues in depth in the sections "Risk Management" and "Issues related to the Use of the City's Investment Pool " below.

## IV. Establishing the MFC as a Depository Bank

As discussed above, we recommend that the City's MFC be established as a non-depository institution at least initially to minimize regulatory hurdles and costs and operational complexities associated with serving as the City's primary depository. If instead the City chooses to establish its MFC as a depository from the outset, we

[12] See Municipal Bank Feasibility Task Force Report, p. 35, footnote # 35

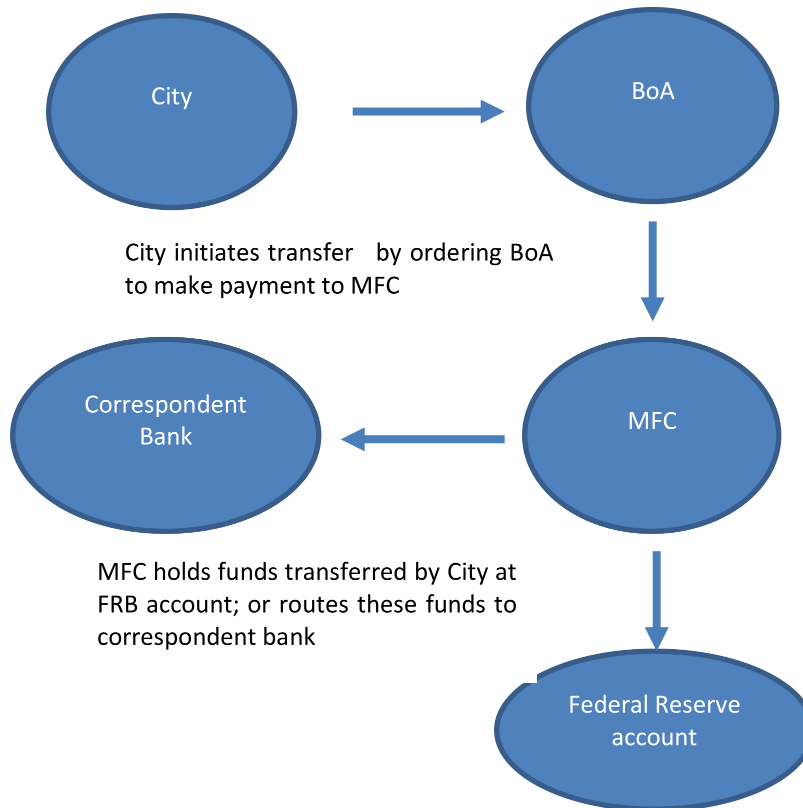
recommend that during the first five to ten years after commencing operations, the MFC operate on a very scaled-down depository model. The MFC would not seek to establish itself as a full-fledged depository bank but would instead conduct payment and settlements through a correspondent banking relationship.

The primary initial impetus behind establishing a state-chartered, FDIC-regulated depository institution is to allow the MFC to directly access funding through the Investment Pool, as authorized through Section 53601(r) of the California Government Code. Limiting the scope of the MFC's initial depository functions would be necessary to reduce the cost of operations to a minimum, and to allow the MFC to serve as a source of long-term, below-market-rate credit.

We here propose two funding mechanisms that would establish a limited depository component of a state-chartered, FDIC-regulated public banking institution. One, the City would set up a designated special purpose account held at the MFC and funded in an amount of $10 million, to be paid through the City's account with Bank of America (BofA).[13] These deposits would be fully collateralized in accordance with the requirements set out in California Government Code Section 53652. This account is primarily for the purpose of establishing the MFC as a public bank, chartered by the State of California and subject to FDIC regulatory oversight. The MFC would hold these funds on behalf of the City and would need to acquire the minimum complement of technologies and logistical capacities to access and clear payments through the major Federal Reserve clearing and settlement facilities. This can be accomplished with minimum initial outlay and will not involve extensive cash management if these deposits are largely held "on reserve" by the City. These mechanisms are outlined in diagram form in Exhibit 8.

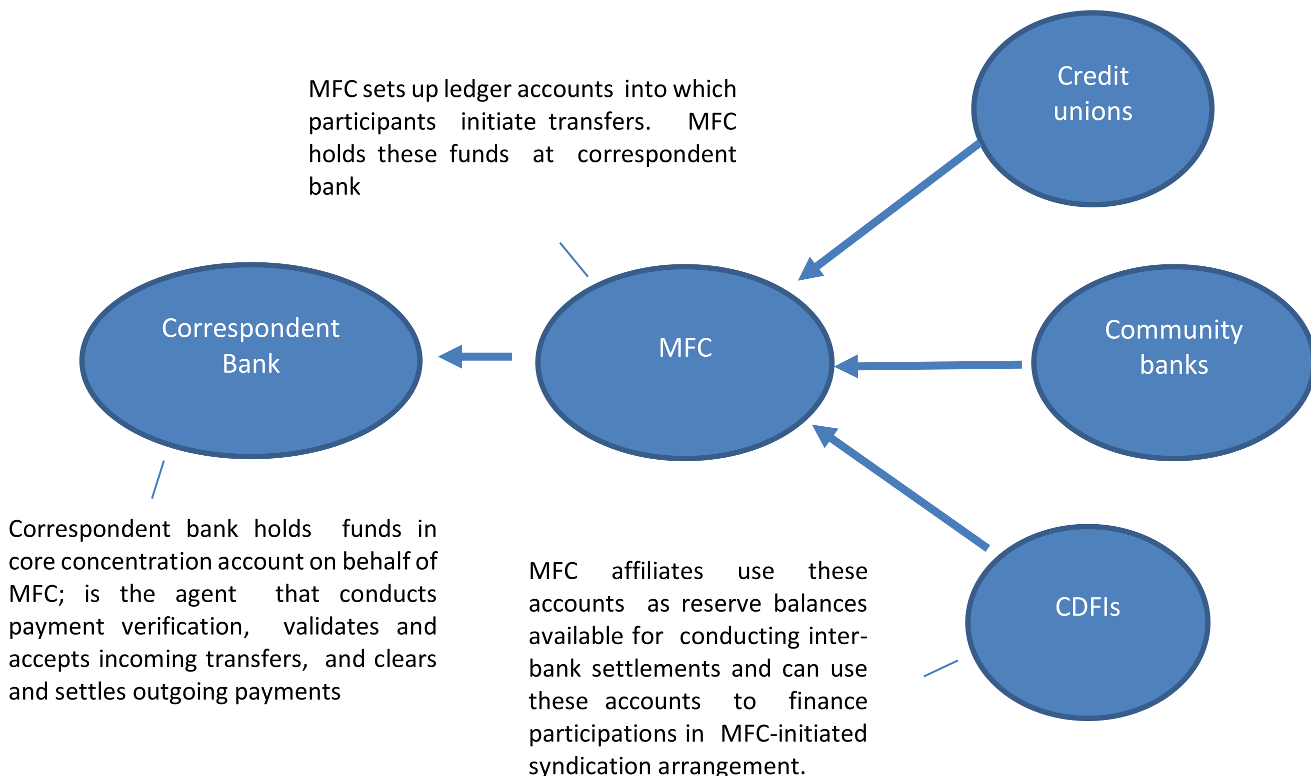
[13] The amount placed into this deposit by the City could be far less. The major objective of creating this account is to establish the MFC as a publicly owned depository bank, not to provide banking relationships to the City.

**Exhibit 8: Establishing the MFC depository**




Second, the MFC can set up accounts to accept deposits from the MFC's affiliated network of credit unions and community banks, as shown in Exhibit 8. Accounts at the MFC would be in the form of liquid reserve balances, available "on demand" for use by the depositing entities in conducting inter-bank settlements. For this reason, these deposits would need to be fully collateralized. To implement this option, the MFC would make extensive use of services provided through a correspondent banking relationship with a mission-aligned depository institution. The correspondent bank would serve as the MFC's custodial bank, receiving and holding funds on behalf of the MFC, and serving as the MFC's clearing and settlement agent. This implies a "layered' account structure. Credit unions and community banking partners would place funding into accounts at the MFC. The MFC holds these funds in the form of deposits at the correspondent bank, which in turn conducts actual transactions on behalf of the MFC and participating affiliates. In effect, the MFC would hold accounts on behalf of its community banking affiliates at the correspondent bank, with all funds pooled in a single core concentration account through which the correspondent bank clears and settles all incoming and outgoing payments.

**Exhibit 9: Reserve account funding provided through the MFC network of community-based lending affiliates**




Setting up a limited, special-purpose City deposit account, and the use of a correspondent banking relationship, would allow the MFC to qualify as a state-licensed depository bank, and to begin to provide banking-like services to a network of community affiliates, without having to undertake outlays on the full range of technologies and logistical capacities typically required to access the full suite of inter-bank payment and settlement systems.[14] Our proposed model has the additional benefit of allowing the MFC to institutionalize partnerships with local credit unions and community banks, which may increase funding placements and use these accounts to finance their participation in syndication arrangements.

Given the limits on the ability to use City deposits to fund the Municipal Financial Corporation's lending programs, and the cost and operational complexities associated with serving as the City's primary depository, we do not believe this should be the primary motivation behind the creation of a public bank. Rather, from the vantage point of providing loans and credit to support affordable housing and infrastructure development,

[14] These include the Federal Reserve operating Fedwire Fund payment mechanism, the ACH system, and the National Settlement Services, as well as full access to the various federally regulated securities clearinghouses through which banks conduct inter-bank transfers and settlement services – e.g., the DTCC Data Repository, the National Securities Clearing Corporation, and the Fixed Income Clearing Corporation.

the primary advantage of forming a depository institution is the ability to attract deposits. If the City MFC can attract a sufficient number of such deposits, this provides a stable, low-cost funding source separate and apart from the City's resources.

**Attracting deposits**

Given the small size of a City-sponsored MFC, the viability of using a depository bank to provide additional funding for affordable housing investment will depend on its ability to attract a sufficient level of deposits. While the MFC could in principle accept retail deposits from individuals and households, providing a full set of retail banking services is more costly, and would involve greater initial start-up costs and time to acquire the capital to provide such services, as compared to providing a set of targeted institutional banking services. In addition, accepting retail deposits could be perceived as a threat by credit unions and community banks. Hence, efforts to bring in deposits must be done in a manner that does not compete with, but enhances, the relative positions of the region's existing network of credit unions and community banks.

For this reason, we recommend that if the City chooses to establish a depository MFC at the outset, it should limit itself to providing depository, disbursement, treasury and cash management services, and short-term advances to institutional depositors — e.g., non-profits, unions, and philanthropic foundations. In addition, to protect the integrity of the funding base of credit unions and community banks, we recommend the MFC only accept transfers made by institutions that currently use depository and treasury management services provided by major banks.

### Accessing the local deposit market

It is difficult to develop estimates of the actual amount of funding that would be available for a municipally owned depository institution. The FDIC deposit market share report provides information on the total amount of deposit accounts held by all depository banks in the San Francisco market. As of June 30, 2018, the total amount of deposits held by the top six banks that were attributed to various branches within San Francisco totaled $181.45 billion. A majority of these deposits were reportedly held within these institutions' major downtown branches. For instance, of the total $92.3 billion reported as deposits held by Bank of America in San Francisco, $80 billion is assigned to the downtown business addresses. We believe these largely correspond to major corporate and commercial business accounts, the deposits of major financial firms and institutional investors, inter-bank claims, and deposits of branch and overseas affiliates. For Wells Fargo, the total reported deposits are $42.4 billion, of which $32.9 billion is reported as assigned to the major downtown branches. If we carry out this calculation for the top six banks by market share in San Francisco, the total funds reported in the retail branches is $50.9 billion.

A shift of 0.5 percent of total deposits from existing banks to the City's MFC would provide a $254 million fund base that could be re-lent. If the depository MFC were to attract an additional $50 million to $100 million from non-profit organizations, unions, and foundations that hold deposits in jurisdictions outside San Francisco, this would provide a $300 million deposit base. Whether these are reasonable estimates is impossible to determine without far more detailed research —which would involve interviews with actual institutions regarding their current banking business, and whether they would contemplate transferring their funds to a municipally owned depository bank.

We believe that attracting the level of funding identified above would require an extensive outreach campaign to inform these entities of the depository, disbursement, and treasury management services that could be provided via the depository MFC. Based on our review of the 990 forms for selected unions, foundations, and non-profits representative of institutional clients that could potentially be served by a depository MFC, it is not possible to determine whether these deposits are currently held in major banks.[15] We believe that attracting a $300 million total depository within five to seven years of commencing operations is a reasonable working assumption. The City could engage in a public education and outreach campaign to ensure widespread dissemination of information and encourage the movement of depositors as a way to support ethical investments; it is possible that our calculations would prove to be a conservative estimate.

## Cost of operations

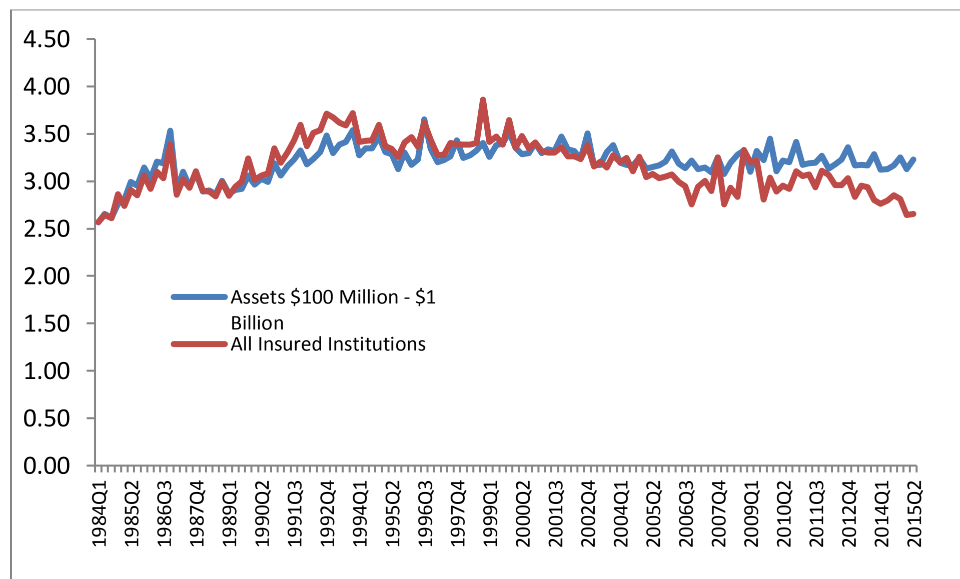
Acquiring the ability to serve as a full-scale public depository would have higher initial start-up costs than establishing a municipally owned depository bank that does not serve as the City's primary depository. However, the Municipal Bank Feasibility Task Force Report does not provide a justified or consistent cost estimation methodology. This is unfortunate, as in our opinion, the report appears to inflate the costs that would be associated with a publicly owned depository that does not provide banking services to the City — the type of limited-purpose depository that we believe should be contemplated if the City determines it is in the public interest to set up a municipally owned depository.

The Task Force report does not contain justification or a costing methodology other than the statement on page 79 that "costs were estimated using a variety of data sources and were vetted by numerous banking experts. However, there is no discussion of exactly what questions were posed to these experts and hence no way to asset the validity of the Task Force Report cost assertions.

[15] 990 forms are the federal tax filing documents submitted by tax-exempt non-profit organizations.

Some baseline for assessing the ongoing operational costs of a municipal financial corporation that does not serve as the City's primary public depository can be derived from historical data on operations costs of FDIC-insured banking institutions shown in Exhibit 10. Banks that hold between $100 million and $1 billion in total assets reported non-interest expenses (operating expenses) as a percentage of total assets of 3.14 percent in the last quarter of 2018. The Municipal Bank Feasibility Task Force Report projects operating costs on the order of 7.5 percent of assets. We do not find sufficient explanation in the Task Force report for its conclusion that the operating costs of a City-sponsored MFC, particularly if it is a depository institution (Models 2.0 and 3.0 in the Task Force report), would be so much higher than industry standards. We believe it is possible for a City-sponsored MFC — particularly one that does not offer retail banking services, but instead is limited to provision of depository and treasury management services to institutional customers — to be able to operate at lower cost.

**Exhibit 10: Non-interest expenses as % of total assets for FDIC-insured banking institutions**




Source: FDIC , https://banks.data.fdic.gov/explore/historical/

If the MFC is established with a primary goal of providing long-term financing to support new production and acquisition of affordable rental properties on the secondary (resale) market, a depository entity is not likely to be a significant funding source. The MFC would need to issue loans at rates lower than operating costs as a percentage of assets, and thus would need the public depository to provide very low-cost long-term credit that would fail to cover the depository's operating costs. Hence, the depository would need to seek out alternative lending conditions, such as participation loans and syndication arrangements that provide higher rates of interest. It will also require the depository to limit its funding sources primarily to non-interest-bearing demand deposits.

## V. A Phased-In Implementation Approach

The BLA approach to capitalizing and funding the lending operations of the MFC does not require the City to undertake a "one-time, all-in" financial commitment that cannot be reversed or scaled back in the event of unforeseen financial contingency, or if questions emerge regarding the MFC's capacity to achieve the policy goals of the City. Rather, in our proposed capitalization and funding model, a significant amount of the initially committed capital, including funding provided from the Investment Pool, can be "unwound" — reversed — if a decision is made to slow down or limit the growth rate of the MFC's operational scale.

We recommend the MFC founding ordinance include provisions requiring the City to conduct comprehensive performance reviews at years three and five from the time the MFC commences operations. The City may contract with an independent banking auditor to review the MFC's progress to that date in achieving stable rates of return, the viability of existing lending programs, adherence to prudent risk-management strategies, and development of partnership relationships with affiliated local community banks and credit unions. These assessments will determine the soundness and economic viability of the MFC and provide the City with the option to slow down the scaling of the MFC lending operations if desired results are not being achieved. This assessment process will provide additional safeguards that we believe will limit the risk incurred by the City, and will give the Board of Supervisors a series of threshold points that can be used to assess the MFC's economic viability and success in meeting the City's policy objectives. If the MFC meets the assessment's performance thresholds, we assume the balance sheet could be scaled as shown in our pro forma mock-up.

Exhibit 11 shows the amounts of capital and funding that could be recouped at each stage in the assessment process based on the funding committed from the Investment Pool to the MFC as well as loan growth projected in our pro forma mock-up of the MFC non-depository balance sheet. At both assessment points, the vast majority of monies that have been used to capitalize and fund the MFC could be liquidated, the conduit debt retired, and transformed back into USTR notes and other liquid securities held in the City 's Investment Pool account.

In year three from the time of commencing operations, the amount that would need to be retained in the MFC portfolio (loans outstanding plus required equity) would be $98 million. The balance of approximately $1 billion is available to be returned to the City. In year five, $1.114 billion in assets of the MFC would be available to be immediately liquidated, leaving $340 million in claims on the MFC still outstanding. Our approach thus provides a series of stop points at which the City can reduce it funding commitment.

**Exhibit 11: Unwinding City commitments at threshold assessment points, balance sheet recovery from MFC**

| Assets | Year 3 | Year 5 | Year 7 |
|---|---|---|---|
| **USTR (2.5%)** | $371,162,500 | $504,746,088 | $481,455,635 |
| **Municipal Bonds (3.5%)** | $750,000,000 | $750,000,000 | $500,000,000 |
| **Loans (2.75%)** | $40,000,000 | $200,000,000 | $850,000,000 |
| **Total Assets** | $1,161,162,500 | $1,454,746,088 | $1,831,455,635 |

| Liabilities | Year 3 | Year 5 | Year 7 |
|---|---|---|---|
| **Equity at assessment point** | $111,162,500 | $154,746,088 | $206,455,635 |
| **Funding through Supplemental Reserve Account (Investment Pool)** | $1,000,000,000 | $1,200,000,000 | $1,500,000,000 |
| **Funding though deposits and /or medium-term notes** | $50,000,000 | $100,000,000 | $125,000,000 |
| **Total liabilities** | $50,000,000 | $1,454,746,088 | $1,831,455,635 |

| | Year 3 | Year 5 | Year 7 |
|---|---|---|---|
| **Capital immediately available to be returned to the City** | $103,162,500 | $114,746,088 | $36,455,635 |
| **Total funding and capital recovery returned to Investment Pool**** | $1,115,162,500 | $1,224,746,088 | $853,955,635 |
| **Total funding committed from Investment Pool** | $1,020,000,000 | $1,220,000,000 | $1,520,000,000 |
| **Net gain/loss to Investment Pool (amount not available for immediate recovery)*** | $95,162,500 | $4,746,088 | -$666,044,365 |

* Negative values indicate funding commitments from the Investment Pool that are not available to be immediately returned to the City. These funds would be recovered as loans reach maturity and principal is returned to the City. Positive values refer to additional monies that could be paid back to the Investment Pool.
** Assumes USTR notes and Municipal Securities are sold at par value

## VI. Establishing a local lending network: loan syndications, participation lending, and credit enhancements

In the BLA model, the MFC would cultivate a network of affiliated institutions composed of local and regional credit unions, banks, and Community Development Financial Institutions (CDFIs), loan funds, and the like. The MFC would support the members of this network by entering into joint lending agreements through loan participations and MFC-

led syndications[16] and by using the MFC balance sheet, to provide credit guarantees to these partner institutions. The joint lending arrangements can be structured in ways that reduce the risks for participating institutions associated with these new loan originations and/or that provide refunding options if the MFC purchases existing loans directly from partner organizations. Lower risk weightings associated with these purchased loans would reduce regulatory capital, increasing the rate of return, and freeing up capital that can be leveraged to fund additional originations. If the MFC buys loans outright, participants in these refunding operations can earn underwriting fees that boost their total earnings. In return, participants in MFC-sponsored participations and syndications, and beneficiaries of risk-mitigation arrangements, would be expected to direct loans to projects and borrowers that meet the MFC's policy objectives. The partners would also be expected to make periodic contributions to the MFC in the form of equity investment in the MFC to institutionalize the mutual lending commitments necessary to establishing a local, community-oriented credit network that can meet certain social, economic, and environmental policy objectives.

*Loan participations* can take several forms. The most straightforward option is for the MFC to purchase loans originated by partner institutions outright, replenishing lenders' balance sheets with cash that can be used to fund new originations. Alternatively, the MFC can enter into a joint lending agreement, with each institution financing 50 percent of the total loan (for instance). The MFC can structure these participations on terms that achieve the MFC's social policy goals and objectives, and that give preferential risk considerations to affiliated lending institutions.

A *loan syndication* refers to a pooled lending arrangement in which a lead underwriter – the MFC in this case – works out the basic terms of a lending agreement – the loan term and interest rate, repayment schedule, covenants, loss provisions, credit guarantees provided to syndication participants, and terms of recourse in the event of borrower default. The MFC would then establish relationships with a number of its affiliates that would jointly provide the funding to support these pooled lending agreements.

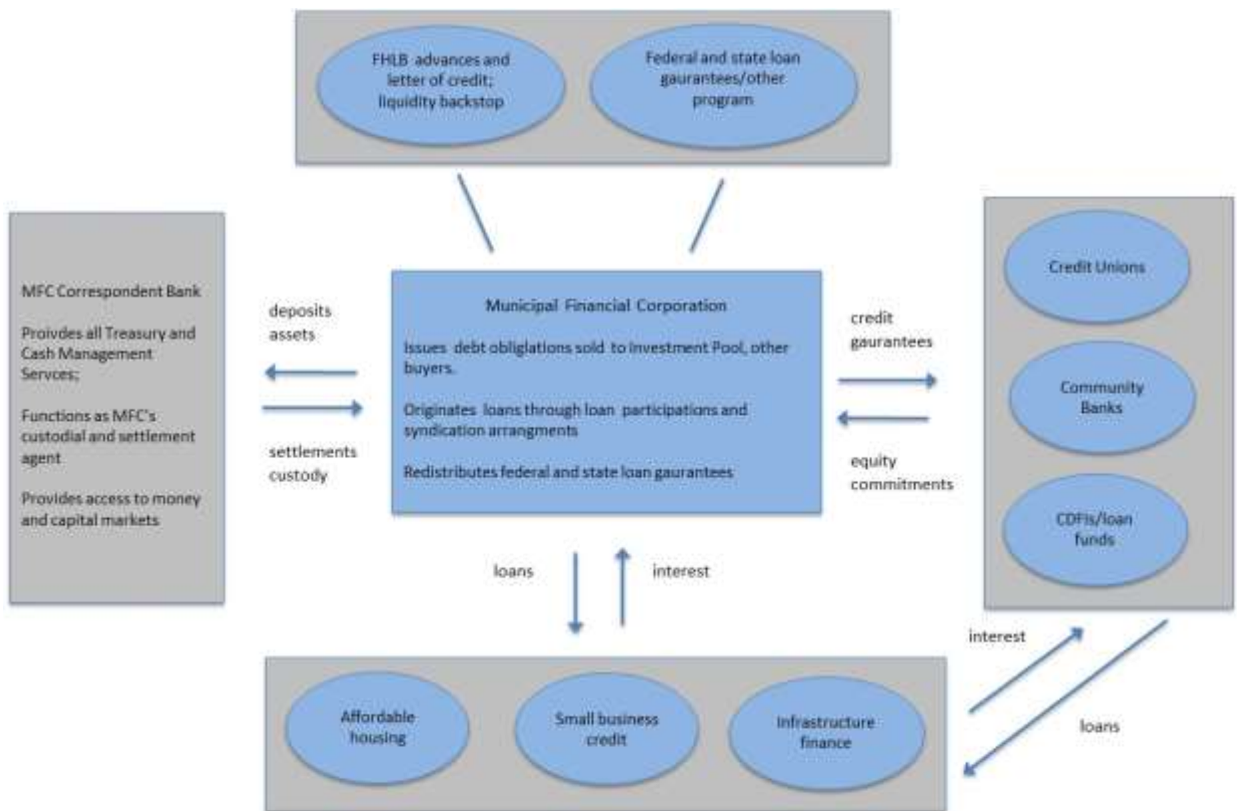
*Credit guarantees* entail the MFC committing to absorb some portion of losses on loans originated by network members. The MFC would provide such guarantees in return for a fee and could add additional restriction to insure that loans for which the MFC did offer such guarantees served to fulfill the MFC's core social, economic, and environmental objectives.

The basic structure of how the MFC (and potentially a special-purpose publicly owned depository bank in subsequent years) would be set up, along with the network of the MFC's various partnership relationships is shown in Exhibit 12. As discussed above, we

[16] A loan syndication involves group of lenders pooling their resources to finance loans, with one institution acting as the lead underwriter in working out terms and conditions of credits extended.

assume the MFC would be funded largely through reallocation of the assets held in the Investment Pool. The MFC could seek other funding sources, such as subsidized credits from mission-aligned foundations, pension funds, and socially responsible investment funds that seek to use their portfolios to support socially equitable and environmentally sustainable economic development, as well as funding from private capital markets through the issuance of medium-term notes, and, if incorporated as a depository bank, through time and savings deposits. However, these private market–based funding sources are likely to be more volatile and would generally mean funding must be procured by the MFC offering higher interest rates that would be available through funding commitments secured from the Investment Pool.

**Exhibit 12: MFC network of affiliated institutions**




As shown in Exhibit 12, the MFC should be seen less as a stand-alone, discreet entity, and more as the nexus of networked relations and the coordinating entity that convenes and maintains a series of partnership relations with other credit-granting entities. To the maximum extent possible, the MFC would originate loans in the context of loan participation and syndications, and through various credit enhancements that the MFC would provide to participants in these joint lending arrangements. In Exhibit 12, this is seen in the lower right area of the graphic: the MFC and its affiliated network of community lending partners jointly provide loans – through syndications and loan participation agreements – to support property acquisitions, origination of below-market-

rate mortgages, small-business loans, and infrastructure finance. Interest payments are apportioned in accordance with the participant's share of the total loan amount.

In the first stage of operation, the BLA model assumes that the MFC will enter into a correspondent banking partnership with a mission-aligned commercial bank that will serve as the MFC's primary banking agent, providing all cash and treasury management services, acting as the MFC's principal custodial agent, and handling the clearing and settlement of all incoming and outgoing payments. In our model, we envision the MFC becoming a member of the Federal Home Loan Bank (FHLB) to access the FHLB's collateralized advances, letters of credit, and swap agreements.[17] Membership in the FHLB, and access to FHLB advances would serve as a source of short-to-medium-term emergency refunding in periods of heightened market stress and potential funding runoffs, and is a critical factor in our overall model of risk mitigation and liquidity management.

Under what we believe are realistic assumptions, the combination of issuance of loans through participations and syndication networks, and the redirection of federal and state loan guarantees to support pooled funding commitments to small businesses provided by the MFC's network of community affiliates, will allow each dollar lent out or invested by the MFC to support the issuance of double this amount in total credit. A $1.25 billion loan portfolio of the MFC could potentially support the origination of upwards of $2.5 billion in total credit when loans originated by all partner financial institutions are included.

In addition, in our model, one of the primary functions of the MFC is to set up and maintain a wholesale loan distribution network. In addition, the MFC could, over time, establish a securitization platform. Establishing a securitization platform involves the MFC purchasing loans originated by its community affiliates, and issuing securities sold to investors supported bypass-through of cash flows generated by the underlying loan pools. The MFC could seek to sell loans originated by the MFC itself as well as by its network of lending affiliates. Buyers could include foundations, pension funds, and socially responsible investors willing to support the MFC's social and environmental policy objectives.

Because of the multiple options through which these various relationships could be structured, and the complexity of the MFC's lending operations, formation and maintenance of a wholesale distribution network, and, possibly, securitization platforms, we will not here attempt to model the various portfolios the MFC could potentially originate, both directly and through participations and joint funding commitments with

[17] Prior conversations with the FHLB have indicated they are open to an MFC being a member of the FHLB, and stated that the barrier, in the case of an MFC depository, is getting regulatory approval from the FDIC. We do not here discuss the role of the FHLB in detail; please see the report on municipal banking published by the Roosevelt Institute for further elaboration of this point. Available at https://rooseveltinstitute.org/municipal-bank-regulatory-compliance-capitalization-liquidity-and-risk/

its network affiliates. In our pro forma estimates, we assume that the Investment Pool is the major source of funding for the MFC loans and investments, and that that funding is provided long-term at minimum costs. This means the Investment Pool sacrifices direct earnings on alternative investments such as USTR notes and the IOUs of federal housing agencies (Fannie Mae and Freddie Mac). In return, the City realizes a far greater social, economic, and environmental return insofar as these funds are redirected back into local circuits of investment to support lending for affordable housing and targeted forms of economic development.

Our pro forma calculations assume that the MFC lends at an average rate of 2.65 percent. This is based on currently prevailing market rates, and the assumption that the MFC, due to the long-term stable funding commitment provided by the City's Investment Pool, is able to lend at 100–200 basis points (1 to 2 percent) below prevailing market rates in the current (pre-pandemic) interest-rate environment. We show that under these assumptions, our proposed operating model is able to generate returns roughly comparable to rates that prevail in the commercial banking sector, and support a lending institution with a very robust capital cushion, as is required to ensure the safety of the City's financial commitments.

The following sections describe the various participant arrangements, credit and loan loss protections, and refunding networks that would be central components of the MFC operational framework and which, if properly designed, will allow the MFC to maximize the impact of its own balance sheet.

**(A) Participation loans allowing each dollar contributed by the MFC to be augmented by funds contributed by other loan participants**

The MFC would organize and maintain a loan syndication network, or group of financial institutions pooling their resources, to expand the number and/or total volume of loans. This would allow multiple lenders – credit unions, local banks, and Community Development Financial Institutions (CDFIs) – to expand their affordable-housing commitments while pooling and redistributing credit risk amongst loan participants. As a result, the MFC could issue its portion of the loan at a slightly lower interest rate, reducing the cost of credit. This will, inter alia, reduce repayment risk and provide some insulation for the commitments of other loan participants. Alternatively, the MFC could, for projects assessed as having low default risk, enter into these partnerships as a provider of subordinated debt, which means the MFC's claim on any proceeds from liquidation of assets in the event of borrower default is subordinated to the claims of other participants. Similarly, the MFC would absorb the majority of losses in the event loans are restructured through reduction of principal and extension of the term of repayment. This will reduce the risk of the superordinate loan participants and could provide additional incentives to lenders to participate in these syndication arrangements.

In return, the affiliates involved in these participation arrangements would utilize some percentage of the profits realized on these loans to purchase shares issued by the MFC. This is necessary to avoid "moral hazard" that could develop if the MFC absorbs a greater share of project risk without requiring reciprocal commitments from the affiliated community lenders.

We envision the basic bi-party participation loan to involve an equal funding commitment by the MFC and the loan participant. Hence each dollar of lending provided by the MFC will secure loans of twice this amount.

(**B) Loan syndications with linked credit enhancements**

The MFC could also engage in partnership lending through loan syndications. For example, the MFC could work out the terms of a mortgage credit issued to finance property acquisitions for placement into a long-term affordable rental housing non-profit or land trust ownership arrangement, and then sell shares in this loan to members of the MFC's network of community affiliates. Depending on the terms of participation, this would allow the MFC to leverage its own funding commitment to secure a far greater volume of total pledged funding commitments.

To encourage participation, the MFC can provide credit guarantees to portions of the loans funded by participants in these syndication arrangements. For instance, the MFC could commit $50 million of its own funding to a syndication loan and invest an additional $50 million in a bond guarantee fund that would purchase USTR notes and municipal debts, which earn around 2.5 percent, on average, at present. Other participants could provide an additional $150 million of funding to the syndicate so that $200 million would be available to be lent out. To provide some guarantee of the participating members' funding commitments, the MFC would pledge to commit earnings from its bond fund investments (USTR notes and municipal bonds) to underwrite the earnings of the other syndication participants in the event borrowers that have secured loans through such pooled credit arrangements could not meet their repayment agreements. The MFC would restructure these loans over longer terms and at lower interest rates. To cover earnings losses of other participants, the MFC could commit to passing through interest earned on its bond fund to supplement lost earnings due to lowering of interest rates.

This mechanism is not the only alternative. Our more general point is that the MFC can structure these syndications to provide some protection and incentives to its network of affiliates to participate in these pooled funding arrangements. The trade-off is that syndication partners would be expected to offer loans at slightly lower than typical rates

**(C) Pooling and redistributed Federal and State loan guarantees**

The MFC could seek to acquire loan guarantees from the federal and state governments and redistribute these guarantees to loan syndication participants in a manner that would

provide effective protections to their funding commitments. This would allow the MFC to magnify the impact of its own balance sheet.

In this option, the MFC would seek a loan guarantee from the federal or state government. For instance, the MFC could potentially enter into an arrangement with the U.S. Small Business Administration (SBA) that would allow the MFC to secure a 75 percent loan guarantee on $10 million in small-business credit. Subject to an agreement with the federal government, the MFC could use this guarantee to cover up to 25 percent of potential losses on a $30 million pooled loan commitment – for instance, loans originated up to this amount would be guaranteed for members of the MFC-sponsored syndication network. The SBA loan guarantee would then be used, if needed, to cover losses of up to $7.5 million, with the actual distribution of this guarantee amongst the MFC and other pool participants according to the terms of the syndication underwriting agreements.

Similar programs could be available from state government. At the time of this writing, the California Infrastructure and Economic Development Bank has a program that will provide guarantees of up to 95 percent of loans originated through the Small Business Disaster Relief Loan Guarantee Program. Participating lenders can use these guarantees to cover the risks associated with small-business lending in the current pandemic, when there is a very high likelihood that a significant number of small business loans will enter into default. If the MFC was willing to absorb a certain amount of risk, these guarantees could be redistributed in the manner outlined above in order to support a proportionately greater level of lending originated through the MFC affiliate network.

**(D) Establishing a wholesale loan sale program and securitization platform**

One of the most high-impact initiatives the MFC could establish is a secondary distribution channel that would allow the MFC and its network of affiliated lenders to sell loans and use the proceeds to fund the issuance of additional credit. In the BLA model, a primary activity of the MFC would be the identification of potential buyers, and the development and maintenance of a sufficiently large pool of market participants. In a wholesale distribution market, the MFC would buy loans, as well as credit originated by the MFC itself, from its network of community affiliates and sell these loans “as is” to buyers such as mission-aligned foundations, pension funds, and socially responsible investors. Because these loans will need to meet certain policy goals and targeted objectives, many of them will be issued at below-market-rate interest. In addition, the MFC may provide certain credit guarantees using the mechanism discussed above (see B and C). To ensure sufficient uptake, the MFC will need to cultivate a large enough number of buyers so that no single investors will be required to commit a large portion of its balance sheet. Provided a sufficient number of buyers can be identified and cultivated, this refunding mechanism will allow the MFC and its affiliates to engage in the issuance of a far larger volume of total credit, and would provide local credit unions and community banks with a refunding mechanism that is simply not available at present.

There are various means through which the MFC can organize and manage these refunding channels. The most straightforward is simply to establish agreements with participants (investors) to buy loans originated by the MFC and its affiliated partners up to a certain amount, provided these loans meet certain conditions and qualifying terms and covenants.[18]

It is difficult to determine the eventual size and scale at which such a refunding conduit would eventually operate. Nor do we here wish to prescribe the types of loans that would be viable candidates for sale through these types of markets. However, we believe that these strategies could support a very large increase in lending capacity of the MFC and its network of community affiliates. We note that the amount of funds under management by CALPERS is around $400 billion. If CALPERS were to commit 1/100th of 1 percent of total funds under management to the purchase of loans whole from the MFC, this would support the sale of $40 million in total loans through the refunding network. Increasing this to 1/10th of one percent results in $400 million being available through this sole refunding conduit. U.S. pension plans currently have somewhere on the order of $16 trillion in total funds under management.[19] Reallocation of a mere 1/100th of 1 percent of this total would absorb $1.6 billion of loans from the balance sheet of the MFC and its community affiliates. [20]

Funds under management by large foundations are another source of potential investment. The Chronicle of Philanthropy reported that in 2019 U.S foundations total assets exceeded $1.0 trillion. Reallocation of 1/10th of 1 percent of these assets would absorb $1.0 billion of loans via a wholesale refunding conduit. The point is simply that there are vast pools of capital that could be tapped, and a primary function of the MFC would be to undertake the long-term cultivation of these types of wholesale distribution networks. Provided a sufficient number of buyers could be cultivated, during periods of economic growth and relative financial stability, it is not unreasonable to assume that these wholesale refunding conduits could absorb upwards of $250 million of loans on an annual basis.[21]

We also envision that, over time, the MFC could set up a securitization platform to provide an additional refunding mechanism for itself and for members of its affiliate network. Loans originated by the MFC and its network of affiliates would be pooled, and

[18] Alternatively, the MFC could set up a loan purchase fund, the proceeds of which would be invested in highly liquid interest-earning assets (USTR notes). When members of the MFC have loans to sell, the MFC would liquidate USTR notes and use the proceeds to take these loans from its affiliates' balance sheets. The MFC would be responsible for selling the loans, for which it will charge its affiliates fees to cover costs plus some margin of profit.

[19] https://data.oecd.org/pension/pension-funds-assets.htm

[20] See www.philanthropy.com/article/Foundation-Assets-Top-1/246975

[21] Wholesale refunding vehicles can close during a financial crisis or could evaporate if foundations sought higher returns on alternative assets.

participation certificates would be issued, supported by the pass-through of the underlying principal and interest payments. If properly managed, securitization would allow the MFC and its affiliates to issue loans, collect these loans into pools, and use the underlying cash flows to issue pass-through securities that can be sold to a network of buyers that support the MFC's core lending principles and social and environmental objectives. We will not discuss the issues surrounding formation of a securitization platform, which are significantly more complex than establishment of a wholesale loan distribution network. Creating this kind of conduit may at some point fall within the ambit of activities the MFC would contemplate in order to maximize the impact of its own balance sheet, and to support the issuance of an accordingly larger volume of total credit.

**(E) Secondary capital and equity injections**

One of the most high-impact strategies the MFC can implement is using its financial resources to inject equity, in the form of *secondary capital*, into the balance sheets of CDFI credit unions that are members of the MFC's affiliate network. Low-Income Credit Unions (LICUs), defined as credit unions with a majority of members at or below 80 percent of Area Medium Income, can issue secondary capital, which is a type of uninsured, fully subordinated, convertible debt. Because this debt is fully subordinated, the National Credit Union Administration (NCUA) allows LICUs to count these funds as equity in meeting regulatory capital requirements. LICUs issue what are, in fact, debt securities that have minimum maturities of five years (actual maturities can be of significantly longer duration). The MFC, as the holder of secondary capital debt issuances, would receive interest, and can demand full payment at maturity. Rates currently vary between 4 percent and 6 percent and will depend on overall market conditions at time of issue.

The impacts are potentially quite significant, given that LICUs' regulatory capital can be leveraged at ratios of approximately 8:1, or even higher for certain categories of loans and investments. The mechanism works through the impact of secondary capital on the liability side of a participating credit union's balance sheet – by issuing subordinated debt instruments, credit unions can directly increase the amount of deposits the issuing credit union can accept. These funds are then available to be re-lent. For example, if an LICU issues $1 million in uninsured, subordinated, convertible debt purchased by the MFC, the issuing credit union could take in $10 million in new deposits that may then be re-lent.

At the present time, the only designated LICU with a presence in San Francisco is Self-Help Federal Credit Union. This could limit the ability to support an increase in the supply of credit through secondary capital injections, given that Self-Help has a fairly small presence in the San Francisco market. However, this limitation could to some degree be mitigated through purchasing secondary capital issued by the parent entity of which the local Self-Help FCU is an affiliate. Provided the Self-Help FCU national office is willing to use these funds to increase lending to projects originated by the MFC such as multifamily property

acquisition loans and loans to local small business this would increase the lending capacity of the MFC's affiliate network.[22]

Similar strategies can be deployed to allow the MFC to inject capital into community development commercial banks. Capital provided to such banks will be primarily in the form of Tier II capital, which, similar to secondary capital provided to LICUs, is a form of uninsured, subordinated, convertible debt. The effect in this case would be more limited than in the case of secondary capital, as Tier II capital is subject to greater regulatory restrictions in terms of percentage of total capital held in this form that can be counted toward meeting FDIC capital requirements. Current regulatory policy distinguishes between various categories of capital that can meet FDIC requirements.

The core form of equity – Tier I common share capital – is counted as core capital for regulatory purposes, and must be maintained at 8 percent of total risk-weighted assets in order for a bank to be deemed "well capitalized" by the FDIC. Subordinated debt, by contrast, is classified as Tier II capital, and cannot be counted for more than 2.5% of total capital, nor can it be used to substitute for an insufficient Tier I capitalization ratio. Hence, the ability of a bank to leverage injections of Tier II capital is more limited than in the case of injection of equity into LICUs in the form of secondary capital. Nevertheless, this option can also be pursued, and is a further means though which the MFC can boost the lending capacities of the network of affiliated community lenders.

## VII. Risk Management

The core risk-management task is to ensure that funds committed to the purchase of the MFC's liabilities are insulated against losses. Any commitment of Investment Pool monies to financing the lending activities of the MFC will need to ensure that measures are taken to protect the City's surplus.

[22] The MFC will incur risks from these types of investments. The debt is uninsured and is fully subordinated in the event the issuers begin to experience significant losses. For this reason, the MFC is exposed to the credit unions' balance sheet losses. The MFC will thus be required to establish strict lending protocols and engage in periodic reviews of the lending policies, portfolio composition, overall capital ratios, and underwriting standards utilized by credit unions that are the recipients of MFC-provided secondary capital injections. This will ensure that the MFC does not acquire large exposure that can translate into major losses under high-stress market conditions. Credit unions that fail to adhere to established protocols and underwriting standards, or that are failing to manage overall balance sheets to control for and limit potential losses, will become ineligible for further equity injections until such deficiencies are corrected.

## Types of risk

Risk management is a complex topic. For present purposes, we will limit ourselves to discussing the three major types of risk that the MFC must be designed to effectively manage. These are: 1) credit risk, 2) interest risk due to maturity mismatch, and 3) rollover (refunding) risks. We here provide a brief description of each.

Credit risk

This refers to the risk that the MFC will incur losses if loans enter into default. For instance, major economic downturns, or overexposure to a particular sector such as the local housing and real estate markets, can result in the MFC beginning to incur higher than anticipated losses in the context of deteriorating local and national economic conditions.

This type of risk is particularly pertinent to the models we have proposed, which we assume will issue the majority of loans to support local infrastructure finance, small business lending, and affordable housing development. The MFC will have a high level of geographical concentration, given that the vast majority of its loans will likely be within the San Francisco market. It will also have a high concentration of loans related to property investment — i.e., housing, and public capital projects. Housing and real estate markets are highly cyclical, and San Francisco is no exception in this regard. It is possible, therefore, that properties acquired using long-term mortgage credits issued by the MFC could experience higher than budgeted vacancy rates, which could potentially impair their ability to maintain timely debt repayments. If these conditions worsen, at some point the property will enter into default.

Similar considerations pertain to small business credit. Some lenders informally report that a small business loan has a 3 percent probability of entering into default in each year from the time of origination. If the average term on small business loans in a lender's portfolio is five years, we would expect 15 percent of these loans to be in default on an annualized basis. While some of these loans could recover, the percentage that is past due, or the amount that must be written off outright, can go much higher during periods of economic contraction. This will require lenders to have made sufficient loan loss provisions in order to weather the downturns and absorb higher than anticipated rates of default.

Interest risk due to maturity mismatch

This refers to the risk attendant on issuing shorter-term liabilities to raise funds to invest in longer-term, often fixed-rate assets. Because shorter-term liabilities must be periodically refinanced — rolled over — at the then prevailing market rate of interest on equivalent types of debt, it is possible, in an environment characterized by rising interest

rates, for a lender to find the cost of servicing its liabilities exceeds the earnings of longer-term fixed-rate loans and investments.

Rollover (or refunding) risk

Rollover risk refers to the risk that a bank's creditors — i.e., the parties that have lent funds to the bank through the purchase of short- to medium-term liabilities (debt securities, short- to medium-term notes, and CDs, in the case of a depository bank) — will demand full cash redemption of the liabilities at the time they fall due for repayment. If the bank's creditors are unwilling to roll over these credit instruments at prevailing interest rates, the bank must be able to validate its debts through selling assets. If the bank does not have a sufficient inventory of highly liquid securities, the bank will enter into default, and become functionally illiquid. This type of risk is particularly prominent during periods of heightened stress or outright panic that characterize a banking and financial crisis.

Liquidity risk

Liquidity risk is used here to refer to a situation in which a bank could experience a sudden and unexpected funding runoff in the context of a banking and financial crisis. In addition to funding that would be lost if creditors demand cash redemption of maturing liabilities (see above), a bank could experience a large-scale drain of deposits if customers (depositors) find themselves needing to draw down account balances to make payments on liabilities that have come due for settlement. This is particularly the case in the event of a generalized financial and banking crisis, which may lead to a sudden and generalized demand for cash to serve as means of payment, and rapid funding runoffs that make banks and other financial entities unwilling to lend funds on a short-term basis.[23] To manage this risk, a bank must have a sufficient inventory of liquid short-term U.S. Treasury notes or a sufficient net positive balance in its reserve position at the central bank to ensure that it is effectively collateralized against any level of potential funding and deposit runoff.

Based on our assumption that the MFC will be funded in large part through the reallocation of funds from the Investment Pool and that the City is purchasing the IOUs of the MFC and agreeing to provide a long-term, low-cost, stable funding source, the earnings structure of the MFC will not be subject to extensive interest rate risk, as IOUs will be rolled over at low or minimal rates of interest. This effectively minimizes rollover and refunding risk. Provided the City does not need to begin to call in funds that have been committed to the MFC on a long-term basis, this effectively mitigates liquidity risk.

[23] This typically takes the form of the inter-bank wholesale capital market and the freezing of the repo markets, which are the means through which banks and other financial entities secure short-term advances.

Hence, the overarching type of risk that the MFC must manage is how to fully insulate the City funding commitments in the event the bank's loans begin to experience heavy losses. There are two strategies for how this can be achieved — assuming, of course, that the MFC has established a set of rigorous and consistent underwriting standards.

The first is to refinance distressed loans by lengthening the term, or repayment period. For instance, assume the MFC has issued a $15 million loan to finance a property purchase for placement into a community trust–type arrangement. At year five on a 30-year mortgage note, the property begins to experience a higher than anticipated vacancy rate that impairs the borrower's ability to make monthly mortgage payments. The MFC could refinance the loan at the same interest rate while lengthening the term of repayment. This lowers the borrower's monthly debt servicing costs and could render the loan viable without requiring the MFC to recognize any capital loss.

However, term restructuring to avoid outright write-down of loan principal may not be viable, depending on the level of distress being experienced by the borrower. Hence, the MFC could undergo periods when it will be required to recognize and absorb losses. Given the concentrated exposure of the MFC to the local property market, and the vicissitudes of the real estate cycle, losses could become significant in the context of a sharp regional, national, or a global economic downturn and banking crisis. Therefore, safeguarding funds committed from the Investment Pool will require the MFC to operate with a very high capital-to-asset ratio.

### The MFC capital-to-asset ratio will far exceed the level at which the FDIC defines a bank as "well capitalized."

In our pro forma mock-up example of the non-depository model, in year ten the MFC's assets consist of $1.250 billion in loans, $500 million in municipal bonds, and a residual balance of $161 million in short-term U.S. Treasury notes. Current risk-weighting methodologies utilized by the FDIC assign a risk weight of zero to deposits held at the Federal Reserve Bank and to USTR securities. Municipal bonds that represent the general obligations of the issuing government are weighted at 20 percent of nominal principal, while revenue bonds are weighted at 50 percent. Conventional real estate loans — home mortgages, and securities created from underlying loan pools that meet certain regulatory standards — are weighted at 50 to 100 percent, depending on whether the mortgage is first lien and meets other regulatory provisions and standards. A 50 percent risk weighting is assigned to multi-family mortgages. Other categories of real estate loans — termed High-Volatility Commercial Real Estate Exposures (HVCRE) — are assigned a 150 percent risk weight.

The FDIC defines a bank that has a capital-to-risk weighted asset ratio of 10 percent or greater as “well capitalized.” Exhibit 13 shows the risk-weighted portfolio of the mock-up MFC presented as Models 1 and 2 below, the non-depository and the limited scale depository models, respectively. In both cases, we have assigned the 150 percent risk weight to the MFC total loan portfolio, under the assumption that these loans are heavily concentrated in the MFC’s real estate portfolio. We also have assigned this risk weighting due to the non-conventional nature of these loans, which are issued at rates of interest well below those that would be available on the private market. Hence, our standard assumes maximum risk. We see that, in both cases, the MFC is well in excess of the capitalization levels required to receive the highest rating from the FDIC.

**Exhibit 13: Risk-weighted capital requirements**

| | MFC non-depository | | MFC limited scale special-purpose depository | |
|---|---|---|---|---|
| | **Unweighted** | **FDIC risk weighted** | **Unweighted** | **FDIC risk weighted** |
| USTR notes | $161 | $0 | $370 | $0 |
| Muni bonds* | $500 | $100 | $500 | $100 |
| Loans | $1,250 | $1,875 | $1,000 | $1,500 |
| Assets (total) | $1,911 | $1,975 | $1,870 | $1,600 |
| Equity | $286 | $286 | $237 | $237 |
| Capital/asset | 15.0% | 14.5% | 12.7% | 14.8% |

* Assumes municipal bonds are general obligation bonds

### Could the MFC withstand a prolonged period of heavy losses?

There are two basic measures of the ability of the MFC to withstand a period of heavy and extended losses. The first is the amount of loans that could be fully written off before all capital of the MFC is fully extinguished, at which point the MFC is fully insolvent. The second is the level of losses that could be absorbed before the MFC reaches the point of zero net earnings on total assets.

In the mock-up presented above, we have modeled the first ten years of the non-depository MFC’s operations, at which point the MFC has $1.911 billion in total assets. Of this total, $500 million is debt obligations of municipal and county governments, and $1.25 billion is loans, which we have assumed are primarily for undertaking housing investments. (We note that the loans could in fact consist of more diverse sectors and types of assets.) We have assumed the average rate of return on total assets is 2.6 percent, which is a conservative estimate. Annual operating costs of the MFC (non-depository) are set at approximately $15.6 million, which is sufficient to employ 25 FTEs in staff and cover all non-personal annual costs. Equity at year ten is equal to $286 million.

It is immediately evident that, with total assets of $1.911 billion, and an outstanding loan portfolio of $1.25 billion and capital equal to $286 million, the MFC could absorb a one-time loan charge-off of 7.57 percent of *total* assets and still have a capital ratio that would qualify it as "well capitalized" by FDIC standards.[24] We note that the MFC could absorb a full write-off of 22.88 percent of total loans before becoming insolvent. This level of loan losses is over four times the level of net losses absorbed by U.S. banks during the 2008 global financial panic, and is comparable to the net portfolio losses absorbed by U.S. banks over the full span of the 1929–1933 Great Depression, during which time bank portfolios shrank on average by around 25 percent.[25]

To provide a more nuanced assessment of the ability of the MFC funding and capital structure to withstand a period of very heavy losses, we consider two scenarios that reflect increasingly dire economic situations. Exhibit 14 shows our "Baseline" depression scenario. We assume that the portfolio structure in existence at the beginning of our catastrophic scenario is equivalent to the portfolio in existence at year ten of our core (non-depository) pro forma mock-up. We assume that an equivalent of 5 percent of loans outstanding at the beginning of the crisis, or $62,500,000 of total loans outstanding, default over the next three years. Hence, by the end of the period, 15 percent of the original loans held in the MFC loan portfolio have been fully written off and/or restructured in way that imposes an equivalent balance sheet loss.

We report returns on assets, returns on equity, and the capital/asset ratios over the three-year period of this level of assumed loan defaults, followed by the first year of return to profitability. As seen in Exhibit 14, net earnings turn negative, as loan losses are charged against income received from the balance of the MFC's performing assets. Losses that exceed net earnings are written off against MFC capital. Both the measures of the capital-to-asset ratios decline. However, the MFC remains above the threshold at which the FDIC defines a bank as "well capitalized". This is largely due to the high percentage of USTR notes and municipal bonds in the total asset portfolio, which we assume does not incur any losses in our baseline scenario. Beginning in year four, we assume the MFC has recognized and charged off in full the loan losses, at which point MFC net earnings once again turns positive.

[24] Given that the U.S. federal government is extremely unlikely to contemplate defaulting on its debt obligations, and the generally lower risk of default associated with the IOUs of state and municipal governments, the vast majority of write-down is likely to involve loan losses.

[25] These numbers are calculated by writing off in full some percentage of the loans in the MFC portfolio and charging these losses against capital. Given the assumption that, at year ten, the MFC has $1.25 billion in loans, and $286.4 million in equity, the MFC can absorb a full change off of 22.88 percent of loans before exhausting all capital.

**Exhibit 14: Risk model Baseline scenario**

| | Year 1 | Year 2 | Year 3 | Year 4 |
|---|---|---|---|---|
| **Annual losses** | -$62,500,000 | -$62,500,000 | -$62,500,000 | |
| **Net earnings** | -$35,134,711 | -$36,058,546 | -$37,013,402 | $24,499,705 |
| **Return on assets** | -1.81% | -1.89% | -1.98% | 1.34% |
| **Return on equity** | -11.22% | -12.97% | -15.30% | 11.95% |
| **Capital/Asset ratio (non-risk weighted)** | 16.16% | 14.61% | 12.96% | 11.20% |
| **Capital/Asset ratio (risk weighted)** | 16.65% | 15.55% | 14.29% | 12.81% |

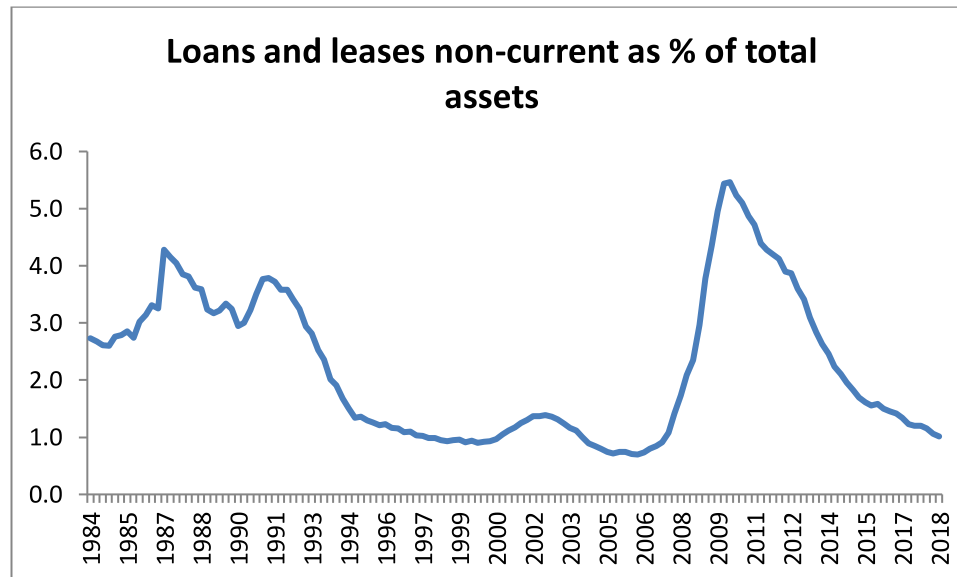
We have also constructed a pro forma mock-up of a "Great Depression scenario" shown in Exhibit 15. We assume loan losses are 8 percent of the total loans outstanding in each year over a three-year period. In addition, we assume that 5 percent of municipal bonds default in years one and two of this crisis scenario. Under these assumptions, the MFC loan and investment portfolio would lose 15 percent of total value. Massive write-offs impose a large-scale destruction of MFC equity capital. However, the MFC emerges as a solvent institution under this more extreme scenario, as the risk-weighted capital-to-asset ratio, while having fallen to very low levels, remains above zero at 2.38 percent. Due to the scale of the assumed losses that must be charged off against MFC capital, the rate of return at the end of the crisis is very high, as the earnings from the performing assets which continue to compose the bulk of the loan MFC portfolio, are calculated against a vastly reduced total net capital. This will allow the MFC to quickly rebuild the capital-to-asset ratio, provided earnings are capitalized and the MFC does not engage in new loan originations until the buffer is restored to an acceptable level.

**Exhibit 15: Risk model Great Depression Plus scenario**

| | Loan losses (8% of total outstanding at year 1: 5 percent default on muni bonds in year 1 and 2) | | | |
|---|---|---|---|---|
| | Year 1 | Year 2 | Year 3 | Year 4 |
| **Annual losses** | -$125,000,000 | -$115,750,000 | -$84,000,000 | |
| **Net earnings** | -$97,503,461 | -$98,605,264 | -$77,242,539 | $220,896,090 |
| **Return on assets** | -5.03% | -5.36% | -4.43% | 1.26% |
| **Return on equity** | -31.14% | -45.73% | -66.00% | 52.50% |
| **Capital/Asset ratio (non-risk weighted)** | 16.16% | 11.72% | 6.72% | 2.39% |

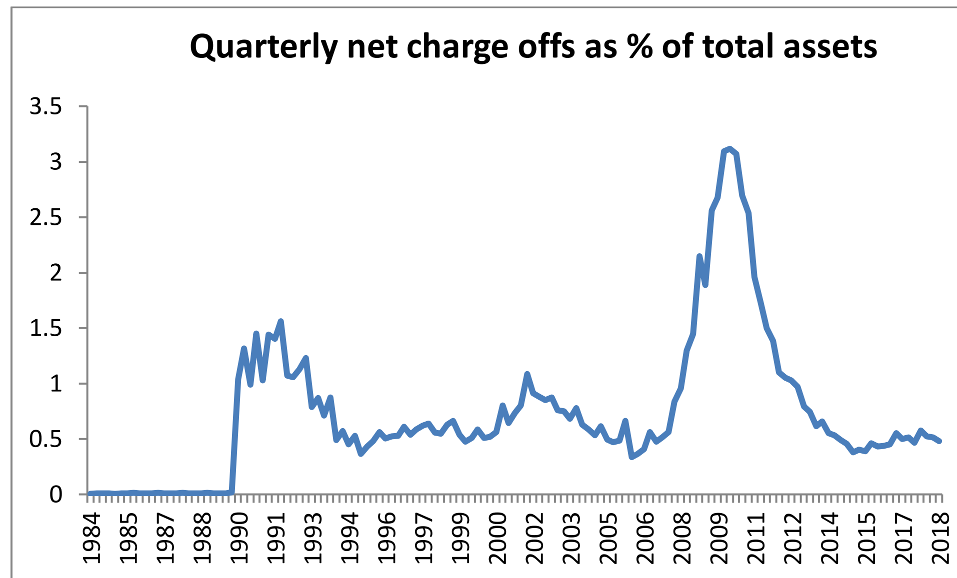
To put this in perspective, during the most recent Great Recession, the total reported loan and leases that were "non-current" — either 90 days past due or in non-accrual status — peaked at 5.46 percent in the third quarter of 2010, according to the FDIC Quarterly net charge-offs — the difference between gross charge-offs and any expected recovery — peaked at 3.1 percent of total assets in the first quarter of 2010. Our model could thus absorb losses significantly greater than those observed in the long aftermath of the 2008–2009 global banking crisis.

**Exhibit 16: Loans and leases, non-current, 1984–2018**




Source: FDIC, https://banks.data.fdic.gov/explore/historical/

**Exhibit 17: Quarterly net charge-offs, 1984–2018**




Source: FDIC, https://banks.data.fdic.gov/explore/historical/

In fact, due to the nature of the lending programs that would be conducted by the MFC, charge-offs of this magnitude would be very unlikely, even in the context of a major economic crisis. Loans can be restructured, primarily through extension of the term, to ease borrowers' repayment burdens while allowing the MFC to avoid having to impose write-downs of existing loan balances provided borrowers are able to meet the new repayment terms. Moreover, other risk mitigations can be included — for instance, triggers that will lead to temporary cessation of new lending activities if vacancy rates in the local rental market fall below certain thresholds. These precautionary measures, and maintenance of a large capital buffer, will mean a slower rate of growth of the MFC's total loan portfolio. These are the tradeoffs required in order to secure confidence in a novel funding model.

These extreme-case scenarios are useful in providing a "first cut" assessment of our model's ability to withstand an extreme economic downturn that could impose major losses on the MFC's loans and investment portfolio. Additional analysis will need to be conducted to develop a more complete analysis of various risk scenarios and the tradeoffs inherent in constructing an MFC that will be able to absorb major write-downs and charge-offs while protecting the funding commitment of the Investment Pool. This will need to involve running various "stress tests" to determine how the MFC will perform under a variety of market scenarios. Our model errs on the side of extreme caution and is designed to fully insulate the funds committed from the Investment Pool. For this reason, the rate of return on MFC core capital and the rate of growth of the MFC loan and investment portfolio are lower than would be the case in a somewhat less risk-averse, but still well capitalized, model. These various tradeoffs will need to be thoroughly reviewed

and vetted by our recommended Implementation Working Group in the course of developing a concrete business proposal.[26]

## Forming the MFC could affect the credit rating of the City

Using surplus City monies to finance the lending activities of the MFC could trigger a downgrade of the City's credit rating, even though none of the recommended funding structures would trigger a downgrade based on the methodologies that credit-rating agencies (CRAs) use in assigning credit ratings to the debt obligations of local governments.

The rating assignment process can have a chilling effect that acts to restrict the range of policy choices that may be pursued at all levels of government. On the basis of the CRAs' own published rating methodology, none of the proposed funding structures should trigger a rating downgrade. For instance, for a municipality to receive the highest ranking on the "Liquidity" and "Debt and Contingent Liabilities" score, Standard and Poor's requires the ratio of "Available Fund Balance" to expenditures to be equal to, or greater than, 15 percent; and the ratio of "Available Fund Balance" to debt service to be equal to, or greater than, 120 percent. Using data from 2018, total General Fund expenditures were approximately $10.1 billion. The General Fund–only portion of the Investment Pool was $4.963 billion. Maintaining the required Fund Balance-to-Expenditure ratio would require the City to maintain $1.515 billion in fully liquid short-term securities, accessible on short-term notice to cover any unanticipated financial contingencies. The City's anticipated General Fund–only annual debt service obligations over the next five years range from a high of $342 million in FY 2018-19 to a low of $224 million in FY 2022-23. To meet Standard & Poor's top rating criteria, the City would need to maintain $410 million in Available Fund Balance.

Similar results are found using the rating methodologies published by Moody's and Fitch. Moody's, for instance, requires an Available Fund Balance-to-Expenditure ratio of 25 percent, in order for a local government to be assigned the highest score on this portion of the overall determination of the credit rating. None of the funding mechanisms we have proposed bring the City anywhere close to thresholds that would trigger a rating downgrade based on the three major CRAs' published rating methodologies. Furthermore, the proposed legal form of the MFC — namely, incorporation as a legally independent corporation with its own Board of Directors charged with oversight of top

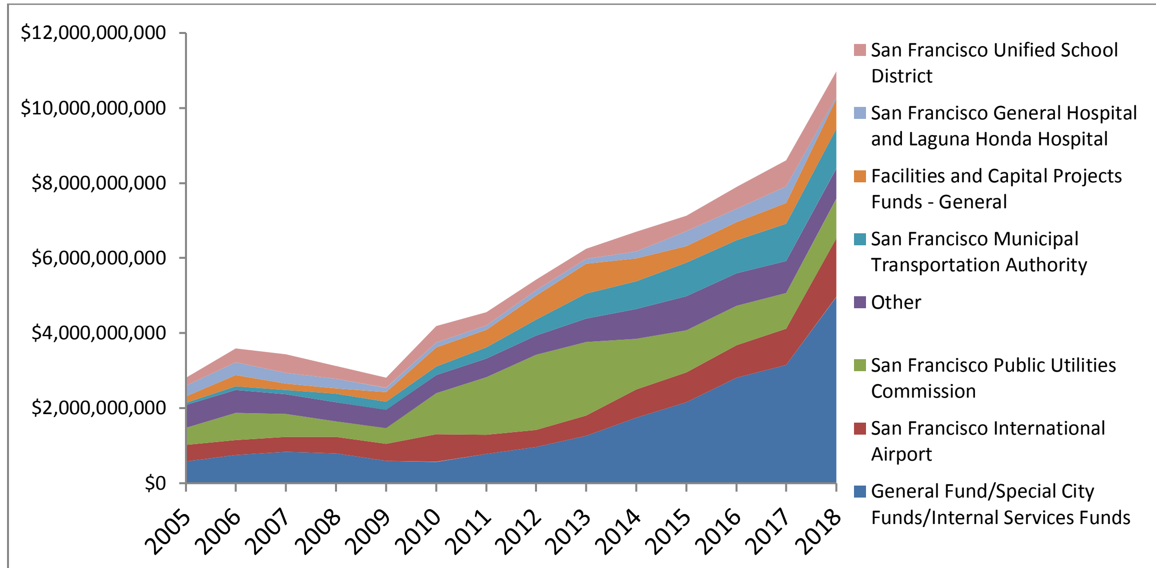
[26] There are a number of additional tools that the MFC can deploy to manage risk. For instance, limits could be set on the annual rate of growth of loans tied to particular classes of assets. And if borrowers begin to experience trouble with debt repayment, these stresses can often be mitigated through debt restructuring, in this case through refinancing to lengthen the time of repayment. Given the purpose and scope of the current report, we confine ourselves to the broad-brush assessment of the MFC's ability to withstand very heavy and sustained losses.

management — can easily be structured in a manner that ensures the City does not incur any additional financial liability beyond the potential loss of monies appropriated for purposes of capitalization and funding.

### Issues regarding the use if the City's Investment Pool as a source of long-term funding

California State law stipulates "funds not required for the immediate needs of the agency" may be invested in a set of designed securities and interest-bearing liabilities. (See California Government Code Section 53601.) The Treasurer currently serves as the fiduciary agent responsible for the safeguarding of surplus monies held and invested in the Investment Pool by City departments and local agencies. In addition to the accounts linked directly to the General Fund (which includes the General Fund balances proper, internal service funds, and the surpluses of "other major governmental funds"), other participants in the Investment Pool include the Airport, the Port of San Francisco, the Municipal Transportation Authority, the Public Utilities Commission, the Unified School District, and City College of San Francisco. Exhibit 18 shows the trend in the amount of funds held in the Investment Pool over the last fourteen-year period, broken down by the total cash surplus held by the various participants in the Investment Pool, and Exhibit 19 shows the total cash balances held in the Investment Pool as of June 2018, as reported by the Treasurer.

**Exhibit 18 Investment Pool cash balances, 2005 through 2018**




Source: Treasurer–Tax Collector

**Exhibit 19: San Francisco Investment Pool balances, 2018**

| Pool Participant | 2018 |
|---|---|
| General Fund/Special City Funds/Internal Services Funds | $4,962,817,250 |
| San Francisco International Airport | $1,562,100,022 |
| San Francisco Public Utilities Commission | $1,052,366,913 |
| Other | $810,056,492 |
| San Francisco Municipal Transportation Authority | $1,059,144,993 |
| Facilities and Capital Projects Funds - General | $795,697,979 |
| San Francisco General Hospital and Laguna Honda Hospital | $59,440,617 |
| San Francisco Unified School District | $675,023,186 |
| Total | $10,976,647,452 |

Source: Treasurer and Tax Collector

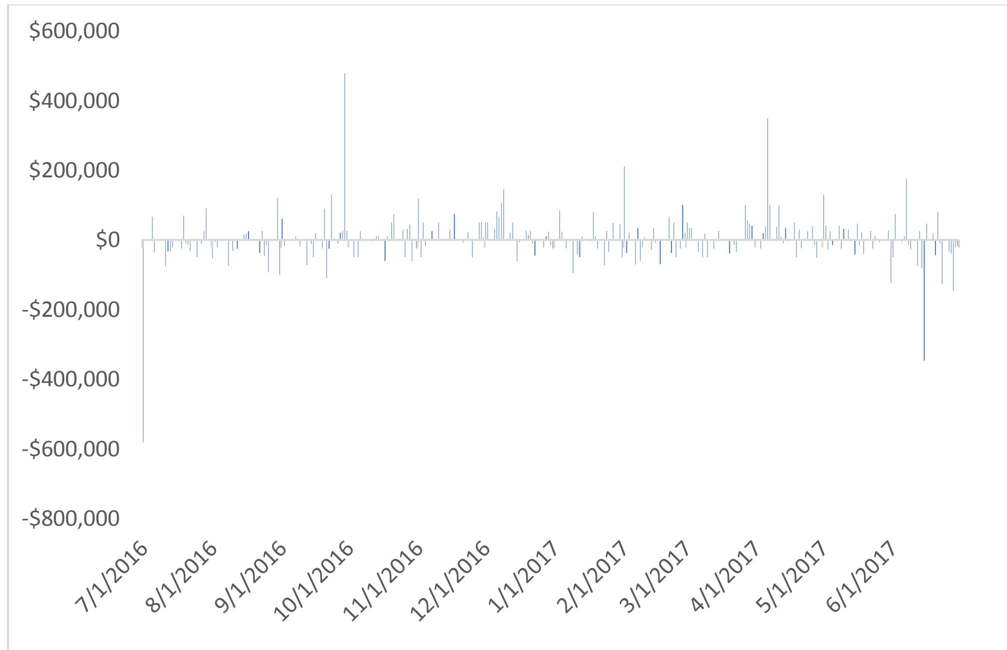
**Using funds in the Investment Pool to fund the MFC will not impair the ability of the Treasurer to meet any level of fund withdrawal by participants in the Pool**

Representatives of the Treasurer–Tax Collector's office have indicated that funds held in Treasury-managed investment accounts need to be kept liquid in order to meet any expected or unforeseen demand by pool participants for fund withdrawals. Participants in the Investment Pool have access to these funds on demand, and hence the Treasurer must ensure that a sufficient portion of these surplus monies is invested in highly liquid securities that have relatively stable secondary-market prices.

The liquidity requirements of the Investment Pool can be evaluated by calculating the ratio of the one-day change in the total funds invested in the Pool to the opening balance for all days in a given fiscal year. This ratio is an indicator of the daily variance and can be used to evaluate the actual level of daily inflows to, and withdrawals from, the Investment Pool as a percentage of total funds invested in the Pool. This variance measure will be positive on days in which there is a net inflow, and negative on days with net outflow. We can use this simple measure to determine both the average daily variances and the extreme values, or days characterized by particularly high withdrawals, to provide a picture of the actual amount of fully liquid investments that the Treasurer needs to hold as a percentage of all funds invested in the Pool.

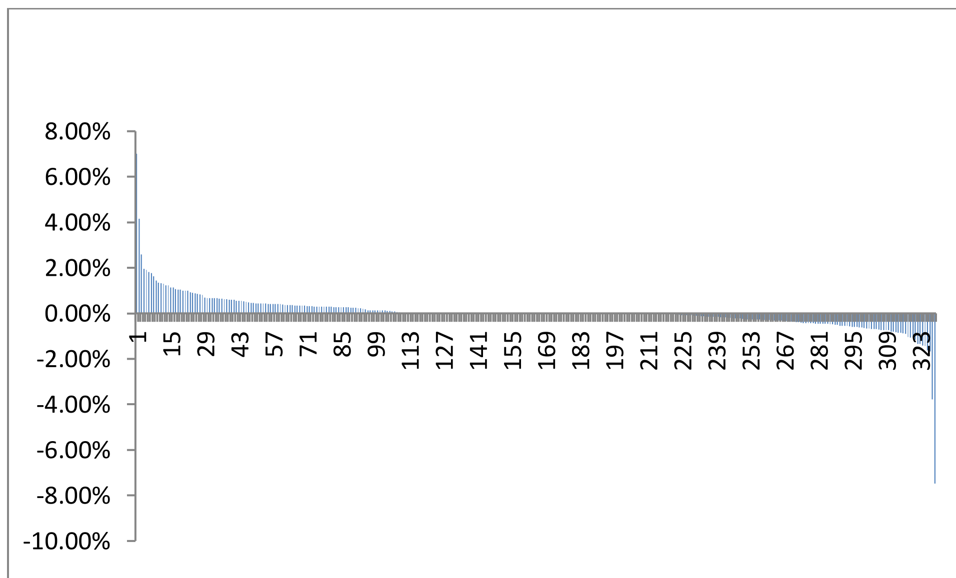
Exhibit 20 displays the net change in the amount of funds that were either deposited into or withdrawn from the Investment Pool for all participants in the Pool for FY 2016–2017. Exhibit 21 shows the difference in beginning and ending daily balances as a percentage of total opening daily fund balance. As can be seen, the largest one-day decrease (outflow) was on July 1, 2016, in the amount of $581,490,935. For all days in the fiscal year, withdrawals exceeding $100 million, which is 1.16 percent of the year-end fund balance, occurred on only six days out of a total of 329 days for which the Treasurer provided data. Of these six days, only two had withdrawals in amounts greater than $150 million.

**Exhibit 20: Daily Variance, FY 2016–17 – additions and withdrawals from Investment Pool, in $1,000s**




Source: Treasurer–Tax Collector

**Exhibit 21: Change as percent of opening Investment Pool daily balances, FY 2016–17**




Source: Treasurer–Tax Collector

The vast majority of days in FY 2016–17 reported either no change, or changes well below 1 percent of the opening fund balance. Data on actual daily withdrawals does not support claims that the cash needs of participants in the Investment Pool — the need to be able

to meet any short-term notification of immediate or impending cash withdrawal — negates the ability of the Treasurer to redirect a significant portion of total funds held in the Pool to provide the MFC with a source of stable, long-term, below-market-rate funding. There is no evidence supporting claims that the majority of the assets held in the Investment Pool must be available for immediate withdrawal. In fact, the overall balance of the Investment Pool is generally quite stable. All cash needs could have been meet in FY 2016–2017 with only 10 percent, or approximately $800 million, of the FY 2016–17 Investment Pool ending balance invested in the type of liquid securities — e.g., U.S. Treasury notes and the obligations of federal agencies — that are readily convertible into cash (bank money) on short-term notice. We conclude it is highly unlikely that the majority of funds held in the Pool would need to be available for withdrawal.

## Appendix A: Detailed Review of the Municipal Bank Feasibility Task Force Report

Pursuant to a resolution adopted by the Board of Supervisors on April 25, 2017, the Treasurer–Tax Collector assembled a Municipal Bank Feasibility Task Force, the purpose of which was to "advise the Treasurer…the Mayor, the Board of Supervisors and relevant City Departments regarding the creation of a Municipal Public Bank."

The Task Force Report presents three models intended to provide a basis for evaluating the economic feasibility of a municipal bank for the City and County of San Francisco. All three models envision an institution that manages around $1 billion in total assets. The models differ primarily in terms of their funding sources, the types of loans they originate, and whether they provide depository services to City government.

**Model 1.0** in the Task Force report is a non-depository variant. The entity is funded through debt securities (medium-term notes) issued on the private capital market. These funds would primarily be used to support housing-related investments.

The major type of loan this institution would issue would be "mezzanine debt."[27] This is a type of shorter-term debt commonly used by market-rate developers to supplement their equity financing, and generally carries a higher interest rate than long-term "permanent" financing. In the Task Force's Model 1.0, this mezzanine debt is provided to housing developers at below market rates. Though not explicitly stated, the assumption appears to be that, in return for receiving lower-cost mezzanine debt, for-profit developers would agree to provide larger affordable-housing set-asides. This Model 1.0 institution is the least costly option considered by the Task Force and is projected to become profitable ten years after commencing operations.

**Model 2.0** in the Municipal Bank Feasibility Task Force Report is a depository bank alternative that would serve as the City's primary depository, thus providing all banking services currently provided to the City under contract by Bank of America. Like a traditional private sector bank, Model 2.0 would be funded primarily through market-rate customer deposits — demand, savings, and time deposits (CDs). The funds from these deposits would be used to engage in the wholesale purchase of small business loans already originated and held by local credit unions and community banks.

The Task Force's Model 2.0 alternative assumes far higher operating costs than Model 1.0, due in part to the costs of serving as the City's primary banking agent. This model does not become profitable until approximately thirty years after commencing operation.

[27] As we explain below, the liability structure of Model 1.0 will severely limit the ability to originate longer-term acquisition loans, and hence will not be a major funding source for the City' small site acquisition program.

**Model 3.0**, the final Task Force alternative, is a hybrid of the first two alternatives, and does not become profitable until approximately sixty years after commencing operations.

Key conclusions based on our review of the Municipal Bank Feasibility Task Force Report and supporting materials are as follows:

- The Task Force Report assumes that the private market, and not the City, would purchase debt securities from the Model 1.0 non-depository institution or make deposits for the Model 2.0 depository in amounts necessary to fund lending operations. The Task Force Report does not provide an analysis of why they assume funding of $850 million will be accessible through placements on the private money and capital markets. Nor does the Report discuss the risks that would be associated with such a funding mechanism — in particular, risks incurred in the event of rising interest rates or a large scale funding runoff.

    - The Task Force Report states that all the monies in the City's Investment Pool are already designated for specific uses, and are not available for appropriation. This assertion is contradicted by statements in the Comprehensive Annual Financial Report regarding allowable uses of reserves, which are based on Generally Accepted Accounting Principles (GAAP), by provisions in Sec. 9.113 of the City Charter, and by Sections 3.26, 10.02, and 10.60 of the City Administrative Code.

    - The Task Force report does not discuss the option of creating a publicly owned depository bank that is not also a public depository. The result is to eliminate a wide range of possible depository models, including institutions with lower operating costs, from any serious consideration.

    - We believe the Task Force Report significantly overstates the costs of operating a depository institution. Our conclusions are based on: 1) comparison of the Task Force Report cost estimates with operating costs of other banks of comparable size and characteristics; 2) a detailed itemized cost analysis and comparison provided at our request by Amalgamated Bank;[28] and 3) our own review of the Task Force's cost estimation methodology, which we believe significantly overstates staffing needs and hence the cost of operations (see below)

    - The affordable housing loan portfolio in the Task Force's Model 1.0 non-depository institution would primarily consist of "mezzanine debt", which is a fairly high-risk form of debt frequently utilized by market-rate housing developers to bridge funding gaps

[28] Amalgamated Bank is a full-service socially responsible bank with assets of approximately $4.8 billion as of December 2018, according to its website.

between equity and senior secured debt.[29] Our analysis concludes that this financing option would fully finance approximately 35 additional units of affordable housing on a yearly basis beyond those that would be available under the City's current Inclusionary Housing arrangements. The total number of units produced by the financing provided by Task Force Model 1.0 could be higher by a factor of approximately 3X if these additional Inclusionary Housing set-asides are leveraged with other funding sources. However, we are doubtful the loan programs in the Task Force model would be fully subscribed on a consistent basis, as this would imply extraordinarily high levels of annual market rate housing construction on an ongoing basis. This is neither realistic, nor desirable from a social equity standpoint, as the model effectively reinforces the current pattern of market-lead gentrification and displacement.

- The Task Force Report states that lending for small site acquisitions is another housing-related program that could be funded using the credit facilities proposed in Model 1.0. Scaling up a housing acquisition program will require the MFC to of long-term, below-market-rate credit. This option will be severely curtailed if the MFC is financed through the issuance of market-rate debt.

- The Task Force Report states that loans for small site acquisitions originated by the non-depository variant (Model 1.0) could be made with maturities of up to 15 years. In our estimation, the funding models the Task Force has proposed would limit the ability of the MFC (Model 1.0) to hold a large share of its overall portfolio in the form of 15-year acquisition loans. Doing so would create a "maturity mismatch," due t the difference between the average maturity on funding liabilities and the average term on loans. This exposes Model 1.0 to potential losses in the event that liabilities must be refinanced (rolled over) at higher interest rates.[30] It also means the MFC would be exposed to funding runoff if investors holding claims on the MFC were to demand redemption of this debt in cash.

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[29] We base this conclusion on the fact that the real estate loan rates stated in the pro forma sheets are set at 5 percent. The Report states that lending for small site acquisition could take place at 4 percent. For reasons we discuss below, we do not believe such loans are viable for the TTX model from an economic standpoint, as most models with average rates on loans of 5 percent are operating at a loss at year ten. For this reasons, the majority of real estate loans would need to consist of mezzanine debt.

[30] Specifically, if the MFC has lent at 4 percent, and subsequently needs to roll over its own debt securities at a higher interest rate, this can erode earnings and result in negative net worth. This scenario drove the savings and loan crisis of the late 1970s and early 1980s. In addition, if creditors demand repayment and refuse to roll over maturity funding instruments, the MFC could find itself becoming functionally illiquid, even if earnings continue to exceed total cost. Many Special Purpose Investment Vehicles (SIVs) set up to invest in securities created from underlying pools of sub-prime mortgages experienced this scenario during the 2008–2009 banking crisis.

**The Task Force Report overstates the ongoing cost of operating a depository bank**

Appendix D of the Task Force Report provides low-end and high-end estimates of Headquarter (HQ) costs. The low-end annual operational cost is set at $50 million, while the high end is set at $75 million, or between 5 and 7.5 percent of assumed assets of $1 billion. We will here use the high-end estimates to illustrate why we have concluded the Task Force Report overstates operating costs of a depository bank. The underlying problems are the same, however, with either the low- or high-end estimate.

The Task Force assigns $6 million to the cost of retaining the core staff of 30 HQ employees hired during the start-up period at $200,000 per employee. The high-end cost estimates also assume the MFC will need to hire 187.5 additional employees, with 37.5 staff members employed in each of the five major lines of business: 1) deposits, 2) disbursement, 3) online payment processing, 4) IT and regulatory compliance, and 5) cash management. The Task Force Report assumes $1.5 million in annual costs related to compliance work, $1.5 million in occupancy costs, $3.75 million in ongoing costs of technology development, and $2.25 million in “other services.”

The model further assumes that the MFC will spend 20 percent of the initial IT start-up costs of $122.5 million (high end) on an annual basis for IT upgrading and maintenance, or $24.5 million per year. This would translate into 122.5 full-time equivalent positions (FTEs) if these services were provided in-house. The additional $3.75 million for “technology development” appears to be an independent IT-related expenditure over and above the 20 percent assumed to be ongoing, based on the initial IT start-up costs. In total, the Task Force cost assignments imply that if the MFC were procuring ongoing IT development and maintenance in-house, the depository variant would need to maintain an IT staff of approximately 178.75 FTEs. While contract IT costs don’t necessarily translate directly into employee unit costs, this appears to an extraordinarily high level of IT staff for a bank with $1 billion in total assets.

The Report does not specify whether some of these services will be procured on a contract basis. If we assume all of these costs are attributed to IT development, the high-end model assumes $33.75 million will be spent on an ongoing basis. This is equivalent to 3.37 percent of the $1 billion in total assets. The costs attributed to ongoing IT development as a percentage of total assets are higher than equal to the *entire* average operational costs of banks in the U.S. with roughly equivalent amounts of total assets under current management. The reader should note that our comparison banks typically maintain retail branch offices, and provide a full range of retail banking services. Given that, once the basic IT systems are in place, the City’s MFC would operate using a highly specific dedicated set of technologies, much of which is standardized. Asserting that the

MFC will need to spend the equivalent of hiring 168.75 full-time software engineers on an annual basis has not been adequately justified and are not consistent with industry standards.[31]

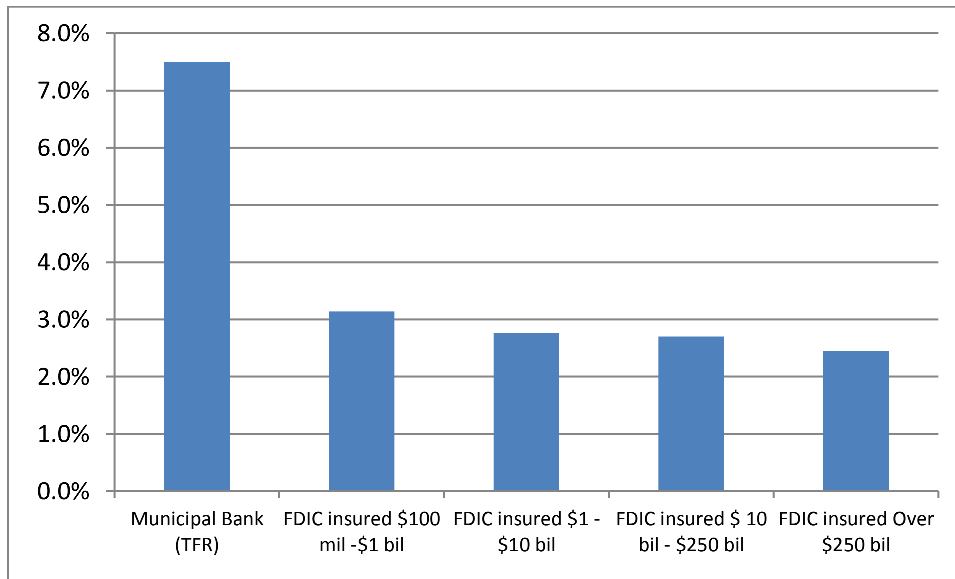
The Task Force Report assumes that 150 FTEs will be employed in cash management, regulatory compliance, underwriting, and monitoring of various department-level payment and disbursement accounts. This is a high staffing ratio for a bank that has approximately $1 billion in total assets, operates a limited set of lending platforms, does very little direct underwriting, will not provide any retail banking services, and is funded largely through the issue of standardized liabilities such as certificates of deposit. We have not been able to locate any explanation of why the Task Force Report assumes a largely automated system for shifting funds between zero balance accounts (ZBAs) and core concentration accounts linked to the disbursement systems would require the equivalent of 25 to 40 full-time employees to monitor these automated account transactions on an ongoing, daily basis. Similarly, there is no explanation of why the MFC would need 25 to 40 employees to oversee the process of on-line payments given that these functions are almost entirely automated at present.

Exactly analogous consideration applies to the depository line of business. We are skeptical that 25 to 40 full-time employees would be required to monitor incoming payments to the various department-level ZBA accounts. As noted, the ZBAs serve primarily as accounting ledgers that allow department staff and the Controller’s Office to track all income receipts and outgoing payments. Once the basic logistical infrastructure is in place, there should be little need to dedicate this level of staffing to monitor these automated clearing and settlement systems on an hour-by-hour or daily basis. Cost estimates provided to our office by Amalgamated Bank stated that these services could be provided with far lower levels of staffing than those that are assumed in the Task Force Report.

Exhibit 22 compares the estimated cost of operations presented in the Task Force Report with non-interest expenses for FDIC-regulated banks grouped by the total amount of assets. As shown, the Task Force’s high-end estimates are vastly out of line with prevailing industry standards. Institutions with assets between $1 billion and $10 billion have non-interest expenses that average 2.77 percent of total assets. By comparison, the Task Force Report assumes non-interest expense will be approximately 7.5 percent of total assets. The Task Force Report also lacks detailed itemization of the responsibilities of staff.

[31] We have no way of assessing the content of such discussions, the way the issues were framed, the questions that were asked, or how these conversations resulted in generation of the Task Force Report staffing and operational cost assessments.

**Exhibit 22: Non-interest expenses as percent of total assets, FDIC regulated banks**

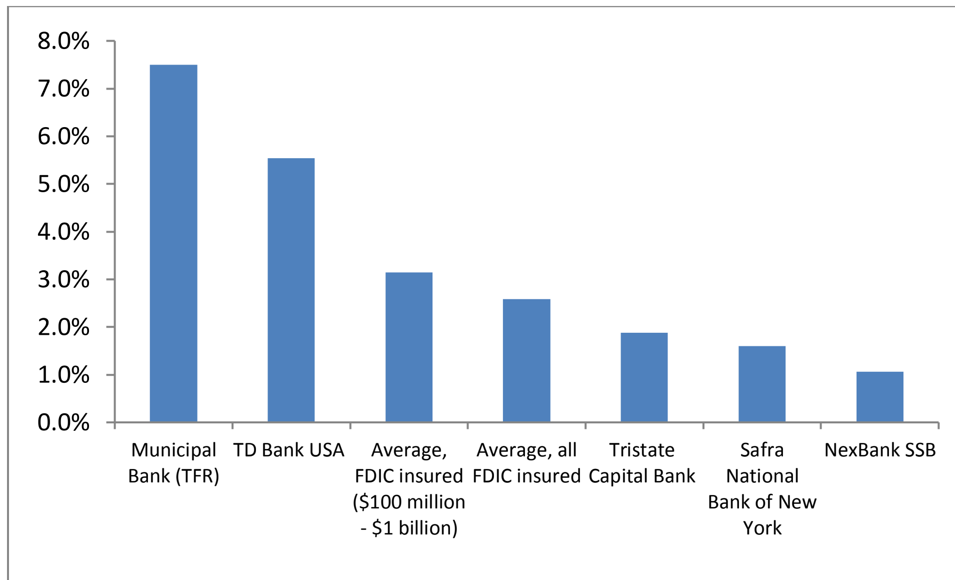



Source: FDIC, https://www7.fdic.gov/sdi/main.asp?formname=compare

Exhibit 23 shows a comparison of the estimates stated in the Task Force Report with selected banks having less than $50 billion in total assets that do not provide extensive retail-level branch banking services, in order to generate a more specific basis of cost comparison. At no point does the Task Force Report assume the City-sponsored MFC will operate as a retail branch-based banking institution. Hence, it is reasonable to surmise that the $850 million in deposits assumed in the Task Force Report for Model 2.0 will come largely from institutional depositors, and will all be managed at the MFC headquarters. To develop a "first cut" comparison, we have selected broadly comparable types of banking institutions — i.e., those that do not provided extensive retail services or maintain a network of retail branches, but are focused on providing banking services such as investment, cash management, and treasury management services to businesses and corporations whose loan portfolios consist largely of industrial and commercial lending, and that may conduct trading and investment management operations, engage in securitizations and derivative underwriting, and provide some international banking services and foreign exchange trading.

As can be seen in Exhibit 23, average non-interest expenses for all FDIC-insured institutions were 2.5 percent in 2018. And those with assets between $100 million and $1 billion were still well below the 7.2 percent ratio of operating costs relative to assets assumed by the Task Force for the Model 2.0 depository. Even the four financial institutions with characteristics most like Model 2.0 had lower operating costs than assumed for the City-sponsored institution.

**Exhibit 23: Non-interest expenses as percentage of total assets**




Source: FDIC Bank Call Reports

Finally, we have included a detailed, line-item breakdown of Amalgamated Bank's estimates of the amounts it would charge to provide the core range of equivalent services that the City currently receives from Bank of America. Amalgamated's cost of services is equivalent to, and in many cases lower than, the cost charged by the City's current depository bank. We note that Amalgamated could provide competitive services at its current size of $4 billion in total assets. This is greater than the projected size of the MFC in the Task Force Report, but far below the $2.325 trillion in total assets held by Bank of America.

It is outside the scope and competence of our office to provide a detailed assessment of the cost of forming and operating a depository bank. However, based on the above comparison with industry standards, we conclude that if the City were to opt to form a depository bank that did not also serve as the City's primary depository bank, the cost of operations would be far below those provided in the Task Force Report.

We agree with the Task Force Report that the initial start-up costs associated with forming a de novo public *depository* bank are likely to be prohibitive. The MFC depository will need to reach a size of around $4-5 billion in total assets before it would have the logistical capacity and internal economies of scale to assume the role of the City's primary depository bank. However, this number will need to be determined by an appropriately qualified team of banking experts. Scaling up a depository bank to assume responsibility for the full suite of banking services required by the City will be costly, and in our opinion should not be the primary motive to move forward with the formation of a depository bank.

## Appendix B: Why the Board of Supervisors can authorize an appropriation of funds from the Investment Pool for purposes of capitalization

The Task Force Report states that the Board of Supervisors cannot appropriate funds currently held in the Investment Pool for purposes of capitalizing an MFC. The report states that all monies in the Investment Pool are already designated for specific uses, and are not available for appropriation. We do not concur, based on statements in the City's Comprehensive Annual Financial Report (CAFR) that are derived from Generally Accepted Accounting Principles (GAAP), as well as the statutory provisions of Sec. 9.113 of the City Charter, and Secs. 3.26, 10.02, and 10.60 of the City Administrative Code.

Funds in the Investment Pool can be removed from the Investment Pool and used for purposes approved by the governing authority of the Investment Pool participants. Subject to verification by the Controller that any such appropriation will not impair the ability of the City to meet all authorized budgeted expenditures for the *current* fiscal year, the Board of Supervisors has the power to appropriate any fund balances reported as "unassigned" in the Investment Pool, as these funds have not been allocated as part of the Board-approved Annual Appropriation Ordinance, and are not otherwise encumbered by voter-authorized set-asides.

As shown in Exhibit 24, the total General Fund balance reported in the 2019 Comprehensive Annual Financial Report (CAFR) as of June 30, 2019, was $2,817,270,000. Of this total, $1,686,776,000 was reported "Not available for appropriations", of which $351,466,000 was shown as encumbered, $496,846,000 committed to carryforward, and $721,737,000 designated as Rainy Day funds and budget stabilization, and $116,727,000 for various other assignments. The remaining balance of $1,130,494,000 was reported as "available for appropriation." Of this subtotal, $186,913,000 was assigned for legal contingencies, $210,638,000 was assigned to appropriations as part of the General Fund for use in FY 2019–20, and is budgeted to cover authorized expenditures for FY 2020-21. The remaining balance of $732,943,000 is "unassigned," and consists of $130,894,000 in General Reserve," $285,152,000 in "Unassigned — Budgeted for use in fiscal year 2019–20," $308,000,000 in "Reserved for other Contingencies," and $8,897,000 designated as "Available for future appropriations."

**Exhibit 24: Fund balance of the General Fund, June 30, 2019**

The fund balance of the General Fund as of June 30, 2019, on a Budget basis is reconciled to the fund balance on a GAAP basis as follows:

| | |
|---|---|
| Fund Balance - Budget Basis | $ 2,817,270 |
| Unrealized Gains/ (Losses) on Investments | 16,275 |
| Cumulative Excess Property Tax Revenues Recognized on a Budget Basis | (23,793) |
| Cumulative Excess Health, Human Services, Franchise and Other Revenues Recognized on a Budget Basis | (87,794) |
| Pre-paid lease revenue | (6,194) |
| Nonspendable Fund Balance (Not Available for Appropriation) | 1,259 |
| Fund Balance - GAAP basis | $ 2,717,023 |

General Fund budget basis fund balance as of June 30, 2019 is composed of the following:

| | | |
|---|---|---|
| Not available for appropriations: | | |
| Restricted Fund Balance: | | |
| Rainy Day - Economic Stabilization Reserve | $ 229,069 | |
| Rainy Day - One Time Spending Account | 95,908 | |
| Committed Fund Balance: | | |
| Budget Stabilization Reserve | 396,760 | |
| Recreation and Parks Expenditure Saving Reserve | 803 | |
| Assigned for Encumbrances | 351,446 | |
| Assigned for Appropriation Carryforward | 496,846 | |
| Assigned for Subsequent Years' Budgets: | | |
| Budget Savings Incentive Program City-wide | 86,979 | |
| Salaries and benefits costs (MOU) | 28,965 | |
| Subtotal | | $ 1,686,776 |
| Available for appropriations: | | |
| Assigned for Litigation and Contingences | 186,913 | |
| Assigned balance subsequently appropriated as part of the General Fund budget for use in fiscal year 2019-20 | 210,638 | |
| Unassigned - General Reserve | 130,894 | |
| Unassigned - Budget for use in fiscal year 2020-21 | 285,152 | |
| Unassigned - Reserve for Other Contingencies | 308,000 | |
| Unassigned - Available for future appropriations | 8,897 | |
| Subtotal | | 1,130,494 |
| Fund Balance, June 30, 2019 - Budget basis | | $ 2,817,270 |

Source: San Francisco Comprehensive Annual Financial Report

In addition, the City has $2,538,400,000 in fund balances held in the Investment Pool by various special revenue, debt service, and capital project funds. These monies are the cash surpluses that exceed levels required to meet current payment obligations of the departments. These funds are not available for appropriation, and hence could not be used for MFC capitalization purposes.

The use of *all* unassigned funds, or the full amount of $1,130,494,000, falls within the Board of Supervisors' discretion. No state-level statutory limitations imply any preemption of the ability of the Board of Supervisors, as the City's ultimate fiduciary agent, to appropriate these funds for any

purpose, provided such appropriations conform to state and local laws. Nor does transfer of fiduciary responsibility over the Investment Pool to the Treasurer suspend the Board's authority over the appropriation of the unassigned fund balances for purposes that conform to allowable uses.[32] If the Board of Supervisors determines it is in the interests of the City, and the general social welfare, to incorporate and capitalize a public lending institution, the Board has the discretion to authorize the appropriation of some, or all, of the unassigned fund balances, subject to the provisions of the City Charter, Section 9.113(d).

Our assertion of this point is fully backed by statements in the CAFR based on Generally Accepted Accounting Principles (GAAP), Section 9.113(a)-(g) of the City Charter, and Section 10.60 of the City Administrative Code.

The statement pertaining to uses and limits of General Fund monies designated as "unassigned" in the June 2019 Comprehensive Annual Financial Report, on page 46, reads as follows:

> Unassigned — is the residual classification for the General Fund and includes all amounts not contained in the other classifications. *Unassigned amounts are technically available for any purpose.* Other governmental funds [i.e., special purpose funds, internal service funds, and other fund participants] may only report a negative fund balance that was created after classification in one of the other four fund balance categories [our italics].

This definition of "unassigned fund balances," based on Generally Accepted Accounting Principles, affirms that unassigned monies have no prior or specific encumbrance or stipulation that implies preemptive restriction on subsequent appropriations.

The Board of Supervisors' discretion over unassigned fund balances is supported by Section 9.113 of the City Charter, which states that surplus fund balances that are not encumbered by any of the purposes stipulated in Section 9.113(a) of the Charter are transferred to the General Fund at the close of each fiscal year by the Controller. Section 9.113(a) of the Charter states:

> (a) Unused and unencumbered appropriations or unencumbered balances existing at the close of any fiscal year in revenue or expense appropriations of the City and County for any such fiscal year, but exclusive of revenue or money required by law to be held in school, bond, bond

[32] The official position issued by the City Attorney is that the City has the statutory authority to incorporate, fund, and operate a publicly owned lending institution. An independent legal review conducted by the law firm Arent Fox has reached similar conclusions. Neither of these legal reviews has identified any ostensible restrictions on appropriations of unassigned fund balances for the purpose of capitalization of a municipally owned lending institution. Further, existing case law allows such uses for purposes such as supporting affordable housing, investments to reduce greenhouse gas emissions, and targeted economic development initiatives, which are well established as social, economic, and environmental objectives deemed to fall under the purview of local governments.

> interest, bond redemption, pension, trust, utility or other specific funds, or to be devoted exclusively to specified purposes other than biennial appropriations, and together with revenues collected or accruing from any source during such fiscal year, in excess of the estimated revenue from such source as shown by the biennial budget and the appropriation ordinance for such fiscal year, shall be transferred by the Controller, at the closing of such fiscal year, to the General Fund.

The Board may authorize an appropriation by a two-thirds vote (8–3 in favor). Any appropriation of these monies must be certified by the Controller on the basis of the Controller's determination that the proposed appropriation will not impair the ability of the City to meet expenditures already incurred under the annual budgetary authorization, Section 9.113(d).[33]

Finally, our interpretation does not involve any violation of the provisions of the Administrative Code, Sections 3.26, 10.02, 10.06, 10.07, or 10.60. The most pertinent sections of the Administrative Code are Sections 10.02 and 10.60. Section 10.02 outlines the statutory provisions that regulate the use of such monies for any lawful purposes, largely identical in substance to the language of Section 9.113(d) of the City Charter:

> Unused and unencumbered appropriations or unencumbered balances existing at the close of any fiscal year in revenue or expense appropriations of the City and County for any such fiscal year…shall be held as surplus.
>
> Such surplus shall be taken into account as revenue of the ensuing fiscal year; *provided, however, that any such surplus created or existing in any fiscal year may be appropriated by the Board of Supervisors by means of an ordinance designated as a supplemental appropriation ordinance, in the same manner and subject to the same conditions, except time, as provided in the Charter for the submission and approval of the annual budget and the appropriation ordinance* [our italics].

Section 10.02 refers to the funds reported on the CAFR as "Unassigned — available for appropriation"; these are part of the surplus monies that are subject to a supplemental appropriation ordinance. As stated in the Charter, Section 9.113(d), and as reiterated in the Administrative Code, the Controller determines that such appropriation will not endanger or otherwise compromise the ability of the City to carry out and conduct the fiscal commitments already approved as part of annual budgetary process.

[33] Section 9.113(d) states: "No ordinance or resolution for the expenditure of money, except the biennial appropriation ordinance, shall be passed by the Board of Supervisors unless the Controller first certifies to the Board that there is a sufficient unencumbered balance in a fund that may legally be used for such proposed expenditure, and that, in the judgment of the Controller, revenues as anticipated in the appropriation ordinance for such budgetary cycle and properly applicable to meet such proposed expenditures will be available in the treasury in sufficient amount to meet the same as it becomes due".

Finally, the other directly relevant provision of the Administrative Code is Section 10.60(b), which outlines the policies and procedures that regulate the uses of the "General Reserve." As seen in Exhibit 24, these are far more narrow, as this section pertains only to the sub-portion of the total cash reserve designated as "Unassigned — available for appropriation," which, as already noted, requires any designated usage to be approved by the Controller's office. The language of Section 10.60(b) reads:

> In addition to the Rainy Day Reserve, the City budget shall include a General Reserve. The General Reserve is intended to address revenue weaknesses, expenditure overages, or other programmatic goals not anticipated during the annual budget process. The Mayor and the Board of Supervisors may, at any time following adoption of the annual budget, appropriate monies from the General Reserve for any lawful governmental purpose through passage of a supplemental appropriation ordinance.

We believe the Administrative Code may be interpreted as implying that the $106,878,000 reported as "General Reserve" does not require prior approval or authorization by the Controller, and hence is available for "any lawful governmental purposes through passage of a supplemental appropriations ordinance."[34] However, even if the City Attorney were to determine that such appropriations are subject to the statutory provisions of Section 9.113(d) of the City Charter (and as affirmed in Section 10.02 of the Administrative Code), this does not alter the substance of our argument, namely, that all surplus monies that are unassigned and unencumbered, or that are not "assigned for Subsequent Year's Budgets," or that are not part of the reserve funds governed by the specific provisions of the Section 10.60(a) or 10.60(c) of the City Administrative Code, are funds that *are technically available for use for any lawful purpose*. Hence, these funds may be used to capitalize and fund the MFC, subject to a determination that doing so is in the public and civic interest.

[34] We recommend the Board request clarification from the City Attorney's office on this matter.

## Appendix C: Housing Acquisition

The MFC housing lending strategy that would result in the largest increase in permanently affordable housing units would be achieved through funding a large-scale property acquisition program. In this option, the MFC would make loans for the purchase of existing private rental housing, placing these properties under public ownership, or into a land-trust-like structure that would hold these properties into perpetuity. There are two broad options for how the ownership of the acquired units could be structured.

*Option 1:* Purchase of multi-family rental units, in which properties would be transferred into public ownership or, alternatively, placed under non-profit management or a land trust arrangement, and transformed into permanent rent-controlled housing units

*Option 2:* Sale of units in privately owned buildings to existing occupants using below market rate MFC originated loans. Current residents would need to provide a down payment of 20 percent, with the balance funded through loans from the MFC offered at 2.65 percent –or below the prevailing market rate. Loans would be pooled, and used to make a lump sum acquisition payment. Properties would be treated as “shares” in a limited equity housing cooperative, or could be held as a share of a land trust type arrangement. If the owner-occupant decides at a future date to vacate the unit, it would be sold back to the cooperative or land trust, with a cap on the repurchase price set equal to the original acquisition price adjusted for inflation plus reasonable reimbursement for occupant improvements.

The analysis of the various considerations regarding the exercise of either of these two types of financing arrangements is complex, and the details of our analysis available on request. The main results of our analysis of *Option 1* can be summarized as follows.

Option 1: Acquisition for placement into a permanent affordable housing fund

Prior to the onset of the COVID-19 pandemic, property prices were at high levels in the San Francisco market. Based on a survey of properties listed on LoopNet, the prevailing capitalization rate in San Francisco, as of early May 2020, was four percent and lower in some cases.[35] This is, by historical standards, a very high ratio of purchase price to net income.

If the capitalization rate increases to five percent, the unit acquisition price decreases by 20 percent. If the capitalization rate subsequently increases to six percent, prices fall by an additional 16.66 percent. The higher the capitalization rate, the more feasible it thus becomes to use low cost (2.0 – 2.5 percent) loans to finance acquisition of properties on the secondary market.[36] For

[35] The capitalization rate is the ratio of the property price to gross rental income. A four percent capitalization rate means that, after deducting operating expenses, the ratio of the purchase price to the net income received by the property owners is 25:1.

[36] To insure these loans are tenable investments for the MFC, it would be necessary to refinance the loans at 2.65 percent, or slightly higher at, or shortly after, year 5, and to again extend the term to 30 years. This can be done without any increase in unit rents in multi-unit rental properties, given that the loan principal that is refinanced has declined due to principal repayment over the first five years. It is also possible to increase the interest rate over the course of the loan to adjust for inflation, and to increase the loan rate to maintain a constant debt service coverage

this reason, the current economic recession, particularly if it is prolonged, creates conditions that are opportune for implementation of the type of debt-financed acquisition strategies we are recommending.

For instance, as shown in Exhibit 25, if we set the cap rate at 6 percent, the acquisition price of a unit with a $2,000 monthly rent and $400 in monthly maintenance costs (net monthly income = $1,600) is $320,000. At this price, it becomes viable to finance acquisition at a loan-to-value ratio of 80 percent at a 2.5 percent interest rate on a long-term (30 year) mortgage. If the cap rate falls to 5 percent (and hence the price rises) the loan rate that is viable (as a starting point) is 2.0 percent. To debt-finance acquisition at the lower cap rate (hence higher acquisition price), the buyer and lender (the MFC in this case) could agree to (a) some deferral of building maintenance over the first and second year, with deferred costs used to pay interest, and (b) upwards adjustment of unit rents in line with increases allowable under the San Francisco Rent Ordinance. Assuming the additional rental income is dedicated to debt service, it can be shown that the property can, over time, sustain payments at a higher rate of interest. Over time, this will allow the MFC to maintain our assumed overall average weighted return of 2.65 – or even higher if loans are held to term.

**Exhibit 25: MFC Acquisition Finance**

| Capitalization rate | Monthly rent per 1-2 BR unit | Net of building maintenance costs | Unit price | Debt at 80% | Maximum monthly debt payment for DSCR of 1.05 | Monthly payment at 2.5% interest rate | Monthly payment at 2.0% | Monthly payment at 1.5% |
|---|---|---|---|---|---|---|---|---|
| 4% | 2000 | 1600 | 480,000 | 384,000 | 1,478 | 1,800 | 1,702 | 1,934 |
| 5% | 2000 | 1600 | 384,000 | 307,200 | 1,478 | 1,548 | 1,466 | 1,608 |
| 6% | 2000 | 1600 | 320,000 | 256,000 | 1,478 | 1,295 | 1,229 | 1,388 |

* Debt Service Coverage Ratio

Several points should be noted. Once, we assume the MFC is willing to lend with a Debt Service Coverage Ratio (DSCR), or the ratio of net operating income to required debt service, of 1.05. At this DSCR, properties shown in the lighter gray are immediately feasible. The readers should note this is significantly lower than DSCR lenders typically require on debt issuance for real estate investments.[37] If interest rates are adjusted upwards over time in line with rent increases tied to the CPI, the DSCR will rise.

Second, assuming debt is used to finance 80 percent of total acquisition price, each unit will require on the order of a $64,000 to $96,000 equity investment (down payment), depending on

ratio. This may be necessary to allow the MFC to sell these loans wholesale (see above section). The details of this analysis are available on request.

[37] We assume occupancy rate of 97 percent. Hence, the project could cover monthly maintenance costs and debt service with a 92 percent occupancy rate. A fall in occupancy below this point would require either deferral of set-asides of maintenance costs, or temporary reduction in debt service payments.

the prevailing capitalization rate. To finance the purchase of 400 properties in a given year, this would require that the City provide a total equity commitment on the order of between $25,600,000 and $38,400,000 per year.[38]

Third, the total number of units that could be acquired on an annual basis, assuming acquisition loans compose the full amount of $1.25 billion of the MFC's loan portfolio, is dependent on the degree to which the MFC can sell loans through the MFC's wholesale distribution network. Exhibit 26 shows the total number of units that could be financed with the full $1.25 billion loan portfolio with the cap rate set at 4, 5 and 6 percent. If all loans are held to maturity, 1/30 of the total portfolio will turn over in a given year. If all principal is re-lent, the MFC can support the acquisition of between 87 and 130 units per year. If we assume the MFC has the capacity to sell $200 million of loans wholesale in a given year, approximately 1/6 of the portfolio will turn over in a given year. The number of units that could be financed and acquired at the 4, 5 and 6 percent capitalization rate rises 434, 543, and 651 per year, respectively. This far exceeds the current volume of acquisitions financed through the MOHCD small site acquisition program.

Finally, a 4 percent cap rate on real estate assets, which was still prevalent in the San Francisco market as of July 2020, is very low by historical standards, and reflects the extraordinary increase in land and property prices that has occurred over recent decades. Even at these unprecedented price levels, the MFC could find ways to provide long-term acquisition finance. Hence, there is no basis to defer the formation of the MFC due to the hyperinflation of real estate prices observed over recent decades. We do note that a fall in real estate valuations (a rise in the capitalization rate) would create more advantageous conditions for rapid scaling of large-scale property acquisitions. This should be seen as an incentive to set up the MFC, as there are grounds to assume that real estate prices in San Francisco may be entering into a period of extended decline.

**Exhibit 26: Annual acquisition volumes, under various refunding assumptions**

| Capitalization rate | Price per unit | Number of total units at fully lent out MFC portfolio | Annual new units acquired w/o wholesale distribution | Annual new units acquired, 1/6 annual turnover | 20 year acquisition, 1/6 annual turnover |
|---|---|---|---|---|---|
| 4% | $480,000 | 2,604 | 87 | 434 | 8,681 |
| 5% | 384,000 | 3,255 | 109 | 543 | 10,851 |
| 6% | 320,000 | 3,906 | 130 | 651 | 13,021 |

Source: Data on building prices are from survey of website Loopnet
* Assumes most units are 1 - 2 bedroom units

[38] It is possible to explore other equity sources, but we do not do so here. We simply note this is a feature of the model that will need to be addressed if the City should decide to move forward with a large-scale acquisition program.

Option 2: Conversion of private rental units into owner-occupied units in limited equity cooperatives and land trusts

The MFC could provide loans to existing tenants in multi-unit rental properties to purchase their units through a jointly owned land trust and housing cooperatives. Tenants would purchase "shares" in the joint ownership land trust or cooperative, and would become owners of their current rental units. If occupants decided to move, the unit would be sold back to the cooperative or land trust. This option allows for loans to be originated at 2.65 percent or potentially higher. Loans would be originated to each of the participating households, with funds pooled and used to purchase the property for transfer into the jointly owned land trust or cooperative.

MFC loans to joint ownership land trusts or cooperatives are financially feasible in the current San Francisco market: a two-bedroom unit renting at $2,000 could be purchased for $480,000 using a 2.65 percent loan and a loan-to-value ratio of 85 percent, as the monthly interest payment would be around $1,970. This model requires that tenants contribute a $72,000 down payment, or 15 percent.[39]

For buildings that have a large number of long-term rent controlled units, this lending program would provide an option for landlords seeking to exit the rental housing market. For buildings in which tenants could meet the down payment requirement, MFC loans would make it possible to purchase their units by providing loans at well below prevailing market rates.

**Acquisition funding for community and arts-based non-profits**

The MFC could provide low cost acquisition loans to local arts, cultural organization and social service non-profits to acquire office and work space. The MFC could provide both short-term working capital and bridge financing loans, and long-term fixed rate mortgage loans for larger amounts and lower rates of interest than are currently available from regional Community Development Financial Institutions (CDFIs).

CDFI funds typically place caps on total lending to any single project or non-profit entity, ranging between $3 to $10 million, depending on the nature of the project and funding availability. Loan interest rates generally range from 5 to 7 percent. The MFC could issue loans for higher amounts and lower interest rates. Once principal had been reduced over the first five to seven years of loan repayment, the loan could be refinanced at prevailing market rates for longer terms. Borrowers' annual debt service would remain unchanged, although loan repayment would be extended over a longer period. Restructured loans could then be sold through the MFC wholesale distribution conduits, raising funds to support the issuance of additional loans, increasing total funding available to local arts organizations, cultural institutions, and community-based organizations.

## Summary analysis of Task Force Model 1.0 property finance

The Task Force report does not provide estimates of the impact of its proposed models on new affordable housing development. To do, so, we here assume the full $875 million loan portfolio

[39] Total occupancy cost to the buyer of a share in a joint ownership land trust or cooperative would be higher to cover essential maintenance costs, and property taxes.

that is envisioned in the Trask Force Report for Model 1.0 is lent out as mezzanine debt. T–This is a short-term debt used to provide additional financing to supplement equity investment and longer-term loans. This follows directly from the fact that the Task Force model assumes loans are issued at 5 percent. At this rate, the ability of Model 1.0 to serve as a significant source of acquisition finance would be extremely limited, given prices currently prevailing in the San Francisco residential property market.

Based on prevailing industry standards, an upscale market rate development in San Francisco will be financed at around 20 percent equity, 15 percent mezzanine debt, and 65 percent permanent debt. For a property development costing $100 million, this implies approximately $15 million is financed using mezzanine loans. Assuming a market rate on mezzanine debt of 11 percent, it follows that if the Task Force Model 1.0 MFC was to lend at 5 percent, developers would realize a savings of approximately $900,000 on a $100 million development. [40]

Assuming a standard affordable housing unit cost of $750,000 (based on 2019 data on several multi-unit San Francisco affordable rate multi-family developments), this results in an increase in 1.2 in equivalent in-lieu payments for each $15 million in mezzanine loans originated by Model 1.0 in the Task force Report.[41]

Given the assumption that the full $875 million is in the form of mezzanine debt, we can calculate the expected annual increase in units financed under various assumptions regarding the time taken for the principal to be paid back. (Note that the shorter the term, the greater the rate of new lending that can be supported on an annual basis, assuming all principal is re-lent)

**Exhibit 27: BLA Analysis of increased housing production of Task Force Model 1.0**

| | | **Average Duration of Loan** | | | |
|---|---|---|---|---|---|
| | Total Loan | 5 years | 3 years | 2 years | 1 year |
| Loans, total and annual origination* | $875,000,000 | $175,000,000 | $291,666,667 | $437,500,000 | $875,000,000 |
| Annual developer savings at 5% interest rate* | $52,500,000 | $10,500,000 | $17,500,000 | $26,250,000 | $52,500,000 |
| Total Annual Market Rate Units** | | 1373 | 2288 | 3431 | 6863 |
| Annual increase units financed through housing set-aside | | **14** | **23** | **35** | **70** |
| Ratio of affordable to market rate units | | 1.02% | 1.02% | 1.02% | 1.02% |

As seen in Exhibit 27, under the most generous assumption that loans are paid back every year, and funds are immediately re-lent, the total increase in units that could be fully funded through the pass-through of savings in the form of increase in developers-in-lieu set-asides is 70 units in total. For a more realistic assumption of a two-year loan term, this number falls to 35. We note

[40] Our assumption is based on conversations with developers with experience in the San Francisco market

[41] Data provide in 2019 by the Mayor's Office of Housing and Community Development

that if the increased set-aside is leveraged by other funding sources, the total increase in funding commitments to affordable housing increased proportionately to the rate at which the set-aside is leveraged. However, the direct effect of the Task Force model is quite meager, as the ratio of new unit financing though this set-aside mechanism in the Task Force model is just slightly over 1 percent of market rate production. Moreover, the entire model is predicated upon a massive increase in market-rate production, and thus further entrenches the long-standing pattern of market-led displacement of the City's lower income residents. For these reasons, we do not consider the Task Force's Model 1.0 to be an option worth pursuing.

## Appendix D. The City's Current Depository Banking Services

### Current banking arrangements

To understand the issues discussed in this report pertaining to the City creating a Municipal Financial Corporation, it is necessary to briefly discuss the current nature of the City's banking services and arrangements. In this section, we show why there is very little advantage, from a funding and lending standpoint, to transferring the City's core bank accounts out of the major multinational banks. This is due to: 1) the small amount of funds actually held at any given time in the City's core concentration account, and 2) collateralization requirements that effectively prohibit these funds from being lent out. Given the fact that serving as the City's primary depository bank would involve higher costs than serving as a small-scale wholesale investment and institutional service bank, our conclusion is that there is very little incentive over the near to medium term to seek to incorporate as a public depository bank.

To see why, we need to distinguish between the City's department-level accounts that serve as the ledger balances through which departments and the Controller's office monitor, record, and track payments and disbursements, and the single City-wide "core concentration account" through which actual transactions between the City and all other parties — including employee payroll — are cleared and settled.

Department-level deposit and disbursement accounts are "zero balance accounts," or ZBAs. These accounts function as the ongoing record of fluctuations in departments' current fund balances. For instance, separate ZBAs may be set up by a department to receive subventions from the federal and state government, or for online merchant credit card and debit card payments (which may be tied to specific programs or sources of payment), or for receipt of funds from bills and invoices sent to parties that utilize various public services, or as various disbursement accounts operated by specific programs or sub-divisions.

Exhibit 28 shows the account structures of the City's Municipal Transportation Agency and the Department of Public Health, respectively, as examples of City department accounts. When the Task Force Report notes that the City currently maintains approximately 200 separate banking accounts, it is referring primarily to ZBAs, as well as some revolving accounts that do hold ongoing cash balances.

**Exhibit 28A: Bank account structure for the Municipal Transportation Agency**

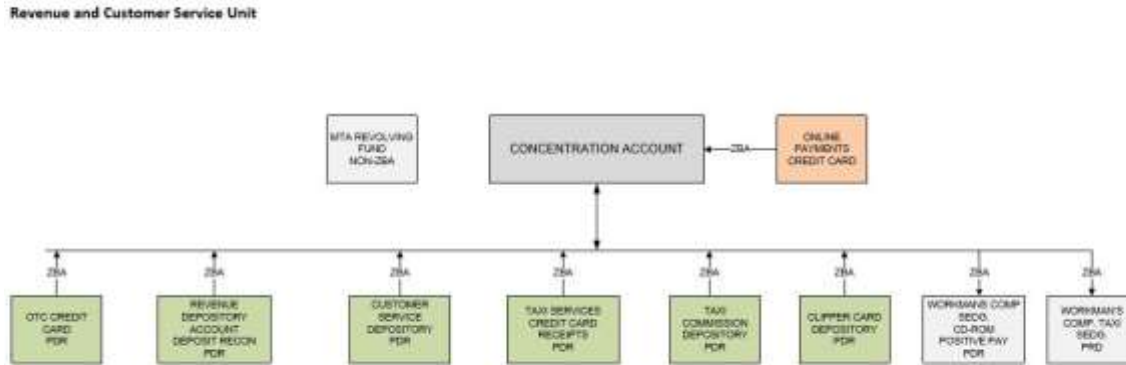
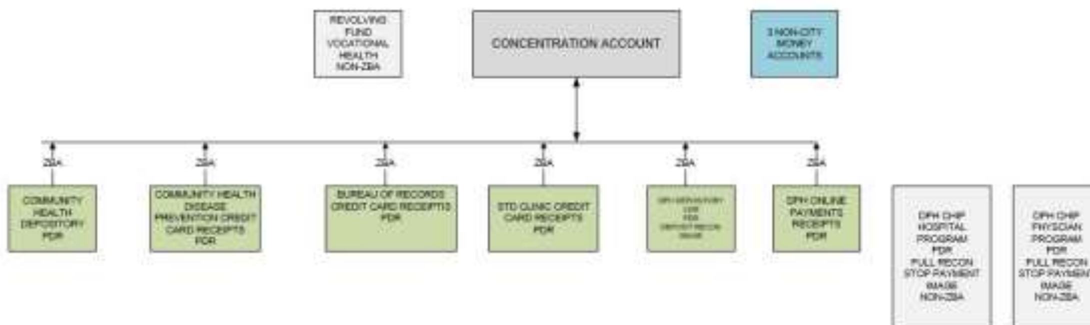



**Exhibit 28B: Bank account structure for the Department of Public Health**




Source: Treasurer–Tax Collector

Very few funds are actually held in department-level ZBA accounts. When a department receives a payment, funds are automatically transferred to a single Citywide core concentration account. For example, if MTA receives $10 million in Clipper card payments on the first of the month, these funds are transferred in real time from the dedicated ZBA to the core concentration account, which is the account through which the City, via its primary banking agent (Bank of America) is linked to counterparties through the inter-bank settlement system. When a department needs to issue a payment, a signal is sent from the department-level ZBA to the core concentration account indicating the ZBA that should be debited, along with the routing number and other relevant account information on the payment recipient's bank. Here also, no funds are held for any length of time in the ZBA account. The ZBAs function as accounting ledgers, with all actual payments cleared and settled through the core concentration account.

In order to maximize the return on the City's liquid funds, the maximum ending daily balance held by the City in its core concentration account is $100 million. On days where inflows (payments received) exceed outflows (payments made) such that the ending daily balance is greater than $100 million, these funds are automatically swept into the Investment Pool. If the City ends the

business day with less than $100 million in the core concentration account, funds are rolled over to the next business day.

If a department has a pending payment of an amount in excess of what would normally be held in the core concentration account, the Treasurer requires three-days advance notification. The Treasury Department requests that all City departments provide advance notice of any pending expenditures exceeding $10 million. The City's bank in turn requires a three-day notice for any wire payments, regardless of size. To conduct settlement, the Treasurer liquidates the required amount of short-term securities held in the Investment Pool. Proceeds from these sales are transferred to the core concentration account. After these funds are spent, the Controller makes a ledger record of the payment transaction and the adjusted departmental-level fund balance.

### Limitations on funding a City MFC using the City's concentration account

Because the maximum balance in the City's concentration account never exceeds $100 million, even if these funds were fully available to be lent out, the actual amount is quite small for a municipal financial corporation, and would not provide one with a viable funding base. Additional restrictions are imposed by the provisions of California Government Code Section 53652, which require that the deposits of local governments be collateralized at or above 105 percent of the total amount held on deposit. The law delineates a very specific set of assets that may be used as collateralization instruments, primarily the bonds, notes, and warrants of agencies of the federal government, states, and political subdivisions thereof. For practical purposes, a small-scale depository for which the deposits of the founding government would comprise a significant share of total funds on deposit would need to collateralize these funds using U.S. Treasury notes or short-term obligations of the federal housing mortgage agencies (Freddie Mac or Fannie Mae). Under the terms of AB 857, adopted in 2019, all funds held on deposit by a local government are required to conform to the provisions of Section 53652 and are effectively "tied up," and cannot be used to support the issuance of credit or loans to other parties.

Unless provisions of Section 53652 were amended to explicitly exempt a public bank such as a City MFC from the current collateralization requirements, all monies held in the City's concentration account would need to be utilized to purchase collateralization instruments such as U.S. Treasury notes, and hence would not be available to be lent out.

For these reasons, a bank that serves primarily as a public depository would have very limited ability to use funds deposited by the City to support its lending operations. If such a bank were to reach a far greater scale, and could maintain a deposit-based funding pool on the order of $500 million or greater, it might be feasible, from a liquidity standpoint, to collateralize the funds of the local government using a Federal Home Loan Bank letter of credit. An expanded deposit pool, with the City share secured by a letter of credit, would allow some portion of the funds deposited by the City to be lent out, as the letter of credit eliminates the need to hold an equivalent amount

of reserves or liquid USTR notes. However, for reasons we discuss below, we think it would take many years for a depository MFC to achieve this scale.

### Receiving FDIC regulatory approval

Under current State laws, Department of Business Oversight approval of a state banking license for a public bank will require the applicant to have received a prior commitment from the FDIC to provide deposit insurance. In granting insurance, the FDIC becomes the MFC's primary federal regulator and resolution agency in the event of insolvency. It is difficult to state with certainty how the FDIC is likely to evaluate a banking application to form a de novo publicly owned depository. We believe it would be unwise to assume the FDIC will readily agree to serve as the MFC's federal regulatory agency. Our caution is based on prior conversation with the head of the Regional Office of the FDIC in 2014, conversations with lawyers at the San Francisco Federal Reserve Ban and the head of regional operations at the San Francisco Federal Home Loan Bank, a meeting with the CEO and CFO of the Bank of San Francisco, a conversation with a former Goldman Sachs regulatory lawyer, and the legal opinions put forth in memos prepared by the law firms of Davis Polk and Arent Fox.

Several factors are likely to bias the FDIC against being willing to give de novo public bank deposit insurance. The MFC is a novel proposal and will encounter institutional inertial resistance. The type of non-orthodox loans that might be issued by the MFC could cause concern amongst federal banking regulators. The MFC will have a high level of exposure to the local real estate market and to the local economy more generally. This creates concentration risk, and could lead to FDIC insistence that the MFC propose a more diversified and orthodox set of lending strategies in order to meet standards required for FDIC insurance. This would undermine the ability of the MFC to offer loans at below market rate in areas designated as primary City policy priorities. Moreover, in granting depository insurance, the FDIC assumes responsibility to function as the MFC's federal resolution agency. The FDIC has no experience regulating or resolving public entities. For these reasons, the FDIC may be unwilling to incur the risks of becoming embroiled in uncertain legal contingencies in the event the FDIC would be required to step in to resolve a failed or troubled municipally owned banking entity.

Finally, if the FDIC rejects a de novo banking application, this could undermine the possibility of moving forward with *any* type of locally owned credit-granting local economic development institution. Opponents of the initiative could hold up FDIC rejection as evidence that the proposal is a high-risk, untested, and costly strategy.

For these reasons, the opinion of our office is that the optimal pathway is to first set up a non-depository institution to provide a vehicle for capitalization, and to fund this institution either through passing an amendment of AB 857 to allow the Investment Pool to directly purchase liabilities issued by the MFC (non-depository), or through the various funding workarounds outlined in this report. If initially established as a non-depository institution, the MFC would not

require regulatory approval from the FDIC. This entity could implement a series of demonstration projects in areas determined to be the MFC's motivating priorities — e.g., affordable housing, small business lending, and infrastructure funding. This would establish an entity that is capitalized, a set of complementary lending programs that are designed to allow them to be rapidly scaled, the basic funding mechanisms to support these lending operations, and a platform to begin to set up partnerships with local credit unions and community banks.

This is why we recommend that the City first pursue the formation of a non-depository MFC. Once the MFC reaches a certain scale, the City can consider becoming a depository bank that would provide banking services to non-profits, unions, pension funds, and foundations. Providing banking services to the City is a longer-term goal, and should not be the primary factor motivating a depository bank's initial formation.

## Appendix E: Recent Trends in Investment Pool balances

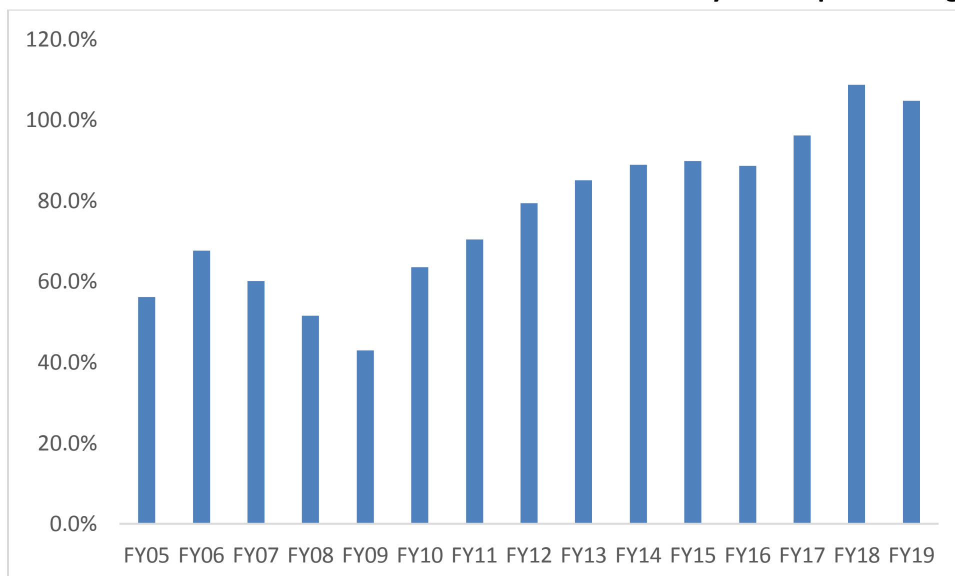
The total fund balance held in the Investment Pool grew from $2.8 billion in FY 2004–05 to just under $11 billion by FY 2017–18, an increase of 390 percent, and a growth rate of 10.46 percent per year. The General Fund–only portion of the Investment Pool increased from $580 million in FY 2004–2005 to $4.9 billion by FY 2017–18, an increase of 855 percent over the thirteen-year period, or an annual growth rate of 16.5 percent.

Exhibit 29A shows the ratio of the total cash surpluses held in the Investment Pool to the Mayor's proposed budget for the corresponding fiscal year for all funds.

Exhibit 29B displays the ratio of the General Fund–only portion of the Investment Pool to the General Fund's annually authorized expenditures. In both cases, the cash surpluses accumulated in the Investment Pool by various participants far exceed annual proposed budgetary expenditure. The rising trend is particularly striking after 2009.

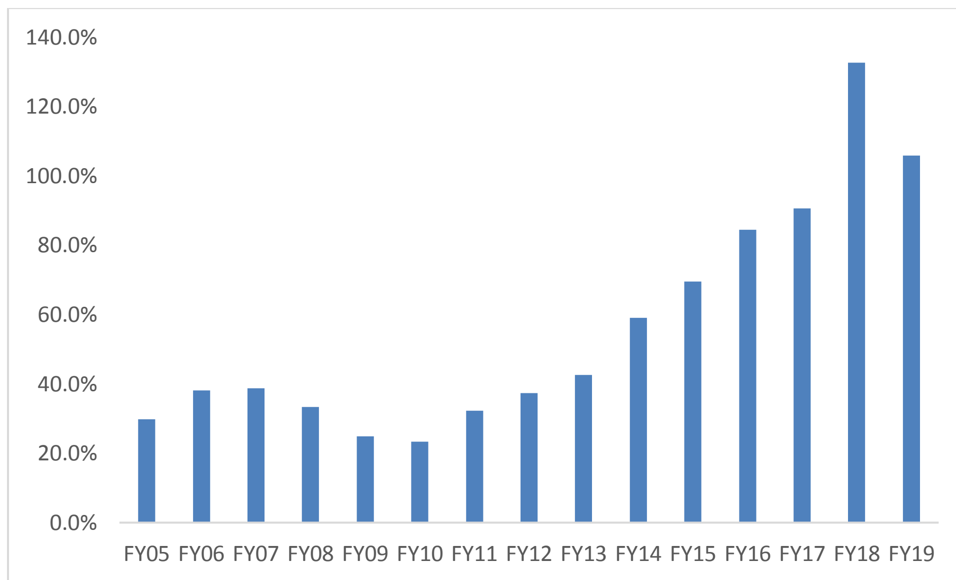
As shown in Exhibit 29A, the total funds held in the Investment Pool by all participants relative to the Mayor's total proposed budget increased from 43 percent in FY 2008–09 to 104.7% in FY 2018–19. The General Fund–only portion of the Investment Pool, as seen in Exhibit 29B, rose from 29.8 percent in FY 2004–2005 to 105.9 percent in FY 2018–2019 — an increase of 355.4 percent over the fourteen-year period, or an increase 9 percent per annum. The annual rate of growth of the ratio of funds held in the Investment Pool to the Mayor's Proposed Budget between FY 2008–09 and FY 2017–18 is 10.3 percent. For the General Fund–only portion, this ratio grew at an annualized average rate of 18.6 percent.

**Exhibit 29A: Ratio of total funds in Investment Pool to Mayor's Proposed Budget All Funds**




Source: Mayor's Proposed Budgets, Treasurer–Tax Collector, and CAFRs, various years

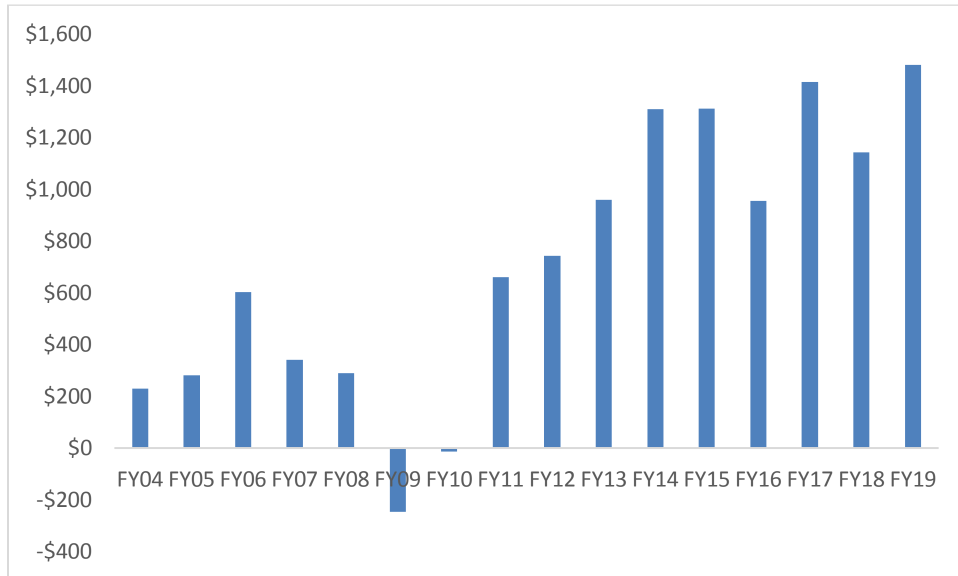
**Exhibit 29B: Ratio of General Fund portion of Investment Pool to Mayor's Proposed General Fund Budget**




Source: Mayor’s Proposed Budgets, Treasurer-Tax Collector, CAFRs, various years, and Treasurer Oversight Committee Report

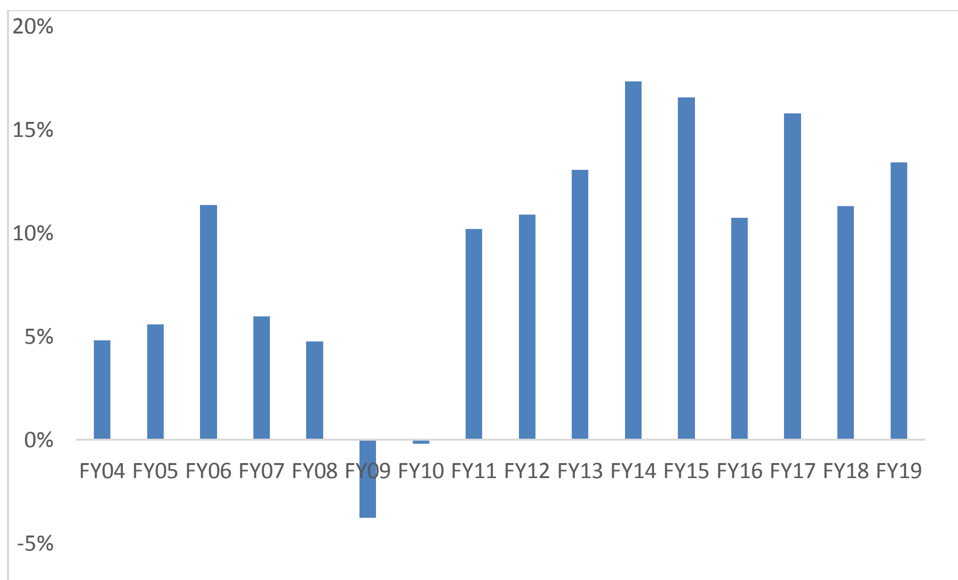
Exhibit 30 shows the annual difference between the Mayor’s Proposed Budget and the year-end total governmental revenues reported in the Comprehensive Annual Financial Report for FY 2003–04 through FY 2018–19. Exhibit 31 shows the end-of-year surplus expressed as a percentage of the Mayor’s Proposed Budget. It is evident the City has been running recurrent and very large annual surpluses, whether stated in dollar terms or as a percentage of the Mayor’s Proposed Budget. As a result, over the last fourteen years, the City has accumulated a large cash surplus that rolls into the end-of-year fund balance and has led to a significant swelling of the total amount of funds held in the Investment Pool and potentially available for capitalization of a City-sponsored MFC.

**Exhibit 30: Difference between Total Year-end Revenues and Mayor's Proposed Budget (millions)**




Source: Mayor's Proposed Budgets and CAFRs, various years

**Exhibit 31: End-of-year surplus as % of Mayor's Proposed Budget, All Funds**




Source: Mayor's Proposed Budgets and CAFRs, various years

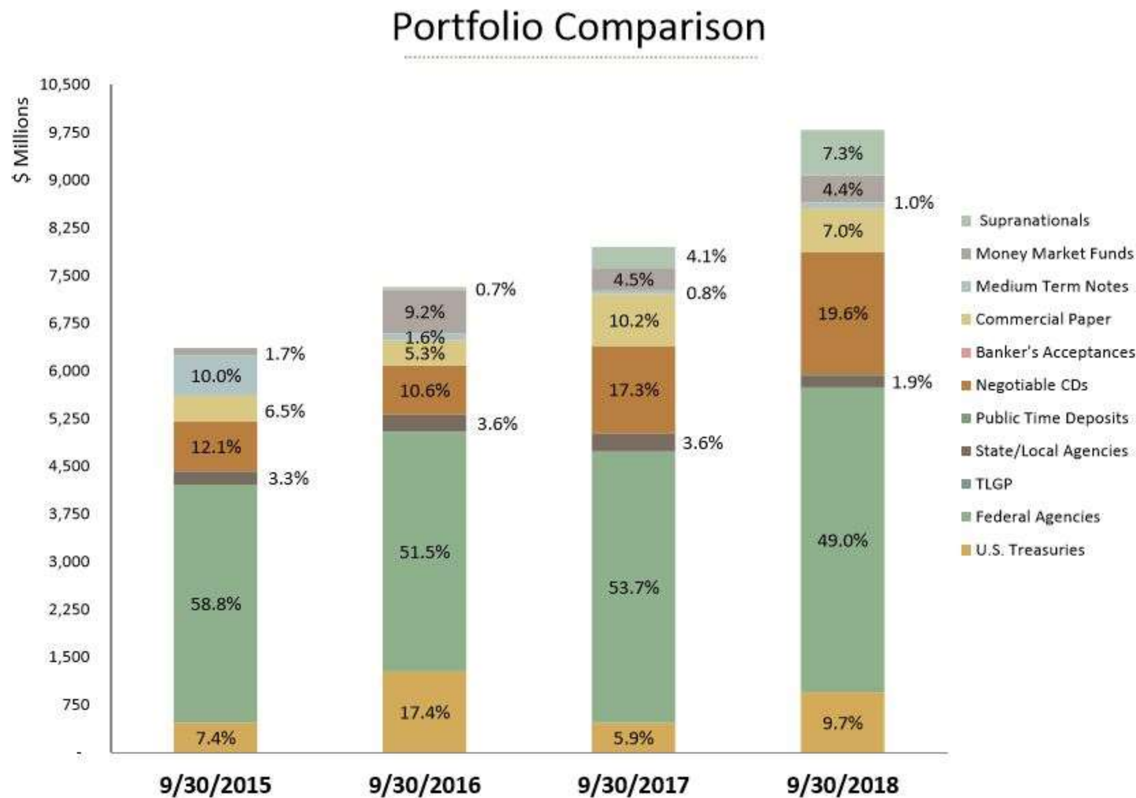
### Uses of Investment Pool funds are not restricted by the ultimate uses of these monies at the Departmental level.

The Task Force Report does not clarify the distinction between the cash balances held in the Investment Pool by the various participating entities, and the investment of such monies, which are regulated by State law. Funds held in the Investment Pool by the various participating entities appear on the balance sheet of the Investment Pool as liabilities owing to the participating entities. The restrictions on the investment of these cash surpluses derive from the provisions of California Government Code Section 53601(a)-(r). The fact that some cash surpluses held in the Investment Pool by participating entities are designated for specific and restricted uses does not imply any particular limitation on how these monies are invested, as long as they conform to the provisions of Section 53601(a)-(r).

### Amounts currently held in short-term government securities exceed prudent levels

Funds placed under the fiduciary care of the Treasurer by the City and other governmental entities that hold surpluses in the Investment Pool are, from the vantage point of the balance sheet of the Treasurer, fully encumbered liabilities "owed" to the depositing entities. This does not imply any restriction per se on how these monies may be invested. Rather, the limits on the investment of these monies are set out in the provisions of CA Government Code Section 53601(a)-(p). As seen in Exhibit 32, the current compositions of the assets held within the Investment Pool are weighted predominantly toward U.S. Treasuries, which as of 9/30/2018 comprised 49 percent of total assets.

**Exhibit 32 Composition of Investment Pool assets**



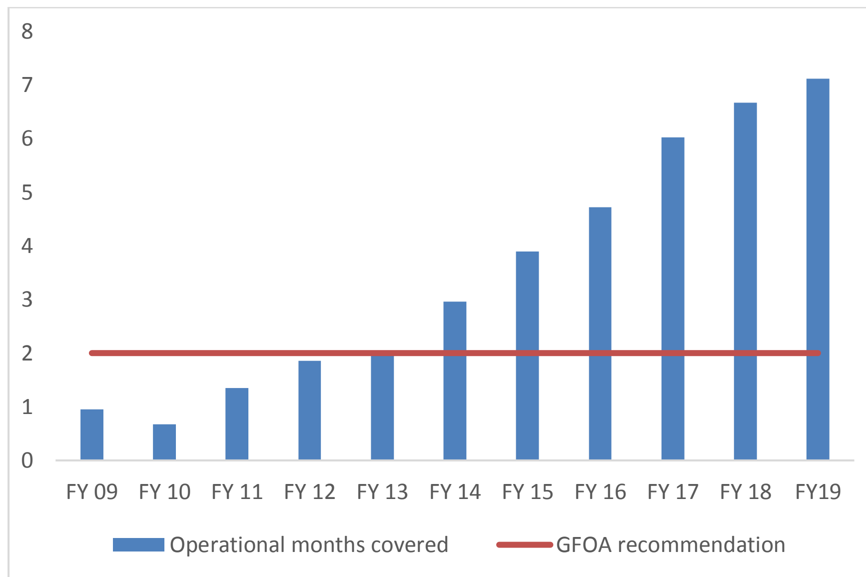

## Why this funding mechanism does not threaten the long-term fiscal condition of the City

The City's current level of unrestricted funds as a portion of the overall fund balance is far in excess of the unrestricted fund balance level recommended by the credit rating agencies and the Government Financial Officers Association (GFOA). To qualify a municipality to receive the top ranking on this component of overall credit ratings from the major credit rating agencies. Standard and Poor's currently requires a municipality to hold 15 percent or more of unrestricted fund balance relative to the authorized General Fund expenditure of the current fiscal year to receive the top ranking on this component of the overall composite credit rating score.[42] Similarly the City's unrestricted fund balance is well in excess of standards adopted by the GFOA, which currently recommends that local governments maintain an unrestricted fund balance equal to two months of annual General Fund expenditure.

[42] Standard and Poor's publishes the criteria used to assign points to various components of the overall composite rating given to a municipal borrower.

The City's FY 2018–19 General Fund authorized expenditures reported in the Comprehensive Annual Financial Report (CAFR) were $4.030 billion. The end-of-year fund balance as of June 30, 2019, was $2.717 billion (GAAP basis). Of this amount, the CAFR (see p. 16) reports $2.11 billion as "unrestricted." If the City were to maintain the unrestricted portion of the fund balance at Standard and Poor's or GFOA recommended levels, the year-end amount would be $605.5 million or $671.66 million. As seen in Exhibit 33, the actual reported unrestricted fund balance exceeds these recommended levels by over 300 percent.

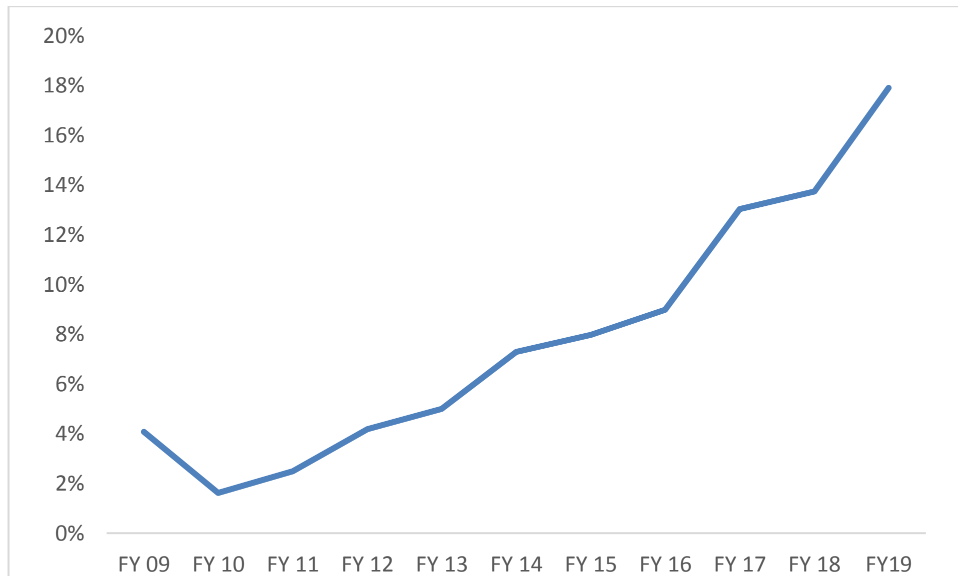
**Exhibit 33: Operational months of General Fund covered by unrestricted fund balance, and GFOA recommended unrestricted fund balance**




Source: CAFR

The City currently has two reserves that exist for the explicit purpose of providing a buffer in the event of unforeseen revenue shortfalls, namely, the Economic Stabilization Reserve and the Budget Stabilization Reserve. These funds were reported at $229 million and $396.76 million, respectively, or $625.76 million in total, in the FY 2019 CAFR. As seen in Exhibit 34, the City's reserve balances have increased consistently in each fiscal year since FY 2010. This exceeds the prudent ratio of unrestricted funds to annual authorized expenditure recommended by Standard and Poor's, and is very close to the recommended threshold of the GFOA. At the present time, the City has a very robust financial position, with reserves that far exceed the amounts the Board of Supervisors and the Controller have deemed necessary to address potential revenue shortfalls in the event of a major economic recession.

**Exhibit 34: Ratio of budget stabilization reserves to General Fund expenditure**




Source: CAFR

The amount of funds currently held in highly liquid short-term government securities in the Investment Pool is far in excess of amounts that need to be held to cover any reasonably anticipated withdrawals. Liquidity concerns do not therefore provide a basis for rejecting our recommendation that the Board of Supervisors use S Supplemental Reserve Account (SRA) to effect a large-scale reallocation of funds to support the lending activities of the MFC. The economic viability of any of the proposed variants of the MFC (depository or non-depository) will require access to long-term, below-market-rate funding. Our review of the data on the daily variance in the Investment Pool indicates the Pool could easily make up to $4 billion in financing available. This undermines one of the major arguments we have heard for why Investment Pool monies cannot be used to support the MFC's lending platforms. It also highlights that the real issue at stake is whether the City is willing to incur the risk of committing some portion of the Investment Pool to funding the MFC loan portfolio. The overarching consideration in this case is whether it is possible to provide sufficient safeguards that will full insulate any commitment of principal from the Investment Pool. We address this question in this report's Section VII on Risk Management.

## Appendix F: Term matching in the Task Force Model, and difference with BLA proposal

The asset (loan) and liability structures that are proposed in both Model 1.0 and Model 2.0 of the Task Force Report involve matching the average terms of loans originated to the average terms of the Municipal Financial Corporation liabilities. Term matching is a standard means deployed to avoid or limit risks associated with "maturity mismatch" — or the interest rate and refunding risks inherent in financing longer-term loans through the issue of shorter-term debt. The term limits and funding sources proposed in the Task Force Report, while in accordance with prevailing practices pertaining to financial portfolio management, place restrictions on the types of loans the MFC could originate. In particular, the Task Force models remove consideration of the MFC funding the issuance of longer-term mortgage and infrastructure debt. The reasoning is straightforward: Let us presume the MFC is funded through the issue of market-rate debt securities, the majority of which consist of debts sold on the private money market with maturities ranging from one to five years. If these IOUs are used to finance loans with terms of ten to thirty years, the MFC's funding instruments will be coming due well in advance of the repayment of loan principal.

If holders of the MFC's debt securities are willing to roll over these liabilities on an indefinite basis, the MFC can avoid having to provide cash payment. However, in this case the MFC would still be exposed to risks if interest rates prevailing in the private market have risen at the time these liabilities fall due, as the MFC would have to roll over this instrument at a higher interest rate. Depending on the amount interest rates have risen, this could erode net earnings, and could lead to operating losses due to higher funding costs that cannot be offset by issuing an equivalent amount of higher-rate loans. The MFC could become insolvent if earning is insufficient to cover the cost of finance.

If the MFC's creditors are unwilling to roll over these debt securities at maturity, but instead demand cash repayment, the MFC could readily find itself in the position of being technically solvent — e.g., with positive net earnings and a robust capital base — but unable to meet demands for repayment, given that it has lent out funds in the form of longer-term, illiquid assets. If the MFC's inventory of shorter-term, more liquid assets is insufficient to settle demands for repayment, the MFC has become illiquid, and investors would be forced to hold the IOUs of the MFC until such time as they can claim cash repayment. For this reason, investors are unlikely to purchase the debt securities and other funding instruments issued by the MFC, unless assurances could be given that means existed to guarantee prompt repayment.

Contingent short-term funding agreements could be set up to allow the MFC to partially manage liquidity risks due to maturity mismatch. For instance, if the MFC is largely funded on the private market through the issue of debt securities of one- to five-year duration, the Treasurer–Tax Collector could support the MFC by providing short-term cash advances that would be collateralized using the MFC's longer-term loans and investments. It is possible to work out similar

arrangements with the Federal Home Loan Bank, which offers member institutions access to collateralized short-term advances secured by property-related loans and mortgages. However, there may be limits on the willingness of the FHLB to countenance an indefinite deferment of repayment. Hence, liquidity management would need to rely heavily on a de facto open-ended commitment by the TTX to provide any level of cash needed for the MFC to conduct timely repayment.

Even if such refunding arrangements were secured, the problem remains that issuing IOUs on the private capital markets will require the MFC to pay prevailing interest rates plus adjustments imposed to account for buyers' assessment of risk. This will limit the ability of the MFC to issue long-term, below-market-rate loans of the type we believe are necessary to support increased investment in affordable housing development and acquisition programs to remove existing units from the private market. Once this lending option is effectively ruled out, the MFC is largely confined to offering higher-rate loans of shorter-term duration. While some short-term, higher-rate loans would be sensible from a financial standpoint, the overall effect will be to sharply limit the ability of the MFC to serve as a source of long-term below-market-rate credit.

This is why we have concluded that achieving social equity goals will require funding commitments from the Investment Pool, including de facto agreements to provide open-ended funding with rollover at interest rates below those that could be obtained on the short-term money markets.

## Appendix G: BLA Staffing Assumptions for non-depository MFC

### Lending and Wholesale Loan Division (15 employees)

Lending Department — oversees lending operations; underwrites all direct MFC loans and investments; evaluates and allocates MFC assets among various credit instruments; responsible for conducting trades to adjust holdings of various types of security investment; manages borrowers' credit risk, assessment of participation programs and secondary capital injections, quality controls, and underwriting provisions; monitors the balance sheet and performance of the MFC's partner organizations.

Wholesale Loan Distribution platform — establishes, operates, and manages the MFC's wholesale loan platform in partnership with participating credit unions and community banks; maintains and expands network of mission-aligned socially responsible mutual funds, public pension funds, and philanthropic foundations that provide a market for loans originated by the MFC and its affiliates.

### Risk Control and Liquidity Management Division (5 employees)

Risk Control and Liquidity Management Department — manages the funding (liability) side of the MFC's balance sheet; monitors and manages rollover and refunding risks, is the internal division that interacts extensively with the Treasurer's Office; serves as the liaison that maintains and oversees the MFC's participation in the Federal Home Loan Bank letters of credit program and FHLB advances.

Risk management staff conducts ongoing monitoring of current market conditions in collaboration with Research and Lending departments; provides analysis to Lending Division; does semi-annual stress tests; distributes these reports to the Treasurer's Office, MFC debt security investors, and participants in the MFC wholesale distribution network.

### Technology Department (2 employees)

Manages IT needs, logistical operations, maintenance of software programs, and compliance with industry technological standards.

### Community Outreach, Marketing, Public Outreach and Education Division (3 employees)

Does publicity, outreach, and marketing of MFC's lending programs; convenes forums; manages press relations; conducts outreach to community and neighborhood groups and other constituencies.

**Research Department (1–2 full-time employees)**

Conducts regular, ongoing review of existing market conditions; analysis of various trends in vacancy rates in both residential and commercial real estate markets; review of local economic conditions such as employment, rate of growth of key local economic sectors, property prices; analysis of financial variables and financial market conditions. Some of this work may be conducted in partnership with the Treasurer's Office and the staff of the City's Chief Economist.

**General Administrative Support (1–2 full time employees)**

Provides general administrative support for internal audits and reviews, personnel matters, general office activities, communications, internal procedures and document review.

## Appendix H: BLA pro forma analysis

We here present a pro forma analysis of the costs and earnings of the MFC (non-depository) of the type we are proposing to establish as the optimal vehicle for increasing local investments in affordable housing, community small businesses and residents, long-term infrastructure lending, and other policy objectives. We also provide an estimate of the costs and earnings that would likely accrue to an MFC (depository) using various broad assumptions as to total non-interest expense (e.g., operating costs) as a percentage of total assets.

Many of the key features regarding capitalization and funding, as well as the MFC's lending operations, are identical in the case of both the non-depository and depository institutions. As noted, the major differences are (a) a depository has access to a larger potential range of funding sources due to its ability to accept deposits; (b) the depository has greater ability to issue short-term advances and to provide a variety of clearing, settlement, and treasury management services, including custodial functions and Investment Pool management services; (c) under the terms of AB 857, a depository can directly access Investment Pool money through the issuance and sale of debt securities; (d) a depository institution has high start-up costs; and (e) a depository has higher ongoing operating costs, and will need to set a higher rate on loans. Our pro forma analysis is used to determine the set of assumptions under which the MFC can offer below-market-rate loans and still be viable in economic terms.

The underlying assumptions and results of our pro forma mock-up are shown below. The main features we assume are that the MFC (non-depository) is funded through credit provided through the Investment Pool that is rolled over at maturity in order to provide a de facto "permanent" source of low-cost, stable, long-term funding. Total assets are estimated between $1.5 billion in loans, and $650 million in municipal securities. The latter could be IOUs of the City, and in our model are assumed to yield 2.5 percent per annum. All profits are reinvested in the MFC.

The MFC is profitable immediately at the point of commencing operations, due to the nature of the funding arrangements with the City. In brief, the Investment Pool commits a large sum of monies to buying MFC debt securities, which are initially invested in municipal securities. Given our assumption regarding the scaling up of staffing and lending operations, costs are initially very low. Note that the profitability of the MFC actually declines as staff is hired, and the MFC begins to ramp up the scale of its lending programs. Overall rates of return are low, and are below the standards currently prevailing in the U.S. banking industry. Despite this, the MFC is able to withstand very heavy losses due to the very high capital-to-asset ratio required to fully insulate the funds advanced by the City.

### Assumptions underlying the BLA model

(a) The MFC will need to offer long-term, below-market-rate finance to serve as a significant lender for housing and infrastructure development and other social policy objectives for a City initiated MFC. This is particularly true in the case of affordable housing.

(b) Providing long-term credits will require a long-term funding commitment from the City's Investment Pool. The purpose of our recommendation that a Supplemental Reserve Account be created within the Investment Pool is to establish a designated funding conduit to provide the MFC with stable, long-term, below-market-rate finance. We assume that the City will provide the MFC with long-term funding at an average annual rate of 0.5 percent (50 basis points). This is more than sufficient to cover the cost of the services provided by the City's current Investment Pool custodial and settlement agent.

(c) Given our proposed phase-in schedule, in which the non-depository MFC is set up and begins to operate concurrently with, or prior to, the application for a state banking license, we assume the MFC would have a Memorandum of Understanding with a mission-aligned bank that would serve as the MFC's primary depository, custodial, and settlement bank.

(d) The non-depository MFC will maintain a staff of approximately 25 to 30 people. This is more than double the number of staff assumed by the non-depository model outlined in the Task Force Report Model 1.0. Our higher staffing requirement reflects the greater complexity of our proposed lending programs; extensive time required to develop and sustain various partnership relationships, including those with newly created LLCs and non-profits that will be housed in various departments of local government; and the establishment of a securitization platform that will necessitate a large and ongoing marketing plan. We assume the depository variant will have approximately 10 to 15 additional staff members, although this number could be higher depending on the scale of operations and the types of services a depository institution would offer.

(e) Our model is structured in a manner that allows it to be profitable from day one of commencing operation. This assumes the City funds a large-scale transfer of monies into the MFC through the Supplemental Reserve Account. The MFC will invest these monies in USTR notes and bonds that pay 2.5 percent per annum, and Municipal Bonds that pay an average annual return of 3.5 percent. These interest earnings would be transferred to the MFC for capitalization purposes.

(f) We assume the MFC commences its lending operations through a series of demonstration projects beginning in the first year of actual operations, and then expands these programs over the next ten years to $1.25 billion in total loans by year ten. We acknowledge that the rate of increase in the MFC loan portfolio may occur at a slower rate than we assume in our pro forma models

(g) We assume the MFC issues long-term loans at 2.5 to 2.75 percent. Thirty-year housing loans for multi-unit rental housing acquisitions may be restructured from time of origination, refinancing the loans at higher interest rates and lengthening the repayment term. Restructured loans may either be held by the MFC, or sold wholesale to raise funds to support the issuance of new loans.

(h) The MFC has a large capital buffer. By year ten, our model shows that the MFC will have $286 million in core capital, of which the City is sole and exclusive owner. Assuming that by year ten the MFC is operating with a $1.25 billion loan portfolio, the MFC could absorbed a full charge-off of non-performing loans of up to 22.88 percent of its total loan portfolio before any losses would be passed on to the Investment Pool.

(i) While we believe that meeting the MFC's guiding goal and policy mandates — particularly in the areas of housing development — will require being structured along the lines we set out here, we do not assume the MFC will be operated exactly as shown in our pro forma mock-up. Our objective here is to demonstrate to the Board of Supervisors, Treasurer, the Controller, and the Mayor's Office that the MFC can be structured in a manner that meets the City's policy objectives while fully protecting the Investment Pool.

**Exhibit 35: Pro forma mock-ups — non-depository; $1.5 billion of funding from Investment Pool, loans at 2.65%**

**Cost of Operation**

| | Year of Operation 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Expense category** | | | | | | | | | | |
| **Salary executive management (CEO, CFO)** | $500,000 | $500,000 | $515,000 | $530,450 | $546,364 | $562,754 | $579,637 | $597,026 | $614,937 | $633,385 |
| **Salary staff (10 FTE employees through year 5, 25 FTE thereafter)** | $2,500,000 | $2,575,000 | $2,652,250 | $2,731,818 | $2,813,772 | $5,796,370 | $5,970,261 | $6,149,369 | $6,333,850 | $6,523,866 |
| **Amortization** | | $100,000 | $103,000 | $106,090 | $109,273 | $112,551 | $115,927 | $119,405 | $122,987 | $126,677 |
| **Rent, other occupancy-related costs** | $500,000 | $515,000 | $530,450 | $546,364 | $562,754 | $562,754 | $579,637 | $597,026 | $614,937 | $633,385 |
| **Other (IT, licensing)** | $500,000 | $515,000 | $530,450 | $546,364 | $562,754 | $562,754 | $579,637 | $597,026 | $614,937 | $633,385 |
| **Correspondent and Treasury management costs** | | | | | | | | | | |
| **Total annual operational costs** | $4,000,000 | $4,205,000 | $4,331,150 | $4,461,085 | $4,594,917 | $7,597,184 | $7,825,100 | $8,059,853 | $8,301,648 | $8,550,698 |

## Capitalization Schedule

| | Year of Operation 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|---|---|---|---|---|---|---|---|---|---|---|
| **General Fund Appropriation** | $5,000,000 | $10,000,000 | $20,000,000 | | | | | | | |
| **Supplemental Appropriation for Investment Pool** | | $10,000,000 | $10,000,000 | | | | | | | |
| **Sale of Shares** | | $500,000 | $1,000,000 | | | | | | | |
| **Foundations** | | | $5,000,000 | | | | | | | |
| **Net earnings from SRA (year 1), MFC's investments thereafter** | $16,000,000 | $17,662,500 | $19,307,913 | $24,275,676 | $24,573,735 | $101,819,823 | | | | |
| **Total Capital (all profits reinvested)** | $21,000,000 | $57,500,000 | $111,162,500 | $130,470,413 | $154,746,088 | $179,319,823 | $206,455,635 | $233,316,926 | $260,089,997 | $286,415,599 |

## Assets, Liabilities, Earnings, Returns, and Risk Ratios

| Assets | Year of Operation 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|---|---|---|---|---|---|---|---|---|---|---|
| **USTR (2.5%)** | | $312,500,000 | $371,162,500 | $530,470,413 | $504,746,088 | $529,319,823 | $481,455,635 | $358,316,926 | $135,089,997 | $161,415,599 |
| **Municipal Bonds (3.5%)** | $1,000,000,000 | $750,000,000 | $750,000,000 | $750,000,000 | $750,000,000 | $750,000,000 | $500,000,000 | $500,000,000 | $500,000,000 | $500,000,000 |
| **Loans (2.65%)** | $0 | $20,000,000 | $40,000,000 | $150,000,000 | $200,000,000 | $500,000,000 | $850,000,000 | $1,000,000,000 | $1,250,000,000 | $1,250,000,000 |
| **Total Assets (all profits reinvested)** | $1,000,000,000 | $1,082,500,000 | $1,161,162,500 | $1,430,470,413 | $1,454,746,088 | $1,779,319,823 | $1,831,455,635 | $1,858,316,926 | $1,885,089,997 | $1,911,415,599 |
| **Combined gross return** | $25,000,000 | $27,092,500 | $29,089,063 | $35,986,760 | $36,668,652 | $45,232,996 | $47,061,391 | $47,957,923 | $49,002,250 | $49,660,390 |
| **Liabilities** | | $63,217,500 | | | | | | | | |
| **Equity** | $21,000,000 | $57,500,000 | $111,162,500 | $130,470,413 | $154,746,088 | $179,319,823 | $206,455,635 | $233,316,926 | $260,089,997 | $286,415,599 |
| **Supplemental Reserve Account (at 0.5%)** | $1,000,000,000 | $1,000,000,000 | $1,000,000,000 | $1,200,000,000 | $1,200,000,000 | $1,500,000,000 | $1,500,000,000 | $1,500,000,000 | $1,500,000,000 | $1,500,000,000 |
| **Medium Term Notes (at 0.5%)** | $0 | $25,000,000 | $50,000,000 | $100,000,000 | $100,000,000 | $100,000,000 | $125,000,000 | $125,000,000 | $125,000,000 | $125,000,000 |
| **Total liabilities** | $1,021,000,000 | $1,082,500,000 | $1,161,162,500 | $1,430,470,413 | $1,454,746,088 | $1,779,319,823 | $1,831,455,635 | $1,858,316,926 | $1,885,089,997 | $1,911,415,599 |
| **Loan loss (0.5 % of loans)** | $0 | $100,000 | $200,000 | $750,000 | $1,000,000 | $2,500,000 | $4,250,000 | $5,000,000 | $6,250,000 | $6,250,000 |
| **Combined cost** | $9,000,000 | $9,430,000 | $9,781,150 | $11,711,085 | $12,094,917 | $18,097,184 | $20,200,100 | $21,184,853 | $22,676,648 | $22,925,698 |
| **Net earnings** | $16,000,000 | $17,662,500 | $19,307,913 | $24,275,676 | $24,573,735 | $27,135,811 | $26,861,291 | $26,773,071 | $26,325,602 | $26,734,692 |
| **Return on assets** | 1.60% | 1.63% | 1.66% | 1.70% | 1.69% | 1.53% | 1.47% | 1.44% | 1.40% | 1.40% |
| **Return on equity** | 76.19% | 30.72% | 17.37% | 18.61% | 15.88% | 15.13% | 13.01% | 11.47% | 10.12% | 9.33% |
| **Capital/Asset ratio (non-risk weighted)** | 2.10% | 5.31% | 9.57% | 9.12% | 10.64% | 10.08% | 11.27% | 12.56% | 13.80% | 14.98% |
| **Capital/Asset ratio (risk weighted)** | | 3691.06% | 52.93% | 34.79% | 34.39% | 19.92% | 15.01% | 14.58% | 13.17% | 14.50% |

**Exhibit 36: Pro forma mock-ups —Scaled down, special-purpose depository; $1.5 billion funding from Investment Pool, loans at 3.5%**

## Cost of Operations

| | Year of Operation | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
| **Expense category** | | | | | | | | | | |
| **Salary executive management (CEO, CFO)** | $1,000,000 | $1,000,000 | $1,030,000 | $1,060,900 | $1,092,727 | $1,125,509 | $1,159,274 | $1,194,052 | $1,229,874 | $1,266,770 |
| **Salary staff (35 FTE employees by year 5)** | $2,500,000 | $5,600,000 | $7,500,000 | $7,725,000 | $7,956,750 | $8,195,453 | $8,441,316 | $8,694,556 | $8,955,392 | $9,224,054 |
| **Amortization** | | $100,000 | $103,000 | $106,090 | $109,273 | $112,551 | $115,927 | $119,405 | $122,987 | $126,677 |
| **Rent, other occupancy-related costs** | | $1,200,000 | $1,236,000 | $1,273,080 | $1,311,272 | $1,350,611 | $1,391,129 | $1,432,863 | $1,475,849 | $1,520,124 |
| **Other (IT, licensing, et al)** | $2,000,000 | $200,000 | $2,500,000 | $2,750,000 | $3,000,000 | $3,090,000 | $3,182,700 | $3,278,181 | $3,376,526 | $3,477,822 |
| **Total annual operational costs** | $5,500,000 | $8,100,000 | $12,369,000 | $12,915,070 | $13,470,022 | $13,874,123 | $14,290,346 | $14,719,057 | $15,160,629 | $15,615,447 |
| **Operating costs as % of total assets** | 0.55% | 0.74% | 1.06% | 1.06% | 0.91% | 0.79% | 0.80% | 0.81% | 0.82% | 0.83% |

## Capitalization Schedule

| | Year of Operation | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
| **General Fund Appropriation** | $5,000,000 | $10,000,000 | $20,000,000 | | | | | | | |
| **Supplemental Appropriation for Investment Pool** | | $10,000,000 | $10,000,000 | | | | | | | |
| **Sale of Shares** | | $500,000 | $1,000,000 | | | | | | | |
| **Foundations** | | | $5,000,000 | | | | | | | |
| **Net earnings** | $14,500,000 | $12,112,500 | $9,646,313 | $10,891,400 | $15,858,733 | $63,008,946 | | | | |
| **Total Capital (all profits reinvested)** | $19,500,000 | $54,500,000 | $102,612,500 | $112,258,813 | $123,150,213 | $139,008,946 | $161,360,047 | $186,103,702 | $211,787,237 | $237,671,290 |

## Assets, liabilities, earnings, returns, and risk ratios

| | Year of Operation | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Assets** | **1** | **2** | **3** | **4** | **5** | **6** | **7** | **8** | **9** | **10** |
| **USTR (2.5%)** | | $319,500,000 | $372,612,500 | $322,258,813 | $533,150,213 | $499,008,946 | $446,360,047 | $321,103,702 | $346,787,237 | $372,671,290 |
| **Municipal Bonds (2.5%)** | $1,000,000,000 | $750,000,000 | $750,000,000 | $750,000,000 | $750,000,000 | $750,000,000 | $500,000,000 | $500,000,000 | $500,000,000 | $500,000,000 |
| **Loans (3.5%)** | $0 | $20,000,000 | $40,000,000 | $150,000,000 | $200,000,000 | $500,000,000 | $850,000,000 | $1,000,000,000 | $1,000,000,000 | $1,000,000,000 |
| **Total Assets (all profits reinvested)** | $1,000,000,000 | $1,089,500,000 | $1,162,612,500 | $1,222,258,813 | $1,483,150,213 | $1,749,008,946 | $1,796,360,047 | $1,821,103,702 | $1,846,787,237 | $1,872,671,290 |
| **Combined gross return** | $25,000,000 | $27,437,500 | $29,465,313 | $32,056,470 | $39,078,755 | $48,725,224 | $53,409,001 | $55,527,593 | $56,169,681 | $56,816,782 |
| **Liabilities** | | | | | | | | | | |
| **Equity** | $19,500,000 | $54,500,000 | $102,612,500 | $112,258,813 | $123,150,213 | $139,008,946 | $161,360,047 | $186,103,702 | $211,787,237 | $237,671,290 |
| **Supplemental Reserve Account (at 0.5%)** | $1,000,000,000 | $1,000,000,000 | $1,000,000,000 | $1,000,000,000 | $1,250,000,000 | $1,500,000,000 | $1,500,000,000 | $1,500,000,000 | $1,500,000,000 | $1,500,000,000 |
| **Medium Term Notes (at 0.5%)** | $0 | $25,000,000 | $50,000,000 | $100,000,000 | $100,000,000 | $100,000,000 | $125,000,000 | $125,000,000 | $125,000,000 | $125,000,000 |
| **Deposits** | | $10,000,000 | $10,000,000 | $10,000,000 | $10,000,000 | $10,000,000 | $10,000,000 | $10,000,000 | $10,000,000 | $10,000,000 |
| **Total liabilities** | $1,019,500,000 | $1,089,500,000 | $1,162,612,500 | $1,222,258,813 | $1,483,150,213 | $1,749,008,946 | $1,796,360,047 | $1,821,103,702 | $1,846,787,237 | $1,872,671,290 |
| **Loan loss (0.5 % of loans)** | $0 | $100,000 | $200,000 | $750,000 | $1,000,000 | $2,500,000 | $4,250,000 | $5,000,000 | $5,000,000 | $5,000,000 |
| **Combined cost** | $10,500,000 | $15,325,000 | $19,819,000 | $21,165,070 | $23,220,022 | $26,374,123 | $28,665,346 | $29,844,057 | $30,285,629 | $30,740,447 |
| **Net earnings** | $14,500,000 | $12,112,500 | $9,646,313 | $10,891,400 | $15,858,733 | $22,351,101 | $24,743,655 | $25,683,536 | $25,884,052 | $26,076,335 |
| **Return on assets** | 1.45% | 1.11% | 0.83% | 0.89% | 1.07% | 1.28% | 1.38% | 1.41% | 1.40% | 1.39% |
| **Return on equity** | 74.36% | 22.22% | 9.40% | 9.70% | 12.88% | 16.08% | 15.33% | 13.80% | 12.22% | 10.97% |
| **Capital/Asset ratio (non-risk weighted)** | 1.95% | 5.00% | 8.83% | 9.18% | 8.30% | 7.95% | 8.98% | 10.22% | 11.47% | 12.69% |
| **Capital/Asset ratio (risk weighted)** | | 3644.65% | 48.86% | 29.94% | 27.37% | 15.45% | 11.74% | 11.63% | 13.24% | 14.85% |

# Municipal Bank Feasibility Task Force Report

Treasurer José Cisneros

San Francisco Office of the Treasurer & Tax Collector
March 2019

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Staff: Molly Cohen, Amanda Fried and Tajel Shah
Technical Consultant: Katherine Chen

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# Executive Summary

The goal of this report is to provide thoughtful analysis of the financial costs and benefits of creating a municipal bank and to outline the policy and operational considerations should the City choose to proceed. A municipal bank presents an opportunity to achieve community goals, such as divestment and reinvestment, in a sustainable and creative fashion. However, it is also a time-intensive and expensive endeavor. Pursuing a municipal bank has significant short-term costs, in terms of money, time and energy. It also has a significant, but uncertain, pay-out in the long-term. Creating a public bank necessarily involves making difficult decisions around trade-offs about how the City should prioritize projects and allocate its money.

This report is the culmination of the Municipal Bank Feasibility Task Force ("Task Force") process. Treasurer José Cisneros selected members of the Task Force in 2017 to research the viability and advisability of a municipal bank as well as other opportunities to leverage the City's banking and investment practices to promote community goals. The formation of the Task Force was recommended by the Board of Supervisors in resolution 152-17 to "advise the Treasurer… the Mayor, the Board of Supervisors and relevant City Departments regarding the creation of a Municipal Public Bank."

The report's analysis is intended to build on the research of the San Francisco Budget & Legislative Analyst, and several recent reports on municipal banking that do an excellent job outlining the policy reasons why a jurisdiction might choose to create a municipal bank. This report seeks to offer concrete figures as well as potential alternatives to a municipal bank to inform and bolster that dialogue. This report provides three financial models for a municipal bank: a reinvestment entity that focuses on affordable housing and small business lending to achieve community goals, a divestment bank that performs the City's cash management, and a combination bank that performs both the City's cash management and affordable housing and small business lending. For all these models, the Task Force did not specify where the funds would come from to support start-up and operations, though they recognized that General Fund appropriations would likely be critical to the banks' success.

Aside from these three municipal bank models, the report also outlines policy considerations associated with starting a municipal bank, such as potential sources of funds for capitalization, start-up costs and deposits. The report also includes other interim or alternative options that could achieve similar aims as a municipal bank and concludes with next steps the City could take should it choose to move forward with creating a municipal bank.

**This report provides three financial models for a municipal bank: a reinvestment entity that focuses on affordable housing and small business lending to achieve community goals, a divestment bank that performs the City's cash management, and a combination bank that performs both the City's cash management and affordable housing and small business lending.**

This report does not opine on whether a

municipal bank, or a particular municipal bank model, is the right option for the City, but rather, seeks to provide enough specifics to guide future policy decisions by the Board of Supervisors and the Mayor. This report seeks to inform the dialogue around municipal banking by offering concrete figures regarding the endeavor.

# 1 Model One: Reinvest

Model One, the first municipal bank model, is focused on lending and reinvestment in areas that are underserved by the traditional banking industry. After significant deliberation and prioritization, the Task Force chose to focus on affordable housing and small business lending as top community goals for the reinvestment model. Model One is not designed to perform the City's cash management and commercial banking functions. This model would not require a bank charter or deposit insurance, because the bank would not accept deposits or serve as the City's banker, but it would need similar capitalization to a traditional bank.

With $1 billion in loans, the municipal bank will be able to bring $1 billion in investment to bear, making 170 affordable housing loans, 60 wholesale small business loans (which will result in numerous small business loans), and 700 direct small business loans. The City currently invests $400 million per year in affordable housing. At $1 billion in loans, the municipal bank would add another $850 million in lending that would revolve on average every three-to-five years, resulting in an additional $200 million investment in affordable housing per year. For small business lending, the bank would add $125 million in wholesale loans and $25 million for 700 in direct loans compared to the approximately 50 loans for a total of $50 million currently issued by the City's Small Business Revolving Loan Fund and Emerging Business Loan Fund.

To achieve financial sustainability, Model One must be approximately $1.1 billion in size with $165 million in bank capital. The model projects it will take around 10 years to achieve a surplus (by comparison the low-end estimate projects a surplus after 5 years, and the high-estimate never achieves a surplus). In the first 9 years, the bank will need $13 million in subsidies to maintain operations (ranging from a low of $4 million and a high of a continuous subsidy throughout operations that can reach $42 million per year due to high losses from direct small business lending). The start-up and operational costs for Model One are lower than those for Model Two and Three, because Model One will not need to develop and maintain infrastructure to serve as the City's banker and will have lower compliance and regulatory costs. The bank will also need 15 percent of its assets held as bank capital. At $1.1 billion this figure is $165 million, and it will increase as the bank gets larger. Model One cannot accept deposits so it will need to secure higher-cost debt to serve as lending principal.

# MODEL 1: REINVEST

**Table 1: Model One Lending Lines of Business at $1 Billion in Loans**

| | Loan Assets at $1B ($MM) | Percent of Loans at $1B | Number of Loans at $1B | Average Size of Loan | Average Interest Rate | Estimated Loss Rate (Low-High) | Average Loan Term |
|---|---|---|---|---|---|---|---|
| **Real Estate Lending (ADU, mezzanine debt, small sites)** | 850 | 85% | 170 | $5,000,000 | 5% | 1-2% | 3-5 years |
| **Wholesale Small Business Lending** | 125 | 12.5% | 60 | $2,000,000 | 2.5% | 0.5-1% | 5 years |
| **Direct Small Business Lending** | 25 | 2.5% | 700 | $35,000 | 15% | 15-30% | 3-5 years |

**Table 2: Estimated Range of Costs Associated with Model One**

| Cost Type | Average Cost | Low and High Cost Estimates | Description | Timeframe |
|---|---|---|---|---|
| Size at annual breakeven | $1.1 billion | $330 million – never | Estimated asset size for bank to breakeven | – |
| Start-up costs | $6.25 million | $5 million – $7.5 million | Cost for staffing, real estate, technology infrastructure | Approximately 2 years before operations |
| Balance sheet capital at annual breakeven | $165 million | $50 million – never | Capital equivalent to 15% of assets at breakeven | Year 1+ until operation ceases |

# 2 Model Two: Divest

The primary goal of Model Two, the divest model, is to create a public bank that can take over the City's cash management and commercial banking functions currently performed by Bank of America and U.S. Bank. Model Two would hold and manage the $100 million currently held in the City's short-term accounts used for daily transactions. The bank would provide disbursements, deposits, cash management, payment processing, and financial reporting and technology solutions for the approximately $13 billion that cycles through the City's accounts on a yearly basis. For a sense of the scale of this work, this bank would be responsible for handling the 1.2 million checks deposited per year by the City, the 323,000 credit card transactions, and 847,000 outgoing payments per year. Given the scale of the City and the number of transactions per year, the cash management work would be complex and costly. The bank would charge the City $600,000 for this work, equivalent to the fees currently paid to Bank of America. The bank would perform participation lending, purchasing loans originated by other banks and credit unions, to make a profit and subsidize the cash management operations of the bank. At $1 billion in loans, it could offer 200 loans at $5 million each.

**This bank would be responsible for handling the 1.2 million checks deposited per year by the City, the 323,000 credit card transactions, and 847,000 outgoing payments per year.**

To achieve financial sustainability, Model Two must be $3.1 billion in size with $460 million in bank capital. The model projects it will take around 31 years to break even operationally for the year (the low-estimate projects a surplus after 25 years, and the high-estimate projects 37 years). In the first 30 years, the model estimates the bank will need $990 million in subsidies to maintain operations until it can break even and achieve a surplus (with estimates ranging from $580 million to $1.5 billion). The bank will also need to hold capital equivalent to 15 percent of assets – at least $165 million at $1.1 billion in assets and increasing from there. The bank will also need a deposit base equivalent to the size of the bank assets less bank capital, so, for example at $1.1 billion in assets and $1 billion in loans, the bank will need to secure $935 million in deposits to perform its lending.

**Table 3: Model Two Lending Lines of Business at $1 Billion in Loans**

| Lines of Business | Loan Assets at $1B ($MM) | Percent of Portfolio at $1B | Number of Loans at $1B | Average Size of Loan | Interest Rate | Loss Rates | Average Loan Term |
|---|---|---|---|---|---|---|---|
| Participation Lending | 1,000 | 100% | 200 | $5,000,000 | 4% | 0.5% | 17 years |

# MODEL 2: DIVEST

**Table 4: Estimated Range of Costs Associated with Model Two**

| Cost Type | Average Cost | Low to High Cost Estimates | Description | Timeframe |
|---|---|---|---|---|
| Size at annual breakeven | $3.1 billion | $2.3 billion – $4.1 billion | Estimated asset size for bank to breakeven | – |
| Start-up costs | $119 million | $95 million – $143 million | Cost for staffing, real estate, technology infrastructure | Approximately 2 years before operations |
| Balance sheet capital at annual breakeven | $460 million | $340 million – $615 million | Capital equivalent to 15% of assets at breakeven | Year 1+ until operation ceases |

# 3 Model Three: Combination

**Model Three is a combination of Models One and Two. It is a municipal bank that accepts deposits, performs the City's cash management and commercial banking, as well affordable housing and small business lending. Model Three will not perform retail banking for customers. Model Three will allow the City to both divest from commercial banking partners and perform reinvestment lending. As in Model One, at $1 billion in loans, the municipal bank will make 170 affordable housing loans, 60 wholesale small business loans (which will result in numerous small business loans), and 700 direct small business loans. As the bank scales up, the magnitude of its investment in the community will similarly scale.**

**To achieve financial sustainability, Model Three must be $10.4 billion in size with $1.6 billion in bank capital. The model projects it will take around 56 years to break even operationally for the year (the low-estimate projects a surplus in 36 years, and the high-estimate never achieves a surplus). During these years of losses, the bank will need an average $2.2 billion in subsidies to maintain operations until it can break even (with estimates ranging from $980 million to a continuous $78 million per year subsidy). The bank will also need a deposit base equivalent to the size of the bank assets less bank capital, so, for example at $1.1 billion in assets and $1 billion in loans, the bank will need to secure $935 million in deposits to perform its lending.**

# MODEL 3: COMBINATION

**Table 5: Model Three Lending Lines of Business at $1 Billion in Loans**

| | Loan Assets at $1B ($MM) | Percent of Loans at $1B | Number of Loans at $1B | Average Size of Loan | Average Interest Rate | Estimated Loss Rate (Low-High) | Average Loan Term |
|---|---|---|---|---|---|---|---|
| **Real Estate Lending (ADU, mezzanine debt, small sites)** | 850 | 85% | 170 | $5,000,000 | 5% | 1-2% | 3-5 years |
| **Wholesale Small Business Lending** | 125 | 12.5% | 60 | $2,000,000 | 2.5% | 0.5-1% | 5 years |
| **Direct Small Business Lending** | 25 | 2.5% | 700 | $35,000 | 15% | 15-30% | 3-5 years |

**Table 6: Estimated Range of Costs Associated with Model Three**

| Cost Type | Average Cost | Low and High Cost Estimates | Description | Timeframe |
|---|---|---|---|---|
| Size at annual breakeven | $10.4 billion | $3.9 billion – never | Estimated asset size for bank to breakeven | – |
| Start-up costs | $119 million | $95 million – $143 million | Cost for staffing, real estate, technology infrastructure | Approximately 2 years before operations |
| Balance sheet capital at annual breakeven | $1.6 billion | $590 million – never | Capital equivalent to 15% of assets at breakeven | Year 1+ until operation ceases |

# Comparison

All three bank models must grow to a large size to break even and all would require significant subsidy and capital investment, though the amounts vary significantly from model to model. Model One, which has reduced start-up and operational costs because it does not need a bank charter or infrastructure to perform the City's commercial banking, requires the least time and investment to break even. It will break even after 10 years and a total estimated $184 million in investment – $165 million in capital, and $19 million in start-up cost and subsidies.

In contrast, Model Two will break even after 31 years and $1.6 billion investment, and Model Three will break even after 56 years and $3.9 billion in investment. It is important to note that the length of time a model projects for annual bank breakeven depends on a variety of factors such as expenses, revenue, and growth rates. Adjusting any of these levers can shorten or lengthen the time it takes for the bank model to break even for the year for the first time.

**Table 7: Average Investment Required for Municipal Bank Models to Break Even[1]**

| | Model One: Reinvest | Model Two: Divest | Model Three: Combination |
|---|---|---|---|
| Break Even Details | | | |
| Years to Break Even | 10 | 31 | 56 |
| Size at Breakeven | $1.1 billion | $3.1 billion | $10.4 billion |
| Estimated Appropriation Required to Break Even | | | |
| Start-Up Costs | $6 million | $119 million | $119 million |
| Operational Subsidy | $13 million | $990 million | $2.2 billion |
| Capital Investment | $165 million | $460 million | $1.6 billion |
| **Total** | **$184 million** | **$1.6 billion** | **$3.9 billion** |

1 These figures are estimated based on bank models and are the average of the low- and high-estimate scenarios.

# Alternatives

**The City could also consider alternative or interim policies and programs that could achieve similar aims as a municipal bank. These initiatives could be aimed at various outcomes and be accomplished via programming, the power of purchasing and contracting, and participating with other legislative and public banking efforts. Opportunities include:**

- **Expand socially responsible banking indicators in the City's banking RFP**
- **Investigate opportunities to break up the City's banking RFP**
- **In-source mail and check processing from commercial banking partners**
- **Advocate for banking sector reforms**
- **Expand Safe, Sound and Local**
- **Create non-bank lending programs**
- **Better publicize existing small business lending programs and CDFIs**
- **Promote and expand the Bank On Program**
- **Advocate for youth bank accounts**
- **Expand Smart Money Coaching efforts**

# Introduction

Across the country, there is a surge of interest in public banking and the formation of new public banks. Public banks are financial institutions owned by any public government entity including nation, state, county, municipality, or agency. Rather than solely serving shareholders, public banks seek to achieve community goals and return profits to people and benefits back to the community. In recent years, jurisdictions around the country, including Massachusetts, Washington, Oakland, Santa Fe, Washington D.C. and Seattle have embarked on feasibility studies of public banking.

In April 2017, the City and County of San Francisco (the "City") Board of Supervisors passed a resolution, urging "the Office of the Treasurer & Tax Collector to convene a task force, and the City Attorney to advise the Treasurer in this effort, for the purpose of advising the Mayor, the Board of Supervisors, and relevant City Departments regarding the creation of a Municipal Public Bank, either as a new City Department or a separate Enterprise Department."[2] Based on this Resolution, the Office of Treasurer & Tax Collector ("TTX"), led by Treasurer José Cisneros, convened the Municipal Bank Feasibility Task Force ("Task Force") to investigate the potential costs and benefits of a municipal bank as well as other opportunities to leverage the City's banking and investment practices to support community development.

The Task Force builds on work that the Treasurer has done previously to improve our City's banking operations, and to strengthen economic security for all San Franciscans. For example:

- Creating a ground-breaking program, Bank On San Francisco, in 2006 that helped unbanked San Franciscans get access to low-cost checking accounts and has been replicated across the country through the Bank On national program.
- Including socially-responsible banking criteria as part of the bid and evaluation process in the 2011 RFP for banking services.
- Battling check cashers and encouraging local businesses to move towards direct deposit and other modern innovative payroll solutions.
- Launching the Kindergarten to College program in 2011 which opens a free and automatic college savings account for all incoming San Francisco public school kindergarteners and seeds it with $50.
- Proactively taking a stand against Wells Fargo – the first Treasurer in the nation to do so – in the aftermath of the news that the bank engaged in widespread illegal practices around account openings.
- Creating the Smart Money Coaching program which offers free one-on-one financial coaching.
- Offering Summer Jobs Connect, which provides youth with credit union accounts and financial education.
- Creating a new investment opportunity with local financial institutions called Safe, Sound and Local, which makes up to $80 million per year of the County's Pooled Investment Fund available for investments in banks, credit unions and community development financial institutions (CDFIs) located in San Francisco that are backed by letters of credit issued by the Federal Home Loan Bank of San Francisco.

The Task Force brings together advocates working to improve access to credit for low-income, communities of color; finance professionals with years of experience in traditional consumer banks, credit unions and

2 City and County of San Francisco Board of Supervisors. Resolution 152-17. Retrieved from: http://sfbos.org/sites/default/files/r0152-17.pdf.

CDFIs; and government officials with expertise in banking, investment, affordable housing and public finance. The Task Force met eight times over the course of about a year to investigate the concept of a public bank. Using a consensus-based process, they created and finalized a set of guiding principles to inform the work of the Task Force and enumerated and prioritized the goals they wanted to see a municipal bank achieve. After laying this framework, the Task Force and TTX staff researched and discussed various bank and governance structures, lines of business, and options for bank capitalization and deposits.

There are several excellent pieces written that describe the benefits of municipal banking as well as the legal challenges around public banking in California. Rather than re-state that body of work, this report aims to provide the Board of Supervisors, the Mayor and the public with a clear analysis of the financial costs and benefits of a municipal bank given the priorities identified by the Task Force. The Task Force found that a municipal bank is feasible so long as the City commits or secures funding for the effort, and state laws are changed. The Task Force generally identified the desire to dis-engage from Wall Street and large commercial banks and the desire to reinvest in the community as primary goals, though the Task Force did not achieve consensus over which goal should predominate. The report includes a divestment model, a reinvestment model, and a combination of the two to reflect this lack of consensus.

Regardless of the exact model, the financial and time commitments required to create a municipal bank are quite significant. This demand for City resources raises a series of policy questions regarding the fiscal responsibility of creating a municipal bank, the City's prioritization of resources and projects, and interim solutions or alternatives to a municipal bank that could achieve similar aims. This report seeks to offer concrete analysis related to developing a municipal bank as well as potential alternatives to a municipal bank to inform and bolster that dialogue and help the Mayor and Board of Supervisors decide whether to move forward with a municipal bank.

The report is split into six sections that build on one another, and in many ways mirror the process that the Task Force went through. The sections proceed as follows:

- About the Task Force – Introduces Task Force members and describes the Task Force process
- Bank Basics – Briefly details how banks operate
- Municipal Bank Primer – Defines municipal banking and what municipal banks can accomplish
- Municipal Bank Models – Offers detailed financial models for three municipal banks
- What Are the Policy & Operational Considerations Around Forming a Municipal Bank – Outlines large policy questions that remain about forming and operating a municipal bank
- Conclusion: A Phased Approach and Next Steps – Concludes with details about a phased path and next steps the City could take should it choose to move forward with a municipal bank

## Cost Analysis Perspective

The major goal of this report is to advance the conversation around municipal banking by providing a rigorous quantitative analysis regarding the costs, timing and product mix to be considered upon determining if a public entity should pursue a municipal bank. The report also provides options for a municipal bank or interim steps that may also address the two rationales for a municipal bank – divesting from Wall Street banks and community reinvestment.

All municipal bank models require significant investment over many years that range from 10 to upwards of 50 years. If the funds invested to support the municipal bank are from the

City's General Fund, there are also opportunity costs to creating the bank, since every dollar put towards start-up costs, capitalization or subsidies may be redirected from expanding existing and creating new services provided by the City.

On the other hand, there could be a cost to inaction, as maintaining the status quo and continuing our banking relationships both have explicit and implicit costs. The private banking industry has been responsible for multiple financial crises that have impacted the City, its finances and its residents and their financial health. Aside from the ideological benefits of divestment, there are potential long-term financial gains. A municipal bank is not a quick win but could pay dividends long into the future. Bank of North Dakota serves an example: one hundred years into its existence, it has a track record of excellence. It returns money to the State, promotes the local banking industry and has helped citizens weather various natural disasters and economic crises over the years. The cost-benefit analysis of a municipal bank, then, changes depending on the timescale used. While in the short-term a bank is expensive, in the long-term a bank could make a profit and prove to be a solid investment, assuming business and financial risks are identified and analyzed.

# About the Task Force

Members of the Task Force were selected through a competitive application process and include experts from inside and outside government, representing a variety of experiences and opinions. The Task Force consists of advocates working to improve access to banking services and capital for low-income, communities of color; finance professionals with years of experience in traditional consumer banks, credit unions and CDFIs; and government officials with expertise in banking, investment, affordable housing and public finance. Together, this group has the knowledge and background to plan and evaluate opportunities for the City to use its banking and investment functions to support the local economy.

Task Force staff and members met with many stakeholders, including staff and consultants working on public banking in other jurisdictions, public banking advocates, staff of banks, credit unions and CDFIs, experts in affordable housing, consumer, and small business lending and municipal infrastructure, and banking experts. The people who generously shared their time, energy and expertise – starting with our Task Force members – are all listed below:

## Task Force members

***John Avalos*** *(National Union of Healthcare Workers),* ***Ada Chan*** *(Association of Bay Area Governments),* ***James Clark*** *(former U.S. Department of the Treasury),* ***Marc Franson*** *(Chapman and Cutler LLC),* ***Paulina Gonzalez-Brito*** *(California Reinvestment Coalition),* ***Kate Hartley*** *(Mayor's Office of Housing and Community Development),* ***Sushil Jacob*** *(Lawyers' Committee for Civil Rights of the San Francisco Bay Area),* ***Jim Lazarus*** *(former San Francisco Chamber of Commerce),* ***Lauren Leimbach*** *(Community Financial Resources),* ***Ben Mangan*** *(Center for Social Sector Leadership at Berkeley Haas),* ***Ky-Nam Miller*** *(The Greenlining Institute),* ***Tim Schaefer*** *(California Treasurer Fiona Ma),* ***Nadia Sesay*** *(Office of Community Investment and Infrastructure),* ***Tajel Shah*** *(Office of Treasurer & Tax Collector),* ***Kat Taylor*** *(Beneficial State Bank),* ***Steve Zuckerman*** *(Self-Help Federal Credit Union)*

## Staff and consultants working on public banking in other jurisdictions)

***Dean Alonistiotis*** *(Chicago, Illinois),* ***Treasurer John Bartholmew*** *(Humboldt County,*

*California), **Todd Bouey** (Los Angeles, California), **David Buchholtz** (Santa Fe, New Mexico), **Michael Burdick** (California), **Bill Dowell** (California), **Bob Eichem** (Boulder, Colorado), **Representative Josh Elliott** (Connecticut), **Dawn Hort** (Oakland, California), **Karen Helms** (Merced County, California), **Chris Herrera** (Los Angeles, California), **Cathy Jackson-Gent** (Global Investment Company - Oakland, California), **Treasurer Hank Levy** (Alameda County, California), **Bill Longbrake** (Washington), **Tim Lueders-Dumont** (Vermont), **Pauline Marx** (Alameda County, California), **Catherine Mele** (Washington State), **Sara Myers** (Vermont), **Shawn Myers** (Washington State), **Eileen Newhall** (California), **Jesse Rawlins** (Seattle, Washington), **Jim Tingey** (Financial Services Solutions – California), **Andrew Westall** (Los Angeles, California), **Treasurer Tina Vernon** (Nevada County), **John Wickham** (Los Angeles, California)*

## Public Banking Advocates

***Marc Armstrong** (Commonomics), **Ruth Caplan** (DC Public Banking), **Juli Carter** (California Nurses Association), **Sylvia Chi** (California Public Banking Alliance), **Jessie Fernandez** (PODER), **Jacqueline Fielder** (San Francisco Public Bank Coalition), **Rick Girling** (San Francisco Public Bank Coalition), **Susan Harman** (Friends of Public Bank Oakland), **Mike Krauss** (Public Banking Institute), **Nichoe Lichen** (Banking on New Mexico), **Richard Mazess**, **Walt McRee** (Public Banking Institute), **Dennis Ortblad** (Seattle Public Bank Coalition), **Steve Seuser** (DC Public Banking), **Kurtis Wu** (San Francisco Public Bank Coalition)*

## Staff of banks, credit unions, and CDFIs

***Agneus Cheung** (Working Solutions), **Karla De Leon** (Main Street Launch), **Jennifer Finger** (Beneficial State Bank), **Ezra Garrett** (Oportun), **Mark Goldfogel** (Fourth Corner Credit Union), **Pete Hellwig** (New Resource Bank), **Phil Hitz** (OneMain Financial), **Rob Holden** (New Resource Bank), **Craig Johnson** (Beacon Community Bank), **Jen Leybovich** (Main Street Launch), **Stephanie Meade** (New Resource Bank), **Vera Moore** (JP Morgan Chase), **Adria Moss** (Pacific Community Ventures), **Deirdra O'Gorman** (Fourth Corner Credit Union), **Ed Obuchowski** (Bank of San Francisco), **Nathaniel Owen** (Mission Economic Development Agency), **Sara Ravazi** (Working Solutions), **Wendy Ross** (Bank of San Francisco), **Janel Schmitz** (Bank of North Dakota), **Ray Shams** (San Francisco Federal Credit Union), **Jacob Singer** (Main Street Launch), **Kenneth Till** (CommerceOne Bank), **Victor Vazquez** (Bank of San Francisco)*

## Experts in affordable housing, small business, and consumer lending and municipal infrastructure

***Avital Aboody** (LA Más), **Nick Bourke** (Pew Charitable Trust), **Paul Carney** (Tenderloin Neighborhood Development Corporation), **Peter Cohen** (Council of Community Housing Organizations), **Luis Diaz**, (Community Check Cashers), **Alejandro Dobie-Gonzalez** (LA Más), **Rebecca Center Foster** (San Francisco Housing Accelerator Fund), **Ipsheeta Furtado** (Fluid Financial), **John Grogan** (LoansAtWork), **Becca Hutman** (San Francisco Housing Accelerator Fund), **Kiran Jain** (Neighborly), **Katie Lamont** (Tenderloin Neighborhood Development Corporation), **Helen Leung** (LA Más), **Dan Leibsohn** (Community Check Cashers), **Jim Mather** (Housing Trust Silicon Valley), **Fernando Martí** (Council of Community Housing Organizations), **Sam Moss** (Mission Housing Development Corporation), **Abby Murray** (San Francisco Housing Accelerator Fund), **Heather Peters** (San Mateo County), **Jonny Price** (WeFunder), **Eric Tao** (AGI)*

## Banking experts

***Scott Arneson** (Fiserv), **Karl Beitel**, **Asya Bradley** (SynapseFI), **David Dubrow** (Arent Fox), **Ashley Elsner** (Green Market Bank), **Gary Findley** (Gary Steven Findley & Associates), **Pat Orchard** (FIS), **Mark Pinsky** (Five/Four Advisors), **Dave Rainer**, **Caitlin Sanford** (Department of Business Oversight), **Phillip Sprinkle** (Jack Henry and Associates), **Mike Stevens** (Conference of State Bank Supervisors), **Walker Todd** (Middle Tennessee State University), **Nancee Trombley** (California Infrastructure Bank)*

## Other experts

***Lauryn Agnew*** *(Bay Area Impact Investing Initiative), J**uliana Choy Sommer*** *(Priority Architectural Graphics),* ***Hannah Dithrich*** *(The GIIN),* ***Miguel Galarza*** *(Yerba Buena Engineering & Construction, Inc),* ***Cara Martinson*** *(California State Association of Counties),* ***Amanda Ream*** *(United Domestic Workers Union/AFSCME)*

Throughout this process, the Task Force worked to crystallize the opportunities for a municipal bank, and provide some clarity about costs, legal risks, and opportunities. This process included research, discussion and prioritization of community and financial goals for a bank. With some clear outcomes in mind, the Task Force directed staff to research and report out about bank formation costs, potential bank structures, lines of business and financial models.

Over the course of nine months, the task force held eight public meetings. The content of the meetings was as follows:

- **Meeting 1:** Introductions, outlining guiding principles for a municipal bank, brainstorming exercise to prioritize community outcomes (result: affordable housing, small business lending, infrastructure, un- and underbanked individuals and cannabis)
  - *Follow-up materials:* Municipal Bank Feasibility Task Force Statement of Work, Public Banking Literature Review, Public Bank Regulatory Fact Sheet
- **Meeting 2:** Presentations on bank regulation, Bank of North Dakota, Beneficial State Bank and Self-Help Federal Credit Union
  - *Follow-up materials:* Survey of Task Force members to further prioritize and rank five community goals (result: affordable housing, small business lending, infrastructure, un- and underbanked individuals and cannabis)
- **Meeting 3:** Discussion of start-up and operational costs for a bank, comparison of balance sheets, income statements and loan portfolios for three banks: Bank of San Francisco, New Resource Bank and Bank of North Dakota
  - *Follow-up materials:* Fact sheet summarizing current City-funded programs in affordable housing, small business lending and infrastructure
- **Meeting 4:** Presentation and discussion of options for funding for capitalization and deposits, as well as potential lines of business for the bank
- **Meeting 5:** Detailed description of and discussion about potential lines of business for the bank as well as operational parameters and governance structure
  - *Follow-up materials:* Draft Executive Summary
- **Meeting 6:** Review Executive Summary and discuss four municipal bank models
- **Meeting 7:** Review three new municipal bank models
  - *Follow-up materials:* Draft Municipal Bank Feasibility Task Force Report
- **Meeting 8:** Review final report
  - *Follow-up materials:* Final Municipal Bank Feasibility Task Force Report

# Bank Basics

Before jumping into what a San Francisco municipal bank could look like and what it could accomplish, it is crucial to understand the basics of banking. The crucial dividing line between a bank and a non-bank entity is the ability to accept deposits from outside entities.[3] By accepting deposits, banks create a financial

3 California Financial Code §§ 1004-1005.

multiplier effect in the community, lending out deposits to profitable projects and growing the local economy. Banks generate a profit by making loans and charging customers fees. Banks take in deposits and pay interest on some accounts and then lend those deposits out to consumers and receive interest on those loans – the difference between interest paid out and interest received is the "spread" and is typically the source of most bank revenue, though banks also charge fees for services. Banks' assets are loans, which generate income, and customer deposits are liabilities. As with all businesses, a bank's assets must cover its liabilities – the difference between a bank's assets and its liabilities is called the bank capital, which is the bank's net worth and also "a measure of a bank's potential to absorb losses."[4] A bank with limited capital is higher-risk for depositors, because a small drop in asset values can lead to distress and failure. Historically, banks held eight percent of assets in capital, though capital requirements have increased since the recession with banks holding an average of 12 and even up to 15 percent of their assets in capital.[5] New banks may be required to hold even more bank capital, as banks use their capital to survive initial years of losses.[6] Bank capital serves as an investment for whoever owns that capital, and banks can choose to use any profit to pay dividends to shareholders or retain the profits to increase bank capital.

# Municipal Bank Primer

The Public Banking Institute, an advocacy organization, defines a public bank as a "chartered depository bank in which public funds are deposited. It is owned by a government unit — a state, county, city, or tribe — and mandated to serve a public mission that reflects the values and needs of the public that it represents. In existing and proposed US Public Bank models, skilled bankers, not the government, make bank decisions and provide accountability and transparency to the public for how public funds are used."[7] Los Angeles' Chief Legislative Analyst's Office performed a literature review and were unable to find "a consistent definition of such a financial institution beyond the core concept of public ownership," though it noted that many definitions incorporated adherence to ideals, like racial, economic and environmental justice.[8] In general, though, a public bank is a bank—an entity that is licensed to accept deposits and make loans—that is owned by and affiliated with a locality, state or nation. A public bank that is owned by a municipality is called a municipal bank (for the purpose of this report the terms

4 Alden, W. (July 10, 2013). What is Bank Capital, Anyway? New York Times. Retrieved from: https://dealbook.nytimes.com/2013/07/10/what-is-bank-capital-anyway/. Similarly, the FDIC explains that bank capital "absorbs losses, promotes public confidence, helps restrict excessive asset growth, and provides protection to depositors and the deposit insurance funds." Federal Deposit Insurance Corporation (April 2015). Capital. Retrieved from: https://www.fdic.gov/regulations/safety/manual/section2-1.pdf.

5 Federal Reserve Bank of St. Louis (September 2018). Bank Capital to Total Assets for United States. Retrieved from: https://fred.stlouisfed.org/series/DDSI03USA156NWDB; Trefis Team (March 10, 2017), How the Largest U.S. Banks Have Strengthened Their Core Capital Ratios Since 2012, Forbes. Retrieved from: https://www.forbes.com/sites/greatspeculations/2017/03/10/how-the-largest-u-s-banks-have-strengthened-their-core-capital-ratios-since-2012/#11fd80af445a.

6 While banks are starting up, bank capital can fund operating costs, make loans (if the bank does not have sufficient deposits) and serve as reserve capital for those loans. The capital requirements for a new bank will often take all these purposes into account. While an established bank must hold anywhere from 8 to 15 percent of assets as capital, a new bank may be required to hold that much in capital plus sufficient funding to sustain the bank until it is able to make a profit.

7 Public Banking Institute. Introduction to Public Banking. Retrieved from: http://www.publicbankinginstitute.org/intro_to_public_banking.

8 Chief Legislative Analyst (2018). Public Banking Framework and Existing Housing and Economic Development Funding Programs. Retrieved from: http://clkrep.lacity.org/onlinedocs/2017/17-0831_rpt_CLA_02-26-2018.pdf.

public bank and municipal bank will be used interchangeably). Like regular banks, public banks need a charter, capital, deposits, and a governance structure and a leadership team. One of the major distinctions between a public bank and private bank is that a public bank could meet community goals rather than solely serve a profit motive. To succeed, a municipal bank must maintain solvency and liquidity and achieve sustainability or make a profit (if growth is the goal), while also adhering to its mission and principles. In this sense, a municipal bank is trying to achieve a double bottom line: meet community goals while still making a profit that can be reinvested to serve the bank's mission.

There are currently two public banks in the United States, the Bank of North Dakota ("BND") and the Territorial Bank of American Samoa. BND was founded in 1919 on a wave of economic populism, capitalized with a $2 million bond offering and charged with "promoting agriculture, commerce and industry" in North Dakota.[9] Under North Dakota state law, all state funds must be deposited into BND, which does not have deposit insurance but is instead insured by the "full faith and credit" of the State of North Dakota.[10] BND primarily partners with local banks and credit unions to facilitate agricultural, commercial, real estate and student loans. The other public bank, the Territorial Bank of American Samoa, was founded in 2016 after the last commercial bank left the territory. It recently gained access to the Federal Reserve's payment system in 2018.[11] Aside from these two public banks, American Indian tribes also own and operate 19 banks across the U.S.[12]

When considering the creation of a municipal bank it is crucial to determine community goals to guide the lending and banking activities of a municipal bank. The Board of Supervisors Resolution authorizing the Municipal Bank Feasibility Task Force states that the "Board of Supervisors believes that the medium- long-term interests of the city are aligned with the sustainable and equitable economic growth of its community" and that the "long-term financial and social well-being of the City is contingent upon the ability to provide equitable and transparent opportunity for all of its residents."[13] When talking about public banking, almost everyone has a different vision of exactly what a municipal bank should do. A major responsibility of the Task Force (and a struggle) was to hone in on community goals. During public hearings and Task Force meetings a variety of ideas came up, including affordable housing, small business lending, divesting from Wall Street, supporting local banks and credit unions, meeting the needs of un- and underbanked individuals, infrastructure, student loans, renewable energy, and cannabis banking.

Over time, two important goals emerged as the most pressing:

1. "Divestment" — Reducing the City's reliance on Wall Street and increasing the City's autonomy over how its deposits are deployed to ensure money isn't used to support harmful industries.[14]

9 Swayze, David S. and Christine Schiltz (Spring 2013), State-Owned Banks: A Relic of the Past or the Wave of the Future?, Delaware Banker. Retrieved from: https://www.pgslegal.com/wp-content/uploads/2017/07/Spring-2013-Delaware-Banker-Article.pdf.

10 Id.

11 Blackwell, R. (April 30, 2018). American Samoa Finally Gets a Public Bank. And U.S. States Are Watching. American Banker. Retrieved from: https://www.americanbanker.com/news/american-samoa-finally-gets-a-public-bank-and-us-states-are-watching.

12 HR&A Advisors Inc. (October 2018). Public Bank Feasibility Study for the City of Seattle. Retrieved from: http://council.seattle.gov/wp-content/uploads/2018/10/HR-A-Advisors-Public-Bank-Feasibility-Study.pdf.

13 City and County of San Francisco Board of Supervisors, Resolution 152-17. Retrieved from: http://sfbos.org/sites/default/files/r0152-17.pdf.

14 For example, a May 2017 San Francisco Budget & Legislative Analyst report found that of thirteen of the largest banks, all financed at least one of the following disfavored industries: firearms, tobacco, nuclear power, Dakota Access pipeline or private prisons. Budget & Legislative Analyst's Office (May 2017). Memorandum re: Large Bank Social Responsibility Screening. Retrieved from: https://sfbos.org/sites/default/files/BLA_Large_Bank_Screening_051917.pdf.

2. "Reinvestment" — Offering lower-cost financing for City priorities like affordable housing development and supporting small businesses.

Staff met with subject matter experts to identify lines of business that could support these goals. Lines of business were selected primarily because they filled a financing or service gap that currently exists where a municipal bank's involvement could meaningfully impact the market. The specific lines of business, as well as current status quo, will be explored more fully in the next section which details the municipal bank models and are outlined in more detail in Appendix B.

# Municipal Bank Models

The purpose of the models is to elucidate the potential of a municipal bank and provide a financial framework for consideration and debate. These models are estimates based on extensive research and will only be improved over time with more specificity about the overall size of a bank, lines of business, and sources of funds. For those interested in more information about the modeling, the report has a technical appendix (Appendix D), which outlines the data and assumptions behind the models, providing detailed explanations of the banks' start-up costs, lines of business, and growth rates.

The banks modeled in this section reflect the priorities of the task force – with one bank primarily focused on reinvestment (Model One), one focused on divestment (Model Two), and a third bank that combines both aims (Model Three). The section below details the main goal of the bank model, the current status quo, operational costs and benefits (in the short- and long-term) and risks. The financial models assume that banks begin with no assets and build their balance sheet up to $1 billion over 10 years and then increase in size from there.[15] The models project bank operations out to 60 years to show the long-term costs and benefits of creating a bank, recognizing that a bank may require significant investment and subsidy in the short-term, but in the long-term it can pay dividends. Because expenses are greater than revenues when the banks are small, all models will need some amount of operational subsidy, which is funding to keep the bank afloat until it grows large enough to achieve financial sustainability.[16] The length of time it will take a bank to achieve financial sustainability depends on a number of factors, including its expenses, its revenue and lines of business, its growth rate, and economic conditions. Adjusting any one of these multiple levers can shorten or lengthen the time it takes for the bank model to breakeven for the year for the first time.

In contrast, another way to envision a bank model is to present each bank at the size it must operate at to achieve financial sustainability without projecting how long it will take the bank to achieve that scale. This presentation eliminates the uncertainty of long-term forecasting as well as the assumptions about growth. Because the bank begins at a size large enough for sustainability, there are no long-term timelines to profitability or operational subsidies – the assumption is that the bank can achieve profitability shortly after opening (with some ramp-up period to establish its loan portfolio). The bank may need significant capitalization and deposits upfront, which may make it more challenging to open a de novo bank at the size necessary to achieve financial sustainability for some bank models presented below.

15 This growth rate is comparable to Beneficial State Bank which took about 10 years and multiple acquisitions to hit $10 billion.

16 In general, the larger a bank is, the more money it can make. This profitability stems both from the increase in the size of the loan portfolio (which drives revenue) as well as some economies of scale on the expenses side.

## Model One: Reinvest

**Goals:** The first municipal bank model is focused on lending and reinvestment in areas that are underserved by the traditional banking industry. After significant deliberation and prioritization, the Task Force chose to focus on affordable housing and small business lending as top community goals for the reinvestment model. A reinvestment-focused lender can promote outcomes and community goals identified by the Task Force, Board of Supervisors or bank leadership and management. Because it is not constrained by typical shareholder maximization requirements, the bank has slightly more flexibility to enter markets and offer products not typically served by traditional commercial banks. It can increase lending in targeted sectors of the economy and achieve community goals both by lending directly to consumers and by partnering with local community banks, credit unions and CDFIs.

**Current State:** The City already expends significant money and energy supporting affordable housing and small businesses.

*Affordable Housing:* The City utilizes numerous funding sources to support affordable housing preservation, rehabilitation and development including:

- Low-income housing tax credits
- Proposition A/C seismic safety loans ($261 million in total for preserving rent-controlled units)
- Proposition A ($310 million for rehabilitation and redevelopment of public housing)
- Proposition C Housing Trust Fund ($20-$50 million per year for development)
- Inclusionary Zoning and Impact Fees (market rate developers build affordable units or contribute a fee).

In total, Mayor's Office of Housing and Community Development (MOHCD) and the City spends and invests $400 million per year on affordable housing on subsidies to develop and preserve affordable housing units and on down payment assistance programs which help individual homeowners purchase their first homes.[17] Despite this funding and numerous homeownership and development programs, the City and developers struggle to build sufficient housing fast enough to meet the enormous need. The lines of business presented below all seek to offer developers and homeowners cheaper and faster financing to support the City's goals of developing and preserving all forms of affordable housing.

*Small Business Lending:* Small businesses are the engine of job creation in our country, our state and our City. In San Francisco, 80 percent of businesses employ ten people or fewer (including sole proprietors), and the City has 33,866 registered businesses that have between two and ten employees.[18] Small businesses have significant need for capital but have difficulties accessing capital because traditional banks shy away from this lending, which is high-touch and high-risk.[19] Despite the challenges, there is a robust ecosystem of small business support in San Francisco, including the U.S. Small Business Administration (SBA), CDFIs, non-profits and City programs all aimed at nurturing

17 The San Francisco Office of the Mayor. (August 2018). Mayor London Breed Signs Budget Targeting Homelessness, Housing, Street Cleanliness, and Public Safety [Press Release]. Retrieved from: https://sfmayor.org/article/mayor-london-breed-signs-budget-targeting-homelessness-housing-street-cleanliness-and-public. For more information on specific City programs aimed at affordable housing, see Appendix E discussing current City work on affordable housing.

18 Internal analysis from the Office of Treasurer & Tax Collector.

19 A 2016 Federal Reserve survey found that 44 percent of small businesses stated that their top challenge was "credit availability or securing funds for expansion." Federal Reserve Bank (April 2017). Small Business Credit Survey. Retrieved from: https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf.

and growing our small business community. For example, the SBA guarantees a portion (typically 75-85 percent) of small business loans originated by banks. The average size of an SBA loan is approximately $350,000, though they can be up to $5 million in size.[20] Additionally in San Francisco, numerous CDFIs[21] offer loans between $5,000 and $250,000 at reasonable rates as well as technical assistance and business coaching for businesses that may not be able to access standard commercial bank or SBA loans. Many of these CDFIs are not able to cover their costs with revenue and receive philanthropic funding, leading to difficulties scaling up. Within the City, the Office of Economic and Workforce Development (OEWD) and the Office of Small Business also support small business through direct lending programs, grant programs and grants to non-profit lenders to support their work. Some example of direct lending and grant programs are highlighted below:

- **Small Business Revolving Loan Fund** – It offers microloans up to $50,000. It is administered by Main Street Launch, a local CDFI. The City covers the administrative costs, and Main Street Launch provides the capital. Since 2009, it has issued 161 loans totaling over $4.57 million. In 2017, it issued 20 loans totaling $816,000. Its loans range in interest from 3.5% to approximately 7.75%.
- **Emerging Business Loan Fund (EBLF)** – It offers up to $250,000 in loans to small businesses. It is administered by Main Street Launch, a local CDFI. The City covers the administrative costs, and Main Street Launch provides the capital. Since 2013, it has closed over 120 loans totaling $16.8 million. Its loans are offered at approximately 7.75%.
- **SF Shines Façade and Tenant Improvement Program** – Since 2009, it has provided technical assistance, business strengthening, and 117 grants (from $10,00 to $150,000) totaling $4.3 million for improving commercial storefront facades and business interiors. The current program budget is $1 million.
- **Americans with Disabilities Act (ADA) CASp Grant Program** – Since 2013, it has provided technical assistance and 647 grants (from $1,000 to $3,000) totaling over $1 million for ADA compliance assessments.

Despite all this effort, small business advocates and CDFI staff believe that gaps remain in small business lending. The following lines of business aim to fill those gaps and also support the excellent work being done by CDFIs.

**Activities:** Model One is a municipal bank that secures funding through debt and performs affordable housing and small business lending. It will not perform the City's cash management and commercial banking. This model would not require a bank charter or deposit insurance, because the bank would not accept deposits or serve as the City's banker, but it would need similar capitalization to a traditional bank. Model One will perform real estate lending and small business lending at below-market rates to decrease the cost of funding affordable housing and assist small business development. The section offers a short description of the lines of business, and more details about the lines of business are available in Appendix B.

*Real Estate Lending:* The real estate lending lines of business will include mezzanine debt (which sits between equity and more senior debt and is the highest-risk form of debt) for workforce housing acquisition and development, mortgages for the small sites acquisition program and loans to finance accessory-dwelling unit construction. 85 percent of the bank portfolio ($850 million at $1 billion

20 Wang, A. (February 5, 2019). SBA Loans: What you Need to Know. Nerd Wallet. Retrieved from: https://www.nerdwallet.com/blog/small-business/small-business-loans-sba-loans/

21 These CDFIs include Main Street Launch, The Opportunity Fund, Mission Economic Development Agency's Fondo Adelante, Pacific Community Ventures and Working Solutions.

in loans) are modeled as real estate loans. The average size of a real estate loan is $5 million for a total of 170 loans in the portfolio (at $1 billion in loans). The interest rate is 5 percent, loss rate is 1-2 percent and average term is 3 to 5 years, though individual loan may be significantly longer, up to 30 years.

*Wholesale Small Business Lending:* The municipal bank would lend large sums of money to CDFIs at low rates, and these CDFIs would use this money to issue small business loans at lower than for-profit market rates. This lending represents 12.5 percent of the bank's portfolio ($125 million at $1 billion in loans). The average size of a wholesale small business loan would be $2 million, and the portfolio would have approximately 60 in total at $1 billion in loans. The interest rate is 2.5 percent, which is slightly below the rate CDFIs are charged by traditional private banks (typically 3 to 4 percent). The loss rate is modeled at 0.5-1 percent, because CDFIs have significant reserves and strong underwriting for their loans. The average loan term is 5 years.

*Direct Small Business Lending:* The municipal bank would offer small business loans to businesses directly. The bank is modeled with 2.5 percent of its portfolio ($25 million at $1 billion) as direct small business lending for a total of approximately 700 loans at any given time. The average size of these loans is modeled at $35,000. The interest rate is modeled at 15 percent; the loss rate is modeled at 15-30 percent, and the average loan term is 3 to 5 years.

Though not included in Model One, there were two other lines of business that were of interest to members of the public and the Task Force. The details on these lines of business are provided below but not included in the model.

*Direct Student Lending (Not Modeled):* For direct student lending, the municipal bank could offer student loans to residents of San Francisco and those studying at colleges and universities in San Francisco. The average loan size would be $10,000. Interest rates would be modeled at 4.5 percent based on BND's published rates

**Table 8: Model One Lines of Business at $1 Billion in Loans**

| | Loan Assets at $1B ($MM) | Percent of Loans at $1B | Number of Loans at $1B | Average Size of Loan | Average Interest Rate | Estimated Loss Rate (Low-High) | Average Loan Term |
|---|---|---|---|---|---|---|---|
| **Real Estate Lending (ADU, mezzanine debt, small sites)** | 850 | 85% | 170 | $5,000,000 | 5% | 1-2% | 3-5 years |
| **Wholesale Small Business Lending** | 125 | 12.5% | 60 | $2,000,000 | 2.5% | 0.5-1% | 5 years |
| **Direct Small Business Lending** | 25 | 2.5% | 700 | $35,000 | 15% | 15-30% | 3-5 years |

as of the end of July 2018 with a loss rate of 2 percent based on BND and other private student loan companies' loss rates. The student loan line of business would bring in modest profits.

*Green Energy Loans (Not Modeled):* For green energy loans, the municipal bank could offer loans for renewable energy projects for small businesses and homeowners. The average loan size would be $50,000, and interest rates would be modeled at 4-5 percent based other banks' rates. Loss rate would be an estimated 1-2 percent. This line of business would result in a similar profile and profit to the real estate and affordable housing loans.

**Operational Components:**
To achieve financial sustainability, Model One must be $1.1 billion in size. The model projects it will take around 10 years to break even operationally for the year (the low-estimate projects a surplus after 4 years, and the high-estimate never achieves a surplus). In the first 10 years, the bank will need $13 million in subsidies to maintain operations (ranging from a low of $4 million and a high of a continuous subsidy throughout operations that reaches $42 million per year in the model). The start-up costs will be lower than in Model Two and Three, only $5 to 7.5 million, because Model One will not need the infrastructure to perform the City's commercial banking, nor will it need the compliance and regulatory components required for a bank. Though it is not a legal requirement, Model One should operate with 15 percent of its assets held as capital. At $1.1 billion this figure is $165 million, and it will increase as Model One gets larger. Model One will also need to secure funding through debt to use as a lending base that is equivalent to the size of the bank assets less bank capital, so, for example at $1.1 billion in assets and $1 billion in loans, Model One will need to secure $935 million in debt to perform its lending.

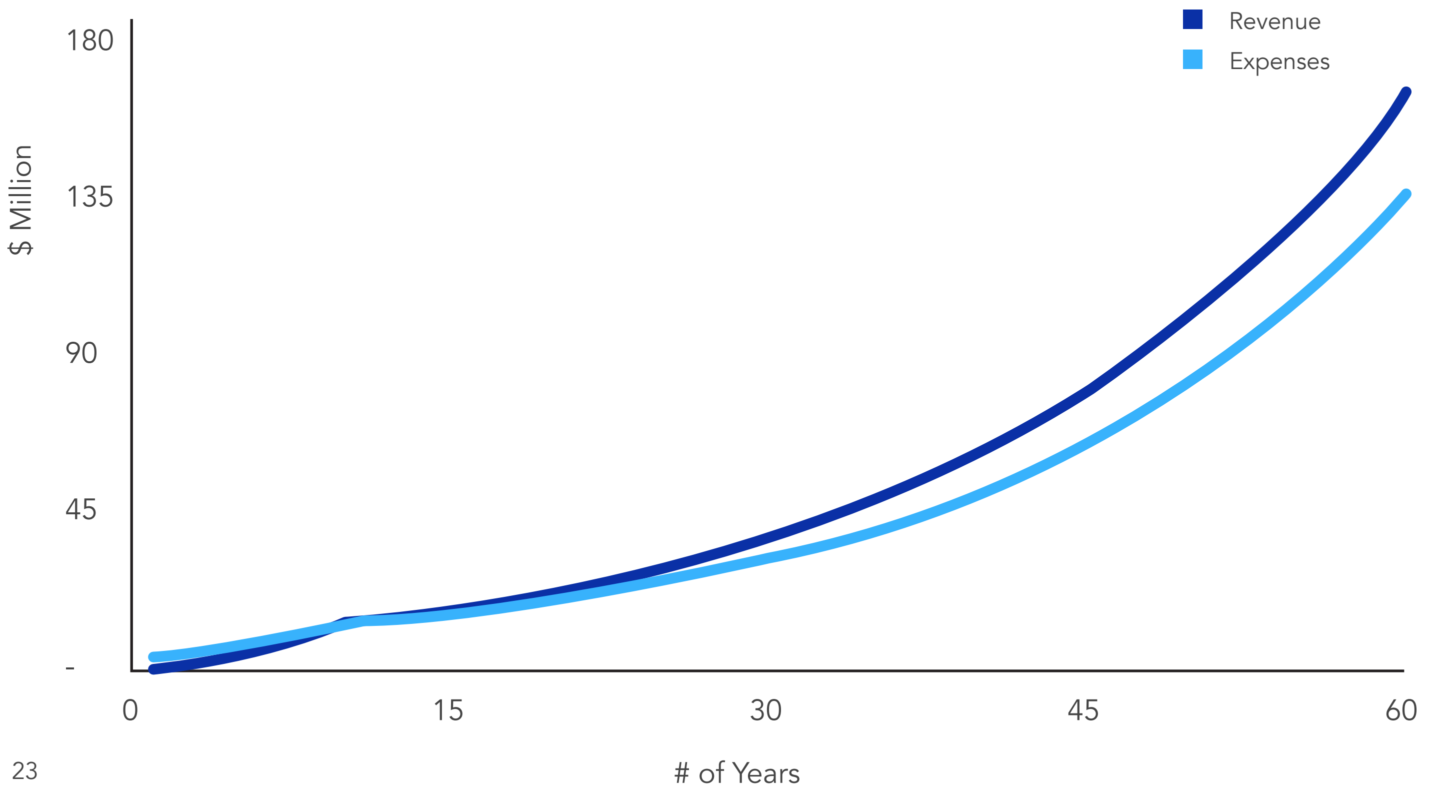
**Table 9: Estimated Range of Costs Associated with Model One**

| Cost Type | Average Cost | Low and High Cost Estimates | Description | Timeframe |
|---|---|---|---|---|
| Size at annual breakeven | $1.1 billion | $330 million – never | Estimated asset size for bank to breakeven | – |
| Start-up costs | $6.25 million | $5 million – $7.5 million | Cost for staffing, real estate, technology infrastructure | Approximately 2 years before operations |
| Balance sheet capital at annual breakeven | $165 million | $50 million – never | Capital equivalent to 15% of assets at breakeven | Year 1+ until operation ceases |

**Table 10: Financial Projections for Model One for the First Ten Years (Low & High Estimates)**

| | Value of Net Outstanding Loans Per Year ($ million) | Total Assets Per Year ($ million) | Net Surplus (Deficit) Per Year - Low Range ($ million) | Net Surplus (Deficit) Per Year - High Range ($ million) |
|---|---|---|---|---|
| Start-Up Years | - | - | (5) | (8) |
| Year 1 | 50 | 55 | (2) | (3) |
| Year 2 | 75 | 83 | (1) | (3) |
| Year 3 | 125 | 138 | (1) | (3) |
| Year 4 | 200 | 220 | (0) | (4) |
| Year 5 | 300 | 330 | 1 | (4) |
| Year 6 | 400 | 440 | 2 | (4) |
| Year 7 | 500 | 550 | 2 | (5) |
| Year 8 | 650 | 715 | 4 | (5) |
| Year 9 | 800 | 880 | 5 | (6) |
| Year 10 | 1,000 | 1,100 | 7 | (6) |
| Total | | | 12 | (51) |
| Capital for Balance Sheet | | | (165) | (165) |

**Figure 1: Projected Expenses & Revenue Over Time for Model One (Average Estimate)**



**Outcomes:** The municipal bank will allow the City to reinvest in the community and serve people, businesses and projects that are currently underserved or unserved by the traditional banking industry. With $1 billion in loans, the municipal bank will be able to bring $1 billion in investment to bear, and the model projects the bank can make approximately 170 affordable housing loans, 60 wholesale small business loans (which will result in numerous small business loans), and 700 direct small business loans. The City currently invests $400 million per year in affordable housing. At $1 billion in loans, the municipal bank would add another $850 million in lending that would revolve on average in 3 to 5 years, adding another $200 million or so to the $400 million in investment for affordable housing per year. This added affordable housing will have further multiplier effects with one analysis finding that building 100 rental apartments results in $11.7 million in local income, $2.2 million in taxes and revenue and 161 local jobs.[22] For small business lending, the bank would add $125 million in wholesale loans and $25 million for approximately 700 in direct loans compared to the about 50 loans for a total of $50 million currently issued by the City's Small Business Revolving Loan Fund and Emerging Business Loan Fund.

**Risks:** The primary risk associated with Model One is the unconventional lending portfolio it will pursue, and the concern that the lines of business as modeled above are unrealistic or unattainable. A lender that performs lending spurned by other banks or that performs lending at below-market rates is necessarily taking larger risks and may face higher defaults than expected or may need to tighten its underwriting standards and perform less lending than anticipated. The model itself includes significant uncertainly about how Model One will perform. With low-end estimates of start-up costs and loan losses, the bank achieves sustainability within 4 years. Under the high-end estimate, which doubles projected loan losses, Model One never breaks even and needs a significant subsidy per year ($6 million per year at $1 billion in size to upwards of $42 million per year at $12 billion in size) in perpetuity to stay afloat.

The difference in the model reflects how loan loss rates, and in particular a higher loan loss rate than expected, can impact bank operations and slow or prevent a path to breaking even. Concerns about loss rates become especially salient as the bank scales and must source a significant number of loans and deals for its portfolio. Bank size was determined based on Task Force feedback, economies of scale and achieving sustainability rather than size of market demand. It's not clear whether performing $200 million per year in affordable housing investment of the type contemplated in the model in San Francisco is realistic (the scale the bank would perform at $1 billion in loans).[23] If market demand and the execution capability of the team assembled to run the bank cannot meet the scope of the municipal bank as modeled, the municipal bank would have to adjust its strategy. The bank could possibly change its product lines or seek opportunities outside of San Francisco. Without adjusting it strategy, it may not be able to achieve the scale modeled or may operate at a greater loss than the high-end estimate.

Loan loss rates are particularly high for the small business lending portfolio, and in the high-cost estimate, small business losses prevent the bank from ever achieving sustainability. These high loss rates led Task Force members to suggest that the bank would need to increase its underwriting standards for this work or pursue an alternative method of encouraging small business lending. Rather than lend directly to small businesses, Task Force members suggested that the municipal bank could

22 California Legislature, "Senate Bill 3," Section 2(h), https://leginfo.legislature.ca.gov/faces/billCompareClient.xhtml?bill_id=201720180SB3.

23 By comparison, the SF Housing Accelerator Fund, a non-profit affordable housing investment fund, has invested over $60 million in affordable housing investment in nine deals in a little over its first year of operations.

guarantee small business loans made by other banks and credit unions, similar to the SBA guarantee program or the California CalCAP Collateral Support (CalCAP CS) program. A guaranty arrangement allows the municipal bank and City to encourage lending that wouldn't otherwise happen without requiring the municipal bank to put its own capital into the loan or perform the administrative tasks associated with loan underwriting, originating and servicing.

Lastly, though the bank does achieve a surplus under low-cost and average-cost estimates, it never will become a significant source of revenue. Though under some estimates Model One will achieve a surplus, become self-sustaining and therefore continue to reinvest in the community indefinitely, it will never become a large generator of income for the City and will not be able to return dividends to the City like Bank of North Dakota does for North Dakota.

**Bottom-Line:** The reinvestment bank outlined in Model One would support affordable housing and small business lending in San Francisco. The model projects that it would require an estimated $5 to $7.5 million in start-up costs and operational subsidies estimated at $13 million (with estimates ranging from $4 million to an ongoing operational subsidy of many millions per year) before it would break even at $1.1 billion in size after 10 years of operation (with estimates ranging from a breakeven at $330 million in size at 4 years to never). The bank would also need $165 million in capital at the annual breakeven point, which would increase over time as the bank grew larger.

## Model Two: Divest

**Goals:** The goal of the "Divest" model is to envision a public bank that can meet the City's cash management and commercial banking needs, allowing the City to avoid working with large banks with practices the City finds objectionable. By removing its banking services from large commercial banks, the City could gain more autonomy over how its short-term deposits are used. The model removes the $100 million currently held in Bank of America accounts. This model does not assume any deposits from or impact on the City's Treasurer's Pooled Investment Fund which is a collection of county, school and special district funds which currently holds over $11 billion. The money in the pool comes from tax revenues, fees, federal and state government, and bond proceeds. All of these funds have already been allocated through the budgetary process and through voter-initiated bond approvals and as part of the capital plan. State law and the City's investment policy sharply limit how the Treasurer can invest the Pool, and in general these investments must be of the highest quality and most secure and short-term in duration. For example, almost 60 percent of the Pool is currently invested in treasuries and federal agencies, and over 50 percent held in securities under 1 year in duration.

**Current State:** The City currently contracts with two large corporate banks, Bank of America and U.S. Bank, to fulfill our City's banking needs. The fees paid to Bank of America and U.S. Bank for banking services total approximately $600,000 per year. These costs are deducted from the interest the City earns on its deposits. The interest is accrued on the nightly $100 million deposited into the bank (these deposits are collateralized for safety) which are used for daily transactions and to pay for banking fees. The City has an annual budget of $11 billion and requires banking services like that of a large multi-national corporation. Annually, San Francisco generates approximately 8 million payment transactions amounting to approximately $13 billion. The City has over 200 bank accounts, and the City processes

24 This figure is lower than the one reported in the November 2017 Budget & Legislative Analyst's report because TTX has taken steps to reduce its banking fee by removing armored car services and supplies from the banking contract and closing underutilized accounts.

significant transactions per year, including:

- 1.2 million checks deposited
- 323,000 credit card transactions for a total of $1.2 billion per year
- 847,000 outgoing payments
- 415 outgoing wires
- 3,200 incoming wires
- Approximately 700,000 ACH credits
- Approximately 500,000 ACH debits

For reference, the City of Seattle Public Bank Feasibility study found that only a national bank with assets greater than $50 billion possesses the scale and capacity to meet Seattle's banking needs, and given San Francisco's larger budget and status as a City and County it has even greater banking needs than Seattle. Only about 40 banks in the country hold $50 billion in assets or more, and most are large global banks rather than merely regional or national banks.

**Activities:** Model Two is a municipal bank that accepts deposits, performs the City's cash management and commercial banking, and participation lending.

*City's Commercial Banking:* The municipal bank would serve as the City's commercial banker, providing disbursements, deposits, cash management, payment processing, and reporting and technology solutions.[25] The municipal bank will hold about $100 million in deposits that are currently held in Bank of America, and under current state law this money must be collateralized via eligible securities at 105-to-150 percent of its value.[26] The bank would charge the City $600,000 for this work, equivalent to the fees currently paid to Bank of America.

*Participation Lending:* The municipal bank would partner with banks to perform participation lending, where a bank partners on lending performed by other banks. In this instance, the municipal bank would initially purchase loans originated by other banks. The goal of this lending is to subsidize the cash management operations of the bank (as a reminder: banks primarily make money by lending out their deposits at a higher rate than the interest that they pay on those deposits). If the municipal bank chose to purchase loans from local community banks or credit unions, this participation lending could support the local banking industry by providing additional liquidity, though this is not the primary aim of the lending portfolio. The model estimates that the average size of the loan is about $5 million with a four percent interest rate, a loss rate of 0.25-0.5 percent and an average term of 17 years.

**Table 11: Model Two Lines of Business at $1 Billion in Loans**

| Lines of Business | Loan Assets at $1B ($MM) | Percent of Portfolio at $1B | Number of Loans at $1B | Average Size of Loan | Average Interest Rate | Loss Rates | Average Loan Term |
|---|---|---|---|---|---|---|---|
| Participation Lending | 1,000 | 100% | 200 | $5,000,000 | 4% | 0.25-0.5% | 17 years |

25 The bank will still utilize financial technology companies for IT systems and an armored courier provider for transporting currency.

26 California Government Code § 53652.

**Operational Components:**
To achieve financial sustainability, Model Two must be $3.1 billion in size. The model projects it will take around 31 years to break even operationally for the year (the low-estimate projects a surplus after 25 years, and the high-estimate projects 37 years). In the first 31 years, the model estimates the bank will need $990 million in subsidies to maintain operations until it can break even and achieve a surplus (with estimates ranging from $580 million to $1.5 billion). The bank will also need to hold capital equivalent to 15 percent of assets – at least $165 million at $1.1 billion in assets and increasing from there. The bank will also need a deposit base equivalent to the size of the bank assets less bank capital, so, for example at $1.1 billion in assets and $1 billion in loans, the bank will need to secure $935 million in deposits to perform its lending.

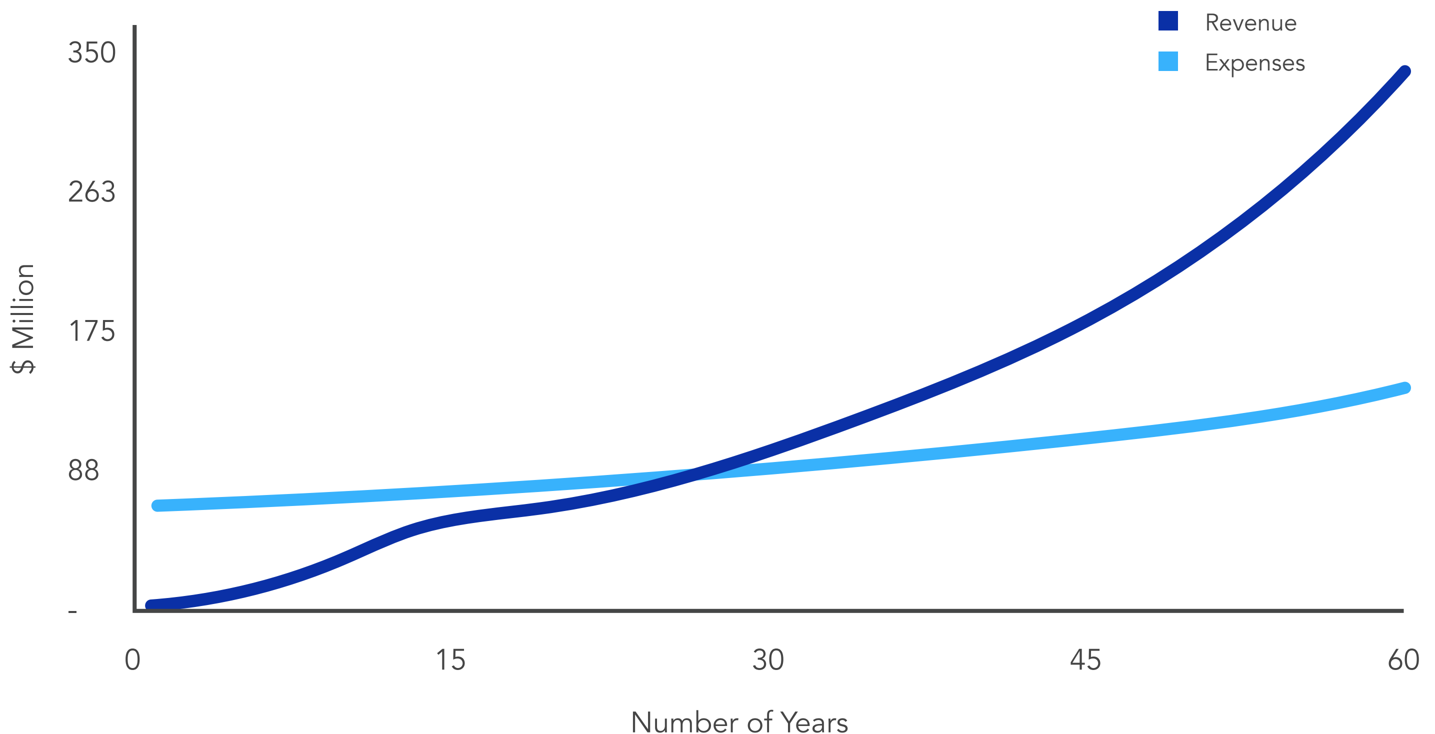
**Table 12: Estimated Range of Costs Associated with Model Two**

| Cost Type | Average Cost | Low and High Cost Estimates | Description | Timeframe |
|---|---|---|---|---|
| Size at annual breakeven | $3.1 billion | $2.3 billion – $4.1 billion | Estimated asset size for bank to breakeven | – |
| Start-up costs | $119 million | $95 million – $143 million | Cost for staffing, real estate, technology infrastructure | Approximately 2 years before operations |
| Balance sheet capital at annual breakeven | $460 million | $340 million – $615 million | Capital equivalent to 15% of assets at breakeven | Year 1+ until operation ceases |

**Table 13: Financial Projections for Model Two for the First Ten Years (Low & High Estimates)**

| | Value of Net Outstanding Loans Per Year ($ million) | Total Assets Per Year ($ million) | Net Surplus (Deficit) Per Year - Low Range ($ million) | Net Surplus (Deficit) Per Year - High Range ($ million) |
|---|---|---|---|---|
| Start-Up Years | - | - | (95) | (143) |
| Year 1 | 50 | 55 | (48) | (73) |
| Year 2 | 75 | 83 | (48) | (73) |
| Year 3 | 125 | 138 | (46) | (72) |
| Year 4 | 200 | 220 | (44) | (70) |
| Year 5 | 300 | 330 | (42) | (68) |
| Year 6 | 400 | 440 | (39) | (66) |
| Year 7 | 500 | 550 | (37) | (64) |
| Year 8 | 650 | 715 | (33) | (61) |
| Year 9 | 800 | 880 | (30) | (58) |
| Year 10 | 1,000 | 1,100 | (25) | (54) |
| Total | | | (488) | (804) |
| Capital for Balance Sheet | | | (165) | (165) |

**Figure 2: Projected Expenses & Revenue for Model Two Over Time (Average Estimate)**



**Outcomes:** The municipal bank will allow the City to divest from commercial banking partners (though the bank will still utilize financial technology companies for IT systems and an armored courier provider). The municipal bank will also perform significant participation lending – at $1 billion in loans, it will offer 200 loans at $5 million each to support its operational costs.

**Risks:** Though the participation lending performed by the bank in Model Two is quite secure, there are still risks associated with chartering and operating a divestment model bank. First, the bank has significant capitalization, start-up and operational costs and will require years of investment by the City before it achieves a surplus. The City would not only need to raise money for start-up costs and capitalization, but it must continue to subsidize the bank for decades. Regulators may be reluctant to approve a bank that requires subsidies or injections for so many years. Because the lending portfolio is relatively long-term term, it is vulnerable to a maturity mismatch (where deposits are owed at a different time than loans mature) or interest rate rises (where the bank must pay more interest on deposits reducing the value of its lending portfolio). Lastly, a bank that is responsible for performing the City's cash management has no room for error. It must perform the City's cash management functions perfectly because any operational issues could impair the City's daily functioning and result in the City not making payroll or missing a debt payment.

**Bottom-Line:** A bank that can perform the City's commercial banking functions and participation lending must be $3.1 billion in size to achieve financial sustainability, with an average $460 million in bank capital and $119 million in start-up costs. The model projects it could take the bank 31 years of losses (with estimates ranging from 25 to 37) before it breaks even on an annual basis, and during this time it would require operational subsidies of $990 million (with estimates ranging from $580 million to $1.5 billion). At $3.1 billion in size, the average breakeven point, the bank would buy $2.8 billion in participation loans to cover its operating costs, which could equate to over 560 participation loans of $5 million each.

## Model Three: Combination

**Goals:** The goal of the combination model is a public bank that both divests – performing the City's cash management and commercial banking – and reinvests in the community by performing affordable housing and small business lending.

Model Three represents the widest spectrum of municipal bank activities and reaches the fullest potential of a municipal bank of all three models, because it combines reinvestment and divestment activities. For some members of the Task Force and the public anything that falls short of both divestment and reinvestment does not do justice to the idea of a municipal bank.

**Activities:** Model Three is a municipal bank that accepts deposits, performs the City's cash management and commercial banking, and affordable housing and small business lending. The activities of Model Three combine the City's commercial banking in Model Two with the real estate lending, wholesale small business lending and direct small business lending in Model One. As with Model One and Model Two, Model Three will not perform retail banking for customers.

**Table 14: Model Three Lines of Business at $1 Billion in Loans**

| | Loan Assets at $1B ($MM) | Percent of Loans at $1B | Number of Loans at $1B | Average Size of Loan | Average Interest Rate | Estimated Loss Rate (Low-High) | Average Loan Term |
|---|---|---|---|---|---|---|---|
| **Real Estate Lending (ADU, mezzanine debt, small sites)** | 850 | 85% | 170 | $5,000,000 | 5% | 1-2% | 3-5 years |
| **Wholesale Small Business Lending** | 125 | 12.5% | 60 | $2,000,000 | 2.5% | 0.5-1% | 5 years |
| **Direct Small Business Lending** | 25 | 2.5% | 700 | $35,000 | 15% | 15-30% | 3-5 years |

**Operational Components:**
To achieve financial sustainability, Model Three must be $10.4 billion in size with $1.6 billion in bank capital. The model projects it will take around 56 years to break even operationally for the year (the low-estimate projects a surplus in 36 years, and the high-estimate never achieves a surplus). During these years of losses, the bank will need an average $2.2 billion in subsidies to maintain operations until it can break even (with estimates ranging from $980 million through a continuous $78 million per year subsidy). The bank will also need a deposit base equivalent to the size of the bank assets less bank capital, so, for example at $1.1 billion in assets and $1 billion in loans, the bank will need to secure $935 million in deposits to perform its lending.

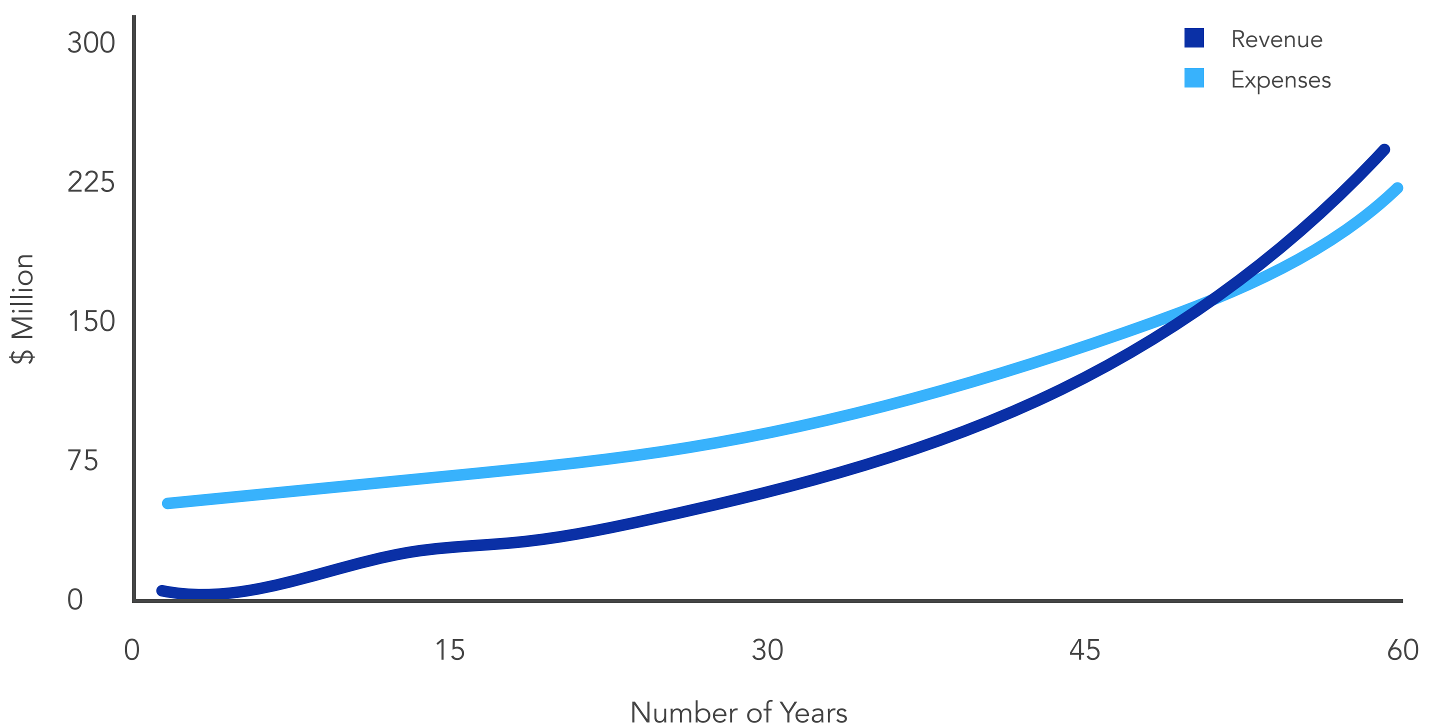
**Table 15: Estimated Range of Costs Associated with Model Three**

| Cost Type | Average Cost | Low and High Cost Estimates | Description | Timeframe |
|---|---|---|---|---|
| Size at annual breakeven | $10.4 billion | $3.9 billion – never | Estimated asset size for bank to breakeven | – |
| Start-up costs | $119 million | $95 million – $143 million | Cost for staffing, real estate, technology infrastructure | Approximately 2 years before operations |
| Balance sheet capital at annual breakeven | $1.6 billion | $590 million – never | Capital equivalent to 15% of assets at breakeven | Year 1+ until operation ceases |

**Table 16: Financial Projections for Model Three for the First Ten Years (Low & High Estimates)**

| | Value of Net Outstanding Loans Per Year ($ million) | Total Assets Per Year ($ million) | Net Surplus (Deficit) Per Year - Low Range ($ million) | Net Surplus (Deficit) Per Year - High Range ($ million) |
|---|---|---|---|---|
| Start-Up Years | - | - | (95) | (143) |
| Year 1 | 50 | 55 | (49) | (74) |
| Year 2 | 75 | 83 | (48) | (74) |
| Year 3 | 125 | 138 | (48) | (74) |
| Year 4 | 200 | 220 | (47) | (74) |
| Year 5 | 300 | 330 | (45) | (74) |
| Year 6 | 400 | 440 | (44) | (74) |
| Year 7 | 500 | 550 | (42) | (75) |
| Year 8 | 650 | 715 | (40) | (75) |
| Year 9 | 800 | 880 | (38) | (75) |
| Year 10 | 1,000 | 1,100 | (36) | (75) |
| Total | | | (532) | (888) |
| Capital for Balance Sheet | | | (165) | (165) |

**Figure 3: Projected Expenses & Revenue for Model Three Over Time (Average Estimate)**



**Outcomes:** The municipal bank will allow the City to divest from commercial banking partners. The municipal bank will also perform significant lending in the community. As in Model One, at $1 billion in loans, the municipal bank will make approximately 170 affordable housing loans, 60 wholesale small business loans (which will result in numerous small business loans), and 700 direct small business loans. As the bank scales up, the magnitude of its investment in the community will similarly scale.

**Risks:** Intuitively, the risks of Model Three include the risks associated with Model One and Model Two; however, these risks compound, because Model Three includes the high costs and strenuous demands associated with performing the City's commercial banking work in addition to the riskier and more labor-intensive lending portfolio. Model Three struggles to achieve sustainability because it combines the high start-up and overhead costs of performing the City's cash management with the reduced profit resulting from a lower-margin but high-impact lending portfolio.

The slowness of Model Three's path to profitability increases the operational, political and regulatory risks. Each year, there is concern that the bank will lose political support and thus its subsidy or that regulators will intervene. Over the course of 56 years, economic conditions may force the bank to change its business model or may stymie its growth. Additionally, the longer the time frame modeled, the less reliable the model results.

**Bottom-Line:** A bank that can perform the City's commercial banking functions and reinvestment via affordable housing and small business lending must be $10.4 billion in size to achieve financial sustainability, with an average $1.6 billion in bank capital and $119 million in start-up costs. The model projects it could take the bank 56 years of losses (with estimates ranging from 36 years to never) before it breaks even on an annual basis, and during this time it would require operational subsidies of $2.2 billion (with estimates ranging from $980 million to a continuous $78 million per year).

## Assumptions

All financial models rely on a set of assumptions about how a business will operate and the prevailing economic conditions. To model the municipal bank structures outlined above, TTX staff and the Task Force made a number of assumptions about municipal bank operations. The assumptions are listed below with a brief explanation. For more details on the modeling methodologies, refer to Appendix D, the technical appendix.

**Assumption #1: The bank will provide one percent return to depositors except in Model One.** Models Two and Three project that the bank's cost of funds would be one percent, meaning the City and other depositors would receive a one percent return on their deposits. Bank of North Dakota's cost of funds is 0.6 percent, and most community banks and credit unions tend to have a cost of funds around one percent.[27] It is important to note that a one percent return may be less than what the City and other depositors would get from other banks and investments (currently the City receives about 0.8 percent on its Bank of America deposits). However, other mission-driven banks that offer similar returns note that they have no problems securing deposits because institutions are interested in supporting their work. Model One, which lacks a banking charter, will have to pay a higher cost of funds, estimated at two percent, because it must raise debt rather than accept deposits, and debt requires a higher rate of return for investors, because it is perceived as riskier.

27 For example, members of the Federal Home Loan Bank of San Francisco reported a cost of funds of 1.06 percent for November 2018. Federal Home Loan Bank of San Francisco. Cost of Funds Indices. http://www.fhlbsf.com/resource-center/cofi/

**Assumption #2: Models Two and Three envision a bank that performs the City's cash management.** The municipal banks modeled in scenario two and three envision a bank that takes over the City's cash management and commercial banking from Bank of America and U.S. Bank, the City's current banking vendors. The municipal bank would be responsible for treasury management, disbursement and deposits, and credit card processing.

**Assumption #3: No models envision a bank that serves as a bond underwriter or custodian of the investment pool.** Aside from cash management and commercial banking, the City also utilizes large commercial banks to underwrite bonds, a form of debt to fund long-term projects, and serve as custodian of the investment pool. Bond underwriters help the City sell its bonds to investors, and a municipal bank would need to be a registered broker-dealer and have expertise in capital markets with a sales channel to perform this work. This expertise is separate and apart from traditional community banking. Similarly, the models do not envision the municipal bank serving as the custodian of the Treasurer's Pooled Investment Fund, because it is not possible to lease a platform for custodian work, and the cost to develop the technology and hire staff would outweigh the limited fee income (currently $200,000 per year).

**Assumption #4: The bank will not provide any non-lending retail services.** The municipal banks modeled do not offer traditional retail banking services for personal or business clients (such as cash management, debit cards, ACH payments etc.), because it is difficult to perform retail banking well, and retail banking greatly increases infrastructure and staffing costs. Banks typically lose money on free checking accounts, and banking experts noted that providing high-quality retail services would be costly.[28] To avoid this loss, the municipal bank will not offer retail services.

**Assumption #5: Models include income from interest spread and commercial banking fees.** A typical community bank earns about 80 percent of its income from interest and 20 percent from fees (such as overdraft fees, account maintenance fees etc.). The bank models assume that revenue comes from interest income (the spread between the interest charged on loans and the interest paid out on deposits), and the $600,000 fee that the municipal bank charges to the City for its commercial banking work in Models Two and Three. Aside from that fee, the bank does not include any fee income. The bank likely will charge fees for its services (such as origination fees, servicing fees etc.), but these fees are not included in the model.

**Assumption #6: Interest rates for direct loans are modeled below-market:** Interest rates for direct loans are intentionally modeled below market rate as the goal of the reinvestment model is to fill gaps in current banking practices and spur investment. Though the models include one interest rate per line of business, this rate is not monolithic (it represents a blended rate and rates may vary based on the project), and interest rates will change over time as the economic conditions and market rates change.

**Assumption #7: Loss rates are modeled based on industry comparisons but may be higher given a riskier portfolio:** To the maximum extent possible, the bank models utilize loss rates based on industry comparisons. Because some of the municipal bank models envision a riskier lending portfolio, all loss rates are ranges, to reflect that the loss rate may be higher than industry comparisons.

**Assumption #8: Source of capital is not defined.** The bank models identify an estimated amount of capital that is required to support the bank's operations. The source of the capital is not defined, and the models do not depend on capital coming from any particular source.

28 Claes, B. (December 14, 2011). Banks lose big on free checking. Bankrate.com. Retrieved from: https://www.bankrate.com/financing/banking/banks-losing-big-on-free-checking/.

**Assumption #9: Source of deposits is not defined.** The bank models identify an estimated magnitude of deposits that is required to support the bank's lending portfolio. The source of these deposits is not identified, and the models do not depend on deposits coming from any particular source; however, the bank will not provide retail banking services (except to the City), so the depositors must be comfortable using the bank as a savings account rather than a checking account. The bank may need to pay a slightly higher return to depositors, because it seeks longer-term deposits.

**Assumption #10: The bank will keep ten percent of funds liquid.** As noted above, banks primarily make money by lending deposits out at a higher interest rate than they pay to depositors. However, banks typically do not lend out all their assets and keep some on-hand as cash or other highly-liquid assets. Similarly, the municipal bank is modeled as lending out 90 percent of assets and holding ten percent of assets in liquid assets.[29]

29 This liquidity explains the distinction made in the models below between the size of the bank (for example, $1.1 billion in assets) and the size of the lending portfolio (for example, $1 billion in loans).

# What Are the Policy & Operational Considerations Around Forming a Bank?

The proposed lines of business and municipal bank models presented above are not meant to be the final word on the options available to the City in creating a municipal bank. Instead, they illustrate several directions – bank versus non-bank entity, divestment versus reinvestment – a bank could take and outline the costs, benefits and risks associated with municipal banking. In developing and analyzing these models as well as the steps necessary to create a municipal bank, a number of important policy considerations emerged. This section highlights the major policy questions that remain around creating a municipal bank that can help answer the question of whether a municipal bank is a good policy idea.

Based on the municipal bank models, the City would need to raise at least $165 million in capital and find upwards of $935 million in debt or deposits. A major policy question becomes: where can the City find funding for capitalization and deposits?

## Sources of Bank Capital

### General Fund Appropriation

The most straightforward way to secure capital is for the Board of Supervisors and the Mayor to allocate funds from the general fund during their standard budget process. Though the City has a budget of $11 billion, only about $2.2 billion of that money is discretionary as the rest belongs to enterprise departments or is set aside for specific voter-mandates. That $2.2 billion must fund all non-enterprise departments and City operations. The Board of Supervisors and the Mayor work together to determine how to allocate this funding, and the capital for a municipal bank would compete against other pressing funding demands.[30] Of this $2.2 billion, $68 million went to the Office of Economic and Workforce Development (OEWD) which supports economic development and small business lending, and $152 million went to MOHCD which supports affordable housing and economic development.[31] Overall, the City

30 Based on the City's Comprehensive Annual Financial Report (CAFR), there were discussions at the Task Force meetings and among advocates about whether the City was running a "surplus," and therefore has significant unallocated funds that could be used to capitalize a municipal bank. In short, aside from one or two funding sources currently held in case of an emergency, there is no unallocated money that could be used to capitalize a municipal bank. Discussions about unallocated funds centered around the funds listed in page 165, defined "Available for Appropriations," which includes "Unassigned Funds." For $95 million in "Unassigned – General Reserve" was initially created to address current year needs unanticipated in the budget, and later was updated to augment the economic stabilization reserves. Admin Code § 10.60 governs the use of these reserves. If used, it must be replenished in the next year unless the City is a recession scenario. The Board can suspend this provision for one year by a 2/3 vote. The $288 million "Unassigned – Budget for use in fiscal year 2018-2019" has already been allocated for 2018-2019 via the City's two-year budget process. Any money taken from this pool will cut current FY18-19 appropriations. The $60 million in "Unassigned – Contingency for fiscal year 2017-2018" was adopted by the Board of Supervisors to address potential changes in federal impacts and ACA changes. $50M remains available, though use of these funds would limit the City's ability to address a cut in coverage or repeal of the ACA. The $14 million "Unassigned – Available for future appropriations" is the fund balance at the end of fiscal year 2016-2017. This money is projected to cover shortfalls and not available for appropriation. City and County of San Francisco, Office of Controller. (2017). Comprehensive Annual Financial Report Year ended June 30, 2017. Retrieved from: https://sfcontroller.org/sites/default/files/Documents/Accounting/CCSF%20CAFR%20FY2016-17%20no%20cover%20FINAL%20reduced.compressed.pdf.

31 The San Francisco Board of Supervisors. City and County of San Francisco Budget and Appropriation Ordinance Fiscal Year Ending June 30, 2019 and Fiscal Year Ending June 30, 2020. Retrieved from: https://sfgov.legistar.com/View.ashx?M=F&ID=6406150&GUID=663AE469-8025-4FFB-B183-4157BA300C25.

spends $400 million on affordable housing per year, though some of this funding comes from non-discretionary sources (like the Housing Trust Fund).[32]

### Philanthropy

The bank could also seek out private philanthropic donations for capitalization. The major benefit is that philanthropic dollars need not come at the expense of other City priorities. It would be important to find mission-aligned philanthropic sources so that the bank could remain focused on community goals, and the philanthropic funding should not impact the bank's ability to be independent.

### Crowdfunding

Lastly, the bank could use crowdfunding, soliciting money from the community to capitalize a bank. The most famous example of crowdfunding is the Green Bay Packers,[33] and the City could use several mechanisms to crowdfund capital from community investment. If the City accepts philanthropic money or crowdsourced money (or uses any third-party money aside from its own), it will need to create a bank holding company to own the bank. This additional level of regulatory structure may increase the costs and complexity of chartering a municipal bank.

## Sources of Funds That Can't Be Used for Bank Capital

### Bonds

The City cannot use a general obligation bond issuance to capitalize a municipal bank because bonds are limited by the State Constitution to specific uses. Section1(b) of Article XIII A of the California State Constitution limits the use of general obligation bonds to "the acquisition or improvement of real property."[34] Though a municipal bank may itself invest in real estate projects, the bond will be used for bank capital and would not qualify as "the acquisition or improvement of real property."

### Pooled Investment Funds

The Treasurer's Pooled Investment Fund holds money that has already been appropriated in the budgetary process and is "not required for the immediate needs" of the City as well as money that belongs to other entities such as the San Francisco Unified School District and City College.[35] All of the funds have already been allocated through the budgetary process and through voter-initiated bond approvals and as part of the capital plan. The California Government Code sharply restricts the types of investment the Treasurer can make with the fund. All investments must be less than five years in duration and must be of the highest quality. State law does not permit the Treasurer to purchase or invest corporate stock,[36] and so the Treasurer currently may not use the Treasurer's Pooled Investment Fund to own corporate stock and capitalize a public bank.

## Sources of Deposits

Aside from capitalization, a municipal bank also needs upwards of $1 billion in deposits, and

32 The San Francisco Office of the Mayor. (August 2018). Mayor London Breed Signs Budget Targeting Homelessness, Housing, Street Cleanliness, and Public Safety [Press Release]. Retrieved from: https://sfmayor.org/article/mayor-london-breed-signs-budget-targeting-homelessness-housing-street-cleanliness-and-public.

33 The Green Bay Packers have been a publicly owned nonprofit corporation since 1923 and has raised capital by selling stock in five different offerings. Today, over 360,000 members of the public co-own the Green Bay Packers via common stock. This stock is not stock in a traditional sense: it does not increase in value; it does not pay dividends, and it cannot be resold (except back to the franchise). Saunders, L. (January 13, 2012). Are the Green Bay Packers the Worst Stock in America? Wall Street Journal. Retrieved from: https://blogs.wsj.com/totalreturn/2012/01/13/are-the-green-bay-packers-the-worst-stock-in-america/.

34 Cal. Const. art. XIII A, § 1(b).

35 California Government Code § 53601.

36 California Government Code § 53601; San Francisco City Attorney's Office (2013), Memorandum re: Municipal Bank Formation.

this funding could come from the City, private businesses, and large institutions.

### City Funds

Deposits could come from a general fund appropriation, from the $100 million the City currently holds in overnight deposits in Bank of America, or from the Treasurer's Pooled Investment Fund via certificates of deposit similar to the current Safe, Sound and Local Program. State law requires that government deposits be collateralized and limited to the amount of capital that the bank holds.[37] The $100 million currently held in the Bank of America account are used daily to pay the City's obligations, and so the City must be able to rely on their availability and liquidity or else the City's financial well-being would be adversely impacted.

### Other Institutions

The bank could also accept deposits from institutions such as other governments (though money may need to be collateralized), foundations, hospitals and universities, as these organizations may want to support the bank's mission. The bank could offer a reasonable return on accounts rather than retail services. Many mission-oriented local community banks note that they do not have any trouble attracting deposits, because consumers want a non-Wall Street alternative to hold their money. If the municipal bank does not offer retail services, though, the return to depositors may need to be higher than the one percent currently modeled.

## How Should Bank Governance Be Structured?

The municipal bank ultimately exists to serve the City and taxpayers, and so the governance structure should likely include both government and citizen representation. However, it is equally crucial that a municipal bank operate as a sound business, independent from the political process and political pressures. The FDIC has expressly noted that applications from public banks will be examined closely because public banks present "unique supervisory concerns that do not exist with privately owned depository institutions."[38] Internationally, political pressure has reportedly impaired the operation of public banks.[39] A municipal bank in San Francisco may be similarly vulnerable to conflict between bank leadership and public figures. City government likely should not have a majority or a perceived majority of the bank governing body, and the rest of the board should be composed of well-respected, independent experts with a background in banking and finance.

Despite concerns regarding politics, it is important that the work of the municipal bank dovetail with the City's work and priorities. The City will likely be the primary investor in the bank, and the municipal bank exists to invest in the community and serve taxpayers. At times, the bank may need to partner with the City: for example, if the municipal bank is providing loans on an affordable housing project, it must ensure that the City has secured and can enforce the developer's commitment to affordability.

37 California Government Code § 53638; California Government Code § 53652.

38 The FDIC Statement of Policy states: "For example, because of their ultimate control by the political process, such institutions could raise special concerns relating to management stability, their business purpose, and their ability and willingness to raise capital (particularly in the form of true equity rather than governmental transfers)." Federal Deposit Insurance Corporation (1998). Statement of Policy on Applications for Deposit Insurance. Retrieved from: https://www.fdic.gov/regulations/laws/rules/5000-3000.html.

39 The head of Slovenia's publicly-owned bank, Nova Ljubljanska Banka (NLB), resigned in 2009 due to political interference, and his successor resigned a year later citing similar reasons. Similarly a study of public banks in 65 countries found that banks that experience political interference (defined as a change in bank executives after elections) have worse financial performance, though the impact is greater in developing countries. Beynet, P. (October 1, 2013). In Banking, Should There Be a 'Public Option'? Lessons from Slovenia's Public Banking Crisis. The New York Times. Retrieved from: https://www.nytimes.com/roomfordebate/2013/10/01/should-states-operate-public-banks/lessons-from-slovenias-public-banking-crisis; Shen, C. and Lin, C. (April 2012). Why government banks underperform: A political interference view. Journal of Financial Intermediation 21(2). Retrieved from: https://www.sciencedirect.com/science/article/pii/S1042957311000271.

The governance structure must not only balance political independence with potential City partnership, but also ensure the bank both turns a profit and remains true to its mission. As fiduciaries of the organization, the Board of Directors must act in the best interest of the bank and the shareholders. Even if the bank is structured as a benefit corporation, the Board must still require that the bank be fiscally prudent and on a path to sustainability. At the same time, the Board must ensure that the bank adheres to its mission and does not engage in mission creep or forgo the mission to pursue greater profitability. The governance structure and formation documents should include provisions to ensure that the bank can both achieve a surplus and operate prudently while simultaneously complying with its mission, but the conflict between pursuing profitability and social goals will likely remain throughout bank operations. Ultimately bank governance and leadership must fully accept this conflict and ensure that a commitment to both social good and fiscal sustainability is baked into the structure of the bank and that all bank stakeholders are committed to making the hard decisions necessary to ensure the bank's ongoing viability.

## What Are the Tensions Between a Municipal Bank and the Treasurer's Role?

Per State law, a County Treasurer has one overriding priority: to ensure the funds in his or her custody remain secure and protected. This requirement applies equally strongly to the money held in the City's cash management accounts with Bank of America and the money held in securities in the Treasurer's Pooled Investment Fund. In 1994, Orange County filed for bankruptcy because of reckless investing by the County Treasurer. Because of this bankruptcy, county programs were cut, services were reduced, and public employees lost their jobs. In the wake of the Orange County bankruptcy and to prevent a similar catastrophe in the future, very strict criteria were codified to govern how county treasurers can manage public funds. Per state law and the City's investment policy, the City's top priority must always be preserving the safety of the principal, followed by meeting liquidity needs, and only then receiving a reasonable yield. Further, county treasurers must require any depository entity provide collateralization of at least 105 percent. This is a critical safeguard of the public's money. Without collateralization, market fluctuations could risk the safety of taxpayer funds, and the City's ability to pay for vital services.

Ultimately, a county treasurer may only put money in a municipal bank if it meets the safety, liquidity and yield requirements mandated under state law. Many of the barriers to a municipal bank – collateralization of public deposits, limits on deposits to capital of the bank[40] – exist to protect the City's money. Money that is fully collateralized cannot be lost in the event of a bank failure. While public banks thrive around the world, bank failure is always a risk – for both public and private banks. The municipal banks modeled above may pose a higher risk of failure than traditional community banks or the Bank of North Dakota, because they plan to perform below-market lending to projects and individuals rejected by traditional banks. While a municipal bank would be governed and monitored by multiple regulators, the decision of whether a municipal bank is safe enough for the City's money is ultimately left up to the Treasurer. In investing and safeguarding the City's money, a county treasurer must act with the "care, skill, prudence, and diligence… that a prudent person" would use.[41] The very thing that makes a municipal bank attractive to the City (filling gaps in service and reinvestment)

40 California Government Code § 53638; California Government Code § 53652.

41 California Government Code § 53600.3. Trustees covered by this rule include: "all governing bodies of local agencies or persons authorized to make investment decisions on behalf of those local agencies investing public funds." Id.

may conflict with the Treasurer's role and priority in safeguarding the funding. Given the high costs – if something goes wrong, taxpayers would lose their money and City services and employees could be impacted – it is crucial that the City ensure that a municipal bank's structure and lines of business align with a county treasurer's mandate.

## What Are Other Options Aside from Creating a Municipal Bank?

Creating a municipal bank is a costly and time-intensive endeavor. Before deciding whether to create a municipal bank, the City could also consider alternative programs and policies that could serve similar aims as a municipal bank. Even if the City chooses to go forward and create a municipal bank, it will likely take at least three years to get a bank that is fully operational. In the interim, there are many opportunities for the City to achieve its goals. These initiatives and programs are aimed at various outcomes: socially responsible banking, small business lending and un- and underbanked individuals. Some of these programs involve some form of money transfer or lending but do not require the City to charter or operate a bank. They frequently take advantage of organizations and work that is already happening, facilitating lending rather than competing directly to make the loans. Opportunities are as follows:

### Other Bank Options

Aside from Models One, Two and Three presented above, Task Force members had a number of ideas for other municipal bank structures. Though the Task Force and staff chose not to pursue an in-depth analysis of these models, the following section provides a brief overview of these models and potential costs as well as benefits of pursuing them.

- **Partner with a fintech to reduce bank costs:** Several members of the Task Force were interested in investigating opportunities for financial technology (fintech) companies to partner with the bank and help drive down municipal bank costs, particularly the costs associated with performing the City's commercial banking. For example, Task Force members suggested that the bank could provide the front end of a municipal bank and utilize a fintech to provide the costly infrastructure and back-end of the bank. TTX staff met with and spoke to many fintechs operating in the Bay Area and around the country, seeking companies to collaborate with. In general, the fintechs that the City encountered were unable to accommodate our needs. Many were too small and lacked the ability to scale up. Others handled only electronic payments and did not have a cash solution, which is necessary given the high-volume of cash that the City handles on a daily basis. Lastly, banking staff were concerned about providing essential functions to a new and untested company or technology, as operational issues or glitches could impair City functioning and result in serious adverse outcomes like the City failing to make a bond payment or missing payroll. Despite these concerns, fintechs still offer significant promise and have the potential to revolutionize the banking industry. There may be existing fintech companies that could help a municipal bank serve as the City's banker in a more efficient and less costly manner. If the right company doesn't exist now, there certainly will be more opportunities in the future. The promise of fintechs suggest that IT costs for a municipal bank could decrease over time as technologies improve.
- **Acquire a local community bank:** Rather than create and charter a new bank, several Task Force members suggested that the City could acquire a local community bank. Acquiring a bank has several benefits. It eliminates the need for the City to create all the infrastructure for a bank, including acquiring FDIC insurance, a state charter, and information technology systems. Moreover, if the City were to acquire an existing bank, it would acquire the bank's

deposits and loan portfolio which could potentially hasten the path to profitability. On the other hand, a concern about acquiring a bank is that it may not be able to accomplish either divestment or reinvestment initially. A local community bank will not have the infrastructure to serve as the City's banker initially, and its loan portfolio likely will not match up to community goals. In fact, for some banks, their outstanding loans may be more of a liability than an asset, because these loans may be risky and not in line with the values of a municipal bank, potentially leaving the municipal bank in the uncomfortable situation of taking adverse action on problematic or predatory loans. However, over time, the bank could build the infrastructure necessary to serve as the City's commercial banker and evolve its loan portfolio to meet reinvestment goals. The cost to buy a bank will depend on a variety of factors: the size, assets, capitalization, facilities, projected revenue and IT infrastructure of the bank. In general, though, the City could expect to pay the net worth of the bank (capitalization) plus a premium (one expert put the premium at approximately 20 percent). There are significant due diligence and regulatory hurdles associated with buying a bank, and bank experts cautioned that acquiring a bank would not necessarily be faster than creating a new bank.

- **Create an investment bank:** Some members of the Task Force felt strongly that a municipal bank should focus more on infrastructure and underwrite the City's bond issuances. For some members this work would occur instead of commercial banking, whereas for others, the infrastructure lending and underwriting would occur in conjunction with commercial banking and lending. To become a bond underwriter, the municipal bank would need to become an investment bank and a registered broker-dealer. It would need to hire staff that have expertise in capital markets and a sales channel to investors and who are willing to work for lower-pay for a municipal investment bank rather than a traditional investment bank. It would also have to meet a heavy compliance burden with thornier conflict-of-interest issues and may have to win bids to underwrite the City's bonds, depending on whether the City uses a competitive or negotiated process. Creating a municipal investment bank would allow the City to reduce or eliminate its reliance on Wall Street investment banks for its underwriting work and would reduce or eliminate the fees it currently pays to those banks. Underwriting bonds would bring in a source of revenue for the municipal bank – rates for underwriting vary from about 0.3 to 1 percent of total issuance in California.[42] Having a municipal bank underwrite bonds, though, would still result in the City taking on debt to perform large municipal projects, and ultimately that debt would likely still be held by institutional investors and higher-income households.[43] Staff were unable to model the costs and benefits of the City creating an investment bank and performing its own underwriting because they did not have the background or expertise necessary.

- **Support efforts to create a state or regional public bank:** Members of the Task Force also suggested that the report include a model for a state-wide or regional public bank. In California, there are numerous proposals for state banks including the State Treasurer's feasibility study for a public bank serving the cannabis industry and a proposal to turn the State Infrastructure Bank (I-Bank) into a depository institution. A full financial

42 Schaefer, Tim (February 1, 2019). Personal interview; KNN Public Finance (October 22, 2013). Cost of Issuance [PowerPoint slides]. Retrieved from: https://www.treasurer.ca.gov/cdiac/seminars/2013/20131022/day1/5.pdf.

43 Municipal Securities Rulemaking Board (2018). Trends in Municipal Bond Ownership. Retrieved from: http://www.msrb.org/msrb1/pdfs/MSRB-Brief-Trends-Bond-Ownership.pdf.

model for a state or regional public bank is beyond the scope of this study. However, there likely would be numerous benefits to a state- or regional-level public bank that would help with the bank's scale, safety and impact. A bank that serves a larger area will likely be able to scale faster and become larger because it could aggregate deposits from numerous jurisdictions. The larger size of the bank would reduce its costs for performing certain work, through economies of scale, and would likely make it easier and cheaper to perform commercial banking for the City and other governmental clients. A bank with a broader geographic reach also would be less concentrated in a given area and could spread its lending activity out over a broader region, making it less vulnerable to local economic shocks. Lastly, a larger bank that serves a region or the state would have a greater overall impact on the economy. There are also some drawbacks associated with a regional or state bank. A regional or state bank would offer the City far less control over outcomes, and a regional bank may need to have a complicated governance structure to ensure all stakeholders are adequately represented. Nevertheless, many Task Force members felt strongly that a state or regional bank could best achieve the goals of the Task Force in an efficient manner.

## Socially Responsible Banking

A major reason legislators and advocates are interested in a municipal bank is because there is a strong understanding that the current banking system is not beneficial for our City and its residents. There are numerous opportunities for the Treasurer to use his power to encourage, advocate and incentivize changes in the banking industry via the power of the purse and the bully pulpit without creating a municipal bank. These options include:

- **Expand socially responsible banking indicators in the City's banking RFP:** In 2011, the City was one of the first jurisdictions to include socially responsible banking indicators in the City's banking RFP. This practice has spread across the country. The City should continue to include socially responsible banking and should increase its prominence in future RFPs and consider expanding the criteria to include a proactive requirement that the City's banking partners offer products and services or participate in City programs.
- **In-source mail and check processing from commercial banking partners:** Currently TTX performs some work like the City's commercial banking partners, including operating lockboxes which receive and process City payments. The City could investigate using TTX and other City staff to perform mail and check processing work and lockbox operations currently contracted to large commercial banks.
- **Continue to break up the City's banking RFP:** Breaking up the City's banking RFP allows smaller community banks and credit unions to bid on the opportunity to provide the City's banking services, potentially allowing the City to reduce its reliance on large Wall Street banks. In 2018, the City of Los Angeles requested responses to its RFP that would allow for its banking business to be broken into six relationships. The result of this RFP is still outstanding. In 2019, the City is removing two pieces of business from the Bank of America contract, which will reduce the fees by over $300,000 per year. Moving forward, the City should consider opportunities to further break up its banking RFP to encourage bidding from smaller banks and credit unions whose values are more in-line with the City's.
- **Expand work on awareness regarding banks and consumer protection:** The Office of Financial Empowerment within TTX currently works with banks and advocates to create a financial system that works for all residents in our City. This work can be expanded to include a scoring mechanism to rate financial institutions and products, and potentially to create a mechanism to

collect, investigate and address consumer complaints.

- **Advocate for banking sector reforms:** Treasurer Cisneros has actively fought for reforms to the banking sector to help San Francisco residents. He battled check cashers and has encouraged local businesses to move towards direct deposit and other modern innovative payroll solutions, and he proactively took a stand against Wells Fargo after learning they engaged in widespread illegal practices. The Treasurer and the City as a whole should continue to advocate for banking sector reforms, using the power of the bully pulpit to fight unscrupulous and predatory behavior and to promote a more equitable and inclusive financial system.

## Community Investment

Many Task Force members and advocates are interested in public banking for reinvestment – ways to see the City's money leveraged for community goals. While a municipal bank can promote local community investment, there are also non-bank opportunities, such as:

- **Expand Safe, Sound and Local:** Safe, Sound and Local, which launched in October 2017, makes up to $80 million per year of the County's Pooled Investment Fund available for investments in banks, credit unions and CDFIs located in San Francisco that are backed by letters of credit issued by the Federal Home Loan Bank of San Francisco. TTX can continue to promote the program to increase participation, particularly by local CDFIs, and should investigate expanding the program.
- **Create non-bank lending programs:** The Board of Supervisors and the Mayor could consider appropriating funding and creating a community investment fund to perform lending in the San Francisco community. Specifically, this lending vehicle could pursue the lines of business identified by the Task Force and staff such as loans for ADUs and LBE contractors. Other jurisdictions have created similar loan funds. For example, the Chicago City Council created a $100 million Chicago Community Catalyst Fund to invest in small business and real estate development in low-to-moderate income communities via a fund-to-fund model.[44] Similarly, Vermont created the Local Investment Advisory Committee to perform local lending in infrastructure, renewable energy, energy efficiency and housing, and the state legislature authorized the Treasurer to use up to ten percent of the state's average daily cash balance (of $330 million) to perform local investments.[45]

## Small Business Lending

Aside from general community investment, Task Force members and members of the public wanted a municipal bank to support small businesses and promote small business lending. Some interim solutions include:

- **Sign on to the Small Business Borrowers' Bill of Rights:** The Responsible Business Lending Coalition, a network of for-profit and non-profit lenders, brokers and small business advocates has created a six-point bill of rights for small business borrowers. The City could also become a signatory, joining organizations like Accion, Pacific Community Ventures, and the National League of Cities.
- **Better publicize existing small business lending programs and CDFIs:** San Francisco is home to a robust ecosystem of small business support programs and lenders, such as CDFIs. The City can work to better publicize existing lending programs and CDFIs and potentially explore the

44 Matuszak, P. (July 5, 2017). Chicago commits $100 million to investment fund aimed at low-income areas. Chicago Tribune. Retrieved from: https://www.chicagotribune.com/news/ct-chicago-catalyst-fund-met-20170704-story.html.

45 State of Vermont Office of the State Treasurer (January 5, 2018). Local Investment Advisory Committee (LIAC) Report. Retrieved from: https://www.vermonttreasurer.gov/sites/treasurer/files/cash-investments/local-investment-advisory-committee/supporting-materials/LIAC_FINAL2018_Report.pdf.

creation of a small business lending/CDFI matching program to allow small businesses to determine which CDFI may best fit their needs.

- **Research opportunities to improve access to credit for cannabis equity businesses:** Because of federal law restrictions, banks and CDFIs will not serve cannabis businesses, which can then only access debt via family and friends and private placement like venture capital funding. Cannabis equity entrepreneurs rarely have access to capital from these sources. To help make the equity program a success, the City can work to expand access to credit for equity cannabis businesses and investigate other opportunities to support these businesses.

## Un- and Underbanked Residents

While no municipal bank models addressed un- and underbanked residents, members of the Task Force and the public indicated that serving this community was a high priority. These interim solutions build on existing work being done in the City to serve this vulnerable population, including:

- **Promote and expand the Bank On Program:** Bank On San Francisco, a ground-breaking program launched in 2006, helps unbanked San Franciscans get access to low-cost checking accounts and has been replicated across the country through the Bank On national program. The Office of Financial Empowerment should continue to promote and expand the program to ensure that it is reaching more unbanked San Franciscans.
- **Advocate for youth bank accounts:** Through Summer Jobs Connect, the Office of Financial Empowerment works to get youth access to appropriate, non-custodial accounts at local banks and credit unions. The City should continue to advocate for non-custodial youth bank accounts and expand the number of local banks and credit unions offering these accounts and working with youth. City departments should also ensure that all youth taking part in their employment programming have the opportunity to access a safe and secure bank account that will start them on the path to financial stability.
- **Expand Smart Money Coaching efforts:** The Office of Financial Empowerment runs Smart Money Coaching programming with local non-profits, offering free one-on-one financial coaching to help people reduce debt, save, and establish or improve their credit scores. The City should expand this program to offer it to more City residents and to ensure that everyone who wants to opportunity to meet with a coach is able to do so.
- **Research opportunities to bring non-predatory small-dollar loans to employees in San Francisco:** The City should investigate opportunities to work with third-party providers to offer a payday-loan alternative such as an employer-based, non-predatory small-dollar loan to employees. The City should first push to offer this service to City employees via a pilot program, and then if that is successful should advertise and promote it as an opportunity for other large employers in San Francisco.
- **Investigate options to provide small grants:** Rather than create or promote an employer-based small dollar loan program, the City could simply choose to offer small grants to people without expecting any repayment. The City already does this in some instances, for example, offering financial assistance to individuals facing eviction or seeking a security deposit.

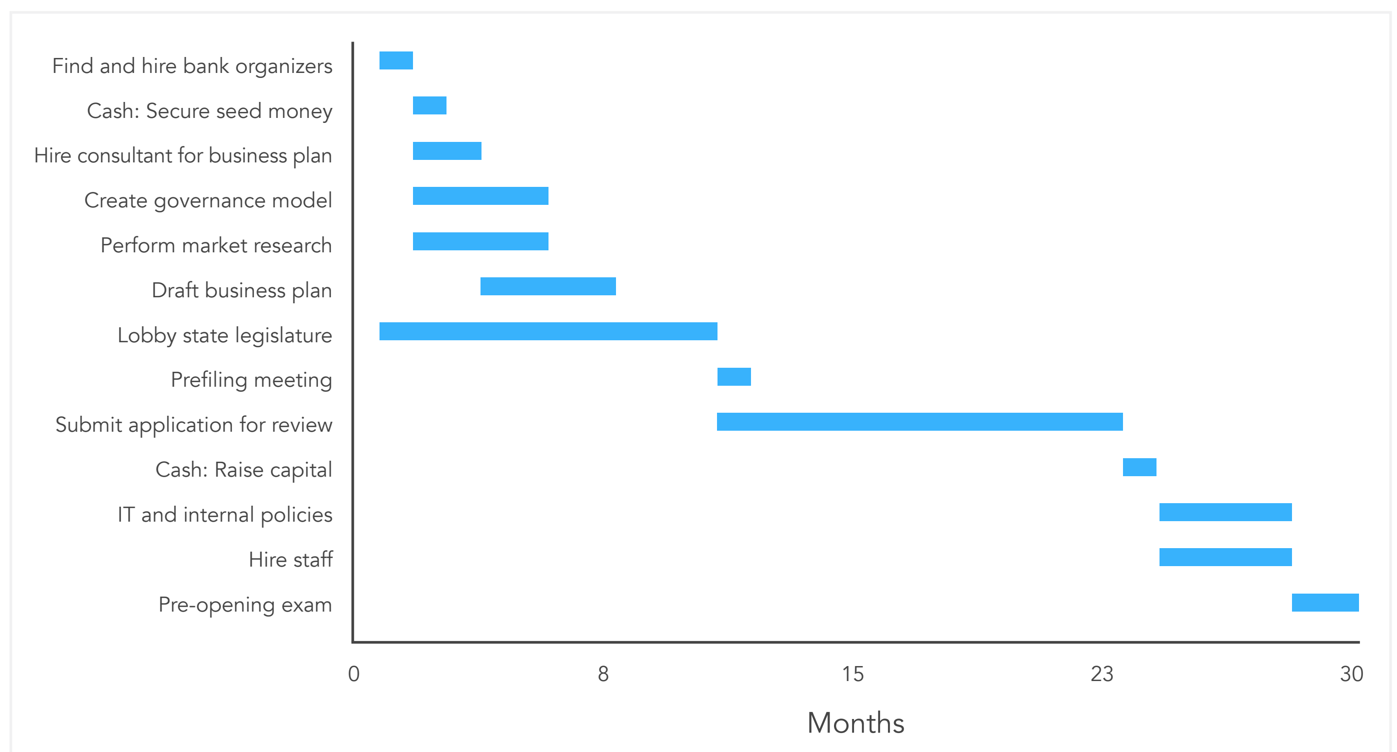
# Conclusion: A Phased Approach and Next Steps

The primary goals behind creating a municipal bank are to divest from Wall Street banks and reinvest in the community. The bank models analyzed show that these goals may be met after decades of significant investment in start-up, capitalization and operational subsidies. After this time, the banks could achieve sustainability and no longer operate at a loss. At scale, a reinvestment bank could funnel millions, and potentially billions, into affordable housing and small business lending, and a divestment bank would ensure that the City could perform its own commercial banking and does not have to rely on Wall Street for its commercial banking services.

The decision about whether to create a municipal bank is a policy matter that rests with the Board of Supervisors and the Mayor. When deciding next steps, the City has many options and decisions ahead – both in terms of whether to create a municipal bank and what form that municipal could and should take. An option to highlight is the opportunity for a phased approach, where the City implements interim opportunities while a municipal bank is in development, and then allows the bank itself to develop over time.

A phased approach could offer a logical and efficient progression and pursuing interim programs will help a municipal bank succeed. Most banking experts suggest it will take at least two years to receive a banking charter and stand-up a bank. The process may be even longer – perhaps even 3 to 5 years – given the novelty of a municipal bank, and the likelihood that the bank will have a less traditional business plan. Additionally, before the City can even apply for a bank charter, it will need to lobby the state for legislative changes, create a governance plan, hire bank organizers, and draft and finalize a business plan.

**Figure 4: Approximate Timeline for Municipal Bank Start-Up Tasks**



To avoid delay and losing momentum, the City could start developing and implementing non-bank lending programs in the interim while the municipal bank is in development. These lending programs could help the City achieve its community goals, develop expertise and build a solid track record and book of business that could eventually transition to a municipal bank once it is chartered. The City could begin with a simple program, like purchasing participation loans, because such a program does not require underwriting or direct lending expertise. Over time, the City could increase the complexity of its lending programs, creating direct lending initiatives which require underwriting, originating and servicing. Some of these programs may require the City to apply for a commercial lending license and establish a separate entity.

Aside from creating momentum, a major benefit of a phased approach is that it allows the City to build up a book of business for a municipal bank. A solid track record of lending could provide the City with credibility when it applies for a bank charter, and equally important, it could help a municipal bank reach profitability more quickly. Banks are typically unprofitable initially because they do not have much lending business bringing in income. Over time as they build up their business, they bring in more money. If a municipal bank already has loans on its books from a prior lending program, its path to profitability may be shorter, and it may need less operational subsidies to cover initial losses. In this manner, short-term investments in lending programs can lead to long-term dividends for a municipal bank and the City.

Though the exact timing and phases are ultimately a decision for the Board of Supervisors, the following figure provides an approximation of what a phased approach could look like:

**Figure 5: Potential Plan for Phased Approach to Municipal Banking**

| Year 1 | Year 2-4 | Year 5+ |
|---|---|---|
| • Establish low-cost financial programs, e.g. purchasing participation loans<br>• Finalize public bank deposits, capital and lines of business, and create business plan<br>• Enact state legislative changes, e.g. public bank charter | • Establish more involved financial programs, e.g. requiring establishing loan underwriting capabilities<br>• Establish applicable non-bank financial entities and begin lending<br>• Apply to relevant regulators for bank charter and deposit insurance | • Establish a bank |

Once a municipal bank is chartered and operational, the bank itself could develop and expand in phases. Many banks evolve, growing and raising additional capital over time. One option is for the bank to begin with a more conservative lending portfolio – perhaps just participation lending as in the divestment Model Two. Over time, as the bank achieves sustainability, it can expand its offerings into affordable housing lending and wholesale small business lending. Eventually it could branch out into higher-risk loans or offer retail services.

Ultimately, if the City chooses to pursue either Model One, Two or Three, the bank would require significant investment until it breaks even. Between start-up costs, operational subsidy (to keep the bank afloat) and capital, Model One would require $184 million; Model Two would require $1.6 billion, and Model Three needs $3.9 billion in investment.

**Table 17: Average Investment Required for Municipal Bank Models to Break Even**

| | Model One: Reinvest | Model Two: Divest | Model Three: Combination |
|---|---|---|---|
| Break Even Details | | | |
| Years to Break Even | 10 | 31 | 56 |
| Size at Breakeven | $1.1 billion | $3.1 billion | $10.4 billion |
| Estimated Appropriation Required to Break Even | | | |
| Start-Up Costs | $6 million | $119 million | $119 million |
| Operational Subsidy | $13 million | $990 million | $2.2 billion |
| Capital Investment | $165 million | $460 million | $1.6 billion |
| **Total** | **$184 million** | **$1.6 billion** | **$3.9 billion** |

## Next steps:

The goal of this report is to provide enough analysis regarding the costs and results of a municipal bank, as well as interim solutions, to allow the Board of Supervisors and the Mayor to decide whether they wish to move forward with a municipal bank. Assuming the consensus is to move forward with a municipal bank, the following -- in addition to the analysis put forth by the San Francisco Budget & Legislative Analyst's office – can be used as a rough outline of next steps the City could take:

**Create a working group to finalize objectives and build a roadmap:** The goal of this Task Force was to determine the feasibility of the City creating a municipal bank and to investigate what that bank could look like. As this report serves as the culmination of that work, the City should transition away from the Task Force and create a new working group of internal City actors to lead the next phase of work. The working group should finalize objectives for the municipal bank and build a realistic roadmap for creating a public bank. This working group could continue to guide the City throughout the chartering process.

**Convene City agencies performing lending work:** To help guide the working group's process, the City should convene all the various City departments doing lending and community development work to share lessons learned and discuss current gaps and areas for improvement.

Departments should evaluate which programs could and should be expanded and discuss opportunities for a phased approach. The convening could result in requests for additional appropriations to support the expanded work.

**Lobby for and enact change to state law to create a public bank charter:** Currently state law does not include a charter for a public bank, only a commercial bank or credit union charter. This lack of a charter would make it more difficult for the public bank to receive a banking charter and operate. The City should work with its state delegation to lobby for and enact legislation to create a public bank charter.

**Develop governance structure, hire bank organizers and create a leadership team:** A bank must have the governance structure, bank organizers and proposed leadership team in place prior to submitting the business plan and application for FDIC insurance and a bank charter. The application for a California bank charter requires information regarding proposed directors and executive officers, including detailed biographical and financial information. The City should develop a governance structure that both limits political interference and also ensures that community perspectives and voices are included. In creating a leadership team, the City must find individuals who have significant banking and financial experience as well as an understanding of the bank's goals. Numerous experts in chartering new banks noted that it was crucial that the bank leadership team have experience in the roles that they would serve in a municipal bank. The proposed directors and executive officers should all be excited by the mission of the municipal bank and ready for the challenge of embarking on a new endeavor.

**Meet with regulators to discuss municipal bank model:** A municipal bank is a novel concept and San Francisco's municipal bank would likely have a non-traditional business model. Accordingly, the City should engage with state and federal regulators early in the process of drafting a business plan to ensure that regulators are onboard with the initiative and comfortable with the structure, governance and business model of the municipal bank.

**Hire a consultant to develop and draft the bank's business plan:** A new bank's business plan is the primary part of an application for a bank charter or FDIC insurance. A bank's business plan must be comprehensive and reflect in-depth planning. The FDIC explains that a plan should "realistically forecast market demand, customer base, competition, and economic conditions," and also "reflect sound banking principles and demonstrate realistic assessment of risk."[47] A bank that will have a special focus or purpose must provide more detail about that feature. There are several consulting companies who focus primarily on advising de novo banks and creating business plans for banks. The City should procure for and hire a consultant to help develop and draft the bank's business plan.

**Work with experts in areas the bank will focus on:** Throughout this application process, the City should remain connected with experts who currently work in the areas of the bank's focus. Banking is an ever-evolving field, and it is important that the municipal bank stay aware of changes in the field as well as economic conditions that may affect the bank's eventual operations.

**Continue to use the City's purchasing power and bully pulpit to push for changes in the banking industry:** One of the main rationales for creating a municipal bank is to create an alternative to the traditional banking industry, which is viewed as harmful and unresponsive to citizens. While the municipal bank is being created, the City should continue to use alternative means to push for changes

47 Federal Deposit Insurance (December 10, 2001). Business Plan Guidelines. Retrieved from: https://www.fdic.gov/news/news/press/2001/pr-form2.html.

in the banking industry. The City can use its purchasing power to promote better banking practices. For example, in procuring a new bank for the City, the Treasurer can require that bidders provide information about their practices and also promise to offer specific products and services should they receive the contract. Similarly, the City, through the Office of Financial Empowerment, can continue to implement innovative programs such as Bank On and Smart Money Coaching which help underserved citizens get access to the banking system. Lastly, the City can use its bully pulpit to advocate for changes in the banking system and for legislation that will make the banking system fairer, more responsive and more accessible for all San Franciscans.

CITY AND COUNTY OF SAN FRANCISCO
LONDON BREED, MAYOR

OFFICE OF SMALL BUSINESS
REGINA DICK-ENDRIZZI, DIRECTOR

February 25, 2020

Ms. Angela Calvillo, Clerk of the Board
City Hall Room 244
1 Dr. Carlton B. Goodlett Place
San Francisco, CA 94102-4689

RE: BOS File No. 210078 – Administrative Code - San Francisco Reinvestment Working Group.

Small Business Commission Recommendation to the Board of Supervisors: **Support with amendments.**

Dear Ms. Calvillo,

On February 22, 2021 the Small Business Commission (SBC or Commission) heard BOS File No. 210078 – Administrative Code - San Francisco Reinvestment Working Group. Preston Kilgore, Legislative Aide to Supervisor Dean Preston, provided the SBC with an overview of the legislation.

The Commission engaged in a substantive discussion regarding the legislation, and specifically opined on the make-up of the Working Group, and the goals of the Working Group. They emphasized the importance of ensuring that a seat on the Working Group be held by an individual with a specific small business background. They also emphasized the importance of ensuring that the Working Group focus on how a public bank may support local economic development. The Commission also discussed how undefined terms used in Section 5.16-4(b)(4(C), specifically that entities that sell tobacco should not be prioritized, may unintendedly exclude many small grocers and corner stores.

The SBC voted (6-0, 1 absent) to recommend that the Board of Supervisors support the legislation, with the following amendments:

- Amend Section 5.16-5 to ensure that at least one of the nine seats of the Working Group be held by a representative with a specific background in small/micro business development;
- Amend Section 5.16-4(b)(4) by including more specific language regarding goals for economic development and expanding economic opportunity, such language may include:
    - Establishing lending priorities that support job creation;
    - Establishing lending priorities that support borrowers who would otherwise be considered "high risk" by mainstream lending institutions; and

- Establishing lending priorities for entrepreneurs from vulnerable populations, like women and minorities; and,
- Amend Section 5.16-4(b)(4(C) to include a definition of tobacco that mirrors the definition utilized by the Healthy Retail SF Program.

Thank you for considering the Commission’s recommendation. Please feel free to contact me should you have any questions.

Sincerely,

Regina Dick-Endrizzi
Director, Office of Small Business

cc: Dean Preston, Member, Board of Supervisors
Sophia Kittler, Mayor’s Liaison to the Board of Supervisors
Anne Taupier, Acting Director, Office of Economic and Workforce Development
Jose Cisneros, Treasurer, Treasurer and Tax Collector’s Office
Ben Rosenfield, City Controller, City and County of San Francisco
Ted Egan, Chief Economist, City and County San Francisco
Erica Major, Clerk, Land Use and Transportation Committee

BOARD of SUPERVISORS

**City Hall**
**1 Dr. Carlton B. Goodlett Place, Room 244**
**San Francisco 94102-4689**
**Tel. No. 554-5184**
**Fax No. 554-5163**
**TDD/TTY No. 554-5227**

# MEMORANDUM

TO: Ben Rosenfield, City Controller
Jose Cisneros, Treasurer-Tax Collector
Brian Goebel, Executive Officer, Local Agency Formation Commission
Shakirah Simley, Director, Office of Racial Equity

FROM: John Carroll, Assistant Clerk, Government Audit and Oversight Committee, Board of Supervisors

DATE: February 3, 2021

SUBJECT: LEGISLATION INTRODUCED

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The Board of Supervisors' Government Audit and Oversight Committee has received the following proposed legislation, introduced by Supervisor Preston on January 26, 2021:

File No. 210078

**Ordinance amending the Administrative Code to establish the San Francisco Reinvestment Working Group to submit business and governance plans for a non-depository Municipal Finance Corporation and for a Public Bank to the Board of Supervisors and to the Local Agency Formation Commission.**

If you have any comments or reports to be included with the file, please forward them to me at the Board of Supervisors, City Hall, Room 244, 1 Dr. Carlton B. Goodlett Place, San Francisco, CA 94102.

c: Office of Chair Preston
Todd Rydstrom, Office of the Controller
Peg Stevenson, Office of the Controller
Mark dela Rosa, Office of the Controller
Amanda Kahn Fried, Office of the Treasurer-Tax Collector
Alisa Somera, Local Agency Formation Commission

SFCDMA

# San Francisco Council of District Merchants Associations

Maryo Mogannam, President · Masood Samereie, Vice-President · Al Williams, Vice-President · Ixchel Acosta, Secretary · Henry Karnilowicz, Secretary · Susie McKinnon, Treasurer

The Honorable Shamann Walton, President
Supervisor Dean Preston, Chair, Government Audit and Oversight Committee
San Francisco Board of Supervisors
1 Dr. Carlton B. Goodlett Place, Room 244
San Francisco, CA 94102

February 4, 2021

RE: File #210078, Administrative Code – Reinvestment Working Group; Neighborhood Merchant Representation

Dear Supervisors Walton, Preston and San Francisco Supervisors,

The San Francisco Council of District Merchants Associations (SFCDMA) has served to protect, preserve and promote small businesses in San Francisco for 70 years. We represent local merchant associations and an eclectic mix of neighborhood businesses in every commercial district.

The SFCDMA has reviewed the legislation (File #210078) to create the San Francisco Reinvestment Working Group that would develop and submit plans establishing a San Francisco Public Bank. We also reviewed the 2019 feasibility report produced by the San Francisco Office of the Treasurer and Tax Collector, as well as the 2020 Analysis of Municipal Bank of San Francisco, produced by the Budget and Legislative Analyst's Office.

We note both reports recommend that the priorities of a San Francisco Public Bank should include small business lending. We also note in the legislation as currently drafted that four seats on the Reinvestment Working Group charged with creating plans for the Bank are reserved for "community representatives" appointed by the Board of Supervisors. However, the qualifications for these seats fail to reflect San Francisco's small business sector as a whole or any reference to neighborhood merchants.

Given the importance of San Francisco's small businesses to the economic viability of the city and the quality of life of its neighborhoods, the jobs and services we provide local residents, and the disproportionate destructive impacts the COVID-19 pandemic has had on our sector, the SFCDMA believes strongly that neighborhood businesses should have a role in designing and planning the city's first public bank.

Should this legislation pass, we urge the Board of Supervisors to include a local small business on the Reinvestment Working Group. Further, the SFCDMA requests that a member of our organization representing San Francisco's neighborhood merchants be appointed to a seat designated for a community representative. Our participation will be key in crafting plans for a public bank that will be responsive to the extraordinary needs of our small businesses and will help shape the recovery and ensure the viability of neighborhood commercial districts across the city.

Sincerely,

Maryo Mogannam, President
San Francisco Council of District Merchants Associations

cc: Clerk of the BOS to be distributed to all Supervisors; Mayor London Breed; Sharky Laguana, President, Small Business Commission, Regina Dick-Endrizzi, Executive Director, Office of Small Business; Secretary of the SBC to be distributed to all Small Business Commissioners

San Francisco Council of District Merchants Associations • 2443 Fillmore Street, #189, San Francisco, CA 94115 • 415.420.8113 • www.sfcdma.org

Print Form

# Introduction Form

By a Member of the Board of Supervisors or Mayor

Time stamp
or meeting date

I hereby submit the following item for introduction (select only one):

- [x] 1. For reference to Committee. (An Ordinance, Resolution, Motion or Charter Amendment).
- [ ] 2. Request for next printed agenda Without Reference to Committee.
- [ ] 3. Request for hearing on a subject matter at Committee.
- [ ] 4. Request for letter beginning :"Supervisor ______ inquiries"
- [ ] 5. City Attorney Request.
- [ ] 6. Call File No. ______ from Committee.
- [ ] 7. Budget Analyst request (attached written motion).
- [ ] 8. Substitute Legislation File No. ______
- [ ] 9. Reactivate File No. ______
- [ ] 10. Topic submitted for Mayoral Appearance before the BOS on ______

Please check the appropriate boxes. The proposed legislation should be forwarded to the following:

- [ ] Small Business Commission
- [ ] Youth Commission
- [ ] Ethics Commission
- [ ] Planning Commission
- [ ] Building Inspection Commission

**Note: For the Imperative Agenda (a resolution not on the printed agenda), use the Imperative Form.**

Sponsor(s):

Supervisor Preston, Walton, Haney, Melgar, Ronen and Chan

Subject:

Administrative Code - San Francisco Reinvestment Working Group

The text is listed:

Ordinance amending the Administrative Code to establish the San Francisco Reinvestment Working Group to submit business and governance plans for a non-depository Municipal Finance Corporation and for a Public Bank to the Board of Supervisors and to the Local Agency Formation Commission.

Signature of Sponsoring Supervisor: /s/ Dean Preston

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