Appendix B: Detailed Description of Lines of Business

Overview

A main goal of the Task Force was 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."[1] However, almost everyone interested in public banking has a different vision of exactly what a municipal bank should do. During public hearings and Task Force meetings a variety of ideas emerged, 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. A major responsibility of the Task Force (and a struggle) was to hone in on community goals. At the first Task Force meeting, TTX staff compiled a list of all the various ideas around public banking discussed by Supervisors and members of the public during the Board of Supervisors' Budget and Finance Committee hearing on public banking on February 1, 2018 and asked the Task Force to prioritize those ideas. The Task Force identified five major goals: affordable housing, non-housing public infrastructure, un- and underbanked individuals, small business lending and cannabis. Later in the Task Force process, Task Force members voted to further prioritize these five goals, resulting in the following ranking:

	Ranked Choice Score (1st=5 pts, 2nd=4 pts)	Ranked Choice Distribution (1 to 5, Left to Right)	Priority by Ranked Choice	Cumulative Voting Score	Priority by Cumulative Voting
Affordable Housing	41		1	31	1
Small Business Lending	33		2	22	2
Infrastructure	31		3	20	3
Un- and Underbanked	30		4	16	4
Cannabis	15		5	10	5

According to this survey, Task Force members felt most strongly about using a public bank to facilitate more housing – after that small business lending, public infrastructure, and un- and underbanked individuals were all equally valued, and cannabis was viewed as the least important outcome.

1 City and County of San Francisco Board of Supervisors, Resolution 152-17. Retrieved from: http://sfbos.org/sites/default/files/r0152-17.pdf.

After prioritizing these five outcomes, the Task Force then had to evaluate how a public bank could achieve these goals and create various "lines of business" or products and services for the public bank to offer. For each goal, the Task Force first considered whether public bank financing could solve the problem. For example, the Task Force realized that a public bank would run into the same issues as a traditional bank if it tried to serve the cannabis industry, and so the Task Force chose not to address cannabis. For goals that the public bank could pursue, TTX staff, subject matter experts and Task Force members brainstormed how exactly a municipal bank could achieve these outcomes. For example, for affordable housing, the Task Force considered various ways a public bank could facilitate the creation of affordable housing—some examples included lower cost financing for affordable housing developers, lower cost mortgages for individual homeowners, and lower cost debt for non-profits acquiring rent-controlled properties through the small sites acquisition program. Eventually with the help of experts, TTX staff outlined various potential lines of business, which were presented to the Task Force for feedback. Some lines of business were rejected, because they were viewed as unprofitable, impractical, unnecessary or harmful. For example, the Task Force felt that small-dollar consumer loans would actually harm borrowers rather than help them in the long run.

Ultimately, the Task Force coalesced around three products to support affordable housing development and two products to support small business lending. For affordable housing, the lines of business include (1) mezzanine debt financing, (2) small sites acquisition program mortgages, and (3) accessory dwelling unit financing, and for small business lending, the lines of business include (1) direct small business lending, and (2) wholesale small business lending. The following appendix outlines reasons the Task Force chose to focus on affordable housing and small business lending, existing offerings in the area and then provides detailed descriptions of the lines of business.

Affordable Housing

By all accounts, San Francisco is in the midst of a housing crisis. Nearly half of the region's renters are considered burdened by housing costs, meaning that they spend more than 30 percent of their income on rent,[2] and only 12 percent of San Francisco households could afford a median-priced single-family home.[3]

The City recognizes this struggle and 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 affordable housing development); and
- Inclusionary Zoning and Impact Fees (market rate developers build affordable units or contribute a fee)

In total, the City spends and invests $400 million on affordable housing per year.[4] In past years, this money has been used for:

- The Downpayment Assistance Loan Program (administered by MOHCD) helped 39 low- and middle-income families purchase market-rate homes in fiscal year 2017-2018.[5]
- The below market-rate homes program

4 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.

5 McCloskey, Benjamin. (August 28, 2018). Personal email.

(administered by MOHCD) allowed 79 low-income households to purchase homes, including by offering 26 downpayment assistance loans for below-market rate properties in fiscal year 2017-2018.[6]

- In 2017, MOHCD held 104 housing lotteries, with over 85,000 households applying for 1,210 units.[7]
- From 2014 to 2017, MOHCD built and preserved 5,949 affordable units, 35 percent of the total units produced across the City in that period.[8]
- The Renal Assistance Demonstration (RAD) Program offers $100 million to rehabilitate 3,500 public housing units and transfer their ownership to local non-profits. The initiative is underway and should be fully completed by 2020.
- MOHCD also runs the Non-Profit Affordable Housing Rehabilitation Program, which provides rehabilitation loans to non-profits to maintain and renovate units and preserve the quality of the housing. MOHCD anticipates providing $13.7 million in rehabilitation loans from fiscal year 2017 through 2020 to renovate 550 housing units.

Despite this funding and work, the City and developers struggle to build enough affordable 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.

Mezzanine Debt Financing: Given the high costs of development, City officials, advocates and housing developers all agree that cheaper financing could help spur more affordable housing development and preservation, particularly workforce housing (serving 60 to 120 percent of area median income), which requires less subsidy but is not eligible for many federal, state and local subsidies. Developers seeking to build and preserve workforce housing cannot access sufficient debt from traditional lenders due to loan-to-value ratios and other requirements and instead must turn to higher-cost equity financing. Developers would prefer to access more debt, including mezzanine debt, which is a form of capital that falls between equity and senior debt. This debt is higher-risk than secured senior debt but lower risk than equity. A public bank could fill the gap left by traditional lenders and provide lower-cost mezzanine financing for workforce housing projects that are City priorities, committed to long-term affordability and developed in accordance with anti-displacement principles. The municipal bank could provide approximately $200,000 in financing per unit (compared to the $700,000 required to construct a unit and upwards of $400,000 to preserve a unit) at 3-7 percent for a term of 2-3 years for development and up to 10 years for preservation (though some loans could be for significantly longer, including up to 30 years). Additionally, rather than perform the lending directly to developers, the bank could offer low-cost funding to the San Francisco Housing Accelerator Fund, a non-profit investment vehicle, which works with the City, non-profit affordable housing developers, and private investors to deploy investment capital flexibly and fast to support affordable housing preservation and development. The municipal bank could offer funding to the San Francisco Housing Accelerator who can then source and underwrite projects.

6 McCloskey, Benjamin. (August 28, 2018). Personal email.

7 San Francisco Mayor's Office of Housing and Community Development. (Undated). 2016-2017 Annual Progress Report. Retrieved from: http://sfmohcd.org/sites/default/files/Documents/Reports/2016-17%20Annual%20Progress%20Report.pdf.

8 San Francisco Mayor's Office of Housing and Community Development. (Undated). 2016-2017 Annual Progress Report. Retrieved from: http://sfmohcd.org/sites/default/files/Documents/Reports/2016-17%20Annual%20Progress%20Report.pdf.

Small Sites Acquisition Program Mortgages: MOHCD runs the small sites acquisition program which provides subsidies to help non-profits acquire, rehabilitate and manage rent-controlled buildings where low-income tenants live that are at risk of conversion. From 2014 to 2017, the program received $75 million in funding from a variety of sources, and in fiscal year 2016-2017, MOHCD made $22 million in loans to assist three non-profits to purchase and rehabilitate 10 properties with a total of 63 residential and 7 commercial units.[9] To purchase these units, non-profits receive a City subsidy of $175,000 to $350,000 per unit and must also find traditional mortgage financing with a loan-to-value ratio[10] of 20 to 30 percent.[11] This mortgage is repaid over time via tenant rents. The public bank could replace the financial institutions and provide the traditional mortgage to support small sites acquisition. The loan size would vary based on the building's size and cost but would likely fall between $3 and $9 million. Currently financing rates are 5.5 to six percent for ten years, and the municipal bank could provide lower rates, potentially 3 or 4 percent for 10 to 15 years. Offering lower cost mortgage financing to the non-profits would allow them to acquire and preserve more units.

Accessory Dwelling Unit Financing: An Accessory Dwelling Unit ("ADU") is a unit added to an existing residential property, and ADUs offer opportunities for small-scale urban infill, adding needed units of housing to San Francisco. Though ADU construction is on the rise in San Francisco, financing issues may make them out of reach for many San Francisco homeowners. Currently only 12 percent of all applications for ADU permits have been from single family property-owners.[12] ADUs typically cost between $200,000 and $250,000 in San Francisco, and studies have found that people typically use cash, credit cards or home equity loans or lines of credit to develop ADUs.[13] These options may not be available to San Francisco homeowners that lack significant personal resources or equity in their homes.[14] The public bank can help fill this gap by offering financing to San Francisco residents who own homes but lack savings to finance construction themselves or the equity to get a cash-out refinance, home equity loan or line of credit to build an ADU.[15] The loan would cover the cost of ADU construction and rates would be between 4 and 6 percent, benchmarking mortgage and home equity loan rates for a term of 20 years with a float period during construction. It is not clear how many San Franciscans would qualify for this product, but the number may be low because many ADUs are built by large landlords or individuals with sufficient cash or equity in their homes to support construction costs.

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.[16] Small businesses have significant need for capital but have difficulties accessing capital[17] because traditional banks shy away from this lending, which is both high-touch and high-risk. Despite the challenges, there is a robust ecosystem of small business support in San Francisco,

15 There are other financing options for ADUs including renovation loans, reverse mortgage, FHA 203(k) loans, Fannie Mae HomeStyle renovation loan, and Fannie Mae HomeReady loan. However, none of these loans fill the financial gap for homeowners that are both low-income and low equity. More information available here: Center for Community Innovation, University of California, Berkeley. (July 28, 2017). Technical Report: ADU Financing Issues in Unincorporated San Mateo County. Retrieved from: https://housing.smcgov.org/sites/housing.smcgov.org/files/2nd_Unit_Financing_IssuesReport.pdf.

16 San Francisco Office of the Treasurer & Tax Collector. (2018). Internal analysis.

17 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." United States Federal Reserve System. (April 2017). 2016 Small Business Credit Survey. Retrieved from: https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf

including the U.S. Small Business Administration (SBA), Community Development Financial Institutions (CDFIs), non-profits and City programs all aimed at nurturing 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.[18] Additionally numerous CDFIs[19] offer loans between $5,000 and $250,000 at reasonable rates as well as technical assistance and business coaching. 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. 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.

Direct Small Business Lending (to LBEs): Staff of CDFIs, small business advocates and City officials all noted that Local Business Enterprise (LBE) contractors (which are small and micro businesses which have contracts with the City) and other general contractors have difficulty accessing loans, and all small businesses struggle to get lines and letters of credit. While the City already has a surety program to assist LBE businesses bid for work, the public bank could offer small business loans to LBE contractors with City contracts, particularly to support the upfront expenses associated with starting up a new City project. This program would be low-risk because only certified LBEs would be served, the funds loaned would be accelerated payments due on a contract, and the maximum exposure period would be 60 to 90 days.[20] There are about 400 LBE contractors that could initially be eligible for the program, and the loan size could be between $10,000 and $300,000, at slightly below market rates which would increase over time as LBEs grow and become ready for traditional financing. Once the public bank shows it can properly underwrite and operate this LBE pilot program, it could expand to fill other small business lending gaps, by serving non-LBE general contractors and offering lines and letters of credit to all small businesses. The bank model estimates that the average size of these small business loans is $35,000 with an interest rate of 15 percent and a loan term of 3 to 5 years.

Wholesale Small Business Lending (to CDFIs): Additionally, to help support, rather than compete with existing CDFIs, the public bank could do wholesale lending to CDFIs. Currently, CDFIs cobble together their funding—the capital that they lend out—from a variety of sources, including the CDFI Fund, the U.S. Small Business Administration, and private sources, such as banks. Like a bank, CDFIs make a profit on the interest spread—the difference between the rate at which they borrow their capital and lend their money. While some of the funding CDFIs receive is cheap, other money from private sources, can be more expensive. The public bank can offer lower cost funds to CDFIs to allow them to loan money to borrowers at lower rates. These CDFIs are well-capitalized, have sufficient reserves and strong underwriting practices, meaning this lending should be low-risk. The average size of a wholesale small business loan is modeled at $2 million with an interest rate of 2.5 percent, which is slightly below the rate CDFIs are charged by traditional private banks (typically 3 to 4 percent). The average loan term is modeled at 5 years.

18 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/

19 These CDFIs include Main Street Launch, The Opportunity Fund, Mission Economic Development Agency's Fondo Adelante, Pacific Community Ventures and Working Solutions

20 Tang, Stephanie. (July 18, 2018). Personal interview.