Municipal Bank Feasibility Task Force Report

Treasurer José Cisneros

San Francisco Office of the
Treasurer & Tax Collector
March 2019

ACKNOWLEDGMENTS

The Treasurer would like to thank the members of the Municipal Bank Feasibility Task Force who graciously gave their time and energy to this process and this report:
John Avalos, Ada Chan, James Clark, Marc Franson, Paulina Gonzalez-Brito, Kate Hartley, Sushil Jacob, Jim Lazarus, Lauren Leimbach, Ben Mangan, Ky-Nam Miller, Tim Schaefer, Nadia Sesay, Kat Taylor, Steve Zuckerman

Staff: Molly Cohen, Amanda Fried and Tajel Shah
Technical Consultant: Katherine Chen

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**