Context and Path for a San Francisco Public Bank

Reinvestment Working Group Meeting

August 18, 2022

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Executive Summary

A SAN FRANCISCO PUBLIC LENDING INSTITUTION SHOULD BUILD CREDIBILITY AND CAPACITY GRADUALLY TO OVERCOME BANKING OBSTACLES AND SUCCEED

The City of San Francisco should take advantage of a phased strategy to overcome potential regulatory and economic obstacles and create a public bank within the next 5-6 years.

- Because *de novo* – newly created – banks are subject to higher regulatory requirements and are more vulnerable to changing economic and market conditions and shocks than established banks, a phased build-up to a municipal public bank can allow it to develop capacity, success, resources, and credibility gradually.
- This approach would help create a public lending institution – a non-depository municipal financial corporation – that can be created more quickly to achieve short-term objectives while establishing the foundations for a full, depository public bank.
- Such an approach is likely to make the bank more credible locally and with regulators and more capable of weathering external shocks.

Context: *De Novo* Banks

It has become more financially- and regulatory-challenging to open a *de novo* banking institution in the United States.

NEW BANKS MUST NAVIGATE COMPLEX FACTORS TO BE ESTABLISHED AND SUCCEED

De novo banks are newly created institutions that receive Federal Deposit Insurance Corporation (FDIC) regulatory approval to begin commercial operations. *De novos* are a component of a healthy and dynamic banking market, though they are more vulnerable to economic shocks – like financial crises – than established banks. The 2009 financial crisis produced an environment that made *de novo* creation more difficult.

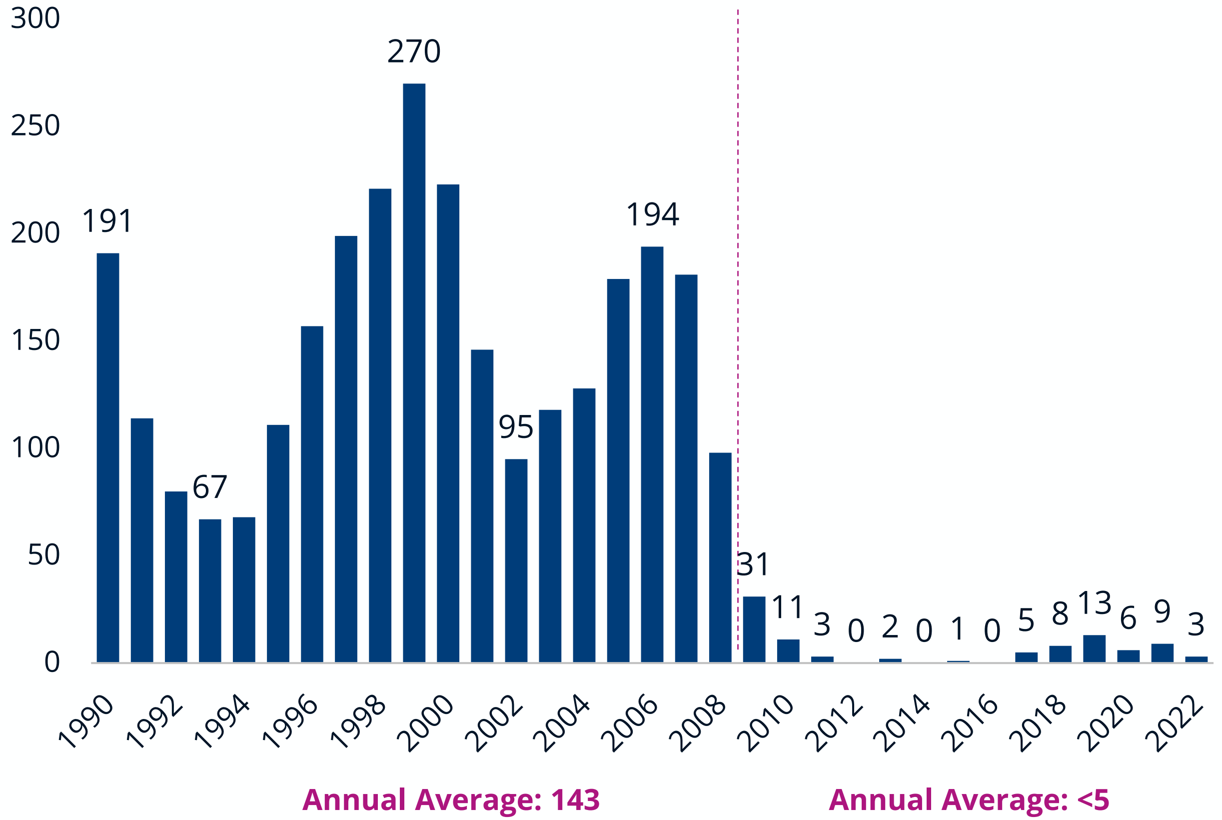
- Financial and regulatory burdens decreased *de novo* bank creation from 140 per year on average between 2000 and 2008 to fewer than 5 per year on average since 2009.
- To satisfy regulatory requirements and face macroeconomic conditions, *de novos* established since 2009 started with $33 million in capital on average, compared to $15 million beforehand.
- Of the nearly 1,400 *de novo* banks created since 2000, 35% have withstood regulatory, macroeconomic, and market (competitive) factors to continue operating today; 10% have failed and 50% have merged in this period.

DE NOVO BANK CREATION DECREASED DRASTICALLY SINCE 2009

This is the result of increased regulatory requirements and economic conditions (e.g., low interest rates) that make establishing and operating new banks difficult. These factors have made *de novo* banks less common in the last decade and highlight the additional financial and legal burdens they face to succeed.

- Prior to the 2008 financial crisis and Great Recession, the FDIC awarded more than 140 *de novo* licenses each year, for a total of more than 1,300 between 2000 and 2008.
- Today, *de novo* banking is the exception. Only 61 new banks were chartered and opened since 2009, fewer than 5 on average each year.

De Novo Bank Charters Awarded (2000 – Present)

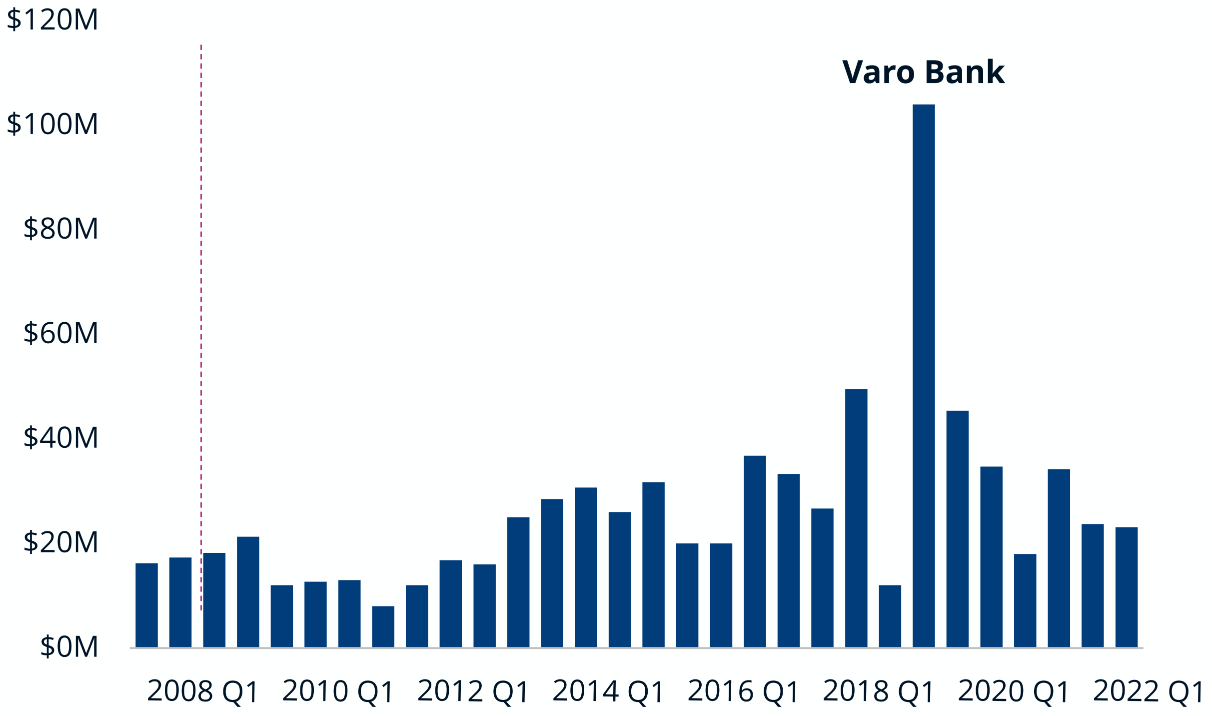


Source: bankingstrategist.com; FDIC

DE NOVO BANKS FACE INCREASED CAPITAL REQUIREMENTS

There is a two-fold increase in the capital required for *de novo* banks following the Great Recession. This entails greater upfront investment to establish a *de novo* bank successfully, satisfy regulatory requirements, and endure macroeconomic hurdles.

Average Capitalization for De Novo Banks Opened (2008 – Present)



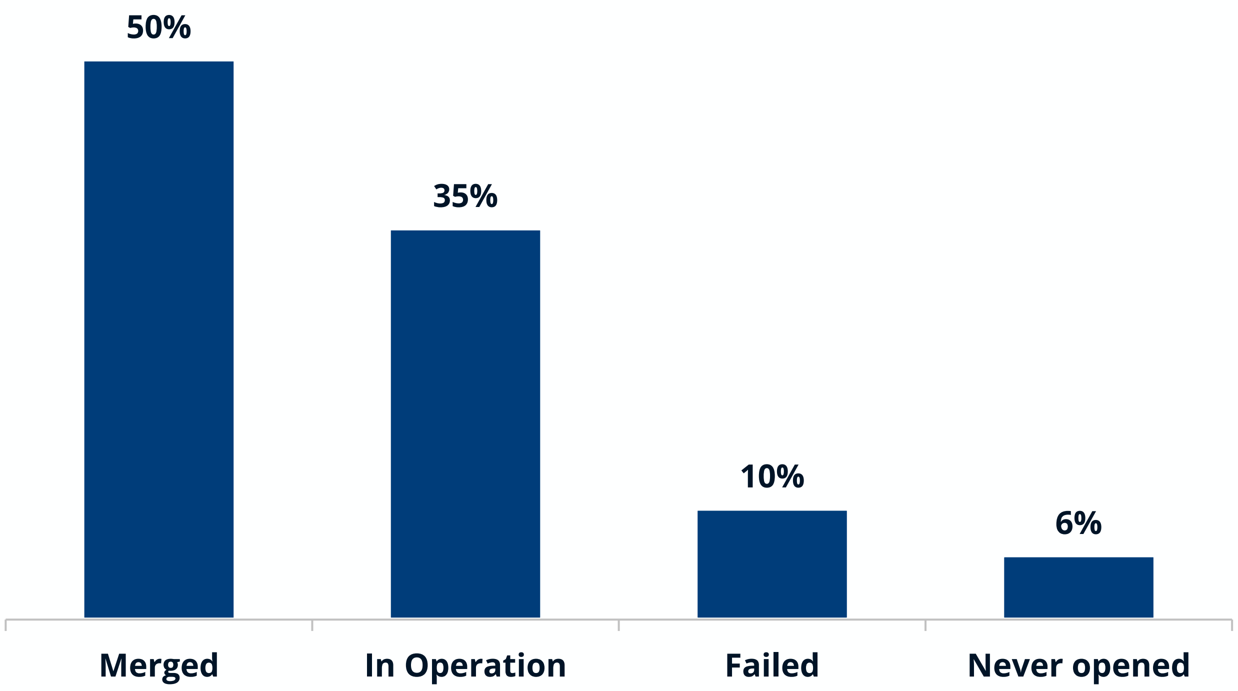
- The average capital needed to establish a de novo bank doubled from $15 million prior to the financial crisis to $33 million post-crisis.
- Banks have needed to acquire more capital to provide a buffer to withstand recession and crises with lower chances of failure.

Source: bankingstrategist.com; FDIC. Note: Varo Bank's high capitalization is explained by the fact that they had already been operating and making revenue for three years with products and services offered in partnership with Bancorp Bank.

COMPLICATED CONDITIONS LIMIT THE LIFESPAN OF DE NOVO BANKS

Operational and macroeconomic factors have caused high failure rates for new banks and lead to half of new banks merging within a decade of creation. Only a third of *de novo* banks created since 2000 continue to operate independently today.

Summary of De Novo Banks Activity (2000 – Present)



- Compared with small established banks, *de novos* are more financially fragile and depend more heavily on non-core liabilities, which are those held by other financial intermediaries and foreign creditors.
- Additionally, *de novos* can struggle to gain market depth, traction, and customers.
- Failed banks during the financial crisis invested heavily in construction and development lending, which made them vulnerable both to consumer and builder-developer foreclosures.

Source: bankingstrategist.com; FDIC; “The Entry, Performance, and Risk Profile of De Novo Banks,” FDIC, 2016.

A Path Towards the New Institutions

San Francisco's route for a community-serving lending institution in the existing regulatory and economic context.

TAKING ADVANTAGE OF PHASING TO BUILD TOWARDS A DEPOSITORY PUBLIC BANK

The current legal and regulatory framework defines a pathway to create a public bank at the state level (through California's Assembly Bill 857) but not at the federal level. Because of the expected high level of regulatory scrutiny that municipal public bank applications will face, San Francisco should maximize the benefits from a two-step process through the creation of a non-depository municipal financial corporation (MFC) first and depository public bank later that allows it to develop capacity, success, resources, and credibility gradually.

- Creating an MFC is faster, less costly, and faces less regulatory scrutiny than creating a public bank. However, only a public bank can receive the City's deposits, expanding lending potential for local priorities
- Establishing an MFC first, the City can develop capacity and demonstrate success in benefiting local communities and build resources and establish credibility in the medium term to achieve its longer-term objective of realizing the benefits of a depository public bank.

ASSEMBLY BILL 857 ESTABLISHES A UNIQUE WINDOW OF OPPORTUNITY

Assembly Bill (AB) 857 creates a pathway for cities, counties, and joint powers authorities to start public banks. This establishes a framework through which local government can create financial institutions that allow taxpayers money to remain local to finance pressing needs like affordable housing, small business support, and clean energy and infrastructure investments.

What is a public bank in California?

"A corporation, organized under the Nonprofit Mutual Benefit Corporation or the Nonprofit Public Benefit Corporation Law, for the purpose of engaging in the commercial banking business or industrial banking business, that is wholly owned by a local agency, local agencies, or a joint powers authority."

What can a public bank do in California?

Engage in all of the following banking activities:

- **Local agency banking:** Accepting a deposit or granting a loan or extension of credit to a local agency
- **Infrastructure lending:** Lending to a local agency to build or improve public infrastructure
- **Wholesale lending:** Granting a loan or extension of credit to a local financial institution
- **Participation lending:** Purchasing or selling an interest in loans with a local financial institution
- Engage in retail activities without partnering with a local financial institution, if those retail activities are not offered or provided by local financial institutions in the jurisdiction of the local agency or agencies that own the public bank.

AB 857 CREATES A PATHWAY AT THE STATE BUT NOT AT THE FEDERAL LEVEL

Public bank charters are new territory for both state and federal regulators. While AB 857 established rules to set expectations and establish rules within California, no such framework exists federally. No applications of business plans have been filed to date, so there are no precedents on which creators or regulators can rely.

The process must go through two regulatory agencies:

- **State level:** Department of Financial Protection and Innovation
- **Federal level:** Federal Deposit Insurance Corporation

DFPI DEPARTMENT OF FINANCIAL PROTECTION & INNOVATION

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Applicants, like the City of San Francisco, should expect:

- **Potentially "competitive" process at state level:** AB 857 mandates that California's DFPI shall not issue more than two public bank licenses in a calendar year.
- **FDIC Board case at federal level:** FDIC approval will require Board evaluation, which will use a more cautious approach until there are several precedents in place.
- **Extended regulatory oversight:** While the FDIC closely scrutinizes *de novos* for their first three years, public banks may be subject to extended oversight beyond this period.

THE CITY'S STRATEGY REFLECTS THE NATIONAL AND REGULATORY CONTEXT

Given the national context and the obstacles to the creation of *de novo* banks outlined in the first section and the regulatory process describe above, the City and County of San Francisco's strategy of establishing a public bank in two steps can help establish the desired institution while building capacity, success, resources, and credibility gradually.

	Step 1: Non-Depository Municipal Financial Corporation (MFC)	Step 2: Depository Public Bank
Regulated by CDFPI/FDIC	No	Yes
Regulated by AB 857	No	Yes
Application Required	No	Yes
Capital Requirements	Low*	High
Timeframe to Create	Shorter	Two Years +
Existing Models	Gov't-supported lending programs	No
Sunset Requirements	No	Yes, 2028 – 7 Years from AB 857 Regulation Issuance
Banking Activities	**Cannot take deposits** or provide a full complement of banking services but **can originate loans**	**Can accept deposits** and **can provide additional banking services** if given the resources and capacity and in compliance with AB 857

*Depends on MFC's structure and programs

A TWO-STEP PROCESS CAN HELP OVERCOME TIMING AND RESOURCE CHALLENGES

The City needs to develop capacity and demonstrate success in benefiting local communities in the short term (less than 2 years). It also needs to allocate sufficient resources and establish credibility in the medium term (3-5 years) to achieve its longer-term (5+ years) objective of using significant City funds to finance areas of interest. A non-depository MFC can achieve short- and medium-term goals while creating the foundation for a public bank.

	Step 1: Non-Depository MFC	Step 2: Depository Public Bank
Provides	• Flexibility and lower costs in being established and operated enable short-term ramp-up • Successful performance can generate resources and credibility to support a subsequent application with regulators	• Pathway to receiving deposits from the City's Investment Pool and other entities, putting City funds to work locally and expanding lending potential (size) far beyond what is possible for a non-depository entity
Requires	• Board of Supervisors appropriations for funds as it cannot receive deposits or rely on the Investment Pool based on state and federal laws	• Higher startup and ongoing operating costs • Lengthy regulatory approval by state and federal agencies

THE TENTATIVE TIMELINE TO ESTABLISHING A SAN FRANCISCO PUBLIC BANK

The two-step process of establishing a non-depository MFC and a depository public bank can take place within the next 5-6 years. Following initial study and the development of viability, business, and governance plans, the City will require Board of Supervisors legislation, MFC creation and operation, a public bank application, and public bank creation. We conservatively estimate the duration of these steps below.

Potential Phases of Public Bank Creation	2022	2023	2024	2025	2026	2027	2028	2029
1. Education, engagement, and banking model selection *(ongoing)* • Confirm MFC and public bank priorities and structure • Stakeholder and community engagement	▶ *Today* 12-18 months							
2. Prepare viability, business, and governance plans • Prepare documents for RWG and Board of Supervisors approval • Ongoing community engagement							*MFC becomes public bank*	
3. Create MFC *(tentative)* • Board of Supervisors passes legislation creating and funding MFC • Board of Supervisors establishes triggers for public bank application			12 months	MFC operation	MFC operation	MFC operation		
4. File public bank regulatory application *(tentative)* • Update Phase 2 plans based on lessons learned from MFC* • Engage with CDFPI and FDIC throughout regulatory process					12 months			
5. Establish the public bank *(tentative)* • Address final regulatory requests** • Capitalize, fund, and establish public bank						12 months	Public bank operation	Public bank operation

Note: All times are estimates based on best available knowledge today.
* Ordinance 87-21 requires the MFC to apply for a public bank license within 3 years of its establishment and for the public bank to be operational within 5 years of MFC establishment.
** FDIC approvals are conditional upon the completion of requested actions. See "Applying for Deposit Insurance: A Handbook for Organizers of De Novo Institutions," FDIC, 2019.

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