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California Public Banking Alliance

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TECHNICAL BRIEF

Public Banking: Mechanics, Funding, Sustainability, Benefits, and Risk Management

A Technical Summary of Public Banks

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MECHANICS OF A PUBLIC BANK

Deposits – Public banks in California will accept and hold deposits from local governments and regional agencies and are owned and managed by a local government (city, county, or region), or a consortium of them. According to the Public Banking Act (AB 857), the legislation that authorized chartering public banks in California, depositors will not be individuals or private investors but cities and counties, publicly owned utilities, and the like.

Lending – Local governments can borrow directly from the public bank to fund projects, bypassing the private middleman or commercial for-profit banks. Public funds can support local initiatives and community-identified priorities through lending, not spending, or losing public funds to out-of-state large banks. California public banks will partner with local credit unions, community banks, and CDFIs*, expanding the lending capacity of these entities for loans to individuals, businesses, and other organizations.

*Community Development Financial Institutions – private non-profits that invest in public projects.

Investment – Public banks will provide financing to infrastructure projects. By enabling local governments to finance public projects, public banks can support initiatives like green infrastructure, affordable housing, public transportation, and small business loans in underserved communities.

Regulation – California established a public bank chartering framework for local governments with the passage of AB 857, the Public Banking Act (2019). Public banks are subject to government regulation and oversight to operate safely and soundly. The Public Banking Act requires relevant local governments to develop a business plan for the bank and receive approvals from state and federal regulators: the California Department of Financial Protection and Innovation (DFPI), the FDIC, and the Federal Reserve.

Governance – Public banks will be governed by an independent board of directors responsible for setting policy and overseeing the bank's operations, with public accountability mechanisms. Approvals from state and regulatory agencies require a

governance plan with public accountability measures, free from political interference.

METHODS FOR ACQUIRING START-UP CAPITAL AND FUNDS FOR LENDING

Capitalization (including start-up capital) is different than deposits and funding that is available for lending. Bank capital is a reserve, usually around 10% of total assets, that stays in the bank in case the bank faces an unforeseen situation requiring immediate liquidity. Deposits are the source of lending, with interest charged to those who borrow the money and a smaller amount of interest paid to depositors. In the case of public banks, the depositors are the founding governments. That spread is one of the ways banks earn income and, thereby, the earned interest is returned to the cities and counties.

Below are some ideas for how a public bank can secure funds for capitalization, as well as deposits for lending. Public banks' funds can come through various means such as repurposing existing public funds, funding from federal or state sources, borrowing and refinancing existing debt once the bank is operational, or potential new “Green New Deal" special taxes at the local level.

Federal and state sources – Federal and state governments have funding that can be tapped for initial capitalization. The Greenhouse Gas Reduction Fund within the Inflation Reduction Act provides $6 billion in capitalization funding for “community lenders” (including public Green Banks), that provide capital for the rapid deployment of low-emission products, technologies, and services.

Banking existing public funds – Rather than depositing public funds in private banks, which use them for private profit, a public bank can serve as a public depository for these funds. This can be done by identifying specific public eserves that can be moved from private financial institutions into the newly established public bank.

Issuing bonds and certificates of deposit (CDs) – Once established, public banks will be able to issue bonds and offer CDs to institutions that want to invest in a responsible bank that serves the community. Investments like these are made for security and liquidity, not yield. The average rate of return in San Francisco has historically been below 2%. Agencies investing their money in public bank notes will not have to sacrifice yield to do so.

A Green New Deal tax – Some communities are looking toward a "Green New Deal" or other special tax with a public bank to facilitate the funding of climate justice projects. Funds from the new tax could be used for the capitalization of a public bank, as well as for lending to address the climate crisis.

Foundations and private universities – Another potential funding source for public banks is through partnerships with foundations and private universities. Many universities are actively seeking opportunities to divest from big banks and invest in socially responsible and locally targeted initiatives. Collaborating with public banks aligns with their mission of responsible investing and can offer a more sustainable and impactful alternative for managing their funds. These institutions can provide deposits or contribute securities to help offset collateralization requirements, strengthening the lending capacity of the public bank.

Currently, public funds are deposited in private-sector banks or invested in securities held in custody by private-sector banks, most of which are massive global institutions with little concern for local needs. These banks leverage those funds to create loans for private profit. A public bank can serve as a depository for public funds and a public bank's business plan can identify which specific funds will be moved from private-sector banks into the newly established public one.

SUSTAINABILITY OVER TIME

As with all banks, the public bank will provide loans that are paid back over time with interest. As loans are repaid, more loans can be made. Banks borrow at a lower rate and lend at a slightly higher one. Loans can be profitable for the public bank while still offering better rates than a particular project can get at a private-sector, for-profit bank. Proceeds from this interest rate arbitrage can be used to pay the expenses of the bank and grow its capital base and reserves.

ADVANTAGES OF PUBLIC BANKS

- Public ownership, oversight, and accountability mean public banks can prioritize the needs of local businesses, individuals, and government agencies, over the short-term interests of private shareholders. This can prevent abuses and misconduct that have historically characterized most corporate megabanks at the expense of municipalities and bank customers.

- Stable, low-cost financing for public projects, such as schools, roads, and hospitals – or financing any critical infrastructure development that may not be attractive or urgent to private banks.

- Reduction of local government reliance on predatory lenders and financial institutions that charge high fees and interest rates and invest in projects such as increasing fossil fuel production or luxury housing which often conflict with community interests.

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- Retention of money in the local economy rather than allowing it to be drained out to distant shareholders and national or global financial centers. Money collected from local taxes, fees, and fines.

- Strengthening the local economy by partnering with local community banks, credit unions, and CDFIs. This kind of partnership will be able to provide affordable loans to borrowers like small businesses and entrepreneurs who may have difficulty accessing credit from traditional banks. Such co-lending allows these other local financial institutions to increase their lending base and broaden their mission.

EXAMPLES OF PUBLIC BANKS

Bank of North Dakota – The Bank of North Dakota (BND) is the only state-owned depository institution in the US. The BND operates as a full-service bank that works mainly in partnership with local community banks, offering financial products and services to individuals, businesses, and government entities. These include checking and savings accounts, loans for agriculture, commercial, and residential purposes, investment services, and financial education programs. The BND has played a key role in supporting the state's economic development for over a century, including providing financing for infrastructure projects and supporting small businesses.

Below is a list of the accomplishments of the Bank of North Dakota:

- Consistently returns a surplus to the state's general fund. Every two years since 2017, the ND Legislature has transferred $140 million of bank profits to the state's general fund to help balance the budget.
- Strong track record of stability, with no credit rating downgrades in its history.
- Played a critical role in helping the state weather the financial crises in 2008 and the COVID-19 pandemic by providing liquidity and support to small businesses through partnerships with community banks administering programs like the Paycheck Protection Program.
- As it’s mandated to serve the public interest, it focuses on investments that benefit the state and its residents, rather than maximizing profits for shareholders.
- It has helped to reduce the state's reliance on external sources of financing, allowing it to retain more of its wealth and resources within the state.
- Consistently outperforms their privately-owned counterparts in terms of financial stability and profitability, demonstrating the effectiveness of a publicly-owned banking model. For example, in 2021 the BND had a 15% return on investment.
- Acts as the financial first responder to North Dakotans when disasters such as floods hit residents.
- Provides below-market student loans for those who attend college in North Dakota.
- Reflects state investment values by underwriting agricultural and energy projects that help North Dakota. These values may differ in other states and localities, but public banks are designed to reflect those values.

Sparkassen – Sparkassen is a network of over 400 public banks in Germany, owned and controlled by local governments, focused on providing financial services to individuals, small businesses, and municipalities in their region.

- Strong track record of supporting renewable energy projects, with a particular focus on solar and wind power.
- Played a significant role in Germany's transition to a low-carbon economy, providing financing for over 70% of the country's renewable energy projects.
- Sparkassen is open to low-income clients and small businesses. They actively encourage people to build up savings, finance 70 percent of all small businesses with fewer than ten employees, and finance more than 50 percent of all business start-ups in Germany.

FINANCIAL COMPONENTS

Public banks are financial institutions owned and/or controlled by a government entity established for the purpose of providing financial services to the government, and in some cases to the general public. Public banks differ from private banks in that they are not motivated solely by profit but are intended to serve the public interest. As a result, public banks can offer lower fees and interest rates on their products and services compared to private banks and can have a longer time horizon for break-even on projects like infrastructure.

One of the key financial components of public banks is using deposits from government agencies and other public entities as a source of funding for their lending operations. Public banks will generate income through the loans that they make, most likely in collaboration with local financial institutions. Once established and following regulatory approval of their safety and soundness, public banks can accept deposits from cities and counties. This will allow public banks to expand their loan activities responsibly and arbitrage the interest rate differential while providing also for the public interest in what it charges and what risks it takes on.

In addition to providing financial services, public banks can also play a role in coordinating economic development and community revitalization efforts, as well as in financing infrastructure projects. Thus, public banks can be used as a tool for local governments to both manage their financial resources and achieve their policy goals.

RISKS ASSUMED BY THE PUBLIC AND SPONSORING ENTITY

All banks operate with managed risks, and public banks are no exception. The major risks assumed by banks are liquidity risk, credit risk, and interest risk. Liquidity risk is the risk that the bank does not have enough money on hand to make interest payments to depositors, to return funds that depositors demand if they decide to withdraw them or to pay operational costs. All banks are required to retain capital reserves and weigh the risk of default on their loan assets based on federal and international banking standards that establish their appropriate capital and liquidity requirements. Public banks can exceed these requirements to be certain that they will be able to handle liquidity risk. Both federal and state regulators will only approve a public bank's business plan if it ensures professional management and oversight.

Credit risk is the risk that borrowers cannot or will not repay a loan with interest as scheduled. Market risk is the risk that the market value of a security or other asset, such as collateral, will decrease due to market conditions. Banks maintain a loan loss reserve that takes into account the relative riskiness of these loans to protect against possible defaults, late payments, or the need to reschedule or write down loan payments.

Banks are required to manage all of these risks responsibly. They do this by utilizing the Uniform Financial Institutions Rating System, which uses 'CAMELS' to examine Capital adequacy, Asset quality, Management systems, Earnings, Liquidity, and Sensitivity to market risk on a routine basis. Regulators regularly check to ensure this is being done conscientiously so that banks remain solvent.

There is no direct risk to individual residents living in a jurisdiction that establishes a public bank. There is some risk to the local government that establishes a public bank, but the California Public Banking Act requires that public banks be chartered and overseen by the state Department of Financial Protection and Innovation (DFPI), as well as the Federal Deposit Insurance Corporation (FDIC). Both agencies are committed to guarding against banks taking excessive risks and ensuring they operate responsibly.

MINIMIZING RISKS

As context, it is important to understand that AB 857 public banks, like conventional, private sector banks, will be subject to close scrutiny and oversight by state and federal banking regulators. No bank is permitted to operate until they receive approval to do so from the FDIC and DFPI, based on a detailed business plan and financial modeling that meets regulatory standards for minimizing the risk of failure, whether that is caused by liquidity, credit, or market conditions. Regulators will not approve a bank to operate unless they are satisfied that the bank has a reasonable likelihood of success. After approval, the bank is not permitted to deviate from that plan without regulatory approval during its de novo period. If at any point the regulators have reason to believe that a bank is at risk of failure, they will intervene to address that risk and prevent failure.

- **Ensuring adequate capitalization** – One of the key risks for public banks is not generating sufficient profits to cover operating costs. To minimize this risk, it is important to ensure that the public bank is adequately capitalized when it is first established and that its expenses do not exceed its realistic revenue expectation independent of additional public expenditure.

- **Ensuring independence and transparency** – To minimize the risk of political pressure on public banks, it is important to ensure that the bank is independent and transparent in its operations. This involves establishing an independent board of directors to oversee the bank's operations and implementing policies to ensure that the bank's activities are transparent and accountable to the public.

- **Establishing clear goals and objectives** – To maximize their effectiveness and minimize the risk of making poor investment decisions, public banks define clear goals and objectives that align with the needs of the local community and the broader public interest. This will enable them to focus their efforts on investments that generate the greatest public benefit and contribute to the overall well-being of the community.

- Public banks should develop a clear mission statement and set specific targets that align with this mission. This may involve identifying key focus areas, such as affordable housing, infrastructure development, or small business lending, and setting specific goals and metrics for measuring progress in these areas. By

- clearly defining their goals and objectives, public banks can ensure that they are making decisions that align with the needs of the community and the public interest and are financially responsible.

- **Implementing strong risk management policies such as strictly observing CAMELS as noted above.**

PROJECTED RATE OF RETURN ON INITIAL CAPITAL INVESTMENT

The Bank of North Dakota achieved a profit of $144.2 million in 2021, delivering a healthy return on investment of 15% for the state. Of course, this cannot be expected of all public banks, especially those just starting out. The rate of return on any investment depends on a variety of factors, including the bank's financial performance, the level of risk associated with the investment, and market conditions.

Public banks do not have pressures to achieve exceptional financial returns as do corporate banks. Corporate for-profit banks are pressured to perform in the interests of their shareholders and executives, while public banks measure their success in terms of financial sustainability and achieving significant improvements in their communities.

MUNICIPAL FINANCE CORPORATION (MFC)

A Municipal Finance Corporation (MFC) and a public bank are two different entities. An MFC is a revolving loan fund that can be established much quicker than a public bank as it does not require regulatory approval but it cannot take deposits. An MFC could be established as an intermediary step toward forming a public bank. By establishing a successful track record for managing public funds and making loans, it could then scale up to a full-fledged public bank. Both of these lending institutions will be set up primarily for lending in concert with community banks, credit unions, and CDFIs, and subject to the policies of a mission statement.

To learn more, read our MFCs and Green Banks Brief.

GREEN BANKS

Green banks are public or quasi-public financial institutions that focus on financing clean energy and other environmentally friendly projects. These banks operate at the state or local level and use public funds to invest in projects that would otherwise be considered too risky or difficult to fund solely by private investors or commercial banks.

Green banks work to accelerate the transition to a low-carbon economy by reducing the cost of financing for clean energy projects. By leveraging public funds to attract private investment, green banks can create a multiplier effect that can multiply the amount of money available for clean energy projects. Green banks also provide technical assistance to project developers to help them prepare and finance projects. This assistance can include help with project design, financial modeling, and identifying additional sources of financing.

Green banks have proven to be an effective tool for supporting clean energy investments. They have successfully financed a range of projects, including solar installations, energy efficiency retrofits, energy-efficient affordable housing, cost-saving appliance upgrades, and electric vehicle infrastructure. In addition to helping to reduce greenhouse gas emissions, these projects also create jobs and stimulate economic growth.

Green banks play an important role in financing the transition to a low-carbon economy. By leveraging public funds to attract private investment, they can finance projects that otherwise would not receive funding and accelerate the development of clean energy infrastructure.

To learn more about green banks, read our Intro to Green Banks.

NOTES FOR ADVOCATES

Orange County bankruptcy – Technical objections to public banking have invoked the 1994 Orange County bankruptcy, with concerns that a public bank would increase the risk of insolvency during a crisis. It's important to note that the Orange County bankruptcy was caused by risky investment in derivatives by the county's former treasurer.

Orange County sued Merrill Lynch in 1995 for $2 billion in damages, contending that the Wall Street firm sold risky investments to OC's then-treasurer, leading to the County's bankruptcy. Merrill Lynch settled for $400 million and Orange County barred the financial firm from doing business with the county for nearly a decade.

Public banks will invest conservatively and will not engage in high-risk activities like derivatives trading. They prioritize the stability and security of funds over maximizing returns. Public banks, as public entities, are subject to increased oversight by the local government agency, and state and federal regulatory agencies. Public banks will also adhere to existing legal and regulatory structures established by California law following the Orange County bankruptcy.

California's collateral requirements – In response to the Orange County bankruptcy in 1994, California implemented a strict collateral requirement of at least 100% for banks holding public deposits. This measure aimed to protect taxpayer money and mitigate risks associated with public funds. By ensuring full collateralization, California sought to enhance the security and stability of public funds, safeguarding public agencies and communities from potential financial instability.

CONTRIBUTORS

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Advancing socially and environmentally responsible public banks.

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