Senate Committees on Governance and Finance & Banking and Financial Institutions

A State Bank? There Is Interest, But Does It Make Cents?

November 23, 2020

Committee Background

This background paper prepares the members of the Senate Governance & Finance and Banking and Financial Institutions Committees for the November 23, 2020, informational hearing titled "**A State Bank? There Is Interest, But Does It Make Cents?**" Through this hearing, the Committees will hear testimony regarding the potential benefits of a state public bank, barriers to its successful creation and operation, and the manner in which its balance sheet can be capitalized, deposits collateralized, and its operations funded. The hearing follows the Governance & Finance Committee's consideration of AB 310 (Santiago, 2020).

At the hearing, the Committees will first hear from public banking advocates regarding potential benefits and options for implementation. Second, the Committees will hear from the two state Constitutional officers, the Controller and the Treasurer, charged with state fiscal management regarding how a state public bank could affect their duties. The third panel is comprised of leaders of other state agencies with potential roles regulating or implementing a state public bank. Lastly, the Committee will hear from other stakeholders who have been involved in prior legislation regarding public banking and access to capital for disadvantaged communities.

This background paper:

- Describes public banking efforts in California;
- Details the duties of constitutional officers and state agencies which may be affected by potential legislation;
- Lists previous public banking legislation; and
- Contains questions from the Committees and responses from public banking advocates regarding a potential state public bank.

Public Banking. Public banking in the United States is more than 100 years old. The nation's only public bank operating at scale, the Bank of North Dakota (BND), was founded in 1919 by the state Legislature to support the state's farmers. BND is the exclusive depository institution for state government funds and also serves local governments, which can voluntarily elect to deposit funds in the bank. Importantly, BND does not compete with private financial institutions. Rather, it partners with local banks and credit unions. The initial underwriting, risk assessment, and credit approval decision are made by the private sector banks. These private financial institutions then originate the loans, apply to participate in one of BND's programs, and BND provides capital to participate in the loan with the private financial institution.

Except for public ownership, public banking proposals vary in the scope of services provided, level of regulation, and capital structure. Proponents generally argue that public banks will benefit the public by:

- Investing public funds in a way that reflects the values of the electorate,
- Divesting public funds from commercial banks that provide financing to industries and firms, or engage in behavior inconsistent with those values,
- Providing capital at a lower cost than the private sector for preferred uses, such as public infrastructure projects, affordable housing, small businesses, and offering banking services to those who lack them, and
- Reducing costs to the state and local agencies for banking services.

Renewed interest in public banking has resulted in legislation or feasibility studies in state and local governments around the country in the years following the financial crisis and the economic recession it caused. Feasibility studies often find significant start-up costs and high levels of financial and operational risk associated with public banks. For example, in March, 2019, the San Francisco Office of the Treasurer and Tax Collector issued a Municipal Bank Feasibility Task Force Report 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." This feasibility study examined three financial models: a non-depository reinvestment entity that focuses on affordable housing and small business lending to achieve community goals (Model One); a depository institution that allows the City to divest from banks that perform the City's cash management (Model Two); and a combination of the two models (Model Three). The below table summarizes the results of the three models studied:

	Model One: Reinvest	Model Two: Divest	Model Three: Combination
Break Even Details			
Years to Break Even	10	31	56
Size at Breakeven[1]	$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

As shown above, both of the models that envision taking deposits (Models Two and Three) are considerably more expensive to establish than the model that envisions lending without also taking deposits. The task force study did not recommend one model over either of the others; instead, the report was intended to provide information for use by the Board of Supervisors and Mayor when deciding whether, and, if so, how, to move forward. Regardless of which option is chosen, any public bank will need significant financial resources to capitalize it.

[1] As used by the authors of the SF report, the "size" of a bank refers to its outstanding loans plus its cash and securities on hand. For a depository, this sum should equal the bank's deposits plus capital.

State Treasurer. Elected every four years, the State Treasurer is the State's lead asset manager, banker, and financier. As part of this role, the Treasurer manages several programs, including the Pooled Money Investment Account (PMIA), a cash pooling and liquidity management account in which all major state funds are physically concentrated into a single cash position for investment purposes. While the Pooled Money Investment Board, consisting of the Treasurer as Chair, the Controller, and Director of Finance, sets investment policy consistent with state law, the Treasurer manages PMIA's day-to-day operations. Because PMIA is a cash management account for temporarily idle funds, its primary investment objectives are safety, liquidity, and yield.

PMIA considers the funds that the state is holding in its various bank accounts as a source of liquidity. However, idle bank balances do not earn interest, and are instead used to compensate the state's depository banks for processing services those banks provide to the state treasury. The Treasurer invests remaining PMIA funds in securities, limited by state law to government securities, securities of federally-sponsored agencies, domestic corporate bonds, prime-rated commercial paper, and repurchase and reverse repurchase agreements. In 2018-19, slightly more than half of PMIA's average daily portfolio was held in U.S. Treasuries, 18.5% in agency coupon securities or discount notes, 16.3% in negotiable certificates of deposit, and 7% in commercial paper. The average investment life is 191 days, with an average annual yield of 1.93%.

The Treasurer also uses PMIA funds to make interest-bearing time deposits in California banks, savings and loan associations and credit unions, as well as national banks, banks located in other states, or any California branch office of a bank headquartered in another state, as well as state or federally chartered savings and loan associations or credit unions that are located in this state. Before the Treasurer makes a cash deposit, the bank or other financial institution must provide sufficient collateral consisting of approved securities with a market value of at least 110% of the deposits, or with approved promissory notes secured by mortgages or deeds of trust with a market value of at least 150% of the deposit. In 2018-19, daily investments in time deposits averaged $4.8 billion daily.

The Local Agency Investment Fund (LAIF) allows cities, counties and special districts to place its temporarily idle funds in the Treasurer's custody, who deposits and invests them as part of PMIA. Participating agencies can withdraw their funds from the LAIF at any time. At the end of June 2020, the LAIF had 2,362 participating agencies and a balance of $32.1 billion, slightly less than one-third of PMIA's current $100 billion portfolio.

PMIA consists of funds from three different sources: the state's Surplus Money Investment Fund (SMIF), LAIF, and General Fund dollars. SMIF consists of the available cash of all special funds which do not have their own investment authority, and all or a portion of the available cash of special funds having investment authority of their own, but which have elected to be included in the program. About half of PMIA's balance comes from SMIF, one third from LAIF, with the remainder - about $20 billion - consisting of General Fund dollars. These proportions can fluctuate.

State Controller. Elected every four years, the State Controller is the state's chief fiscal officer. The Controller issues warrants and electronic fund transfers from the State Treasury, audits all funds disbursed from the state, and pays all of the state's claims, including payments to schools and local governments as well as payroll expenses. The Controller manages state cash flow by either borrowing externally or internally. External borrowing consists of the Controller requesting the Treasurer to issue revenue anticipation notes, where investors provide immediate cash and subsequently repaid by the end of each fiscal year. The Controller borrows internally from certain funds allowed by statute, including PMIA, to cover any cash flow shortages. However, state law prohibits the Controller from borrowing from other funds, including LAIF.

The California Infrastructure and Economic Development Bank. The California Infrastructure and Economic Development Bank (I-Bank) supports economic development through its authority to issue bonds, make loans, and provide credit enhancements. I-Bank's activities are organized into the following direct loan and conduit financing programs:

- The Infrastructure State Revolving Fund Program, which provides low-cost loan financing to local agencies for public infrastructure projects.
- The California Lending for Energy and Environmental Need, which directly funds energy efficiency and street lighting for municipalities, schools, universities, and hospitals.
- The Jump Start Loan Program, which provides microloans, technical assistance and financial literacy training.
- The Small Business Loan Guarantee Program, which guarantees repayments to lenders that provide financing to small businesses that experience capital access barriers.
- The Farm Loan Program, which supports direct loans to smaller farms for purchase, operating costs, and other expenses.
- The Industrial Development Revenue Bond Program**,** which provides tax-exempt revenue bond financing for eligible manufacturing companies.
- The 501(c)(3) Revenue Bond Program, which offers tax-exempt revenue bond financing for certain nonprofit, public benefit corporations.
- The Public Agency Revenue Bond Program, which provides tax-exempt revenue bond financing for governmental entities.
- The Exempt Facilities Program, which allows for tax-exempt conduit bond finance for projects that are government-owned or consist of private improvements within publicly-owned facilities, such as private airline improvements at publicly-owned airport.

Additionally, the 2020-21 Budget Act includes $25 million General Fund for I-Bank to provide capital to Community Development Financial Institutions (CDFI) and other mission based lenders to enable the origination of more loans in underbanked communities. I-Bank recently implemented this program as the California Rebuilding Fund, which seeks to make flexible, affordable loans to small businesses with 50 employees or fewer through participating community lenders, including CDFIs.

I-Bank is governed by a Board of Directors consisting of the Director of Finance, the Treasurer, the Director of the Governor's Office of Business and Economic Development (GO-Biz) who serves as Chair, and the Secretary of Transportation, or their designees. Additionally, statute bars the I-Bank from accepting deposits of money for time or demand deposits.

In 2012, the Legislature codified GO-Biz in law as the lead entity for economic strategy and the marketing of California on issues relating to business development, private sector investment, and economic growth (AB 29, Perez, 2012). Under Governor Brown's Governor's Reorganization Plan #2 (GRP#2), GO-Biz now houses the I-Bank, the California Film Commission, the California Tourism Commission, Small Business Development Centers, and the Small Business Loan Guarantee Program, effective July 1, 2013. The now-defunct Business, Transportation, and Housing Agency housed I-Bank prior to GRP#2.

Chartering and supervising banks. The Financial Code regulates the businesses of commercial and industrial banking in California, administered by the Department of Business Oversight (DBO), which was recently renamed the Department of Financial Protection and Innovation (DFPI). The Commissioner of Financial Protection and Innovation must make or cause to be made a careful investigation and examination of the following items when an organization files an application to organize and establish a corporation to engage in the banking business:

- The character, reputation, and financial standing of the organizers and their motives in seeking to organize the proposed bank.
- The need for banking facilities or additional banking facilities, giving particular consideration to the adequacy of existing banking facilities.
- The character, financial responsibility, banking experience, and business qualifications of the proposed officers of the bank.
- The character, financial responsibility, business experience, and standing of the proposed stockholders and directors.

State law prohibits the Commissioner from approving an application to form a bank in California until the Commissioner has ascertained all of the following to their satisfaction:

- That the public convenience and advantage will be promoted by the establishment of the proposed bank.
- That the proposed bank will have a reasonable promise of successful operation.
- That the bank is being formed for no other purpose than the legitimate objects contemplated by the Banking Law.
- That the proposed capital structure is adequate.
- That the proposed officers and directors have sufficient banking or trust experience, ability, and standing to afford reasonable promise of successful operation.

The DFPI is responsible for ensuring the safety and soundness of state-chartered banks under its jurisdiction. It carries out this responsibility through regular examinations and offsite monitoring of quarterly and annual financial information submitted by licensees.

Local agency investments. Since 1913, state law has authorized local officials to invest a portion of local agencies' temporarily idle funds in a variety of financial instruments. Originally, state law limited the instruments to government bonds, but over time the laws governing local agency investments have been amended to keep pace with changing investment opportunities and current market offerings. California law allows local officials to deposit money in state or national banks, savings associations, federal associations, credit unions, or federally insured industrial loan companies in the State of California. When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, state law outlines local agencies' investment objectives, also known as the prudent investor standard. The primary objective is to safeguard the principal of the funds under its control. The secondary objective is to meet the liquidity needs of the depositor. The final objective is to achieve a return on the funds under its control. State law limits the percentage that local agencies can invest in many types of investments. This encourages local agencies to diversify their investment portfolios, which limits the risk to the local agency if any investment does not have the expected return. Local agencies make investments with different maturity dates, which refer to the date when the borrower must make the final payment due on an investment. Local agencies work with community and national banks to help manage these deposits.

The COVID-19 pandemic has significantly affected local agencies' investment practices. Local agencies have seen their revenues decrease because of decreased economic activity and stay-at-home orders intended to decrease their residents' exposure to the virus. Making matters worse, local agencies also face increased public health costs to respond to the unprecedented public health emergency. Both factors reduce the amount of funds local agencies have to invest in longer-term investments or projects, and require local agencies to focus their efforts on short-term cash management to maintain core services. For example, local agencies issued $2.4 billion in debt in May 2020, $1.2 billion less compared to May 2019, which may indicate local agencies' reluctance to add any additional fiscal obligations and to maintain a higher level of liquidity in their cash portfolio.

Related Legislation:

In 2019, the Legislature enacted AB 857 (Chiu), which created a process for a local agency to apply for a public bank license from DFPI. The bill required the local agency to meet the same general requirements and approval criteria as private sector applicants, including deposit insurance provided by the Federal Deposit Insurance Corporation, as well as routine supervision and examinations to evaluate the nature of the bank's operations, the adequacy of the bank's internal controls and its internal audit function, and the bank's compliance with laws and regulations. If weaknesses are identified, the bill permits regulators to correct deficiencies in the bank's risk management practices and address weaknesses in the bank's operations.

SB 528 (Hueso, 2019) authorized the state and local agencies to deposit funds into I-Bank and removed I-Bank from the Governor's Office of Business and Economic Development's supervision to a newly formed Commission. The measure was approved by the Governance and Finance Committee, then significantly amended by the Banking and Financial Institutions Committee into a measure that formed a task force to study the idea of turning I-Bank into a depository. The amended bill did not advance from the Senate Appropriations Committee's suspense file.

AB 310 (Santiago, 2020) would have created a depository bank in I-Bank, required the Treasurer to deposit specified percentages of state funds into I-Bank over time and target an investment of 10% of the Pooled Money Investment Account's average daily balance in I-Bank, as well as moved I-Bank out of GO-Biz, among other changes. The measure did not advance from the Governance and Finance Committee.

Questions and Answers:

In advance of the hearing, the Committees sent the following questions to Asm. Santiago and advocates for a state public bank. Below are the questions and the responses provided to the Committees:

1. Why have local agencies not applied for bank charters under the AB 857 (Chiu) process?

   AB 857 authorizes ten total applicants for public bank licenses and limits the number of licenses granted to two per year. Applicants are restricted to cities and counties. At maximum, ten local public banks could be created over a period of seven years.

   The DFPI has yet to issue regulations. In our conversation with DFPI, they have informed us that they will not accept applications for public bank charters until their regulations have been issued.

   San Francisco, Los Angeles and the East Bay are the regions which we expect to submit initial applications. The COVID-19 pandemic has severely disrupted their plans. In San Francisco, Supervisor Fewer introduced legislation in November 2019 that would have created a task force to draft a business plan, which was to be finalized for approval by December 2020. That legislation has not moved forward due to the pandemic. We expect legislation to move forward in 2021.

   In Los Angeles, City Council approved a motion to seek qualifications from consultants who can build a business plan and application for commercial bank charter for the city, directing the City Legislative analyst to compile the requirements and scope for such a project and report back. We expect the CLA to finalize these requirements and for City Council to issue an RFP in early 2021 or earlier, especially if efforts like AB 310 which mobilize public finance as a tool for COVID recovery are successful.

   In the East Bay, advocates have raised funds and hired a consultant to initiate a viability study.

   I-Bank currently provides infrastructure loans to local governments for infrastructure projects and economic expansion projects. After conversion to the state public bank, the state public bank could expand the definition of infrastructure or economic expansion to include financial infrastructure loans to local governments who seek to create an AB 857 bank. A financial infrastructure loan could fund bank organizational costs such as the viability study, consultative processes, and applications to state and federal regulators for chartering authority and deposit insurance.

2. What specific services should a state bank provide, and to whom? What are reasonable dates to expect a state bank to begin providing each of these services?

   A state public bank should serve as an economic development partnership bank-- focused on equitable community development, financing infrastructure and lowering borrowing costs for state and local governments. Unlike commercial banks, it should serve a public good primarily and a profit mandate secondarily. This is not meant to endanger the fiscal solvency of such an institution, but rather to re-prioritize profits towards community reinvestment, particularly to meet community needs left unmet by commercial banks.

   Partnership banking for equitable community economic development*. As an expansion of I-Bank's Small Business Finance Center (SBFC), the state public bank would partner with Financial Development Corporations (FDCs), community financial development institutions (CDFIs) and local banks and credit unions to provide loan guarantees and direct loans for small businesses that experience capital access barriers. The SBFC is already operational and through it additional capital can start to flow from the state public bank to CDFIs in the form of long-term loans and loan purchases. We recommend changing the name of the SBFC to the CDFI Center. As a center focused on CDFIs, the program would center both small business lending and equitable community development-- including the preservation of existing affordable housing and development of new affordable housing. As an expansion of existing services, these services could be provided immediately.*

   Lower borrowing costs for state and local governments*. The state public bank would offer services as a placement agent or central issuer of debt securities as a public investment bank, using well-established processes currently contracted to private parties. These services could be offered to local governments, energy and school districts, and public/private projects. After conducting a planning process and hiring necessary staff, the bank could offer these services within one year. Studies from Berkeley have pointed to the high cost of debt borne by small agencies like water districts and school districts, with bond issuances regularly costing 8% or more. The state public bank would be able to pool risk and offer economies of scale, and eventually in-house at-cost underwriting and direct-to-broker relationships, to lower the cost of debt for these agencies.*

   Accessing the federal system*. The state public bank would create an account with the Federal Reserve, giving it access to the borrowing window. The state public bank would increase credit available to the state and local governments, by providing a centralized process for tapping special recovery programs like the municipal liquidity facility or future programs offered by the central bank or Treasury. Such access would allow immediate liquidity for the bank, currently effectively at no cost and indefinitely, and would afford other state and local agencies a much lower cost of debt. Right now, such benefits have accrued exclusively to commercial banks, leaving public agencies with a* *choice between commercial spreads and the still more expensive Municipal Liquidity Facility. With direct access to the Federal Reserve, local agencies would have more choice and flexibility when borrowing.*

A state public bank could stand in for those public borrowers immediately, and serve as the primary financial institution charged with interaction with the Federal Reserve on their behalf. The bank would immediately establish issuance and underwriting frameworks for qualified bonds (for programs like MLF) and commercial/non-profit/secured lending (PPP and similar programs), aggregating placement activity to achieve more favorable outcomes for California municipalities and targeting recovery funds to those left out of the current methods. The state bank could also place additional guarantees and program qualifications on behalf of sub-issuers, adding additional value and security to California public-purpose debt and opening a new window to ESG capital allocations for the state.

Access to the federal system may take two years after conversion of I-Bank to the state public bank.

***Depository services and cash management**. The primary depositor in a state public bank would be the State. Additional depositors and customers include local governments and local financial institutions. The depository services and cash management services would be launched pursuant to a study and plan. The bank would need to arrange insurance for deposits, most likely from the FDIC. A reasonable time frame for launching depository services may be three years after conversion of I-Bank to the state public bank.*

3. Feasibility studies (City and County of San Francisco, Massachusetts, Washington DC) state that significant amounts of time as well as funds to capitalize and operate a bank are necessary for successful implementation, which vary based on the type of bank created and services provided. What is the source of money to fund both bank capital and operating (personnel, facilities, information technology, etc.) costs? How much will be needed for each?

   The City and County of San Francisco commissioned a follow-up study to review the work of the County Treasurer. This follow-up study was conducted by the Budget and Legislative Analyst's Office (BLA). The BLA Report found that, contrary to the Treasurer's Feasibility Study, a San Francisco non-depository public bank could be immediately profitable and could bring enough capital to bear within 10 years to have a significant impact on the preservation of affordable housing and the expansion of credit to underserved small businesses. These two findings alone justify the effort that the City would put into creating its own bank.

Existing financial and human capital: I-Bank's assets

An initial source of capitalization is I-Bank's existing balance sheet which has roughly $819 million in assets, including $267M in cash or cash equivalents across three funds.

The bank already has staff, systems and facilities which can be leveraged to accomplish many functions of running a bank, including executive management, risk management, human resources, IT and data security. The additional tasks needed of a state public bank already largely exist inside I-Bank, which employs experts and trained teams in public finance, loan underwriting, securities and bond issuance, regulatory compliance. These organizational assets can be leveraged where new capacities must be added to I-Bank services, such as bond placement and depository services.

The current program support expense for I-Bank is under $10 million per annum. Though much of the work needed for these new services can be completed by existing staff and resources, even a doubling of this budget for new staff, business process and compliance requirements related to a de novo bank may leverage billions in federal and private investor capital for recovery and budget flexibility in California. Such staffing needs will of course be assessed by I-Bank staff and phased in accordingly.

Where lending and financial capital is concerned, I-Bank's funds, including the Guarantee Trust Fund and Small Business Expansion Fund can be expanded to serve the needs of short term COVID-19 recovery and long term equitable community economic development. Expanding existing programs will improve their scale and efficiency without reinventing the wheel and costing the state startup capital.

Source of Funding: Capital investment from the General Fund.

In addition to the capital that already exists, the state could appropriate additional funding as capital and operations funding for the bank.

Source of Funding: Fund backed by a federal guarantee; with investment from the SMIF, PMIA, CALPERs or other sources.

In the future, the state public bank could seek additional funding from a variety of sources, such as an investment from the Surplus Money Investment Fund (SMIF) or Pooled Money Investment Account (PMIA). The PMIA is currently invested in federal agencies and corporate commercial paper, earning an average yield of less than 2%. If I-Bank obtained a federal guarantee for its assets, it may be able to attract an investment from the SMIF or PMIA. That is, a federal guarantee would eliminate the possibility that loan defaults would result in the insolvency of the institution. In addition, concerns about illiquidity would be allayed because federally-guaranteed assets can easily be sold on the secondary market.

With a federal asset guarantee, I-Bank could sell debt securities to raise a very large loan fund in the range of $10 billion. This fund, which we refer to as the California Equitable Recovery and Rebuilding Fund (CERRF), would serve as the primary source of capital for new programs offered by the state bank. These programs will include expanded activities of the CDFI center, and expanded activities of the infrastructure financing program, including: public investments tied to revenue earned from infrastructure projects, special tax districts, loan interest and receivable from qualified conduit loans, and interest earned from public bond financing. The cost of seeking financing through CERRF will be lower than from the private markets, especially for smaller and rural local governments. This will result in substantial savings to local taxpayers, and to the state.

I-Bank currently earns roughly 2.89% on assets ($15M in revenue vs $552M in non-cash assets). The PMIA by comparison earned 2.27%. $10B invested in the I-Bank at its current performance would earn the fund $62,000,000 per year more than PMIA is currently earning in private investments with the same money. Assuming the loan is made at the same rate of return the PMIA currently enjoys while investing in corporate commercial paper, the CERRF could use this additional yield to expand its operations and cover costs related to increased expenses at I-Bank. The real impact will be felt by the hundreds of municipalities who would be able to responsibly bridge gaps in revenue without cutting services, and the hundreds of thousands employed in support projects and businesses who can keep their jobs and eventually thrive in a wide-based recovery.

4. What is the business plan for a state bank? Who is responsible for developing the business plan? Should it be set forth in statute or left to the discretion of those operating the bank? If the bank is to be a depository, as well as a lender, what would its balance sheet look like? How much regulatory capital should the bank hold compared to its assets and to collateralize its deposits? Should a public bank be subject to the same regulatory capital requirements as other depository banks? Who would deposit funds in the state bank? Would deposits be mandatory or permissive?

Because the state public bank is an expansion of an existing and successful financial institution, a de novo business plan is not required. Rather, a business plan for specific new and expanded lines of business would be required, namely the expansion of participatory lending and municipal lending, and the addition of depository services, cash management services, and broker-dealer / bond placement agent services.

Development of a business plan for these lines of business would be the responsibility of I-Bank, but would be conducted in coordination with outside consultants and public research institutions. One such organization is the Center for California Studies at Sacramento State, who we plan to work with to complete a business plan study.

These new lines of business, such as the establishment of depository and cash management services for the State and local governments; a new public investment fund; or the addition of bond placement agent services, would be accompanied by appropriate plans, scope, budgeting, and diligence performed by bank staff. New major lines of business, such as becoming a depository, would be approved and overseen by the Bank's governing commission.

The creation of new lines of business should be set forth in the statute. The statute should provide, at minimum, what these new lines of business are, who the contemplated depositors would be, and whether any deposits should be mandatory. The timing of launching specific lines of business should be left to the discretion of the bank commission and bank management, provided that statutory benchmarks shall be met before business lines are launched. For example, prior to accepting deposits, the bank shall obtain deposit insurance.

The bank's assets would comprise loan guarantees and loans to small businesses, municipal governments, nonprofits, community development financial institutions and other eligible borrowers. Its liabilities would be deposits (once chartered as a depository bank) and notes. Ordinarily, commercial banks need Tier 1 capital equaling at least 10% of assets. However, if the bank's assets are federally-guaranteed, its risk-weighted capital can be as little as 4% of assets. For example, if the bank's assets were $10 billion, it would ordinarily require $1 billion in risk-weighted capital. However, federal guarantees would reduce this amount to $400 million. This risk-weighted reserve ratio is consistent with the Basel III global standard for banking risk, and is comparable to standards met by large commercial banks.

The bank's depositors and noteholders could be governmental entities (including pension funds) and could also include larger private institutions, such as endowments or tech companies with large cash reserves. Because private company deposits are not subject to collateralization rules, these accounts could comprise a significant share of the bank's deposits. As stated above, the statute would determine if the state would be required to deposit funds in the bank, and if so, what percentage of funds. In no event would local governments be required to deposit in the bank. However, because the yields offered on these deposits would be competitive with those offered by other institutions, and services may be offered at a similar or lower cost, many local governments may choose to do business with the state public bank. This is the case with the Bank of North Dakota and local governments in the state.

Turning to sources of capital, the typical bank earns a return equaling around 2% of assets or $200 million for a $10 billion institution. However, because it would offer borrowers more affordable financing than private institutions, the state bank's return on assets is likely to be lower--perhaps 1% or $100 million for a $10 billion institution.

However, with a capital requirement of only $400 million this $100 million would represent a 25% return on equity--a rate of return that would be attractive to investors such as public employee pension funds. Moreover, given today's low interest rates--and risk-free assets--the state could easily afford to secure the bank's capital through borrowing. Finally, one or more state authorities could swap earning loan assets for bank equity.

5. How should a state bank be structured operationally? How should it be governed?

   The state bank should be structured as an independent agency governed by a commission. The Commission's members would be jointly appointed by the Governor and Legislature. Similar to a board of directors, the Commission would be responsible for governance, oversight and setting strategic direction for the bank. There would be strict separation between the oversight role of the Commission and the activities of the bank staff. The Commission would oversee the bank's executive director, but not get involved with staffing and lending decisions. The bank would follow best practices to identify and prevent potential conflicts of interest involving commissioners and the activities of the bank.

6. Should a state bank be subject to state or federal banking regulations, or otherwise required to obtain a state charter or federal license? If so, which ones?

   At minimum, the state public bank should be subject to audit oversight from the DFPI, State Auditor and an independent CPA. It should be subject to Federal Reserve regulations and should be required to seek a master account number and access to credit from the Federal Reserve and the Federal Home Loan Bank.

7. What entity should regulate a public bank?

   AB 857 "local" public banks are regulated by the DFPI and the FDIC, primarily. See Answer #6.