Municipal Banking: An Overview

Financing Socially Just and Sustainable Forms of Urban Development

Report by
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REFUND AMERICA PROJECT

ROOSEVELT INSTITUTE
REIMAGINE THE RULES

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Executive Summary

Toward a New Model of Social Finance

"The Municipal Bank: An Overview" and the accompanying technical document lay out a broad framework for how municipalities can establish, fund, and operate publicly owned municipal banks based on principles of egalitarian, redistributive justice, worker rights, and more ecologically sound urban development. While this paper focuses on the potential for cities to create publicly owned banks, many of the core principles involved also apply to state-level initiatives.

Issues related to capitalization, ownership structure, transparency, and governance are addressed. The paper also outlines a variety of lending initiatives through which municipal banks can advance and realize a broad set of redistributive and environmental objectives. As discussed below, municipal banks, when properly designed and managed, can generate significant financing for infrastructure and affordable housing. Municipal banks will allow tax revenues that are currently devoted to paying interest and principal on public debt obligations to be recaptured and redirected into local investments to improve employment prospects and economic opportunity in low-income, often disproportionately minority neighborhoods. Municipal banks can help cities undertake major infrastructure investments to reduce fossil fuel usage and automobile dependence. In addition, public banks can partner with local credit unions and community banks to increase the flow of credit to local businesses and low-income minority communities, through participation lending, risk sharing, and targeted social equity investments.

> *The Public Bank Project is dedicated to developing financial alternatives to the current system of Wall Street–dominated finance to expand the policy options of local governments and to promote public-utility models of banking and finance. This project has grown out of recognition of the*

problems endemic to the current system of predatory-extractive private finance, and the urgent need to develop viable, socially egalitarian, and ecologically sound alternative forms of economic development. Our particular focus is ways that local governments can pursue innovative policy initiatives to increase public-sector investments in areas such as affordable housing, infrastructure, and targeted economic development within low-income neighborhoods; and to reinvigorate the relation between citizens and local government.

The Urgent Need for Alternatives

A fundamental social function of financial markets is to issue loans and to allocate capital to support long-term economic development. Our current financial system has increasingly abandoned this central function. The growth of contemporary financial markets — and of financiers' trading profits — has become increasingly decoupled from activities that direct financial resources back into productive investment. Savings of extremely wealthy households are today far more likely to be deployed in the purchase of highly opaque financial products than to be absorbed back into productive circuits that are the ultimate source of social wealth. Moreover, many products sold to the upper strata of capital-owning households — various securitized financial products, CDOs, and the like — often saddle borrowers (workers, students, and state and local governments) with onerous repayment obligations, while extracting revenues through myriad fees and charges for financial transactions and servicing costs. The net effect has been to further reduce workers' real wages and to siphon off local and state tax dollars, while creating an upward redistribution of wealth and income to the top tier of wealthy U.S. (and global) households.

It should therefore come as no surprise that movements in financial market performance indicators—stock market indexes, financial firms' stock valuations, banks' reported profits, and bankers' and financial employees' bonuses—have become inversely correlated with the economic welfare of the majority of U.S. workers. Banks report robust profits amidst a rise of long-term structural unemployment, reductions in workers' average wages, increased poverty rates, and austerity-induced cuts in public expenditures and vital government services, all of which further depress living standards and induce ever greater precarity for working-class households. Consequences of these predatory financial practices have been particularly devastating for many lower-income households and neighborhoods, disproportionately African American and Latino.

Ongoing efforts by advocate groups to require financial institutions to reinvest in local community development, and to limit the most egregious forms of financial abuse, are essential to counter the predatory incentives that drive Wall Street business practices. However, finance capital will never voluntarily internalize social equity or environmental objectives into their core business models and lending practices. Incentives inherent in our present regime of deregulated predatory finance represent the complete antithesis of what is needed to achieve more egalitarian forms of economic development and to carry out the massive planned infrastructure investment required to shift our economic system away from fossil fuels in favor of low-carbon energy alternatives. Improving the welfare of working-class communities and developing economies that internalize ecological limits simply cannot be achieved by extracting concessions from corporations, given the profit-maximization incentives and antisocial lending practices that are integral to the operational fabric and culture of modern finance.

Many of these problems are widely recognized. Yet the ability of urban social movements and progressive advocates to advance genuine alternatives repeatedly comes up against the stark reality of lack of alternative finance resources. Under such conditions, it is hard to even imagine, let alone implement, a more socially equitable, ecologically sustainable form of alternative economic development. In recognition of this need, over the last two years, the Public Bank Project has developed a basic template for the establishment, funding, and operation of municipal banks. While the initial focus of this work centered on the ability of charter cities in California to form and operate municipal banks, with modifications this basic template can be implemented by municipalities in other U.S. states that grant substantial "home rule powers" to local governments.

Municipal banks will not, by themselves, solve the full spectrum of fiscal and economic challenges facing U.S. cities and their working-class residents. Nevertheless, they can be a critical step toward developing financial institutions premised on accountability to the needs of working-class and low-income constituencies. If combined with well-crafted local tax and land use policies, municipal banks offer a powerful tool for supporting investments in affordable housing, providing funds for land trusts and cooperative rental housing, and nurturing local business and worker cooperatives.

Initially, these alternative measures will take shape as local and regional experiments exploring ways to redirect financial flows toward equitable and environmentally sound investments. Over time, these initiatives could form the blueprint for a more far-reaching reconstruction of our current system along a public-utility model of banking and finance. They can do so, moreover, in ways that reverses decades of devaluation of the public sector by reaffirming the positive, even transformative, role of government as an agent of social improvement.[1]

What follows is a brief overview of how a municipal bank could be established, and the types of activities toward which its financial capacities could be directed.[2]

Developing Real Solutions

Municipal banks allow cities to recapture local funds currently invested in money market instruments and retain tax revenues currently siphoned off by payments of principal and interest to municipal bond owners (consisting largely of very wealthy households), enabling the municipality to channel these funds back into local investments in affordable housing, infrastructure, and economic development. Through tapping the deposit base of local governments, taking in municipal cash reserves currently invested in the money markets, and creating a supportive set of financial arrangements with public pension funds, socially responsible investors, and mission-aligned philanthropic foundations, municipal banks would provide cities with access to large, often low-cost funding pools to support affordable housing and infrastructure

[1] Please see the Public Bank Project website at publicfinance.us for specific documents and legal memos relating to feasibility in other states and municipal jurisdictions outside of California.

[2] A far more detailed and technically elaborate document that outlines in some detail the formation, incorporation, and funding of this type of institution in California is available at www.rooseveltinstitute.org

investments. Municipal banks could similarly be a major source of support for community land trusts, cooperative ownership structures, and neighborhood stabilization efforts.

Many cities have established programs and initiatives to support affordable housing and small business development. However, the scale of these initiatives is often limited due to lack of funding, and the use of bonds to finance capital improvements imposes a revenue drain on the local tax base. Municipal banks have additional funding resources that are simply not available to City governments or its component units, due to the ability to accept and lend out deposits. In addition, a bank can issue liabilities — certificates of deposit, bankers' acceptances, and medium-term notes — to raise funds to support projects that fulfill the City's priority social policy objectives. A municipal bank can provide access to these sources of finance without creating any ongoing claims on municipal finances.

Municipal banks could also become powerful partners to existing community banks, credit unions, and community-development financial institutions, enabling them to extend their services to households that are currently underserved, or even exploited, by present U.S. financial arrangements. Moreover, they can do so in ways that enhance the accountability of municipal governments to local residents and provide a real-world model for reinvigorating the relationship between citizens and local government.

Options for Implementation

Local governments have two broad options available for establishing locally owned and controlled municipal financial institutions. Option 1 is to create a full-fledged, state-chartered depository institution outright, through either a City Council ordinance or a voter-approved Charter Amendment. Option 2 is to embark on a two-stage process that would first establish a non-depository Municipal Financial Corporation that could make long-term housing and infrastructure investments, together with a smaller-scale, limited-purpose depository institution. Once this entity is in operation, the municipality could then expand its operations to establish a locally controlled depository institution that would take over all depository and cash management services currently contracted out by the city to private commercial banking institutions.

Option 2 would be easier to implement, given the far more stringent regulatory and legal compliance issues required to form and charter a depository bank. In addition, many of the technical competencies that would be developed in the course of the formation and operation of the Municipal Financial Corporation would carry over into the subsequent establishment of the depository institution. This track record would enhance the case for viability of the proposed bank with the state and federal regulators that must approve the charter of the depository institution.

Option 1: Creating a municipal banking institution

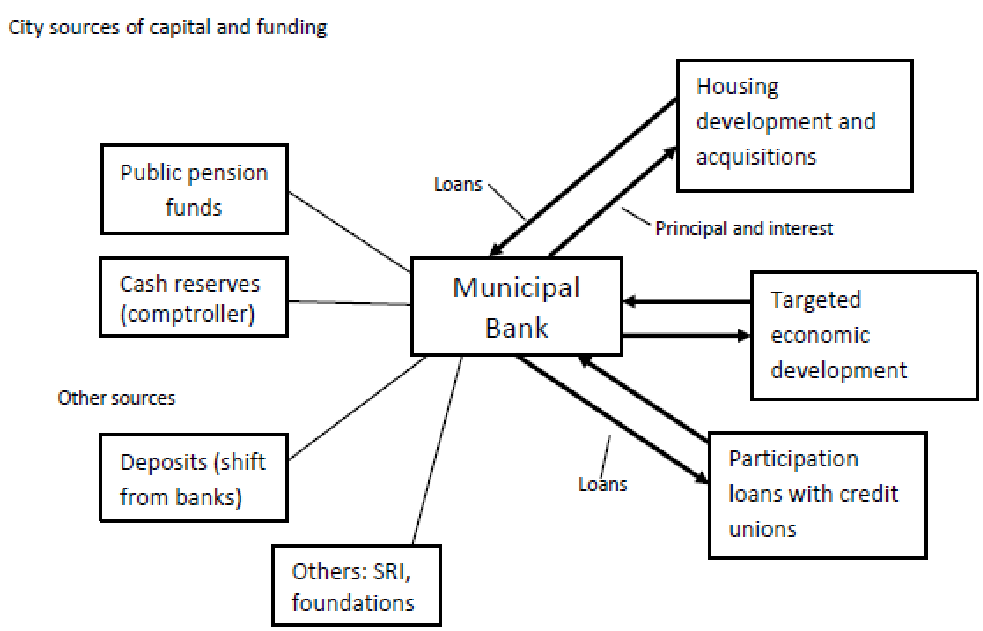
A City would establish a public bank through either an ordinance or a Charter Amendment. The Bank would be an entity legally separate from the City, incorporated under state charter as an independent banking institution. Different legal forms of incorporation exist in various states; in California, a public bank could be incorporated as a Legal Benefit Corporation. This is a form of incorporation in which explicit provisions pertaining to broad public policy goals are set out in the Articles of Incorporation. In order to ensure operational autonomy from City politics, an independent Board of Directors would govern the Bank. Members would be appointed by the Mayor and City Council (or Board of Supervisors if constituted at the county level), but would thereafter have full autonomy in overseeing management and insuring that the Bank continued to fulfill the founding policy goals set forth in the founding Articles. Board members would be selected according to criteria such as requisite expertise, demonstrated commitment to the mission of the Bank, and representation of constituencies typically excluded from decisions about public finance.

Shares in the Bank (Bank stock) would be organized into various classes structured to ensure that the municipal government, as the ultimate controlling corporate entity, remains the sole controlling interest through exclusive power to appoint the Board of Directors. Retaining exclusive power of appointment is essential to insuring continued fulfillment of the public purpose and objectives that motivated the establishment of the Bank. The municipality, as the ultimate controlling interest, could either own the Bank in its entirety or sell non-controlling classes of shares to other investors. Owners of these subordinated share classes would be eligible to receive dividend payments, but would not exercise any controlling influence on Bank policy or the selection of the Board. The City would at all times retain ultimate authority and oversight; any subsequent amendment or dilution of control could occur only through an ordinance whose ratification would be subject to legislative approval by the City Council.

There are two sources for raising the initial public equity. The first would involve the appropriation of some set amount of money from the General Fund. This would be a limited appropriation, and would be set up so that the municipality does not incur any ongoing financial or legal obligation.

The second source of public capitalization is the interest earned on funds held in the local government Investment Pool — these pools are sometimes referred to as cash balances, or surpluses. In the case of larger cities that are not facing bankruptcy, the amount of funds held in these pools is often of sufficient size that a limited set of transfers would provide a substantial sum of money for the initial capitalization.

Figure 1: Overview of basic structure



Public money allocated to fund the initial capitalization could in this manner be supplemented by contributions and investments from foundations, pension funds, and socially responsible investment funds. The most important requirements to begin exploring the options available (and potential timeline) for public-sector capitalization are to develop the political will, build requisite local coalitions, and ensure the buy-in of key local government agencies and officials.[3]

Loans and investments of the Bank would be funded through a variety of sources and vehicles, including: 1) transfer of the City's deposits and cash accounts currently held in large commercial banking institutions; 2) the issue of debt (short-term and medium-term notes) purchased using funds under management by the City Treasurer; 3) the issue of Certificates of Deposit sold to the Treasurer and other "outside" investors; 4) bankers' acceptances; and 5) repo-like operations that would be conducted with the City Treasurer to insure adequate provision of short-term liquidity. Additional funding sources could include bank deposits from local governments, pension funds, public-sector unions, and socially oriented nonprofits. The Bank could also issue bonds of longer duration to finance long-term investments in affordable housing and infrastructure development.

The Bank would use this funding base to support affordable housing and large-scale infrastructure development. In addition, the Bank could support economic development in low-income neighborhoods in partnership with local banks and credit unions that have established branches, relationships, and retail lending outlets. To maintain low overhead costs (and to avoid competition with local lenders), the Bank would not operate an extensive network of retail branches. Retail loans to local businesses would be originated through partnering with existing credit unions and Community Development Financial Institutions (CDFIs), with the Municipal Bank's role being primarily to provide additional funding through participation lending. All lending activity would be subject to rigorous evaluation to insure that credit allocation is fully independent of political considerations and fulfills the public policy goals set out in the Bank's founding Policy Statement.

Option 2: A two-stage process for creating a new system of equitable and just local finance

In option 2, the provisions outlined above regarding ownership, the structuring of various classes of shares, and the independence and composition of the Board are largely identical. The difference is that the establishment of a locally controlled financial institution would have a two-stage formation process. The first stage involves creating a non-depository Municipal Development Corporation that will issue medium-term notes to raise funds for investing in capital projects and affordable housing. The funds raised by affordable housing developers would be placed in a complementary depository entity — the Municipal Bank — that

[3] For further discussion of issues related to capitalization, see the document "The Municipal Bank: Regulatory Compliance, Capitalization, Liquidity and Risk," available at www.rooseveltinstitute.org

would begin to carry out basic account management and payment services on behalf of these nonprofit entities. The depository bank could similarly begin to accept deposits from nonprofit organizations, unions, and pension funds to expand its operational capacities.

The second stage is the application to the Federal Home Loan Bank for a letter of credit that will satisfy state-level requirements for the full collateralization of public-sector deposits. This will allow the Bank to conduct all depository and cash-management services, overdraft services, sweep arrangements, and provision of short-term lines of credit to local governments. Both the Municipal Development Corporation and the Municipal Bank will be incorporated and chartered as entities legally separate from the City. These entities will entail no ongoing need for General Fund revenue, nor will the formation of these entities necessitate higher taxes. The municipal legal entity that is set up to hold and vote the city's controlling interest — the Municipal Financial Corporation — would be defined as a Bank Holding Company per USC 12, Sec. 1841, and hence would be subject to oversight by the Federal Reserve. The municipality would at all times retain sole controlling interest, be vested with exclusive rights over Board appointments, and vote the municipality's stock as the sole directing interest. The City would retain the right to dissolve and reconstitute the Board should the Board fail to insure that the Municipal Financial Corporation is acting to fulfill its founding public purpose.

Profits of a Municipal Bank

The Bank's profits will be used in two ways. (a) Profits can be capitalized, and then leveraged to provide a means of increasing lending capacity, while maintaining strict conformity to the Bank's own internally mandated capital requirements; and (b) they can be invested in dedicated funds set up to provide a long-term source of subsidy for interest-rate payments on affordable housing bonds, mortgage loans, and loans to small businesses and worker co-ops; or to serve as equity to assist with initial costs of purchasing rental housing to remove such properties from the speculative market. This latter option is particularly attractive in the case of cities experiencing rising housing costs and associated problems of involuntary displacement.

Assuming that the return on assets is 1 percent (a conservative estimate — see the document "The Municipal Bank: Regulatory Compliance, Capitalization, Liquidity and Risk," on capitalization and funding of a Municipal Finance Corporation and Municipal Bank, at), a $1.5 billion portfolio would earn $15 million in annual profits that could be capitalized and placed into various subsidy funds.

Hardwiring a democratic, equitable public purpose and public mandate

Charter or home-rule cities have three broad pathways by which to pursue the formation of a public bank. Specifics of these options will vary by state; what follows are broad guidelines for thinking about actual implementation strategies for creating a Municipal Bank.

1. *A one-time line-item appropriation can be proposed by the Mayor and ratified by the City Council (or Board of Supervisors if the Bank is created at the county level). This would provide the initial equity investment required to move toward the establishment and organization of a Municipal Financial*

Corporation, and later a full-fledged Municipal Bank. That appropriation would be matched by a directive, initiated either through executive action or by the order of the legislative body, compelling the relevant county and city departments to establish and incorporate a legally independent, state-chartered banking corporation.

2. *The Corporation (and Bank) can be established through a legislative ordinance that would directly modify the City Charter to include provisions for establishing the Bank, with a full and explicit outline of its founding purposes and the compelling public policy objectives to be served by the institution.*

3. *The Corporation or Bank can be created through a citywide voter-approved Charter Amendment.*

We believe that, where possible, the Charter Amendment is the preferable choice. It can guarantee that the Municipal Financial Corporation, and later the Municipal Bank, are constituted to fulfill a public purpose (i.e., to provide funding for investments not supported by the private market). A Charter Amendment also insures democratic ratification of the founding mandate by the voting public, which will significantly enhance the legitimacy of the Bank amongst the voting public.

In addition, a Charter Amendment is the strongest means to "hardwire" economic and social equity goals into the operation and governance of the Bank, and to insure that the Bank's founding policy goals and objectives will not be subverted by, for instance, directing funds toward high-end, market-rate housing development.

Public funds that would provide the initial equity share of the municipality would require a financial commitment from the city's General Fund and/or its investment pool. The founding municipality will set up a public conduit entity that will receive funds for use in the purchase of the public-equity share, and who will be the legal entity that actually holds the City's controlling share. Through this entity, the founding municipality would be established as the sole party that exercises the ultimate controlling interest over the Municipal Financial Fund and its subsidiaries. While the City will have jurisdiction in voting rights in Board elections, it will not exercise any actual control over the deliberations and decisions of any standing Board once it has been elected, and will not in any way be involved in the management or conduct of ongoing business operations.

Conflicts of Interest and Risk Management

Skeptics might object here that a public entity, being susceptible to corruption, cronyism, and patronage, will be unable to maintain rigorous lending standards and provide sufficient safeguards. Concerns over the risks a publicly owned Bank could pose to the City are valid and must be rigorously addressed. In particular, it is necessary to ensure that the Bank will not be captured by "insider interests" that might direct resources toward projects that fail to conform to the Bank's founding objectives or that pursue high-risk lending activities, eroding requisite underwriting standards. The principal means of enforcing compliance with strict underwriting criteria is to mandate regular independent external review of the Bank's balance sheet and lending practices. This ensures ongoing conformity with the capital and liquidity ratios set out in the Bank's founding documents (Articles of Incorporation, charter amendments, and corporate bylaws,) and limits any reorientation toward more high-risk lending and investment. Moreover, mechanisms must be established to ensure that such review is conducted by entities that are not themselves subject to commercial conflicts of interest and that are fully insulated from the machinations of local politics.[4]

There are compelling reasons to assert that the public utility nature of the Bank will mitigate any tendency for Bank management to engage in excessive use of leverage to finance higher-risk, potentially higher-return loans and investments. That tendency is a particularly acute problem in the case of private finance (as opposed to non-financial businesses), given that private banks can issue new loans and support the rapid expansion of their balance sheets through funds (reserves) purchased on the interbank market. A public utility model of finance is not subject to pressures to maximize returns on shareholder investments, thus eliminating one very powerful factor motivating private banks' excessive build-up of leverage. An independent review and assessment process for portfolio composition and leverage limits will safeguard the Bank from ensnarement in political patronage relations or profit-seeking pressures that could lead to a deterioration of underwriting standards. The effect will be a more robust balance sheet than is typical of the private banks currently accept and manage public sector deposits.

Given the technical complexities of some of the financial aspects of risk management, those interested in this aspect of the structure and operations of the Municipal Financial Corporation should consult the longer document "The Municipal Bank," available at www.rooseveltinstitute.org

Dis-intermediating Wall Street, Re-intermediating Local Government

The Larger Political-Economic Context

In the years since 1980, and particularly over the last two decades, municipalities and public districts have increasingly come to rely on the bond market to finance investments in affordable housing, infrastructure, and public improvements. Many factors explain this trend. Chief amongst these have been major cuts in funding for HUD and elimination of federal capital grants, which have forced local governments to turn to the municipal bond market to finance capital investment. Elimination of federal urban programs was part of the systemic shift toward a more competitive form of "urban entrepreneurialism" and the attendant shift toward more market-centered urban regimes that promote employment and grow the local tax base by providing subsidies and various enhancements to private firms to attract and retain private investment.[5]

For relatively wealthy cities, recourse to the municipal bond market has enabled the funding of needed investment in infrastructure and capital improvements. For cities suffering from problems of protracted disinvestment, recourse to the municipal debt market often comes with far more deleterious costs. Unfavorable credit ratings, which are often systemically biased in assessing the likelihood of borrower

[4] Further details regarding various issued pertaining to oversight and governance are outlined in the document "Governance and Oversight of the Municipal Bank," available at www.rooseveltinstitute.org. Also note that the proposed capital and liquidity ratios significantly exceed capital-to-asset ratios adopted by the FDIC for all banks that receive FDIC deposit insurance. These are outlined in greater detail in the document "The Municipal Bank: Regulatory Compliance, Capitalization, Liquidity and Risk," available at www.rooseveltinstitute.org

[5] There is a vast literature on how policy shifts associated with the demise of Keynesianism and the rise of neoliberalism have affected cities and constrained policy options. See, for example, Brenner et al. (2002); Ebel et al. (2013); Kratke (2014); Moody (2007); Peck (2012); Peck and Tindall (1994); Peck et al., 2013; Ryan et al. (2012); and Swyngedouw (2000 and 2005).

default[6], result in increased borrowing costs. In addition, many of the bond deals and financial packages sold to municipalities by Wall Street investment banks — complex swap agreements, auction rate securities, variable-rate debt obligations, and the like — carry hidden, and at times devastating costs such as reset provisions in the event of a “credit event,” as well as various penalties and termination clauses that end up saddling already overburdened and underfunded municipalities with often exorbitant debt-servicing costs.

Even in the absence of problems created by derivative instruments, the growing recourse to financing capital projects through the municipal bond market creates a significant drain on local tax revenues, which must be paid out to the institutional fund managers and wealthy households that are the primary owners of municipal debt. As a result, even cities with relatively favorable investment ratings and strong local economies may end up transferring significant amounts of local tax dollars to very wealthy households. Hence, while municipalities may benefit from access to low-cost capital due to federal tax breaks for holders of this debt, the financial flows associated with municipal bonds have a broadly regressive character. In this sense, municipal debt markets are yet another mechanism for effecting regressive — i.e., upward — transfer of income and wealth.

To be clear, the following discussion does not presume that purchase of short-term municipal debt obligations of the founding municipality, or other municipal governments and enterprise entities, is the preferred or optimal use of the bank’s financial resources. The following discussion is used to illustrate the more general point regarding how a municipal bank could serve as a mechanism for fiscal recapture and redeployment of funds currently paid to wealthy bondholders. At the same time, the purchase of short-term municipal securities has several distinct advantages. For one, many states allow municipal bonds to be used to secure public-sector deposits. Municipal securities thus provide a means to meet deposit collateralization requirements. Moreover, municipal securities are generally regarded as a high-quality, low-risk asset class. Holding such securities in the Bank’s own portfolio will thus help to lower the Bank’s own borrowing costs. Finally, as discussed below, short-term bond series are repaid over short time periods. These assets are thereby converted back into “cash” that can be used to fund the origination of higher-yield loans and investments that fulfill the Bank’s social and economic priorities and objectives.

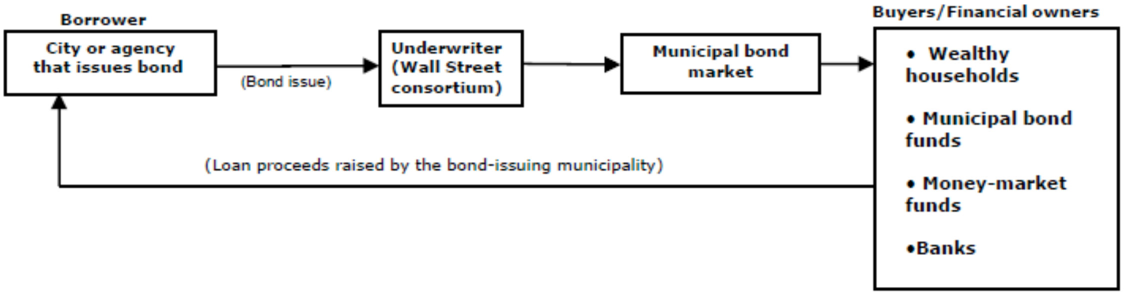
Recapturing Public Dollars for Local Investment

Current underwriting relationships and funding flows associated with municipal bonds are shown in Figure 2. When a municipal entity wants to access the municipal bond market, the municipality will typically hire an investment advisor. The advisor’s role is to provide consultation regarding the optimum credit and maturity structures; the use of various covenants that might create — or inhibit — early repayment; refunding options; and options regarding maturities and interest rates. The advisor is also, in principle, supposed to offer counsel regarding the potential risks associated with the use of various financial mechanisms such as swaps and variable-rate debt obligations.[7]

[6] See Joffe (2015).

[7] For an overview of the role of bond markets and Credit Rating Agencies in enclosing the policy space of municipalities, see Hackworth (2007). For a discussion of New York City, see Moody (2007). See also Joffe (2015), Luby et al. (2013), and Raineri et al. (2012) for discussion of specific issues pertaining to bias in CRA ratings of municipal debt, and underwriting costs.

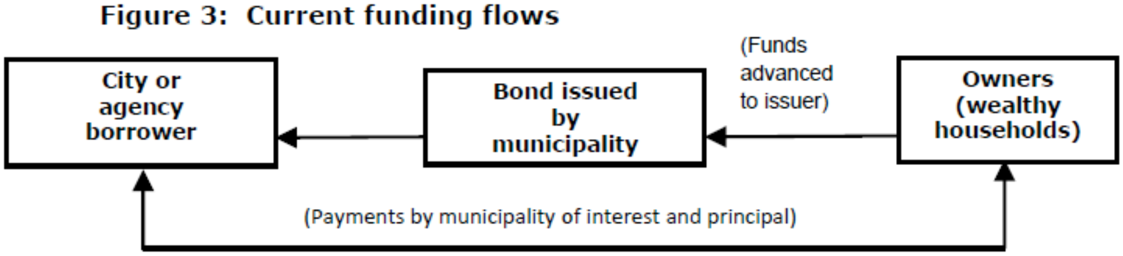
Figure 2: Bond funding, origination and underwriting
(Competitive funding issue)



Bonds are issued through either competitive or negotiated sales. In the first type, the issuer solicits from underwriters competitive bids for the price and rates at which various bonds can be sold. Underwriters, often in the form of consortiums, purchase bonds from the issuer and then sell the various "securities" (see Figure 3, below) through their network of buyers. When the bond is issued through negotiated sale, a single underwriter (or consortium) is selected by the issuer to oversee all aspects of debt structuring and the management of the final sale. Proceeds of the issue are typically used over a period of several years to finance capital projects.

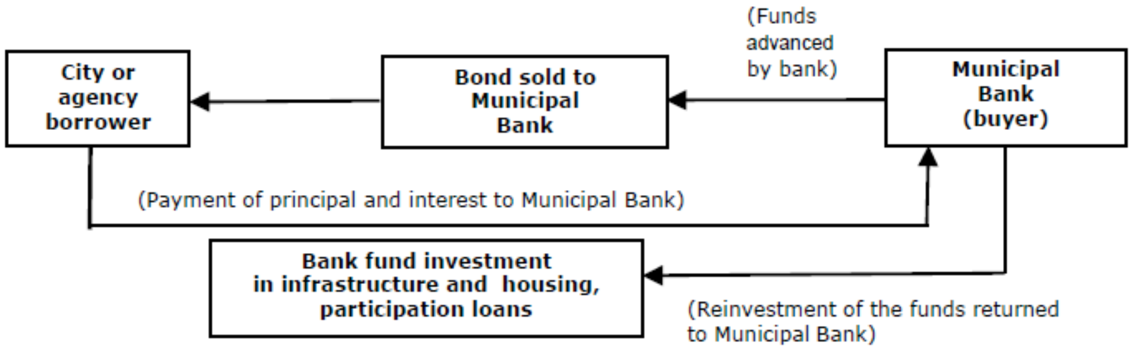
The funding flows associated with a municipal bond issue are shown in Figure 4.

Figure 3: Current funding flows



A Municipal Bank offers a vehicle through which cities can begin to recapture interest and principal payments currently being transferred to wealthy households and direct these financial flows back into local circuits of investment. To begin to recapture tax revenues currently distributed to bond holders, the Municipal Bank could become a major buyer of the shorter maturity bond series issued by municipalities. Funds that would otherwise be siphoned off and re-invested in the global financial markets can be directed back into investments in local housing, infrastructure, and economic development. (See Figure 4). For large cities, a potentially quite significant amount of funds could be recaptured to support local affordable housing development, infrastructure investment, and participation loans with local credit unions targeting low-income neighborhoods, as well as alternative business models such as co-ops. (See below for the example of San Francisco.) In addition, for all cities in which the Municipal Bank concept is legally allowable under existing state constitutions, it would offer a means to begin to develop long-term capital pools that over time could become a significant new source for funding local economic development.

Figure 4: Alternative funding flows with Municipal Bank as buyer



Over time, Municipal Banks could also provide the infrastructure for forming a network of underwriters and purchasers of municipal bonds that would offer an alternative funding conduit to the current underwriting channels organized and controlled by Wall Street. If eventually complemented by the re-institution of a progressive system of federal taxation and a large-scale, federally financed program of urban investment in affordable housing and infrastructure, the Municipal Bank would form a critical component of a new framework for a far more egalitarian and ecologically sound regime of local and regional (re)development.

An Example: The Case of San Francisco

The numbers in Table 1 (below), pertaining to San Francisco[8], assume that the hypothetical Municipal Bank purchased all of the series with maturities of one to five years issued between 2007 and 2015. The figures in the right-hand column are the total amounts that would have been paid to the Bank in that calendar year and could have been used to fund investments in housing and economic development. The potential amount of funds that are otherwise distributed to wealthy households and large (often global) institutional investors, is quite substantial. The total potential recapture by a Municipal Bank between 2008 and 2020 comes to $930.3 million, or an average of $68 million per year. Payments received by money market funds, commercial banks, bond funds, and wealthy households during this period could be made available for investments in affordable housing.

The compelling rationale for creating a Municipal Bank in a city such as San Francisco can be brought into focus by comparing the potential funding impact of a Municipal Bank bond-purchasing program with the 2015 Mayor's Office housing bond, which, if passed by voters, would raise a total of $300 million to be distributed across a variety of affordable housing programs over 10 years or so. Funds raised through the Mayor's bond issue would amount to less than a third of the sum that could have been generated by a Municipal Bank bond-purchasing program, had it existed, over the years 2006 to 2015, with the debt repayments used to support lending for affordable housing development. (See the section "Supporting Affordable Housing," below.) Combined with the Bank's role in direct lending for property acquisition and new development, a bond recapture program would significantly enhance existing conduits for funding

[8] Note that this example is meant to be illustrative only, and different specifics will pertain based on the particularities of the existing financial condtions and the needs of the founding municipality. Please consult the document "The Municipal Bank: Regulatory Compliance, Capitalization, Liquidity and Risk" (available at http://www.rooseveltinstitute.org) for additional examples.

affordable housing investment, financing infrastructure enhancements, and supporting economic development in low-income neighborhoods.

Table 1: Total potential revenue recapture, San Francisco, 2008-2020

2008	$ 625,000	2015*	$133,445,000
2009	$ 65,110,000	2016*	$ 89,365,000
2010	$ 68,955,000	2017*	$ 53,365,000
2011	$ 69,020,000	2018*	$ 42,785,000
2012	$121,485,000	2019*	$ 28,160,000
2013	$139,830,000	2020*	$ 2,670,000
2014	$115,495,000	2008-2020*	$930,310,000

*(Source: San Francisco Controller's Office, bond prospectuses, all searchable series issued between 2008 and 2015. Years with * are projected debt-servicing costs on current bonds outstanding, all currently at fixed rate.)*

Why Would a Municipal Bank Primarily Buy Short-term Series?

When a municipal entity issues bonds, the total issue is broken down into what are termed "series" that have different maturity dates. Typically, the first series is due in one year, the second series is due in year two, and so on. The "standard" municipal bond will typically have a total maturity of 25 to 30 years. The preference for the Bank purchasing shorter-term series rests on several considerations.

First, there is the need for the Bank to stay liquid, i.e., to hold debt that is repaid over a period of several years, ensuring a constant return flow of funds. This is a requirement in order to support additional lending that realizes the Bank's social mandate and policy objectives, and to maintain a strong cash flow so the Bank can honor customers' demands for cash withdrawal and settle its own short- to medium-term debt (medium-term notes, certificates of deposit, bankers' acceptances) issued to finance loans and investments.

Second, investing in longer-term series exposes the Bank to losses due to changes in interest rates. If interest rates rise, the current mark-to-market price of longer-term series bonds will fall. These losses must be recorded as capital losses, and can expose the Bank to the risk of credit downgrades and increased funding costs—even when the Bank has no cash flow problems and an otherwise robust long-term balance sheet.

More critically, any significant rise in short-term interest rates can impose losses if funding costs for the Bank exceed earnings on longer-term series bonds held on the asset side of the Bank's balance sheet. For instance, if the Bank has $200 million in medium-term notes due in a give year, these must be either rolled over at the prevailing market interest rate; repaid out of cash flows; or redeemed through the sale of some portion of assets from the Bank's balance sheet. To continue to issue new loans and protect current earnings, the rollover option is the preferred alternative. Holding long-term fixed-rate bonds on the Bank's balance sheet could result, over time, in refunding costs exceeding earnings on long-term investments. The Bank could find itself in a negative net worth situation, and if financing costs continue to rise, could eventually become insolvent.

Additional advantages accrue to the Bank from investing in municipal debt. These assets are not subject to FDIC loan concentration limits, and thus can be purchased and held in any amount. A Municipal Bank could not only purchase the shorter-term series of the local government that has set up and directly owns the Bank, but could become a buyer of the IOUs issued by other regional municipal governments, as well as revenue bonds issued by enterprise departments and public benefit corporations. Over time, the Bank could become a major source of funding for both city-specific and regional investment.

Supporting Affordable Housing

This Policy Brief is intended to provide a brief overview of how a Municipal Bank could play a significant role in preserving and developing new affordable housing. While a Municipal Bank could finance both acquisition programs and new production, the largest impacts would likely be realized by linking the Bank to a City-sponsored acquisition program.[9]

The three schemes outlined below all assume the City has set up a Housing Development and Acquisition Fund that would be the conduit for linking loans issued by the Municipal Bank to property acquirers (land trusts and nonprofit housing developers) with City-sponsored program that would provide additional subsidies, as well as the means to channel funds raised through municipal bonds to investments in various city affordability programs. The schemes outlined below are not meant to be exhaustive. Rather, they are meant to provide the conceptual framework that sketches out the broad parameters of how a Municipal Bank could serve as a major source of both short- and long-term financing to preserve and expand the stock of housing that is permanently affordable to households earning at or below city and regional median income.

Overview of How a Municipal Bank Could Support Affordable Housing Development

The broad framework of establishing, capitalizing, funding, and operating a Municipal Bank is presented in the longer document "The Municipal Bank: Regulatory Compliance, Capitalization, Liquidity and Risk," available at www.rooseveltinstitute.org. In brief, the Bank would be capitalized through a one-time (non-recurrent) allocation of money from the municipal General Fund, as well as allocation of interest earned from the assets under management by the Treasurer/Controller's office held in the local investment pool.[10]

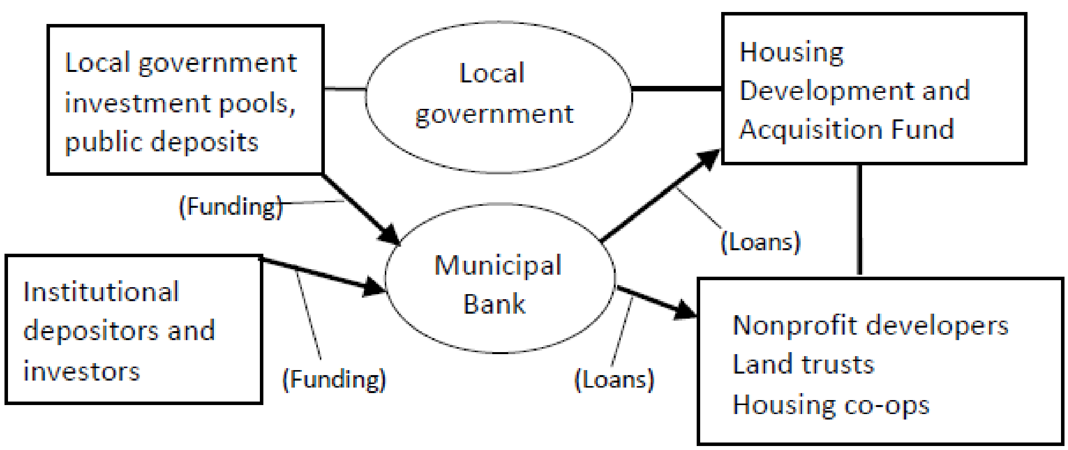
[9] There is an extensive literature on urban housing finance, gentrification, and urban development. Some of the theoretical and empirical perspectives that inform the current work and demonstrate the need for alternatives forms of affordable housing finance, can be found in Beitel (2007 and 2016); Canarella et al. (2012); Clark (1988 and 1995); Dymski (2012); Gotham (2012); Jager (2003); Lees et al. (2008); Lipietz (1985); Schwartz (2012); Smith (1996); and Wyly et al. (2012).

[10] Most municipalities have accumulated surpluses that are not part of the general fund, which are invested in shorter-term, low-risk, yield-bearing assets—U.S. Treasury instruments, the notes of FNMA and FHLMC, bank CDs, and commercial paper. These pools earn interest—that, even in a very low-interest-rates environment, can be significant in terms of total amount, given the scale of funds under management. For example, the San

The Bank would fund its lending activities by taking in bank deposits from local governments, nonprofit organizations, unions, pension funds, and other institutional depositors. In addition, major (even primary) sources of financing would involve the issue of various short- to medium-term liabilities by the Bank, i.e., medium-term notes (debt securities of one- to five-year duration), certificates of deposit, and bankers' acceptances.

Because of the Municipal Bank's relatively restricted scale (when compared, for instance, to the scale and reach of the world's leading global banks), initial lending would need to be funded out of either deposits or funds raised on the money markets through the issue of the short- to medium-term debt.[11] Many loans originated by the Bank would not conform to underwriting standards required to be eligible for securitization through the Fannie Mae (FNMA) multi-family commercial mortgage program, DUS (Delegated Underwriting and Servicing Lenders). To realize a large-scale investment program that could have significant impact in housing markets of high-rent cities such as San Francisco or New York, well advanced in terms of gentrification (in such cases, it is more proper to speak of "hyper-" or "super-gentrification"), the Bank would need to establish and maintain a network of secondary buyers. Loans would be issued, and after some initial servicing period, these loans would be sold to pension funds, socially responsible investment funds, and foundation endowments. The cash raised from sale through this secondary market would then be available to be deployed back into supporting additional acquisitions and new development. The result is the formation of a large-scale revolving loan fund to ensure the timely conversion of these assets back into "cash deposits" — technically, sale of loans converts assets back into deposits held "on reserve" at the Federal Reserve Bank.

Figure 5: Funding affordable housing



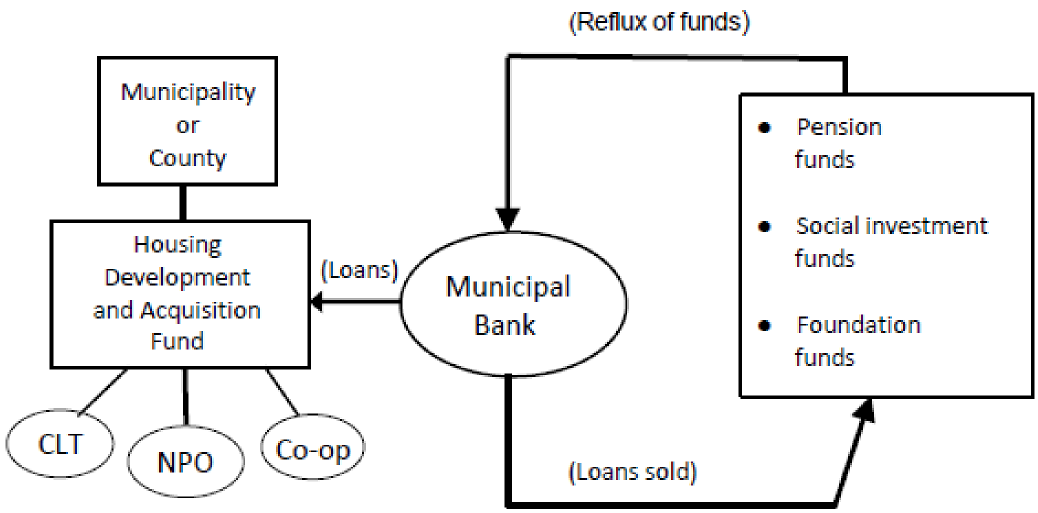
The Bank is funded through shifting the deposits of local government, sale of medium-term notes to local government investment pools and other institutional investors (pension funds), and issue of time deposits and bankers' acceptances.

Francisco Investment Pool has earned between $45 million and $55 million in interest over the last three years. These earnings are a potential source of capitalization of the City's own equity share.

[11] Major money center banks are never "deposit constrained" in terms of lending decisions. As is by now well established, the banking system in aggregate creates money (deposits) in the act of making loans. Loans create deposits; deposits do not, in aggregate, create new loans. However, what is true of the banking system in aggregate is not true for every individual bank. Smaller community banks, while technically able to issue loans in advance of receiving deposits, may have reasons for not doing so, as persistent net deficits on their accounts vis-à-vis all other banks can lead to funding problems in the form of lack of access to overnight sources of interbank credit on the interbank wholesale funding markets, and/or increased refinancing costs—i.e., to "rollover risk." The situation of the Municipal Bank, at least initially, would be akin to that of a smaller regional bank.

Accordingly, a primary function undertaken by the Bank would be developing a network of buyers of loans the Bank would originate. This will necessitate establishing long-term relationships with pension funds (particularly those tied to public sector unions), socially responsible investment funds, and foundations endowments seeking to align investment policies with social mission. The market-making role of the Bank is one of the more innovative aspects of the proposed model, as it involves the formation of new secondary conduits that will absorb large sums of assets off the balance sheet of the Municipal Bank.

Figure 6: Creating new secondary markets



Bank sells loans through secondary network of buyers. Funds received are used to make additional loans.

CLT: Community land trust
NPO: Nonprofit housing fund
Co-op: Limited equity housing co-op

It will be necessary to cultivate a sufficiently large network of buyers that control large pools of capital to insure that no single buyer of loans sold by the Bank will be required to allocate a significant portioned of total funds under management to this potentially lower-yielding asset. The issue here is not so much one of risk, given the Bank's commitment to stringent internal controls and underwriting standards. Rather, the need for a network of buyers reflects the fact that loans originated by the Bank will generally carry lower rates of interest than those available on comparable private sector property-related mortgage debt. Accordingly, only a small portion of any given pension fund or endowment is likely be allocated to this class of assets. To ensure sufficient impact — for instance, to allow the Bank to originate and sell loans totaling $100 million to $500 million annually — will necessitate a large capital pool that can absorb this debt without negatively impacting buyers' long-term earnings.

The Housing Development and Acquisition Fund (HDAF) would serve to link funding mechanisms developed by the Bank to existing city programs and funding sources secured through the issue of voter-approved affordable housing bonds. This will ensure the requisite policy coordination and enhance the impact of both the Bank's lending and existing City-sponsored affordable housing programs. The Bank, while constituted as a legally independent entity with full operational autonomy from the municipality, will act as a partner with existing departments and agencies that provide various subsidies and financial supports to develop low- and moderate-income housing

Funding a Program of Social Housing Investment

The overarching objective of a City-supported acquisition program is to remove elements of the residential stock from the speculative market and to create a supply of housing in which rents are tethered to median income growth. There is no reason to presume that the Municipal Bank could not also provide loans to support new construction. The focus on an acquisition program is to limit the complexity and length of the discussion, and to illustrate the kinds of innovative policy tools a Bank could offer the City. The equity options and schemas outlined below are meant to be illustrative, not prescriptive, and are far from exhaustive. Rather, the goal is to foster innovative thinking regarding options for how a Bank could further the goals of increasing housing access for low- and moderate-income households.

There are three general options by which a Municipal Bank, working with existing municipal housing development agencies and affordability programs, can support public equity investments into both new development and a publicly supported acquisitions program.

Option 1: Equity committed directly by the City

The Housing Development and Acquisition Fund (HDAF) will act as the municipal agency that exercises the equity interests of the City in cases in which the property is acquired using equity committed by the City. When the acquisition is rental property, the stock would be placed into a City-operated, City-owned housing fund that would contract with nonprofit entities or land trust nonprofit corporations that would manage this housing on behalf of the City. The municipal ownership share is "passive" in this sense, as the City will not be involved in any ongoing management functions, collection of rents, negotiation of lease agreements, listing of vacancy properties, or capital maintenance.

Ownership will be structured to ensure that strict rent control provisions, including limits on rent increases on vacant units, are legally "hardwired" into the ownership of the HDAF. Neither the City nor the HDAF will receive dividends on this equity.

Option 2: Equity committed by the Municipal Bank

In this option, profits earned by the Municipal Bank can be paid into a dedicated fund set up by the Bank to serve as a source of equity. To execute actual acquisition, this equity will be supplemented by a loan made to the HDAF serving as intermediary between the Bank and a nonprofit housing developer. Alternatively, the loan could be made directly to the nonprofit.

In either case, the HDAF and the Bank would assist the nonprofit in all phases of financing and acquiring the property. The nonprofit housing developer or Community Development Financial Institution (CDFI) will act as property manager, responsible for ongoing maintenance, capital improvements, and rent collection; with the HDAF and Bank, it will also oversee the pass-through of monthly (or annual) payments on acquisition debt.

Option 3: Direct purchase in full by the Municipal Bank

In this option, the Municipal Bank would finance the full cost of the initial acquisition by selling some portion of its existing stocks of government securities to raise "cash" that would be transferred to the seller's bank. As in Options 1 and 2, property management functions would be the purview of the HDAF and affiliated nonprofit. Subsequent to acquisition, the Municipal Bank would underwrite bonds or self-amortizing 25- to 30-year loans issued by the HDAF and distributed through the Bank's network of secondary buyers. The Municipal Bank would retain equity title. The portion of the total acquisition price covered by the sale of bonds or mortgage loans through the Bank's secondary networks would serve to replenish the Bank's cash assets available to finance subsequent investments.

The following sections discuss various lending schemes through which the Bank could support affordable housing. The focus below is primarily on financing an acquisitions program to create stock of permanently affordable rental housing. There is no reason the Bank could not also be a source of financing for new production. In either case, the general mechanisms are similar. Maximizing the Bank's impact will require the ability to sell loans to secondary buyers that operate commercial rental mortgage securitization programs or to existing agencies such as the FNMA. Hence, much of the emphasis in the schemes presented here is on finding ways for the Bank to finance property acquisition at loan-to-value ratios that are greater, and debt service coverage ratios that are lower, than those required to be eligible for existing FNMA and Federal Home Loan Bank (FHLB) securitization programs. Loans that do not meet these underwriting criteria will be sold either through the Bank's own network of secondary buyers, or through a mechanism set up to use public subsidies to reduce initial principal in order to meet securitization standards of the FMNA and FHLB.

Scheme A: Self-Amortizing Long-Term Acquisition Financing

In the most straightforward scenario, the Bank will originate long-term fixed-rate self-amortizing loans to acquire existing housing. Issuers could be land trusts, nonprofit housing developers, and limited-equity co-ops. The City, through the Housing Development and Acquisition Fund, could also issue bonds to acquire existing properties. Debt could be used either to acquire rental properties or for conversion of existing rental units into owner-occupied land trusts or co-ops. Rates on loans would be set at or below prevailing market interest rates on "conforming" 25- to 30-year self-amortizing mortgages, and would be lower than rates typically obtainable on commercial property loans from Community Development Financial Institutions. In addition, the Bank could offer loans at higher loan-to-value (LTV) ratios and lower debt service coverage ratios (DSCRs) than those required by Fannie Mae in order to quality for existing commercial mortgage loans securitization programs.

Loans would be sold to pension funds, socially responsible investment funds, and foundation endowments. Proceeds realized from these sales could be placed in a dedicated fund used to support additional acquisition and new development financing.

Scheme B: Use of the Municipal Bank to Boost the Impact of City Equity Investment

In this funding option, the Bank would originate a 30-year bond issued to acquire an existing property.[12] Loans would initially be issued at LTV ratios of up to 90 percent and DSCRs as low as 1.10, respectively. Short-term series would be repaid at near zero interest rates for the first three years of the loan. At year three, total outstanding principal would be reduced to 80 percent of the acquired property. The loan could be carried to term as originally issued[13], or, alternatively, the borrower could trigger a refinancing option to convert the remaining principal outstanding into a 30-year self-amortizing fixed-rate (or variable-rate) loan. The latter option has the advantage of allowing the refinanced loans to meet LTV ratios required to be eligible for securitization through Fannie Mae (and possibly FHLB). It can also potentially enhance the attractiveness of the loan to the Bank's network of secondary buyers. The choice between the two will be made based on which option reduces overall funding costs to the borrower, and which can increase the potential for secondary sale.

Additional options can allow for an even greater reduction in total outstanding principal at year three. For instance, the borrower could issue a 10-year bond. The City would pay a subsidy allowing the borrower to pay down the principal due in years one through three. Principal payments could be placed into a sinking fund, or the bond could be structured into series. (See the section "Dis-Intermediating Wall Street," above.) At the end of year three, the remaining principal would be refinanced into a fixed-rate 30-year amortizing loan. Refinancing under this scenario would lower the LTV ratio from over 90 percent at the term of the initial origination to 63 percent at year three. The lower LTV ratio and higher DSCR would allow the loan to qualify for securitization through the FNMA, or through the Bank's own secondary network of buyers.

Funds provided by the City to subsidize principal repayments in years one through three would flow back to the Bank and return to a dedicated City-sponsored housing acquisition fund. Money received by the Bank from the sale of the refinanced bond would be returned to a revolving loan fund. The full amount of the initial principal (90 percent of initial loan value) would thus be recaptured, and could be recycled in a similar manner to fund acquisition by subsequent property acquirers.

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[12] The bond could be used to finance new construction, but would have greater impact and surety if issued to finance the acquisition of existing rental property.

[13] It is possible to issue variable-rate bonds, and for the borrower to offset the interest rate risk entailed, by entering into a swap agreement with the Federal Home Loan Bank. Details of this option are complex, and are discussed at great length in "The Municipal Bank: Regulatory Compliance, Capitalization, Liquidity and Risk," at www.rooseveltinstitute.org

Scheme C: Conversion into Owner-Occupant Land Trusts or Co-ops

This funding scheme assumes that housing stock acquired can be made available to existing residents as owner-occupied units in a limited-equity co-op or land trust system of ownership. The model is similar in its initial stages to Scheme B — the Bank would originate an acquisition loan used to acquire an existing property. Individual mortgage loans would be offered to occupants to convert rental units into shares in a limited-equity co-op.

The City, through the HDAF, would provide a portion of the initial funding as up-front equity. The remainder of the purchase would be financed through an acquisition loan that the Bank would originate on behalf of the HDAF. Once the property is acquired, loans would be made to existing occupants at levels such that the cost of repayment is no greater than 25 to 30 percent of annual income (higher for borrowers whose earnings are at or slightly above the area median income). Borrowers would use these loans to buy their share in the property from the HDAF, which retires its loan to the Municipal Bank. (The Bank finances these transactions through a set of balance sheet operations, debiting the accounts of the buyers and crediting the account of the HDAF.)

As in the prior examples, the Bank sells the newly originated mortgages to a pension fund or socially responsible investment fund. (Limited-equity co-op shares are not eligible for FMNA securitization.) Proceeds from these sales are moved back into short-term U.S. Treasury instruments or some other low-risk security. Occupants' down payment would be returned, through the HDAF, to the City.

The advantages and disadvantages of either option — acquisition of rental housing or housing for conversion into owner-occupied units—must be considered in selecting the actual policy mix that will guide the Bank's lending policies as well as the supplemental housing supports provided by the founding municipality. Ideally, the acquisition program would be designed with sufficient flexibility to support acquisition of both types of properties, which would be maintained as permanently affordable rental housing. This option has an added advantage in states that have statutes limiting rent control.[14]

Acquiring rental housing creates a stock of permanently affordable housing accessible to those who lack the financial means to make a down payment, or who do not desire to become homeowners. Another advantage of focusing on rental housing, as opposed to owner-occupied land trust or co-op models, is that occupants do not see the unit as a personal financial investment. Even for persons committed to long-term residence, it is difficult to avoid the desire to realize a higher resale price if and when either personal circumstances or a shift in housing preferences induce a desire to move. This is particularly true in markets characterized by long-term price appreciation, such as San Francisco, Los Angeles, or New York. In these circumstances, moving to a different unit of housing within the same or a different, but price-comparable, urban market can be hampered by the limits on the resale price that characterize a land trust or co-op model. In markets with rising property values, this can undermine the desirability of ownership forms that place strict limits on resale value, thus denying owners the ability to realize the overall inflation of property prices at the point of

[14] In California, for instance, no city can impose rent control on units built after 1980.

resale. This is, in part, why limited-equity co-ops have often seen a longer-term erosion of support amongst owner-occupants in places like New York.

The chief advantage of owner occupancy structured along a co-op or land trust model is the ability to maintain a large stock of permanently affordable owner-occupied housing that can be passed on to future generations. In a more short-term pragmatic sense, owner occupancy has the advantage of reducing some of the overhead such as maintenance and administrative costs associated with management by a nonprofit entity — or, potentially, by the municipality—of long-term rental housing.

Linking the Bank to Existing City Programs

The impact of the Bank's lending can be significantly enhanced if loans are linked to local programs that can provide various financial supports and subsidies for affordable housing. The details of how a municipality can direct local revenues to support acquisition and new production will vary according to the nature and composition of existing affordable housing programs, local economic considerations, and the overall fiscal strength of the municipality or county.[15]

In brief, funds apportioned out of the municipality's General Fund and channeled though existing programs could be used in two ways. The first would be through equity-type investments to provide funds for initial acquisition and/or equity funding to support the issue of long-term debt. Alternatively, the municipality could dedicate an ongoing General Fund appropriation to providing interest-rate subsidies to reduce the long-term cost of servicing the loans. With reduction of the repayment burdens on the borrower, properties can be financed at higher LTV ratios and lower DSCRs. Initial equity requirements would be reduced, and the Bank could finance an increased volume of total loans.

Enhancing the Impact of Local Housing Bonds

One of the more innovative "synergies" available from a Municipal Bank is the ability of the Bank to directly purchase general obligation bonds issued by the municipality. (See the section "Dis-Intermediating Wall Street," above.) For local governments able to absorb the financing costs of issuing general obligation bonds, the Bank would offer a set of funding mechanisms that could greatly enhance the overall impact of money raised through the issue of affordable housing bonds.

For instance, assume the City issues a $300 million affordable housing bond. To simplify, assume the bond has a final maturity of 25 years. The total issue is broken down into a set of "series bonds" in which repayment is due at the end of each successive year. Each series is allocated $12 million. The Bank purchases the first five series (years one through five) for $60 million. As the series bonds are repaid, the funds are channeled into a dedicated housing finance fund invested in high-quality municipal bond funds, or in other securities of comparable risk and duration. All interest earned is capitalized back into the fund. These monies can then be used to issue low-interest loans such as those described in Schemes A, B, and C. For instance,

[15] For a discussion of how the municipality could use existing City funds currently allocated to affordable housing programs to enhance the impact of the Bank, as illustrated by the case of San Francisco, please see "The Municipal Bank: Regulatory Compliance, Capitalization, Liquidity and Risk," www.rooseveltinstitute.org

under Scheme B, property purchases could take place at much higher LTV ratios than is possible through loans currently available from CDFIs. As portions of the initial principal are retired, this lowers the LTV ratio, increases the DSCR, and allows the property to support a rate of interest on the remaining principal that enhances the asset's attractiveness to secondary buyers. Repayment of the initial zero-interest portion of the loan, plus the additional acquisition loan, results in all funds being recouped and returned to the housing finance fund. The net effect is that $60 million in tax revenues that would have otherwise been paid to wealthy bond investors is permanently recaptured.

A Note on Secondary Markets

A major function of the Bank would be building and maintaining a network of relationships with pension funds and socially responsible investment funds that would comprise a secondary market for the sale of the types of loans the Bank would originate. In essence, the Bank would be creating new secondary markets, utilizing some of the advantages of these financial conduits while avoiding their predatory abuses. It would do so, moreover, in a manner that directly linked secondary sales to the financing of additional affordable housing. This is one of the more innovative policies that could be set up through a Municipal Bank, and over time could significantly impact the ability to alter the current dynamics of local real estate markets.

Variable-Rate Debt

For bonds the Municipal Bank retains in its own portfolio, an adjustable rate will apply. This rate will be set by, for example, calculating the average weighted cost of funds on municipal bonds that meet the required credit standards at the time of issue, and then adjusting upwards by 25 basis points to account for project specific risk. Lending at a variable rate is necessary in order for the Bank to hedge against increases in its own funding costs — given that the Bank funds itself through the issue of short- to medium-term debt. Holding long-term loans at a fixed rate creates risks due to maturity mismatch in the event that interest rates rise, increasing the costs to the Bank of rolling over and refinancing maturing shorter-term debt.

Variable-rate loans create risks for borrowers who could find themselves faced with debt-servicing costs increasing at rates that exceed the corresponding rise in the cash flows being generated from the underlying property assets.

There are two possible mechanisms to offset this form of risk. The first involves the investment of the sinking fund in shorter-term assets to more closely match changes in the rates earned on sinking fund investments to changes in current market rates. The disadvantage of this strategy is that it will require a large up-front investment.

A more viable strategy is for the Bank to assist the HDAF and/or participants to enter into interest-swap agreements that transform variable-rate obligations into fixed interest rates. Alternately, the MFC/Municipal Bank could finance the long-term debt of HDAF participants at fixed rates, and then swap these for floating rates. The use of swap agreement to manage interest rate exposure creates problems of counterparty risk if these swap agreements are entered into with private market participants. Swap agreements can also carry both up-front and, in many cases, hidden costs, and have been used by major financial institutions as a mechanism to extract excessive fees and penalties in the event that terms on swap contracts need to be reset, or in the event of "premature" cancellation of a contract.

The Federal Home Loan Bank (FHLB) offers an alternative to private market underwriting conduits as a way to hedge interest-rate risk for HDAF participants. The basic structure of a swap arrangement that involves the HDAF participant borrowing at a floating rate from the Bank, set in relation to a floating reference market rate such as LIBOR or the Federal Funds rate. To swap this floating rate into a fixed rate, the borrower would pay a fixed rate to the FHLB and receive a floating-rate payment in return, which in turn is set by adding a markup on some base short-term market rate. The total funding costs to the HDAF participant are thus the fixed rate paid to the FHLB plus the difference between the floating rate paid on the bond held by the Bank and the floating rate received from the FHLB.

Analogous processes would be used by the Bank to swap fixed rates earned on bonds issued by HDAF participants into floating rates, to offset the risk of a future rise in rollover and debt refinancing costs. In this case, the Bank finances the property acquisition at a fixed rate through funds that are procured via the issue of medium-term notes of significantly shorter maturities, or that may be issued at some indexed variable rate. To protect against higher future funding costs, the Bank would pay a fixed rate to the FHLB and receive an indexed floating rate.

In either case, the ability of the Bank to finance and hold bonds to maturity will depend upon the availability of the appropriate swap instruments from the FHLB that will insure that HDAF participants can service all payment obligations through property rents, earnings on sinking fund investments, and subsidy payments provided by local governments.

Basis risk. Basis risk refers to the risk that yields on assets may not move in tandem with obligations on liabilities, and may even go in the opposite direction, if they are indexed to different market benchmarks. Even if the sinking fund yields move in line with current market rates, basis risk exists if the fund is invested in assets other than the benchmark to which the HDAF participant's own debt is indexed (here assumed to be the municipal bond rate of issues of Aa or higher, plus 25 to 50 basis points[16]), as the relative changes in rates may not correspond and, again, may even move in different directions.

To mitigate this form of risk, the Bank can index both variable rate assets and liabilities to the same market rate — for instance, the average rate on municipal debt published by the Federal Reserve Bank. This will insure the earnings and obligations of the Bank and of HDAF participants, as well as the earnings on sinking fund investments, all move in the same direction, effectively eliminating basis risk. (This assumes that the sinking fund is invested largely in the debt obligations of states and municipal governments).

Participation Loans and the Social Capital Venture Fund

Participation Loans

[16] A basis point is 1/100 of 1%. 100 basis points are equal to 1%; 25 basis points are equal to 0.25%.

The Bank will partner with local credit unions and CDFI through participation loans to direct credit to local businesses and low-income neighborhoods. Priority will be given to projects and enterprises that have a demonstrated commitment to local hiring, the capacity to provide entry-level jobs with viable career ladders to youth suffering from high rates of unemployment, and commitments to invest earnings back into local neighborhoods. Particular preference will be given to business and enterprises that have alternative ownership and management structures, such as worker cooperatives and collectives, that might otherwise have difficulties in accessing credit.

The partner institution — the credit union or CDFI — will conduct evaluation of borrowers' financial status and, in the case of business loans, review the soundness of the business plan, relevant business experience, and assessment of market demand. The loan agreement and all supporting documents will be submitted to the Municipal Bank for review. Once the loan is originated, the partner institution will be responsible for monitoring ongoing borrower compliance and for the collection and distribution of payments.

The Municipal Bank will conduct regular reviews of the partner institution's financial status and the conformity of participation loans with agreed-upon lending criteria to safeguard the Bank's financial interest, and to insure loans are fulfilling the Bank's priority policy objectives. The MFC participation portion will range between 25 and 70 percent of notional principal. The maximum individual loan amount will be $1,000,000; the amount of the loan portfolio that may be allocated to participation loans and buy-downs (see below) will be capped at 25 percent of total assets.

Rates for the Municipal Bank portion of the loan will be set at a level ranging from 1.5 percent to 2.25 percent over the Federal Home Loan Bank advance rate, depending on the quality of borrower collateral. Collateral must be posted; loan applicants seeking funding for projects that have no collateral may apply for loans through the social capital venture fund.

Buy-down Program

The MFC will operate a buy-down program to allow qualifying businesses that already have loans outstanding with credit union partners and CDFIs. Loan buy-down refers to a process whereby the Municipal Bank refinances a portion of the existing loan outstanding at a lower interest rate. This directly reduces the borrowers' costs of debt service. In return, the applicant must demonstrate that the businesses operated in accordance with the social goal and objectives of the Bank regarding labor rights, payment of fair wages and benefits, commitment to local economic development, and implementation of sound environmental practices. In addition, evidence must be presented that savings from the buy-down will be directed toward additional job creation in ways that continue to meet priority social and economy policy objectives.

Rates will be set as in the loan participation program. Interest reduction will vary according to the ability of the borrower to demonstrate the social and economic benefits that would accrue from various levels of write down of the current rate charged on the loan. In general, the greater the potential benefit, the greater will be the interest rate reduction to maximize economic impact. Fees will be charged commensurate with the actual costs of administration and overhead associated with the loan plus a margin to insure a positive net rate of return. Defaults will be apportioned in accordance with the relative share of the total loan.

Social Capital Fund

De novo and start-up business that realize the MFC founding social and economic objectives, yet for which borrowers do not have any tangible collateral, may apply for loans through the Social Capital Fund.

In return for absorbing greater risk, the Municipal Bank may acquire a minority equity interest in the form of convertible debt that may be evoked in the event the borrower wishes to terminate interest payments on the loan. Conversion will require approval of the Municipal Bank, and will be made based on determination of the effects of such conversion on the Municipal Bank's net rates of return, assessment of risk, and ability to maintain payments on outstanding short- to medium-term debt.

An amount of 50 percent of the total funding allocated to the Social Capital Fund will be charged against the MFC/Municipal Bank's Tier 1 capital. This charge is an internal accounting adjustment, and is not required to maintain conformity with FDIC mandates regarding regulatory capital. The write-down is to insure sufficient risk provisions, given the higher likelihood of default on this category of asset. Write-downs of the Municipal Bank's common stock will be treated as the adjusted Tier 1 regulatory capital upon which the Bank's own risk-weighted capital-to-asset ratios will be set.

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