

Date of Hearing: April 22, 2019

ASSEMBLY COMMITTEE ON BANKING AND FINANCE

Monique Limón, Chair

AB 857 (Chiu) – As Amended March 19, 2019

SUBJECT: Public banks

SUMMARY: Provides for the establishment of a public bank, as specified, by a local agency. The public bank would generally be required to comply with all requirements in state law that apply to commercial banks.

Specifically, **this bill:**

- 1) Defines public bank as a corporation, organized for the purpose of engaging in the commercial banking business or industrial banking business, that is wholly owned by a local agency, local agencies, a joint powers authority that is composed only of local agencies, or a special district.
- 2) Requires a public bank to identify in its articles of incorporation either a social purpose or specific public benefit, as specified, and to comply with reporting and transparency requirements related to benefit corporations or social purpose corporations.
- 3) Requires a public bank to obtain and maintain deposit insurance approved by the Commissioner of Business Oversight, either provided by the Federal Deposit Insurance Corporation (FDIC), private share insurance, or self-insurance.
- 4) Requires a public bank to comply with all requirements of the Financial Institutions Law (Division 1 (commencing with Section 99) of the Financial Code) and the Banking Law (Division 1.1 (commencing with Section 1000) of the Financial Code), except to the extent that a requirement of those laws is inconsistent with a requirement proposed by this bill, in which case the requirement of this bill shall prevail.
- 5) Requires a public bank, wherever possible, to conduct retail services in partnership with local financial institutions, as specified.
- 6) Notwithstanding the requirement to partner with local financial institutions, authorizes a public bank to engage in banking activities, including, but not limited to, infrastructure lending, wholesale lending, and participation lending.
- 7) Provides exceptions related to a local agency's ability to deposit funds in or purchase debt securities from a public bank, as specified.
- 8) Provides that a local agency that owns or controls a public bank is not considered a bank holding company pursuant to state law.
- 9) Exempts a public bank from state and local taxes, with specified exceptions.

EXISTING LAW:

- 1) Provides for the Department of Business Oversight (DBO) and authorizes DBO to administer the Financial Institutions Law (Financial Code Section 99 et seq.).
- 2) Provides for the Banking Law (Financial Code Section 1000 et seq.) as a division within the Financial Institutions Law. Specifies authorizations, requirements, and restrictions that govern how a corporation may engage in commercial banking activity in the state.
- 3) Specifies requirements and restrictions related to the management of financial affairs by a local agency (Government Code Section 53600 et seq.). Local agency means county, city, city and county, including a chartered city or county, school district, community college district, public district, county board of education, county superintendent of schools, or any public or municipal corporation. Requirements and restrictions relevant to this bill include, but are not limited to, the following:
 - a. Provides that all governing bodies of local agencies are trustees and therefore fiduciaries subject to the prudent investor standard. Requires a trustee to act with care, skill, prudence, and diligence under the circumstances then prevailing, including, but not limited to, the general economic conditions and the anticipated needs of the agency, that a prudent person acting in a like capacity and familiarity with those matters would use in the conduct of funds of a like character and with like aims, to safeguard the principal and maintain the liquidity needs of the agency.
 - b. Establishes that the primary objective of a trustee shall be to safeguard the principal of the funds under its control. The secondary objective shall be to meet the liquidity needs of the depositor. The third objective shall be to achieve a return on the funds under its control.
 - c. Declares that the deposit and investment of public funds by local officials and local agencies is an issue of statewide concern.
 - d. Provides a specified list of relatively low-risk securities that a local agency may purchase or obtain (Government Code Sections 53601 and 53635).
 - e. Provides for how a depository institution, including a bank authorized pursuant to the Banking Law, must protect deposits received from a local agency (Government Code Section 53630 et seq.).

FISCAL EFFECT: Unknown

COMMENTS:

1) PURPOSE

According to the authors:

AB 857 provides more local control, transparency, and self-determination in how local taxpayer dollars are leveraged in the banking system by allowing local governments to charter their own public banks. These public banks would have oversight from the Department of Business Oversight (DBO) and a separate,

professional board. In contrast to profit-driven commercial banks, the public bank's board of directors will have a fiduciary duty to protect taxpayers' assets.

AB 857 also requires partnerships between a public bank and existing local financial institutions to provide retail services, enabling public banks to provide affordable loans and lines of credit to local businesses and nonprofits, and increase the lending capacity of the local banking system.

By creating a public bank, taxpayer money will be held by an insured financial institution that measures its return on investment not only by profits, but also by its success in supporting communities.

2) BACKGROUND

The concept of public banking is not new. In fact, the California Legislature considered two bills in recent years that proposed establishing a public bank that would be owned and operated by the state, but neither bill was enacted into law.¹ Except for public ownership, other features and purposes of public banks are not universally agreed upon. When voicing support for public banks, proponents have cited the following potential benefits:

- The opportunity to invest public funds in a way that reflects the values of some of the electorate,
- The ability to divest public funds from commercial banks that provide financing to industries that advocates do not like (e.g., fossil fuel producers, prison operators, gun manufacturers),
- Providing capital at a lower cost than the private sector for preferred uses (e.g., public infrastructure projects, affordable housing, small businesses, unbanked/underbanked),
- Reducing costs to the government for banking services.

There is only one public bank operating at scale in the United States: the Bank of North Dakota (BND). 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.

On the heels of the 2007-08 financial crisis, renewed interest in public banking has sparked legislation or feasibility studies in state and local governments around the United States. To date, no state or local government has established a public bank, and feasibility studies often

¹ Two bills were introduced in the 2011-12 Legislative Session. AB 750 (Hueso) would have created a task force to study a public bank at the state level. The bill was approved by the California Legislature but vetoed by Governor Brown who said the matter was "well within the jurisdiction and competence of the Assembly and Senate Banking Committees." AB 2500 (Hueso) would have established a public bank at the state level. The bill was never heard in policy committee by request of the author.

find significant start-up costs and high levels of financial and operational risk associated with public banks.

On February 4, 2019, the Assembly Committees on Banking and Finance and Local Government held a joint informational hearing on public banking at the local level. The committees heard testimony from the Commissioner of Business Oversight, the State Treasurer, county treasurers, supporters of public banks, and representatives of existing commercial banks. A background document and testimony submitted by witnesses can be found on the Assembly Banking Committee's website, along with a link to a video of the hearing.

3) BIG BANK TAKE LITTLE BANK

The ongoing consolidation of the banking industry may contribute to a feeling that the private banking system is not fulfilling the needs of local communities. According to the FDIC, the number of banking institutions in the United States has declined by more than two-thirds since 1990. There were more than 18,000 banks operating in the 1980s. In 2017 there were fewer than 5,000. Over the same period, total assets held by commercial banks increased by more than fivefold from \$3 trillion to over \$17 trillion, according to the Federal Reserve. This trend was driven by merger and acquisition activity where larger banks purchased smaller banks to increase their geographic reach, leverage economies of scale, or expand into new products or services.

4) SERVING LOCAL NEEDS

According to the authors and supporters, one of the motivations for this bill is to support local communities. In concept, a public bank may be structured to respond better to the needs of people in a local area than a large, publicly-traded bank that has a broader customer, employee, and investor base distributed across the country and around the globe. Although this bill requires a public bank to identify in its articles of incorporation either a social purpose or a specific public benefit, the bill does not specify how a public bank shall be governed or if and how a public bank should reflect the demands of a local community.

What if members of a community have conflicting demands of a public bank? Should a public bank operate under democratic principles? If so, how should minority groups be protected from the tyranny of the majority? Establishing an effective governance structure to guide the decision-making process of a public bank will be a critical element that shapes whether a public bank could better meet the needs of a community than existing private sector banks.

Even if a public bank establishes an effective governance structure, the question remains whether such a public bank would better serve community needs than existing private institutions. As of 12/31/2018, there were 243 state-chartered banks and credit unions operating in California. Nearly all of these institutions held assets of less than \$10 billion, placing them in the category of "community banks" according to the Federal Reserve. Many of these smaller financial institutions generate business primarily, sometimes solely, through serving customers in their local geographic regions. In order to better serve its community, a public bank would likely need to offer products and services at a lower price or higher quality than existing institutions that serve the area.

5) SEEKING POLICY OUTCOMES THROUGH PUBLIC BANKING

Supporters of the bill identify an array of policy outcomes that they hope public banking will facilitate or values that can be expressed by a public bank's activities, including, but not limited to, the following:

- Investments in climate change mitigation, renewable energy, affordable housing, public infrastructure, and small businesses.
- Divestment from the fossil fuel industry, providers of private prisons and detention centers, and gun manufacturers.
- Moving local government funds out of large commercial banks that provide financing to aforementioned industries.

This bill provides flexibility for a local government to decide which, if any, of these objectives to pursue through the establishment of a public bank. In considering these objectives, the Legislature and local governments may identify alternative paths to achieve these goals at a lower cost, both in terms of government expenditures and total societal resources.

6) DBO and FDIC: HOW TO PROTECT A PUBLIC BANK FROM FAILING

Banking is inherently risky. Making loans and managing deposits expose a bank to potential financial losses, liquidity constraints, and even failure. During the last financial crisis, 440 banks were closed by the FDIC from 2009-2012, or approximately 5-6% of the total banks in operation. The failure of a public bank – capitalized with taxpayer funds and holding tax receipts as deposits – could cause significant damage to a local government's ability to engage in normal operations (e.g., paying public employees, making payments on outstanding bonds and debt, paying city contractors and non-profits).

This bill, as proposed to be amended, provides protections of taxpayer funds by requiring a public bank to be regulated and supervised by the DBO and FDIC. While private banks under the supervision of the DBO and FDIC have failed, these regulators provide two critical areas of protections to avoid potential losses: initial review of a bank charter application and ongoing supervision for safety and soundness.

Initial Review

If a local agency desires to form a public bank, this bill requires the local agency to submit an application for a bank charter with DBO through the same process provided for traditional commercial banks. Under existing law, the Commissioner of DBO cannot approve the application until he or she has ascertained to her satisfaction that:

- a. The proposed bank will have a reasonable promise of successful operation.
- b. The proposed capital structure is adequate.
- c. The proposed officers and directors have sufficient banking experience, ability, and standing to afford reasonable promise of successful operation.

In reaching its decision, DBO considers:

- a. The character, reputation, and financial standing of the organizers or incorporators and their motives in seeking to organize the proposed bank.
- b. The character, financial responsibility, banking experience, and business qualifications of the proposed officers of the bank.
- c. The adequacy of capitalization to support the projected volume and type of business.
- d. The reasonableness to achieve and maintain profitability.
- e. The viability of the Business Plan given the economic condition, growth potential, and competition of the proposed market area.
- f. Whether the bank is free from abusive insider transactions and apparent conflicts of interest.

This initial review process could serve to protect a local agency from starting a public bank without appropriate personnel and financial support in place or from starting a public bank with an unviable business plan.

Ongoing Supervision

Under the proposed bill and existing law, both the DBO and FDIC would provide routine supervision and examinations of a public bank 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 regulators have tools to correct deficiencies in the bank's risk management practices and address weaknesses in the bank's operations.

In the context of a public bank, the FDIC could serve as a critical backstop in preventing undue political influence on the decisions of the bank. A public bank raises unique concerns around how elected officials in local or state government could pressure the bank to give special treatment to political supporters. While it is likely that DBO examiners would identify bad behavior, it is important for a regulator outside of the California political process to also serve in an oversight role and be empowered to use enforcement authority over a public bank that was corrupted by undue political influence. Oversight by the FDIC helps to mitigate the risk of loss of taxpayer funds due to risky decisions by a public bank.

7) COLLATERAL REQUIREMENTS: HOW TO PROTECT TAXPAYER FUNDS IF A PUBLIC BANK FAILS

Existing law provides protections for taxpayer dollars that may be deposited in a public bank. After the bankruptcy of Orange County in the mid-1990s, the Legislature passed laws requiring that funds deposited by a local agency must be protected with special collateral requirements. These requirements ensure that taxpayer funds are backed up, even if the size of the local agency's deposit account is greater than the FDIC protection limit of \$250,000. This bill does not exempt a public bank from these collateral requirements.

While collateral requirements protect local government deposits, any capital provided by the local government as shareholder equity or as a non-deposit liability to a public bank may be exposed to losses. As fiduciaries and trustees of taxpayer funds, local government officials should carefully consider the risks involved with public bank proposals, particularly in light of their responsibilities under the prudent investor rule.

8) ARGUMENTS IN SUPPORT

The California Public Banking Alliance writes:

Unlike a privately-owned bank, which prioritizes shareholder returns, public banks leverage their deposit base and lending power to benefit the public. This allows public banks to focus on pressing local needs, like affordable housing, small business loans, and public infrastructure projects such as rebuilding after wildfires. A public bank's decisions may consider the needs of the community and leverage public funds to meet those needs at a lower cost than the private sector.

AB 857 provides more local control, transparency, and self-determination in how local taxpayer dollars are leveraged in the banking system by allowing local government to charter their own public banks. These public banks would have oversight by the DBO and a separate, professional board. In contrast to profit-driven commercial banks, the public bank's board of directors will have a fiduciary duty to protect taxpayers' assets.

Fossil Free California writes:

Fossil Free California supports and endorses AB 857 "Public Banks", which could provide a stable alternative to megabanks that provide financing for fossil fuels and fossil fuel infrastructure projects. Over the last three years the world's biggest banks have poured more than \$1.9 trillion into extreme fossil fuel projects. Finding a public alternative to these banks is consistent with our mission of ending financial support for fossil fuels and promoting a just transition to a low-carbon economy.

9) ARGUMENTS IN OPPOSITION

The California Bankers Association writes:

AB 857 infers that banks are not serving their communities, an argument repeatedly made by public bank activists in a variety of forums. There are 155 banks operating in California, which combined, originate more than \$100 billion in new loans annually. Proponents for the creation of a public bank have failed to identify how the current marketplace is not meeting the public's financial needs...

While AB 857 attempts to achieve partnership with local financial institutions, the measure creates a tax advantaged entity that will directly compete with community banks. This measure does not preclude a municipal bank from engaging in retail banking services or from offering commercial loans...Commercial banks, particularly community banks, will be harmed by the taking of local agency deposits which would otherwise be used as a source of liquidity by these banks to make loans into their communities. The notion that the public bank will cooperate with local financial institutions is illusory and this measure forces community banks to compete on an unlevel playing field.

The California Association of County Treasurers and Tax Collectors writes:

While CACTTC certainly understands the motivation to move public dollars away from certain private, commercial banks, there is simply no question that country treasurers complying with state law cannot possibly deposit county funds into a public bank. We have communicated this directly to the public bank advocates and have also provided them our policy statement on the matter, which was developed prior to the introduction of [AB 857]. Moving forward this legislation creates a false sense of hope for proponents who have been repeatedly advised that county pools cannot be used for these purposes, and that critical statutory protections of local dollars cannot be lightly dismissed.

10) DOUBLE-REFERRAL

This bill is double-referred. If passed by the Assembly Banking and Finance Committee, the bill will advance to the Assembly Local Government Committee. This analysis does not opine on whether a public bank is within the scope of services that a local government should consider providing.

11) PROPOSED AMENDMENTS

Amend proposed Government Code Section 57602 to read:

A public bank shall obtain and maintain deposit insurance ~~approved by the Commissioner of Business Oversight, either~~ provided by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. Sec. 1811 et seq.), ~~private share insurance, or self insurance.~~

~~(b) In seeking and retaining insurance, a public bank may do all things and assume and discharge all obligations required of it that are not in conflict with state law.~~

Amend proposed Government Code Section 57600 to read:

For purposes of this division:

(a) "Local financial institution" means a certified community development financial institution, a credit union, or a small bank or an intermediate small bank, as defined in Section 25.12 of Title 12 of the Code of Federal Regulations.

(b) "Public bank" means a corporation, organized for the purpose of engaging in the commercial banking business or industrial banking business, that is wholly owned by a local agency, local agencies, a joint powers authority formed pursuant to the Joint Exercise of Powers Act (Article 1 (commencing with Section 6500) of Chapter 5 of Division 7 of Title 1) that is composed only of local agencies, or a special district.

~~(c) "Self insurance" means deposits guaranteed by the owners of the public bank in an amount approved by the Commissioner of Business Oversight~~

Add new section in Government Code requiring a local agency to conduct a study prior to submitting an application to organize and establish a public bank pursuant to Section 1020 of the Financial Code. At a minimum, that study shall include:

- (1) A fiscal analysis of costs associated with starting the proposed public bank.
- (2) An estimate of the initial amount of capital to be provided by the local agency to the proposed public bank.
- (3) Financial projections, including pro forma balance sheet and income statement, of the proposed public bank for at least the first five years of operation.
- (4) A legal analysis of whether the proposed structure and operations of the public bank would likely comply with Section 6 of Article 16 of the California Constitution.
- (5) An analysis of how the proposed governance structure of the public bank protects the bank from abusive insider transactions and apparent conflicts of interest.

REGISTERED SUPPORT / OPPOSITION:

Support

350 Bay Area Action
 350 Silicon Valley
 Alliance For Community Transit - Los Angeles
 Asian Pacific Environmental Network
 California Nurses Association
 California Public Banking Alliance
 California Reinvestment Coalition
 City And County Of San Francisco, Board Of Supervisors
 Coleman Advocates For Children & Youth
 Commonomics Usa
 Community Financial Resources
 Democracy Collaborative
 Democratic Party Of The San Fernando Valley
 Divest La
 Fossil Free California
 Friends Of The Earth U.S.
 Green Party Of Santa Clara County Ca
 Home It
 Hubert H. Humphrey Democratic Club
 Indivisible Ca: Statestrong
 Indivisible East Bay
 Local Clean Energy Alliance
 Los Angeles County Democratic Party
 Mcgee-Spaulding Neighbors In Action

Media Alliance
Orange County Poor Peoples Campaign
People For Public Banking
Poder
Public Banking Institute
San Francisco Living Wage Coalition
San Francisco Rising Alliance
Seiu State Council
South Bay Progressive Alliance
Sunflower Alliance

79 delegates of the California Democratic Party

Oppose

Bay Area Council
California Association Of County Treasurers & Tax Collectors
California Bankers Association
California Chamber Of Commerce
California Community Banking Network
California Credit Union League
Howard Jarvis Taxpayers Association

Analysis Prepared by: Michael Burdick / B. & F. / (916) 319-3081