Memorandum

DATE: July 8, 2015

TO: City Council

FROM: Ross Chaney, Economic Development Specialist – RC

VIA: Kate Noble, Interim Director, Housing and Community Development Department KN

RE: Public Banking Initiative – Mid-Project Update

Item and Issue:

This is a mid-project update on the Public Banking feasibility study. The Finance Consensus Document for the Public Banking Feasibility Study (attached) provides information on the conditions in which city staff and the professional consultant (Building Solutions, LLC) are developing potential uses of public banking functions for the City of Santa Fe" (per Resolution 2014-89)

Building Solutions (represented by Katie Updike) has met with a variety of community representatives, local bankers and advocates and a variety of small groups to solicit input, context and ideas for the feasibility study. City staff and Building Solutions are now working to determine what potential actions, regulations and/or policies might constitute constructive (and feasible) responses to the current market conditions. Once those are clarified, Arrowhead Center (NMSU) will help quantify the expected economic impacts.

Upon completion of the feasibility study, the City Council can determine whether or not it wishes to take any action to implement any options or alternatives reviewed in the study.

Finance Consensus Document
For Public Banking Feasibility Study
July 1, 2015

Introduction

As part of the Public Banking Feasibility study, the City and Building Solutions LLC (Consultant) determined that it would be useful to survey the City's current banking sector policies and activities, as well as both local and national market conditions. This exercise helps develop an understanding of where the market is functioning as expected and where there are opportunities for the City, or for other financial sector players, to improve regional economic performance. The document is not intended to provide recommendations, but rather to survey current conditions and to use the findings to identify areas where making changes could improve financial sector performance (whether by the City or others). Not all of the areas covered in this document *require* the implementation of a public bank, however, they all relate to banking functions, regardless of the ownership of the institution.

<u>Banking Sector Concerns</u>: These concerns are national and are not isolated to Santa Fe. Each region has its own nuances; however, with the generalized statements made below, are echoed in the local market. Further information is included in the body of this document.

a. **Banking sector liquidity and regulatory changes in capital requirements are reducing willingness to take large deposits and causing historically low New Interest Margins.** Will the City have difficulty placing deposits in the near future (at least until some of the financial sector liquidity is deployed/lent) or could interest rates dwindle to zero or negative territory reflecting the cost of reserves and collateral?

b. **Loans under $500,000 are more difficult to obtain**, particularly from traditional commercial banks. Emerging web-based portals may fill some of this demand but the lack of regulatory oversight and borrower awareness and preparedness may limit early adoption in the region. What can or should the City do to stimulate this class of lending?

c. **Regulations are proving to be extremely onerous on smaller community and regional banks**. The core capital and reporting regulations may have the unintended consequence of encouraging further consolidation of local banks into larger banks. Federal legislation to alter these regulations appears stalled.

d. **All of Santa Fe's local banks appear to have acceptable Community Reinvestment Act (CRA) ratings.** This would imply that deposits received in the area are being redeployed in the area[1]. This, however, is over-shadowed by the fact that Loan to Deposit ratios are at 30-year lows nationally (implying that there is weak conversion of deposits to loans). New Mexico loan to deposit ratios are substantially below the low national levels.

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1 Century, Community Bank, and NM Bank & Trust are listed in FDIC records as having Satisfactory CRA ratings as of 2012 and 2013 review dates. Wells Fargo Financial Bank (not specific to New Mexico) has an Outstanding rating as of its last review in 2008. Los Alamos and FNB of Santa Fe are not listed in easily accessed public records.

City Policy and Procedures: This consensus document discusses both the management of investments and the issuance of bonds. The Finance Department is in the process of modifying some of these policies. This document identifies areas where there is potential value-added which could be achieved.

New Financing Trends: Two significant market trends are analyzed. The emergence of on-line lenders, which use both private and public data to make loan decisions, are growing quickly. While they are still a relatively small sector in the market, they are filling severe gaps in the consumer and small business lending market. This is further complemented by the "impact investing" trends which reflect an increasing desire on the part of investors to make a difference and make money.

City of Santa Fe Collateral Policy

N.B. The City of Santa Fe Finance staff follow guidance of the Government Finance Officers Association ("GFOA") for developing policies which are approved by Council, and which conform to New Mexico State laws. Finance management follows a prudent guideline that prioritizes security, liquidity and yield – *in that order.* The relatively minimal costs associated with the City's short term collateral requirements and liquidity objective is modest, however, for purposes of this study, an attempt to quantify the trade-offs is made in order to help focus on areas that could have meaningful impact on City finances.

The City's policy to require 102% collateral on all bank deposits (in excess of FDIC insurance levels of $250,000) is above the State statutory requirements. Full collateral is common among governmental entities nationwide, even though the State of New Mexico requires by statute only 50% collateral and per regulatory practices uses a tiered collateral requirement ranging from 50% to 102% based upon ratio analyses[2]. 102% collateral levels means that virtually none of the City's deposits are going into the Santa Fe community as liquidity for lending, **HOWEVER,**

a. The collateral provides excellent insurance against bank credit risk.

b. Some municipal collateral policies allow for a wider class of collateral, including performing loans. New Mexico's statutes appear to limit collateral (50%) to high grade Federally-issued or insured paper.

c. Extremely low "cost of collateral" (the cost for a bank to provide collateral) is at historically low levels. This means that the foregone interest revenue of full collateralization is relatively modest...maybe $100,000 to $200,000 per year[3] for an average cash placement range of $190-240 million. This abnormally low premium for the collateral is due to the unusually high levels of excess deposits/reserves, as demonstrated in the following graph:

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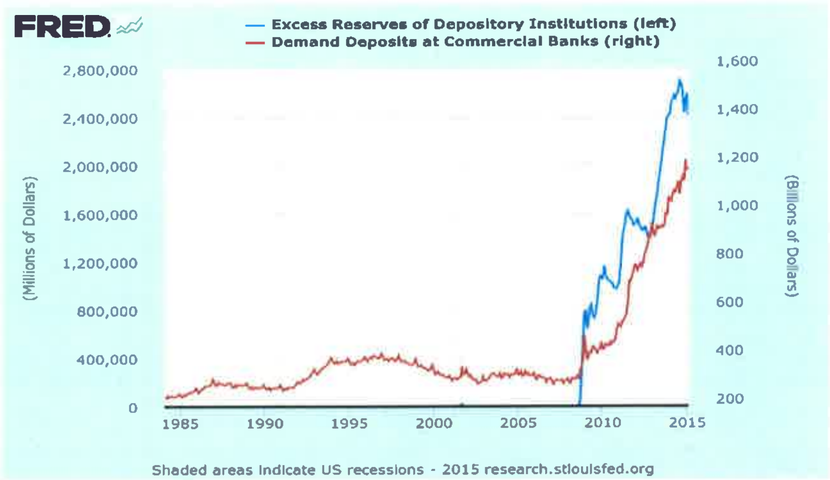
2 Depending upon credit ratios, many of the State's depository banks are required to hold only 50% against State deposits (per statute and regulation). Ten of the State's depositories hold less than 100% collateral on State deposits, although all of the depositories hold more than the required minimum of 50% or 75% of the deposits.

3 $100 million City's deposits X 10 to 20 basis point premium (.0010% to .0020%) = $100,000 to $200,000

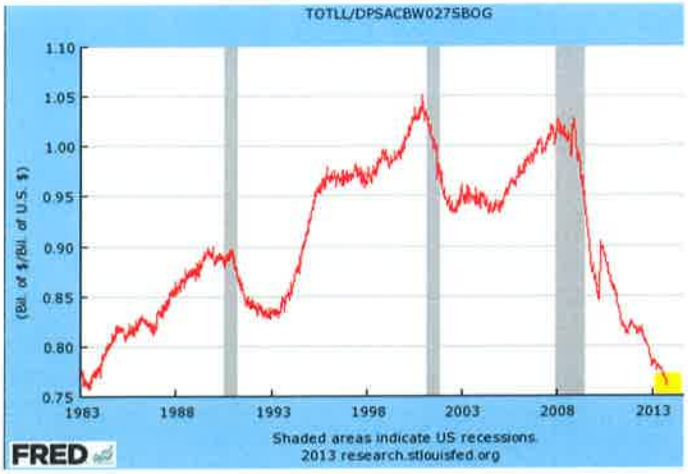
Reserves and Demand Deposits - Commercial Banks



d. Bank Loan to Deposit ratios also reflect the excess reserves (see chart below). This ratio is at 30 year lows due to tighter regulation, limits on real estate lending, and high excess reserves resulting from the "quantitative easing" at the Fed as noted above. Thus, if the City altered its collateral requirements, the banks might NOT have loan demand (or the willingness) to utilize those funds. Santa Fe's depository banks have even lower Loan to Deposit ratios than the national average, but they appear to be higher than New Mexico's level of 66%, suggesting a sluggish lending environment.[4]

U.S. Bank Loan to Deposit Ratios 1983 to 2013

N.B. New Mexico's depository bank ratios average about 66% - a level which is below the national average of 75%.



4 New Mexico also has one of the lowest Section 109 loan to deposit ratios in the Country. This ratio calculates the *State* ratio of non-New Mexico domiciled Loan to Deposit ratios to New Mexico bank loan to deposit ratios. It is used in order to discourage interstate banks from collected deposits in a state where it is not adequately serving credit needs. The Fed (Federal Reserve Bank), OCC (Office of the Controller of the Currency), and FDIC (Federal Depository Insurance Corporation) consider 50% or below to be in violation of Section 109 and subject to sanctions. See http://www.occ.gov/news-issuances/news-releases/2014/nr-ia-2014-97a.pdf for further information. The FDIC now discloses the State bank ratios annually.

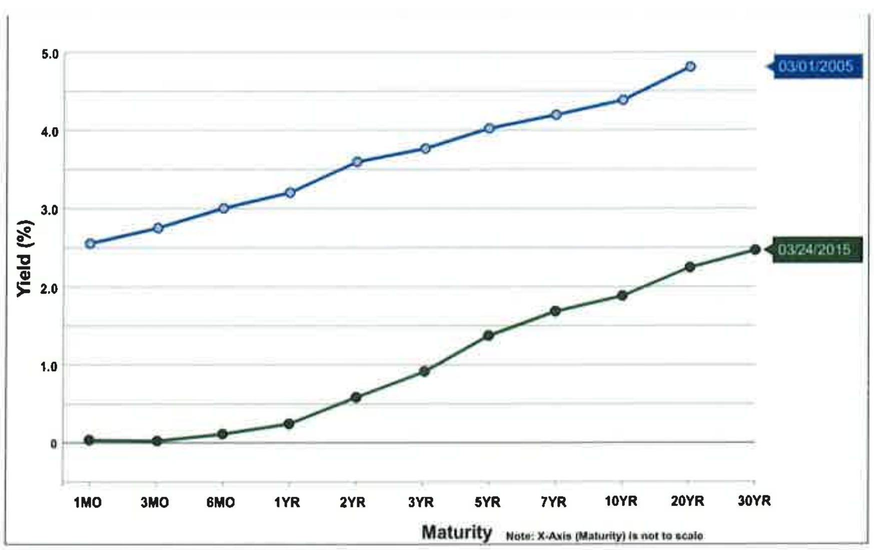
e. These conditions are expected to persist nationally for some time given low inflation, reluctance of the Fed to raise interest rates, and risk averse behavior among depositories world-wide. It is unclear why New Mexico banking institutions have loan to deposit ratios which are so much below the national averages. It could be lack of lending competition, weaker loan demand, and/or heavier regulation. It is also possible that the relatively high level of public funds in the banking system in New Mexico creates a structurally lower Loan to Deposit ratio, given the regulatory collateral requirements.

Liquidity

Liquidity in the City's investment portfolio (including restricted and unrestricted cash) reflects the almost flat yield curve under one year. On demand cash (cash which is immediately available without penalty) is being maintained at $50 to $90 million (the higher level only in anticipation of bond payment dates). This would normally cost the City between 25 and 50 basis points in foregone interest revenue for short term deposits, however, at currently depressed interest rates, the difference between "savings" (immediately available funds) and CDs (fixed term deposits, i.e., 1,2,3, 6, etc, months) is negligible – and at times overnight deposits are earning more than short term CDs. This high level of liquidity is probably resulting in less than $100,000 per year of foregone interest revenue, UNLESS more funds could be invested longer term, while still maintaining adequate short term liquidity. Longer term investment decisions also need to be weighed against the possibility of increasing rates, and the perceived political risk of marking to market the longer term investments, as required by the Government Accounting Standards Board 31.

The table below illustrates the Treasury rates which generally parallel bank deposit rates. The comparison between 2005 (prerecession) and 2015 illustrates not just the drop in rates, but also the flattening of the yield curve in the period under 1 year.

Comparison of Yield Curves in 2005 and 2015



One further note is necessary regarding municipal liquidity. The State encourages municipalities to maintain no less than 1/12th of their budgeted expenditures in unrestricted and unassigned cash as a measure of liquidity. The City's calculation was down to 35 days (or $83,278 above the 1/12th budget level) as of year-end 2014. This is a decrease from prior years and will be a focus for improvement in the foreseeable future. The State guideline may become a requirement from the State in the future. It is also a ratio that is monitored by the rating agencies.

External Bond Funding

Santa Fe typically issues bonds for capital outlays long before the projects are "shovel ready." For example, it is still managing significant amounts of cash from bond proceeds received in 2008 and 2012. This typically means that the Finance Department (or New Mexico Finance Authority "NMFA") must invest the funds at a substantial discount to the bond rate for a period of time that typically exceeds the three year total expenditure policy (sometimes by over five years). It can be difficult to predict the expected cash flow as bond projects are being planned, bid, built, and put into service. Additionally some bond projects must wait for State or Federal matching funds which can further delay project starts. If ON AVERAGE the City issues $20 million in long term bonds per year and takes ON AVERAGE four years to fully expend the proceeds, the cost of carrying the excess bond proceeds in the early years could be over $2 million over five years[5]. Bond covenants, sinking fund reserve requirements, and market timing issues all impact these estimates. Additionally the financial and administrative controls over disbursements are critical aspects of long term project management. Better planning for capital expenditures together with improved "matching" on cash expenditures could meaningfully lessen the financing costs imbedded in capital expenditures.

Market Conditions

The lending "gaps" in the market seem to be (anecdotally) in the following areas:

a. Small business lending – under $1,000,000. The chart below illustrates that despite an increase in GDP (post recession), there has been a continued decrease in small business lending, most dramatically by the largest banks[6].

b. Real estate lending. Regulators continue to focus on limits on loans backed by real estate collateral. This seems to be impacting the credit availability of rental units more than homeownership credit.

c. Angel capital and to a lesser extent Venture Capital (in Santa Fe).

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5 $20 million X 2% X 2 years X 5 years = $4 million (less costs for interim liquidity or securing long term rates)

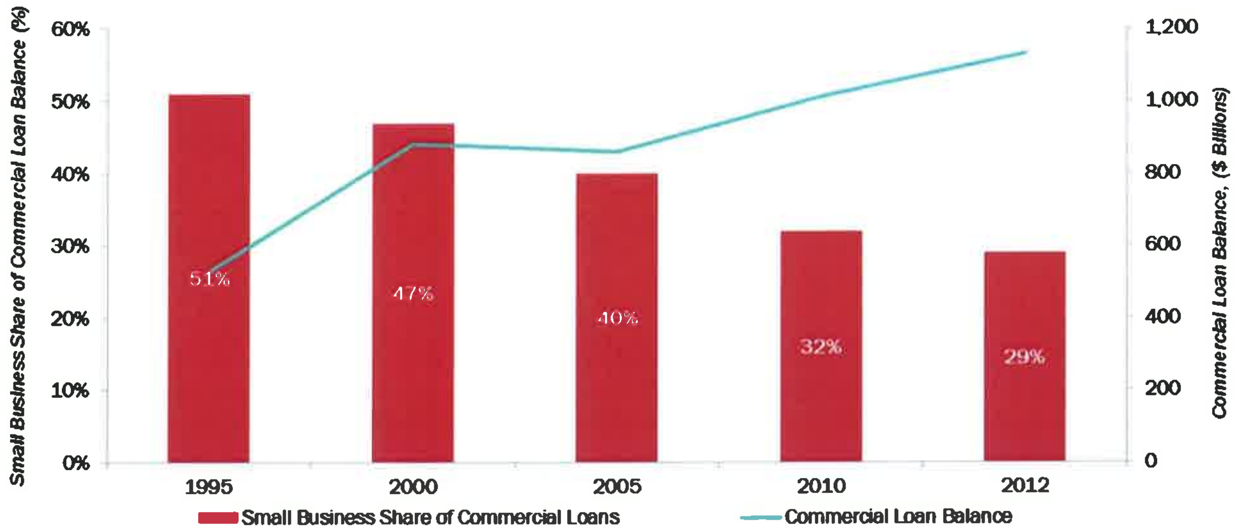
6 The lending market *may be* further exacerbated by interstate banking. In an effort to curb taking deposits in one state and lending them in another state, Section 109 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Interstate Act) requires non-state domiciled banks to maintain a Loan to Deposit ratio that is 50% or greater than the host state ratio. New Mexico has one of the lowest Loan to Deposit ratios in the US at 66%, thus compliance would require that only 33% of New Mexico deposits in non-New Mexico banks need to be reinvested in New Mexico to maintain compliance.

d. Impact investing. It is too early to tell what foundations and qualified Investors will do in this arena, however, the national and international trend should be beneficial for Santa Fe, which has a disproportionate share of investment advisors and investors who make Santa Fe a part-time or full-time home.

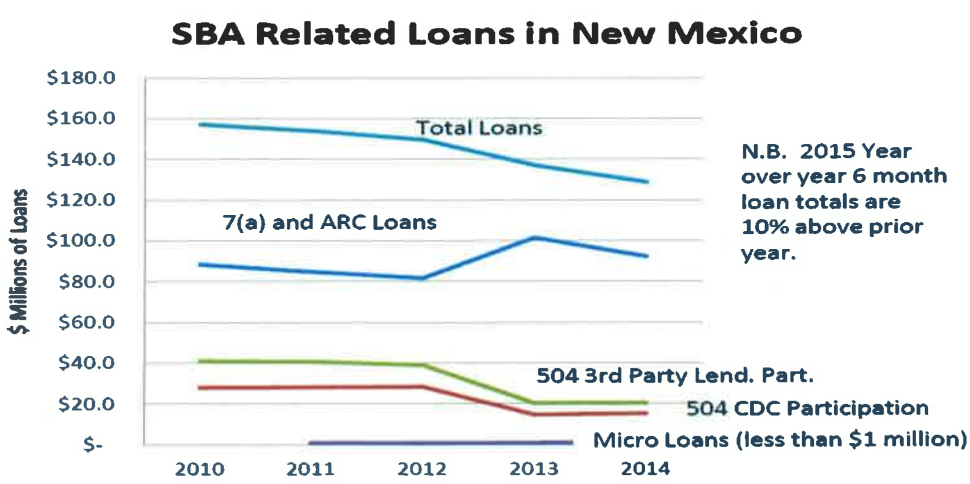
e. Small consumer loans do not appear to be a problem in Santa Fe; however, the ubiquitous presence of "pay-day lenders" is of concern.

Small Business Loans as a Share of Total Loans Are in Secular Decline

Small Business Share of Loans at Banks (%) vs. Total Outstanding Commercial Loans ($ Billions)



Source: Federal Deposit Insurance Corporation, Call Report Data. As of June 2012.



An excellent summary of the small business lending market can be found in a 65-page working paper issued by the Harvard Business School, written by Karen Gordon Mills and Brayden McCarthy in 2014. **"The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game,"** (http://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf)

In general, the "market" for smaller business loans is scattered, unorganized, and difficult to serve. The entities perceived to be best at serving this market appear to be the Community Development Financial Institutions ("CDFIs") and credit unions. CDFIs obtain grants from the Federal government and foundations, and raise debt from the marketplace (including commercial banks). These non-commercial bank entities have helped target services to lower income and more difficult to serve markets, although they are constrained in part by:

a. Lack of long term funding (e.g., Homewise, a CDFI focused on residential mortgages)
b. Lack of operating (over-head) funding (e.g., Accion, a CDFI micro-credit lender)
c. Too few qualified loans (e.g., The Loan Fund, a CDFI)
d. Lack of broad proximity (e.g., Guadalupe Credit Union)

Homewise claims to have the majority of the mortgage market in homes under $350,000 in Santa Fe, a significant achievement and a major source of homeownership capital. Throughout the country these entities have been filling key niche areas of lending that have either been abandoned by commercial lenders or deemed as too difficult to serve (e.g., neighborhood groceries, charter schools, etc.). In some markets (e.g., Chicago), the traditional commercial banks and the government are funding the CDFIs as an alternative to staffing more robust community lending groups. This cooperation has meant that the CDFIs have received and developed significant expertise in specialized community finance. The relationships between government, commercial banks, and CDFIs in northern New Mexico appears to be occurring, but perhaps is less robust. Regardless, the CDFIs and Credit Unions exist and potentially can play larger roles. In some ways, the CDFIs are a form of public bank in as much as they receive Federal funding (and often local government funding) and they must demonstrate that they are filling an underserved community need.

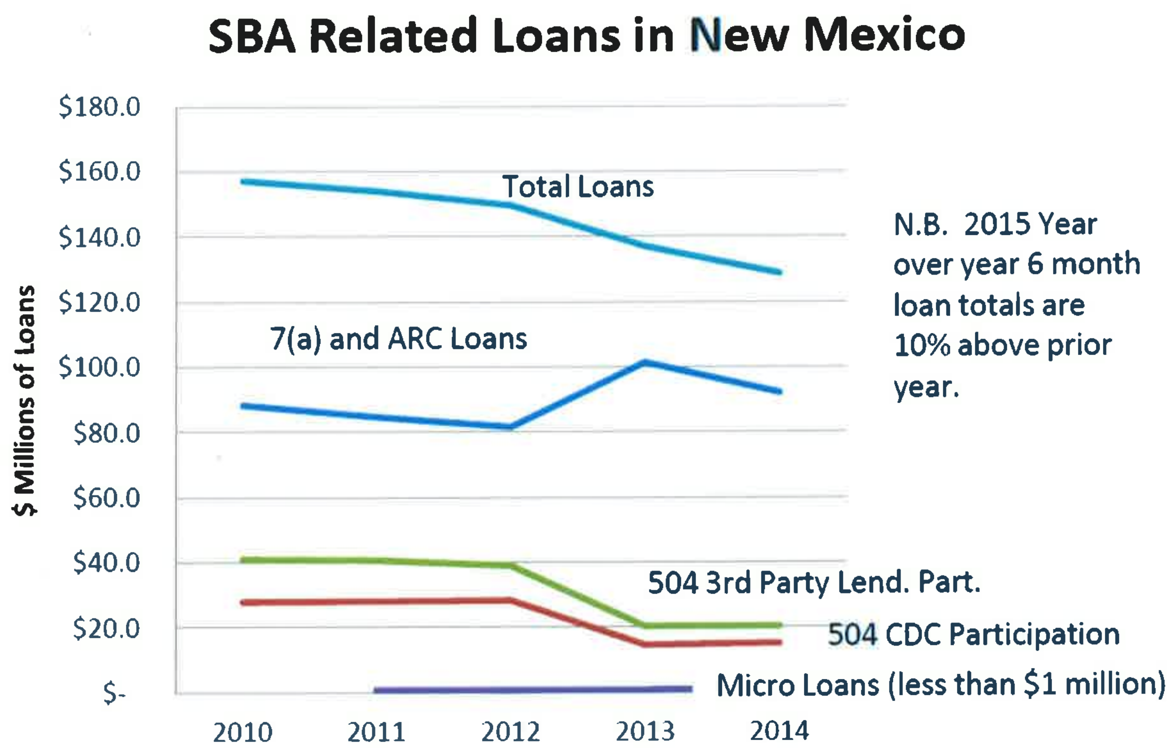
A recent 2015 survey conducted by the City of Santa Fe with over 600 businesses (over 90% under $1 million in payroll) further confirmed the concerns regarding access to capital:

Need for Capital

Access to Capital		High	Medium	Low	
	Strong	2%	5%	23%	30%
	Fair	5%	16%	23%	44%
	Weak	**8%**	**5%**	13%	26%
		14%	26%	59%	100%

As might be expected the businesses with medium to high need for capital correlate with the fair to weak access to capital. What percentage of these firms are credit-worthy is uncertain, however, the national and local indicators would suggest that growth may be curtailed by a reduced access to capital.

The Small Business Administration (SBA) has been a key component in developing borrower capacity and in providing guarantees and funding to this more difficult to serve market. Notwithstanding the temporary surge in credit post-recession as a result of the JOBS act infusion of capital through the SBA, the New Mexico SBA reports the following credit extensions.



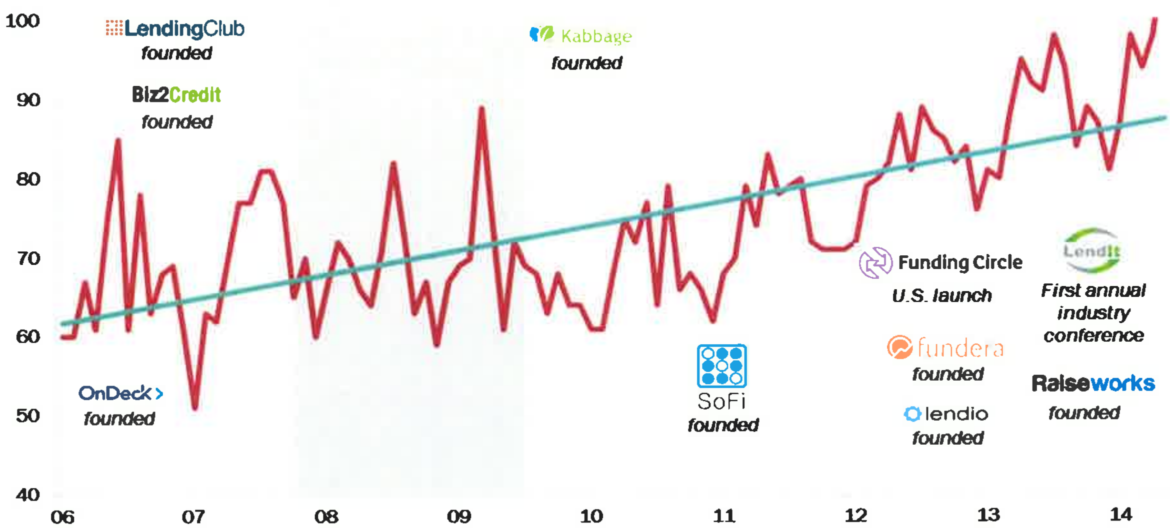
Source: SBA regional office in Albuquerque, New Mexico District Lender Rankings and Loan Activity, 2010-2015

Emerging Banking Entities

There is growing interest in peer to peer lending, crowd funding, and other forms of internet based lending. Regulation "A+", released March 25, 2015, further clarified and documented the requirements for smaller "public" offerings, as required by the Jobs Act. This document is not intended to forecast the effects that these regulations will have on the markets, however, it is expected to make it easier to publicize and sell securities, as well as broaden the investor market, to include investors who do not qualify under Regulation D as sophisticated investors. These emergent financial vehicles could provide Santa Fe with a more robust financial 'ecosystem,' especially if there can be a more visible and transparent understanding of the relatively new markets.

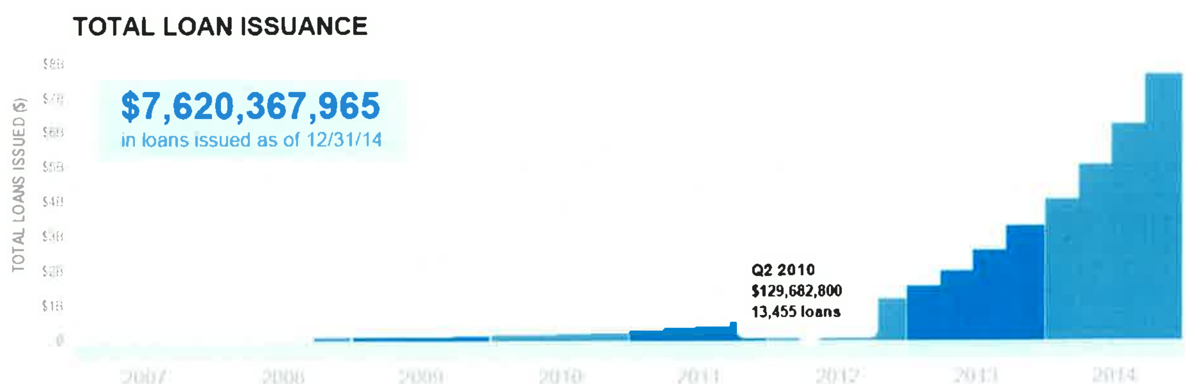
Similar to Amazon, AirBnB, ZipCar, et al, there are robust web-based platforms that are emerging for consumer credit, and increasingly now for business credit, particularly for the market under $1 million....the market that is increasingly being ceded by the traditional lenders. It is too early to tell how these emergent technology based lenders will fare under adverse market conditions; however, the following two charts illustrate the rapid recent growth of the sector, precisely during the post-recession years.

Average Monthly Google Searches of "Term Loan"



Source: Google.com/trends. As of May 2014.

Lending Club Lending

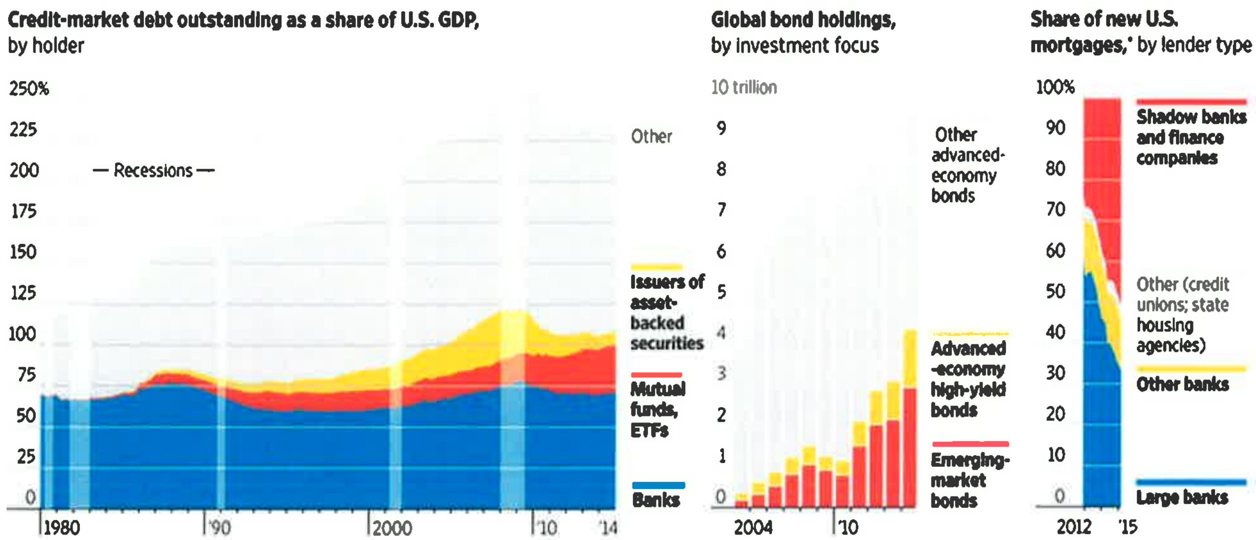


N.B. This chart shows loans "issued" not loans outstanding. Less than $50 million was lent in New Mexico since inception, presumably because Lending Club did not find it efficient to register in New Mexico (secondary market trading is permitted). Lending Club went public in December 2014, which now opens their market for investors to all 50 states, including New Mexico. Some analysts note that a substantive amount of the growth came from traditional banks buying loans, rather than from Peer-to-Peer growth.

While Lending Club is one of the largest players in this market, there are many others with both competing models (including payday lenders!), and different modalities. A chart in Appendix A provides a broad perspective on the new "marketplace" lenders. Some traditional lenders are even finding it attractive to bridge their clients into this market, yielding a better return for themselves (fee) and minimizing the credit and regulatory risk to themselves. The efficiencies (and lack of regulations) seem to be compelling enough for some traditional lenders to attempt to maintain the client relationship, while getting the loan product elsewhere.

Systemic Shift

As bank regulations stiffened in the wake of the financial crisis, some riskier types of lending have shifted to the shadow-banking realm.



*Measures share of mortgage originations backed by Fannie Mae, Freddie Mac, the Federal Housing Administration and the Veterans Administration

Sources: Federal Reserve (credit supplied); IMF (bond holdings); American Enterprise Institute (loan origination)

THE WALL STREET JOURNAL.

Three Emerging Models in Online Lending to Small Businesses

	Online Balance Sheet	Marketplaces	P2P Platforms
	OnDeck> Kabbage	fundera Biz2Credit	LendingClub Funding Circle
Model	Use balance sheet capital to decision loans via new risk scoring algorithms that include non-trad'l data	Connect borrowers with range of traditional and alternative lenders, incl. big banks, SBA, new players	Connect prime and super-prime quality borrowers with capital from consumers, inst'l investors
Loans to Date	Est. $1.5B as of 4Q13	N/A	Est. $4.7B as of 4Q13
APR	20 - 50 percent	Wide variation given range of products and lenders	9 - 12 percent
Terms	6 - 12 months on average; focused on new loans	Wide variation given range of products and lenders	3 year or 5 year; largely focused on refinancing of credit card debt
VCs	Google Ventures, First Round, Tiger, SAP Capital	Khosla Ventures, First Round Capital, Square 1	Khosla Ventures, Kleiner Perkins, General Atlantic

Source: Harvard Business School Working Paper, 2014

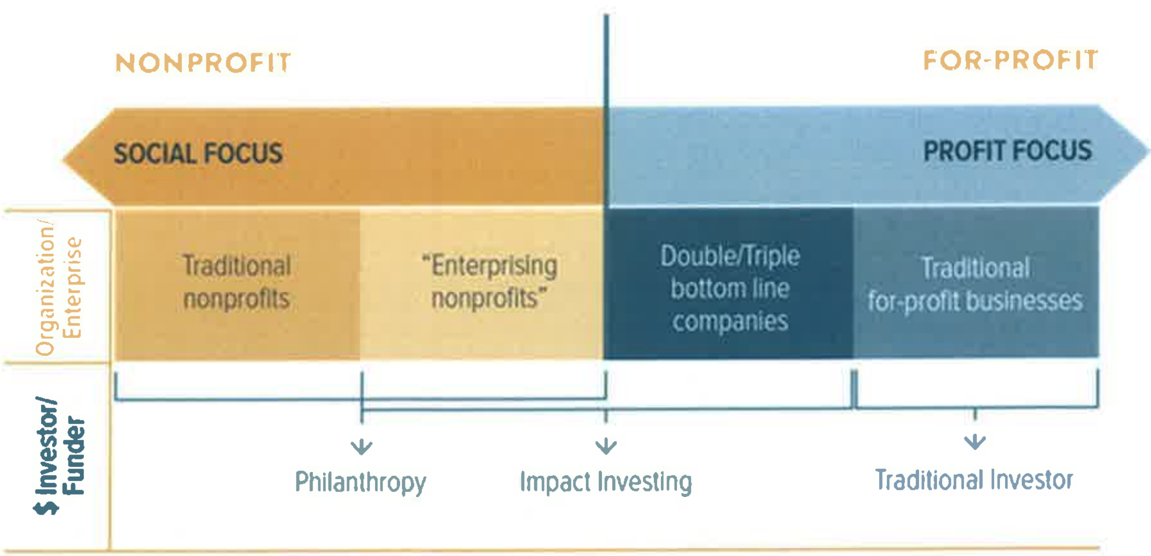
Of particular concern both nationally and at the state level is how these emerging financing vehicle should be regulated. They generally fall "between the cracks" of the FDIC, SEC, and Consumer Finance Protection Bureau regulations. Efforts to regulate are also tempered by the fact that many of these vehicles are serving the very gaps left open by the retreat in commercial bank lending to smaller businesses. Regulation (or market place opinions) will, or should, address the following areas:

a) Transparency and Disclosure
b) Oversight and Monitoring
c) Borrower education and literacy

Twenty states, including Oregon, Colorado, and Arizona, have or are in the process of developing permissive "crowd-funding" platforms for *intrastate* transactions between borrow and lender. They are all designed to allow smaller individual investments by investors who are not exempted by Regulation D as an accredited investor (e.g., $1 million net worth and $200,000 annual income). Most of these regulations appear to be more permissive than Federal regulations, albeit for smaller limits. It is possible that local markets may become important alternatives, especially for smaller transactions. New Mexico has developed new regulations which are expected to be published and enacted in 2015.

Impact Investing

Another sector that has gained cache, particularly in recent years, is impact investing, the concept of meeting more than just a financial bottom line. Terms such as Triple Bottom line, B corps, and mission related investing, all point to the concept that the very simple division between Non-profit and For Profit is blurred. There are many philanthropic ventures that are increasingly looking for more sustainable, financeable business models, and increasingly shareholder driven companies are recognizing the value of having robust social goals.



Foundations can use their corpus (investment funds) to make mission or program related investments, rather than just making grants. The Santa Fe Community Foundation and SVH Support (related to Christus St. Vincent Hospital) are collaborating as they begin making loans to non-profits and/or for-profits with tangible social missions. Impact Network Santa Fe (IN Santa Fe) has convened both investors and potential entrepreneurs to encourage the growth of this type of investing in the local economy. Kellogg Foundation, a long time experienced impact investor, is providing support as well. Demographic research is identifying larger numbers of women and millennials in the investor markets as key drivers of this trend. Increasingly fund managers are documenting that returns on "sustainable" investing, another subset of the impact investing market, appear to be achieving equal or better returns than traditional portfolio investing.

IN Santa Fe has identified and engaged in conversations with several of the emerging impact investors who are using web portals to post opportunities (investees/borrowers) and to allow investor/members to seek, review, and ultimately fund opportunities – both locally and globally. This approach could help bridge the investor market in Santa Fe with the emerging Peer to Peer and MarketPlace lending platforms. This approach illustrates another way in which the internet is providing access to capital in new ways, just like most retailers now offer merchandise over the internet.

Conclusion

The areas that appear to hold the greatest promise for the development of potential vehicles to improve financial and economic performance either by the City or related parties are:

i) Develop a better match for disbursements on City capital expenditures to the funding
ii) Investigate alternative investment vehicles and/or collateral arrangements that comply with State Law and yet address the possibility of continued decreased interest in large deposits within the commercial banking sector
iii) Promote methods to encourage and/or enhance small business lending.

These areas of investigation may or may not require the implementation of a public bank; however, they all correspond with aspects of bank functions, as traditionally described. Most importantly the objective of bringing more of the community back into community banking persists as the primary goal of helping Santa Fe have a more robust financial market place.

Comments, concerns, and ideas are welcome!

Please feel free to contact:

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Appendix A

"Marketplace" Lenders