Issue Paper: Creating a Public Bank for King County

March 14, 2016

Issue

Should King County take additional steps to explore the feasibility of creating its own public bank? This issue paper provides background information, analyzes feasibility considerations, and includes a recommendation.

Background

The Public Banking Institute (PBI) advocates that states and large local governments should form their own locally controlled municipal public banks to create financial resources that will support economic development and affordable housing, create jobs , lower public debt, generate non-tax revenue, and support the local financial industry. PBI was formed in 2010 to examine how the public bank model can be applied to other states, cities and counties. On February 16, 2016, representatives from PBI met with Executive Constantine and staff from the Finance and Business Operations Division (FBOD) to discuss the benefits of public banking and how interest is growing in other states and large municipalities across the country.

PBI indicates Germany's public banks have been successful for generations and were responsible for financing their economy after WW II. PBI also points to the Bank of North Dakota (BND) as a long-standing model for public banking. Established in the 1900's to support local farmers, BND is currently the only state-owned bank in the United States. The bank's mission has expanded over the years and its primary focus is on economic development with lending that supports farm/ranch operations, small businesses, rural communities and college students.

By law in North Dakota, all state revenues (taxes, fees, permits) are deposited in the public bank. Local municipalities can also choose to deposit funds in the state's bank but are not required to do so. BND is referred to as a "partnership" bank that does not compete with the local banking industry to offer services, such as checking and savings accounts. A partnership bank has no branches, tellers or ATM's. Instead, the partnership bank works with the local banking industry to distribute affordable credit into the local economy, in the form of loans. A partnership bank essentially assist local banks, credit unions and savings and loans to make larger loans than they might otherwise make and to "buy down" the interest rates of these financial institutions, which assists more borrowers to qualify for the loans.

According to PBI, over 15 states have introduced draft legislation about public banking and the following cities are investigating the formation of a public bank: Santa Fe, Allentown, Philadelphia and Pittsburgh. In January 2016, the City of Santa Fe published a detailed study concluding that *"A public banking initiative...is feasible and has the potential to provide enhanced fiscal management, improved net interest rate margins, and a more robust local lending climate."*[1] The study projects an economic impact exceeding $24 million in seven years.

The State of Washington and the City of Seattle have explored public banking. In 2012 and 2013, the State of Washington drafted legislation that would form a state public bank known as the Washington Investment Trust. The Trust was intended to finance infrastructure

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[1] *Public Banking Feasibility Study Final Report for the City of Santa Fe*, January 2016

construction projects, create jobs and lower the costs of bond financing. The legislation did not move out of committee. In late 2014, City of Seattle Councilmember Nick Licata sponsored a series of community briefings to explore the feasibility and benefits of public banking. Seattle's City Attorney recommended caution because of legal uncertainties and inherent financial risks.

Analysis

The analysis that follows reviews possible fund sources for a public bank; discusses Washington State constitutional limitations about the lending of credit; indicates possible pathways for forming a public bank; and comments on expert resources required to operate a public bank.

--Capital Funding

The startup of any bank requires capital funding, which includes the money to start up and operate, as well as funds to guard against losses. Listed below are the most likely capital funding sources for a King County public bank followed by comments about the practicality of each.

- Issuance of debt. A public bank could be created by issuing bonds, which was the path taken by BND. Assuming the bank is profitable, the bond is eventually paid off from the profits. While in theory the County could take this approach, the County would be required to pledge its full faith and credit to the repayment of the bonds, thereby assuming the full risk of starting up and sustaining a public bank. National bond rating agencies would likely view this debt as increasing risk to the General Fund at a time when the reserves of the General Fund have been diminishing. This may lower the County's top bond rating and substantially increase the cost of borrowing.

- Use of General Fund reserves. The County could fund a public bank through a one-time appropriation from General Fund reserves. This would not be practical or prudent at this time. General Fund reserves are already at minimum levels. In fact, Standard & Poor's recently placed a negative outlook on the County's top bond ratings primarily due to the financial outlook of the General Fund and the pattern of decreasing reserves.[2]

- Use of Investment Pool assets. The County could withdraw some of its funds out of the King County investment pool—funds which are not needed for immediate expenditure—and invest them in the new bank. Those County funds contributing money to the new bank would be exposed to any credit losses. Placing these collective funds at risk goes against current investment pool policies and raises legal questions about how to recover the funds in the event of a public bank default or failure. The transfer of funds could also hamper the operations of the $6 billion investment pool which is comprised of the funds of King County agencies (40 percent) and the funds of approximately 100 other special districts (60 percent). The special purpose districts will likely be concerned about exposure to losses. While in theory the special districts could join the County in transferring funds to help set

[2] Ratings Direct, King County, *WA Bond Outlook Revised on Negative on Continued Fund Drawdowns*, Feb 12, 2016

up the public bank, it is doubtful that special districts would see this as a prudent risk until the bank was well established and distributing earnings.

- Other funding sources. Besides the two options above, PBI indicates that other funding sources may be used for capital funding of a public bank including: selling equity investments to other local governments and pension funds; issuing Certificates of Deposit (CD's) or bank notes to outside investors; or investing employee pension funds. Participation from other local governments and pension funds is doubtful, especially from the outset, as they would be assuming the full risk of the bank start up. The State controls the County's pension funds and ongoing concerns about the adequacy of reserves in pension funds make them an unlikely source for funding a new public bank. Finally, the public bank would probably have to offer earnings above standard market rates on CD's or bank notes to attract a significant number of outside investors, and the payments to investors would decrease bank profits.

--Washington State's lending of credit clause

A public bank such as BND is designed to expand lending for a wide range of capital projects and economic development activities. A question that arises in our State is whether a public bank's lending would violate a clause in the State constitution prohibiting the lending of public credit. The State of Washington is one of the more restrictive in the nation in regard to how public funds may be utilized to attract private investment. Specifically, Article 8, Section 7 of the state constitution provides:

> *No county, city, town or other municipal corporation shall hereafter give any money, property, or loan its money, or credit to or in aid of any individual, association, company or corporation, except for the necessary support of the poor and infirm.*

A PBI white paper explains that local governments can create a public bank by initially forming a Municipal Development Corporation (including formation of a Municipal Bank) that would be separate from the local government and managed by an independent Board of Directors.[3] The legal question that must be answered is whether the operation of such a Municipal Development Corporation would be allowed or perhaps limited in scope by the State constitution's lending of credit clause. Lending that supports small businesses or other forms of economic development would appear to be strictly prohibited. It could be argued that infrastructure projects, such as affordable housing, are intended to support the "poor and infirm" and therefore the lending of credit would be allowed. Lending that supports the construction of County-owned capital infrastructure projects would not be affected by the clause and would be allowed. The allowable lending practices of a public bank would need to be confirmed by a thorough legal analysis.

[3] Public Bank Project, *Public Banks for US Cities*, Karl Beitel and David Schecter (no date)

--Formation of a public bank
PBI points out that charter or home-rule local governments, such as King County, have broad pathways to pursue the formation of a public bank. The main pathways include the adoption of an ordinance or a voter approved amendment to the local government's charter. Developing a detailed ordinance would not be practical without first addressing the Washington State constitutional limitations and completing a thorough feasibility analysis. A charter amendment, if approved by the voters, would enhance the legitimacy of the Bank. But is it doubtful that voters would want to risk public funds without some type of guarantee that the bank would be profitable.

--Banking expertise
As stated above, the County would need to appoint a Board of Directors for the bank with expertise and knowledge about banking and lending practices. The bank would have to hire employees with the expertise to work with other bankers in the community at evaluating the risk and credit worthiness of borrowers. The County would have to develop the internal expertise, similar to the role of a federal bank examiner, in overseeing the operation of the bank and replacing board members when needed. It would be important to factor in these types of oversight costs and resources if the County decided to move forward with a public bank.

Recommendations
The public banking concept has merit but comes with many legal uncertainties and operating risks. Unfortunately for King County, a public bank is a "no go" from the start if it worsens the financial condition of the General Fund. If executive leadership chooses to pursue this concept further, we recommend the following steps be taken:

1. Request a written legal opinion from the Washington State Attorney General's Office regarding whether it would be legal for King County to operate a public bank and, if so, what would be the limitations of such a bank on the lending of credit. If the Attorney General opinion is favorable, the PAO should review the preferred method of forming a public bank. The PAO will likely need outside counsel with expertise in banking to conduct the review (estimated cost $5,000 to $15,000).

2. Brief council staff and councilmembers on the public banking concept and determine if there is any traction to analyze the concept further.

3. Fund a comprehensive feasibility study by a consultant with expertise in banking and knowledge of the County's operations. The feasibility study should analyze: set up and phasing options; governance considerations; operational considerations; risks and how to mitigate those risks; banking sector interests and concerns; impacts on King County operations, including the investment pool and the General Fund; impacts on King County bond ratings; benefits anticipated, including self-funding of capital projects and the avoidance of bond issuance costs; and possible partnerships with other jurisdictions. The comprehensive feasibility study completed for the City of Santa Fe cost $50,000.