



An Act to Establish a Massachusetts Public Bank

S.632 (Eldridge) / H.975 (Connolly, Cabral)

Massachusetts Public Banking FAQs

Question 1:

How will a Public Bank manage risk and ensure safe and sound management of its assets?

Answer:

The bill provides that the public bank will be regulated by the MA Division of Banks, according to the same rules that apply to private banks chartered in Massachusetts. The public bank, as a member of the Federal Reserve System, will also be supervised by the Fed. Standard banking regulation will subject the public bank to capital requirements as well as requirements to maintain adequate loan loss reserves for its loans. To further ensure its safety, the public bank's cost savings will allow it to build additional loan loss reserves, above and beyond those maintained by private commercial banks.

Question 2:

How will the public bank ensure that lending for community development does not present undue levels of risk?

Answer:

The public bank's portfolio will include two main forms of lending: (#1) lending to entities like community banks and community development financial institutions (CDFIs) and (#2) lending through acquiring of loan participations from those entities. When the public bank lends to CDFIs and community banks (#1), it will be protected by their capital and loan loss reserves. Those reserves are substantial. When the public bank lends through participations (#2), it will benefit from the expertise of those institutions. Data analysis by our experts demonstrates that their experience in community development lending successfully controls undue risk: such lending has charge-off and delinquency rates that are similar to commercial bank portfolios. Out of an abundance of caution, the public bank will dedicate additional loan loss reserves to this type of lending. It will be able to do so through the cost savings discussed below.

For a copy of the bill, please visit masspublicbanking.org.

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Question 3:

If community development lending is not too risky, why aren't private banks filling the gap?

Answer:

There are several reasons why private banks do not provide sufficient levels of community development lending. One reason is unfounded perceptions about the “riskiness” of community lending in the banking sector. As noted above, the data demonstrates that these perceptions are unfounded. Another reason is the key role of technical assistance. An important way in which CDFIs reduce the riskiness of their borrowers is by providing them with technical assistance (TA). Banks typically don't provide technical assistance to borrowers because this increases the cost of making a loan. By supporting CDFIs, the public bank helps channel loans to the borrowers who need it but typically don't have access to bank financing. A third reason for the gap in lending is more general: in many instances, private banks simply charge more than many community development borrowers can afford. The public bank's cost savings allow it to lend sustainably at lower rates than typical bank rates, particularly for projects like affordable housing, where interest rates directly affect the affordability of the housing.

Question 4:

What are the cost savings the public bank will benefit from?

Answer:

As further detailed in the testimony, the annual savings of the public bank are at a range of 2-3% of assets, that is, \$32-\$48 million annually. That is a large amount that can be used to responsibly reduce lending rates to borrowers and build additional loss reserves. The breakdown is as follows. First and most importantly, the public bank will benefit from high operating efficiency. Unlike a private bank, the public bank will only have one depositor (the state treasurer), and its lending will be done through CDFIs and community banks. This saves the need for branching, customer service, marketing, sophisticated IT systems etc. Nearly two thirds of the public bank's cost savings will come from these lower operating costs. Second, under the bill, the commonwealth will forgo interest on deposits in the public bank and will hold its shares in the public bank at a lower-than-market rate of return. While the lower remuneration on deposits and shares in the public bank represent an opportunity cost to the state, that opportunity cost is small, at a range of \$17-\$24 million. That cost will be easily recouped through the increase in tax revenue from economic development by the public bank.

Question 5:

Will deposits in the public bank be insured by the Federal Deposit Insurance Corporation (the FDIC)?

Answer:

No. A depositor's coverage by FDIC insurance is generally capped at \$250,000 per bank. Depositors holding larger balances are not covered by the FDIC. Given that the state treasurer is the only depositor in the public bank, and the large size of its balances, deposit insurance will not be relevant for the public bank. That said, prudent risk management will protect the treasurer from any losses (see discussion above). In fact, funds held by the state bank will be more carefully regulated than balances currently held by the state in the Massachusetts Municipal Deposit Trust. The MMDT, holds about \$7 billion in state balances (2020 figures, government-wide funds, exclusive of fiduciary balances). The MMDT is not chartered as a bank (nor covered by FDIC insurance), and for that reason, is not subject to important prudential requirements that would apply to the public bank. According to the bill, the treasurer will transfer \$1.4 billion in MMDT balances to the public bank.

Question 6:

Can the public bank endanger the state's finances or jeopardize its credit rating?

Answer:

No. First, the public bank's professional management and prudential regulation by MA Division of Banks and the Fed make the possibility of failure remote. The study and modeling discussed in the testimony demonstrate that the public bank has a highly sustainable business model. Second, bank regulatory provisions mean that any losses sustained by the bank would be very limited. Bank regulators are required by law to close a bank long before its capital (the \$200 million appropriated under the bill) is depleted, a concept known as "prompt corrective action."

Finally, even in the exceedingly remote scenario where the public bank failed, its size is far too small to affect the state's finances. With assets of \$1.6 billion, the public bank will be one of the smallest banks in the state (total assets of private banks in Massachusetts are about \$350 billion). Its size will also be a tiny fraction of the state's \$104 billion in liabilities.

Question 7:

What is the size of the appropriation required under the bill?

Answer:

The only appropriation required under the bill is for \$200 million to fund the public bank's capital (in four annual installments of \$50 million). Once capitalized, the public bank is designed to be financially sustainable and not to require any further appropriations. The \$1.4 billion transfer of balances to the public bank from MMDT does not require an appropriation. It is merely a change in one form of liquidity management by the commonwealth to another.

Question 8:

Appropriations aside, does the bill have any other budgetary implications?

Answer:

Community development facilitated by the public bank will increase tax revenues. For every dollar of new economic activity, the state recoups 5 cents in income and sales taxes. One dollar of lending by the public bank could create multiple dollars in new economic activity. For example, a new small business pays new wages, the employee uses the wages for new purchases, those purchases support other entrepreneurs etc. The new tax revenue created by the public bank will considerably exceed the small opportunity cost it would involve for the state budget. As discussed in the testimony, borrowing costs on the \$200 million in capitalization for the public bank amount to about \$3 million annually in the current yield environment. Even taking a more conservative measure –the lower-than-market return the state will receive on its shares in the public bank—the opportunity cost is about \$10 million. Next, the opportunity cost of shifting the \$1.4 billion in MMDT balances to the public bank is \$14 million annually, reflecting an average 1% yield on those balances over the past decade (our cost estimates are robust to a variety of interest rate environments. We'll be glad to elaborate on this point). Even under extremely conservative assumptions, new tax revenue generated from over \$1 billion in economic activity facilitated by public bank lending will exceed the \$17-24 million in total opportunity cost detailed above. The budgetary implications of the public bank are therefore net positive for the state.

Question 9:

What is the benefit of having the public bank chartered as a bank as opposed, to say, operate as a loan fund?

Answer:

A bank charter is essential for the public bank's design. Banks have unparalleled capacity as lenders. Their business model allows them to lend at lower rates than other lenders. Most basically, banks occupy a privileged place in our monetary system. The payments system in which banks participate allows them to extend their own liabilities in the form of monetary promises, commonly known as bank deposits. Because we use deposits as money, we do not require banks to pay us a high rate on these deposits. By contrast, non-bank lenders need to fund their lending by raising expensive equity and long-term debt. Effectively, deposits allow banks to enjoy high leverage, extending eight to ten times as much in loans as their equity, and borrowing (through deposit liabilities) at exceptionally low rates. The public bank would allow Massachusetts to build on the same basic business model available to banks: appropriate a finite amount of capital (\$200 million), and then leverage that capital effectively and sustainably to support a much larger amount of lending (\$1.6 billion minus a portion used as a liquidity buffer).

Question 10:

How is the public bank different from the existing work of the quasi-publics?

Answer:

Although Massachusetts has several credit programs, there is no considerable overlap between these programs and the public bank. In some instances, the public bank will address credit needs that are distinct from those of the existing programs. In other instances, the public bank's mission is comparable to an existing program, but that program is extremely limited in its scope. In such instances, the bill authorizes and even prioritizes public bank collaboration with quasi-public entities to bolster their capacity. A few examples discussed in the testimony include:

- Mass Development's 2020 loan portfolio was only \$87 million. Its commercial loans and guarantees were a small portion of that amount, and its offering of technical assistance was limited (under \$1 million), and provided almost exclusively to cities.
- Mass Growth offers technical assistance more broadly, but its 2020 lending portfolio was only \$33 million.

The strongest testimony about the need for a collaborative approach comes from community development practitioners with decades of experience in the commonwealth. For example, Mr. Bob Van Meter, former chief executive of LISC, a CDFI, provided written testimony that "... the Public Bank will meet needs that Mass Growth Capital and other small business lenders are not able to meet alone. It will collaborate with other lenders by participating in loans and providing lower interest funds that can bring down the total cost to the borrower." The expanded funding capacity of the public bank is a product of its bank charter, a feature that the existing quasi-publics do not enjoy (see discussion above).

Question 11:

Does this proposal differ meaningfully from the postal banking model that is common in Europe?

Answer:

Yes. The public bank will not serve individual depositors, as postal banking does. The public bank is not designed to provide a public option for deposit accounts to individuals (an important issue in itself, but not one addressed by the current initiative). Its only depositor will be the state treasurer. Rather, the public bank is designed to increase access to credit to the underserved small businesses, farms, municipalities, and housing and workers cooperatives. Thus, the Public Bank would expand the financial opportunities available to underserved communities and areas. However, it would avoid the high operating costs associated with postal banking's offer of retail deposits. As explained above, these operating cost savings help to make public bank's business model highly sustainable.

Question 12:

Is the \$1.4 billion transfer from MMDT too large?

What if the state treasurer would need to use the balances deposited in the public bank?

Answer:

The \$1.4 billion transfer from MMDT was sized to be small enough to prevent interference with cash management by the treasury.

- That amount constitutes a small portion of the current balances the state treasurer maintains in MMDT (some \$7 billion, 2020 figures, exclusive of fiduciary balances).
- All MMDT balances represent “slow money” that the state treasurer set aside from funds used for daily transactional purposes. “Fast money” used for day-to-day use (e.g., payroll) is kept in commercial banks and will not be handled by the public bank. Even in the most recessionary times, the remaining MMDT balances (over \$5 billion) will be available before the state treasurer needs to use public bank deposits. In other words, the funds to be held by the public bank are the very slowest tranche of the slow money.
- Under the bill, the state treasurer enjoys flexibility to use public bank deposits during the year as long as it maintains the minimum required balance as an average over the entire year.
- In cases where the state treasurer needs to make use of its deposits, the public bank will have powerful tools to manage its short-term liquidity. Like all commercial banks, it will maintain a liquidity buffer, have access to interbank markets, and, if the need arises, to the Federal Reserve’s discount window.

Question 13:

How will the public bank fit into the local community bank and credit union landscape?

Answer:

The public bank will work in collaboration with existing financial institutions in Massachusetts to help meet currently unmet credit needs. The bill is designed to ensure that the public bank will not compete with any existing banks, credit unions, community development corporations (CDCs), or CDFIs.

- With respect to depository services, the public bank will not offer individual deposit accounts (as discussed above, its only depositor will be the state treasurer).
- On the lending side, by its very design, the loans the public bank will hold are ones commercial banks are not interested in originating.
- The public bank will work in collaboration with CDFIs, community banks, and quasi-publics. It will bolster the capacity of these institutions by offering them flexible and low-cost credit, acquiring loan participations from them, and collaborating with them in the origination of larger projects that currently go unfunded.
- The small size of the public bank reinforces its noncompetitive role as collaborator: it will only have assets of around \$1.6 billion compared to assets of \$350 billion by private commercial banks in the state.

Question 14:

How does this proposal differ from past proposals for public banking in Massachusetts?

Answer:

The current public banking bill differs from the 2010 bill in three basic ways: its goal, its size, and the deposit base of the public bank. The current bill is designed first and foremost to promote access to credit to underserved communities in the state. By contrast, the 2010 bill that sought to create a public bank to stabilize the state's macroeconomy (that bill was introduced during the Great Recession). To provide economic stabilization, the proposed 2010 bank would have needed to be very large, having \$30 billion in assets (a 2011 Boston Fed study found that macro stabilization would have been difficult even at that size). Meanwhile, the current proposal is for a far smaller public bank with only \$1.6 billion in assets, an amount scaled to the more targeted goal of increasing community development finance. Finally, the large 2011 bank would have required an equally large deposit base. Such deposit base would have required private deposits in addition to all state deposits. By contrast, the small size of the public bank in the current proposal means the deposit base can consist of a small portion of the state treasurer's MMDT balances, and will not involve balances used for the treasurer's day-to-day cash management. This feature cuts cost and dramatically reduces the operational complexity of the public bank.

Question 15:

How would the phased capitalization of the bank over 4 years work, given its reliance on future legislatures to continue the appropriation?

Answer:

The phased appropriations schedule in the bill is consistent with the recent practice of the Legislature in enacting major legislation, and follows the approach used in the 2019 Student Opportunity Act's (SOA). This approach is achieved through a two-step process. Step 1 is that the Legislature passes a proposed law (i.e. the public banking bill) scheduling multi-year appropriations that are "subject to [future] appropriation." Step 2 is that the Legislature appropriates the funding through the state budget in the appropriate fiscal year. The public bank does not present any difficulties in using this approach. Even the remote possibility of changes in the annual appropriations amount does not present special risks to the public bank. Its business operations will be built gradually and will be able to adjust to any changes.

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