Expanding the California IBank: It's Our Interest

Infrastructure Funding: California gets its funds for infrastructure largely through the issuance of tax-free municipal bonds ("munis"). For both state and local entities, muni bond issuance came to almost $100 billion in 2017. The average interest rate paid on these bonds, which had an average principal of $25 million, was 2.5 to 4.5% depending on duration [1]. About 60% of the bonds were for new projects, while 40% were to refinance previous issues to take advantage of lower interest rates. About one-third of California munis are issued for education, of which half are for K-12 and half for colleges and universities. Another third are for public works, about 10% are for hospitals and health care facilities, and the remaining 20% are for a variety of other purposes.

The Cost of Financing Infrastructure: California accounts for about 17% ($700 billion) of the $4 trillion market in U.S. municipal bonds.[2] The annual payment on these bonds at the older 3% interest comes to $20 billion, or about 8% of all California taxes. Over $1 trillion in California infrastructure projects are needed over the next decade. Financing costs, including issuance fees, interest payments at a near-term 4% rate, plus transaction fees on munis issued by commercial banks, would add another $750 billion to the tab over a typical 30-year time frame[3]. That total is at current interest rates, and interest rates are going up.

The municipal bond buyers are the wealthiest 5% seeking to lower their personal tax rate; less wealthy households pay most of the income tax, sales tax, and user fees that make up the interest payments. Municipal bonds are a form of regressive taxation, an effect that can be minimized by funding infrastructure through a public bank. A large public bank issuing $100 billion in loans at <3% interest annually over a decade could almost halve the $750 billion interest cost to California over the next decade.[4] The interest would not go to wealthy investors but would be retained by the public bank to cover costs and to expand its loan portfolio for funding more infrastructure projects.

California Infrastructure and Development Bank (IBank): The first step in demonstrating the feasibility of a larger state public bank could readily be achieved by expanding the scope of the IBank, an existing state agency. First established in 1994, the IBank is a revolving fund for infrastructure operating under the governor. It was funded five years later and detailed procedures were established for financing loans.[5] Despite limited capitalization, the IBank has grown over the past 15 years, leveraged its loans,[6] and expanded its functions.

The original function of the IBank was to provide infrastructure financings (ISRF and CLEEN loans) to local and regional entities. Its reach has been limited, however, because it became encumbered with bond debt after $277 million was removed from its balance sheet by the legislature in 2003 to repair the state budget following the dot.com market collapse. The IBank has had to issue tax-exempt revenue bonds to get the funds to issue loans. It has nevertheless succeeded in leveraging a total of $650 million in loans, of which $300 million on average were outstanding over the past 5 years. Demand for loans is high and will increase with available funding. In the past year there were 172 requests for infrastructure loans totaling over $1billion

A second function of the IBank is to serve as a conduit for state agencies, public entities, and non-profits that wish to initiate tax-exempt bonds funded as municipal bonds. A total of $37 billion of these "conduit bonds" have been issued since 1998, with sharp growth in recent years. About $1 billion in applications over each of the past two years resulted in 80% receiving funding in the form of munis.

In addition, the IBank under a new executive director[7] implemented a Small Business Financing Center (SBFC) in 2013 that provides loan guarantees through independent agencies, including CDFI banks and credit unions, for businesses and farms having difficulty obtaining loans from private banks. A total of $1.6 billion in guarantees were issued over the past five years, generating an estimated 300,000 jobs.[8]

Overcoming IBank Limitations: Besides its $361 million in bond debt, the IBank's financings and loan guarantees are currently limited by the fact that it is a "bank" in name only. Unlike depository banks with an account at the Fed, it cannot extend credit as a multiple of 8 to 12 times its tier 1 capital. In the last three fiscal years (2014-17) the IBank financed only $150 million of ISRF loans (five annually at an average of $10 million each).[8] This is a minute fraction of the $56 billion issued by local entities (2,800 bonds averaging $20 million) and the 300 bonds issued by the state (averaging $75 million).[1] In its first year or two as a depository with unencumbered capital, the IBank could increase its annual low-cost ISRF loans 10-fold to $1 billion, providing significant savings to public entities. That would fulfill the annual requests it now gets for loans. In addition, given sufficient capital to leverage loans, many if not all of the $1 billion in tax-exempt conduit bonds it currently handles also could be financed directly at lower interest rates than through publicly-issued munis. The IBank's ability to provide loan guarantees to other financial institutions also would be amplified allowing its SBFC to expand its role in supporting small businesses and farms.

Initial Steps: The IBank's capacity can be improved in 18-24 months by converting it into a depository institution with an account at the Federal Reserve. A preliminary step by the state (through PMIA) will be to invest in a 5-year revenue bond from the iBank for $500 million at the same 2.75% rate as the 5-year T-bill. This is an investment not an expense. The injection of capital would compensate for the funding withdrawal of 2003 adjusted for interest and inflation*.* The iBank can then redeem its $360 million of outstanding bonds and retain the interest expens*e.* With approval of depository status the $500 million can become interest-bearing preferred stock which together with over $400 million of unencumbered capital would become the basis for leveraging several billion dollars in loans; (b) remove two-thirds of its current costs due to interest on revenue bonds,[9] thus generating retained earnings; and (c) cover the costs of funding its transition to a depository.

Second Steps: After the bank became a depository, the State Treasury would need to add the IBank to the 8 private banks holding Treasury accounts, and should commit to depositing occasional funds sufficient to meet the liquidity requirements of the bank's expanding loan portfolio. This also would obviate the need for short-term borrowing from the FHLB or the Fed overnight windows. As it does now, the depository IBank would provide its services *only* to public entities (municipalities, counties, JPAs, pension funds) and not to individual or business clients. Public entities, including pension funds, could deposit in the IBank directly (checking, savings, money market, CD). Those with LAIF[10] or CalTRUST[11] accounts (totaling $25 billion) could allocate a percentage for deposit at the IBank. All deposits would receive competitive interest rates, while serving to maintain an appropriate loan-to-deposit ratio for making low-cost infrastructure loans to those same public clients. The IBank would be the equivalent of a credit union or mutual bank for its public clients, with its many advantages ensuring its continued growth.

Retained Earnings: Currently, financings by the IBank are at an average 3% interest rate, targeted at 15% below the interest rates for munis of comparable rating and duration. The origination and issuance fees of the IBank are also 3 times lower than loans from commercial banks. Lower interest rates mean that public entities need to recover less from the public in fees and taxes and the payout can be over a shorter term. The interest paid on deposits is going up which along with non-interest operational costs will constrain profit margins. Today the IBank's non- interest operating costs include work on loan guaranties and conduit bonds as well as the loans themselves. There also will be some costs for regulatory compliance. Even with moderate operating costs an estimated 10% of interest income will be retained earnings that can capitalize additional low-cost loans. This pilot project will prove the model for other states.

Public Support: Interest in public banks to serve individual clients and small businesses is rapidly growing across the US. In California, there is much interest in a state bank for servicing the cannabis business[12], as well as in city and county banks (Los Angeles, Napa, Oakland, San Francisco, San Diego, Santa Barbara). Critics claim, however, that even "small" city banks will require a large capital investment, have high operational costs like other retail banks, and have high risks, particularly if providing services for lower-income clients or small businesses. Private banks derive all their profitability from serving corporations, large businesses, and wealthy rather than low or middle-income clients. Fiscal analysis has not been done for proposed public banks in California that would serve retail clients. The Bank of North Dakota, the ATB of Alberta (Canada), and 25% of foreign banks are public and do serve "retail" clients.

In contrast to these public retail banks, the IBank would provide services only to a limited number of qualified municipalities and JPAs that have minimal risk of default or the need to restructure loans. An expanded IBank will entail both less risk and less cost to public entities and the taxpayers, and earnings from this cost-effective enterprise can go to expand its reach. It really becomes "our interest" and not that of the super wealthy. A depository IBank can get the backing of public officials, public employee unions, small business groups, and environmental organizations, as well as garnering the favor of proponents of a broader public bank. The depository IBank will be a test case for larger public banks (city, county, regional or state) in California, as well as for revolving funds in other states seeking lower-cost solutions to correct decades of infrastructure problems and to prevent the privatization of infrastructure. The Democratic Party Platform in March 2018 recognized this with a plank supporting legislation, now in draft form, for converting the IBank into a genuine infrastructure bank.

---

1. California Debt & Investment Advisory Commission (CDIAC)
http://www.treasurer.ca.gov/cdiac/reports/annual/2016/annual.pdf
This report summarizes loans and bonds by state and public entities subject to state reporting requirements. An update was provided in Dec 2017.
http://www.treasurer.ca.gov/cdiac/debtpubs/2017/201712.pdf

2. Private Placement of Municipal Debt: Lessons from California's Mandatory Disclosure Rule https://www.volckeralliance.org/publications/private-placement-municipal-debt-lessons-california's-mandatory-disclosure-rule#files

3. The interest alone on a muni of $1 trillion for 30 years at an effective 4% rate is $719 billion. https://www.bankrate.com/calculators/mortgages/loan-calculator.aspx

4.. A loan from a public bank having the same monthly payment as the above noted $1 trillion muni but at a 3% interest rate would generate $423 billion of interest over 25 years. That's a 41% savings but the lower costs for issuance and transaction fees, as well as staggered disbursement, would further reduce the payout.

5. The IBank was funded with $45 million in 1999. Its first executive director, Stan Hazelroth, was appointed in 2001. At that time an additional $425 million was funded but $277 million was taken back two years later leaving only $162 million. The withdrawal was due to the "dot-com" financial crisis which affected all state finances. http://www.pbs.org/wnet/blueprintamerica/reports/by-topic/growth-development/a-national-infrastructure-bank-the-state-i-bank/554/

6. The IBank was able to use existing municipal loans as collateral for issuing more loans. http://www.caeconomy.org/reporting/entry/a-new-old-way-to-pay-for-upgrades-to-californias-water-system

7. Teveia Barnes succeeded Hazelroth as executive director in 2013.

8. IBank Annual Report for 2016-2017 http://www.ibank.ca.gov/wp-content/uploads/2018/03/IBank-FY2016-17-Final-CAFR.pdf

9. Interest costs on the revenue bonds account for 65% of all costs while operating costs are 35%. The latter costs run to about 45% of the limited interest income and include costs for activities not associated with generating interest income ie conduit bonds and loan guarantees

10. The Local Agency Investment Fund (LAIF with $22 billion) operates under the State Treasury as part of its Pooled Money Investment Account (PMIA) http://www.treasurer.ca.gov/pmia-laif/laif/index.asp

11. The CalTRUST is a Joint Powers Authority for investments by public entities under CA Govt Code § 6509.7 (2016) which provides a safe harbor and holds $2.8 billion. However, the funds deposited there cannot be "leveraged" to issue municipal loans. http://www.caltrust.org

12. Cannabis is a class 1 drug like heroin, hence all related business is prosecuted. The Federal Reserve refuses accounts to any institution dealing with cannabis. Recent legal symposia from several top firms have focused on the problems. *https://cdn2.hubspot.net/hubfs/2796535/Cannabis%202.0%20&%20Federal%20Prohibition's%20Continued%20Impact.pdf?t=1525839949874*