I. INTRODUCTION

This memo outlines legal and practical issues that should be considered in deciding whether to pursue the establishment of a city-owned bank.

While there are legal arguments both for and against the proposition that the City can establish and own a bank, in light of the financial risks involved, we advise a measured and deliberate approach. This includes: 1) determining the overall purpose in establishing a municipal bank, 2) determining specific goals to be achieved, 3) conducting a detailed analysis of economic, geographic, and demographic conditions in the bank's proposed market including supply and demand analysis, 4) analyzing the feasibility of alternative banking models in light of market conditions, 5) establishing a detailed business plan that will sustain a bank's business operations, minimize risks, and achieve the stated goals, 6) remove legal impediments that would jeopardize the bank's financial health, and 7) obtain legal protections that would assure financial security.

II. Legal considerations

The Washington Legislature has not explicitly conferred upon local jurisdictions the power to create banks, nor has the State itself created one. The financial health of a municipal bank could be seriously impaired by any legal challenge to the ability of the City to establish a bank in the first instance, and by other legal challenges to specific functions that such a bank would undertake. It is in the best interest of the City to minimize risks of legal challenges and potential liability prior to the establishment of a bank. It would be imprudent to establish a bank only to have its legitimacy challenged after operations have begun, deposits have been received, loans have been made, and projects whose financing depends on the bank have been started.

A strong legal foundation either through legislation or the obtaining of competent legal authority should be established prior to embarking on an enterprise whose financial health depends on economic factors.

III. Financial Risks

The City should decide whether establishing, owning and operating a city-owned bank is financially feasible. At a minimum, beyond merely deciding that the overall purpose of a bank would be to facilitate financing for affordable housing, this includes defining specific goals to be achieved and the methods and strategies to achieve them. For example, as shown below, the risk profile differs markedly depending on whether such a bank engages predominantly in extending mortgage loans to individual residential homebuyers, or whether it engages in extending development loans for multi-family or other housing.

The Federal Deposit Insurance Corporation (FDIC) in 2012 completed a statistical analysis for the period 1984 through 2012 of community banks, which includes banks that "mainly conduct lending and deposit gathering activities within a fairly limited market area,"[1] but more notably, do not fit within the description of a non-community bank which includes, among others, the "four largest banking organizations (Bank of America Corporation; Citigroup Inc.; JP Morgan Chase & Company; and Wells Fargo & Company)."[2]

The study is helpful because it is likely that any bank established by a municipality in Washington for the limited purposes of promoting affordable housing would be similar to a community bank. Of importance is the FDIC's analysis of how specializing in certain lending areas such as mortgage lending or construction and development affected community banks' financial health and failure rates.

The study categorizes community banks into seven lending specialty groups: "mortgage specialists, consumer specialists, commercial real estate (CRE) specialists, commercial and industrial (C&I) specialists, and agricultural specialists, while the rest were categorized into a group with multiple lending specialties or a group with no lending specialty. The no specialty group was the largest group in nearly every period, and is made up of banks that are diversified lenders or that tend to have more securities and fewer loans."[3]

"CRE loans include construction and development (C&D) loans, loans secured by multifamily properties, and loans secured by nonfarm, nonresidential real estate."[4]

In general, the study found that during the study period "[c]ommunity banks in the mortgage, agricultural and no specialty groups were generally the strongest and steadiest performers over the study period, reporting lower provision expenses to assets and a lower incidence of failure than each of the other four lending specialty groups."[5]

On the other hand, "[a]t the other end of the spectrum, CRE (commercial real estate) lending specialists turned out to be the lowest-performing lending specialty group by a

[1] [1] *FDIC Community Banking Study,* December 2012, p. 1-5.
[2] *Id*., p. 1-4.
[3] *FDIC Community Banking Study,* December 2012, p. V.
[4] *Id*., p. 5-2.
[5] *Id*.

variety of measures. They trailed the average ROA [return on assets] of all community banks by one-third, and failed more than twice as often as the average community bank."[6]

"CRE specialists performed slightly better than the average for all community banks in good economic times, but performed significantly worse during the periods that coincided with banking crises."[7]

"Most notably, banks that had high levels of C&D (construction and development) loans performed significantly worse than other banks."[8]

The poor performance of commercial real estate specialists including those that engaged in construction and development loans can be attributed to the 2008 economic downturn:

> Lending strategy is an important factor in community bank success, and it proved to be especially so in the tumultuous second half of the 2000s decade. More than two-thirds of community banks entered the decade as members of one of three baseline lending specialty groups that demonstrated consistently strong performance across the study period. Nonetheless, hundreds of community banks left these baseline groups in the first half of the decade as the U.S. real estate boom was nearing a peak and pursued alternative lending strategies built on C&D or CRE lending. These institutions slightly outperformed those that remained in the baseline lending groups while real estate prices were rising. After 2007, community banks that shifted to these alternative lending strategies underperformed those that remained in one of the three baseline groups by a substantial margin, as did community banks that began the decade already engaged in the C&D and CRE lending strategies. Finally, almost 60 percent of community banks chartered between 2000 and 2005 also were engaged in the C&D or CRE lending strategies by 2005, and these institutions also generally underperformed new community banks that pursued one of the three baseline lending strategies.[9]

Regardless, "CRE specialists clearly experienced the most volatile earnings performance . . . reporting the lowest pretax ROA of any group in three intervals (1986-1990, 1991-1995, and 2006-2010), and the highest pretax ROA of any group in the other two intervals (1996-2000 and 2001-2005)."[10]

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[6] *Id*.
[7] *Id*., p. 5-22.
[8] *Id*.
[9] *Id*.
[10] *Id*., p. 5-10.

The varying performance of these banking specialties, as identified by the FDIC, has important implications for any bank that the City would seek to establish. For example restricting the bank's practice to one that is statistically stronger and more stable, such as mortgage lending may reduce the risks associated with a practice that is more volatile, such as construction and development. Both these lending specialties, however, may be methods to achieve an overall purpose of facilitating affordable housing. On the other hand, depending on the needs of Seattle's citizenry, its current supply of housing, and its projected capacity for expansion, one or more of these options may or may not be appropriate. It is therefore imperative that any effort to establish and operate a municipal bank clearly define the overall purpose, specific goals, and detailed methodology to be employed.

III. CONCLUSION

The establishment of a bank entails inherent financial risks. Legal risks also exist because the Washington courts have not addressed multiple legal issues concerning whether and under what circumstances a municipality may establish, own and operate a bank. At a minimum, the City, should it embark on such an endeavor, should strive to obtain clarity both in the law and on the financial front before implementation. In furtherance of this we recommend the following:

A. Legal clarity. The City should seek legal clarity affirming the City's authority to establish, own and operate a bank prior to establishing one.

1. Court rulings. It is unlikely that a ruling can be secured from a court prior to the City taking concrete steps to form a bank as a court will not rule, even in a declaratory action, unless there is an actual case or controversy. This places the City at a disadvantage, however, as an adverse ruling would likely result in a loss to the City in terms of investment of time, effort and planning should the city establish a bank only to lose a legal challenge.

2. Attorney General Opinion. The City could request, through one or more of its legislative representatives, an opinion from the Washington Attorney General. Such an opinion, while instructive, however, would not be binding on a court.

3. State Legislation. The City may seek enactment of legislation by the Washington Legislature authorizing and guiding the City in the establishment, ownership and operation of a bank, including the establishment of adequate safeguards.

B. A Clear Implementation Plan. The City should develop a thorough plan determining specific and tangible goals, and specific and concrete strategies to achieve those goals, including benchmarks to measure achievement. These include:

1. Determining the target constituency to benefit from the bank, its composition and magnitude, the needs of the constituency, and the desired outcomes concerning the constituency.

2. Based on the needs to be met, a determination of financial resources necessary to meet those needs.

3. A determination of how the constituency would receive the most benefit from available banking tools. For example, does the constituency need assistance in obtaining mortgages for available housing, or is there an affordable housing shortage that would require construction and development?

4. A determination of whether the needs of the constituency can be met at an acceptable risk level in employing a particular strategy.