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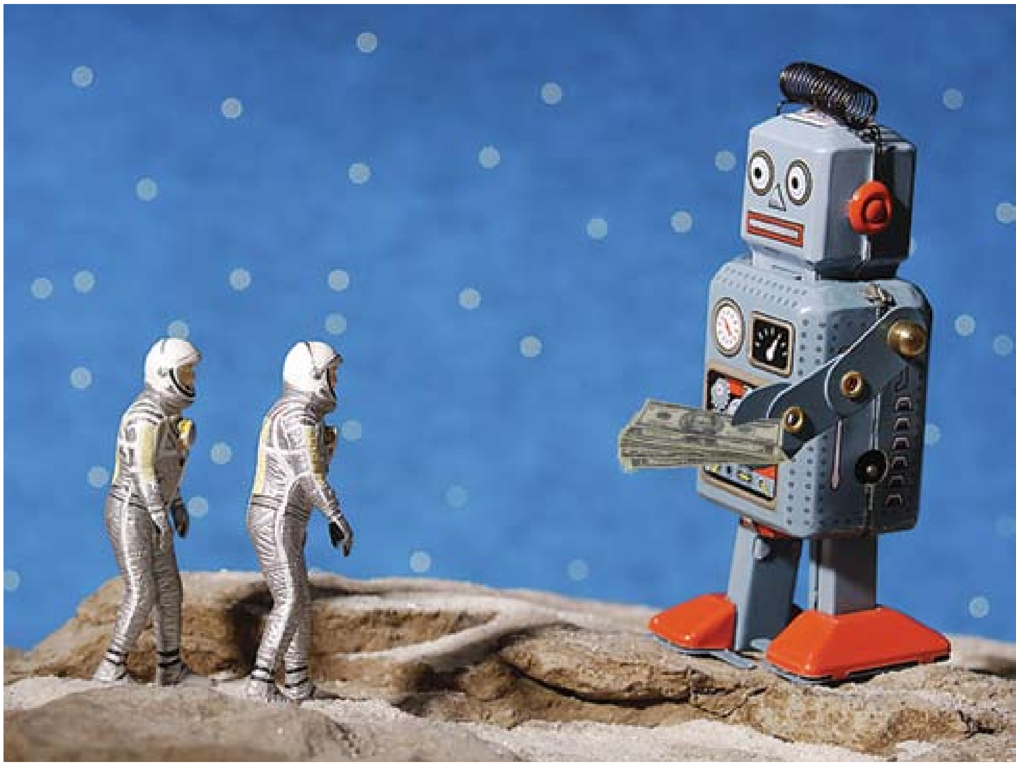
State-Owned Banks

A Relic of the Past, or the Wave of the Future?

Cover Story

State-Owned Banks

The Future of Banking or a Relic of the Past?



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According to the National Conference of State Legislatures, during the 2012 legislative session, twenty bills and resolutions were pending in fifteen states to study the issue of state-owned banks or create a state bank or investment trust.[1] The genesis of this surge appears to be the success of the only state-owned bank currently in existence: The Bank of North Dakota. In this article, your authors will: (1) consider the case for state ownership of a commercial bank using the Bank of North Dakota as the model; (2) reconstruct Delaware's tortured experience with the state-owned Farmers Bank; and (3) advocate as an alternative to state bank ownership the widespread, successful utilization of specialized funding agencies and platforms by state government, including Delaware.

The Bank of North Dakota

The Bank of North Dakota ("BND" or "Bank") might seem to be a relic. Formed in 1919, it was the result of popular consensus in North Dakota to assist the agricultural community in buying and selling crops and financing farm operations. Today, the BND operates with more than $270 million in capital and has returned some $300 million to the North Dakota's treasury over the past ten years.[2] North Dakota currently has the nation's lowest unemployment rate and a robust state budget surplus. While much of this can be attributed to the state's soaring oil production, many wonder if BND is part of this economic success.

The BND was founded by legislative mandate and charged with the mission of "promoting agriculture, commerce and industry" in North Dakota. The Bank is overseen by the North Dakota Industrial Commission, whose members include the Governor, who serves as chairman, the Attorney General and the Commissioner of Agriculture. The primary deposit base of the Bank is revenue from the state. All state funds and funds from state institutions are required by law to be deposited in the Bank. The Bank also accepts deposits from any source, including private citizens and the United States government.

While the BND has no branch offices or ATMs, it does provide small business loans and student loans, and it partners with local banks in participation loans.[3] The state's assets are used to capitalize the Bank, and unlike other banks, BND as an instrumentality of the state pays no state or federal taxes. It is not a member of the Federal Deposit Insurance Corporation ("FDIC"): rather, its deposits are guaranteed by the full faith and credit of the state. Its profits are returned to the state's treasury.[4] In the past ten years, the Bank has returned over $300 million to the state's general fund, helping to ensure regular budget surpluses and eliminating the need for drastic tax increases or budget cuts that many other states have had to confront.

Additionally, in times of natural disaster and economic distress, the BND has exhibited tremendous financial flexibility. In April 1997, Grand Forks, North Dakota faced record flooding of the Red River and major fires which caused devastation throughout the city. The Bank took unprecedented action to assist families and businesses by quickly establishing nearly $70 million in credit lines. The effort was led by the Bank's president, John Hoeven, who would subsequently serve as North Dakota's Governor and United States Senator.[5]

The Alleged Advantages of State-Owned Banks

As BND exemplifies, a state-owned or public bank can provide low interest loans to businesses and individuals in that state, provide financial flexibility, particularly in times of economic need or natural disaster, and focus its services directly on the needs of the citizens of that state. It also can serve as a significant source of revenue for a state. Many argue that a well-run state-owned bank can aid state and local governments through budget shortfalls, thereby averting impairment of government services. State-owned banks can purchase municipal bonds for infrastructure and economic development, serve as a secondary market for in-state mortgages, provide loans for income-producing projects such as transportation, energy and housing, and can make loans that commercial banks are unwilling to make.[6]

As noted above, many other states are looking to the North Dakota experiences and investigating whether a state-owned bank can help their struggling economy. In Hawaii, two bills were introduced (H.B. 1840 and H.B. 2103) to create a task force and develop legislation to establish the Bank of the State of Hawaii. Both bills passed the House, but did not appear to gain further support. Illinois introduced H.B. 2064 which would have created the Community Bank of Illinois, with a structure similar to the Bank of North Dakota. Mississippi introduced H.B. 996 to create the State Bank of Mississippi, which would, among other items, guarantee the deposits in the bank and exempt such deposits from all state, county and municipal taxes. Two states close to home, Maryland and Virginia, introduced legislation and resolutions (H.B. 1258 and H.J.R. 12, respectively) that created study committees to review and evaluate the creation of a state-owned bank. It does not appear that any of the twenty initiatives gained passage in any state.

Given the apparent success of the Bank of North Dakota, are there reasons why every other state is approaching the initiative so cautiously? The answer is "yes."

The Obstacles and Disadvantages to Forming a State-Owned Bank

While the supporters of state-owned or publicly-owned banks tout the benefits to communities and state revenue, there are a number of nagging concerns with state formation of a publicly owned bank, particularly in the current financial and regulatory climate. First, a bank needs a significant amount of start-up capital. The FDIC has strong capital requirements for new banks, which must be in cash or cash equivalents. For the protection of the banking public, state and federal banking regulators impose strict, ongoing capital and surplus requirements. In the current economic climate, it is difficult to imagine how a state or other public entity would find funding to adequately capitalize a state-owned bank and therefore tie up that capital for the indefinite future. Most states that are struggling to balance budgets cannot realistically provide the type of funding that would be necessary to adequately capitalize a state-owned bank, with or without adherence to FDIC capital requirements.

Second, the United States has a comprehensive state and federal regulatory system in place to ensure the safety and soundness of banks, and the protection of consumers. With a state-owned model, what entity provides that regulatory oversight and consumer protection? As Delaware well knows, and as discussed infra, if the bank is influenced by elected or other state officials, it is possible politics will influence the bank's mission and operation to the detriment of both its customers and taxpayers. Additionally, using the BND model, if a state-owned bank is not required to be a member of the FDIC, what assurances are given to customers that their deposits are safe and secure, or that the bank is adequately capitalized? While BND is backed by the full faith and credit of the state, one could presume that by the time a state-owned bank's capital position is impaired, the demands on the state's resources would trump the economic interests of the depositors

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Third, this country has developed a robust and sophisticated banking system, where customers have access to large national and regional banks, local community banks, credit unions, mortgage banks, trust companies and credit card banks. All of these institutions are highly regulated and operate in the commercial marketplace. Despite protests to the contrary from its proponents, state-owned banks compete with these private institutions on an unlevel playing field, one on which the state-owned bank has access to a guaranteed stream of substantial deposits (to wit, the requirement that all state funds be deposited there), is exempt from the payment of taxes, and is largely free from the state and federal laws and regulations which govern all other financial institutions. In short, the success of a state owned-bank is premised in no small measure on government-created competitive advantages at all levels. It makes one wonder if bank leaders in North Dakota would oppose the creation of BND if the idea were first proposed today.

Fourth, state-owned banks bring little to the table of the consumer of retail banking services. Banks in Delaware and around the country offer convenient, affordable and innovative services to their customers. Large commercial banks offer customers the ability to access branches nationwide and access sophisticated services beyond a typical deposit account or small business loan. Community banks have a personal stake in the economic growth, health and vitality of the communities they serve, particularly the small business community. In today's environment, banks offer wide access to ATMs, internet and mobile banking, seven-day branch hours, enhanced technology and a host of services and products designed to meet the needs of their customers. They also offer FDIC deposit insurance. Clearly, retail bank customers are not advantaged by a state-owned bank.

Fifth, publicly owned banks in other countries have reversed course and privatized in recent years, recognizing the benefits of private commercial banking. For example, the Commonwealth Bank of Australia was founded under the Commonwealth Bank Act in 1911. In 1990, it was converted to a public company with conventional share capital and part-government ownership. In 1991, the bank became a public company and was fully privatized by July 1996. This privatization allowed the bank to offer a full range of financial services to all Australians and furthered the bank's focus on customer service, improvements in technology and expansion of its customer base.[7] Likewise, Banco do Brasil S.A. was founded in 1808 and is the oldest active bank in Brazil, and one of the oldest financial institutions in the world. During its long history, it performed many functions that exceed traditional banking, such as issuing currency. In 1992 it was restructured as a commercial bank. Today, Banco do Brasil is controlled by the Brazilian government but its stock is publicly traded, and it operates in international markets, including the United States.[8]

Finally, a state-owned bank is, by definition, an instrumentality of the state that creates it. During favorable economic conditions, the interests of a state and its bank instrumentality are likely in lockstep, as is the case currently in North Dakota. But during times of economic stress, the landscape can shift dramatically as expectations regarding the need for greater profitability of the bank, and the pressure to assume greater risks, escalate. Witness Delaware's rueful experience in this regard.

The Delaware Experience: Farmers Bank

In 1837, the Delaware General Assembly authorized the State's purchase of 40% of the common stock of Farmers Bank ("FBD"). Thereafter, the State would utilize FBD as the exclusive depository for state funds, and rely upon it for a variety of accounting and even tax collection functions. Over time, the state's ownership increased to 49.8% of FBD, which, when combined with staggered voting for directors, assured the state of effective control. This marriage survived, largely without incident, for almost 125 years.

Beginning in the early seventies, as interest rates ballooned, and the economic fortunes of the state faltered, there was mounting pressure on FBD to realize progressively greater yield on its loans and investments in order to offset the sky-rocketing rate of interest payable on the Bank's deposits. What transpired thereafter brought FBD to insolvency. Enter an urbane Connecticut banker named Ed Danforth, who had an appetite for risk. Enter a fraudulent commercial mortgage operation out of Virginia (Bell Mortgage Corp.). Enter two FBD loan officers who, after being wined and dined in Florida, and given the promise of a discount mortgage, increased the amount of critical lines of credit for certain of the Bell Mortgage principals. Enter a Delaware bank commissioner who, while considering and later approving a controversial branch application requested by FBD, received a loan from a New York bank that FBD arranged.[9] All were indicted, and many of those individuals were convicted and sent ot prison. Said the FDIC in 1976 report which chronicled FBD's descent into insolvency:

> "Almost every facet of good banking practice was violated or neglected, and the results were inevitable."[10]

Delaware had little choice but to attempt a bail out of its bank. After negotiations with the FDIC, Delaware had to purchase a new class of FBD preferred stock (resulting in its ownership of 83.8% of FBD) for $20,000,000, as a quid pro quo for the FDIC's purchase of $40,000,000 in non-performing FBD debt for $32,000,000. But the deal was not sufficient to save FBD: In 1977, the Delaware General Assembly passed emergency legislation authorizing the distress sale of FBD to Girard Bank of Philadelphia. The State (and many prominent Delawareans) lost most of its investment.

In a presentation to a Delaware Bankers Association luncheon in 2005, your authors stated that the lesson to be learned from the Farmers Bank debacle is this: "NO STATE SHOULD OWN A BANK." We Delawareans should embrace this lesson with equal vigor today, the present success of the Bank of North Dakota notwithstanding.

The Better Course: Targeted State Funding Platforms

The remarkable thing is that the better alternative to state-owned banks already exists in well-established abundance. At least 32 states (including North Dakota)have established and capitalized special loan, grant and hybrid funding authorities that target many if not most of the unique business funding needs in their states: small business start up and expansion, job creation through relocation incentives, Brownfields remediation grants, mezzanine financing and equity positions. Critically, these facilities are structured to complement; rather than compete with, business funding products offered businesses by commercial banks.

The California Industrial and Commercial Bank, originally capitalized by the State of California in 1999 at $181,000,000, is often cited as the paradigm of state economic development programs, but it no more impressive or comprehensive than the constellation of funding programs available through the Delaware Economic Development Authority ("DEDA"). DEDA and its Council on Development Finance offers direct and indirect loan programs, targeting small business start up and expansion, loans and grants to businesses who commit to locate and create jobs in Delaware, matching grants for Brownfields remediation and equity investments. With an infusion of $30.4 million in the Fiscal Year 2011 Bond Bill, the total assets of the Delaware Economic Development Authority soared to $112.7 million as of June 30, 2011.[11] And, while net charge offs by the Authority have averaged .25% (as against 1.82% for FDIC-insured banks' industrial and commercial loans), the Authority is in a unique position, legally and by virtue of its capital and organizational structure, to take loan risks that are outside the bounds of commercial bank underwriting standards but that portend a significant economic development reward for Delaware.

Despite the economic success of the Bank of North Dakota, we think states are well advised to look for alternative financial mechanisms for supporting unique funding needs in their states rather than dive into the unsettled waters of a state-owned bank.

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Notes:

1- http://www.ncsl.org (January 16, 2013).
2- See Bank of North Dakota website: www.banknd.nd.gov
3- See Bank of North Dakota website: www.banknd.nd.gov
4- CBS News, "State-Owned Banks a Blueprint for the Future?" (February 16, 2010).
5- Public Banking Institute, "An Introduction to State Owned Banks,"(www.publicbankinginstitute.org).
6- Governing, "The Case for a State-Owned Bank," (www.governing.com/columns/public-finance/col-case-State-owned bank – North Dakota) (April 12, 2012).
7- www.commbank.com.au/about-us/our-company/history.html
8- http://www.forbes.com/companies/banco-do-brasil
9- The News Journal, "Green got loan. OK's new branch," (November 20, 1976, p.1).
10- Sunday News Journal, "Report blasts Farmers' past, present leaders," (October 3, 1976, p.1).
11- Delaware Economic Development Authority, "Financial Statement for the Year Ending June 30, 2011" (the Statement for FY 2012 is in process).