Banking in the Public Interest – Keystone of a New Prosperity

A Pennsylvania Partnership Bank

Key Questions and Answers for Pennsylvania Elected Officials and Policy Makers State Treasury Staff, Bankers Taxpayers and Voters

An initiative of
The Pennsylvania Project, Inc.
2019 Edgely Rd. | Levittown, PA 19056
A non-partisan, not for profit Public policy advocacy organization

www.publicbankingpa.org
info@publicbankingpa.org
Dear Fellow Pennsylvanian,

Not so long ago, the words “banker and banking” were synonymous with prudence, probity and respectability. But say those words today, and millions of Americans react with anger and scorn.

What happened?

With the support of several administrations and Congresses of both political parties, a significant portion of the vast network of community banks that served local depositors, businesses and communities was gobbled up in the creation of the new, “money center” mega banks. This is the Wall Street banking cartel that operates through the Federal Reserve and controls the nation’s supply and cost of money and credit.

Then Washington allowed these banks to combine their banking and investment operations into the “too-big-to-fail” banks, which then gambled away the hard assets of the American people – mortgages, savings, pensions and investments.

Fraud became a business model and the “too-big-to-fail” banks failed. The American people lost many trillions of dollars of their wealth. The middle class was devastated, while the gamblers made off with their fortunes.

Nothing has changed, and the American people are awakening to the reality that the federal government has been “compromised” – as one reporter writing for the Wall Street Journal so carefully put it.

Tens of millions of dollars of annual lobbying by the banks, and now who knows how many millions of campaign contributions guarantee federal inaction. And the sources of these “legalized bribes” can now be hidden in the so-called “Super PACS.”

But America needs a sound, effective and responsible banking industry. And it is within reach.

Across the nation, support is growing for the creation of state, municipal and county “Partnership Banks,” based on the model of the hugely effective Bank of North Dakota.

We invite you to learn about Partnership Banking, and join our effort to create a Pennsylvania Partnership Bank.

Sincerely,

Mike
Mike Krauss
Chairman, the Pennsylvania Project, Inc.
A Pennsylvania Partnership Bank
Key Questions and Answers for
Pennsylvania Elected Officials and Policy Makers
State Treasury Staff, Bankers
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The following information was drawn from already published material prepared by the Center for State Innovation, Demos and the Public Banking Institute, with additional research by the Pennsylvania Project, Inc. / Pennsylvania Public Bank Project.

Q: How will a Pennsylvania Partnership Bank work?

A: Participation loans
A Partnership Bank (also sometimes referred to as a public bank, development bank, or state bank) primarily interacts with the banking community through participation loans made with community banks to small businesses, homebuyers, farmers and students. The loans help increase a private bank’s lending power and small businesses’ job creating power. A Partnership Bank can also purchase part or all of a loan after it has been issued, to help a private bank stay within its capital adequacy and portfolio balance requirements.

Direct bank stock lending
A Partnership Bank can also provide capital to private banks through bank stock loans for mergers and acquisitions, capital refinancing, or capital expansion.

Infrastructure funding
Partnership Banks can be a source of funding for local governments when they buy debt for infrastructure investments. Access to low cost funds from the regional Federal Home Loan Banks, along with low overhead and an emphasis on public-purpose lending, allow the bank to lend its own assets, often at lower rates than private sources.¹

The banks can also provide reliable Letters of Credit for tax-exempt bonds at lower interest rates.

Banker’s bank functions
The Bank of North Dakota (BND) acts as a mini-reserve bank for the state’s banking industry and serves the functions of a bankers’ bank — a ‘wholesale’ bank providing core services including participations to smaller banks. There are only 22 bankers’ banks in the country and a Partnership Bank could help provide community banks with lower cost,
higher quality services.\(^2\) Banks are free to continue working with private bankers’ banks—a Partnership Bank is simply another option for community banks to use.\(^3\)

**Q: How much capital is needed to start a Partnership Bank? Where would it come from?**

**A:** That depends on how much impact policy makers want the Bank to have on the commonwealth’s economy and job creation, and how soon. Of course, a Partnership Bank would need to sustain its capital adequacy, so depending on the size of state deposits that will be held at the Partnership Bank, this could drive the capital needs. It seems likely that there will be a transition stage where the Partnership Bank’s participation loan portfolio grows and there are arguments for growing the capital at a similar rate.

Ultimately, a Partnership Bank can be thought of as an economic engine that will be greatly impacted by the inflow of state deposits and reinvestment of profits into Partnership Bank capital. Center for State Innovation analysis shows that even after accounting for debt service obligations due to start-up capital, Partnership Banks in Oregon, Washington State, Hawaii and other states would be profitable in about two to three years with an actual return on equity of about seven to 10 percent per year, and could be scaled up to full operation within five years.\(^4\)

The likely sources of Partnership Bank start-up capital are a General Obligation bond issue, or other dedicated state funds, such as “rainy day” funds. The Partnership Bank will replace the rainy day fund, maintained because states and municipalities do not have ready access to lines of credit. In an emergency the state can borrow from the bank—effectively itself—at no or very low interest. This is precisely what North Dakota did in the immediate aftermath of the devastating Grand Forks Fire and Flood of 1997.

Moreover, funds in the Partnership Bank can be reliably expected to provide greater returns to the economy and treasury than rainy day funds.

In the event that the controversial privatization and sale of state owned liquor stores occurs, Pennsylvania legislators and policy makers may wish to consider capitalizing a Pennsylvania Partnership Bank in part with proceeds from the sale.

**Q: Will a Partnership Bank compete with community banks?**

**A:** No. In fact, as ‘participation lenders,’ Partnership Banks are designed to complement community banks, not compete with them. Partnership Banks are primarily banker’s banks and do not have branches. They generally do not originate business loans, take in deposits from businesses or individuals, or offer consumer banking products.
The BND Charter states explicitly that the bank is “*to be helpful to and to assist in the development of state and national banks... and not in any manner to destroy or to be harmful to existing financial institutions.”

The North Dakota Bankers Association and its member banks strongly support the Bank of North Dakota.

**Not competing over loans**
A Partnership Bank has no interest in competing for the origination or refinance of private loans, so private banks need not fear that allowing participation will lead to a loss of customers.

**Not competing for deposits**
A Partnership Bank can be prohibited from taking private deposits, as well as local government deposits. In fact, the bank can help community banks secure local government deposits less expensively through Letters of Credit. Under some proposed Partnership Bank legislation, private banks would no longer receive, or would receive fewer, short-term state deposits. But most community banks receive little or none of this money at present as states currently require 100 percent collateral or higher for these funds.

**Overall competitiveness of the banking market**
Due in part to BND’s supportive role, North Dakota has one of the lowest Herfindahl-Hirschman Indexes (HHI) for banks—a measure of market concentration—in the U.S., much lower than the HHIs of similar states such as Montana, South Dakota, and Wyoming. Despite being one of the least-populous states, North Dakota has more community banks than Hawaii, Maine, and New Hampshire combined.

No North Dakota bank has more than 10 percent of total deposits, and the two biggest out-of-state banks—Wells Fargo and U.S. Bank—actually lost market share there in the last three years.

*In contrast, since 1997 Pennsylvania has lost more than 175 banks chartered in the commonwealth - 29 in the last four years alone. The total assets of In-State Banks have declined from about $479 billion in 2007 to a little over $281 billion in 2010. Of that total, more than 90% is held by only one bank.* (Source, FDIC and the Federal Reserve)

Q: Does a Partnership Bank have to take in all state deposits?

A: No, a Partnership Bank is not required to take in all state deposits. In fact, a new bank cannot put all of a state’s deposits to work right away in productive investments, and needs a ramp-up and capital-development period of several years.
The Bank of North Dakota grew into its role over several decades. First capitalized with a General Obligation bond of $2 million—worth $23.9 million in 2011 dollars—the bank now has assets of more than $4 billion. Roughly half of BND profits are plowed back into the bank’s capital to expand its lending capacity, and the rest returned to the state’s general fund—revenue without taxation.

Q: How can a Partnership Bank guard against imprudent risk?

A: The Bank of North Dakota has stringent safeguards in place to protect taxpayers. As a result, BND has never suffered major losses from loans and has always turned a profit for taxpayers, even when losses from loans are included.

- Independent audits. The bank is audited annually by an outside firm, and biennially by the North Dakota Department of Financial Institutions. Partnership Banks operate like independent financial institutions rather than state agencies. However, BND’s outside auditor publicly presents its review of the bank’s financial condition—perhaps the only public review in the country.

- Legislative oversight. The bank is required to present its audit annually and its budget biannually to the legislative committees of the North Dakota House and Senate.

- Loan loss reserves. No loan portfolio is immune to individual loan failures, and as with other banks around the world, a Partnership Bank would have a loan loss provision and would follow prudent banking practices. Thus, even if some loans held by the Partnership Bank fail, it could not only cover its deposits, but continue to provide a profit to both the bank and the state. In 2010, BND’s loan-loss allowance was 1.79 percent, less than the 2.03 percent average at similarly-sized banks. BND’s Asset Liability committee constantly monitors loan-loss ratios.

- Capital standards. BND maintains its capital ratio at eight to ten percent for all levels of capital, higher than the Federal Reserve’s standard.

- Lending limits, underwriting standards. All loan decisions are reviewed by committee, senior management, and even the bank’s Advisory Board and governing board.

- Credit review. An internal independent department reports directly to the bank president and Advisory Board on risk ratings. In addition to being monitored by state regulators, a Partnership Bank would be required to meet external safety and soundness standards such as S&P ratings in order to maintain access to its own liquidity.

Thus even if some loans held by a Partnership Bank fail, the Bank could not only cover its deposits but provide a profit to both the bank and the state through state dividend payments. In 2009, BND showed a profit of $58 million, including loan defaults.
past decade, BND has returned an average of $30 million per year to the state general fund. Analysis suggests this would be the case in other states as well.

In North Dakota, it is the bank that has helped the state manage its risk. During the recession that followed the bursting of the dot-com bubble, BND was able to pay a special one-time dividend that helped North Dakota close a $40 million budget deficit. And the role of the bank in providing capital and partnering with community banks helped stabilize the state’s banking industry and lower the risk of bank failures in the financial crisis that began in 2008. In fact, no banks in North Dakota failed as a result of the recent banking industry collapse.

Further, a Partnership Bank is just that — a bank — and not also an investment, trading or speculation enterprise. There will be no participation in the exotic and risky “financial products” such as derivatives or credit default swaps that led to the collapse of Wall Street.

Q. Wouldn’t political interests end up forcing a Pennsylvania Partnership Bank to make bad loans?

A: No. In addition to the safeguards outlined above, we propose that in Pennsylvania as in North Dakota, the Partnership Bank will be run by a professional banking staff, not any state agency, authority or committee of the state legislature, adhering to prudent financial policies, not high risk practices.

Managers and officers will be salaried civil servants and receive no bonuses or commissions for loan volume, activity or increased profits. No officer or manager can have any “stock position” or compensation package of the kind that led to the reckless pursuit of short term profit that collapsed Fannie Mae and Freddie Mac.

The primary assets of a Partnership Bank are participation loans in which the loan originator is a private bank. This public-private partnership provides market-driven checks against manipulation by political actors.

It is important to note that the Bank of North Dakota has enjoyed the support of both Democratic and Republican administrations and legislators. U.S. Sen. John Hoeven—also a Republican former Governor of North Dakota—was President of the Bank of North Dakota earlier in his career.

Q: Won’t this just increase regulations on private banks in the state?

A: No. A Partnership Bank does not add any regulatory burden for private banks, nor is it a financial bailout to private banks, like the federal government’s Troubled Asset Relief Program. A Partnership Bank is not pushed into risky lending instruments by stockholder-
driven profit-maximization and can act as a stabilizing, market-driven force in Pennsylvania credit markets.

Q: Doesn’t Pennsylvania already have economic development programs that do these things?

A: A Partnership Bank is not an economic development program, and does not replace current state economic development efforts. A Partnership Bank can be a source of liquidity to help organize funding for projects designed by the state’s economic development agency that meet the Bank’s strict lending criteria. BND works closely with North Dakota’s economic development agency—they are housed together.14

Unlike revolving loan funds, a Partnership Bank has the power to leverage funds—ten-to-one as a rule of thumb—and can therefore increase the state’s ability to fund economic development.

The creation of a Partnership Bank may also be an opportunity, as Oregon Treasurer Ted Wheeler argues in his January 2011 letter to Oregon legislators, to “consolidate *the state+’s existing economic development funds and programs under a single roof... to better align these efforts with our objectives.”15

Q: The Treasurer of the Commonwealth of Pennsylvania already gets a good return on the commonwealth’s investments. Why change that?

A: A Partnership Bank is not a substitute for an investment manager, and we would expect that the Treasurer would retain these functions. For example, in North Dakota, BND does not manage the state pension fund investments.

Also note that deposit income does not suffer. A Partnership Bank pays the state Treasury a market-average rate for its deposits. In fact, in FY 2009-2010, that added up to an estimated $23.4 million from the interest on state deposits held at BND (along with $63.2 million in FY 2009-2010 BND profits, a total of 5.28 cents per dollar deposited).16 Compare that to the 2.53 cents per dollar that Washington State’s Treasurer received in 2009-2010 from its depository banks.17

Q: Can a Pennsylvania Partnership Bank act as the state’s fiscal agent or concentration bank? Would it be cost-prohibitive to set up that operation?

A: The Bank of North Dakota handles the functions of a fiscal agent for North Dakota and remains profitable. Partnership Banks tend to have much lower overhead than comparable private banks due to the lack of costs like branches, ATMs and marketing. Over the last 15 years (1995-2009) the Bank of North Dakota averaged an efficiency ratio
of about 28 percent, while small- and medium-sized banks in North Dakota averaged about 62 percent.\textsuperscript{18}

Once up and running, the bank costs the state nothing to operate and in fact returns money to the state. The primary difference is that while a concentration bank such as Bank of America is the only bank to benefit from state deposits, a Partnership Bank would spread the benefit to small- and medium-sized banks throughout the state through participation loans.

Q: Would a Pennsylvania Partnership Bank impair liquidity in state deposits?

A: No. Like any private bank, a Partnership Bank has to carefully manage liquidity day-to-day in order to be able to meet all its operational needs. State deposits in a private financial institution are managed so that funds are available to the state to withdraw to meet payroll and other obligations as necessary. A Partnership Bank would be no different, and the Bank of North Dakota has demonstrated over the past 92 years that it can do so capably—and still turn a profit.

Q: Isn’t setting up a Pennsylvania Partnership Bank just too complex?

A: There are more than 8,000 thousand banks in operation in the U.S. and new private banks are formed every year. This is not something never before done — like putting a man on the moon.

\textit{A Partnership Bank is more straightforward to set up than a private bank. As a ‘wholesale’ bank, it would have one location, no marketing, very little or no direct lending and a single source of deposits—the state government. A focus on participation loans also reduces the need for bank loan officers and loan brokers. Costs of operation are substantially reduced.}

Q: Isn’t the reason that banks curtailed lending 2008-2010 due to a decrease in loan demand?

A: No, it is one of several factors. While a reduction in lending during an economic downturn is in part a reflection of decreased demand for new loans—businesses holding off on expansion—much of the loan demand curve is tied directly to the cost of debt. Reacting to the excesses of Wall Street, regulators tightened their underwriting standards and increased the interest cost to borrowers, and demand for new loans naturally dropped. Center for State Innovation analysis shows that banks in North Dakota reduced lending 33 to 45 percent less than comparable states, due in no small part to the stabilizing effects of its Partnership Bank.\textsuperscript{19}

Q: Isn’t North Dakota’s economy strong not because of the state bank, but because of recently discovered natural gas and oil deposits?
A: In part. But a booming energy economy does not explain the underlying strength of North Dakota’s lending markets. The Center for State Innovation analyses compare North Dakota’s lending market against those in states with similar populations and economies: Montana, South Dakota, and Wyoming. All four states also have benefited from a boom in energy prices. In fact, Montana and Wyoming have extracted much more gas than North Dakota. But North Dakota ranks ahead on the measures that BND influences: loan-to-asset ratios, average loans per capita, quality of bank assets, HHI, and numbers of banks per capita.  

The above cited CSI analysis that explores and attempts to tease apart the economy-lending linkage a little—though obviously the two are quite intertwined—has found that BND’s support of North Dakota’s small- and medium-sized bank lending market has helped keep that market strong, independent of other major components of the state’s economic health such as the housing market and the oil and gas industries.

It is also worth noting that oil and gas production and extraction tax revenues provided $71 million to the state general fund over the 2007-2009 biennium (the statutory cap), while the Bank of North Dakota returned $60 million; thus the bank’s direct impact on the state budget surplus has been almost as great as that of the oil and gas industries.  

Additionally, while other states have had far larger energy industries and revenues for far longer than North Dakota, unemployment is substantially lower in North Dakota (it is the lowest in the nation) compared to, for example, Alaska and Texas.

In sum, the above suggests that while oil and gas revenues are certainly important to North Dakota’s economy and fiscal health, they are not the only factor driving it, and that the state’s Partnership Bank plays a major role.

But Pennsylvania is also developing substantial natural gas reserves. The revenue and jobs from the industry, combined with the broader reach of a Partnership Bank into the economy, suggests that Pennsylvania has a remarkable opportunity to create an era of sustainable and broadly shared prosperity and economic development, reaching into every county and community in the commonwealth.
Notes


3. There is room for both a healthy Partnership Bank and healthy bankers’ banks in most markets. North Dakota is an excellent example: it has both a large, healthy, and long-running Partnership Bank and a private bankers’ bank operating in the state’s credit market. In fact, the Minnesota-based United Bankers’ Bank works with community banks in North Dakota and is even a member of the North Dakota Bankers Association which is very supportive of the Bank of North Dakota. Over the last seven years, United Bankers’ Bank has more than doubled its assets and deposit base and has averaged about $2.5 million in net income while sharing markets with the Bank of North Dakota. Fargo-based Partnership Bank and Trust is another example. The bank provides correspondent lending services to community banks in North Dakota. Over the last seven years, Partnership Bank and Trust’s assets have grown by over 70 percent to over $2 billion, and profits average about $13 million per year.


6. Less than two percent of the Bank of North Dakota’s deposits come from private individuals.


8. Federal Deposit Insurance Corporation, Deposit Market Share Report (accessed April 5, 2011) http://www2.fdic.gov/sod/sodMarketBank.asp?barItem=2. Contrast these numbers with those of Vermont, another predominantly rural state with similar demographics: two out-of-state banks control 42.8 percent of deposits, and the state had only 23 institutions in 2010, compared to 100 in North Dakota.


10. FDIC insurance is unnecessary and costly for a bank that holds state deposits and has no private depositors. The FDIC’s $250,000 cap covers a tiny portion of any state’s deposits. A Partnership Bank would be closely regulated by state regulators.


17. Ibid.


