Dēmos Center for State Innovation

RESPONSE TO NEW ENGLAND PUBLIC POLICY CENTER'S REPORT: *THE BANK OF NORTH DAKOTA: A MODEL FOR MASSACHUSETTS AND OTHER STATES?*

The New England Public Policy Center (NEPPC) report "The Bank of North Dakota: A model for Massachusetts and other states?" touches on some of the key data regarding the impact of the Bank of North Dakota. Unfortunately, the report spends much of its time raising concerns—in many cases spurious—regarding the BND, rather than examining the model's potential in the state. And while the methodology of the analysis is generally reasonable, a number of assertions in the report are at best misleading and at worst, lack any foundation. Below, we look at a few of these, which we've grouped into three general objections voiced by the report: "there's no need," "it can't work here," and "it's too risky."

"THERE'S NO NEED"

ASSERTION 1. THE FEDERAL GOVERNMENT HAS ENACTED FINANCIAL REFORMS AND PROGRAMS THAT ADEQUATELY ADDRESS THE NEEDS OF SMALL BUSINESSES.

"Massachusetts policymakers would be better off studying the federal programs that have been augmented since the crisis, and then considering whether the state could adopt policies to complement the federal programs, or expand their availability locally. (Page 4)

"At the national level, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 overhauled the financial regulatory structure. New programs of the U.S. Treasury Department, and the Small Business Job and Credit Act of 2010, were also designed to remedy credit shortfalls for bank-dependent businesses. (Page 5)

"In the wake of the financial crisis, the U.S. Treasury Department has introduced two new vehicles to bolster lending to small businesses. (Page 15)

The drastic and persistent decline in bank lending to small businesses has been well chronicled (see, e.g., "Banks slashed small business lending by $43 billion," *CNNMoney*, 2/11/11; " "Lending Falls at Epic Pace," *Wall Street Journal*, 2/24/10; "Bernanke: $40B in small biz loans disappears," *CNN Money*, 7/12/10; "Small business loans lacking," *Milwaukee Journal Sentinel*, 7/19/10). The study itself notes that, despite ongoing federal programs, the needs of small businesses are not being met:

> *"In national surveys of small businesses by the National Federation of Independent Business, the percentages reporting that their credit needs were being met has fallen from a range of about 35–40 percent in the decade preceding the crisis to just above 25 percent today. (Page 14)*
>
> *"A study of small business lending in New England by the Federal Reserve Bank of Boston noted that during the financial crisis, community banks appeared to have been largely unable or unwilling to offset the contraction in the credit supply stemming from the actions of large banks.* (Page 14)

Similar surveys of small business owners in several states found that more than half said they had experienced difficulty in obtaining credit (see Direct from Main Street: Oregon Small Business Views on Credit and Lending, http://mainstreetalliance.org/wordpress/wp-content/uploads/2011/01/Direct-from-Main-St_OR.pdf; Direct from Main Street: Washington Small Business Views on Credit and Lending, http://mainstreetalliance.org/wordpress/wp-content/uploads/2011/01/Direct-from-Main-St_WA.pdf). Much uncertainty remains about the ability and political will of the federal government to remedy this situation.

Ralph Shulansky, Chairman of the Bankers' Bank Northeast confirmed as much in their 2010 annual report:

> *For the financial services industry, the past few years might well be termed an "Era of Uncertainty." Three years ago, there was doubt about the capacity of government to prevent a complete meltdown of our economy. The mega-institutions deemed to be the "drivers" of our financial system were given particular attention and hundreds of billions of taxpayer dollars were committed to the survival of the fittest of those institutions.*

There was comparatively little focus on the plight of the thousands of community banks and hundreds of credit unions facing similar problems and an uncertain future. Our national economy was fortunate to have escaped a financial disaster, which might have been worse than the "Great Depression" of 1929, but uncertainty persists and there are many issues and problems to be resolved.

Although the mega-institutions have, for the most part, evidenced a return to profitability and liquidity, the pace of recovery for smaller financial intermediaries — community banks and small credit unions — is glacial. Last year, more than 150 community banks failed and many more disappeared via merger and consolidation. To this date, late February 2011, twenty more community banks have failed.

And the Federal Reserve has telegraphed that, rather than expanding credit and lending support, it is more likely to contract it.

Eric S. Rosengren, president of the Federal Reserve Bank of Boston, said in a recent interview that the Fed had reached the limits of responsible policy. "We've done things that are quite unusual. We're using tools that we have less experience with," Mr. Rosengren said. "Most of the criticism has been that we're being too accommodative. That is a concern that we have to put some weight on." (*New York Times*, June 1, 2011)

In all, it seems clear that current federal efforts have not remedied the dearth of small business lending, nor are they likely to be expanded in the foreseeable future. As such, it makes perfect sense for states to explore policies intended to spur small business lending and hence small business job creation, including creation of a publicly-owned financial institution modeled on the Bank of North Dakota.

ASSERTION 2. STATE PROGRAMS ALREADY EXIST THAT FULFILL THE FINANCIAL AND ECONOMIC DEVELOPMENT ROLES OF A STATE BANK.

"Many of BND's lending and development roles are the responsibility of quasi-public agencies in other states. Massachusetts, in particular, has a richer array of quasi-public lending agencies than North Dakota. The largest entity, MassDevelopment, aims to promote economic growth and prosperity, and arranges tax-exempt bond issues for the benefit of private parties. Other, smaller authorities provide credit to specialized sectors that are unable to secure competitive rates in the private market. For example, the Massachusetts Clean Energy Center specializes in arranging loans to environmentally friendly technology firms, while the new Massachusetts Growth Capital Corporation focuses on small businesses. (Page 16)

This assertion fundamentally misunderstands the role of the Bank of North Dakota. The primary purpose of the BND is not to engage in economic development in the traditional form of supplying grants or loans to "specialized sectors that are unable to secure competitive rates in the private market." By engaging in participation loans with local banks, a Partnership Bank works in conjunction with the private market, strengthening partner banks and mitigating against risk from political actors. The primary functions of a Partnership Bank are listed by the study:

"BND did assist North Dakota banks through "record loan growth, letters of credit for public deposits, and a record amount of fed funds borrowed." (Page 14)

To the extent that a Partnership Bank supports a state's economic development portfolio, it has significant advantages over a simple economic development fund: it has the power to leverage the state's funds—10 to one as a rule of thumb—and helps support private banks and businesses across the lending industry. Moreover, it is important to note that North Dakota still has a full coterie of economic development programs, including the North Dakota Development Fund, Revolving Rural Loan Fund, Rural Incentive Growth Program, Childcare Loan Program, New Venture Capital Program, Entrepreneur Loan Program and Entrepreneur Center Loan Program. A Partnership Bank like the Bank of North Dakota doesn't make them irrelevant, but is simply an additional tool in a state's ED portfolio, and an added attraction for businesses considering locating or expanding in-state. For example, the Development Fund works with the Bank of North Dakota to provide funding to rapidly growing companies in the state through its New Venture Capital Program. The BND provides these companies with flexible financing through debt and equity investments.

ASSERTION 3. BIG BANKS AND BANKERS BANKS IN MASSACHUSETTS ALREADY PROVIDE THE SAME SERVICES A STATE BANK WOULD PROVIDE.

"The structure of banking markets in Massachusetts is very different from that in North Dakota. In Massachusetts, the top three banks account for nearly one-half of bank deposits, and banks with less than $500 million in deposits account for only about 16 percent of total deposits. Thus, larger private banks already exist to meet the credit and other service needs that smaller banks are unable to satisfy. (Page 17)

The "top three banks" in Massachusetts that the NEPPC report refers to are presumably Bank of America, RBS Citizens, and State Street Bank & Trust. These three account for 45 percent of the state's deposit market, according to FDIC data. Of these, only State Street Bank & Trust is based in Massachusetts.

Of these three, only the smallest, RBS, is lending at a respectable pace, with an average loan to asset ratio (LTA) of 69 percent over the past four years. The other two, accounting for just under a third of the state market, had LTA ratios of eight percent (State Street Bank & Trust does not focus on lending) and 51 percent over the past four years, both quite low. By way of comparison, BND's LTA ratio over the same period was 71 percent. Also, as detailed in the introduction, SBA lending has dropped off significantly for these big three banks in Massachusetts.

And while the NEPPC piece often speaks from a perspective of the big banks, we should note that small- and medium-sized local banks run the risk of losing depositors to these three big banks if they collaborate on participation loans (whereas a publicly run Partnership Bank could be set up to not compete for private deposits).

The NEPPC's discussion does not include this analysis, and it seems odd to argue that these "larger private banks" will meet the "credit and other service needs" of the state's businesses, including the business participation loans cited at the beginning of this section of the report, when they are not in fact lending very much at all.

The report also discusses private bankers' banks as an alternative to a Partnership Bank and implies that one would obviate the need for a participation bank. Nationally, however, bankers' banks serve less than 60 percent of the banks in those markets where they exist, according to quarterly aggregated financial data compiled by the Bankers' Bank Council. This obviously leaves over 40 percent of the banks in their banking markets unserved (It is also worth nothing that the bankers' bank market is dominated by one bank: about 30 percent of the market is controlled by TIB, headquartered in Texas.)

The bankers' bank that is positioned to serve the needs of banks in Massachusetts—Bankers' Bank

Northeast—is chartered in Connecticut and is neither a large bank, a large bankers' bank, nor an especially well-performing bank over the last few years. Recent FDIC data puts Bankers' Bank Northeast's assets at $89 million—about 0.1 percent of total bank assets of Connecticut-chartered banks. Bankers' Bank Northeast's assets also make it one of the smaller bankers' banks, accounting for only about one percent of the U.S. bankers' bank market. Over the last four years, Bankers' Bank Northeast had an average net income of $456,000, and its average LTA ratio of 21 percent reflects a fairly anemic participation loan service. The NEPPC report did not discuss any of this.

These numbers show that there is plenty of room for both a healthy Partnership Bank and a healthy bankers' bank or banks in the Massachusetts market. North Dakota is an excellent example of a credit market that includes a large, healthy, and long-running Partnership Bank and a private bankers' bank. The Minnesota-based United Bankers' Bank works with community banks in North Dakota and has more than doubled its assets to $640 million over the last seven years and averaged about $2.5 million in net income per year while "competing" with a $4 billion Partnership Bank.

In general, public institutions compete productively with private ones in a multitude of sectors: education, energy, mail service, student lending, and more. The Federal Reserve Board is in many ways a public intervention in the private financial market, but most agree that its existence is indispensible for the banking sector.

"IT CAN'T WORK HERE"

ASSERTION 4. NORTH DAKOTA IS TOO DIFFERENT FROM MASSACHUSETTS FOR LESSONS LEARNED IN NORTH DAKOTA TO HELP POLICYMAKERS IN MASSACHUSETTS.

"In 2010, BND had total assets of $4 billion and total deposits of $3.1 billion. It was comparable in size to the 180th-largest private bank in the nation, making it slightly smaller than Middlesex Bancorp (headquartered in Natick, Massachusetts). (Page 8)

"Massachusetts and North Dakota have very different demographic, labor, and banking landscapes. (Page 12)

"The structure of banking markets in Massachusetts is very different from that in North Dakota. (Page 17)

"As a result of inherent economic and geographic characteristics and its regulatory stance, Massachusetts has a greater presence of relatively large financial institutions with the capacity to fund sizable projects. (Page 18)

The Bank of North Dakota was created due to a unique set of socio-political factors in North Dakota in the early 1900's, but the modern Partnership Bank model does not rely on anything unique to North Dakota to function.

A Partnership Bank should be thought of as an economic tool—much like a private bank—where the specific loan portfolios and levels of loan loss provision will depend very much on the unique economy in which it is working in. This does not mean that the model of a publicly-owned bank that uses public capital to leverage publicly-funded deposits into publicly-held assets could not be applied in any state that didn't have—as North Dakota did in 1919—a farmer's revolt over grain prices.

ASSERTION 5. COMPARING NORTH DAKOTA TO SOUTH DAKOTA SHOWS THAT A STATE BANK HAS LITTLE TO NO EFFECT ON THE STATE ECONOMY.

"South Dakota's unemployment rate, in contrast, has been very similar to that of North Dakota throughout this period. That suggests that the presence of a state-owned bank may not be the major explanation for North Dakota's low jobless rate relative to other parts of the nation. (Page 13)

"Other indicators show that North Dakota's economy has been quite volatile, especially during the sharp swings in commodity prices in the late 1970s through the late 1980s. Measured by real personal income, North Dakota's economy has been more cyclical than South Dakota's, Massachusetts', or the nation's. (Page 13)

This argument is flawed. The report sets out to pull down a straw man, spending two pages (12-13) arguing—correctly but unnecessarily—that there are other factors besides the Bank of North Dakota at work in the North Dakota economy. For instance, the authors attribute "North Dakota's recent economic resilience to the strong performance of industries such as agriculture and energy." It seems axiomatic that a state's economy is dependent on multiple factors, including the strength of its most important sectors. As we've pointed out elsewhere:

> Economically, it is, of course, difficult to separate the health of the lending market in a state from the overall economic health of the state. Over the past two years, North Dakota has been one of the states least impacted by the recession and it is difficult, if not impossible, to know to what extent that is due to the presence of the BND as opposed to other factors. However, attempting to tease apart the economy-lending linkage slightly, analysis has found that the health of North Dakota's small- and medium-sized bank lending market has been strong independent of other major components of the state's economic health (namely, the housing markets and oil and gas industries). This provides circumstantial evidence, at least, that the BND has played an important role in supporting the state's lending market.

Our view is echoed by the President of the Bank of North Dakota, Eric Hardmeyer, in an exchange with the authors of the NEPPC report:

> *"I think that we've played a significant role in the state's recent success, but to quantify a role and tell you what that is would be difficult. But certainly to lay the success of the state's economy at our feet wouldn't be appropriate either."* (Pages 13-14)

It should go without saying that the major direct effect of a Partnership Bank—its effect on the lending market in the state—is a more appropriate measure of its impact on a state's economy. The NEPPC report touches only very lightly upon this.

The fact that North Dakota's economy is not fundamentally unique from those of comparable states such as Montana, Wyoming, and South Dakota helps us isolate the increase in lending by small- and medium-sized banks in North Dakota likely attributable to the role played by the BND. For a thorough analysis of North Dakota and multiple comparator states, see the Center for State Innovation's recently published analyses on proposed Partnership Banks in Oregon, Washington, and Maine.

ASSERTION 6. THE BANK'S CONTRIBUTION TO STABILIZING THE STATE'S FINANCES IS MINOR. MOREOVER, THIS ROLE IS IN CONFLICT WITH A PARTNERSHIP BANK'S PRIMARY AIM OF PROVIDING CREDIT TO QUALIFIED BORROWERS.

"During the past 35 years, the bank has returned roughly two-thirds of its profits to the state, on average. However, this share has been quite variable, ranging from a low of near zero in 1989 and 2000 to more than 150 percent in 1996 and 2001. Although the average share of profits that BND transfers to the state is large, the overall share of state expenditures financed by this means is fairly small. From 1971 to 2009, transfers from BND were equivalent to 0.75 percent of state expenditures, on average. The highest share—1.82 percent—occurred in 1996. (Page 9)

"As noted, North Dakota relies primarily on a separate fiscal stabilization fund to meet revenue shortfalls rather than counting on transfers from BND. The likely reason is to give BND relative autonomy in its lending decisions. A state bank that managed its activities with an eye toward optimizing its transfers to state government would likely fall short in its basic mission to provide credit to qualified borrowers to promote economic development. This point is especially pertinent in times of economic difficulty, when state coffers often drain, and a state bank would have to serve the competing goals of stabilizing state budgets and providing credit to a sluggish economy. (Page 18)

"While the government of North Dakota receives dividend-type payments from the Bank of North Dakota, it relies much more heavily on traditional fiscal stabilization funds to smooth out its overall revenue stream. (19)

The authors of the NEPPC report would be hard-pressed to find a state legislator to agree with them that a contribution amounting to one percent of all state expenditures—about $300 million in Massachusetts in 2011—is insignificant. A state institution that exists to fill a variety of roles—managing state liquidity, supporting local banks, lending to small business—and has managed to generate a profit every year according to data available since 1971 is a remarkable success. As noted in the report:

> *"These transfers have helped state government balance its budget when other revenues have fallen during recessions. During the 2001–03 biennium, the state turned to BND to plug $25 million of its $43 million budget shortfall, mitigating the need for spending cuts and tax increases.* (Page 9)

The Bank of North Dakota has demonstrated that it can return a modest but stable revenue stream that is not overly reliant on volatile credit markets.

The NEPPC report is quick to attribute North Dakota's recent economic success to the state's oil industry. However, it is 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's budget has been almost equal to that of the oil and gas industries. The NEPPC report does not discuss this. And, as noted elsewhere, there are plenty of states with strong oil industries in particular and energy sectors generally—Texas and Louisiana, to name a couple—that are not faring nearly as well economically as is North Dakota.

It is a false choice to argue—as the NEPPC report does—that a Partnership Bank cannot help stabilize lending markets and a state budget at the same time. As noted above, in the wake of the tech bubble collapse and resulting national recession, the BND returned a special one-time dividend to the state to help make up the state's budget shortfall. By all accounts this did not jeopardize the bank's role in propping up the state's lending markets in a time of crisis.

Finally, the NEPPC extends its misunderstanding of the role of Partnership Banks to a near absurd-conclusion, arguing that a Massachusetts Partnership Bank would be little more than a revenue-generating scheme similar to state control of liquor sales.

"IT'S TOO RISKY"

ASSERTION 7. BND HAS IN THE PAST BEEN A BURDEN ON STATE FINANCES.

"BND's poor performance during North Dakota's severe agricultural crisis and recession of the 1980s exacerbated the state's fiscal stress. (Page 4)

"On the other hand, financial difficulties at BND can exacerbate state fiscal problems. In the mid-1980s, bonds issued by the state to purchase BND farm loans began to sour because of difficulties in the farm sector, and state policymakers considered imposing a new tax to make up for shortfalls in debt service. BND appears to have absorbed much of the revenue loss by drawing down its capital reserves, avoiding the need for a general levy. (Page 10)

But as the report itself notes, BND was able to cover any losses with reserves and still remained profitable during the 1980s:

> *"BND has shown a profit each year, according to data available since 1971. In fact, BND has consistently produced high returns on its assets compared to similarly sized private banks.* (Page 8)

In addition, BND's 1995 Annual Report makes clear that this was a simple transfer of funds, not an emergency bank failure that "exacerbated the state's fiscal stress":

> The State of North Dakota, through the North Dakota Real Estate Trust (Trust), issues long-term bonds in 1982, 1984, and 1986, of which the proceeds were used to provide funds to The Bank of North Dakota. In connection with these bond issues, the Bank of North Dakota is obligated to purchase bonds and uncertificated obligations when there is insufficient cash flow in the Trust for payment of the bonds and interest as they become due.
>
> The 1995 North Dakota Legislature passed House Bill Number 1017 which authorizes a transfer to the Trust from The Bank of North Dakota, in the sum necessary to fund the deficit in the Trust as of June 30, 1995. In July 1995 the Bank transferred $23,157,193 to fund the deficit.

For a bank with over $1 billion in assets in 1995, a $23 million transfer is not large.

ASSERTION 8. A STATE BANK WOULD BE SEEN AS A COMPETITOR TO PRIVATE BANKS IN MASSACHUSETTS, WOULD WITHDRAW PUBLIC DEPOSITS CURRENTLY HELD IN THOSE BANKS, AND THIS WOULD NEGATIVELY IMPACT THE MASSACHUSETTS ECONOMY.

"An aggressive timetable that required the state to withdraw such deposits from private institutions would be disruptive, as it would require them to reduce their lending and investment portfolios, which would likely have a negative impact on the Massachusetts economy. A gradual phase-in would mitigate these disturbances but limit the capacity of the new bank in its startup years. (Page 19)

Most of the state's deposits are held in non-Massachusetts banks:

> *"Massachusetts state government deposits in private financial institutions total $522 million. (Page 19) ... [o]nly $2 million of the $522 million is deposited in Massachusetts-based banks. (E-mail correspondence with Henry Clay, director of investments, Massachusetts Department of the State Treasurer, March 11, 2011.)* (Endnote #61)

These out-of-state banks presumably use most of those deposits for lending outside Massachusetts, and generate profits from them that are not subject to state income tax. Thus, it seems reasonable for Massachusetts policymakers to consider whether there might be more productive uses of those deposits. The NEPPC report does not discuss this.

The report next objects that a Partnership Bank modeled on the BND would compete with private banks.

"In this market environment, existing private-sector banks would likely view a new public bank as an undesired competitor rather than a welcome partner. (Page 18)

But the report's own findings contradict this assertion:

> *"The only major area where BND actively competes with other banks is student loans. However, as a result of the Health Care and Education Reconciliation Act of 2010, the federal government will originate future student loans.* (Page 8)

ASSERTION 9. CAPITALIZING A STATE BANK WOULD BE COST PROHIBITIVE.

"Creating a state bank would entail significant startup costs. BND was capitalized initially through a $2 million bond issue in 1919. Adjusting for inflation, that amounts to a state bond issue of approximately $25 million. However, that calculation does not adjust for growth in the size of the economy between 1919 and today. Assuming a 13-fold expansion—the growth in the national economy over the past 70 years—puts the required capitalization at $325 million. Scaling up that amount to reflect the larger size of the Massachusetts economy yields a required capitalization in the range of $3.6 billion. That is equivalent to some 21 percent of the state's outstanding direct debt, and would be an especially ambitious amount of debt to issue when state finances remain under pressure. (Page 19)

In discussing the bank's capital, the report inflation-adjusts BND's initial capitalization for the passage of time, and then multiplies again by 13 to account for the "growth in the national economy." That methodology seems to run some risk of double-counting for growth in the money supply. More importantly, it begs the question of why the capital requirement of a bank would be a function of U.S. GDP. The authors then scale up again for the size of the Massachusetts economy to arrive at $3.6 billion in capital necessary to start a bank.

In the next paragraph, the report calculates that Massachusetts has, at most, $4 billion in readily-available deposits that could be moved to the bank, which would result in a nonsensical one-to-one leverage ratio.

> *"Massachusetts state government deposits in private financial institutions total $522 million. Another $3.5 billion in state funds are managed by the Massachusetts Municipal Depository Trust, an investment fund overseen by the state treasurer.* (Page 19)

An accurate way to think of capital is as a reserve account, in which the Bank holds $1 as capital for every $10 dollars worth of assets. Therefore capital needs are based on the amount of deposits (liabilities) in the bank and would be used to obtain earning assets. So, if $522 million in state deposits were eventually put into a Partnership Bank, then this would mean—at a 10-9-1 asset to liabilities to capital ratio—that the Bank could have $580 million in assets and require $58 million in capital, far less than the $3.6 billion suggested in the report. Even if the entire $3.5 billion in state funds managed by the state's Treasurer were deposited in a Partnership Bank, the bank would need about $450 million in capital—or 12 percent of the $3.6 billion figure suggested by the NEPPC.

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