The Bank of North Dakota: A model for Massachusetts and other states?

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Introduction

- Chapter 240 of the acts of 2010 reorganized Massachusetts' economic development system.
  - Key thrust was to address the credit needs of small businesses.
  - Section 180 mandated the formation of a commission to study the feasibility of creating a state-owned bank.
  - Commission required to seek guidance of president of Federal Reserve Bank of Boston or his designee.

- Since the onset of the financial crisis and recession, at least eight other U.S. states have considered creating a state-owned bank to some degree.

- Our study intended as a resource for the Massachusetts commission while also addressing the discussions outside of Massachusetts.

Outline of presentation

- Background information on publicly-owned banks, especially the Bank of North Dakota.
- Analysis of benefits of having a state-owned bank.
- Costs of starting a state-owned bank.
- Recommendations.

History and current status of state-owned banks

- Publicly-owned banks are not uncommon abroad, but nations moved toward greater privatization starting around the late 1980s.
  - 18 of 26 economically advanced nations have little or no government ownership of banks, according to the IMF.

- The formation of new state-owned banks in the U.S. was last seriously considered in the1970s.

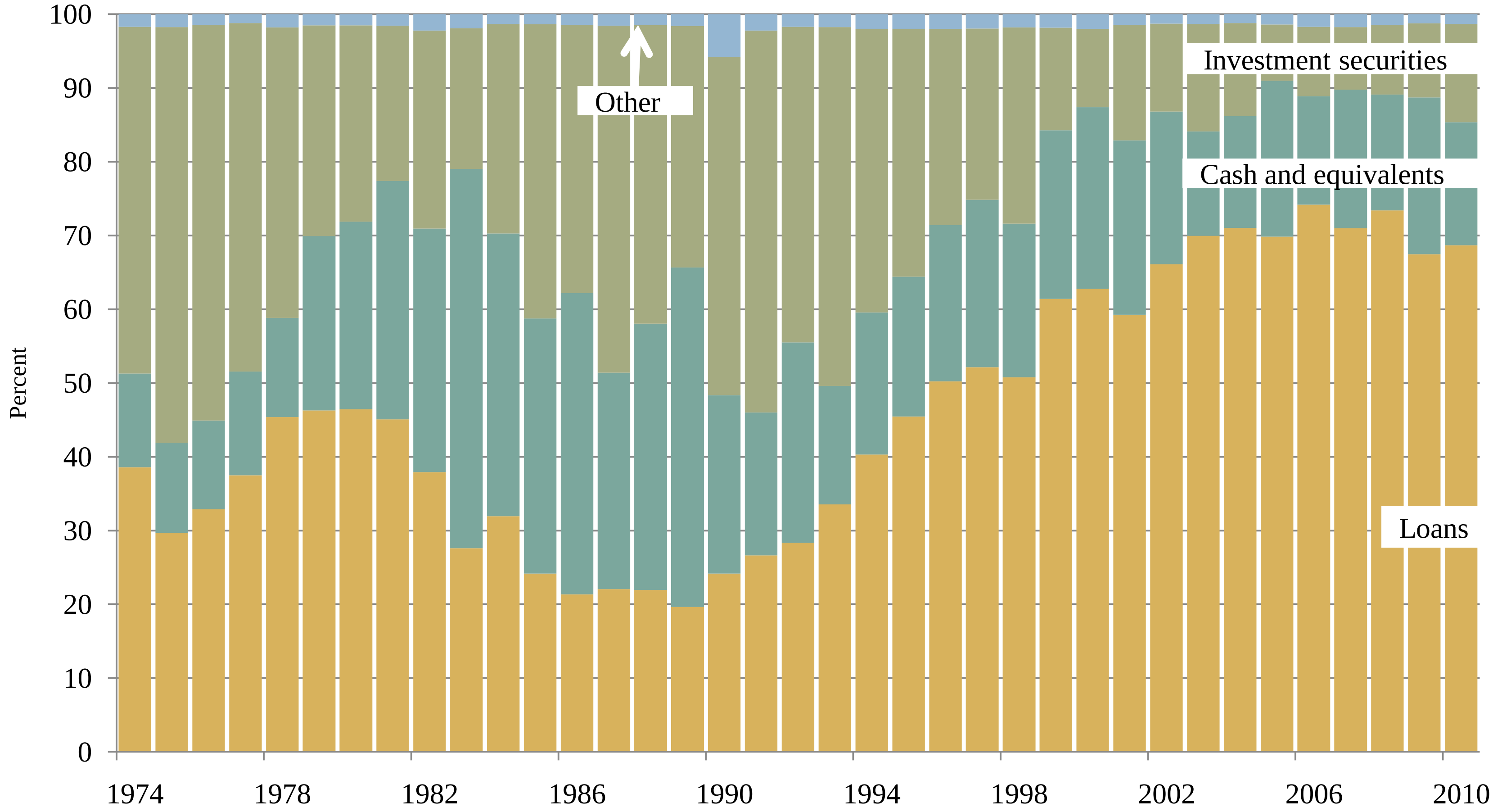
- The Bank of North Dakota (BND) is the only state-owned bank in the United States.

Brief history of BND

- BND was formed in 1919 because North Dakota farmers were having difficulty securing adequate credit at a reasonable cost.
- Its original capitalization and restrictions on operations were designed to avoid competing directly with private banks.
- BND has been consistently profitable, according to the available data.
- BND is perceived as conservative and well managed.

BND has shifted toward a greater emphasis on lending and economic development in recent decades.

Breakdown of BND's balance sheet by asset type



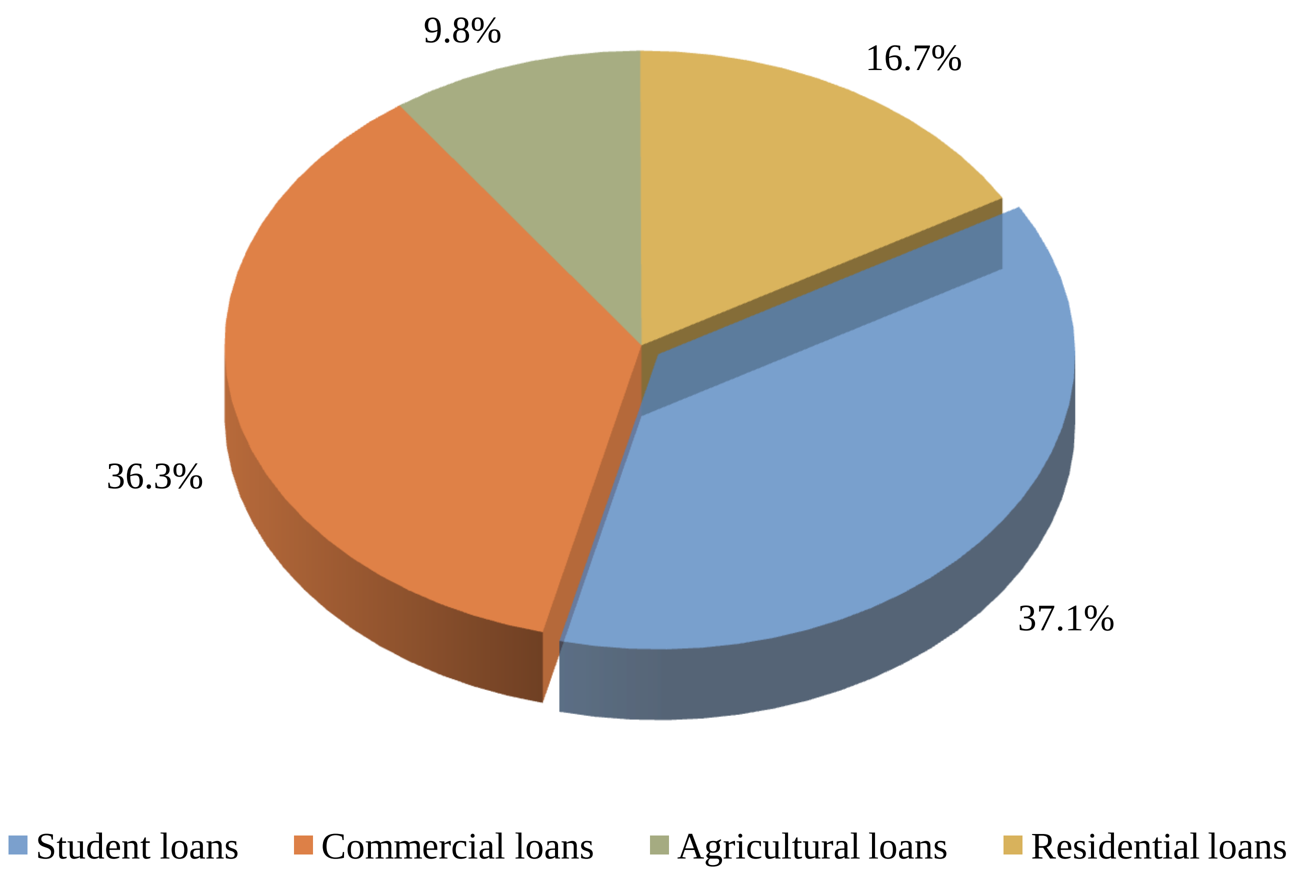
Source: NEPPC calculations, based on Bank of North Dakota, *Annual Report*, 1975-2010.

BND's current operations

- $4 billion in assets, $2.8 billion in loans.
- Accounts for 15 percent of North Dakota bank deposits.
- All state cash reserves must be deposited in BND.
- Deposits insured by state of North Dakota, not FDIC.
- Overseen by 3-member commission (governor, attorney general, agriculture commissioner).
- Budget controlled by legislature.

Student loans and commercial loans form the largest portions of BND's portfolio.

Breakdown of BND's loan portfolio by loan type



Source: NEPPC calculations, based on Bank of North Dakota, *Annual Report*, 2010.

Benefits of a state-owned bank

- Advocates commonly cite four potential benefits from having a state-owned bank:
  - Stabilizes the state's economy
  - Provides local businesses improved access to credit
  - Augments the lending capacity of small community banks
  - Helps fund state government through profits

- Our study examines the evidence and analyzes its relevance for Massachusetts and other states.

Objective: Stabilize the state's economy

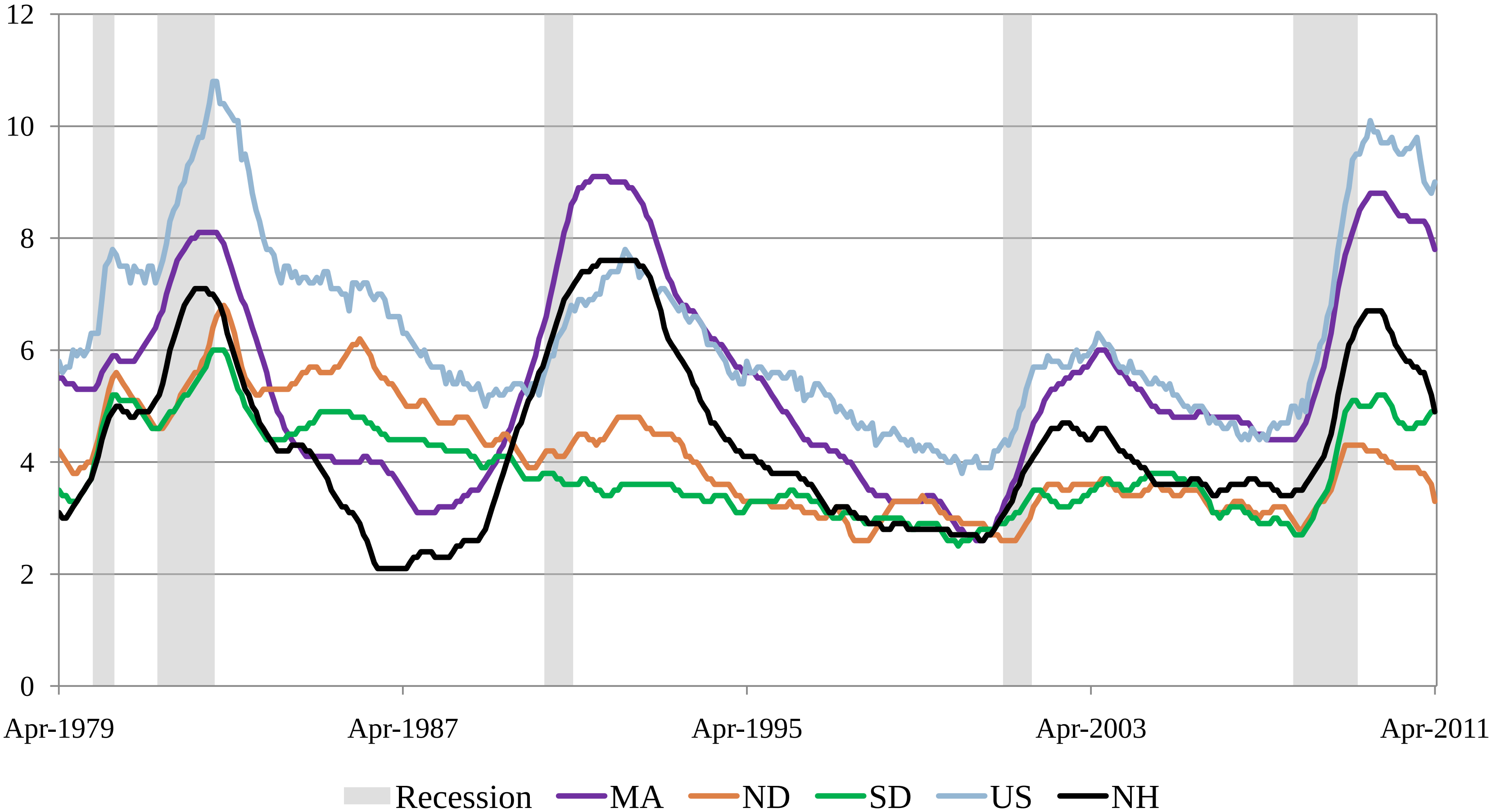
- North Dakota has fared exceptionally well during the recent national recession.
- North Dakota's overall performance is mostly attributable to oil and natural gas extraction and high commodity prices.
- *"I think that we've played a significant role in the state's recent success, but to quantify a 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."* — BND president Eric Hardmeyer

North Dakota’s economy has been volatile over the longer run.

- North Dakota economy suffered when agricultural commodity prices plummeted in the 1980s.
  - BND made only 18 loans to owners of foreclosed farmland.
- North Dakota economy has not consistently outperformed South Dakota’s.
  - South Dakota similar to North Dakota in geographic location, size, population, and industry mix.
  - But South Dakota has a very different banking structure: one private bank accounts of over two-thirds of total bank deposits.
- Implication: BND’s overall role in stabilizing the North Dakota economy seems fairly minor.

The unemployment rate in both Dakotas has historically been lower than in the nation.

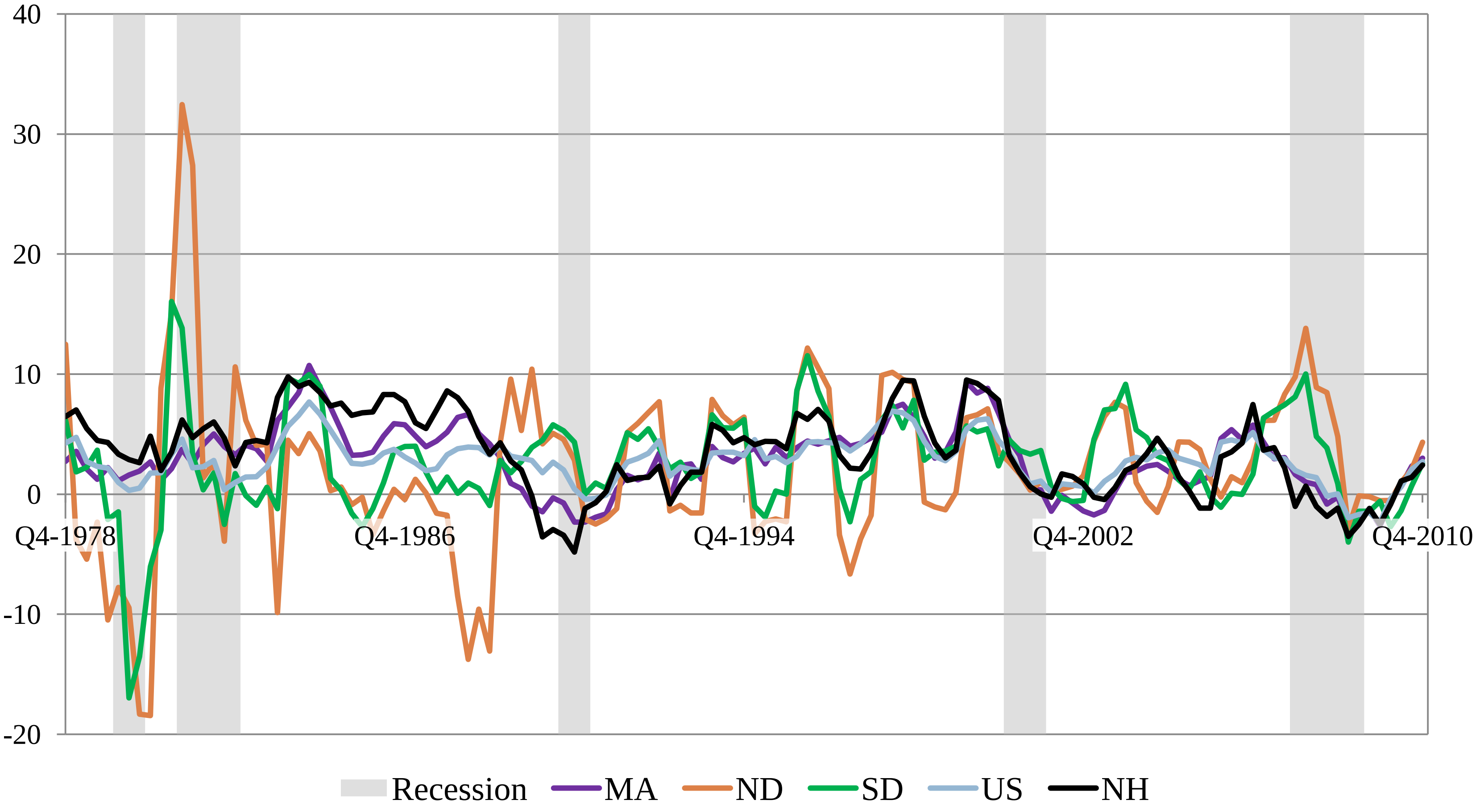
Historic unemployment rates



Source: Bureau of Labor Statistics and NBER/Haver Analytics

North Dakota has suffered from greater income volatility than South Dakota or the U.S.

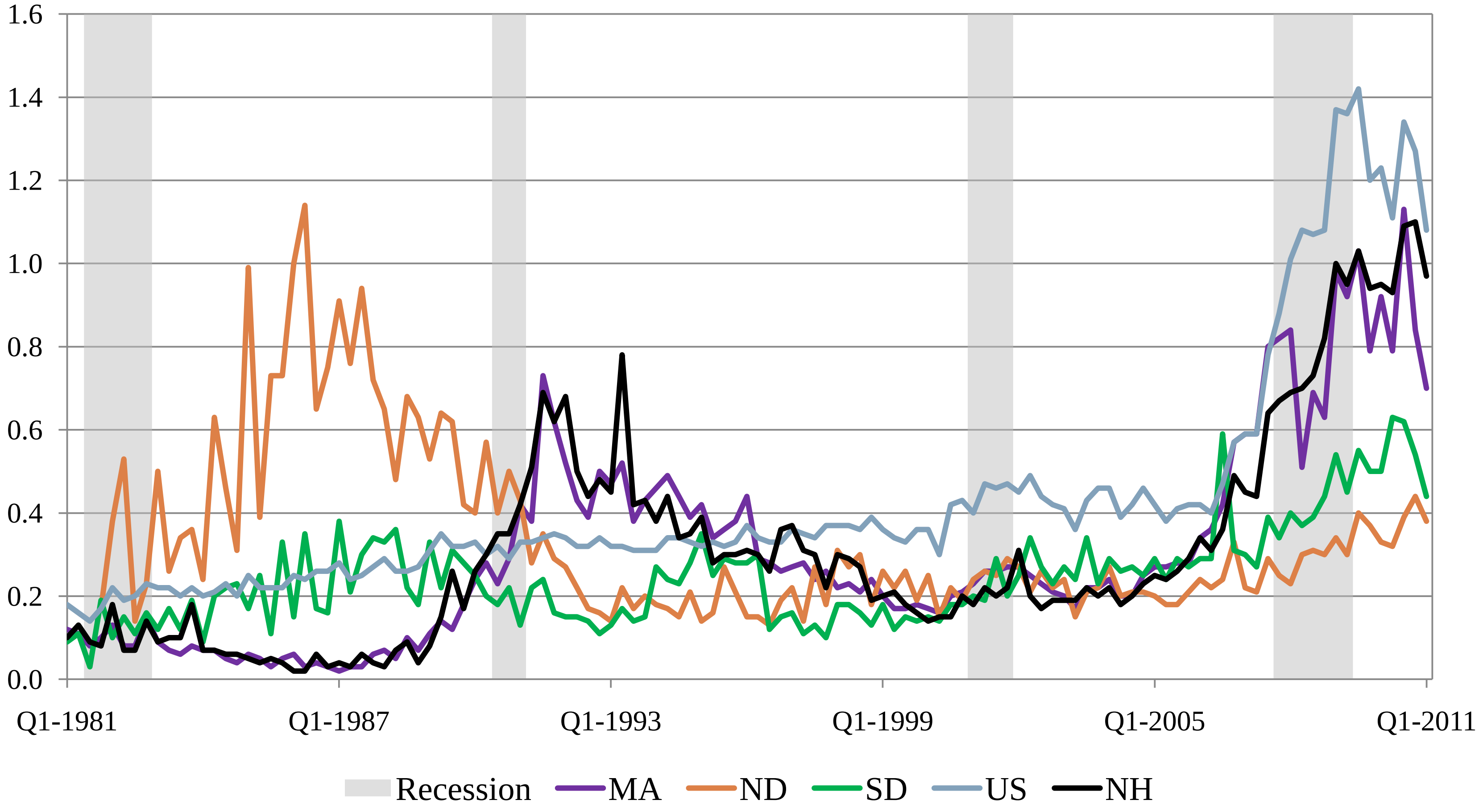
Historic real personal income growth rates



Source: Bureau of Economic Analysis and NBER/Haver Analytics

North Dakota had very high foreclosure rates in the 1980s.

Historic mortgage foreclosure starts



Source: Mortgage Bankers Association/Haver Analytics

Objective: Provide local businesses improved access to credit

- Bank lending fell nationwide during financial crisis and recession of 2007-09.
  - Small businesses found it harder to obtain credit than before the crisis.
  - Explanations include both loan supply and loan demand.

- North Dakota was less exposed to “Wall Street”-type problems than most other states.
  - Agricultural and energy sectors remained strong.
  - Small community banks account for a large share of lending.

- However, North Dakota banks had to satisfy regulatory guidance that called for comprehensive liquidity planning.

BND's willingness and capacity to serve as a liquidity backstop are limited.

- BND assisted North Dakota banks through loans, letters of credit, and federal funds market borrowing.
- However, BND viewed economic development lending as its core mission, backup credit as secondary.
  - *"We will need to consider our liquidity situation and ensure that we have adequate funding for our mission-critical programs."*— BND president Eric Hardmeyer
- And BND was wary of duplicating existing federal programs offered by Federal Home Loan Bank, FDIC, and Department of the Treasury.

Federal lending programs have been expanded further since the crisis hit.

- The Federal Home Loan Bank (FHLB) provided advances to banks, especially in the early days of the crisis.
- The Small Business Administration relaxed some of its program criteria.
- The Treasury Department has developed two new vehicles to induce greater small business lending
  - The Small Business Lending Fund
  - The State Small Business Credit Initiative

State agencies perform some of the same functions as the Bank of North Dakota.

- States have public and quasi-public agencies that fulfill similar economic development and financing objectives as BND.

- Massachusetts has a particularly rich array of such organizations including but not limited to:
  - MassDevelopment
  - MassHousing
  - Massachusetts Educational Finance Authority
  - Growth Capital Corporation
  - The Capital Access Program administered by BDC Capital

- Further reforms of state agency structure may be a viable approach to meeting small business lending goals.

Objective: Augment the lending capacity of small banks

- About 50 percent of BND's lending derives from participating in or purchasing business loans originated by smaller banks.
  - Participations enable banks to issue loans that exceed their legal or internal lending limits.
  - Purchases "free up" space on bank balance sheets and allow them to originate more loans.

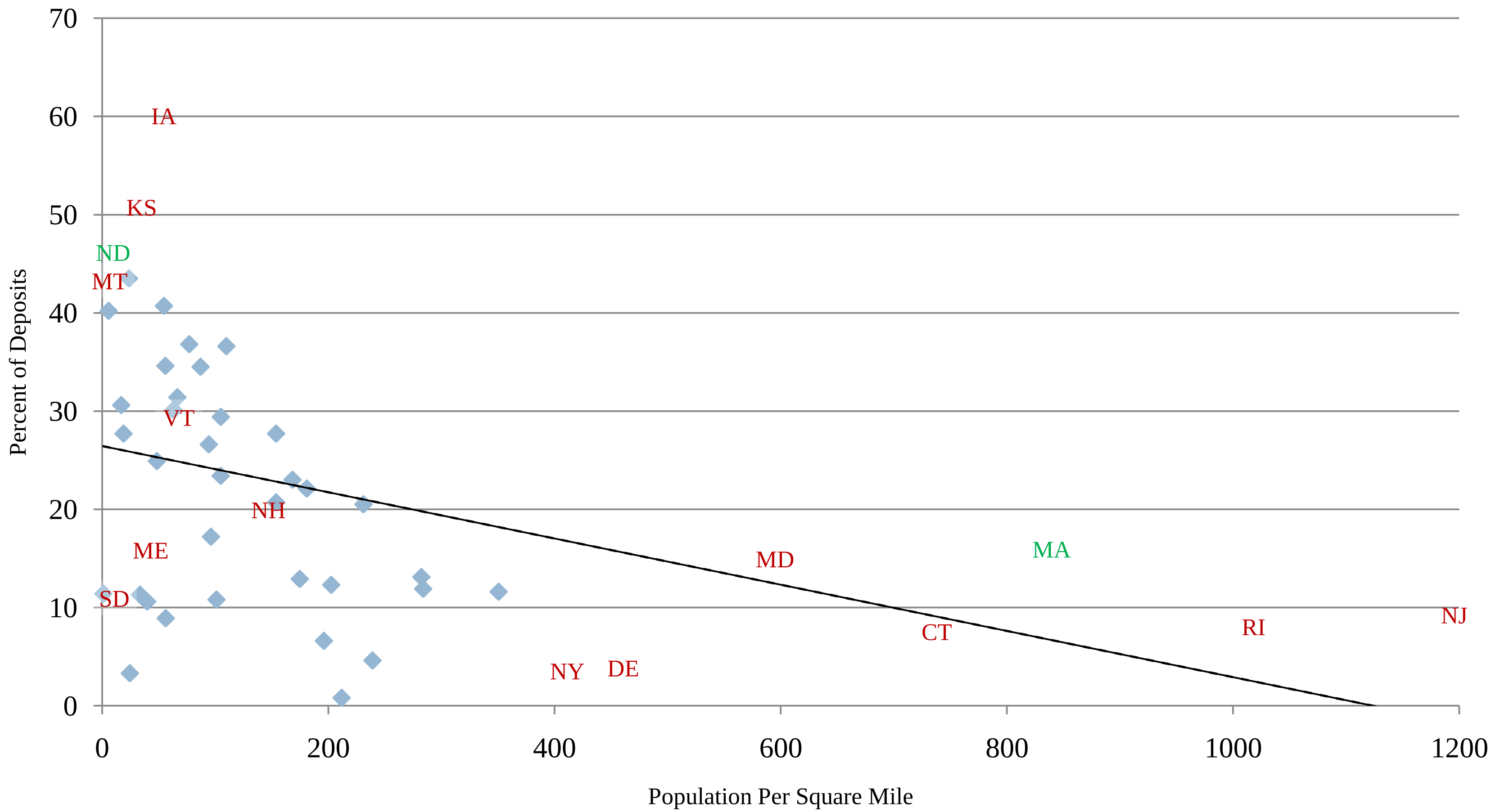
- Our study finds that serving as a lending partner for small banks in North Dakota is BND's most important current role.

Small banks account for a large share of the banking market in North Dakota.

- 46 percent of North Dakota bank deposits are held by banks with less than $500 million in deposits (versus 16 percent in Massachusetts).
- Banking market structures reflect state geographic characteristics: sparsely populated rural state vs. densely populated urbanized state.
- Structures also reflect history of bank regulation and deregulation: intrastate branching and entry of out-of-state banks.

Small banks tend to have higher market shares in sparsely populated states that deregulated late.

Correlation of deposits in banks with less than $500 million in total deposits to population density



Source: NEPPC calculations based on Federal Deposit Insurance Corporation, Summary of Deposits, 2010, Bank of North Dakota, Annual Report, 2010, and US Census Bureau

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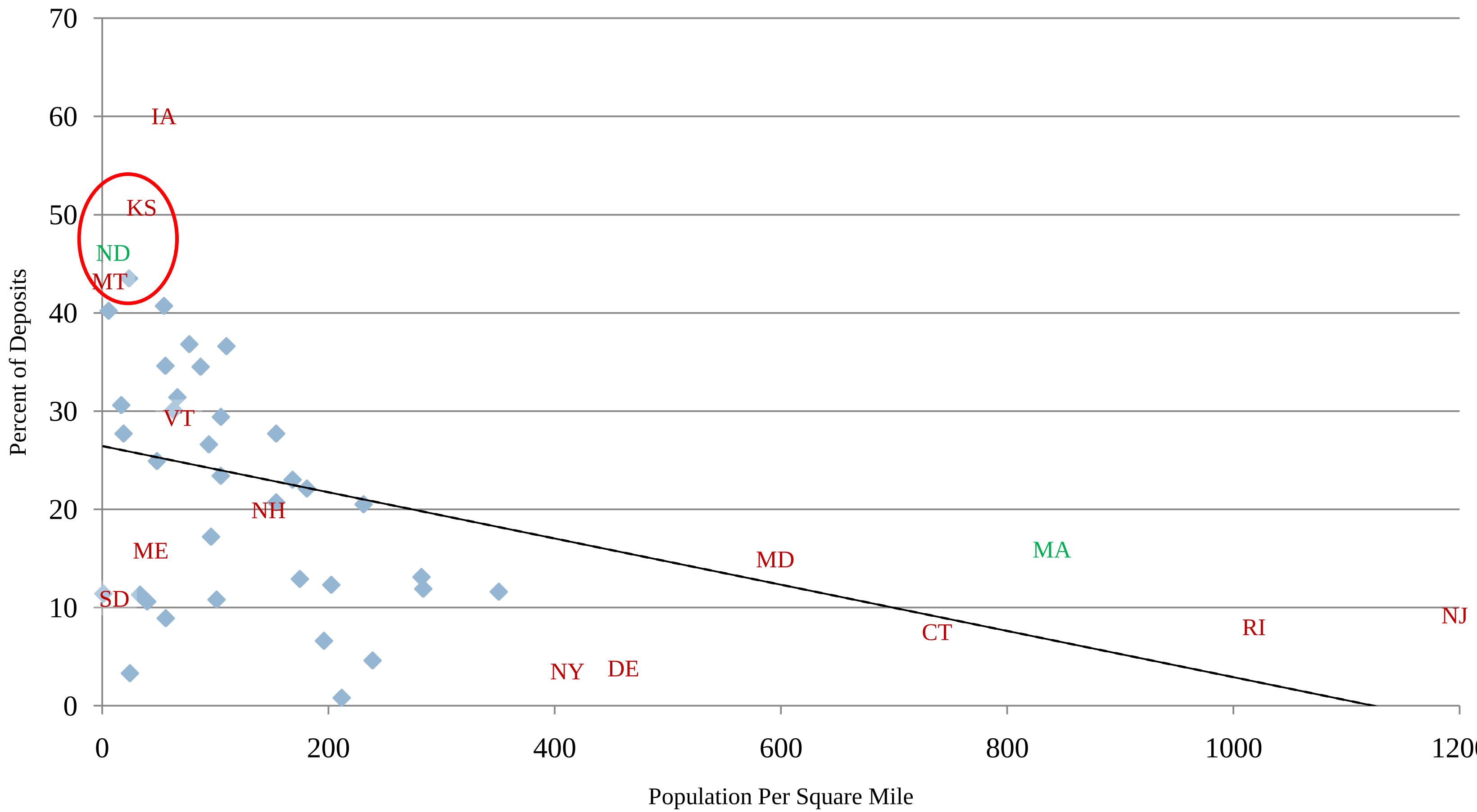


Source: NEPPC calculations based on Federal Deposit Insurance Corporation, Summary of Deposits, 2010, Bank of North Dakota, *Annual Report*, 2010, and US Census Bureau.

The North Dakota public bank model may not be appropriate elsewhere.

- Smaller banks might view a new public bank as a partner, but larger financial institutions would see it as a competitor.

- Private bankers' banks are an alternative partnership model.
  - Owned by and provide services to member institutions.
  - Exist in over 20 states.

Objective: Help fund state government

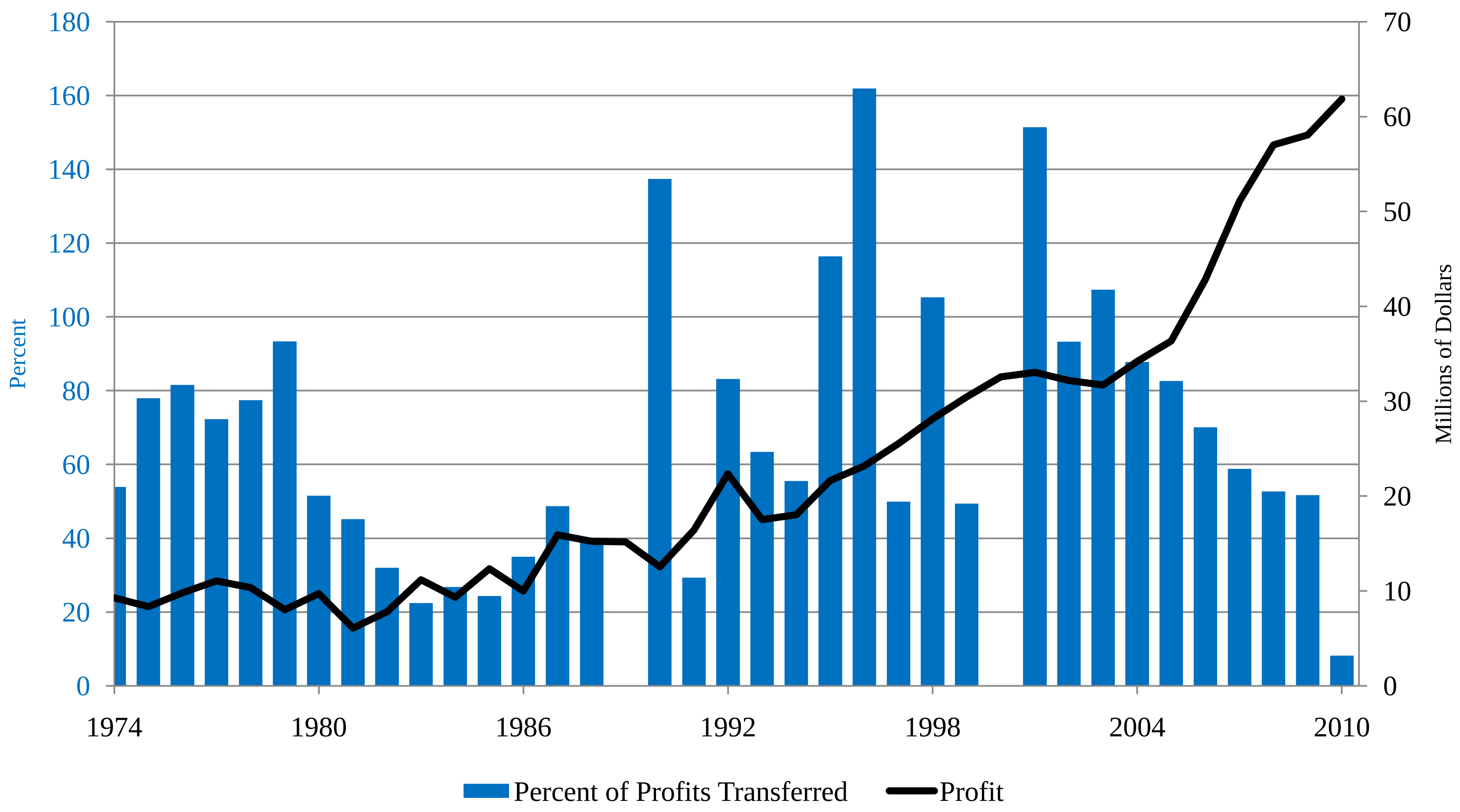
- On average, BND transfers two-thirds of its profits to the state. Amounts to under 1 percent of total state revenue and total state expenditure.

- In recent years BND has returned about $30 million per year to the North Dakota state general fund.

- BND's budgetary contribution has evolved as North Dakota has built up new and larger stabilization funds.
  - Functions more like a typical state-owned enterprise than a rainy day fund.

BND transfers to the state coffers have ranged from zero to over 150 percent of profits.

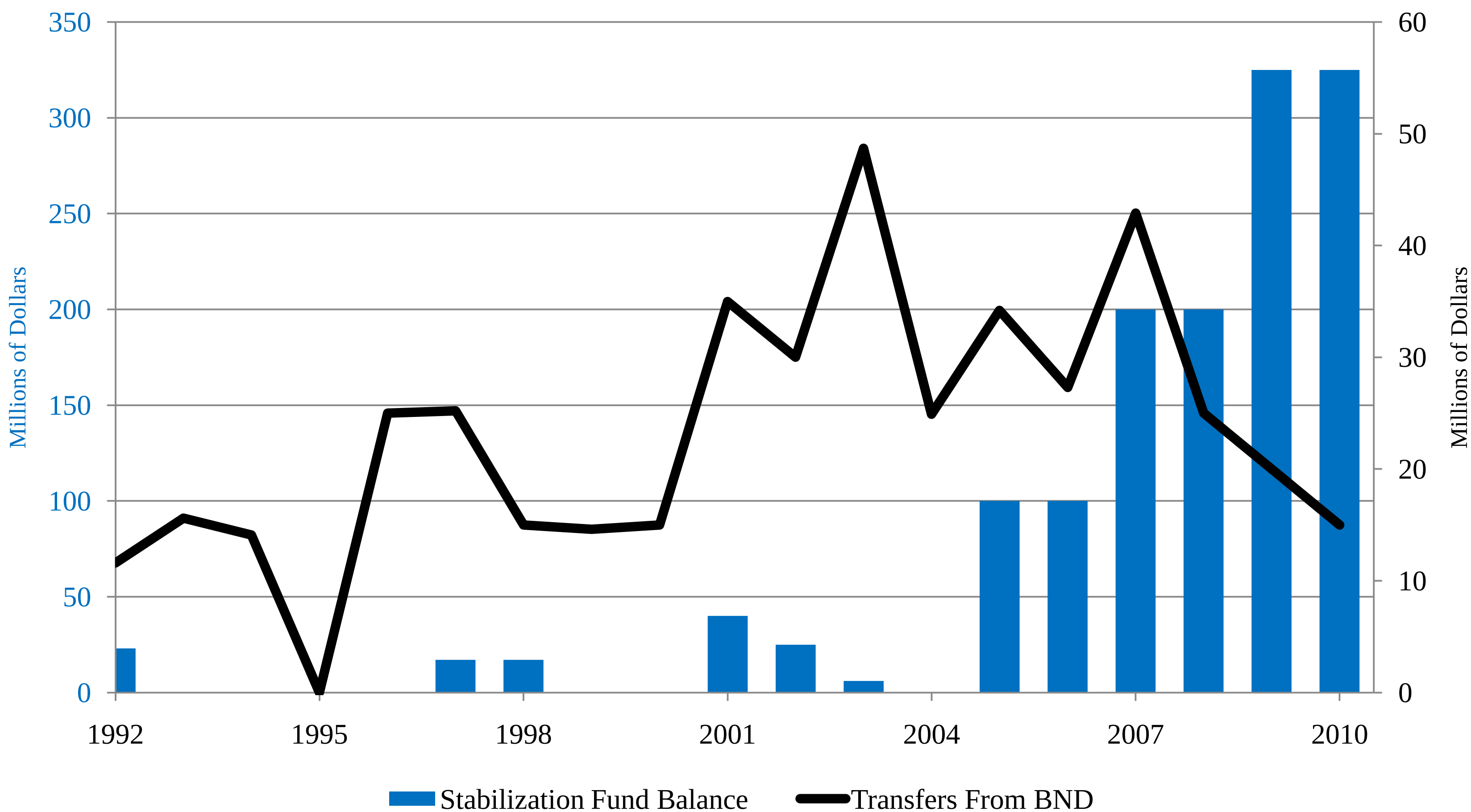
Bank of North Dakota transfers as a share of profits



Source: NEPPC calculations, based on Bank of North Dakota, Annual Report, 1975-2010

North Dakota has developed a variety of tools besides BND to respond to revenue shocks.

Bank of North Dakota transfers in relation to stabilization fund balances



Source: NEPPC calculations, based on The National Association of State Budget Officers, "The Fiscal Survey of States." Fall 1991- Fall 2010, data provided by Eileen Holwegner of the North Dakota Office of Management and Budget, and North Dakota Comprehensive Annual Financial Report, 2004 - 2010

States should not overestimate the revenue contributions from having a state-owned bank.

- Net revenues to state are less than bank transfers.
  - Foregone taxes on private banks displaced by public bank.
  - State may earn below-market interest rates on deposits.

- Revenue risks exist: State is liable for any public bank losses.
  - Bank management quality remains key.

- Transfers to state government come at the expense of building up bank capital and making loans.

Summary: Evidence on benefits is mixed.

- BND has arguably increased the lending capacity of North Dakota's small banks.
  - But is this a key objective for other states?

- The willingness and capacity of a state-owned bank to offset a serious credit crunch has not been shown.

- BND's contributions to stabilizing the state economy and finances appear to be relatively minor.

Costs of starting a state-owned bank

- Initial capital required to set up a state-owned bank could be substantial, depending on desired scale.
  - BND capitalized through $2 million bond issue in 1919.
  - Today's equivalent in MA would be about $3.6 billion, about 21 percent of state's direct debt outstanding.

- Schedule for depositing state funds would have to be worked out.
  - Aggressive schedule for withdrawing funds from private institutions could disrupt the state economy.
  - Gradual phase-in would delay any benefits of state-owned bank lending.

- Additional legal and regulatory hurdles could arise in some states.

Recommendations for states considering creating a public bank

- First identify the relevant problems.
- Then consider the degree to which a state-owned bank would address these problems, based on the available evidence and its relevance.
- Also consider alternative solutions that do not require up-front capitalization, such as reforms of public or quasi-public agencies.

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