Public (Partner) Banks and Community Banks

A public bank is a financial institution chartered by the state government and mandated to serve a public mission that reflects the values and needs of society. Public banks are run by professional bankers that are accountable to democratically selected board members and are owned by the government. Our state public bank model would act as a partner bank and support, rather than compete with local community banks.

A partner bank is a financial institution that works with local lenders to help them provide better services and interest rates to the public. In doing so, it works as a *partner*, rather than acting as a commercial *competitor*, with other lenders. The specific article within the legislation that we propose states:

"The Bank of West Virginia may not compete with local financial institutions for banking services and shall work with state agencies and local financial institutions towards the goal of expanding the number of community banks, credit unions and other financial institutions within the state to provide access to capital to promote business startups and growth, agricultural and community development and access to low cost affordable housing in this state."

The state (partner) bank *partners* with community banks in order to help them achieve their missions. It leverages the resources of the state towards supporting a diverse ecosystem of local lenders by expanding the lending capacity of these organizations.

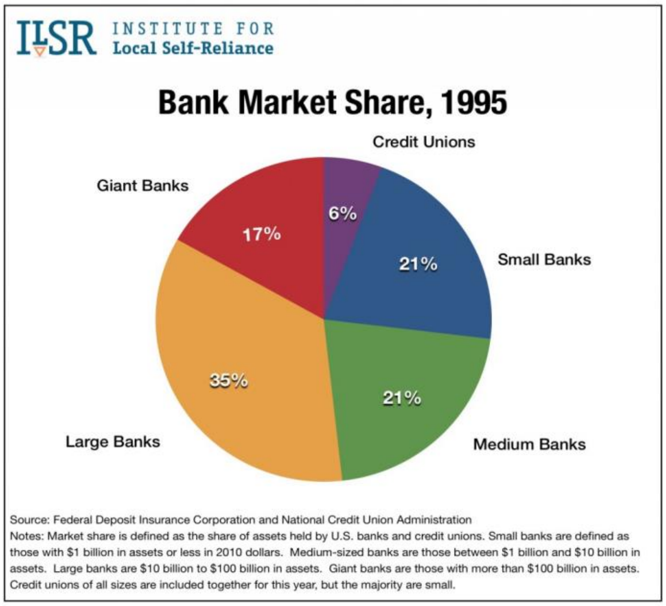
This is distinct from the commercial banks because rather than directly offering retail and commercial banking services to individuals and businesses, the partner bank *partners* with a local lender who manages the loan. The partner bank primarily interacts with these local lenders, receiving applications for loans that align with the partner bank's mission.

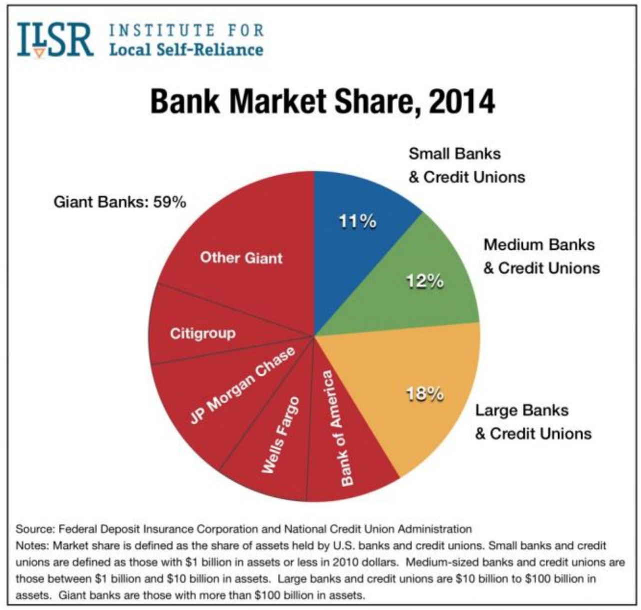
Commercial and partner banks are not mutually exclusive models — a public bank can take on aspects of both a partner and commercial bank. The legislation we propose is modeled after the Bank of North Dakota (BND), which is the only state public bank in the country. The one exception to the partner model of the BND is student loans which are directly handled by the state (partner) bank.

The BND also functions as "a kind of mini Federal Reserve." It has an Automated Clearing House system, which is the electronic back-end infrastructure for local lenders and governments to offer online deposit and payment services to their customers, as well as other "banker's bank" services.

While a partner bank like the BND does not have the central banking power of monetary policy like the Fed, it takes on the central banking function of a "backstop" for local lenders by providing them with additional cash reserves if needed to help them meet liquidity and capital requirements set by the Federal Reserve. The BND provides a range of banking services to North Dakota's government agencies and financial institutions.

Banking deregulation in the 1980s and 1990s — culminating in the repeal of Glass-Steagall in 1999 — coincided with the consolidation of the banking sector into big bank conglomerates. To illustrate this dramatic change, see the following charts from the Institute for Local Self-Reliance:





Bank consolidation has significant downstream effects on community banks and local economies. Community banks disproportionately serve rural communities, providing over three-quarters of agricultural loans and over half of small business loans in 2014, despite holding only one-fifth of total bank assets. They also meet many Americans' needs for financing education, medical debt, and residential mortgages when big banks are absent. Through this same deregulation period, community banks have lost a significant market share and overall volume in individual, small business, and residential mortgage lending markets.

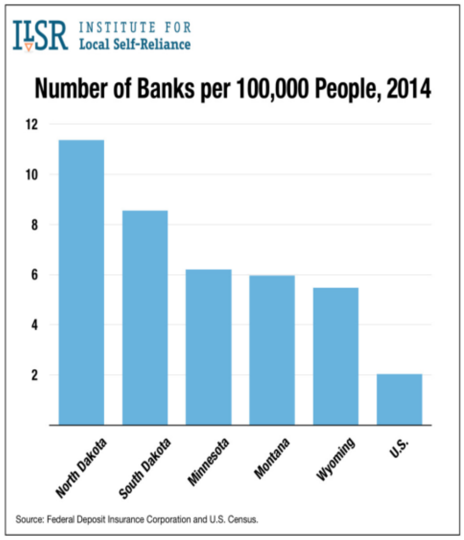
The loss of community banks has accelerated since the 2008 financial crisis. Between 2008 to 2014, about one in four community banks — 1,791 in all — closed. Community banks fared better in the crisis compared to larger banks, but Dodd-Frank — the 2010 financial regulation overhaul — imposed new regulatory barriers that were much more difficult to meet for smaller financial institutions. By imposing new barriers while neither ending the "too-big-to-fail" status of the megabanks nor reversing the repeal of Glass-Steagall, many community banks have been "squeezed" out of their market share to the benefit of the megabanks.

In terms of community banking, North Dakota has the most local banks per capita in the US. In 2014, small and medium-sized banks held 83 percent of deposits in the state, compared to the market average of 29 percent. North Dakota's lending per capita for community banks averaged $12,000 from 2001 to 2010, compared to a $3,000 national average.

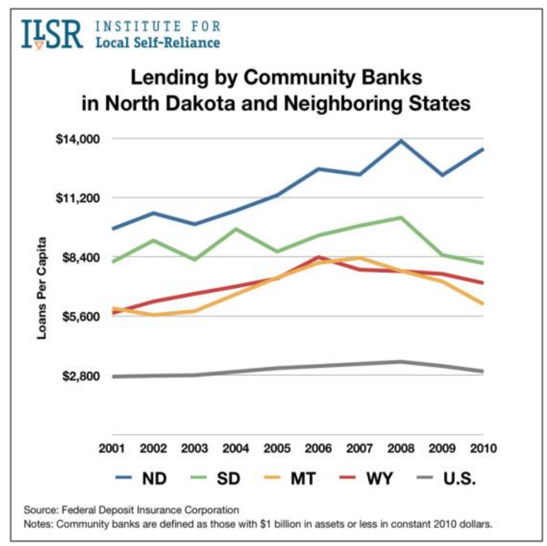
For small business lending per capita from community banks, North Dakota's rate was 434 percent greater than the national average. The loan-to-asset ratio — a measure of how much risk a bank can leverage — for the state's community banks remained higher than its neighbors and the national average, and did not decline nearly as steeply following 2008.

The evidence suggests the BND is one of the key drivers for this resilience. As Abby Rapoport of the *American Prospect* points out:

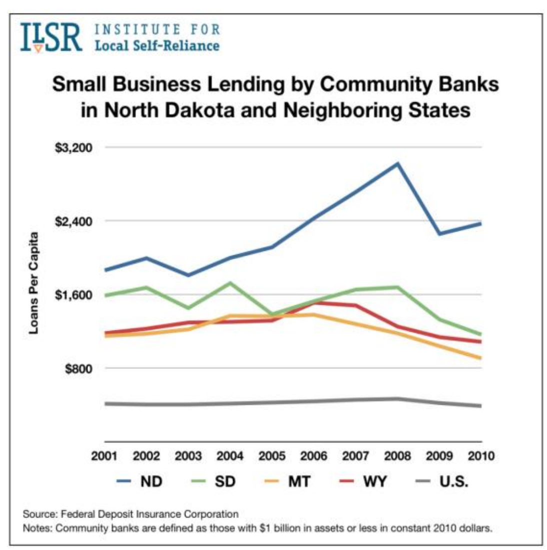
“During times of economic crisis, from the Great Depression to the Great Recession, the state bank has been essential to cushioning the blow for North Dakotans. It offers countercyclical support, meaning that in bad times, when credit starts to dry up, it plays an even bigger role in offering credit and helping struggling small banks make loans to good candidates.”



The graphs to the right on lending by community banks in North Dakota, neighboring states, and the US illustrate this point. Following the 2008 crisis, the others all had lower loans per capita, but North Dakota is the only one that returned trending upwards within a year, meaning the state’s lenders had a stronger ability to perform countercyclical lending.



These findings point to a state economy that has benefited from the utilization of a partner bank. The BND offers support for bucking the trend of bank consolidation in favor of local lenders, especially in a state that fits the geographic and economic niches of community banks: rural, agricultural, and dependent on small businesses and home ownership for wealth building. Compared to its neighbors in the Midwest with similar geographic and economic makeups, North Dakota outperforms them — and a key distinction between them is the BND.



How partner banks answer the “knowledge problem”

A partner bank combines the best of both worlds of finance: community-based lending with the capacity of large-scale financial institutions. As Ben Bernanke, former Chairman of the Federal Reserve, said in a 2011 speech to the Independent Community Bankers of America:

> *"The largest banks typically rely heavily on statistical models to assess borrowers' capital, collateral, and capacity to repay, and those approaches can add value, but banks whose headquarters and key decisionmakers are hundreds or thousands of miles away inevitably lack the in-depth local knowledge that community banks use to assess character and conditions when making credit decisions. This advantage for community banks is fundamental to their effectiveness and cannot be matched by models or algorithms, no matter how sophisticated. The IBM computer program Watson may play a mean game of Jeopardy, but I would not trust it to judge the creditworthiness of a fledgling local business or to build longstanding personal relationships with customers and borrowers."*

In other words, local lenders have a fundamental advantage in gathering information about the risk of loans to small businesses, homebuyers, development projects, and more because they can build meaningful relationships with their borrowers.

Typically, "risk" and "credit" is considered in purely "actuarial" terms: a statistical approach of assessing whether to lend or not. This misses out on the human and community aspects of risk — its counterpart, *trust*. Purely actuarial-based lending assumes zero trust because distant lenders lack relationships with borrowers and instead build risk into its profit scheme based on statistical evidence of prior lending. In contrast, local lenders are able to develop long-term relationships and trust with the communities they are a part of, giving them a much richer wealth of information when considering whether to provide a loan. This difference between actuarial and community-based lending is the reason many small business entrepreneurs, first-time homebuyers, and first-generation college students, especially from marginalized backgrounds, find themselves blocked from access to traditional capital and instead rely on local lenders. This is not to say local lenders do not have an actuarial lens to their work, but rather that they are better suited to consider the human and community elements of their loans, which is imperative for being able to finance an economy that works for the many.

When considering the risk of a loan from an actuarial lens, there are a number of components considered to determine the loan terms offered. These include:

- **Interest rate**: how much extra the borrower must pay back to the lender.
- **Collateralization**: the assets the borrower will give to the lender in the event of default. Generally, as the borrower's collateral increases, the loan's terms become more favorable.
- **Seniority**: the priority of debt collectors in the case of default, relevant for partnerships between the public bank and local lenders. A lender will generally offer better terms if given seniority.
- **Size (absolute and relative)**: how much the loan is worth both in absolute terms and relative to the lender's capacity. Generally, as size increases, the lender will offer less favorable terms.
- **Maturity**: the date when the principal - the original loan amount - is due to be paid back.
- **Operating cost**: how much it costs for the lender to administer the loan. This is covered by the profit earned from the interest.

A key component to highlight specifically for partner banks is the need to build into its risk assessment the *proportion* of the loan taken on between it and the partner lender. The smaller the proportion of the loan put on the partner bank, the more favorable the terms of its side of the loan.

This *proportion* element of risk assessment is what primarily builds the principle of partnership into the lending model of the bank. For instance, if a local lender is willing to offer 90% of a loan that is relatively large to their overall capacity, the bank can trust that the local lender has sufficient information to do so and is confident about the low risk of default, which allows the bank to offer its 10% portion at the most favorable terms possible.

For instance, take a local credit union whose members are all residents of a rural town. One of the members, Abby, would like to start a small outdoors equipment shop but lacks either the start-up capital or personal credit to get a loan from a big bank. Although she lacks a formal education in finance or business, Abby tries to borrow $50,000 from her credit union by presenting a business plan, which includes her knowledge about the local outdoors culture and how it is currently underserved by faraway Walmarts and box stores. The credit union may trust Abby and her mission, but it is still responsible for properly managing its members' deposits. $50,000 is also a large loan amount relative to their overall lending capacity. It can only offer her a loan that is either much smaller than her asked amount or has an interest rate much higher than Abby can afford.

If the state had a partner bank, the credit union could instead go to it and tell them about a promising small business loan for one of its members. They would then be able to work out a joint loan between the credit union and the public bank. Because the credit union is willing to take on the risk of Abby's loan despite her relatively large ask, the public bank trusts that the credit union has good information about the local economy and Abby's potential for success. The end result: Abby is able to start her small business, the local economy grows, the town and county's tax base increases, the credit union advances its mission, and state funds are leveraged towards local productive value rather than the extractive profits of Wall Street.

This approach answers what is known as the "knowledge problem" or the "economic calculation problem" posed most notably by economist Friedrich Hayek. It is commonly associated with criticism of "central planning", specifically in regards to state socialism, in which government administrators do not have proper signals from the market to be able to price goods, services, wages, etc. This criticism leads toward general support for markets because prices reflect the knowledge aggregated along the value chain of production.

A partner bank along the lines detailed here answers this challenge, and answers it better than the prevailing private financial institutions, because actuarial-based risk assessment done from afar, regardless if conducted by a public or private entity, is a type of central planning. It attempts to incorporate the price signals of the market into capital investment strategies for the firm but it does not have local information from the borrower themselves— decisions are based on macro-level statistical analysis rather than on the full information of the requested loan. Comparatively, local lenders have a fundamental advantage at gathering this information.

In this light, in order to overcome the "economic calculation" problem, a state-level partner bank would generally not attempt to provide direct lending to borrowers. Instead, by partnering with local lenders, it would expand their lending capacity to be able to both enter "bank deserts" and push back against traditional private financers. Rather than viewing public banks as inherently "socialist" simply because it is owned by the government, this partner bank model incorporates the best of both state and market mechanisms for aggregating information and providing financing — improving both the efficiency and equity of the financial system for communities.

How partner banks build local economic resilience

This fundamental advantage of community-based lending leads to a number of subsequent advantages.

The bank creates a diverse lending ecosystem that is more resilient to the boom-bust cycles of the global financial system. This was demonstrated by the experience of North Dakota in the wake of the 2008 financial crisis, as discussed above.

When local businesses and governments hold their deposits in Wall Street banks that engage in risky speculation, their money is susceptible to system-wide market failures. Following the mortgage foreclosures, medical bankruptcies, and small business failures of a market crash, the cycle starts over with reinvestment by the same private capital that caused the destruction to the local economy in the first place.

Partner banks do not risk the public's money by leveraging it for speculative trading. Instead, the bank supports the development of a diverse lending ecosystem that, over time, can support local economies independently of Wall Street. When the boom-bust cycle reaches its downturn, this prevents local economies from being taken down with it. Once a recession sets in, this resilient lending ecosystem can offer an alternative for countercyclical reinvestment that serves the needs of people rather than Wall Street, solidifying the strength of community wealth building organizations even further and giving them greater scale to build new local economic systems.

Virtuous economic cycles

Local lending groups are typically fellow members of a community, meaning the local lender's revenue goes towards localized operating costs (*e.g.*, local suppliers and contractors) and the salaries of people who shop at local businesses and pay taxes locally — a virtuous cycle that keeps money within the local economy. Traditionally, private finance is not place-based, meaning credit is extended from out-of-state and the profit earned on the loans is extracted from the community towards the salaries of Wall Street bankers.

This was one of the main arguments of North Dakota's Nonpartisan League when establishing the BND in 1919. The Democracy Collaborative's Thomas Hanna and Adam Simpson set the scene:

"At the dawn of the 20th century, the remote and relatively new state of North Dakota was firmly under the control of corporate interests. Heavily indebted small farmers and small businesspeople were beholden to terms set by out-of-state railroad companies and grain monopolies (both backed by big corporate banks) in order to access broader markets. The railroads in particular (which owned vast swathes of land in the state) were pernicious tax avoiders, depriving the government of desperately needed development funds…

...In 1915, former Socialist Party organizer and flax farmer Arthur C. Townley formed the Nonpartisan League (NPL), which, among other things, advocated for worker's compensation, a graduated state income tax, and public ownership of banks, mills, warehouses, insurance programs and other enterprises as a way of wresting economic power from the corporations."

Wresting economic power from distant corporations into the hands of the people is only the first step. The power of a state partner bank builds on itself over time by building a resilient diverse lending ecosystem with lenders embedded in the communities they serve. The dynamic relationship between the bank, the lenders, and the local economies is a virtuous cycle that supports one another, establishing long-term prosperity and resiliency.

Summary

To summarize:

- A state public bank is a financial institution owned and chartered by the state government, and mandated to serve a public mission that reflects the values and needs of society.
- A state public bank is run by professional bankers that are accountable to democratically selected board members and are owned by the government.
- A state public bank built on the partnership model would provide more capital backing to local community banks, thus helping them serve their community and increasing the loans that they provide and their bottom line.
- A state public bank can help shore up well managed community banks in times of financial stress (depressions and recessions) by investing in these banks to keep them from failing.
- A state public bank can act as a "banker's bank" by providing financial services such as Automated Clearing House (ACH), Direct-Cash Management, Bond Accounting, Coin & Currency, Deposit Accounts, Executive Analytics, Fed Activity Settlement, Fed Funds, Fed Funds Sweep, Federal Reserve Pass-through, Foreign Currency/Drafts, Government Security Purchases, Item Processing, Letter of Credit - Deposits (LOC), Loan Payments, Pledging Services, Repurchase Agreements, Safekeeping, Wire Transfers. (all of which are provided by the BND model).
- A state public bank, through these services, can actually increase the number of community banks, thus reaching out to underserved areas (banking deserts).
- A state public bank can help community banks build a diversified, resilient economy for our state that can persevere through the boom / bust cycles of our nation's economy.
- The one actual state public bank in our country, the Bank of North Dakota, has been in existence since 1919. It is incredibly popular politically and among the community banking associations in the state. It has weathered the great depression and the great recession, supported the community banking industry through these times and provided immediate emergency relief during times of natural disasters. It has returned over $300 million to the state's treasury over the past 10 years, which has reduced taxes and helped the people of North Dakota.

Resources

www.wvpublicbank.org – The West Virginia Public Bank Project is an all-volunteer organization committed to establishing a state public bank in West Virginia.

www.publicbankinginstitute.org – The Public Banking Institute is a national organization dedication to the public banking industry.

https://bnd.nd.gov/ - The Bank of North Dakota, chartered in 1919, is the only state public bank in the nation.

https://ellenbrown.com/books/the-public-bank-solution/ - Ellen Brown is recognized as one of the foremost banking experts in the world. Her books are some of the best resources for in depth understanding the history of money, the banking industry and public banks.