Banking & Credit in America

How Public Banks And Other Public Benefit Financial Institutions Can Rescue Our Communities And Revive Local Economies

Across America, Main Street is starving, deprived of the financial mechanisms that keep small businesses alive.

To help local economies and employment return to healthy levels, we must get capital and credit flowing to Main Streets throughout the country.

This document details a plan to do just that.

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INTRODUCTION

The U.S. economy remains mired in recession. But this recession has disproportionately affected Main Street, while Wall Street public companies have been making record profits and are sitting on large cash reserves. Capital and credit are abundantly available to them.

In contrast, Main Street is struggling to keep its head above water. Local small businesses are starving for capital (investment) and credit (loans), each for different reasons.

Since the 1930s, capital for local businesses has been virtually non-existent at the community level, due to stringent federal securities laws written on the heels of the 1929 stock market crash. Those laws and inadequate systems for addressing the needs of small businesses and local communities have made it nearly impossible for small businesses to raise capital.[1]

As a consequence, communities have been forced to rely nearly exclusively on credit to fund local economies and small businesses, credit that has come predominantly from community banks.

However, even credit has now dried up for Main Street small businesses, largely because community banks are no longer in a position to lend. This lack of credit has a more pervasive impact on a community than just making it hard on small businesses. Collectively, bank loans are the source of over 90% of all the money in circulation and without credit flowing, small businesses struggle to survive and stay afloat, and their local communities struggle as a consequence.

Unless Main Street can recover, the nation and its workers will remain in trouble. Small businesses actually employ over half of all of America's workers and generate the vast majority of net new jobs.[2]

So when credit stops flowing, money dries up across the board. Since the financial crisis began, over *$3 trillion* dollars have been withdrawn from circulation, primarily by the big banks, leaving the country with too few dollars chasing too many available goods and services. Yet community banks are not the villains. They, like the rest of us, are caught up in the Wall Street-driven real estate crisis that is stripping assets from local communities and devastating local economies.

Unfortunately, the real estate crisis appears to be just the tip of the iceberg. Revelations of corruption and fraud on Wall Street,[3] and a recognition that the game is rigged in favor of insiders, have prompted small investors to leave the

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[1] *"Capital Offense - The SEC's Continuing Failure To Address Small Business Financing Concerns"* http://www.commonwealthgroup.net/docs/CapitalOffense-TheSECsContinuingFailureToAddressSmallBusinessFinancingConcerns.pdf

[2] *"Job Growth in U.S. Driven Entirely by Startups" Kauffman Foundation Study,* http://www.kauffman.org/newsroom/u-s-job-growth-driven-entirely-by-startups.aspx

[3] *"The Scam Wall Street Learned From the Mafia"* http://www.rollingstone.com/politics/news/the-scam-wall-street-learned-from-the-mafia-20120620

stock market in droves. But our state and local government investment funds, pension funds, foundation and endowment funds, and other pools of public money continue to invest billions on Wall Street, and virtually zero dollars on Main Street. The nation continues to depend on Wall Street as the repository of nearly 100% of our public investment dollars (capital) and the majority of our deposit dollars.

But Wall Street banks are neither returning those investment dollars to our communities, nor providing loans, even though they have abundant money. Small business lending by the big banks has nearly disappeared entirely. And there is no indication that they will ever turn their attention back to Main Street given the huge profits they generate in the unregulated shadow banking system.

The only other alternative for getting credit flowing at the community level is community banks, but unfortunately they are not able to turn on their lending spigots. Because of the Wall Street–fueled collapse in the real estate market, community bank loan portfolios have plummeted in value and, as a consequence, regulatory agencies have imposed severe constraints, blocking them from making critical loans needed by local businesses. From 2008 to 2011, 414 banks have failed, compared with just 11 in the five years prior to 2008.

But there is a bright spot. North Dakota has not had a community bank failure in over a decade and its community banks are the healthiest in the nation with plenty of money to lend.

As community banks go, so go their communities and in turn, the nation. We therefore need to understand why North Dakota's banks are so healthy and how we can replicate that success.

North Dakota is unique in that it is the *only* state or local government that *owns* its own bank (Bank of North Dakota or BND), which serves as both a central bank and bankers' bank to the state and its community banks. It is in essence a "wholesale" bank — its customers are other banks and credit unions. It provides those customers with substantial financial resources that enable them to stay healthy and put them in a position to lend, thereby ensuring abundant credit throughout the state, just like the Federal Reserve does for Wall Street banks.

However, North Dakota's government-owned bank is unique only in the United States. Approximately 40% of all banking worldwide is done by either government-owned or non-profit owned banks, collectively referred to as "public banks," banks that are owned in one form or another by the public at large, rather than wealthy individuals and corporations.

We can look to Germany for one model for keeping community banks healthy and providing much needed credit to small businesses. Like BND, German community banks (called *Sparkassen*, i.e., savings banks) are publicly owned by the equivalent of local community non-profit organizations. Unlike BND, Sparkassen banks serve retail customers and in particular local small businesses. As a consequence of the support provided by the Sparkassen banks, Germany has one of the healthiest small business communities in the world, a key driver of

the country's economy. Small and medium-size companies, known as the *Mittelstand*, account for about 70% of German jobs. Export-oriented and concentrated in high-value manufacturing, they are worldwide market leaders, particularly in business-to-business segments.[4]

BND represents a government-owned, wholesale bank model, whereas the Sparkassen represent a non-profit-owned, retail bank model. Both have a place in our economy and the U.S. could benefit by having both models widely used.

However, getting other state and local governments to set up BND-like banks, or non-profits to setup Sparkassen-like banks, could prove difficult. Banks need to start with capital, which they leverage (multiply) into loans. And even though state and local governments have very large investment pools to draw from (currently nearly exclusively invested on Wall Street), replicating the BND model is unlikely in today's polarized political environment.

At the same time, U.S. non-profit organizations would have a hard time replicating the Sparkassen model, primarily due to the lack of financial resources to properly capitalize their banks. Yet they can move more quickly and efficiently than their government counterparts.

Fortunately there is a way they can join forces to offset each other's weakness and leverage their respective strengths, to establish both BND and Sparkassen-like organizations. This book lays out a vision for how both BND and Sparkassen-like structures can be established on a parallel, dual-track basis, to rapidly and efficiently deploy these models throughout the country, primarily by leveraging a partnership between government and non-profit organizations.

The result is the potential to rapidly replicate the North Dakota and German success stories throughout the nation, without the drawbacks that might be encountered if either governments or non-profits tried to go it alone.

In this document we:

- Analyze the problem of no credit.
- Show how BND and Sparkassen banks can provide the templates to solve that problem, at the wholesale and retail levels.
- Explore how governments and non-profits might independently try to set up BND and Sparkassen-like institutions.
- Show how by teaming they can better accomplish that goal.
- Detail the mechanics of how to set up both types of operations.
- Show how new forms of real estate and mortgage companies can be used to stop foreclosures and help community banks, thereby removing their biggest barrier to local lending.
- See how those real estate and mortgage companies can serve as the building blocks to grow an entire public benefit financial system.

[4] http://en.wikipedia.org/wiki/Mittelstand

CHAPTER 1

THE NATURE OF THE PROBLEM

Beginning with the Wall Street-precipitated collapse of the real estate market in 2008, the nation is experiencing its worst financial crisis since the Great Depression. Yet this crisis does not affect all segments of the economy equally. We have two parallel economies, one apparently extremely healthy, the other just the opposite, both a consequence of the availability — or lack — of credit.

Credit is the fundamental "grease" of any economy, and those that find themselves with little or no credit flow experience contraction and a host of related problems. Credit has all but dried up on Main Street. Yet it appears to be flowing without constraint on Wall Street.

Wall Street "big businesses" seem to have credit to spare, and their coffers are bulging with cash reserves resulting from record high profits. In contrast, Main Street small and medium sized enterprises (SMEs) are suffering from increasingly tighter credit, falling sales resulting in lower profits, in turn leading to increased layoffs, dangerously low financial reserves and business failures. And given that SMEs employ over half of all private-sector workers and generate the majority of new jobs, we find this to be the primary driver behind the current high national unemployment figures.

The ability of small businesses to finance growth is largely dependent on the capacity of local community banks to lend them money. Small and mid-sized banks ($10 billion or less in assets), while controlling only 22% of all bank assets, account for 54% of small business lending. Wall Street banks (historically reluctant lenders to SMEs) now devote only 18% of their commercial loan portfolios to small business. And their approval rate for small business loans is below 10%. Making matters worse, as big banks have consolidated the market, SMEs have had even more difficulty obtaining loans.

Main Street banks are thus critical to the national economy. But their lending ability is severely hampered and their total numbers are rapidly dwindling. Why? The answer is crucial to understanding how to restart the flow of credit at the local level.

WALL STREET BANKS & THE MORTGAGE MESS

Community banks are casualties of the financial crisis, beset by external forces that tie their hands and prevent them from meeting the demand for credit from local businesses.

The first external force is the collapse of the housing market brought on by the excessive and often illegal manipulation of mortgage markets, primarily concerning mortgages found under the private registry system called MERS,[5]

[5] *Mortgage Electronic Registration Systems, Inc.(MERS) http://en.wikipedia.org/wiki/MERS*

which holds at least 60% of all U.S. mortgages. MERS is predominantly owned by a group of large Wall Street banks, mortgage and title companies and was set up to bypass local county real estate registry systems. The big banks' manipulation of the mortgage market has resulted in an epidemic of foreclosures, many found to be fraudulent or otherwise improper.

Yet these banks have offset their losses with massive profits realized by securitizing those mortgages with instruments called derivatives that, separate from the mortgages themselves, yielded many times the actual value of the mortgages. These derivative financial instruments made the losses on mortgages nearly irrelevant. Thus, even though they have large numbers of foreclosures on their books, the big banks are largely immune to the problem they created.

Not so for smaller banks, which found themselves with collapsing real estate loan portfolios and no means to offset them with derivatives like the big banks. Most had played by the rules and followed sound legal and business practices in originating their loans. In contrast, many of the big banks played fast and loose with their loan portfolios, often granting loans to financially unqualified borrowers who would not be sound credit risks under normal circumstance, because the bulk of their financial gains came from the derivative products and not the mortgages themselves.

REGULATORS

The collapsing real estate market triggered the second force that has exacerbated the pressure on community banks — regulators, in particular the Federal Deposit Insurance Corporation (FDIC). Even though community banks are not the primary cause of the nation's credit crunch, regulators are treating them as though they are just as responsible as the big banks.

Regulators are mandated to ensure that banks remain financially sound, and when they become less so, to force those banks to take steps to get back on a healthier track. Regulators are not concerned with the health and vitality of the communities served by the banks, just the banks themselves. Unfortunately, the measures they require of the banks to make them healthier have a negative impact on communities and the banks' customers, small businesses in particular.

Chief among regulators' demands is to tighten up and improve overall loan portfolios, i.e., get rid of riskier loans, cancel lines of credit (even for long-established customers), establish higher standards for new loans, and in many cases, require them to raise more capital before they can do more lending. All of these requirements make less credit available to the community. Decreased credit availability means slower local economies, creating a negative reinforcing cycle as the banks find fewer and fewer customers deemed creditworthy by regulators.

The collapse of loan portfolios and the increased burden imposed on community banks by regulators have created massive pressure on community banks, leading to the largest loss of community banks since the Great Depression. Over the past dozen years, some states have lost as many as 25% of their local banks.

This reduction has manifested along two parallel trends: a massive consolidation of big banks getter bigger by absorbing smaller, weaker banks and the shutting down of others too small to become acquisition targets and too weak to stand on their own. In both cases, communities are rapidly losing key institutions that have been critical to their economic health and vitality. If we don't rescue community banks, we have no foreseeable way out of our economic doldrums.

Unfortunately, there is almost nothing the community banks can do on their own to stop this cycle. And it is unthinkable that regulators will suddenly be required to take the larger view and loosen their demands on the banks with an eye toward helping communities solve their credit problems. And barring a massive federal rescue scheme for re-capitalizing community banks (impossible in today's political climate), they and their communities are on their own.

CHAPTER 2

A DUAL PATHWAY OUT

The conditions described are true for all states but one — North Dakota. For reasons explored below, credit is still flowing at the community level, business is booming, unemployment is the lowest in the nation and community banks are thriving. In fact, there have been no community bank failures in more than a decade (the only state with that record) and the state enjoys the highest number of community banks per capita of any state, with less consolidation than elsewhere.

In North Dakota, community banks are still owned by private investors but receive a variety of wholesale banking services and financial resources from the publicly owned Bank of North Dakota. In Germany, by contrast, the community banks themselves are publicly owned.

A BND-like structure can be deployed in other places throughout the country, to provide BND-like services and resources to those community banks that are strong enough and who want to remain independent, privately owned entities.

However, for those community banks that no longer can or want to go it alone and don't wish to be part of a larger private banking group, thereby losing their identity and connection to the community, becoming part of a Sparkassen-like structure may be the answer.

We will examine each of these structures more closely to see how they can be used to get credit flowing again on Main Street.

We begin with North Dakota, held up by many as the one bright light in a broad field of dim and fading lights. What is different about North Dakota? And how might we replicate its success?

Many argue, as did Catherine Rampell of the *New York Times*,[6] that a boom in oil production is the secret to the state's financial health. However, Ellen Brown of the Public Banking Institute[7] shows[8] that oil alone cannot account for North Dakota's success, since other states with similar oil economies are nowhere near as healthy.

Brown points out that the only major difference between North Dakota and similar states is the existence of a unique banking environment that stands behind the state's abundance of credit and the health of its local banks and communities — the Bank of North Dakota.

If other states with nearly identical natural resources and economic makeup but no bank are not doing anywhere near as well as North Dakota, then common

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[6] *"The North Dakota Miracle," http://economix.blogs. nytimes.com/2011/08/19/the-north-dakota-miracle/*
[7] http://www.publicbankinginstitute.org/board-andstaff.htm
[8] *North Dakota's Economic "Miracle" - It's Not Oil http://www.yesmagazine.org/new-economy/the-north-dakota-miracle-not-all-about-oil*

sense leads us, like Sherlock Holmes, to conclude that "…when you have eliminated the impossible, whatever remains, however improbable, must be the truth."

CHAPTER 3

BANK OF NORTH DAKOTA

The Bank of North Dakota (BND)[9] is a central bank, owned and operated by the state of North Dakota. It serves as a bankers' bank (i.e., a wholesale bank and more) to the state's community banks and credit unions, as the Federal Reserve does for Wall Street banks. BND is the only government-owned (therefore "public") bank in the United States, even though public banks are common worldwide. So what does BND do that has such a huge impact?

BND IS A BANKERS' BANK

Many describe BND as a bankers' bank. A bankers' bank is "a financial institution that provides financial services to community banks … By leveraging positive economies of scale, bankers' banks are able to provide many services to community banks that typically would be economically available only to large national or multinational banks. The advantage here is that community banks which use these services can in turn offer them to their customers, allowing these smaller independent banks to effectively compete with larger banks."[10]

As used in United States, the term "bankers' bank" is actually an official designation of a type of bank recognized by the FDIC and the Federal Reserve. Bankers' banks are exempt from maintaining reserve accounts with the Federal Reserve provided they follow guidelines concerning their ownership structure and with whom they conduct business.

There are currently 22 official bankers' banks in the United States, defined as depository institutions that satisfy all of these requirements:[11]

- Are organized solely to do business with other financial institutions.
- Are owned primarily by the financial institutions with which they do business.
- Do not conduct retail banking, i.e., do not do business with the general public.

Given the above definition of a banker's bank, BND does not conform to any of those requirements and therefore is not officially a banker's bank. Yet many still call it a bankers' bank because it provides very similar services to its community banks as bankers' banks do for their customers. But BND is more than that.

The 22 private bankers' banks ranging from the largest[12] to the smallest[13] provide their clients with similar services in the form of correspondent banking, cash

[9] http://en.wikipedia.org/wiki/Bank_of_North_Dakota
10 http://en.wikipedia.org/wiki/Bankers_bank
11 http://www.fdic.gov/regulations/laws/rules/7500-600.html
[12] *The Independent Bankers Bank (TIB) http://www.mybankersbank.com – with branches in at least 11 states and net assets of approximately $190 million*
[13] *Great Lakes Bankers Bank (GLBB) http://greatlakesbb.com - with branches in 2 states and net assets of approximately $9 million*

management services, credit card services, electronic banking, funds management, lending programs and more.

BND provides many of those same functions,[14] but goes much further to provide additional financial resources and facilitate the flow of credit within the state, including student loans, farm loans, secondary real estate loan acquisition, disaster relief funds, loan guarantees, buying up of loans from the banks and more).

In particular, its lending programs[15] are much more extensive, both in terms of direct lending and participation loans. (For a detailed description of BND's services, including its support of banks and other local financial institutions like credit unions, read the transcript of retired BND senior vice president Ed Sather speaking a nationwide conference call in 2011.)[16]

The Institute for Local Self-Reliance (ILSR)[17] examined the Bank of North Dakota and published the following information about BND in May 2011.[18]

A substantial portion of BND's $2.8 billion loan portfolio consists of participation loans[19] in which BND finances part of a loan made by a local community bank.

At the end of 2010, BND had about $1.2 billion in participation loans in its portfolio, an amount equal to *19%* of the total value of loans by the state's small and mid-sized community banks. This allows the local banks to not only increase the amount of loans on their books (making them more money), but also participate in larger loans than they could on their own, helping them retain customers that they might otherwise lose to larger banks.

The bank began buying residential mortgages from community banks some 15 years ago, allowing the state's banks to resell their mortgages in-state (freeing up their own portfolios), rather than to large banks in major financial centers. Those larger banks used to poach those clients once they had their mortgages. As of 2010, BND held 7% of the mortgages in the state totaling over $500 million.

North Dakota has 35% more banks per capita than South Dakota and four times as many as the national average. Over the last 10 years, the amount of lending per capita by small community banks (those under one billion in assets) in North Dakota has averaged about $12,000, compared to $9,000 in South Dakota and $3,000 nationally. The gap is even greater for small business lending. North Dakota community banks averaged 49% more lending for small businesses over the last decade than those in South Dakota and 434% more than the national average.

North Dakota's small and medium-sized banks (under $10 billion in assets)

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[14] *http://bankd.nd.gov/about_BND/pdfs/faqs.pdf - with one central location and net assets of more than $330 million*
[15] *http://bankd.nd.gov/lending_services/index.html*
[16] *Ed Sather, retired BND SVP, 2/16/2011 http://www.publicbankinginstitute.org/pbi-conference-calls.htm*
[17] *http://www.ilsr.org*
[18] *http://www.ilsr.org/rule/bank-of-north-dakota-2/*
[19] *http://en.wikipedia.org/wiki/Participation_loan*

account for 72% of deposits in the state compared to a national average of 30%.

According to graphs[20] also published by ILSR, North Dakota's community banks maintain a higher average loan-to-asset ratio — meaning they are able to devote more of their assets to economically productive lending, rather than safer holdings like U.S. government securities. They have also generally maintained a higher average loan-to-asset ratio than their counterparts in four neighboring states and nationwide.

BND does forego some profit in order to further economic development in the state. The bank offers several programs that accept higher levels of risk or lower returns on certain kinds of loans. Through its PACE Fund (Partnership in Assisting Community Expansion), for example, BND buys down the interest rate by 1%-5% for some job-creating business loans.

BND also has a Business Development Loan Program, which enables new and existing businesses to obtain loans that have a higher degree of risk than would normally be acceptable to a lending institution, while its Beginning Entrepreneur Loan Guarantee Program guarantees 85 percent of a loan of up to $100,000 made by a local bank to a start-up entrepreneur.

Those additional services are largely the reason North Dakota community banks are the healthiest in the nation.

Why is BND able to provide these additional services and do more for its customer banks than the other banker's banks?

BND HAS MORE MONEY

In order to better understand what BND can do, we first need to understand the role of capital (assets) and deposits (liabilities) in banks, concepts that apply to all banks, not just BND, and other wholesale, central banks and banker's banks.

Most people believe that banks loan their depositors' money. Not true. Deposits do not have any direct bearing on the amount of funds that a bank may loan. In reality, banks create loans based on a multiple of their capital, not deposits.

Typically the amount of money that a bank is allowed to lend is in the vicinity of $10 in loans for every $1 in capital. Banks use deposit money to cover demands for cash withdrawals, including the loan money they create for borrowers. They don't actually lend out those deposits but rather create the credit money out of thin air when they make a loan. We will explore this concept more below, but for now it is important to understand that a bank's lending limits are set by how much capital it has, not deposits. The more capital, the greater the total dollar value of their loans.

Given that, why is BND better able to service is customers than can the other bankers' banks? In raw terms, BND has a much larger pool of both capital (and deposits) than do the other bankers' banks, which it can use to support credit

[20] http://www.ilsr.org/charts-bank-north-dakota/

throughout the state. It has nearly twice as much retained[21] capital for use in a single state (with less than 700,000 population) compared to the largest private bankers' bank, which spreads its more limited resources over 11 states. And by law, all of the state of North Dakota's financial resources have to be deposited with BND. Many other government entities like cities and school districts also place their funds with BND. This large capital and deposit base gives BND the capacity to provide the state's community banks with direct financial support that goes considerably beyond that available to the customers of the other bankers' banks.

This is important because the other private bankers' banks are limited to the funding provided by their owner/customer banks, and thus whatever resources they make available back to themselves is limited by the resources they initially contribute and grow via business operations. The BND capital and deposit pools come from the state and other resources, not from its customer banks, and therefore are above and beyond those resources held by the community banks in North Dakota, who did not have to capitalize BND in order to get its benefits.

Thus the customers of the 22 bankers' banks are limited by the extent of their own internal financial pool, whereas the North Dakota community banks can tap a deep pool of resources developed independently from their own resources. North Dakota community bankers acknowledge that if they did not have BND and had to turn to other 22 conventional bankers' banks, they could not achieve anything close to what they can in partnership with BND.[22]

In this sense, BND is more like a central bank, much like the FED is to the Wall Street banks. Thus BND is able to conduct activities like buying up loans from its customer banks (giving them needed liquidity), providing the bulk of the funds for larger loans than an individual bank might do on its own,[23] or syndicating a larger loan that BND is able to share with two or more community banks.

In this way, small North Dakota community banks can act like large banks on nearly every dimension, without having to be big banks themselves and without the risk of losing customers to the big banks (especially outside of the state) because they cannot service their needs. All of this means that these banks are able to maintain much healthier loan portfolios and overall general economic health (and thus relations with the regulators like FDIC) than can most of the rest of the nation's banks.

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[21] *BND keeps capital needed to support its statewide credit programs and returns the balance to the state's general fund. Over the past 10 years BND has contributed more than a third of a billion dollars to the state's coffers. It contributions represent the single largest source of funds for the state, a good indicator of just how deep the capital pool is for BND.*

[22] *On March 23, 2012, the Public Banking Institute held a nationwide conference call with Eric Hardmeyer, President of BND, Rick Clayburgh, President, North Dakota Bankers Association and the CEOs of two ND community banks to talk about BND and its relationship to the community banks. Listen to "Call recording Bankers Roundtable 032312.mp3" http://www.publicbankinginstitute.org/pbi-conference-calls.htm*

[23] *Example: $10 million loan, $9 M of which is provided by BND and $1 M of which is provided by the local bank, but the local bank manages the whole process and the customer deals only with the local bank.*

BND HAS A PUBLIC BENEFIT MANDATE

One of the most important but less obvious characteristics of BND is its mandate and mission. BND is owned and operated by the state of North Dakota. It has no private shareholders that it is beholden to and it is not solely limited to profit making (especially short-term profit making), but can consider the needs of the state's residents and economy balanced with sound and safe banking practices. Thus its mandate synchronizes with the needs of the society in which it conducts business and all its profits inure to the benefit of the state and its citizens.

This is nearly diametrically opposite that of the large Wall Street banks, where the emphasis on short-term profit maximization has led to improper and often illegal behavior that is not only damaging to society, but as many observers predict, damaging to the banks themselves in the long term.

Those big banks are making more money by buying government bonds with money they borrow from the FED (like borrowing money from your mother to buy bonds from your dad and pocketing the spread), and by speculating in derivatives and the like in the shadow banking system than by lending to small businesses. Thus it would be unrealistic to look to Wall Street banks for help in getting credit flowing again on Main Street.

CHAPTER 4

PUBLIC BANKING AROUND THE WORLD

As we pointed out, North Dakota is the one state that is economically quite healthy and had no credit problems. Both its community banks and its business communities appear to be largely immune to the economic problems plaguing the rest of the country. We noted that the unique factor in North Dakota versus comparable states is the fact that it owns its own bank and concluded that the Bank of North Dakota was the key element in its economic success.

Can we look to other places in the world where economies are strong and determine if public banking plays a role?

We do find a correlation between the presence of public banking and the vibrancy of economies.[24] This is especially the case with a number of developing economies and in particular the BRIC[25] countries (Brazil, Russia, India and China), all of which have some form of publicly owned banks at the national level.

In contrast, we find that many of the rest of the world's economies are in trouble. Not coincidentally, two of Europe's healthiest economies, Switzerland and Germany, have robust public banking systems. Switzerland's cantonal banks, commercial banks owned by the cantons (states) in which they are based, account for almost one third of the banking sector in Switzerland, with Zürcher Kantonalbank and Banque Cantonale Vaudoise as the country's third and fourth biggest banks.

Germany, which is nearly singlehandedly propping up the rest of European Union, predominantly uses public banking at the local level, and thus provides us with a model that we might be able to adopt here in the U.S.

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[24] *See also "Public Sector Banks: From Black Sheep to Global Leaders" by Ellen Brown* *http://www.webofdebt.com/articles/brics.php*

[25] *http://en.wikipedia.org/wiki/BRIC*

CHAPTER 5

GERMANY AND THE GERMAN SAVINGS BANK MODEL

We first need to place the German saving bank model in the context of the overall German banking environment. The German system is structured into distinct categories, differing in legal form and ownership.

The first is private banks, which resemble the majority of banks (big and small) in the United States. They are owned by private investors (whether publicly traded or privately held) and include Deutsche Bank[26] and Commerzbank,[27] Germany's largest and second largest private banks respectively.

The second category is a group of more than 1,110 co-operative banks known as Volksbanken and Raiffeisenbanken.[28] They have a membership structure where each member has one vote independent from their capital share.

The third category is the public banks,[29] which account for approximately 40% of all banking in Germany. Organized under the German Savings Banks Finance Group (Sparkassen-Finanzgruppe)[30] this sector is made up of multiple elements including local Sparkassen (retail banks similar to U.S. community banks), regional Landesbanken (predominantly wholesale banks, more closely akin to BND), an investment company, Landesbausparkassen (similar to real estate savings and loan associations), Sparkassen associations, insurance companies, leasing companies and more.

THE SPARKASSEN BANKS

The Savings Banks Finance Group is Germany's largest finance group in terms of total assets, with over 600 affiliates (of which 430 are Sparkassen) nationwide providing services through 16,000+ branches to more than 50 million retail customers. And with around 350,000 employees, it is the biggest employer in the German banking market.

The Savings Banks Finance Group ensures that all sections of the population have access to, and benefit from banking services. The group holds a strong position in the German retail market and is particularly active in providing finance for small and medium-sized enterprises (SMEs).

Sparkassen are legally and economically independent units of municipalities and districts or special-purpose associations (Sparkassen-Zweckverbände). The translation for this structure is "municipal trusteeship of local governments." The local governments are not shareholders but simply have a hand in their oversight. Sparkassen were originally 100% publicly owned, essentially a department within

[26] http://en.wikipedia.org/wiki/Deutsche_Bank
[27] http://en.wikipedia.org/wiki/Commerzbank
[28] http://en.wikipedia.org/wiki/Volksbank
[29] http://en.wikipedia.org/wiki/German_public_bank
[30] *See these brochures* http://www.mainstreetmatters.us/docs/GermanSavingsBanksFinanceGroup.pdf *and* http://www.mainstreetmatters.us/docs/Inside_theSavingsBankGroup.pdf

the local or regional government. This changed in 1931 when they were made independent, largely to free them from inappropriate interference by elected officials.

The Sparkassen banks themselves most closely resemble non-profit foundations in the U.S., and each bank is an independent credit institution run on an entrepreneurial basis, yet they cooperate and aid each other as needed.

Savings banks are governed by public law and are answerable to the municipalities. Like U.S. community banks, they are independent and decide locally on their business policy and especially on product range and prices. This ensures that the savings banks gear their business activities to the regions of the respective municipalities, thereby promoting local economic development.

Primary beneficiaries of the Sparkassen banks are small and medium-sized business enterprises. Together with the Landesbanken, savings banks held a 43.3% market share in self-employed and business loans in 2007. This puts them easily in the lead in business finance in Germany.

Savings banks also have market leadership in the financing of new business startups. They finance one of every two startups in Germany, something unheard of in the U.S. Germany's small business community is considered one of the healthiest in the world, leading the way in exports, in no small part due to the role played by the Sparkassen banks.

Sparkassen banks support their small and medium-sized corporate customers in all phases of their development. They are also at their customers' side during difficult periods for as long as this is economically justifiable and compatible with banking regulations.

Sparkassen banks are regionally based and are tasked with focusing on their specific operating region and its overall health. For this reason, it is crucial for Sparkassen banks to keep an eye on the effects of a business customer's potential failure and the impact that would have on its employees, suppliers and customers, as well as the social environment and the local community. Hence, Sparkassen have a vested interest in the economic success of their region.

APPLYING THE SPARKASSEN MODEL IN THE U.S.

We can see that the German Sparkassen bank model addresses local community needs and economic health, and thus, like BND, may have a place here. However, in contrast to the BND model where BND provides support services to community banks that remain independently owned and operated, the Sparkassen model would convert a number of local community banks from private to public ownership.

These banks would be acquired by a central, publicly owned organization (probably one per state) in a process that would resemble acquisition by a bigger, privately owned bank. The key differences are that they would:

- Keep the original bank name and identity they had before the acquisition.

- Remain a local bank, serving the local community.
- Be part of a larger, well financed public banking group that can provide them with plenty of additional capital and all the resources of a larger institution, allowing them to act like a big bank while maintaining a small bank identity.

These banks may avail themselves of the resources of other BND-like public banking structures, or get similar services from their own parent structure or both. Both the BND-like and the Sparkassen-like structures have a place in the new American public banking world, and we (NCG)[31] propose a dual-track development of both, as we will detail later. For now, let's see how public banks of both types can be set up.

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[31] *National Commonwealth Group, Inc. (NCG), a 501(c)(3) non-profit organization, is the primary sponsor of a plan to incorporate both the BND model of public banking and the Sparkassen version into one hybrid model of our own design.*

CHAPTER 6

DUPLICATING THE BND AND SPARKASSEN SUCCESS STORIES

Getting credit flowing again on Main Street is our main objective, since local economies cannot recover until credit returns, and credit returns only if we can get community banks healthier and lending again. Community banks, and to a lesser extent, local credit unions, are the primary source of credit in local economies, and as we have seen, community banks are in trouble nationwide, with the exception of the banks in North Dakota.

If we were to establish BND-like wholesale banks that were able to provide BND-like services to other community banks around the country, those that don't want to be absorbed by bigger banks and are healthy enough to stand on their own (with help from public bankers' banks), should become even healthier and improve their prospects of increasing lending.

However, the BND-like solution is incomplete. There are a good number of banks that cannot or do not wish to continue to go it alone, even with the help of a bankers' bank. Those banks might prefer to become part of a Sparkassen-like system. Let's explore how we can establish both models.

We first need to define the key ingredients required to set up any public banking structures. The first is money. Capital is the key resource that a bank uses to create credit money for borrowers. And believe it or not, state and local governments can provide that capital in an amount that would more than do the job of getting America back on its economic feet.

How can that be? We hear about the financial difficulties that state and local governments are currently experiencing, so how could they possibly come up with the funds to capitalize public banks, especially enough to solve our nation's credit problems?

The answer is that governments of all sizes are actually sitting on large piles of cash. Most people are not aware of them because those funds cannot be tapped to address current needs. They exist to serve other purposes, as we will explore below. Fortunately, those financial resources *are* available for investments and could serve as a deep pool of funds for our public banking effort.

WHERE CAN LOCAL GOVERNMENTS GET INVESTMENT FUNDS?

It turns out that local governments, from states down to the smallest jurisdictions like cities, villages and townships, actually have significant pools of funds. The key is that these are *investment funds*, and in the aggregate, add up to hundreds of billions of dollars in each state, and collectively across the country, trillions of dollars!

Where do these funds come from and why don't we know about them? Where and how are they normally invested? Can any of these funds be used to support our public banking objectives? Normally the answer is no, but there are ways

they can be used, which we will explain below. Let's first take a closer look at state and local government finances, and then explore how local governments can tap investment and other funds to provide a means of achieving our public banking objectives.

Most people have heard of government "budgets," which show the plans and authorizations for the spending of everyday funds for current and future years. Budgets represent the inflow and outflow of current operating funds needed to keep that government running on a day-to-day basis. State and local government budgets everywhere are under tremendous pressure, often with very large shortfalls of revenues compared to their expenditure obligations. Those shortfalls are leading to an unprecedented number of municipalities filing for Chapter 9 bankruptcy.

However, most state and local governments are also sitting on large pools of assets, many of which are liquid but which cannot be used for current budgetary requirements, but rather are like a savings plan. This would be like us having too small a paycheck for our monthly expenses, while at the same time having a substantial long-term savings account that we cannot touch.

Unfortunately, many governments are selling some of their fixed assets (buildings and other similar assets), and in some cases their revenue generating assets like parking meters, just to cover their current expenses. And they are often doing so at below fire sale prices. This would be like us selling our house at a deeply discounted rate, just to pay for our current needs. We and they should not sell those assets, but instead put them to work for us to help cover current expenses and maintain a basis for future benefits.

Let's explore this idea of leveraging rather than selling assets. We find those assets listed on government balance sheets rather than on their budgets. A balance sheet lists all assets (what is owned – liquid and fixed) on one side and all the liabilities (what is owed both near-term and long-term) on the other.

An examination of the balance sheet of most governments shows that the bulk of their net assets, assets left over after all current and long-term obligations are accounted for, are made up predominantly of various special funds. These special funds are typically things like pension funds, rainy day funds and the like, most of which are placed in some form of long-term investments, rather than held in checking accounts. Those funds are almost always invested passively and nearly universally on Wall Street. And all those funds are largely unavailable for current expenditures. Most of these funds have been accumulated incrementally over many years through various special appropriations and programs.

Yet getting a clear picture as to what these funds are for, where the money comes from and what is currently being done with those funds, is not very easy to do. Even if we were to examine the government balance sheets, most of these funds are largely obscured with vague accounting descriptions.

Governments tend to represent them as single line items, without any explanation as to what the funds are and what they are used for. Apparently they fear that if

the public knew about them, they might demand the government use those funds for covering budget shortfalls and current needs, even though that would not be a legally correct, nor a fiscally prudent use of those funds. Nonetheless, the underlying information about those funds is available, if you know where to look.

Each year all state and local governments throughout the country are required to prepare an in-depth financial report on their assets, liabilities, revenues and expenditures. This report has to be in a format that conforms to the Government Accounting Standards Board (GASB) accounting and financial reporting standards. It is called the Comprehensive Annual Financial Report (CAFR). The CAFR describes what actually was spent and the status of assets and liabilities at the end of the fiscal year.

CAFR reports are one of the least known and least understood pieces of information available from our governments. Almost nobody outside of government knows about these reports, and a search of the Internet will reveal little about them, even though every government in the country has to produce them every year.

For example, this (dated) site http://cafrman.com/ is the product of one dedicated and passionate researcher/advocate that provides a good deal of information on the topic of CAFR reports. It contains links to old government data (~2003) that gives a good feel for how much money is available to governments for investment purposes. Current research shows that such funds have grown even larger.

CAFRs are a treasure trove of information. The CAFR has four main parts covering Governmental Funds, Propriety Funds, Fiduciary Funds and Component Units. The "budget" is covered in the Government Funds section. It is the other sections that we find the investment funds we are looking for. And the magnitude of those funds is often quite surprising. Here is a brief explanation of each of those categories.

Propriety Funds represent the various fees, fines, penalties, licenses, parking fees, utility charges, inspection charges, charges for other services, charges for various goods, assessments and a variety of other revenue-generating charges for activities provided by a government body or one of its agencies. Taxes are not included in this category, as they are found under the Government Funds section. These Proprietary Funds are one of the fastest growing segments of revenue generation, because unlike taxes, they don't normally require voter approval and local governments are turning to them with increased frequency to solve their cash flow problems. As a result, a good portion of these funds go into the general fund for current usage, but some of them are invested for some form of long-term use.

Fiduciary Funds are pools of funds that the government entity manages as a fiduciary[32] or trustee on behalf of another beneficiary. A typically fiduciary fund

[32] http://en.wikipedia.org/wiki/Fiduciary

would be a city employee pension fund. These funds are almost always long-term investment funds, where the goal is to grow the fund for some future extraction (such as paying pensioners in retirement). Fiduciary Funds represent some of the largest pools of funds managed by governments and, since they are almost exclusively invested, represent one of the best sources we can look to for financing public banks and other public benefit financial institutions.

Component Units are legally separate organizations for which the primary government is responsible. Examples could be a utility service owned by the city, or a bank owned by a county. In each case, the primary managing government is financially accountable for that entity. As with Proprietary Funds, fees, product and service charges, assessments, fines, penalties and licenses are major revenue sources. Also like Proprietary Funds, a significant portion of these resources is used for current operations and some is managed as a long-term investment.

If one drills into CAFR data (see examples at http://cafrman.com), one finds that the scope of such funds is often quite significant. Even the smallest government jurisdictions (like a township) tend to have relatively large pools of funds, and this is probably the single biggest strength of state and local governments — in aggregate, they have a substantial amount of money that could be made available to support their local communities and a public banking effort.

However, nearly 100% of those funds that are dedicated to investments are currently placed with far-off money managers (typically on Wall Street) with little or none of those funds being applied to local needs. Thus the public's money goes off to "foreign lands" and provides virtually no local benefit.

Yet given that such funds sit in investment pools, we have what would appear to be is a near perfect match with our goal of building widespread BND and Sparkassen-like structures, particularly if those governments participate in shared ownership in public banks. However, it turns out that state laws constrain government financial managers to liquid investments, that is, investments that can be sold off readily in the public marketplace. Direct investments in a bank or a bank holding company would not be considered very liquid. A walk through Michigan's statutes related to those kinds of investments will give a good sense of what such managers are normally allowed to do.[33]

Therefore it is not likely that even shared investments (in conjunction with other government agencies) would fit within the government money managers' investment constraints and they certainly wouldn't be able to set aside the dedicated funds required for a bank they would own exclusively.

That said, there are ways around these limitations, especially if done jointly with others, which we will cover later. We will explore the topic of shared ownership versus sole ownership of a bank later in the section titled "Sole Ownership or Pooled Investments for Public Banks."

[33] See Section 129.91, Michigan Investment of Surplus Funds of Political Subdivisions, Act 20 of 1943 http://www.legislature.mi.gov/(S(f2tikf55adlonznk3qvhs1mw))/mileg.aspx?page=getObject&objectName=mcl-129-91

For now, let us turn our attention to another key financial component of commercial banking – deposits. Banks need deposits as well as capital and this is where state and local governments can also help our public banks.

Local governments usually manage substantial amounts of money under their current budgets that they have to maintain on deposit somewhere. And given the size of those budgets, the amount of money that they need to deposit can be much larger than many local community banks can absorb.

In fact, most local governments do not bank with their local community banks, precisely because those banks cannot absorb such large deposits. That is because regulators only allow banks to take in certain percentages of deposits compared to their capital base, and those limits would often be exceeded if a local government tried to deposit their funds with a local bank. As a result, monthly deposits (like investments) are shipped off to Wall Street banks, which are big enough to absorb them.

FDIC insurance limits play a role here, too. This is a topical issue given the year-end 2012 pending expiration of the congressionally authorized Temporary Account Guarantee provision of FDIC insurance.

The public banking structures we will explore later would be capable of absorbing much larger deposits to go along with their larger capital pools. Thus local governments can be a major source for both capital and deposits, the collective "grease" needed to lubricate local economies. They need only provide a portion of what they currently deposit elsewhere to substantially ramp up credit facilitation in their communities, and as these public banks grow and thrive, more can be added to the pot.

We can see where the creators of the Bank of North Dakota recognized this dual financial requirement and baked it into the creation of BND. The law establishing the creation of BND not only set up the bank and provided for its capital base (the state issued a bond to obtain that startup capital), it also called for *all* of that state's non-investment, operating budget funds to be placed on deposit with BND.

Under the shared ownership model we will describe later, each of our participating investor governments could also place deposits with our BND and Sparkassen public bank equivalents, thereby supplying them with the liquidity they need to carry out their credit operations. Again, each jurisdiction might supply only a small portion of its potential deposits, but in aggregate this could yield a large cash base for the banks.

HOW CAN LOCAL GOVERNMENTS USE THEIR INVESTMENT FUNDS?

As we mentioned earlier, most state laws would block usage of governments' investment funds for projects like a public bank. So how can we get around that limitation and allow governments to leverage their investment funds via public banking to not only produce better returns than they might see on Wall Street, but also allow them to stimulate their local economies..

One option is for state legislatures to modify their laws to allow state and local treasurers to invest directly in a local public banking effort. Such an effort would in all likelihood be an uphill battle — approximately 20 states have recently attempted to get approval for some sort of public bank similar to the Bank of North Dakota, but no state has been able to pass such legislation, for many of the same reasons that could stand in the way of changing the money manager laws.

However, there is another path available that is not dependent on new legislation. Rather than placing existing investment funds directly into a public bank, it provides for an alternate source of new funds, creating an indirect means by which local government money managers might use some of their investment funds to support public banking in their jurisdictions.

GOVERNMENT JOINT VENTURES

There are many circumstances where two or more government jurisdictions determine that they need to join forces to achieve a common goal, the government equivalent of a business joint venture. Examples might be:

1. Two small adjacent townships establish a common fire department rather than funding and administering separate departments.
2. Two or more local jurisdictions determine that they need a common utility district (water, sewer, etc.) and elect to form a joint effort.
3. Two or more local jurisdictions decide that they would like to put together a joint economic development effort rather than going it alone.

A number of states have established laws governing the establishment and administration of such joint efforts. These laws eliminate the need for local governments to get permission from their state legislatures for joint efforts.

These government joint ventures go by a variety of names ranging from Joint Powers Authorities (JPAs) in California,[34] to Inter-Local Agreements (ILAs) in Michigan,[35] to Joint Exercise of Powers Agreements (JEPAs), in Minnesota.[36] They share a number of features in common.

First, they normally provide for the joint effort to perform any function that the individual participants are already legally entitled to do on their own. The state has determined that if they can already do it on their own individually, they should not have to go to the legislature to get special permission to carry out that function together. Permission would normally only be sought if the parties want to do something that is not covered by existing statutes. Such permission may be in the form of a specific exemption for that single joint effort or, if enough other

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[34] authorized under the California Joint Exercise of Powers Act http://www.leginfo.ca.gov/cgi-bin/displaycode?section=gov&group=06001-07000&file=6500-6536

[35] authorized under the Michigan Urban Cooperation Act of 1967 http://www.legislature.mi.gov/(S(q1xpgjfsolb2j3ynbr10gx55))/mileg.aspx?page=getObject&objectName=mcl-Act-7-of-1967-Ex-Sess-

[36] authorized under the Minnesota Joint Exercise of Powers Act http://www.lpa.state.mn.us/laws/joint471.html

jurisdictions want the same right, a blanket provision that might allow all such efforts.

Such a joint effort will largely function as a free-standing entity that is effectively independent from the entities forming it. It can have its own administrative body responsible for managing its intended activities, including managing its own set of funds, which may come from the jurisdictions forming the joint entity, but also can come from separate sources.

This last point is the key that unlocks the funding for public banking. Such joint efforts are often empowered to raise funds through the issuance of bonds that are then sold on the bond market. And usually the liability for those bonds rests solely with the joint project and not with the underlying entities that formed it. It is this feature that provides a solution for our public banking objectives.

If two or more government jurisdictions desire the benefits of public banking, they can form a joint entity and have it issue bonds to raise funds to support that objective. The bonds would raise new money that could be funneled into the specific public banking effort this team elects to support.

Let's say that two adjacent counties would like to encourage low-income housing or support renewable energy companies. The counties would first come to an agreement on the type of credit facilitation they want for their communities and how they would share any gains that result from the project. They would then translate that conceptual agreement into a formal agreement that is used to establish the joint effort (normally resulting in the creation of a new government corporation).

Once that entity is set up and has the management and infrastructure called for in the joint agreement, it is ready to raise the money needed to pursue its targeted objectives. It would follow standard procedures to raise money through the issuance of bonds and sell those bonds in the public bond market. For our example, let's say it raises $10 million.

Those funds would then be invested with the public banking entity that will carry out that targeted programs. The investment agreement between the joint entity and the public banking group would spell out that those funds be used for the objectives defined by the joint entity.

The public banking group is then responsible for applying those funds towards the intended project, managing the project to those objectives, tracking the financial results and returning to the investing joint entity whatever type and amount of distribution was agreed to with the initial investment.

Using our $10 million figure, whatever has resulted from applying that money to the targeted program (say loans on low income housing) will sooner or later produce income on the loans. Once the banking group subtracts its program expenses, any gains left over will be returned to the investors according to the formula agreed to in their investment agreement.

The joint entity will take the proceeds it receives from the banking group and

apply them to servicing the bond debts. Any excess amount would be available for distribution to the parties that formed the joint entity. And given that these governments came together to achieve a societal goal rather than a pure financial goal, if the project only covers the costs of the bond obligations it would normally still be considered a success.

However, if recent results reported by the Bank of North Dakota are any example, those governments might realize a surplus over their costs. BND's 2010 annual report indicates that it realized a 19% ROE (return on equity)[37] from its operations. If it had to pay 10% for bonds (a very high rate) it would still have had nearly double that, leaving a considerable profit. That is not to say that all such efforts will produce these kinds of results, but they do show what is possible.

Let us close this chapter by returning to the CAFR investment funds we described earlier. We noted that even though governments have substantial pools of such funds, state laws restricting financial managers' use of those funds would make it difficult to apply any of that money to a public banking effort.

However, now that we have defined a method by which those governments can raise new funds from the public bond market, we have created a potential backdoor for our fund managers to use some of their investment funds for a public banking effort. The reason is inherent in the nature of the bonds themselves.

Some states may already consider bonds as fitting the definition of the kinds of liquid securities that these managers may invest in. Thus they might be able to use some of their investment funds to purchase bonds from either their own joint entities or from the joint entities of others in that same state. Certainly buying each other's bonds keeps their investment funds circulating within their own state, even if there might be a reason to not buy the bonds issued by their own joint entity.

Those bonds could be resold in the bond market (far more so than private equity in a bank) and thus investment managers could satisfy their mandate of investing in liquid assets while at the same time directing money into a long term, illiquid type of investment (the public bank).

And if a state does not already consider such bonds as fitting the definitions of the types of securities that those managers can buy, it would not take a large and complicated bill to add them to the list of acceptable securities, something most states would probably be able to get passed with little resistance.

The net result is that the public banking effort in that state could be greatly facilitated by local governments, first by setting up local JPAs/ILAs/JEPAs that allow local groups to decide what areas they most need to apply the benefits of public banking and then by using those joint efforts to generate the funds needed to drive the effort. We would expect to see a diverse and robust variety of public banking programs, all contributing to a state's economic health and

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[37] See North Dakota's Economic "Miracle"—It's Not Oil, http://www.webofdebt.com/articles/north_dakota.php

probably “bootstrapping” its economy far better than would ever be realized by any federal or other program.

Let’s now take a look at the bank systems themselves – how they can be set up, how they can be managed and what might they do.

CHAPTER 7

ELEMENTS & OWNERSHIP OF A PUBLIC BANK

The foremost condition of a public bank is that it needs to serve society rather than private interests. That means in one form or another, it has to be owned by and for the benefit of the public – the core attribute of what we call a public bank.

BND is a public bank because it is owned by the state government and therefore by taxpayers. But state ownership is not the only option for a public bank — there is no legal reason why a county, city, township or other government entity could not also own a bank, as many do around the world.

There may be statutes at the state and local levels that could make bank ownership problematic for any particular government jurisdiction, statutes that might not be easily changed in today's polarized political environment.

However, government ownership of a bank, whether at the state or local level, suffers from one major shortcoming – cumbersome and lengthy decision making. Yet the nation cannot afford to wait for governments to work through that process and get their banks up and running.

This widespread government inertia is probably the single biggest factor that could slow the adoption of BND and perhaps even Sparkassen-like structures, especially in the short term. Fortunately there are alternatives.

OWNERSHIP ALTERNATIVES

Are there other ways that a bank can be operated for the benefit of the public? Two other vehicles offer sound alternatives:

- A non-profit organization, which may be organized under a number of corporate and tax structures, but generally exists to serve some public benefit (education, charity, scientific, religious, etc.). The Sparkassen banks are built on this model.
- A trust, whose resources are held in trust for the benefit of a defined beneficiary.

Nobody "owns" a non-profit, nor does anybody "own" the type of trusts contemplated here.

Trusts can be legally extremely complex and include complicated and obtuse tax structures. There are many different kinds of trusts, each serving a different purpose, and their scope is beyond this writing. Conversely, the rules for the formation of most non-profits are relatively simple, as are their tax issues and obligations. We will therefore limit our exploration to non-profits as the chief alternative to government ownership of banks.

The U.S. Internal Revenue Service (IRS) classifies non-profits under several

categories, most under Section 501(c) of the IRS code. The most common is a 501(c)(3) organization, the kind that covers churches, charities, social service organizations, schools, scientific research organizations and the like. Its activities must be limited to serving a public benefit (its "exempt purpose") and, in exchange, its income (if related to its purpose) is normally exempt from federal taxation, and donations to it are tax deductible by the donor.

One of the key attributes of a non-profit is that it also has a high degree of flexibility and self-determination, which allows it to move quickly and efficiently. Those attributes make it for us the most attractive vehicle for setting up and managing a public bank.

Finally, putting in place a public banking infrastructure does not necessarily require that a bank be wholly owned by our non-profit. As we will explore later, certain public banking projects may be achieved through existing banks, in which the non-profit is an investor rather than a sole owner.

Such investment approaches can provide the added benefit of getting a particular public banking program up and running faster that might be achieved should we wish to own a bank outright, primarily due to regulatory requirements as we will explain later. In addition, the majority of the funds in this investment-only approach would go directly into the intended project rather than in building infrastructure in a new bank or paying off previous owners to buy an existing bank, thus putting our public banking dollars to work faster and more cost effectively.

CHAPTER 8

ESTABLISHING GOVERNMENT-OWNED PUBLIC BANKS

When all gets said and done, we think that trying to get a government entity (a country, state, county, city etc.) to establish its own bank is a difficult goal to achieve. And we have developed quicker and easier ways of establishing public banks.

Nonetheless, we feel it's necessary to go through the exercise of what might be involved in setting up a government-owned bank in the United States.

The creation of the Bank of North Dakota serves as an example. The authorization and creation of BND required a bill in the North Dakota state legislature and a bond issue to capitalize it. Any state wishing to have a state-owned bank like BND will probably have to follow similar steps.

At least 20 states have begun exploring this option, but given the number of legislators who would have to support the effort, no state has yet authorized one, although several are quite close.

What about other government entities? It turns out that it may be easier to form government-owned banks at the local level.

Political subdivisions like counties and cities may not need specific legislation at the state level to form their own banks, as every state already has a fully authorized banking authority empowered to grant state banking licenses to any qualified applicant (whether a for-profit, non-profit or government) provided that the applicant can satisfy the criteria for obtaining a bank charter.

A county, for example, need only pass a resolution to establish a county-owned bank and then empower county representatives to apply for a charter from the state. Simple in theory, but difficult in practice. Voter approval might be required if the county wishes to fund the bank via a new bond issue, since the county would be likely be liable for any bonds issued to fund the bank (in contrast to bonds issued by a JPA/ILA/JEPA in which the county would not bear responsibility), and in today's economic climate, voters are reluctant to approve new bonds.

Nonetheless there is a good deal of knowledge around the country on how to set up a bank and local governments need only turn to those experts for guidance. As of August 2008, FDIC reported that there were a little over 8,400 banks in the country[38] with numerous trade associations, schools for banking, consultants, attorneys and others representing a reservoir of expertise that governments can tap.

The only prohibition might be existing laws that constrain local governments from owning their own bank. Such rules will vary state by state. A careful search

[38] http://en.wikipedia.org/wiki/Banking_in_the_United_States#Active_banks_of_the_United_States

of all such potential regulations would need to be made in each state where smaller political subdivisions might contemplate establishing their own bank.

SOLE OWNERSHIP OR POOLED INVESTMENT FOR PUBLIC BANKS

These potential barriers surface when the government entity would be the sole owner of such a bank (like BND and North Dakota). The conditions attached to exclusive ownership may be quite different from those of pooled ownership, i.e., when several government entities make partial investments in a bank. (For example, a county might join forces with its cities and townships to form a jointly owned bank.) The chief reason sole ownership may be problematic has to do with how governments manage their money.

Government accounting is different from accounting in the for-profit or non-profit worlds. Governments have to place their funds into separate accounting "buckets" that cannot normally be intermingled. That, in part, accounts for the condition we mentioned earlier where governments cannot use special funds (like fiduciary funds) for their current budget needs.

If such an entity wanted to wholly own its own bank, it would be required to authorize a special fund to capitalize the bank (i.e., provide it with an initial pool of funds to begin operations), which might come from an existing pool, but will more likely require a new pool typically funded by such means as issuing a bond, like North Dakota did for BND. With so many local governments in financial difficulties, getting a new bond issue approved might be difficult.

Taking from an existing pool might prove more viable if a government jurisdiction were to contemplate sharing ownership. This approach may change the legal and financial dynamics substantially. To understand how, we need to first look at how governments manage their funds.

All government entities (and in particular their chief financial officers, usually treasurers) are mandated to manage their existing funds on behalf of that entity. They have to manage each separate accounting "bucket" as though it were a stand-alone entity. And that includes funds that they are required to invest. With respect to funds they manage, treasurers place money with other parties, typically financial management organizations, as either deposits or investments, depending on the purpose of the funds being managed.

For example, the money that a jurisdiction needs for its day-to-day operations (generally brought in via tax dollars and placed in the general fund) would normally be deposited in short-term demand deposit accounts or very short-term interest-bearing accounts, so that the funds are available as needed. Other funds, such as pension funds (sometimes not needed for decades), need to be placed primarily in investments so that the initial pool of funds can be grown for later extraction.

When it comes to investments, our legal and tax system recognizes two general forms of investments, active and passive. Active investments usually entail involvement in the management of the enterprise receiving the investment funds

(i.e., running the business) and associated liabilities risk. Passive investments normally entail no involvement in day-to-day decision making and management of an enterprise, and therefore usually shield the passive investor from liabilities other than the potential loss of their investment.

Normally government investments are almost exclusively passive. The key question government officials need to ask is whether they want to be responsible for running a bank.

Were a government to be the sole owner of a bank, it would in all likelihood have to manage it, making it an active investment with all the liabilities and responsibilities that come with owning and running a business. Ownership shared with other governments and non-profits under a passive investment strategy are inherently less risky from a liability standpoint, and certainly would be easier.

WHO GOES FIRST?

The problem with this shared approach is that someone has to step forward as the initial organizer, establish the bank, navigate the requisite approvals and allocate the dedicated funds to launch operations. This entity could be viewed as the bank's sole owner during that time. This would be considered an active investment. In the above example, that might be the county or one of its larger cities.

What if no single government entity wants to assume that leadership and management role, and everyone wants to be a passive investor? That is where the non-profit alternative can come into play, a scenario we explore later in this document.

For now, let's assume that one or more governments find a way to establish and fund a public bank. Why should they take that step and what benefits might they and their communities realize? Let's look at the flow of money in local economies and how these public banks will contribute.

INVESTING LOCALLY

Local governments' investments in a local public bank may be more beneficial than their existing investments, especially those on Wall Street, which are proving to be far riskier and less rewarding than planned. And even if those investments provide some positive return, they typically don't provide broader benefits to local economies. Wall Street rarely returns those funds to local economies in the form of either investments or credit.

A 2011 study by The Demos research and policy center[39] titled "Banking on America: How Main Street Partnerships Banks Can Improve Local Economies"[40] noted:

> "Across the country, states are considering proposals to move general

[39] http://www.demos.org
[40] http://www.demos.org/publication/banking-america-how-main-street-partnership-banks-can-improve-local-economies

> revenue deposits out of the Wall Street banks that dominate the banking business today, and use them to capitalize a new local public structure with a mission to grow the local economy. A "Main Street Partnership Bank" would be modeled on the nearly 100-year-old public Bank of North Dakota (BND). This public policy innovation—also known as a Public Bank or State Bank—could contribute to the health of local community banks, state budgets and small business job growth in an era of rapid banking concentration, budget deficits and disinvestment on Main Street."

The study concluded:

> "Main Street Partnership Banks could provide states a way to put local tax dollars to work supporting the local economy—providing an innovative solution to a rising problem. As finance has grown more concentrated, speculative and globally focused over the past decade, it has also grown less accountable to the real economy, particularly at the local level. Governors and Treasurers across the country are beginning to realize that they can no longer wait for Wall Street to reinvest in their communities, or to provide fairer terms for their investment and banking services. After operating in relative obscurity for nearly 100 years, the Bank of North Dakota is now serving as a bi-partisan model for public finance and sustainable local lending in the 21st century."

If state and local jurisdictions were to invest funds within the state and preferably within local economies, there would be a compounding benefit. Not only would the governments realize gains from their investments (as they theoretically would with Wall Street investments), but the community would also be made healthier through the circulation of those investment funds.

The more money available in a local economy the healthier it is. Both investment funds and funds provided as credit have that same beneficial impact. Each dollar in circulation changes hands multiple times in a well-known multiplier phenomenon that enhances its impact several times over.

This is especially the case with the "buy local" movement.[41] If we buy from local businesses rather than big box businesses headquartered elsewhere, our local economy sees even greater overall financial activity.[42] Estimates are that a dollar changes hands two to seven times before it leaves a local community with a payment that goes outside that community. Thus dollars injected into local economies multiply to the benefit of the whole community.

The economics department[43] at the University of North Carolina has published a description of this multiplier effect. According to their calculations, every one hundred dollars invested/spent in the economy as a whole will yield at least five

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[41] *'Buy Local' Movement Gains Traction* http://www.nuwireinvestor.com/articles/buy-local-movement-gains-traction-58355.aspx

[42] *"The Multiplier Effect of Buying Local"* http://solenow.org/2012/03/300/

[43] *"Multiplier Effect"* http://www.unc.edu/depts/econ/byrns_web/Economicae/multipliereff.html

hundred dollars in total economic activity (both inside and outside the local economy), a 5:1 ratio. They speculate that the multiplier could be much higher (14 to 15 times higher) if their assumptions about savings are less and the spending more.

The opposite is also true. When money is removed from circulation (over $3 trillion since 2008), the local and national economies lose that compounding effect. That is one of the key reasons why the dearth of credit from community banks is having such a devastating effect on local economies across the nation.

Establishing BND and Sparkassen-like public banks can be the key to getting community banks healthy. Investment funds from local government jurisdictions, invested in local public banks, would help community banks to increase their lending to small businesses. That would expand the benefits realizable by those banks and would have a positive ripple effect throughout local economies.

More importantly, investments in those banks multiply benefits more than investments in other kinds of businesses. That is because banks can do something no other entity can — they can "create" money in the form of credit to borrowers. The Federal Reserve, in its publication *Money, Banking and Monetary Policy*, makes this clear when it states, "Banks actually create money when they lend it."[44]

Banks do not have to take money from someone else (depositors) to create loans. Instead, banking laws allow them to *create new money* with just a few mouse clicks![45] While technically true that only the government can "print" physical money (paper currency and coins), banks nonetheless inject "new" (digital) currency into local economies with every loan they write. More than 90% of all money in circulation begins as bank credit.

Can banks create as much money as they want? No, but the limits are not absolute, varying in time and conditions. Regulators allow a bank to create loans up to a certain multiple of the capital held by the bank (the bank's assets). When economic times are tough, they tend to lower the total allowed (10 times or less), and when things improve, they tend to raise the ceiling on loans (12 times or more). And even though they set an average multiple across all banks, regulators will vary that number, based on the economic health of each individual bank.

Currently in the United States, banks can do so on a ratio of approximately 10 times, that is, create $10,000 of new credit money for every $1,000 of capital. Thus every thousand dollars invested by the government or other investors in a local public bank translates into the potential for $10,000 in credit for the community, which puts that $10,000 in circulation in the local economy and compounds the value of the investment money.

Using our 2 – 7 times *local* economy multipliers, coupled with the 10:1 loan multiplier, we see that the initial $1,000 invested in local banking could produce

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[44] *P. 11* http://www.dallasfed.org/assets/documents/educate/everyday/money.pdf
[45] *Dollar Deception: How Banks Secretly Create Money* http://www.webofdebt.com/articles/dollardeception.php

as much as $20,000 -$70,000 worth of financial transactions in the local community – a multiplier of 20 to 70 times that investment! Almost nothing else a government could possibly do would have that huge positive financial leverage that directly benefits the local economy. And according to the University of North Carolina study, those funds continue to circulate when they leave the local economy for an overall larger stimulus for the country as a whole.

And those $20,000 -$70,000 in local transactions could return direct benefits to the investor government in the form of local sales taxes, property taxes, fees and assessments that could easily exceed the original $1,000, which continues to make more money as interest and earnings on the loans themselves.

Analysis of recent returns to the Bank of North Dakota show an average greater than 20% annualized return on assets over the past five years, with a lower loan default rate that the average of all the community banks in the state. That means that the original $1,000 has doubled in value in under five years – a figure that far exceeds what local governments are realizing from Wall Street investments today!

As we noted, deposits are not the source of funds that are lent out. When someone deposits money with a bank, the bank has to give them that money back any time they demand it. That is why such funds are often called "demand deposits".

Banks may temporary use those funds elsewhere in the bank's operations, but don't actually lend that money to a borrower. Otherwise the depositor would not be able to get their money back until the loan is paid off, as would be the case if we placed our money with a non-bank lender who then takes our money and lends it out. Banks are different.

Banks shuffle money around through accounting and use deposit money to cover short-term demands on credit money created with loans. So if a borrower writes a check from the loan they received from Bank 1, that check has to be covered if Bank 2 presents it back to Bank 1 for payment (called settlement).

Conversely, Bank 1 may get a check deposited from a different account held at Bank 2. That check would offset all or a portion of what the Bank 1 needs to pay Bank 2 on the original transaction. Banks tally up all these transactions at the end of each day and only have to cover any differences.

For example, Account Holder A at Bank 1 writes a check for $10,000 to Account Holder B in Bank 2. Account Holder C in Bank 2 writes a $9,000 check to an Account Holder D in Bank 1. At the end of the day, the banks compare notes and Bank 1 remits $1,000 to Bank 2. It often uses its depositors' funds to cover those nightly settlements. Thus deposits in banks serve a role in the process, but are not the funds that banks actually lend to borrowers.

Thus *capital* (not deposits) is king in banks with respect to how much they can lend. And given the large amounts of investment money currently owned and controlled by state and local governments (the CAFR funds we mentioned), a

redirection of even a small percentage of those funds into a public banking vehicle could have huge positive impact on local economies nationwide. The key, as we discussed previously, is being able to release a portion of those funds from the current investment restrictions.

CHAPTER 9

NON-PROFIT OWNED BANKS

So if getting a government to set up its own bank is difficult, what alternatives are available? We find that the not-for-profit world can provide us with answers.

In contrast to for-profit corporations, nobody owns a non-profit. It exists purely for the purpose of providing some benefit to society. If it is dissolved, its assets are considered public property and must be distributed to another non-profit.

However, like any for-profit corporation, a non-profit can own (wholly or partially) just about any kind of business, including a bank. Since non-profits exist for a public benefit, a bank owned by a non-profit corporation is essentially a publicly owned bank. That is what the Sparkassen banks in Germany are, community banks owned by a local non-profit, or more correctly, are non-profits themselves.

If a U.S. non-profit-owned bank were formed to aid local economies, its profits would normally be tax free. If it were formed for some other purpose (e.g., scientific research), then the profits from the bank might be considered what is called "unrelated business income" and could potentially be taxable. In our case, the existence of the bank would conform to the purpose of the non-profit owning and running it.

Among the handful of non-profit owned banks in the United States are:

- One PacificCoast Bank, FSB[46] (formerly OneCalifornia Bank), a federally charted savings bank owned by the private foundation[47] One PacificCoast Foundation.[48]
- Virginia Community Capital (VCC)[49] formed a state-chartered community development bank called Community Capital Bank of Virginia (CCB). CCB is a for-profit, FDIC-insured, commercial bank, wholly owned by a non-stock, non-profit entity.

WHO CONTROLS A NON-PROFIT?

Government-owned banks could be subject to public and political pressure. In contrast, non-profits would normally be far less subject to political influence and so would any banks they own.

They may be influenced programmatically by large donors, but that is different from pure political influence. But even that influence has to be legal and conform to the exempt purpose for which the non-profit was formed. And none of its resources can be directed legally to the private benefit of any one individual or group.

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46 http://onepacificcoastbank.com/
47 http://en.wikipedia.org/wiki/Private_foundation
48 http://onecalfoundation.org/
49 http://www.vacommunitycapital.org/

Even though they are considered public benefit organizations, non-profits are not run by public bodies, but by their boards of directors and senior management. The only outside influence would be from regulators, as is the case for all banks. They would not, however, be subject to direct influence from the general public. That in many peoples' eyes is a good thing, but others may have concerns about accountability.

So should we be concerned about accountability with non-profit owned banks? Of course. However, this may be easier and more straightforward than some might believe. And a case can even be made that a non-profit-owned and managed bank may result in a more reliable custodianship of our public resources than we might find with government run institutions, even though the governments are purportedly subject to voter and taxpayer scrutiny.

Here's why. Non-profits have been around for a long time and have been intensively scrutinized, especially by funding sources. When we think of non-profits we automatically think of do-gooders, not crooks. The vast majority of people who get involved with non-profits do so because of an altruistic urge to serve and give back to society. The non-profit community has a long history of dedication to public need and misappropriation or misdirection of funds is a rarity.

Prudent and reasonable banking management safeguards will also ensure that public funds are protected and used exclusively for public benefit, further enhanced by the nature of the agreements that cover how a government investor's funds are to be managed.

Compare that with local government leadership. Most politicians leave office far better off financially than when they entered, often by an amount far exceeding what might be accumulated by their government salaries alone. Public polls historically rate trust in non-profits far higher than governments, and for good reason. Thus the likelihood is that public funds will be better and more faithfully protected by the non-profit community than the government community.

HOW NON-PROFITS ARE RUN

The senior management of a non-profit (especially in its early days) is often controlled by one individual or a small group, who conceived of the original idea for the non-profit (its purpose) and drove it into existence, much like an entrepreneur does in founding a for-profit enterprise. Such individuals are often called "social entrepreneurs."

These founders and others on the team contribute their effort and time, knowing that any gains made by their organization are "held in trust" for the public benefit and that no single individual, founder or otherwise, is permitted to gain personally, beyond normal salary and employee benefits (i.e., they cannot receive any equity in the corporation and/or businesses it might own). This reinforces our expectation that non-profits will generally be honest custodians of public funds.

FREEDOM TO DEFINE THE MISSION

The result is a high degree of independence that allows these organizations to define their own mission and serve society in whatever manner they choose. As a practical matter, whether outsiders have influence over the organization depends on their source of financial support.

Primary sources of funding (such as major foundations that provide large grant funds) often have strong influence on what a non-profit does and how it does it. In contrast, non-profits that are broadly supported by the general public (donations, volunteers, etc.) are often quite independent.

In any case, the leadership can target a particular objective like helping the economically disadvantaged or people of color, helping students, aiding distressed homeowners, fostering the greening of communities or, as with our primary purpose, supporting community banks and other public benefit financial institutions, in their effort to serve the broader credit and financial needs of the whole community.

PROFESSIONAL BANK MANAGEMENT

A key benefit of a non-profit organization is its ability to assemble a professional bank management team, certainly something a government established bank could also do. Since a public benefit banking enterprise needs to be managed and operated just like any other well-run bank, solid banking decision-making needs to stand at the center of the enterprise, with the social and economic goals addressed using those guidelines. This ensures the ongoing success and continuity of the program. The Bank of North Dakota is managed this way, and remains largely free from political and other outside influences.

Non-profits closely resemble for-profit businesses in how they are run, so running a bank would be a more natural function for them than it might for a government organization. If active management of the bank is the responsibility of the non-profit stakeholder, then government stakeholders could be passive investors and relieved of that responsibility.

DRAWBACKS OF NON-PROFITS

The single most common problem encountered by non-profit organizations is their constant need to raise funds, whether small individual donations from the general public, or larger blocks of funds from donor organizations, both public (governments) and private (foundations and other grant-making organizations).

One way to offset that need is to incorporate a profit-making business within their operations, especially if it synchronizes with their primary mission (think Goodwill or the Salvation Army). Such would be the case for a non-profit-owned bank. Getting sufficient capital to reach sustainability would normally be the single biggest challenge of a non-profit wanting to establish a bank.

CREATING STRENGTH FROM WEAKNESS

In the previous chapters, we saw the strengths and weaknesses of governments and non-profits. To recap:

Government Weaknesses

- Subject to laws and outside influences that could make it difficult to launch their own banks.
- No experience managing or operating banks and running a business in general is an unnatural act for them.
- Would have to establish a dedicated pool of funds to capitalize the bank, and such an investment would be an active versus passive investment.

Government Strengths

- Nearly every government, from the state level down, has large pools of funds that they currently manage, a good portion of which are invested passively in outside investments. Such funds could be tapped for passive investment in some form of commonly owned bank, wherein the investing government would have no day-to-day management responsibilities.
- Since such investments are already routine, special approvals may not be required (varies by state and local regulations).

Non-profit Weaknesses

- Lack of money to capitalize the bank, both initial funds to set up or acquire a bank and then to expand it with more capital.

Non-profit Strengths

- Freedom from most outside influences and regulations (other than normal banking regulations), allowing the bank to be established and run quickly and efficiently by banking professionals.
- Experience running a business.
- Nimble decision-making ability

Clearly, if we were to bring these two groups together, we find that the bank can most easily be set up and administered by a non-profit organization and funded by government organizations, allowing each to benefit from the strengths of the other.

Such collaborative enterprises would follow conventional banking structures wherein the bank is either a stand-alone entity owned directly by its owners, or established as a subsidiary of a bank holding company[50] (a parent company with one or more subsidiaries), wherein the holding company owns the bank and the investor/owners own the holding company. The general rule is that if you want more flexibility, the bank holding company model is preferred, the main reason we recommend it for this kind of public partnership arrangement.

[50] http://en.wikipedia.org/wiki/Bank_holding_company

CHAPTER 10

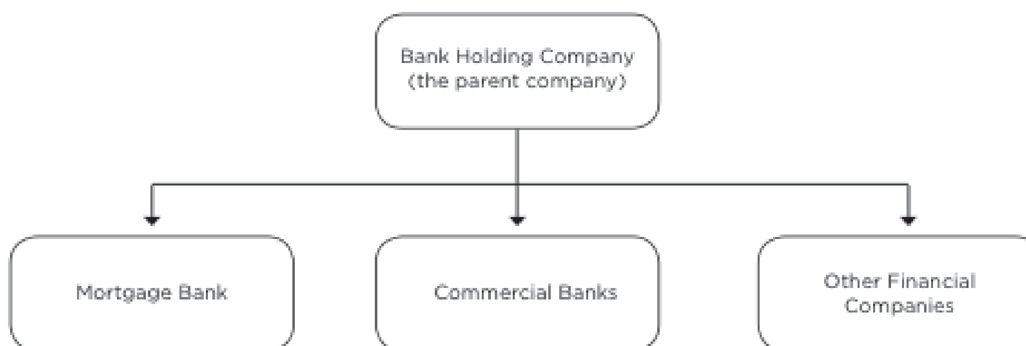
A MODEL STRUCTURE

Our goal is to build a new local financial ecosystem designed for the public benefit. This means incorporating the best of the old system and redirecting its mechanisms towards our collective needs rather than the enrichment of a few.

Banking stands at the very center of the financial world. Commercial banks[51] in particular are allowed to do things that no other institution can – principally create money as a legal multiple of their assets – manifested in the form of credit money for borrowers, as we described in Chapter 8. Thus banks inject new money into an economy, rather than merely recirculate existing money. All other financial systems and the rest of the economy revolve around this nucleus of banking and are dependent on it.

A complete ecosystem would thus have at its center one or more deposit-taking, loan-generating commercial banks. Alongside those banks would be other financial institutions like mortgage companies, insurance companies, venture capital companies, brokerage firms, community investment funds and more, all serving a public benefit.

Figure 1 depicts the relationship of those entities to each other and their parent organization.



The question is, does one start with the commercial bank component and build from there or start with one or more of the other financial institutions and add the commercial banking component downstream? With one key exception (investing in existing banks versus owning one outright), we at NCG[52] believe that the latter might be easier to launch, faster (fewer regulatory requirements than with ownership of a bank) and less expensive.

Thus, for those with more limited resources and/or less knowledge and skills about commercial banking, we will lay out a plan for starting with non-bank

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[51] http://en.wikipedia.org/wiki/Commercial_bank

[52] *National Commonwealth Group, Inc. (NCG), a 501(c)(3) non-profit organization*

subsidiaries and show how to add one or more commercial banks to the mix when more resources are available. Alternately, if more resources are available, but little knowledge of commercial banking, it would be possible to get started with targeted investments in existing banks (investments that require some form of public banking to be performed), wherein those banks remain in control of their banking operations and our public banking group is restricted to being a passive investor for the time being. We will explore that option later. For now, let's see how we can get going with a non-commercial banking operation.

There are any number of public benefit financial entities that we might contemplate. However, given the housing crisis, we feel that financial entities related to real estate should be a high priority. In particular, we suggest starting with three types of real estate-oriented subsidiaries, (stand-alone companies under a parent company) each serving a different role in dealing with the housing crisis through foreclosure prevention, and collectively providing us with a foundation upon which to build our larger public benefit financial enterprise, including the commercial bank component.

The first is a real estate fund that would acquire distressed mortgages and notes from existing lenders, in the process blocking foreclosures. The fund can acquire those notes and mortgages by purchasing them at a discount using investor funds or by getting the current owner of the notes and mortgages to assign them to the fund in exchange for equity (the assignment requires approval by regulators). Thereafter the real estate fund company would negotiate new terms with the homeowner, yielding new reduced mortgages/notes, rental agreements and other possible combinations.

The new mortgages and notes could be then sold to the second entity, a type of mortgage company called a mortgage bank. Mortgage banks provide financing to buy and hold mortgages and notes and our mortgage bank company would thereby be a key source of financing for the real estate fund, allowing it to buy more distressed notes and mortgages from other lenders or pay back the lenders who assigned their notes and mortgages to the fund, and keep that cycle going.

The third entity is a company that owns real estate and rents it to third parties. Where a rescued homeowner is not in a position to enter into a new mortgage and note agreement with the real estate fund company, they nonetheless might be able to enter into a rental agreement, thereby allowing them to remain in the home even if no longer as the homeowner. That agreement might also be a rent-to-own agreement that would eventually allow the former homeowner to repurchase the home.

Each of these companies would attract a different kind of investor, but collectively these companies would work in concert, each focused on a subset of the need. They are designed to deal primarily with the most pressing credit problem in the United States at this time, the local housing crisis that has resulted in an epidemic of foreclosures and is the focus of a project under development by NCG called the National Foreclosure Prevention Program.

(See the book published by NCG titled "Eminent Domain: How to use eminent domain to stop foreclosures, rescue homeowners and save communities"[53] *for an in-depth exploration of the housing crisis and how communities can use eminent domain to stop foreclosures in those communities. Our mortgage banks should be one of the principal sources of funding to be used by those same communities to address their local housing crisis. We will explore this topic in more detail below).*

Let's take a look at each of these subsidiaries/companies in turn.

[53] http://www.eminent-domain.us

CHAPTER 11

REAL ESTATE FUND

The easiest and perhaps most immediately impactful entity that can be established is a real estate fund company, more correctly a real estate hedge fund.[54] [55]

A hedge fund is defined as "a type of pooled fund investment vehicle set up and facilitated by a money manager. The investment goals of the hedge fund are usually defined in an offering or prospectus. The fund may invest in a myriad of products ranging from stocks and bonds to real estate or mortgage notes. It may invest in all of the above or other products. Funds are typically structured in an LLC or partnership form and are mostly an unregulated entity. Because of this fact, investors must be accredited with a basic understanding of investing and risk. Investors need a certain amount of liquidity and must document sufficient assets to prove this criteria has been met."[56]

For the most part, setting up a real estate hedge fund is much like forming any other small private company where the organizers need to raise capital from outside parties to fund their planned business activities. Such fundraising normally falls under Regulation D[57] (Reg D) of the Securities Act of 1933 (1933 Act)[58] and corresponding state securities laws. The 1933 Act is administered by the Securities and Exchange Commission (SEC) and contains the regulations that govern fundraising for most small, private companies.

A pooled investment company[59] is a way of investing money alongside other investors in order to benefit from the inherent advantages of working as part of a group. Normally pooled investment companies are regulated by the federal government under a different set of regulations established under the Investment Company Act of 1940, (1940 Act),[60] which is also administered by the SEC. The 1940 Act applies to all pooled investment companies, including mutual funds, but exempts several types of investment companies from the act's coverage. The most common exemptions are found in Sections 3(c)(1) and 3(c)(7) of the act and include hedge funds.

However, even hedge funds, if they invest in any securities (or money market accounts which may, in certain circumstances, be deemed to be securities), can come under the jurisdiction of the Investment Company Act. Not so for hedge funds that concentrate solely on real estate. They need only concern themselves

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[54] Hedge funds have been the subject of much negative publicity, but they are a useful tool that gives us the ability to carry out our broader goals.
[55] http://en.wikipedia.org/wiki/Hedge_fund
[56] http://www.artisanrealestategroup.com/arizona/2011/08/what-is-a-hedge-fund
[57] http://en.wikipedia.org/wiki/Regulation_D_(SEC)
[58] http://en.wikipedia.org/wiki/Securities_Act_of_1933
[59] http://en.wikipedia.org/wiki/Pooled_investment
[60] http://en.wikipedia.org/wiki/Investment_Company_Act

with Regulation D.[61] From a regulatory standpoint, that is about as low a regulatory threshold as one can get in any kind of financial enterprise, and it is certainly far below that required of commercial banks and even mortgage banks as described below.

That is not to say that such a fund would not fall under any other regulatory authority. The kind of real estate hedge fund we are advocating may need to register with the state as a mortgage bank or other similar designation, which requirements are largely defined state by state. See the chapter on mortgage banks for those kinds of requirements. For now, we will assume that we can get started solely under Reg D and once the fund is established, its activities may need that further coverage.

Given the above, we find that setting up a real estate hedge fund falls within the common experience of most entrepreneurs who have raised outside capital for their companies. The same applies to the accountants, attorneys and other advisors who work with such entrepreneurs and thus the basics for setting up a real estate hedge fund are actually widely known. So setting up such an enterprise should be relatively quick and easy, as is covered in brief detail here[62] and in greater detail here.[63]

What can we do with this entity once we have set it up and funded it and how does that apply to our goals of addressing the housing crisis as the foundation for building our public benefit financial enterprise? The answer lies in the nature of our proposed real estate hedge fund.

Let's first take a closer look at hedge funds in general. A hedge fund is an investment company that can undertake a wide range of investment and trading activities, wider than most other funds. Hedge funds can generally invest in any kind of asset where they can take advantage of some sort of arbitrage,[64] i.e., buy low – sell high strategy. It matters not what the primary asset might be, just whether the hedge fund can purchase an asset that can be leveraged to increase its value and then sold off to realize a financial gain.

Many hedge funds work strictly with securities (stocks, bonds and derivatives) on the stock market, including creative uses of shorts and longs. Others make money by arbitraging commodities or currencies. Still others buy more unusual assets such as a creditor's position in a corporate bankruptcy, or distressed loans from lenders. It is this last asset category that is the focus of our proposed real estate hedge fund. The following section will explain how.

BACKGROUND

In Chapter 1 we addressed the poor health of community banks throughout the

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[61] http://www.hedgefundlawblog.com/real-estate-hedge-fund-structure.html - this law firm blog contains an significant amount of information about hedge funds in general and this particular page addresses real estate hedge funds and the question of regulation under Reg D & the 1940 Act
[62] http://www.artisanrealestategroup.com/arizona/2011/08/what-is-a-hedge-fund/
[63] http://www.hedgefundlawblog.com/monthly-feature-start-up-hedge-fund-timeline.html
[64] http://en.wikipedia.org/wiki/Arbitrage

nation, the role of real estate loans in community banks and how that negatively impacts their ability to provide other forms of credit, in particular small business loans. Let's explore those ideas in more detail to see how our real estate hedge fund can address those problems.

As we mentioned in Chapter 1, the U.S. recession has disproportionately affected Main Street, while Wall Street and its public companies have been making record profits and are sitting on large cash reserves. Capital and credit are abundantly available to them.

In contrast, Main Street is struggling to keep its head above water. At the center of this stands the housing crisis, characterized by millions of homeowners who have lost their homes to foreclosure and many more who stand poised to lose theirs. Foreclosures not only hurt the homeowner, but the rest of the community suffers as well. A 2007 study by the Joint Economic Committee of the U.S. Senate concluded that "foreclosures are costly – not only to homeowners, but also to a wide variety of stakeholders, including mortgage servicers, local governments and neighboring homeowners. The high costs of foreclosures – up to $80,000 for all stakeholders combined – present a strong incentive to prevent them."[65]

Other studies have chronicled additional harm ranging from dramatic increases in crime in hard-hit neighborhoods, mental health degradation in children and adults impacted by foreclosures, and a clear and pervasive negative effect on the economic health and general welfare of communities.[66] Less well known is the effect of the housing crisis on the availability of other forms of credit, principally because of the impact of the housing crisis on community banks. That connection between housing, community banks, the availability of other forms of credit in the community and the economic health of the community tied to credit availability (as explained below) causes us to focus on community banks as the starting point for our foreclosure solution.

COMMUNITY BANKS & FORECLOSURES

Community banks are the primary engine that helps drive local economies[67] by injecting new money[68] in the form of business loans to local small businesses. Collectively, bank loans from all banks in the country are the source of over 90% of all the money in circulation (not the government as most people believe) and without credit flowing, small businesses struggle to survive and stay afloat, and their local communities struggle as a consequence.

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[65] http://www.jec.senate.gov/archive/Documents/Reports/subprime11apr2007revised.pdf & summarized in press release at http://www.jec.senate.gov/public/index.cfm?p=PressReleases&ContentRecord_id=fa65b237-7e9c-9af9-7f02-295f11af9ecb&ContentType_id=66d767ed-750b-43e8-b8cf-89524ad8a29e

[66] http://www.nw.org/network/neighborworksprogs/foreclosuresolutions/reports/documents/7ForeclosureImpacts.pdf

[67] Big banks, like those on Wall Street, find lending to small businesses too small anymore to be worth their time and money and as a result have turned away from local community lending, probably never to return.

[68] The Federal Reserve, in its publication Money, Banking and Monetary Policy, makes this clear when it states, "Banks actually create money when they lend it." http://www.dallasfed.org/assets/documents/educate/everyday/money.pdf

In Chapter 8 we described how each dollar in circulation changes hands multiple times in a well-known multiplier phenomenon that enhances its impact several times over. The more money that is available in a local economy, the healthier it is. Conversely, when money is withdrawn, the whole community suffers financially. If community banks are impaired in their primary mission – lending to the local community, especially to small businesses – then the whole community is affected.

In contrast to the big banks, lending to local small businesses is the bread and butter of community banks, followed to a lesser extent by real estate loans. Unfortunately, community bank small business loans have largely dried up. Regulators allow banks to have a mix of high to low risk loans in their portfolios, within certain ratios and balanced with their capital assets.

Bad loans throw a hand grenade into the mix. Because of the housing crisis (precipitated by the big banks on Wall Street) community banks' real estate loan portfolios have been devastated, dragging down the rest of their loan portfolios, which in turn has diminished or eliminated their ability to make other kinds of loans, in particular small business loans.

If we can do something about those bad real estate loans held by community banks, then we can have a direct positive impact on the rest of the local economy, principally small businesses.

As we stated in Chapter 1, unless Main Street small businesses can recover, our national economy cannot recover. Wall Street banks have deserted small and medium-sized businesses, making huge profits in the largely unregulated shadow banking system. These big banks have historically never circulated local investment dollars in local communities, and now community banks are unable to do so due to increased capital requirements from regulators as a result of misbehavior by the big banks.

What local communities need to do is pull back even a fraction of those funds from Wall Street and redirect them to the benefit of our local economies. How? One answer is the kind of a real estate fund program we are discussing here. And one of the best ways that the program can funnel those funds into the local community is to help community banks, which in turn can not only address the foreclosure problem but turn their small business lending spigots on again.

The best way to get community banks lending again (thereby getting local economies healthy) is to help them offload their distressed real estate loans and replace them with cash. And the best way to help homeowners is to block immediate foreclosures until an alternative solution can be put in place (new mortgage/note, rent to own arrangement, rental etc.) that allows them to remain in their homes. Can we do all of those things in one integrated solution? That is where our real estate hedge fund comes in.

A model has already been demonstrated,[69] developed by Lew Ranieri who invented the concept of mortgage-backed securities,[70] (MBSs, a form of a financial derivative.)[71] Wishing to undo some of the damage caused by the misuse of MBSs, Ranieri founded Selene Residential Mortgage Opportunity Fund, an $800M+ investment fund that purchases distressed loan "portfolios" at a discount from the big banks and then renegotiates the terms with individual homeowners.

Those renegotiations may result in a new (lower principal and payments) mortgage and note, a rental agreement, a rent-to-buy agreement or some other arrangement that allows the homeowner to avoid foreclosure and in most cases to remain in the home. The key is that by buying the original notes and mortgages at a discount, Ranieri's group is able to purchase those assets at a price low enough to leave room to redo the contracts, resulting a new mix of assets ranging from new mortgages and notes, to rental properties and more and still have an overall gain (the essence of hedge fund arbitrage).

With Selene, Ranieri has not only been able to salve his conscience, but is turning a tidy profit for his investors. Fortune estimates that it is delivering a consistent return of between 10% and 12% when it disposes of the new assets it creates. Ten-year Treasuries, by comparison, yield 3.4% at the time of writing. Others have jumped on the bandwagon, but to date, most have ignored community banks whose distressed loan portfolios are too small to attract their attention.

Our real estate hedge fund is designed to do for community banks what Selene does for Wall Street banks. Our plan is therefore scaled to the size, needs and circumstances of community banks.

Our hedge fund thus carries out three key functions, each of which addresses a problem plaguing homeowners and communities nationwide:

- Purchasing distressed loans from community banks thereby freeing them up to provide more much needed credit within their communities.
- Rescuing homeowners facing immediate foreclosure and establishing new arrangements that help them stay in their homes if possible.
- Taking one class of assets – mortgages and notes – and converting them into multiple classes of assets such as new mortgage and notes, rental properties, or other classes.

We have already addressed the importance of the first two functions. The importance of the third function might not be evident at first glance. Here's why it matters.

Most investors prefer to invest into one class of assets. However, buying one type of an asset in order to change it into another kind of asset is an uncommon type

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[69] *See http://money.cnn.com/2009/12/08/real_estate/lewie_ranieri_mortgages.fortune/index.htm & http://online.wsj.com/article/SB10001424052748704720004575377022447064474.html*
[70] *http://en.wikipedia.org/wiki/Mortgage-backed_security*
[71] *http://en.wikipedia.org/wiki/Derivative_(finance)*

of business. But doing so is what enables the first two solutions and the benefits they deliver.

This is why our hedge fund is so important. By performing that conversion, it can pass the newly created assets on to investors who prefer investing in those specific kinds of assets. Thus we establish a mortgage bank for the mortgages and notes and a rental property company for the rental property assets, as covered in the following chapters.

AN ALTERNATIVE APPROACH

Let's look at one other way that our hedge fund can obtain distressed notes and mortgages directly from community banks. In this case it can do so without the necessity of raising investor funds to purchase them. Instead, the bank would transfer them directly to the hedge fund in exchange for an ownership position. This approach is quite different from the Selene model, as we will explain.

One of the key factors in the previous approach is that investors want to buy low and the bank wants to sell high.

The investors are looking to make a profit and they recognize that they are assuming a high degree of risk. After all, those old notes are a problem because they have become what the bank calls "impaired." Thus, if investors are to take over the bank's position, they will want to buy those instruments for the lowest price possible so as to leave them room to negotiate new instruments that will deliver a profit.

The bank, in contrast, is looking at three factors. First, selling the impaired notes will remove them from their loan portfolio, making their portfolios healthier. Second, they will replace those impaired notes with cash on their balance sheet. This improves their capital base, which is used to determine if they can make any new loans. And the more cash they get, the better.

However, the third factor is the major downside for the bank if they sell the note and mortgage for less than the homeowner owes. Any shortfall is recorded as a "loss" to the bank. Regulators do not like impaired loans on the books of banks, but they are also not fond of losses. The bigger the loss, the more problems for the bank.

And thus the bank has to do a delicate balancing act — improving things on one side while taking a hit on the other. Thus they are motivated to sell as high as possible, the opposite motivation from that of the investors.

This alternative approach removes investors from the equation, allowing the bank to realize the maximum profit possible from the activities of the hedge fund.

DIRECT ASSIGNMENT

The most common way for an investor to acquire ownership in a company is to invest money. But that isn't the only way.

Other assets can be used to accomplish the same thing. In this case, the hedge

fund agrees to let the bank "assign"[72] its interest in the notes and mortgages (i.e., transfer their ownership rights to those assets) to the hedge fund in exchange for an equity (ownership) position in the fund.

While a group of such notes and mortgages could be assigned at one time, it is probably best to treat each note and mortgage as a separate investment. That way the disposition of each note can be tracked and its profit or loss allocated to the appropriate contributing parties, without a commingling of assets.

Once the fund has ownership of the old notes and mortgages, it is then free to work out new arrangement with those homeowners as is already contemplated above. Those new arrangements will result in new notes and mortgages, rental agreements, and the like, all of which would be subsequently sold to other investors.

After those assets are sold, the fund would distribute the proceeds to the bank that assigned the original notes and mortgages (thus the separate tracking). That is the same kind of distribution that the fund would pass on to investors who invest cash in the fund rather than assign notes and mortgages.

However, proceeds from the sale would almost certainly yield a better return to the bank then selling the old note and mortgage at a discount up front. The result is that the bank will realize the maximum return without having to share any of it with investors.

The following example shows the difference between the two approaches:

Current outstanding note with the bank is $100,000. After the fund obtains the old note, a new note is established with the homeowner at $75,000 and thereafter sold by the fund for that amount. $75,000 would be distributed to the cash investors or the assigning bank as follows:

- If the original note was purchased by the fund using investor money, assume the fund pays the bank a discounted amount of $50,000 for purchase of the note. In this case the investor makes a $25,000 profit (note bought for $50,000 and sold for $75,000) and the bank records a $50,000 loss ($100,000 note sold for $50,000).
- If the bank assigns the note to the fund for $100,000 but gets back $75,000, the bank would record a $25,000 loss ($100,000 - $75,000).

One of the additional benefits of this approach over using investor funds to purchase the notes and mortgages is that the fund is not constrained on how many notes and mortgages it can acquire primarily because it is not limited to a certain pot of money with which to purchase those notes. It can take in as many notes as there are banks willing to assign them. And the more notes that are assigned, the more homeowners are rescued from near certain foreclosure, and the more banks benefiting as well.

With a few modifications, the same strategy can also be used for bank-owned

[72] http://en.wikipedia.org/wiki/Assignment_(law)

foreclosed properties.

If a bank goes all the way through a foreclosure, it now owns the property itself rather than a promissory note and a lien against the property (the mortgage) and the former homeowner is normally evicted. Thus the bank now has a very different asset, known as bank REO (real estate owned) property.

That property normally sits empty (not rented and therefore not generating revenue) until the bank can sell it. Selling a foreclosed, empty property is difficult and usually results in a substantially reduced sale price compared to an occupied, maintained home. In contrast, if the property is occupied with a renter under a lease, then a seller can usually get closer to full market value in selling the home with the attached lease to an investor or investor group looking to own rental properties.

But banks are not in the home rental business, nor do they want to be in the property selling business. That is where our hedge fund comes in. A bank could assign a REO home to the hedge fund, which could attempt to sell it as-is, or preferably, convert it into a rental property for later sale, as that will probably yield a higher profit.

The problem for the hedge fund in this circumstance is that it would inherit an empty property that might require repairs to get it back in rentable condition. Then it has to find a prospective renter and get them to sign a lease agreement and move in.

All that is much more complicated than working with a previous homeowner who is still occupying the home (as in the case of an assigned note and mortgage), but is well within the business model of the fund, which would be far better equipped than a bank to carry out these activities. Thus assignment of REO properties represents another form of investment that a bank can arrange with the hedge fund to mutual benefit.

There is, however, one wrinkle in this plan. As of the time of this writing, unlike other corporations, community banks are not normally allowed by regulators to have ownership in private equity funds like a hedge fund. However, exemptions can be granted on a case-by-case basis, and if enough banks wish to adopt this strategy, a more blanket exemption might be granted.[73]

One way around this problem is to combine two of our above described approaches — begin with an approach similar to Lew Ranieri's portfolio acquisition program (buy the notes and mortgages at a discount from their current remaining balance) and combine that with a "shared upside" component similar to the assignment approach.

The bank and the hedge fund negotiate a conditional sale of notes and mortgages at a discount (perhaps 30%-40% of the remaining balance on the notes) that transfers ownership of those notes and mortgages to the hedge fund.

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[73] *Interested parties can contact National Commonwealth Group, Inc., the publisher of this document, for up to date information on this regulatory issue.*

However, in contrast to the Lew Ranieri approach, the bank retains a right to participate in any future gain realized by the sale.

Thus the sale agreement would include a provision that once the hedge fund converts the old contract with the homeowner into some new arrangement (new note and mortgage / rent-to-own agreement / pure rental agreement) and sells that new contract, the hedge fund and the bank will split any gains based on a predetermined formula. If the initial purchase price is low enough, the hedge fund may be able to finance the transaction with debt, thereby eliminating the need for investors as contemplated under the assignment approach, but this conditional sales contract would probably not require permission from regulators, as an assignment would.

Let's walk through an example transaction to see how that would work. Let's say that a homeowner still owes $100,000 on home worth $150,000 (if sold in a non-distressed sale, not as a foreclosed property). Assume that the hedge fund borrows approximately $30,000 to purchase the old note from the bank.

The hedge fund negotiates with the homeowner to turn over their deed in lieu of a foreclosure (which the hedge fund would be allowed to do as the new owner of the old defaulted note and mortgage). The homeowner would also sign a lease agreement that would support a sale price of $150,000 for the home as a rental property with a tenant in place and under a lease agreement.

When the property is sold to another party that wants to own rental properties, the hedge fund collects the full $150,000, pays off its $30,000 loan and has approximately $120,000 left over to divide between itself and the original selling bank. Let's assume that the agreement with the selling bank calls for a 50/50 split. This formula is negotiable between the parties and can easily range from a 90/10 split on one side or a 10/90 split on another.

In the case of a 50/50 split, the hedge fund would keep approximately $60,000 and give the other $60,000 to the bank as a final settlement on the purchase contract. Since the original $30,000 received by the bank is now further enhanced by the subsequent $60,000 payment, we see that in this scenario, the bank obtains a final yield that is approximately 90% of the old outstanding balance. That would far exceed what the bank could normally expect with its current options for dealing with the impaired real estate loan in question.

Finally, returning to the assignment concept, there is another source of homes that could be assigned to the hedge fund in a fashion similar to REO assignments. In this case, the current owners of the properties would typically be county governments that wind up being owners of homes as a consequence of foreclosures precipitated by failure to maintain property tax payments. In such cases, the county government can seize the property and evict the current occupant.

Such properties would be nearly identical in character to bank REO properties. Yet governments would be even less equipped to properly dispose of those homes through a rental-to-sale strategy. Today, such properties are often sold for

just the back taxes. Many counties are now establishing land banks,[74] to which they transfer properties seized under tax foreclosures.

Land banks normally own, rehabilitate and reactivate abandoned properties (or tear them down if they cannot be rehabilitated). However, many recent seizures have been completed with the homeowner still in the home. Whereas the empty properties would resemble bank REO property, this new crop of occupied, tax foreclosed homes would more closely resemble the occupied homes covered by existing notes and mortgages that a note holder would assign to the fund. In this case, our fund would probably be better equipped to manage those homes than could the county or its land bank.

Neither the county nor the land bank has the same kind of regulatory constraints as commercial banks with respect to such assignments and thus both the counties and the hedge fund are free to structure whatever deal makes sense for all parties.

With all that in mind, let us now look at the other entities that make this economic ecosystem work.

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[74] *See "Neighborhood Stabilization & Land Banking" by Prof. Alexander* http://cslr.law.emory.edu/fileadmin/media/PDFs/Journal_Articles_and_Book_Chapters/20.3.Communities_and_Banking.Alexander._Neighborhood_Sta.pdf

CHAPTER 12

MORTGAGE BANKS

The term mortgage company is often used to describe both mortgage brokerage firms and mortgage banking firms, but they are not the same thing. A mortgage broker arranges loans between a homebuyer and a mortgage bank (the lender), and gets a commission for doing that work[75] but is not the source of funds.

That is the role of a mortgage bank. Mortgage banks (also called mortgage lenders) provide the money to finance the purchase of homes and other properties. We advocate that our ecosystem establish a mortgage bank as one of its first entities.

As we will see, the costs associated with the formation of mortgage banks is substantially less than forming or buying commercial banks, yet they will directly address the single most important critical credit need within our communities – the need to help homeowners caught up in the housing crisis.

For now, let's examine why these kinds of banks are quicker, easier and less expensive to launch than commercial banks.

MORTGAGE BANKS VS. COMMERCIAL BANKS

The key here is what mortgage banks are allowed to do and the regulatory oversight that they are subject to. Mortgage banks lend money to real estate buyers and the money they lend is either their own money or money they have borrowed from other sources that they are obligated to pay back.

No new money is created. They can only lend money – dollar for dollar – that they either already own or can borrow. Lending money for real estate purchases is their sole activity. And given that they are using their own money, they function under a relatively simplified regulatory environment compared to commercial banks.

Commercial banks are allowed take in deposits from the public and are allowed to lend out approximately $10 for every dollar of their own money. Clearly that means they can lend a whole lot more than they actually have, but the ability to do that comes with a heavy regulatory price tag. They have to be a licensed bank (called "chartered") authorized to conduct banking under the scrutiny of multiple regulators (both state and federal) who monitor them very closely.

A further contrast pertains to the type of business that each bank engages in and whether they retain the loans or sell them.

Mortgage banks almost never do anything other than real estate loans. And even though they *can* put up their own money to fund the loans, they frequently borrow money from their "warehouse line of credit"[76] (a short term revolving line

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[75] http://en.wikipedia.org/wiki/Mortgage_bank
[76] http://en.wikipedia.org/wiki/Warehouse_line_of_credit

of credit) and re-sell those loans in what is called the "secondary market",[77] the proceeds of which they use to pay down their warehouse line of credit.

Thus the basic business model for the majority of mortgage banks is making profit on the spread between their cost of money and what they sell those loans for, coupled with various fees charged for setting up the loan (called loan origination fees).[78] A smaller percentage of mortgage bankers fund the loans from their own capital and retain those loans in their own portfolio as income-generating instruments, providing a return on their own capital investment.

Unlike mortgage banks, commercial banks conduct a much wider variety of services. They accept deposits and provide checking and savings accounts. They also provide secured and unsecured loans (business lines of credit, business loans, consumer loans including car loans, etc.) and more.

When it comes to real estate loans, commercial bank generally fall into two general categories – those provided by local community banks and those provided by the Wall Street banks.

On the average, local community banks retain loans on their books and do not re-sell them in the secondary market. Their basic revenue model is based nearly exclusively on loan origination fees charged up front, followed by the income generated by the monthly payments made on those mortgages.

In contrast, the larger banks not only charge loan origination fees, but they usually re-sell those mortgages and corresponding promissory notes into various secondary markets, often to another entity that they also control. This is especially the case for banks that are members of the MERS system[79] and mortgages that are transferred into the MERS system.

Those banks and their partners use mortgages and notes as the foundation for the creation of MBSs that represents another revenue source beyond the revenue generated by the mortgage origination fees and the mortgage monthly payments.

Sources estimate that MBSs yield those banks many times the income that the basic mortgage agreement does, and thus financially are much more important to them than the basic mortgage and note. Those original instruments are just a means to go where the "real money" is, at least from the big banks' perspective.

Most economists point to the securitization process as fundamentally skewing and corrupting real estate finance, leading to such things as the push for sub-prime mortgages (sometimes called "liars loans") and subsequent collapse of the housing market. It also creates artificial constraints around the original instruments that largely prevent big banks from willingly renegotiating those loans.

Thus we find that the business model of local community banks is much more in

[77] http://en.wikipedia.org/wiki/Secondary_market
[78] http://en.wikipedia.org/wiki/Loan_origination
[79] http://en.wikipedia.org/wiki/MERS

tune with the real needs of the real estate market and homeowners. We feel that the large bank model, while yielding much larger returns to the banks, is fundamentally detrimental to the rest of society and thus we favor returning to the basic real estate business model of the community banks.

Unfortunately, today the majority of mortgage banks sell their loans into the MBS system, thus contributing to the problems created by the big banks. Therefore, along with the community banks, we favor only mortgage banks that retain the loans in their own portfolios and do not resell them into the MBS-dominated marketplace. Or if they do, they sell them only to organizations that employ a new class of MBSs that are designed to be flexible to the real world needs of homeowners and the real estate market (see below).

It should be immediately clear that we could leverage our investment dollars to create substantially more total loan dollars if we have a commercial bank. However, getting there entails a protracted and expensive path, as we will demonstrate in greater detail later.

So for now, we recommend the "invest, buy and hold" mortgage bank approach to providing credit for our communities. Better to get started now and do what we can for communities than wait for a more ideal condition. We feel it will be easier to establish commercial banks on the heels of mortgage banks and potentially other financial subsidiaries.

SETTING UP A MORTGAGE BANK

Mortgage banks are considered a "non-depository" financial services company. Unlike commercial banks, mortgage banks have not, until very recent times, operated within any kind of uniform regulatory environment and licensing structure.

A commercial bank can receive a charter (a license to be a commercial bank) from a state government or from the federal government. Whoever grants that charter is a regulator over that bank, but other regulators also have oversight, including the FDIC (Federal Deposit Insurance Corporation) and the Federal Reserve (if there is a bank holding company) and perhaps others.

Mortgage banks, on the other hand, are largely regulated by state banking regulators and essentially have no federal regulator to answer to. They are constrained by numerous federal laws concerning lending to the public, especially following the housing crisis and the epidemic of subprime mortgages,[80] but their equivalency of a commercial bank charter largely comes from the states, which until recently had little in the way of a coordinated environment for mortgage banks.

In January 2008, the Conference of State Bank Supervisors (CSBS)[81] and the

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[80] http://en.wikipedia.org/wiki/Housing_and_Economic_Recovery_Act_of_2008
[81] http://www.csbs.org/Pages/default.aspx - *CSBS represents all the individual state agencies that oversee state chartered commercial banks and all other financial institutions such as credit unions, savings institutions, trusts, consumer credit institutions and the like*

American Association of Residential Mortgage Regulators (AARMR)[82] created an organization called the Nationwide Mortgage Licensing System (NMLS),[83] whose system goals are "to bring greater efficiencies and coordination to the regulation of non-depository financial services providers through the automation and streamlining of state licensing and the sharing of information across jurisdictional lines."

NMLS is owned and operated by the State Regulatory Registry LLC (SRR), a wholly owned subsidiary of CSBS, which describes NMLS thus:

"State mortgage regulators from around the country have been working since 2003 to develop a nationwide licensing system for the residential mortgage industry that will improve supervision of the mortgage industry, streamline the licensing process for mortgage companies and professionals, and enhance consumer protection.

The Nationwide Mortgage Licensing System & Registry (NMLS) is a web-based system that allows state licensed mortgage lenders, mortgage brokers, and loan officers to apply for, amend, update or renew a license online for all participating state agencies using a single set of uniform applications. NMLS brings greater uniformity and transparency to the mortgage industry while maintaining and strengthening the ability of state regulators to monitor the industry and protect their citizens."[84]

NMLS describes itself as:

"...the legal system of record for non-depository, financial services licensing or registration for participating state agencies, including the District of Columbia and U.S. Territories. NMLS is the official system for companies and individuals seeking to apply for, amend, renew and surrender licenses managed through NMLS on behalf of the jurisdiction's governmental agencies. NMLS itself does not grant or deny license authority.

NMLS is the sole system of licensure for mortgage companies for 53 state agencies and the sole system of licensure for mortgage loan originators under the SAFE Act.[85]

NMLS is also the legal system of record for the registration of depositories, subsidiaries of depositories, and mortgage loan originators under the Federal banking agencies' Registration of Mortgage Loan Originators Final Rule published July 28, 2010."[86]

Mortgage banks generally operate under the mortgage banking laws and license requirements[87] of each state in which they conduct business. Those laws are

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[82] http://www.aarmr.org/
[83] http://mortgage.nationwidelicensingsystem.org/
[84] http://www.csbs.org/srr/Pages/default.aspx
[85] http://en.wikipedia.org/wiki/Secure_and_Fair_Enforcement_for_Mortgage_Licensing_Act_of_2008#Secure_and_Fair_Enforcement_for_Mortgage_Licensing_Act_of_2008
[86] http://mortgage.nationwidelicensingsystem.org/about/Pages/default.aspx
[87] http://mortgage.nationwidelicensingsystem.org/slr/Pages/default.aspx

generally administered by the state's banking department, which also charters commercial banks.[88]

In most cases, there is no specific corporate form (corporation, LLC, partnership, etc.) required to be a mortgage bank. Thus we can find mortgage banks that are formed as corporations (C type and S type), LLCs, general partnerships, limited partnerships and in some cases even sole proprietors.

For a variety of reasons, we favor using limited partnerships,[89] at least in the early days. That is driven largely by the kinds and numbers of investors we would like to back the early effort, and the ease and speed with which those structures can be put in place. We explore limited partnerships in a later chapter.

Our goal is to get the banks operational and providing funds as soon as possible. Over time there may be good reasons to use other vehicles to expand the overall operations or to provide a mechanism for other kinds of investors (such as perhaps the public). In addition there are good reasons to add commercial banking to the mix as soon as is economically viable and allowable by the regulators, steps we will entertain later.

The mortgage bank is now in a position to purchase the new notes and mortgages created by the real estate hedge fund. By selling those instruments, the fund is able to convert those assets into cash, which it can use to pay back its investors or, if the investors agree, buy more distressed notes and mortgages.

Likewise, if the hedge fund obtained notes and mortgages or actual homes via the assignment process, any resulting new notes and mortgages can be sold to the mortgage bank. The hedge fund is then in a position to distribute proceeds from that sale to the assigning parties, who may also elect to leave them with the fund in order to acquire more properties for processing into new arrangements.

If those assigning parties have other properties held in reserve that have not yet been assigned, then one application of the first proceeds might be to repair, retrofit and rehabilitate more dilapidated properties in order to make them attractive for resale.

Frequently, foreclosed homes have been neglected or even deliberately damaged by the former tenants (usually in retaliation for the foreclosure and eviction) and those properties become even harder to sell as a result. The better properties might be transferred first and proceeds from those sales redeployed to fixing up impaired properties to improve their salability and value.

Now let's look at the third subsidiary in this equation – the real estate rental property company.

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[88] *Directory of State Banking Departments* http://www.csbs.org/about/what/Pages/directory.aspx
[89] http://en.wikipedia.org/wiki/Limited_partnership

CHAPTER 13

THE RENTAL PROPERTY COMPANY

Most community banks have little or no interest in owning rental property. Renting property is a completely different business than that of lending. As a consequence, when a homeowner falls behind on payments, the bank will normally only contemplate some form of new purchase agreement (if that) but rarely the conversion of a purchase agreement into a rental agreement.

The normal sequence of events when a homeowner misses one or more payments on their contract with the bank is that the bank first notifies them that they are in default and demands that they cure the default. If the default goes uncured, the bank sooner or later initiates foreclosure proceedings (this varies by state). If the foreclosure completes, the bank seizes the property and evicts the homeowner. Thereafter the property sits on the books of the bank until it is able to sell it.

However, our real estate hedge fund company is not a community bank and therefore is not constrained by its business model from converting a purchase agreement with a homeowner into a rental agreement. Owning rental property is a perfectly viable business to be in, just not for banks.

Unfortunately that means that with the bank, the homeowner is forced to leave the home if no outside party steps in to change the normal course of events. Our real estate hedge fund company can change that course of events, and enter into a new purchase agreement (note and mortgage) or some other arrangement such as a rental agreement.

Not every homeowner who is rescued from immediate foreclosure by the real estate hedge fund will be in a position to enter into a new mortgage and promissory note. However, the homeowner will still need a place to live and a high percentage of those who cannot enter into a new purchase agreement will nonetheless be in a position to rent the home.

Thus the fund can scrap the old mortgage and note, take over full ownership of the home and thereafter enter into a rental agreement with the former homeowner. The fund can subsequently sell the property and its rental agreement to our rental property company, whose investors are primarily interested in owning rental properties.

In the process, the real estate hedge fund company is once again able to dispose of assets in exchange for cash, allowing it to pay back its investors or the note and mortgage holders who assigned the original notes to the fund. If investors prefer, the fund can also reinvest the cash by buying more distressed mortgage contracts.

And as we noted in the previous chapter, if the assigning parties have other properties held in reserve, the first proceeds might be used to repair, retrofit and rehabilitate more dilapidated properties, in order to make them more attractive for resale.

Finally, there is an additional nuance that our rental property company and its investors might contemplate, an opportunity that fits between the mortgage/note and rental property spaces.

Some of the homeowners may be in a position to enter into a purchase agreement for an amount that is less than the full value of the property. For example, let's say that a home that used to be worth $150,000 is now worth $100,000. Let's assume that our real estate hedge fund purchased the old note and mortgage at $60,000. A new note and mortgage should be at $100,000, the current fair market value of the home. But what if the homeowner can only afford a $75,000 note within their current budget, but still would like to own rather than rent the home?

Here is where the hedge fund could get creative and enter into two different agreements with the homeowner. The fund could arrange for an investor "co-owner" to purchase an equity stake in the home (in this case a 25% stake) with the homeowner purchasing the rest of the equity with a new note and mortgage (the remaining 75% of the equity). Thereafter the fund could sell the new note and mortgage to the mortgage bank, having already sold a percentage ownership stake to the co-owner.

A fourth division could be established to provide a home for investors who would be interested in taking such equity stakes in homes alongside homeowners. In essence, investors who wish to participate with homeowners as co-owners of their private homes, rather than as owners in a mortgage bank company or a rental property company, can invest in another company dedicated to such investors. This opens up two scenarios:

- The company could purchase stakes in individual homes on a group basis wherein the investors invest in the company and the company purchases equity positions in a group of homes, thereby spreading the risk of the investors over many homes.
- Individual investors place their funds with the company (a limited partnership) and those funds are used to purchase stakes in individual homes in a direct, pass-through fashion wherein each investor only owns a stake in the individual homes they select and fund, not a shared group with other investors.

This fourth option has a number of nuances, such as ownership variations that could lead to other types of companies, that fall outside the scope of this document. For now, we will restrict our discussion to the other two most common companies – the mortgage bank and rental property company.

CHAPTER 14

PROCEEDING WITH A HOLDING COMPANY

We previously explored the pros and cons of setting up banking enterprises owned solely by governments or non-profits. We concluded that by joining forces, they could offset each other's weaknesses and leverage each other's strengths.

Our proposed public benefit bank enterprise model begins with that premise – a partnership between one or more non-profit organizations and one or more government organizations, supplemented by various other investors. While that partnership structure could be formed in a number of ways, our preferred approach is as follows.

To begin with, a non-profit organization would organize the initial public partnership banking structure. Since nobody can own a non-profit and the goal is that other non-profits and government entities (along with other participants like pension funds and others) will be stakeholders in these enterprises, a stand-alone, for-profit financial services holding company would be established that would resemble Figure 1 in Chapter 10.

Each would initially be owned by the organizing non-profit, along with other partners over time. These public benefit banking and other financial services holding companies would then establish new real estate hedge fund companies, mortgage banks, real estate rental companies and related entities, and later establish or acquire existing commercial banks as wholly owned subsidiaries under those holding companies.

HOLDING COMPANY OR SUBSIDIARY – WHICH COMES FIRST?

In establishing such an enterprise, however, a parent holding company is not always the first step. For example, many community banks start off as stand-alone entities, wherein the investors come together, form the bank corporation, get the approval of the regulators and obtain their ownership interests by purchasing stock in the bank corporation itself.

Many banks maintain that status throughout the life of the bank. They can grow by adding more branches without the need for a holding company, but if they want to obtain or start another bank with its own separate charter, they then face a choice on how to proceed.

They can either invest independently in the next bank and hold its stock as a separate investment, or bring the banks together under one ownership vehicle – a bank holding company. If the latter, they accomplish that goal by swapping the stock they own in individual banks for stock in the holding company, and the holding company owns the stock in all its subsidiaries (banks and other financial institutions).

Alternatively, if the investor/owner group wants to establish more than one company in a relatively short period of time, it might make sense to form the holding company as the first step and then have it establish each of the companies that will be its subsidiaries. That saves having to go through a reorganization.

In contrast, if there will be any delay in establishing additional businesses (subsidiaries under a holding company), then setting up one of the companies as a stand-alone entity to start, and rolling it up into a holding company formed later, may be more efficient and cost effective in the near term.

Here is the sequence of events to put it all together, if we start with the creation of a holding company (later we will entertain starting with the stand-alone company.)

PUTTING IT TOGETHER

One or more non-profit organizations elect to create and administer a public benefit financial services organization. For simplicity, we will explain this idea in terms of a single non-profit organizing the project.

Our founding non-profit needs to set up a corporate structure to serve as the parent company in the enterprise. First, we have a number of decisions and preparations to make.

In particular we have documents to prepare, depending on whether we will be forming a corporation or an LLC (described below), that will serve as the legal framework for the organization, how it is run and the role and relationship of its various participants. Decisions need to be made before those documents are put together to reflect those decisions.

With that in mind, let's look at some background information that we need to include in those preparations.

BACKGROUND

Most bank holding companies are formed as corporations, and they are normally formed in the state where the enterprise will be based. However, for reasons explained below, we suggest either using limited partnerships in conjunction with the corporation, or a different approach entirely – an LLC (with or without limited partnerships). Let's explore each approach to setting up a holding company.

A LIMITED LIABILITY COMPANY FOR A HOLDING COMPANY

One option is a somewhat unusual form of corporate structure for the financial holding company — an LLC (limited liability company). LLCs provide for limited liability, pass-through tax treatment and customized ownership terms per owner. This form of a holding company may well be the preferred approach if we anticipate a relatively small organization overall, with a limited number of partner/investors.

If we anticipate a larger organization with a larger number of partner/investors, then we might want to go with a corporation as the holding company, as we will explore later. For now, let's look at the structure of an LLC holding company, how it would work and the benefits of such a structure to help us realize our goals for the enterprise.

LLCs provide their investors the same limited liability afforded investors in a corporation. In corporations, investors' risk is normally limited to the amount of their investment and creditors cannot reach outside the corporation to try to recover any losses. LLCs function in the same general manner as corporations on that point. Thus our non-profit owner(s) would have limits on their liability that does not go beyond their ownership in the enterprise.

However, in addition to liability, there are profit-sharing considerations. Corporations are "taxable entities," meaning they are supposed to pay taxes on their profits before distributing the remainder to their owners, but LLCs themselves do not pay taxes on their profits.

LLCs just report their profits – their owners pay the taxes. In that sense, LLCs are more like partnerships (general and limited partnerships) in that they are considered tax "reporting" entities but not tax "paying" entities.

Partnerships inform taxing authorities (IRS, state and local taxing authorities by filing an information-only return) of what their profits and losses have been for the reporting period and who their owners are with respect to allocating those profits and losses as set forth in the investment agreements with each owner. In turn those owners report their portion of the partnership's profits and losses on their individual tax returns.

The result is that our non-profit entities (and all other partners) receive their full allocation of profits without taxing authorities reducing that amount by taxing them at the corporate level before distribution. Next, given that the initial owner is a non-profit, the profits allocated may well be tax free if those distributions are considered "related income."[90] The same would apply to governments and other non-taxable entities that might become owners at a later date.

Next, LLCs also resemble partnerships in one other key area that distinguishes them from corporations. In a corporation, corporate law mandates that every investor who invests in a particular round and type of stock get the identical set of rights as every other investor in that round. They also receive the same pro-rata percentage of ownership that is identical to the pro-rata amount allocated to the other investors based on their respective investments.

In partnerships, there is no legal requirement to treat each investor the same. Each investor may have a unique investment agreement with the partnership that grants them their own set of rights and percentage allocation of ownership (share in profits and losses). However, the reverse is not true. All the owners may, in fact, have an identical set of rights and ownership allocation as every other investor.

[90] http://articles.bplans.com/growing-a-business/earning-income-as-a-nonprofit-corporation/140

There is just is no legal mandate that they must have the same.

LLCs resemble partnerships with respect to rights and ownership allocation. That is, each and every owner can have a unique agreement with the LLC. This means that each non-profit that owns a piece of the financial holding company can have a unique set of rights and responsibilities assigned to it by virtue of its investment agreement, allowing great flexibility with respect to its role and relationship with the enterprise.

OTHER CHARACTERISTICS OF LLCS

LLCs come in two general varieties and we recommend that our financial holding company be set up as a manager-managed LLC. [91] In a manager-managed LLC, certain parties are designated as the managers and they run it. The other type of LLC is called a member-managed LLC, in which *all* members (owners) have a say in operations.

In turn, a manager-managed LLC provides for two types of participants – managers and members. The "members" of the LLC are the owners (like stockholders in corporations), but might not be the managers. The managers might not be owners, but are tasked with conducting the business of the LLC. Thus the managers could in fact be hired professionals, who have no ownership stake in the enterprise.

LLC managers can be one or more individuals or even separate business entities (like another LLC or corporation) hired by the members and tasked with running the LLC. Members that are not also managers are considered passive investors, who, other than potentially selecting the managers, have no role in the active management of the enterprise.

This manager-managed type of LLC closely resembles a special type of partnership called a limited partnership, where there has to be at least one general partner (who manages the partnership), and at least one limited partner (who only puts in money but has no active role in management). In a limited partnership, the general partners are the active investors and the limited partners are passive investors.

With this particular LLC holding company model, one or more non-profit organizations will be designated as the managers of our holding company LLC. They are also members. Those managers will be responsible for the day-to-day management of the enterprise.

Which leads us back to the formation of the financial holding company. Normally, the LLC would be established in the state where the enterprise will conduct its principal business, but it need not be, as the role of the holding company is to be the owner of the subsidiaries that will be formed under this parent company, and ownership and business operations need not occur in the same state.

The individual subsidiaries will in all likelihood be formed in the state where they

[91] http://smallbusiness.chron.com/manager-managed-llc-3078.html

conduct the bulk of their business, but their parent (ownership) company can be located anywhere. There are various strategic reasons for choosing the domicile (home state) of the parent company, and legal and tax counsel should be sought for making that decision.

IMPLEMENTATION

There are three key documents involved in setting up an LLC in any state, and although some states don't require the second two, we recommend that they always be used. They are:

- The Articles of Organization[92] (very similar to articles of incorporation for a corporation – but with some key differences) that are usually filed with the Secretary of State.
- The LLC Operating Agreement (OA)[93] (very similar to the by-laws of a corporation) is a private agreement (*not* filed with the state) among the members governing the LLC's business, and member's financial and managerial rights and duties.
- A document that spells out the ownership interest and rights of the prospective member in exchange for their investment. There is no standard name for this agreement. We will call it a Subscription Agreement (SA). Sometimes the details contained in an SA are incorporated in the Operating Agreement (with just a signature page for the members to represent their acceptance of all its terms), but often are contained in a separate agreement between the investor/member and the LLC. More often than not, the main components of an SA are made part of a document commonly called a Private Placement Memorandum (PPM).[94]PPMs with private company investments are the counterpart to a Prospectus[95] in public company investments. They give information like the company history, biographies on its management team, its financial statements, and most importantly, disclosures – in particular a delineation of as many risk factors as the founders can define.

Potential investors are usually first provided a PPM and a "term sheet,"[96] along with a business plan and other promotional information about the company. If they like what they see, they are then given the Operating Agreement.

Operating agreements are frequently used to cover the investment terms for all the members, if those members receive essentially the same terms for their investment, including rights and percentage ownership. In those cases, each member either signs one signature page along with all the other members, each agreeing to *all* the terms of the operating agreement, or each investor may sign a

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[92] http://en.wikipedia.org/wiki/Articles_of_Organization
[93] http://en.wikipedia.org/wiki/Operating_agreement
[94] http://www.ehow.com/about_5409255_private-placement-memorandum.html
[95] http://en.wikipedia.org/wiki/Prospectus_(finance)
[96] http://en.wikipedia.org/wiki/Term_sheet

stand-alone signature page with the rest of the agreement attached.

However, when each investor has a unique ownership arrangement with the LLC, then two documents are frequently used – operating agreements and subscription agreements. Operating agreements then include all the terms, conditions and issues that apply to *all* the members whereas a subscription agreement applies only to a single member and spells out their unique relationship terms with the LLC. Because we might want to have unique relationships for each investor/owner, we would suggest the use of the SA as the tool for defining the unique set of rights and responsibilities of each member within our LLC.

This will especially become important when we bring in the financial partners, as we will be able to craft a unique agreement with each of them that addresses their particular goals and concerns. For example, a particular county might become an investor with the goal of providing direct support to the local community banks within their county. Within certain parameters, each SA would allow us to structure something to address those goals. It will also allow us to direct their investment into specific subsidiaries like a mortgage company, community bank, etc.

COMPLICATIONS

Bringing passive investors into the parent company at this point can be complicated, especially when they have divergent interests that must be accommodated. But there is another, more troublesome, constraint.

Section 12(g) of the Securities and Exchange Act of 1934 (as amended) defined that a company with 500 or more shareholders and at least $10 million in assets would be required to file annual and quarterly reports with the SEC as a "public reporting company." Providing those reports can be costly and time consuming and therefore most companies try to avoid hitting those limits.

Over the years this has been especially problematic for community banks, which invariably cross the assets threshold and have had to be careful on the number of owners of record so as to avoid those reporting requirements, especially if they have no intention of being a public company and listing on a stock exchange.

Fortunately, after years of inaction on complaints, Congress in March 2012 introduced some fundamental changes to the reporting requirements, to the delight of the small business community and especially community banks.

The Jumpstart Our Business Startups Act (JOBS Act)[97] was signed it into law in April 2012. One of its key provisions was a loosening of the shareholder limits for all small businesses, with a special consideration for community banks.

The maximum shareholder limits were raised to 2,000 owners of record (excluding shareholders who received employee compensation plan securities;

[97] http://blogs.law.harvard.edu/corpgov/2012/03/29/congress-passes-the-jumpstart-our-business-startups-act

and crowdfunding[98] investors) with a maximum of 500 unaccredited investors[99] for all non-bank small businesses. Banks and bank holding companies are allowed 2,000 owners, whether accredited or unaccredited.

While that has made a significant difference in how many investors we can bring into our financial enterprise, it does nothing to diminish the complexity of having a large number of investors with differing priorities concentrated in our holding company. We therefore prefer to connect them directly with the types of subsidiaries they are interested in, e.g., a bank, a mortgage company, a real estate investment fund, etc.).

One of the ramifications of bringing investors directly into the subsidiaries is that if none or few investors come in at the holding company level, we no longer need the flexibility of the LLC structure and can organize as a regular corporation, the vehicle of choice for most holding companies.

A CORPORATION AS THE HOLDING COMPANY VEHICLE

Corporations have been around for centuries. People are familiar with them, and through the years ownership and management have become quite standardized.

The Articles of Incorporation (filed with the state) define not only the existence of the corporation but the classes of ownership, which tend to be structured around simple, uniform groups.

Management is performed by officers whose roles are likewise fairly standardized, such as a chief executive or president and a chief financial officer or treasurer. Overall control is embedded in a board of directors.

The by-laws of the corporation are often used to expand on the number, types and roles of officers, as well as the number, terms and rules regarding the establishment of the board's directors. Many corporations work with simplified and generic by-laws and some even without them. By-laws are strictly an internal document that is not filed with the state or other parties.

Ownership in a corporation is represented by shares of stock.[100] That is, we invest our money in the company and get an ownership interest represented by shares of stock, which used to be pieces of paper containing the key details, but nowadays are frequently only recorded on computers with no physical "stock certificate" being issued. Our percentage ownership in the company is represented by the number of shares we own as a percentage of all of the shares owned by all of the company's shareholders.

The majority of corporations in America have just one class of ownership represented by what is called "common stock".[101] Most state laws spell out the rights and responsibilities of common stock holders in such detail that corporations frequently don't add any further refinements.

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[98] http://en.wikipedia.org/wiki/Crowdfunding, & http://www.orrick.com/practices/corporate/jobs_act.asp
[99] http://en.wikipedia.org/wiki/Accredited_investors
[100] http://en.wikipedia.org/wiki/Stock
[101] http://en.wikipedia.org/wiki/Common_stock

The Articles of Incorporation as filed with the state have to define and authorize all classes of stock before the corporation can sell that stock to investors. Sometimes a corporation will establish two or more classes of common stock and/or one or more classes of what is called "preferred stock",[102] each with a different set of rights.

For example, a corporation may establish two classes of common stock. Class A shareholders may get all the dividends issued by the corporation and Class B shareholders may have the right to elect all the members of the board of directors, or any other division of rights and responsibilities that the owners decide.

All owners of a particular class of stock have to be treated the same, with no special consideration given to individuals. In fact, state laws require that all shareholders in one class of stock have the identical rights, privileges and responsibilities as every other shareholder in that class.

Given all this standardization in corporations, we find that deviations in both classes of ownership and management are more the exception than the norm. So if there is no need to have special treatment, owner by owner, with the exception of a limited number of groups which would all be treated the same, a corporation can be a very effective vehicle.

In contrast, an LLC is much less uniform. How ownership is defined and who manages the enterprise is more customized. The Articles of Organization filed with the state are used primarily to define the general existence and purpose of the organization, but not its ownership.

As we stated, ownership and management structures are fleshed out in the most important document of an LLC – its Operating Agreement, the legal equivalent to Articles of Incorporation for a corporation but practically more like a souped-up version of corporate by-laws.

Almost everything about the LLC organization is defined in the Operating Agreement – who owns it, if there are designated managers and if so, what their responsibilities are, and even if there will be the equivalent of a board of directors (not normal for an LLC).

If custom terms are required for individual owners, those terms can be added section by section for each owner, or they are sometimes spelled out in a side document (as an attachment to the Operating Agreement) to provide for greater detail.

Those side documents can also take the form of an individual Subscription Agreement, which acts more like a standalone agreement defining the terms of the owner's investment, rights and responsibilities. That member/owner is then also subject to the Operating Agreement.

[102] http://en.wikipedia.org/wiki/Preferred_stock

A CORPORATION OR LLC AS THE HOLDING COMPANY VEHICLE

There are pros and cons for selecting a corporation versus an LLC as the holding company vehicle. Flexibility for financial backers on the terms of investment is desirable, but as we will see, there is an alternative mechanism that will allow us to customize investment arrangements with each investor, one that can be done with either type of holding company, as we describe in the next chapter.

Having prepared our plan and supporting documents, we are now ready to set up the holding company. We file the Articles of Organization (if LLC) or the Articles of Incorporation (if corporation) with the state, giving us the legal entity to begin putting the other parts in motion. Next, the founding non-profit:

- If an LLC – approves and signs the Operating Agreement and the Subscription Agreement (along with a recommended PPM), pays whatever is determined as its capital contribution and become the legal owners of the LLC holding company.
- If a corporation – forms a board of directors, holds a first board meeting, adopts by-laws and approves the issuance of stock to the founding members. The founders then approve and sign a Subscription Agreement (along with a recommended PPM), pay whatever is determined as their capital contribution and receive stock in the company representing their ownership in the corporation.

At this point, the holding company is largely a paper organization. The founding non-profits need only have put in a token investment to establish their ownership. There need not be any cash investment at all and ownership simply granted to the non-profit, but we feel it is cleaner to actually put in some cash.

The costs of setting up the holding company and the legal components needed should only entail a few thousand dollars, not a significant sum for most non-profits.

Next, rather than bring in any investors directly into the holding company, we propose to bring them into the subsidiaries. So now we need to create those subsidiaries.

FORMING THE SUBSIDIARIES

First we recommend setting up three LLC subsidiaries to serve as the general partners in the limited partnerships that the mortgage bank, hedge fund and rental property company subsidiaries will establish to capitalize their respective businesses. And in this case, we do recommend that those LLCs be formed in the state where they will conduct the bulk of their business.

The managers of the holding company will establish a different Operating Agreement for the real estate hedge fund LLC, the mortgage bank LLC and the real estate rental company LLC. Initially each will have only one owner – the parent holding company, regardless of the number of owners in the holding company itself. It will be a manager-managed LLC and initially the holding company will be the manager of those subsidiaries.

Costs through this phase should be no more than a few thousand dollars. We don't face any significant costs until we launch the business operations of each subsidiary, primarily manager and employee salaries.

Those operating funds may come from investors who subsequently invest in the subsidiary LLC itself, or from limited partners when the subsidiary LLC sets up one or more limited partnerships (described below). In any case, the total amount needed to launch and administratively run each of these businesses (excluding the money needed to acquire the assets of each business) is considerably less than the costs of launching a commercial bank business.

BRINGING IN INVESTORS

Once again we need to prepare some documents that will serve as the legal framework for investors, along with other documents that will serve as the foundation for the business of those subsidiaries, such as mortgage agreements, promissory notes, rental agreements and rent-to-own agreements.

For each subsidiary, two pools of funds are needed. The first, smaller pool is to cover basic operating expenses such as employee salaries and facilities costs. The second pool is the funds needed to acquire the assets of the business, such as mortgages and promissory notes from lenders. This pool will be much larger, and a portion of its resources can be used to cover the operational costs of the subsidiary business, primarily through transaction fees, i.e., fees for setting up the loans and the like.

Of the three initial subsidiaries — the hedge fund, the mortgage bank and the rental property company — the hedge fund could launch with a smaller capital pool because it could acquire a good portion of its assets (principally the notes and mortgages or foreclosed homes) by direct assignment in exchange for equity in the fund. However, the likelihood is high that the vast majority of the assets of the mortgage bank and rental property company will be acquired with cash provided by investors.

We have two ways to approach investor participation in our subsidiaries. They could be passive investors, using the SA as their individual investment agreements, or the LLC can set up a separate limited partnership agreement where the LLC is the general partner and the investors are limited partners.

With respect to the second pool of funds, the former might work if we had a small number of potential investors that would rarely grow or change. However, we envision the need for a continuous expansion of both the number of investors and the total amount of funds needed by these subsidiaries to conduct their businesses. In that case, the limited partnership vehicle provides more flexibility.

In contrast, the funds needed to get the business up and running entail both startup costs and ongoing operations. The startup costs and initial operating expenses could be covered by investor funds that could come from the non-profit owner or from other investors. Once the company is conducting its business, its operating funds could come from management fees (from the pool

of limited partnership funds) and transaction fees in managing those various businesses. All in all, the total startup funds needed for these costs should not exceed a few hundred thousand dollars, a far cry from what is required to establish a commercial bank, as detailed later.

Now let's look at limited partnerships, the primary source for the much larger pool of funds needed to acquire the bulk of each of our subsidiaries' assets.

CHAPTER 15

LIMITED PARTNERSHIPS

A limited partnership[103] is a form of partnership consisting of two types of partners – one that manages the partnership and the other that serves as a passive investor. There must be at least one of each type for it to be a valid limited partnership, but there can be more than one in each category.

The manager is called a general partner (GP). The passive investors are called limited partners (LPs). The GPs are responsible for conducting the affairs of the limited partnership, can enter into agreements on behalf of the partnership and can be held liable for the debts and obligations of the partnership. The LPs have no role in the management of the partnership and their liabilities are strictly limited to the extent of their investment. Thus LPs cannot be held responsible for the debts of the partnership. This makes limited partnerships ideal vehicles for investments by passive investors.

Both GPs and LPs can be composed of individuals, corporations, LLCs, or any other form of legal entity. However, because the GP can be held liable for the debts and obligations of the partnership, most GPs protect themselves by organizing as an entity that has limited liability itself, such as a corporation or LLC. That way the individuals behind the GP can shield themselves from any personal liability for the debts and obligations of the limited partnership.

Partnerships, whether general partnerships[104] or limited partnerships, are normally established by the parties entering into a written legal agreement (it can be a verbal agreement, but that is very risky) that spells out the purpose(s) for the partnership, how it will be managed, who its members are and their rights and responsibilities.

Limited partnerships, unlike general partnerships, are often required to file a document with the state where they are based called a Certificate of Limited Partnership. The certificate identifies the existence of the partnership and notifies the state of its existence.

A Certificate of Limited Partnership is somewhat analogous to Articles of Incorporation, with the key difference that the filing of the Articles constitutes the legal step for the establishment of a corporation whereas a Certificate of Limited Partnership simply "registers" with the state an already legally existing entity.

Venture capital firms[105] and hedge funds[106] commonly use limited partnerships as an investment vehicle, for some of the same reasons specified above. In both cases, we have a management firm that is set up to manage a pool of funds put up by investors, and the limited partnership mechanism provides them with

[103] http://en.wikipedia.org/wiki/Limited_partnership
[104] http://en.wikipedia.org/wiki/General_partnership
[105] http://en.wikipedia.org/wiki/Venture_capital
[106] http://en.wikipedia.org/wiki/Hedge_fund

some of the best tools to accomplish that goal. Likewise we feel that it will provide our real estate hedge funds, our mortgage banks, our real estate rental companies, our commercial banks and other subsidiaries with comparable tools.

A limited partnership is similar to a manager-managed LLC, but a key difference is that a limited partnership is set up with a private contract between the partners, one that is not filed with the state. As we noted, the Certificate of Limited Partnership is a form of a notification to the state rather than a document used to legally create the entity, in contrast to the Articles of Organization for an LLC that have to be filed with the state in order for the LLC to come into existence.

With both LLCs and corporations, the potential limited partner investors would normally receive a PPM along with a business plan and other documentation about the intended business of the subsidiary. If they elect to invest, then they sign and accept the terms of the limited partnership as follows.

Usually the general partner drafts the limited partnership agreement, called a Limited Partnership Subscription Agreement (LPSA),[107] which is directly analogous to a SA for an LLC. It spells out the terms of the investment and the rights and responsibilities of the limited partners and the general partners. Once completed, signed by all the partners, the Certificate filed (if required by the state) and investor monies turned over, the enterprise can conduct business.

It is important to note that each limited partnership is a discrete business entity managed by the general partner(s), who conduct business on behalf of the limited partnership. For example, we mentioned that venture capital firms and hedge funds use this vehicle extensively. Let's take an example venture capital firm to see how they raise and manage a pool of funds.

THE VENTURE CAPITAL MODEL[108]

Several experienced venture capital money managers decide to set up their own VC firm. Typically they will form an LLC (we'll call it ABC Ventures) and put in some of their own money to enable operations until they raise a pool of funds. They prepare a business plan and the supporting documentation needed to adequately describe their business to prospective investors, write up a Private Placement Memorandum, prepare the Limited Partnership Subscription Agreement and proceed to locate those investors (many of whom they may already know).

Let's say their goal was to raise $100 million (a small fund by today's standards) and they call this first fund ABC Ventures Fund #1 (the legal name of the limited partnership). They solicit prospective investors and provide them with the appropriate documentation to make an investment decision. Typically these candidate investors are pension funds, endowment funds, government investment funds, public and private foundations, faith-based investment funds

107 http://www.ehow.com/facts_7248261_limited-partnership-subscription-agreement.html
108 http://en.wikipedia.org/wiki/Venture_capital

(e.g., churches), family investment funds, wealthy individuals and other deep pocket sources of private investment.

Sometimes those investors agree to put in all their funds at one time; other arrangements call for them to put in a certain amount up front and commit to providing more later. For simplicity, we will assume that our hypothetical investors put in the full $100 million up front.

Once the fund has received all of the investment it needs to begin operations, it proceeds to look for investments. Since this is a venture capital firm, those investments would be investments in other companies. If the fund were a hedge fund, then the investments would be in whatever area the hedge fund concentrates on such as stocks and bond, real estate or other asset classes.

ABC Ventures would let the world know that they have funds to invest and invite companies to approach them with requests for investment. Typically there are far more companies looking for investments than there are venture capital firms willing to invest in them (VCs typically invest in only about 2% of the companies looking for investment), so they have no shortage of applicants.

The companies seeking funding are unaware of the source of funds (the limited partners) that the VC firm uses. Those companies approach the fund management company, i.e., ABC Ventures LLC, to solicit their investment.

If the VC management firm decides to invest in a company,[109] it actually enters into the investment contract in the name of the fund. For example, ABC Ventures Fund #1 becomes the investor/partner in the company seeking an investment. In exchange, the fund receives an ownership interest in the company in the form of shares of stock (usually preferred stock) and often rights to purchase more shares at a later date.

The VC management company will continue to make investments into various companies until all of the money in the fund is invested or locked up for future additional investments in those companies (later "rounds"). At this point, the VC management company would not be able to invest in any new companies unless it formed another pool of funds, let's say ABC Ventures Fund #2.

Each new fund would be a separate limited partnership that may or may not include any or all of the investors that are partners in any other fund. VCs tend to have long investment cycles and fewer separate funds under management (typically 1-5 funds) than hedge funds, which often have dozens of separate funds and shorter cycle times for the fund from commencement to liquidation.

We anticipate that due to the nature of the business of our real estate hedge fund subsidiaries, they will have a relatively short life cycle (6 months – 2 years) and thus we expect a growing number of funds over time, similar to other hedge funds rather than VC funds. Our mortgage bank subsidiaries and our real estate rental companies will normally have much longer investment cycles, and thus we expect to have fewer and larger funds for them.

[109] http://en.wikipedia.org/wiki/Venture_capital_financing

FUND MANAGEMENT COMPANIES' COMPENSATION

How are VC and hedge fund management firms compensated? Let's use ABC Ventures as an example, where ABC Ventures LLC serves as the general partner to the limited partnership and manages the fund.

Usually the general partner receives two forms of compensation for its role as the managing partner — a management fee and a performance fee (frequently also called the "carry"). Those fees are often represented by a shorthand abbreviation such as 2/20, which means 2% and 20%.

The management fee is an annual fee (often taken monthly or quarterly) usually calculated as a percentage of the total funds under management. In our example that would be 2% of $100 million or $2 million a year, normally received each year, until the fund is liquidated. The management company uses that fee to cover its operational costs in conducting the business of the limited partnership, in this case, investing in other companies and managing those investments.

The performance fee is a share of the profit from the fund, which is distributed after the investors get their original investment back. This occurs when the business of the fund is wrapped up and the fund is liquidated.

Like every venture capital firm, ABC Ventures starts out every investment with the goal of someday pulling money back out of the firms it invests in. That financial extraction can take place in several different ways and is commonly referred to as a "liquidity event."

A liquidity event can occur if the company goes public[110] (a rare event nowadays), at which point ABC could sell all or a portion of its stock. More commonly ABC would arrange to sell the whole company to someone else (often another company).

In any case, when ABC has liquidated its investment in every company it can (often only a fraction of the total number of companies invested in survive and continue to exist rather than die, let alone provide a return to the fund),[111] they are now ready to liquidate the fund itself. At this point they take whatever funds they have been able to realize from all the liquidity events and take off the top an amount equal to the total amount of funds that the limited partners originally invested in the fund. This amount is returned to those LPs as a return *of* their investment (which is non-taxable).

If any money remains after return of the investment to the LPs, that represents profit to the limited partnership and would constitute a taxable return *on* its investment. The total profit would be distributed to both the limited partners and

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[110] http://en.wikipedia.org/wiki/Public_company
[111] Typically a fund invests in 10 – 30 companies. Results vary depending on the focus of the fund (seed stage versus later rounds). Average results – 2 to 4 companies die entirely, 2 to 6 become "zombies" or "walking dead" in VC parlance (i.e. – they survive, but won't go public or be sold, so the fund cannot get a return on them), and only 1 to 3 have a liquidity event and provide some return to the investors. VC funds used to provide high returns (not unusual for up to 7 times the original investment) but nowadays are producing much poorer results. See http://news.cnet.com/8301-1023_3-57430180-93/turns-out-investing-in-venture-capital-funds-isnt-a-great-idea/

the general partner on the basis of a formula agreed to at the commencement of the fund. Following our ABC Ventures example, the profit would be divided 80/20 between the LPs and the GPs respectively.

Let's say that the fund doubled its money and upon liquidation had $200 million in the bank. The first $100 million would be returned to the LPs as their return of investment. That would leave another $100 million to be divided as an $80 million return on investment to the LPs and a $20 million distribution to the GPs as the performance fee or carry.

Normally the liquidation of the fund occurs a good year or more after its commencement date (often 10 years or later). This is significant to the partners since any profit distributed will be taxable, but the tax rate will depend on the time between the investment and the liquidation and distribution.

The period from the fund commencement to the date of liquidation is referred to as the "holding period" for tax purposes to the partners. In the United States, the holding period is categorized as short-term or long-term (currently one year). Any profit realized is called "capital gain."[112] The tax is called "capital gains tax"[113] and is divided into short-term and long-term capital gains, each at a different tax rate.

Short-term capital gains are normally taxed as "ordinary" income,[114] and the rate varies according to the taxpayer's personal tax rate based on their total taxable income. Profits made on investments that are held for more than a year (long-term capital gains) are taxed at a reduced flat rate typically around 15% for most investors, well below the ordinary income tax rate for most investors.[115]

However, that should not matter to our non-profits, which are managing our various subsidiaries as general partners. If they have been formed to carry out these kinds of public benefit activities, then any income they realize from the management of those enterprises would be tax exempt.

The only time it would be an issue is if these activities are considered outside their exempt purpose[116] (the non-profit reason they exist) as defined by the IRS. If a non-profit organization carries on a business activity that is outside the purposes for which it was formed, any income from those activities is considered "unrelated business income"[117] and would be taxed as in a for-profit organization.

Thus it is important that the non-profit organizations that set up and run our public benefit financial enterprises include those activities in their defined

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[112] http://en.wikipedia.org/wiki/Capital_gain
[113] http://en.wikipedia.org/wiki/Capital_gains_tax_in_the_United_States
[114] http://en.wikipedia.org/wiki/Ordinary_income
[115] *This lower tax rate tends to favor the wealthy, who have money to invest. This group includes fund managers who are taxed at this lower rate on the shared portion of their funds' profits (the "carry" or "carried interest"), even though they did not actually invest any money. Most people feel they should be taxed at ordinary income levels as this income is more in the form of compensation for services rather than a return on investment.*
[116] http://en.wikipedia.org/wiki/Tax_exemption
[117] http://en.wikipedia.org/wiki/Unrelated_Business_Income_Tax

purpose, and ensure that the IRS approves those activities.

CHAPTER 16

THE FINAL PIECES

We envision building our public benefit financial enterprise by starting with homeowners facing foreclosure and building our initial structures around addressing that problem.

The first entity we need to form is the real estate hedge fund company. Given that we will need to form the mortgage bank subsidiary and the real estate rental company soon afterwards, we will very quickly need to form the holding company to serve as the ownership entity for the enterprise. Keep in mind that the holding company is used primarily as an ownership vehicle and not an "operating" vehicle.

WHAT DOES THE REAL ESTATE FUND NEED TO GET STARTED?

As the manager of the real estate hedge fund company, the general partner manages the process of acquiring mortgages and promissory notes related to real estate. That means working directly with lenders to acquire their distressed real estate loans.

Once a deal has been struck with the lender, the general partner signs the papers on behalf of the limited partnership, the entity that is entering into the transaction with the note holder.

This is very similar to what happens with a typical venture capital deal. Entrepreneurs negotiate an investment deal with the managers of a venture capital firm. However, the actual investor is not the venture capital management firm but rather the limited partnership fund that the venture capital management firm represents in the transaction.

That fund has a finite amount of money and when all of it has been invested, the venture capital management firm sets up another fund (another limited partnership), with new money and potentially a whole new set of investors. The venture capital management firm then continues to invest in companies on an ongoing basis, representing the new fund, while still representing the old fund and its investments.

The same would apply with our real estate hedge fund. When it uses up all the money in its initial fund to purchase home mortgages and notes, it would normally put together another limited partnership fund to continue buying more home loans.

However, given the flexibility of limited partnership laws, we would allow partners to enter and exit on an ongoing basis since we can track their capital contributions (either as cash or assigned notes) as a free-standing investment. That means we would normally only need one limited partnership that would

accommodate current and future investors on a revolving basis.[118]

For the fund to make money, it will need to scrap the old mortgages and notes and enter into new agreements with those homeowners, thereby creating the "new" assets of the partnership that will later be sold. The key is that these new instruments will not be homogeneous like the original instruments, but rather a mix of new assets ranging from new mortgages and notes, to rent-to-own agreements and pure rental agreements, depending on the financial condition of the former homeowner.

Once all these new agreements are put in place, the fund will sell off those assets. Now our mortgage bank and real estate rental companies come into play. The goal is to convert those new assets into cash in order to provide cash back to the investors who provided the funds to buy notes and mortgages or to investors who assigned the notes and mortgages and/or foreclosed properties. The fund will be compensated for its efforts through a different financial arrangement made with each of those investor types.

If the investor provides the fund with cash, then the fund will use it to acquire notes and mortgages (at a discount from their face value) and convert the ownership in those old notes and mortgages into one of the new asset classes for later sale. The goal for this group of investors is to realize more money from the sale of those new assets than the amount invested. The investor partners and the general partner would share in any gains made on those transactions in a typical hedge fund split (probably 80/20).

If the investor assigns notes and mortgages and/or foreclosed properties to the fund in exchange for an equity interest, the transaction is more complicated. To begin with, a value has to be ascribed to the assigned note and mortgage or foreclosed property that will be used to calculate the value of the "investment" by the current note holder. That value is negotiable between the fund and current note holder and there may be considerable variation on typical values assigned based on the type of note holder or property owner doing the assignment.

A further complication arises if the asset to be transferred to the fund is the actual foreclosed home and not just the related note and mortgage. A lender with foreclosed properties on their books that are sitting idle and producing no value might want to transfer those properties into the fund in order to convert them into cash once the fund sells them or converts them into rental properties. The same applies to governments that may obtain properties from tax foreclosures. They too might want to assign them to the fund for disposition.

For example:

- Community banks are required by regulators to periodically place a value

[118] *The only reason we might set up additional limited partnerships would be if we get too many investors in any one partnership so as to push the SEC ownership limits, forcing reporting as a public company as we discussed in Chapter 14. Should we start bumping up against the 500 partner limit, we need only create a new limited partnership and we are then free to add another 500 partners in that entity, and so on.*

on each loan they hold and to record that value on their balance sheet. That might differ from the actual face value of the current loan, as is often the case when the borrower is in default. Example – current outstanding balance is $100,000 but the regulators make the bank discount it to $80,000 because it is "impaired" and have them record that lesser value on their balance sheet. It is that recorded value (versus face value) that will probably be used to determine the value of the assignment to the fund and, in investor parlance, would constitute their "basis" in the investment. Nonetheless, that value may well be higher than the real market value, as we will explore below.

- If the property in question is one that a lender (like a community bank) has already foreclosed on and wishes to put into the fund in order to help liquidate that asset, then a value has to be agreed upon with the fund. If the property owner is a commercial bank, then once again the regulators will require them to ascribe a value to that property for recordation on their balance sheet, which is a good starting point for determining the value of the investment using the assignment of the actual property to the fund.
- A home that was subject to a tax foreclosure by a county government presents a very different set of circumstances. In that case, the county would have no comparable regulator looking over its shoulder. Such properties are often sold for just the "back taxes" that caused the seizure and foreclosure in the first place, often far below the potential market value of the property. The county would be far better served in assigning those properties to a fund and thereby realizing a greater return to county coffers than a tax sale alone. In assigning the property to the fund, the county would be at liberty to place just about any value on it they wished (at or above the taxes owed) provided the fund managers agree with the value.

Each of the above examples represents a different set of conditions that lead to a different compensation structures between the general partner and the limited partners. Let's take the first example and explore its various outcomes and how we would ascribe value to the different partners based on the end results.

If the asset being assigned is a note and mortgage, then we need to see what happens if the new asset created is a reduced note and mortgage or a rental agreement, and the probable yield that will result from the sale of those two asset classes. If a new note and mortgage is generated, with high probability it will be a new note that is smaller in value than the previous one. Example – original note was for $100,000 and the new note is for $75,000, which could result from either a drop in value of the home (it was underwater) or the homeowner has less ability to pay or both.

In this case the subsequent sale of the new note would only yield approximately

$75,000 in a sale to the mortgage bank subsidiary. That is the individual return on the original $100,000 value representing a loss. In this case the fund would be compensated for managing the process before remitting the balance to the original note holder. We propose that something in the range of 5% of the proceeds of the sale (i.e., $3,750) would go to the general partner and the balance to the investor (i.e. $71,250), which would liquidate that individual investment.

The bank would record a loss of $28,750 on the original $100,000 loan. That might not sound good until compared with the alternative. If the bank agrees to sell the original distressed note and mortgage up front rather than assigning it, the bank will probably only realize about $50,000 in the sale and thus a $50,000 loss. Things could get even worse if the bank has to go all the way to a foreclosure and then try to sell the seized home. Such sales can result in an even greater loss to the original note holder than a pre-foreclosure discounted sale. Thus the assignment approach will probably yield a better return for that investor than any alternative approach.

The original note holder can even recover the full value of their assigned note and mortgage and possibly make a profit as well if the new asset created is a rental property with the old homeowner leasing rather than buying it.

If the old homeowner is not able to enter into a new note and mortgage, but can afford to rent the property, then they and the fund managers may agree to have the homeowner relinquish their "deed in lieu of foreclosure" to be replaced with a lease agreement. The fund becomes the owner/landlord of the home and the former homeowner is now a renter.

That property, accompanied with a lease agreement, could have a resale value that is higher than the outstanding real estate loan on the home. That would especially be the case where the amount owed on the property is less than the fair market value of the home if sold under normal, non-distressed conditions. Thus a sale to the rental property subsidiary may yield a profit on the transaction. Example – outstanding balance of $100,000, home sells for $150,000 to the rental property subsidiary, yielding a $50,000 gain on the original assignment value over the outstanding loan balance due the lender.

In that case the general partner would receive a different compensation split. In a traditional hedge fund, the partners would split that gain on a 20/80 basis. Thus the original note holder would receive $100,000 (their assigned value) plus 80% of $50,000 or $40,000, for a total of $140,000 (a $40,000 profit). The general partner would retain $10,000.

Given the unusual approach we are taking with this type of hedge fund, where investors may assign assets rather than invest cash, we have a slightly different formula. In this case the general partner would keep either 5% of the sale proceeds or 20% of the profit made over the original assignment value, whichever is greater.

For example, a sale of the above home for $110,000 would yield the GP only $2,000 under the 20/80 formula, but $5,500 under the 5% formula. The lender

would still realize the full face value of the loan ($100,000) plus a modest profit of $4,500, a value that far exceeds what they are likely to get with any other approach.

If the home is "underwater" (homeowner owes more than the current fair market value of the home), then the yield to the note holder investor would resemble the conversion to a new and lower note and mortgage with a 5% fee to the general partner for managing the process. Again, this yield is probably far higher than they could probably achieve any other way.

This is the hedge fund's core business – obtaining old notes and mortgages, whether at a discount or by assignment, and converting them into new instruments that can be sold for as much as can be realized given each particular property, the current resident and the current market.

Buying and holding mortgages and notes is something that just about anybody can do if they have the money, and there is essentially no government oversight or licensing required.

But owning rental property may require a license (typically a real estate license), depending on state requirements and the nature of the property owner. For example, individual property owners may have different requirements than corporations, LLCs and partnerships.

However, to enter into new mortgages and notes with the homeowners, even if the investor already has an old note and mortgage and one could consider this activity a renegotiation, just about every government (typically the state coupled with certain federal regulators) will require some form of license (to be a mortgage bank or mortgage broker et al.) to authorize the investor to carry out that activity. (See Chapter 12 where we describe the Nationwide Mortgage Licensing System (NMLS) for licensing of mortgage bankers, brokers and loan agents.) Thus, to carry out this aspect of the business, the general partner will have to address the potential license requirements of the state they operate in (covered below).

Finally, if our enterprise were just a run of the mill real estate hedge fund functioning in part as a mortgage banker, the licensing requirement would normally be the only other new element we would have to address. However, since our overall enterprise is intended to serve as a public benefit financial enterprise where our primary objective is to serve the public rather than just focusing on pure profit motives, we have one other ingredient we need to add to incorporate that larger objective — new, more homeowner-friendly mortgages and promissory notes.

THE NEED FOR NEW MORTGAGE/PROMISSORY NOTE CONTRACTS

Mortgages and promissory notes will serve as the foundation for the real estate hedge fund and the subsequent sale of those instruments to our mortgage bank subsidiary. To fit our larger mandate, we need to ask how we would do things differently from common practice today.

One of the reasons why so many homeowners are facing default is the terms of existing contracts. The vast majority establish conditions that can best be described as "all or nothing" and favor the position of the lender. Failure to abide by the terms of the agreement allows the lender to seize the property with almost no middle ground.

There are few, if any, provisions in those contracts that contemplate a change in circumstance for the homeowner such as loss of a job, extraordinary medical expenses, etc. Contracts are not structured with the goal of keeping the homeowner in the home as a primary objective.

In addition, there is normally no prohibition against the lender assigning and re-assigning their side of the contract. The homeowner usually has no say in that assignment. That freedom on the part of the lender plays a substantial part in the MERS system where assignments are privately tracked, not publicly recorded as has been the case for over 200 years.

That assignment also plays a key part in the use of those contracts to create various forms of mortgage backed securities.[119] The structure and requirements of MBSs make it nearly impossible for the lender to re-negotiate the loan with the homeowner, to accommodate the homeowner's changing conditions.

However, there is no legal requirement that lenders have the unilateral right to assign their rights in the contract without the permission of the homeowner. Clearly they may well prefer it (especially the MERS mortgage lenders), and they may not fund such agreements in the first place or buy them afterwards without that freedom. But the contract does not have to be written that way. In fact, there are many contracts today that contain clauses prohibiting the assignment of the rights in a contract held by one party without the written approval of the other party.

Consumers historically had the right to choose between a lender who sold the mortgage and one who did not. Most did not show a preference, either because they were unaware of that option or because of pricing considerations. Community banks have flexibility if a customer requests that a loan not be sold, and most, unlike Wall Street banks, will retain a loan upon request.

As a consequence, we feel that a much-needed component in our public benefit financial system is to provide for mortgage/promissory note contracts that are more balanced between the homeowner and lender. In particular, we recommend that they contain provisions that anticipate the need to renegotiate the contract due to changing conditions on the part of the homeowner, and make foreclosure and seizure the last option after other resolution mechanisms.

Also, we recommend that those contracts require recordation of the assignment with the county recorder. Assignments not recorded with the local government recorder can actually result in clouded titles. "A cloud on title reduces the value and marketability of property because any prospective buyer aware of the cloud

[119] http://en.wikipedia.org/wiki/Mortgage_backed_securities

will know that they are buying the risk the grantor may not be able to convey good title."[120]

The contract might also call for a prohibition on the use of the contract as the basis for any kind of mortgage backed security, especially if it creates rigid conditions that prevent re-negotiations with the homeowner. At minimum the contract could restrict the usage of the contract in that manner to certain prescribed types of MBS – those that can be flexible in dealing with changed conditions on the part of the homeowner.

The inflexibility of mortgage contracts and promissory notes actually contributes to our housing crisis. Thus we need a new version of those documents that are more "homeowner friendly," which in turn makes them more community friendly. And helping to keep the homeowner in the home would normally be better for the investors as well.

A substantial percentage of homeowners live from paycheck to paycheck. The breakdown of a car, unexpected medical expenses and any number of setbacks can result in hard choices. What doesn't get paid? All too often the mortgage payment is put at the bottom of the pile.

The problem with that is that once a homeowner gets a month behind, even if they are able to pick up their payments the following month, that one month non-payment doesn't disappear and the homeowner continues to appear delinquent with their lender. And trying to catch up on a single missed payment can be nearly impossible. Yet mortgage agreements typically have little in the way of elasticity to accommodate missed payments. One missed payment can cascade into ultimate foreclosure, which is good for neither the homeowner nor the lender.

We believe it makes sense to have mortgage contracts that provide for that contingency. If a homeowner knows they are going to miss a payment, then there should be an easy way for them to skip one payment without negative consequences.

For example, the contract might be structured so that in any one year, and for a maximum of certain number of years (say 5 out of a 30-year mortgage), the homeowner need only notify (by phone, mail, email, etc.) the servicing entity that they will miss a particular payment, with no reason needed and no approval required.

That missed payment will automatically be tacked onto the end of the contract plus some pre-agreed penalty, something like one additional monthly payment added onto the agreement.

This approach would cover a significant portion of the population who face only periodic and not too severe financial difficulties. Homeowners would have the piece of mind that missing any single month's payment will not risk the loss of their home. The lender benefits too, in that the contract provides for a flexible means to handle those emergencies.

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[120] http://en.wikipedia.org/wiki/Cloud_on_title

However, we have to recognize that some homeowners will experience more catastrophic financial conditions. Once again it makes sense to try and anticipate those possibilities with an adaptable mortgage contract.

For example, we feel that the contract should provide for up to six months hiatus in extreme circumstances, requiring a written request that includes a detailed explanation why it is needed and a projection for how long it will be needed. That projection would be in the 2 – 6 month range.

As with the one-month hiatus, there would be an offsetting penalty in favor of the lender to compensate for the missed payments. A simple formula could be the same add-on payment or some other formula that is defined in the mortgage contract. Thus both the homeowner and the lender have a provision for these more extraordinary circumstances.

If the projected hiatus is for longer than six months, the lender might need to re-negotiate the mortgage (sell off part of the interest in the home to another party to reduce the size of the payments or other measures) or arrange for the homeowner to sell the house within a reasonable period of time and move on.

And that latter point should go both ways, e.g., the homeowner should be entitled to initiate re-negotiations on the mortgage and note. With all these terms, we are attempting to have the contract anticipate these kind of real world conditions and provide resolution options that get around the "all or nothing" solution that has resulted in many homeowners simply walking away from their loan, more often than not with big Wall Street banks viewed as rapacious, heartless and inflexible. More flexible loan terms will help differentiate community banks.

Foreclosure should be the last option. Even then such a provision should be more humanely structured, e.g., sell the home, convert the contract to a rental or some other less aggressive action than a sheriff's eviction. Such provisions should not only benefit the homeowners, but the lenders as well, as in many cases, more homeowners will be able to continue with their home purchase resulting in fewer foreclosures.

Once new homeowner friendly mortgage contracts and promissory notes can be crafted, those contracts could then be acquired by other financial entities (outside our public benefit financial enterprises), provided that they agree to abide by the terms of the contract. Thus the contract becomes the driver in the system and who actually owns them on the lender's side becomes less significant.

That opens this system up to a larger number of potential funding sources. Those revised contracts are under development by the National Commonwealth Group, Inc. (a 501(c)(3) non-profit)[121] at the time of writing. Sample contracts will be posted on http://www.eminent-domain.us. Check there for the latest development on this and other issues related to the housing crisis.

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[121] *See www.commonwealthgroup.net, www.eminent-domain.us and www.mainstreetmatters.us*

OPERATING PROCEDURES AND LICENSING

The final step needed before we can begin operations is to create the policies and procedures for running the real estate hedge fund company. Law firms like Hudson Cook, LLP[122] can provide guidance on lending laws and compliance requirements.

In addition, the organization needs to have in place all its requisite licenses, permits and approvals. In addition to the NMLS[123] registry system, there are various law firms that can help with the licensing process, including Vestevich & Associates, P.C.[124] in Michigan, which specializes in licensing issues in all 50 states.

BYPASSING THE HOLDING COMPANY TO START

What we would do differently if we formed the real estate hedge fund, mortgage bank and real estate rental company as stand-alone entities without first forming the holding company? We don't recommend it, but provide the following in order to demonstrate what would be involved in that approach.

In this case, when we form (file with the state) an LLC for each of those entities, our non-profit founder will take ownership directly in these new LLCs, rather than through the holding company. Thus the approach we discussed previously with respect to setting up the parent holding company by the non-profit organization would apply.

We would set up these entities as manager-managed LLCs, where at least one of the non-profits would be designated as the manager or professional managers are hired.

With those pieces are in place, it is ready to set up the first limited partnership funds, establish the formalities, including policies, procedures, licensing and so on, and begin operations. When the team is ready to expand into other activities such as setting up or buying a commercial, deposit taking bank, establishing an insurance company, creating a venture capital or other investment company, it is time to create the holding company.

The owners of these LLCs will determine where they want to set up a holding company and proceed to follow the same steps they would have followed had they formed the holding company first, with one key exception – how they take over ownership of the holding company.

The owners of the LLCs would assign their ownership interest in those LLCs to the holding company and receive an ownership interest in the holding company in return. At that point they own the holding company and the holding company owns the LLC subsidiaries.

When viewed at the independent LLC end of this process, who owns those LLCs is

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[122] http://www.hudco.com/section.cfm?section_id=9
[123] http://mortgage.nationwidelicensingsystem.org/
[124] http://www.nationwidelicensing.com

the only thing changing. This would not alter the existing relationships of the various limited partnerships that the LLCs had previously established. A reminder that these LLCs (not the owners) serves as the general partner in those limited partnerships, and only the owners of the LLCs would change, not the LLC's relationship with the limited partners.

We now have the beginnings of the financial enterprise depicted in Figure 1, Chapter 10. There is one key difference now compared to starting with the holding company and then forming the subsidiaries — we now have operational entities that should have accrued considerable value, which now becomes the value on the balance sheet of the holding company.

This can become extremely important when we start looking at forming or acquiring commercial banks, as we will entertain in the next chapter.

CHAPTER 17

ADDING COMMERCIAL BANKING

We now have in place the real estate hedge fund, the mortgage bank, the real estate rental company and their parent holding company, and are now ready to add more businesses and partners.

When we get to commercial banking we have to deal with some key issues that are substantially more complicated, costly, time consuming and subject to regulatory oversight than is the case with mortgage banking.

Nonetheless, commercial banking opens up a whole new world with respect to our goal of creating public benefit financial enterprises. As we noted, commercial banks can do something that no other financial institution can and that is create money when they make loans. Credit injects *new* money into a local economy, money which multiples many times in terms of the total economic value it brings to the community.

Therefore we want to add commercial banking as soon as we can. But it represents a much bigger jump than other forms of financial institutions.

THE BIGGEST HURDLE

The single biggest hurdle is the initial capital needed to buy or build our bank. If the enterprise does not already have a sufficient asset base to get into commercial banking, then the organizers must obtain the funds needed. That financial threshold is the chief reason we advocated the mortgage bank first strategy, as we will explain shortly.

In the previous chapters, we showed how a real estate hedge fund, a mortgage bank and a real estate rental company could be launched with just a few hundred thousand dollars or less, excluding the funds needed to fund the mortgages and rental properties themselves. Not so with commercial banks.

Typical total capital requirements for buying or building a commercial bank are usually in the $10 million to $25 million range, sometimes more. Most state and federal regulators require a capitalization of at least $10 million for a "de novo"[125] (new) bank's capitalization and often as much as $20 million. A similar amount would be required to purchase an existing (small) bank.

Those funds are what would be needed just to *own* a functioning bank, but not necessarily the funds needed to expand its lending operations. Those additional loan-enabling funds would be above and beyond those needed to own the bank, even though a portion of those initial capital funds would be used to support lending.

For example, if we *acquired* a bank for $10 million dollars, all of those dollars would go to the previous owners and we would only have the amount of cash

[125] http://www.brighthub.com/money/personal-finance/articles/43558.aspx

already owned by the bank at our disposal to run the bank and support its lending operations. If we want to expand lending beyond the limits allowed by regulators based on that cash and other assets of the bank, we would need to bring in additional capital.

That means our non-profit organizers would have to assemble a group of investors willing to put up $10 million to $25 million dollars as a capital investment (versus a loan) to go into just funding the purchase of an existing bank (preferred) or building one from scratch, which costs about the same but takes longer. In today's economic climate, that is difficult enough for a normal for-profit banking enterprise, let alone a non-profit organization.

What about borrowing the funds? That is no different than trying to start any other business on credit. It is nearly impossible to obtain a bank on credit (i.e., borrow funds or float a bond issue to get the money needed to either set up a de novo bank or buy one), just as it is nearly impossible for any startup business to obtain a bank loan if it has no capital and no business history.

What if the founder/owners are already wealthy? Regulators will normally not allow anyone to start or buy a bank with borrowed funds. So even if the prospective owners have the capacity to borrow funds, the regulators would require them to put in capital.

That means that capital has to be raised from investors and that requirement would apply whether the investors wish to establish a standalone bank or establish one under a bank holding company. That is an important distinction, because regulators will allow a *holding company* to borrow funds (loans, bonds, etc.) to buy a bank (or start one from scratch), but will not allow individuals, regardless of how wealthy they are, to establish a bank with borrowed funds. A holding company *will* be able to borrow funds *if* it already has sufficient assets and a business generating income, enough to satisfy the credit requirements of the parties putting up the credit money. In those circumstances the regulators *will* let them use borrowed funds to obtain a bank (buy or build).

Thus a holding company can own a bank that it obtains strictly with borrowed funds, which it can pay back out of the profits of the bank. (One of the typical ways a big bank buys up smaller banks is to borrow the funds.) That means any capital we bring in thereafter can be directed straight into increasing the lending limits of the bank rather than being used to buy or build the bank.

That brings us back to our mortgage banking business. Properly run, our mortgage bank business, as a subsidiary of the holding company, should be able to grow to the point where the holding company has the credit worthiness needed to then borrow funds to either buy or build a bank. Thus we would avoid the need to raise capital for establishing a bank.

With that in mind, let us look at the question of buying a bank or building one from the ground up. Which is better and why?

BUILD, BUY OR INVEST?

Most banking experts recommend acquisition as the fastest, most efficient and often least expensive way to *own* a bank in the United States. However, if our goal is to provide public banking services to our communities as quickly as possible, the fastest way to accomplish that is to *invest in existing banks*, with the requirement that they use those funds for targeted public benefit objectives. The requirements for regulatory approval of investment in a bank are far less onerous (no pre-approval or a short approval process, depending on the size of the investment and the *amount of control,* if any, given to the new investor) then either buying a bank or building a brand new one.

The next fastest way is to buy a bank, which can take approximately six months. Building one from scratch can take one to two years, if the regulators will even allow a new bank to be formed in the first place, something that is difficult to achieve in today's economic climate.

Purchase prices for community banks can range from around $5 million up to billions, whereas investing in a bank can cost far less. Acquiring an existing bank can translate into picking up a turnkey operation with a charter, personnel, buildings, computer systems and the other elements needed to operate. These infrastructure elements, along with the bank charter application, can take from one to two years to set up for de novo banks.

Buying a bank can be accomplished in a matter of months. If the bank is already owned by a bank holding company, acquiring the holding company with its bank subsidiary already in place is the most efficient path to the structure we recommend. If the holding company is not in place, it would need to be established and registered with the Federal Reserve, which has regulatory jurisdiction over all bank holding companies (along with "financial holding companies" established under the Gramm-Leach-Bliley Act of 1999).[126]

As we mentioned previously, we advocate for a corporation to serve as the holding company but also provide for a somewhat unusual form of corporate structure — an LLC. And just as we advocated for the subsidiary LLCs if an LLC is chosen as the vehicle for the holding company, we recommend that it be established as a manager-managed LLC.[127]

A manager-managed LLC provides for two types of participants – managers and members. The members of the LLC are the owners of the LLC and the managers may or may not be owners.

With our particular model, one or more non-profit organizations will be designated as the managers of our holding company LLC. They are also members. They will be responsible for the day-to-day management of the company.

The balance of the member owners will be passive investors, composed of governments, non-profits (e.g., foundations, university endowment funds,

[126] http://www.fedpartnership.gov/bank-life-cycle/grow-shareholder-value/bank-holding-companies.cfm
[127] http://smallbusiness.chron.com/manager-managed-llc-3078.html

churches) pension funds, and other investors. All of these investors have a fiduciary (trustee) role on behalf of the public or a particular group of beneficiaries. Each of these investors will enter into a custom investment agreement with the holding company that spells out the amount of money they will invest, what it is to be used for and what they wish to see accomplished with the application of their funds.

How much will it cost?

Our preferred path will require $2 million to $5 million to start and produce the fastest results, whereas the alternate, non-bank path can be launched with just a few hundred thousand dollars, but can take much longer to reach the commercial public banking goal.

We set $2 million - $5 million as our target as that should be sufficient to invest in a small bank where those resources are sufficient to produce a meaningful impact on the targeted objectives. Otherwise we would need to raise at least $10 million in order to actually acquire a bank and leave some working capital to grow it and its companion activities. Our structure would allow for adding substantially more capital after the initial investment and/or acquisition, obtained from various public sources. And thus growth can be realized relatively quickly, once we have the initial basic chartered public banking infrastructure in place.

Where are the target banks?

There are only 22 bankers' banks in the country. None that we are aware of might be open to an investment or even be acquirable. Bankers' banks have a different infrastructure and business model than a community bank. In addition, the scope of services provided by most bankers' banks is substantially more limited than that provided by the much larger Bank of North Dakota, which we wish to emulate in terms of the full scope of services provided.

In contrast, there are a large number of small community banks that could be candidates for investment and/or acquisition to provide our first retail Sparkassen-like public banking services. We conclude that it would be much easier to get started with the retail banking emphasis first, and then add the wholesale services as a parallel business focus, which could be added to one or more existing community banks rather than going to the limited number of bankers' banks.

USING AN LLC AS THE HOLDING COMPANY

Normally a bank holding company is formed as a for-profit corporation, less frequently as an LLC. A corporation works best when all or most investors are to have the same investment terms, a common attribute of most for-profit banks and bank holding companies, since corporations use classes of stock for investment purposes and all investors within one class are legally constrained to the same investment terms (i.e., percentage of stock purchased per amount of investment, and other such terms).

But if flexibility is required in structuring custom investment agreements between the bank holding company and multiple investing partners with no common goals, an LLC could provide the ideal legal structure.

Under an LLC, management is free to craft a custom investment contract with each investor. For example, some of the funds provided by a county could be dedicated to addressing its credit needs in a "virtual branch" banking concept, a university endowment fund might want to establish a student loan program, and a city could support green energy loans or credit programs for small businesses.

Thus investors could enter into an agreement with the bank holding company that a percentage (up to 100%) of the funds they invest and deposit will be dedicated to serving their particular needs with any balance assigned to shared objectives.

In essence the investor partner would define the goals (usage) for their funds and the bank holding company would be responsible for managing to those objectives as long as the goals are financially sound. Accounting would be similar to government accounting with separate accounts for each investor.

Nonetheless, for our purposes we favor the conventional corporation holding company and shall proceed with that model. We then can accomplish an almost identical set of custom goals for investors by setting up a limited partnership that funds the bank directly rather than through the top-level holding company. Each limited partner can define how they want their investment to be used by the bank.[128] Such a limited partnership itself would be a bank holding company by definition because it is a separate business entity that owns and/or controls a bank or a bank holding company that owns and/or controls a bank.[129]

Like our other subsidiaries, we would establish an LLC as the general partner to the limited partnership and it would manage the investments of the limited partnership – in this case in one or more banks. In turn, our corporation would own the LLC, and the corporation would also be classified as a bank holding company because it owns a bank holding company that owns a bank.

BND AND SPARKASSEN-LIKE BANKING STRUCTURES

Up to this point we have explained this concept in generic terms that fit both the BND wholesale banking model and the Sparkassen retail banking model.

We anticipate the formation of at least one state-level Sparkassen-like bank holding company in each state. Regions would be served by BND-like bank holding companies, each serving multiple states (with the probable exception of California, which could be a region unto itself). Thus when the system is fully deployed, each state should be covered by at least one state Sparkassen bank

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[128] *Such directed investments – e.g. specifying what the investment funds are to be used for may well run into complications with certain regulators, and how to navigate those waters is beyond this writing, but reinforces the need to lead to a new regulatory environment that characterizes public banks serving a public benefit, as distinct from privately owned banks serving their shareholders.*

[129] *http://www.fdic.gov/regulations/laws/rules/6000-300.html*

holding company and one regional bank holding company, each addressing a different customer constituency.

Keep in mind that the BND-like structures will focus on credit facilitation to free-standing, privately owned community banks and credit unions (BND provides credit only, not capital). As BND has demonstrated, credit facilitation can prove quite significant if the bank is sufficiently strong enough and has all the capital it needs from its own resources. This is not easy to accomplish in today's environment where investors have become increasingly reluctant to invest in community banks, and existing shareholders are unwilling to dilute their interest with new investments.

In contrast, the Sparkassen-like structures will acquire community banks from existing private owners and making them part of a jointly owned public benefit partnership banking system in each state. Those acquired banks will then be wholly owned subsidiaries of the holding company and not only receive credit facilitation from the parent, in a fashion that also resembles the types provided by the BND-like structures, but perhaps more importantly, capital.

Each bank under this structure would have the potential to receive as much capital as it wants, given the needs of the community and the resources available from government and other investors, which could easily exceed what the system could absorb. And given the public nature of the ownership and the way investment agreements will be structured, concerns about dilution by existing shareholders will not be a concern. Thus we have the potential for opening up the credit spigots in each community necessary for them to return to economic health.

With both of these structures in place, each investor will have the opportunity to invest in either or both types of public bank holding companies depending on their investment preferences, a far greater level of flexibility than they have currently. Both will benefit our local communities in a different but complimentary manner.

Let's now examine these two models to see how investment funds would flow and how they would be used.

THE BND WHOLESALE MODEL

Our BND-like holding companies and their banks will implement their credit program by working with community banks and credit unions. They will be responsible for ensuring the creditworthiness of all loans and loan programs and that sound banking is practiced at all levels The bank alone will determine if credit can be extended towards any targeted program, free from political interference.

The financial limits of any particular program would be constrained by the amount of money invested and deposited by investors in that region, who can define how targeted their funds must be.

For example, a region might cover all eight of the Great Lake states. The city of Youngstown, Ohio may want its funds applied only in support of the community banks in Youngstown and the immediate environs, whereas a pension fund for a union with a presence throughout the region might allow their investment to be used throughout the entire region but only in support of loans to union shop or employee-owned businesses.

In any case, if those investments dedicated to a specific geographic location or targeted credit group become fully deployed, then all it takes to open the lending spigot further for those applications is to get more investment and deposit dollars.

Over time, investors may change the focus of their target programs or expand their scope. The nature of the investment agreement of each investor will provide for ongoing program flexibility. It is their money and they decide how they want it to work in their communities or for their targeted beneficiaries. It is up to the holding company and its bank to do that responsibly. In this way, participating investors can get the benefit of having a bank of their own without actually creating and running one themselves. And the enterprise can simultaneously address the larger macro issues in which all the participants share an interest.

THE SPARKASSEN-LIKE RETAIL MODEL

We can apply those same concepts to the state level Sparkassen-like banks. The key difference is that instead of just providing BND-like credit facilitation to stand-alone private banks, these holding companies will seek out and acquire community banks.

Many bankers feel overwhelmed by the current financial and regulatory environment. The FDIC in particular (at the behest of Congress) has been coming down hard on banks, pushing them along dimensions that the agency deems necessary for them to remain (or become) healthy. A frequent demand is that they bring in more investment to improve their loans-to-capital ratios.

In fact, this is so common that bankers jokingly refer to FDIC as “Forever Demanding Increased Capital.” Jest or not, the need to raise more capital is proving to be very difficult. Potential investors consider community banks to be a risky investment (with good reason), therefore demanding higher returns. That means current investors may have to take what is euphemistically called a “haircut,” (investor parlance meaning a substantial reduction in someone’s current position demanded by later investors).

For this and a number of other reasons largely related to the general state of the economy, a substantial number of community banks could be available for acquisition under this model. Already the number of independent community banks has dropped substantially and there is nothing to indicate that this trend will abate. That is where our public banking model can come to the rescue by helping revive those banks and allowing them to continue to serve their communities, probably with an increased capacity over their current capabilities.

Our community of investors could therefore be interested in seeing those local banks converted to public ownership, under which they can be freed up to resume lending to local communities instead of fending off regulators and otherwise struggling to keep their heads above water.

Note – In the addendum, we further explore the regulatory environment that goes along with FDIC deposit insurance, which may have bearing on our public banking structures.

BOTH MODELS

With respect to both our BND-like and Sparkassen-like structures, investment agreements could call for the funds to be directed into non-bank subsidiaries. Bank holding companies are allowed to own a variety of financial subsidiaries and if they obtain the financial holding company designation from the Federal Reserve, then they can own just about any kind of financial enterprise from insurance companies and investment banking companies to brokerage companies, venture capital funds and the like.

For example, a subsidiary might hold mortgages that are initiated by the enterprise or come from outside sources such as community banks. This mortgage investment pool could have long-term investment objectives that are synchronous with the public benefit purposes of the overall enterprise and they would represent separate investment opportunities for the government, non-profit and pension fund partners. Another option might be a venture pool to provide capital to startups or other targeted companies such as renewable energy companies, community investment pools and the like.

These and other specialty finance companies can be made part of both our wholesale and retail bank holding companies if those holding companies directly hold and invest in banks or in parallel subsidiaries where the bank holding company (as a limited partnership) is owned by an overarching holding company that owns these other subsidiaries as well. Each of these various subsidiaries (banking and non-banking) would be targeting a different area of our economy, so as to provide a complete financial ecosystem that is publicly owned and managed for the public good.

Thus, long-term investments coming into these holding companies and/or limited partnership subsidiaries would be directed differently for non-bank and banking subsidiaries. The LLC structure at the subsidiary level would allow these holding companies to arrange for custom investments to be directed into any of the targeted subsidiaries (primarily using limited partnerships). Any number of other compatible financial subsidiaries might be formed under the holding company, providing for a more complete financial enterprise dedicated to serving the public.

Finally, it is important to point out that in contrast to today, investments by each government, non-profit and pension fund partner and the application of those funds would be completely transparent to the public. Taxpayers would know

where their governments were investing their money and, to the extent that borrower privacy concerns are respected, full disclosure of the application of those funds. This way local citizens and other constituents can see exactly what their leaders have prioritized, how much they have allocated to those priorities and the outcomes of the applications of those funds.

LEGAL MECHANICS AND OPERATIONS

What form of expertise is needed to create this kind of organization? At a minimum:

1. Experts in banking are needed to:

- Deal with the regulators who have a say in the establishment and operations of the enterprise.
- Negotiate purchase of a bank (or bank holding company) or set up de novo operations.

2. Experts in the establishment of manager-managed LLCs are needed to construct custom LLC and limited partnership investment agreements.

3. If the enterprise will acquire a bank holding company with a bank subsidiary, legal expertise in mergers and acquisitions will also be needed. The existing bank holding company is likely a corporation, which would need to be merged into the target LLC, a special form of merger requiring particular legal expertise.

4. A professional banking team must be assembled to run the enterprise. They will need to be identified early, since regulators will want to approve those who will be running the operation at both the management and board levels.

If a de novo operation is established, then a team will have to be assembled from the ground up. If an existing organization is acquired, some of the requisite personnel may already be in place. However, even in the case of an acquisition, the in-place team may not have the expertise required to operate a bankers' bank. Thus the organizers need to make sure that in addition to basic banking operational expertise, bankers' bank expertise is provided for.

When these pieces are put together, we get a structure similar to the attached organization chart (see the appendix), which depicts the key components and the relationships between the participants for both the BND-like structure and the Sparkassen-like structure, with a central organizing entity to establish and coordinate them.

National Commonwealth Group, Inc. has begun to put together the first regional and state-level public bank holding companies.

Given the public ownership nature of this concept, National Commonwealth Group expects to work with other parties through the country to build up a public banking network. Interested parties may contact us regarding joint efforts.

National Commonwealth Group, Inc.
info@commonwealthgroup.net

CHAPTER 18

RECAP

The U.S. recession remains stubbornly deep and wide — except on Wall Street. The financial sector is enjoying record profits while local economies struggle. Main Street, like all economies, relies on the availability of money to keep its economic engine running — but money is currently unavailable.

Community banks, the primary source of local money, are not lending and therefore not pumping new money into their communities. They are severely handicapped by the Wall Street-induced housing crisis and the subsequent aggressive response by regulators.

However, there are economic bright spots. In North Dakota (and around the world in countries like Germany), small business credit is abundantly available, and the communities served by those small businesses are healthy and thriving.

Public banks support small businesses

Their economic health can be explained by one common element — their economies are served by public banks (rather than privately owned banks), which provide plenty of credit locally. Where we find public banking structures, we find healthy economies. We concluded that the U.S. needs to widely deploy public banks, backed by the substantial financial resources of state and local governments.

Governments team with non-profits by providing investment funds

We showed how local governments could team with a non-profit organization to establish a new public banking structure, leveraging each other's strengths to achieve what neither could alone. The result would be two parallel public banking structures, one focused on wholesale banking to support existing banks, the other to convert smaller community banks into publicly owned banks under a larger publicly owned structure, thereby keeping them alive and serving their communities.

Governments work with community banks as they have worked with Wall Street banks

Both of those structures contemplate non-profit organizations setting up and running these public benefit financial enterprises, using funds from state and local governments and other funding sources. The governments do not own or run the banks! They are passive investors, as they currently are with Wall Street banks, except that now they are diverting some of those investment dollars to Main Street banks. The tools used are the same tools used by the large financial conglomerates on Wall Street, only turned to serving the needs of society rather than investors with short-term profit objectives. However, given that non-profits rarely start with their own independent source of funds, we laid out a strategy for how those organizations can bootstrap their efforts, eventually growing into a full-fledged public benefit financial ecosystem.

The housing crisis as a springboard to healthier local economies

The plan focuses on the issue that stands at the center of our economic problems – the housing crisis. We showed how a special private equity fund could be established with almost no upfront investment. It could begin almost immediately to help communities address their foreclosure problem and keep homeowners in their homes. This plan can serve not only community banks forced to foreclose on homeowners in default on their mortgages, but also local governments foreclosing for non-payment of taxes. These actions help stem the tide of foreclosures that are devastating communities nationwide.

Building blocks for local financial systems that put money into local economies when it's needed

We showed how we could establish at least two parallel organizations that can purchase the new assets created by the first fund as a result of its new arrangements with homeowners. Those three organizations and subsequent companion organizations that will constitute the complete ecosystem will ultimately be housed under a common parent holding company, which can be set up at the start of the process or downstream when two or more organizations need to be

brought together.

A public benefit financial ecosystem

Each of these first organizations will have a role in our larger public benefit financial ecosystem and lay the foundation for an eventual public banking structure (wholesale and retail). We showed how to creatively use one of the key tools of the financial industry, the limited partnership, to obtain and direct funds and other resources toward building these structures.

Self-reliance, entrepreneurial spirit and strong communities: American values rebuilding America

The above infrastructure can be built in each state to serve its communities. This new ecosystem is built on the premise of serving local communities, using resources found locally rather than relying on Washington or Wall Street. And its very nature creates a positive economic feedback loop. The more it does, the more it enables and the result is that communities and states are able to bootstrap themselves into permanent economic health.

ADDENDUM:

DEPOSIT INSURANCE AND WHAT COMES ALONG WITH IT

When smaller banks are on their own, they are at increased risk of failure over larger banks, especially in today's environment. Depositors in those banks would likewise be at risk of losing their deposit money if their bank goes belly up. That is what happened during the Great Depression and prompted the federal government to establish the Federal Deposit Insurance Corporation (FDIC). The primary purpose of the FDIC is to provide a guarantee to depositors that, should their bank fail, they will still be able to get their deposit money back. The FDIC currently guarantees depositor's money up to a maximum of $250,000 in any one bank.

We can clearly see the justification for deposit insurance provided by the FDIC. And like other insurance programs, those "payouts" are financed by insurance "premiums" paid by somebody. In this case it is the banks themselves that are required to pay the FDIC insurance payments.

Normally states require state-chartered banks to be members of FDIC and be covered by its insurance fund. Today however, membership comes at a much bigger cost to the banks than just the insurance premiums.

To be a member of the FDIC insurance fund means that a bank also has to accept regulatory oversight by the FDIC. And as we indicated, that oversight is creating a burden on community banks that many say is so extreme that they may not be able to stay in business. It is not uncommon for a small bank to have to dedicate 20% or more of its personnel just to regulatory compliance. That translates to financial costs that produce no financial gain and just eat into profits.

Community bankers find themselves waging a survival battle on two fronts – dealing with the problems caused by a greatly weakened economy and regulators who are exacerbating those problems with unrealistic and excessive demands. One respected president of a small bank with over 35 years bank management experience recently summarized his feelings about FDIC by saying, "FDIC is coming in and shooting the wounded!"

AN ALTERNATIVE TO FDIC DEPOSIT INSURANCE

At various times in the past, alternatives to FDIC have been tried on a local basis, with none grabbing hold sufficiently enough to permanently replace FDIC. However, given the current state of affairs, community bankers across the country are calling for an alternative insurance system.

Such banks fall into two categories – those that have obtained their charter from the state where they are headquartered and those that have been chartered by the federal government. Individual states can change their insurance

requirements for the banks that they charter. Federally chartered banks will probably be forced to continue to accept FDIC.

Given that stand-alone banks will continue to be at risk for failure, it is unlikely that the states will allow their community banks to forego any insurance, but may allow them to change where they get that insurance. However, for the community banks acquired by our state-based Sparkassen-like structures, we might find a set of conditions in which insurance (at least of the FDIC variety) may no longer be deemed necessary, thus freeing those banks from the other problems that accompany FDIC insurance.

As our state-based model grows in size and strength, bolstered by large capital infusions by state and local governments, pension funds and others, there will come a point at which the risk of any individual depositor losing their deposit funds becomes largely eliminated. That is because the banks under this structure, even though they appear to be small independent banks, are not in reality stand-alone entities but part of a larger, publicly funded enterprise whose existence is dedicated to serving the public and not a group of wealthy shareholders.

If this were a private banking enterprise composed of a holding company that owns a number of community banks (common throughout the U.S.), management at the holding company level would likely let poorer performing subsidiaries die rather than pump in the resources necessary for a rescue. These multi-bank enterprises may be faced with the same capital-raising problems that stand-alone community banks face, so this choice is not unreasonable in today's environment.

Our public banking structures are a different matter altogether. Here the ultimate constituents are the public, and closing any one community bank would be viewed as going against the very mission of the whole enterprise. So in contrast to the private banking model, a public banking model would be motivated to ensure that all its banks and their branches are healthy and serving their communities efficiently and constructively.

Most of the banks in the system will be added via acquisitions of smaller, stand-alone banks, formed by their founder/owners with no one to guarantee the quality level. That means that one can expect a mix of talent, systems, policies and procedures. Clearly any deficiencies in those banks will have to be addressed and rectified.

One solution is that management at the holding company level establishes a uniform set of policies, procedures, practices and systems that will be required of their subsidiary banks.

This will also require that the holding company establish its own internal oversight mechanisms to ensure that each bank is legally and financially operating at optimum levels, and has the resources, personnel and expertise needed to get the job done. If necessary, personnel will receive enhanced training and guidance on bank management, and additional resources and expertise will be brought in when warranted .One key resource will be increased capital that,

unlike in today's private banking environment, could be made abundantly available.

The net result is that the prospects of a bank being closed down are extremely unlikely. It could happen. But given the public, collaborative nature of the enterprise, in the unlikely event of a shutdown, customers would simply be handed off to one of the other banks.

In such a circumstance, the concept of FDIC insurance would no longer be needed. Thus a state, working closely with this public banking enterprise, may determine that a requirement to be a member of FDIC or any other insurance fund outside this public structure would no longer be necessary. That may require some formal structure to ensure that all depositors would continue to be protected, but it is a viable pathway to pursue.

Those banks would thus be freed up from the most onerous of the burdens imposed by FDIC and could redirect their time, resources and attention to better serving their communities.

One final note. What we have described applies to banks brought in under our Sparkassen-like bank holding company structure. What about the BND–like structures? The customer banks would still be independently owned, private banks. The bankers' banks themselves would be another matter. In fact, the rationale for them not having to be part of FDIC would be more immediate and justifiable.

A reminder that FDIC insures depositors up to $250,000. Our bankers' banks will not have any depositors who have deposits that are less than $250,000, and thus all depositors would have funds (probably the majority of their funds) uninsured.

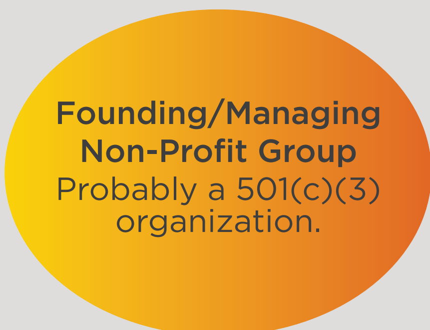
Having FDIC in this picture to provide insurance normally geared towards small depositors would be an obvious mismatch. Therefore we expect that the bankers' banks will address this issue with the states that grants them their charters, to determine the appropriateness of having FDIC in the equation.

PUBLIC BENEFIT PARTNERSHIP BANKING: A MODEL

A bank/finance holding company co-owned by various non-profit and government organizations, managed by a non-profit management group

Passive Owners

Holding Co & Managing Partners.



Banks & Other Subsidiaries