RESCUE & RECOVERY

Facilitating Economic Revival:
An Opportunity For States and Community Banks

NCG / National Commonwealth Group

Main Street companies rely on local banks

- Main Street is dying because no credit is flowing. Banks large and small have largely stopped lending to small businesses.
- Community banks were the primary source of credit in our communities – principally to small businesses which account for about 50% jobs in the country and the majority of net new jobs.
- Community banks are themselves dying or being absorbed by bigger banks. Over 10,000 banks have disappeared since 1984 (17,901 > 7,357 in 2011, ~ 60%) and that trend has greatly accelerated since 2008.

Note: FDIC defines community banks around criteria related to traditional lending and deposit gathering activities and limited geographic scope. They generally have less than $1 billion in assets.

Community banks are key to recovery

- Unless we stop this trend, there will be nobody left who will lend to small businesses.
- If small businesses can't get credit, our local economies will never recover.
- Thus the death of community banks represents a grave threat to Main Street America.
- To date, no one has devised a way to rescue community banks and thus rescue our communities – with the exception of one state, North Dakota.

What's unique about North Dakota

- North Dakota has one thing that no other state has – **its own central bank.** The Bank of North Dakota (BND) provides direct support to banks and credit unions (its primary customers, not the general public), making them the healthiest in the nation.

North Dakota's healthy community banks

- Provide as much credit as the state can use.
- Zero bank failures in over 10 years.
- 4 times the number of banks per capita as the national average.
- Small and medium-sized banks account for 72% of deposits vs. 30% nationally.
- Higher average loan-to-asset ratios than their counterparts in four neighboring states and nationwide.
- Can sell residential mortgages to BND, keeping money in-state and preventing customer poaching by larger banks.
- Since 2001, lending per capita by small community banks has averaged about $12,000, compared to $3,000 nationally.
- North Dakota community banks averaged 434% more lending for small businesses over the last decade than the national average!
- Participation loans increase the amount and size of loans on the books, helping retain customers that might otherwise be lost to larger banks.
- **Yet BND itself is extremely profitable — it generated a 19% return on equity for the state in 2010!**

An opportunity for community banks

- BND is owned and run by the state, but that is not the key to its success. Rather it is the **services and financial support it provides to banks**, backed by money from the state.
- Other states need only provide those same central bank services to their community banks — **with an independent source of funds to back them** — to achieve those same goals.
- NCG has developed a structure to achieve those goals, providing a tremendous economic boost to the state and creating a significant economic opportunity for participating local banks.

Outside funding critical

- Around the nation, 22 bankers' banks provide somewhat similar services to BND.
- But — they are funded by their customer banks. When those are short of funds, so is the bankers' bank.
- Once again, the key to North Dakota's success is:
  - A **state-wide central bank** providing services and financial support to community banks.
  - An **independent source of funds** for the central bank.

Adapting the North Dakota model

- NCG has developed a system that can emulate the BND model.
  - It establishes a public benefit partnership banking structure set up and run by a not-for-profit organization.
  - It creates partnerships with local banks that allow NCG to provide the BND-like services.
  - It is backed by passive investors that include state and local governments, foundations, pension funds, university endowment funds and others.
  - It includes a means to rescue failing banks.

How do we accomplish this?

- First you need a bank charter authorized to carry out those activities. That can be accomplished by:
  - Starting a new bank
  - Buying a bank
  - Partnering with a bank
- It normally takes up to two years for FDIC to approve a new charter, if at all. Buying a bank takes capital and regulatory approvals, which can take six months or more.
- The fastest way is to partner with a bank.*

*The bank must be considered sufficiently healthy that it may commence a new line of business without having to get pre-approval from bank regulators. Otherwise the regulators may prevent the bank from starting new business lines.

Partnership benefits

- By partnering with select local banks, NCG:
  - Provides them with new and potentially very profitable business lines.
  - Provides other banks around the state with additional financial benefits.

*See the Appendix for details on the advantages and disadvantages of both options.

Partnership options

- There are two* primary ways to partner with a bank:
  - Through the bank's holding company (if one exists).
  - Through a subsidiary under the bank (if permitted by the bank's chartering agency).
- NCG recommends establishing separate subsidiaries each focused on a single BND-like service area. Those entities may be formed under one partner bank or spread among two or more.

*See the Appendix for details on the advantages and disadvantages of both options.

Next steps

Phase 1: Agreement

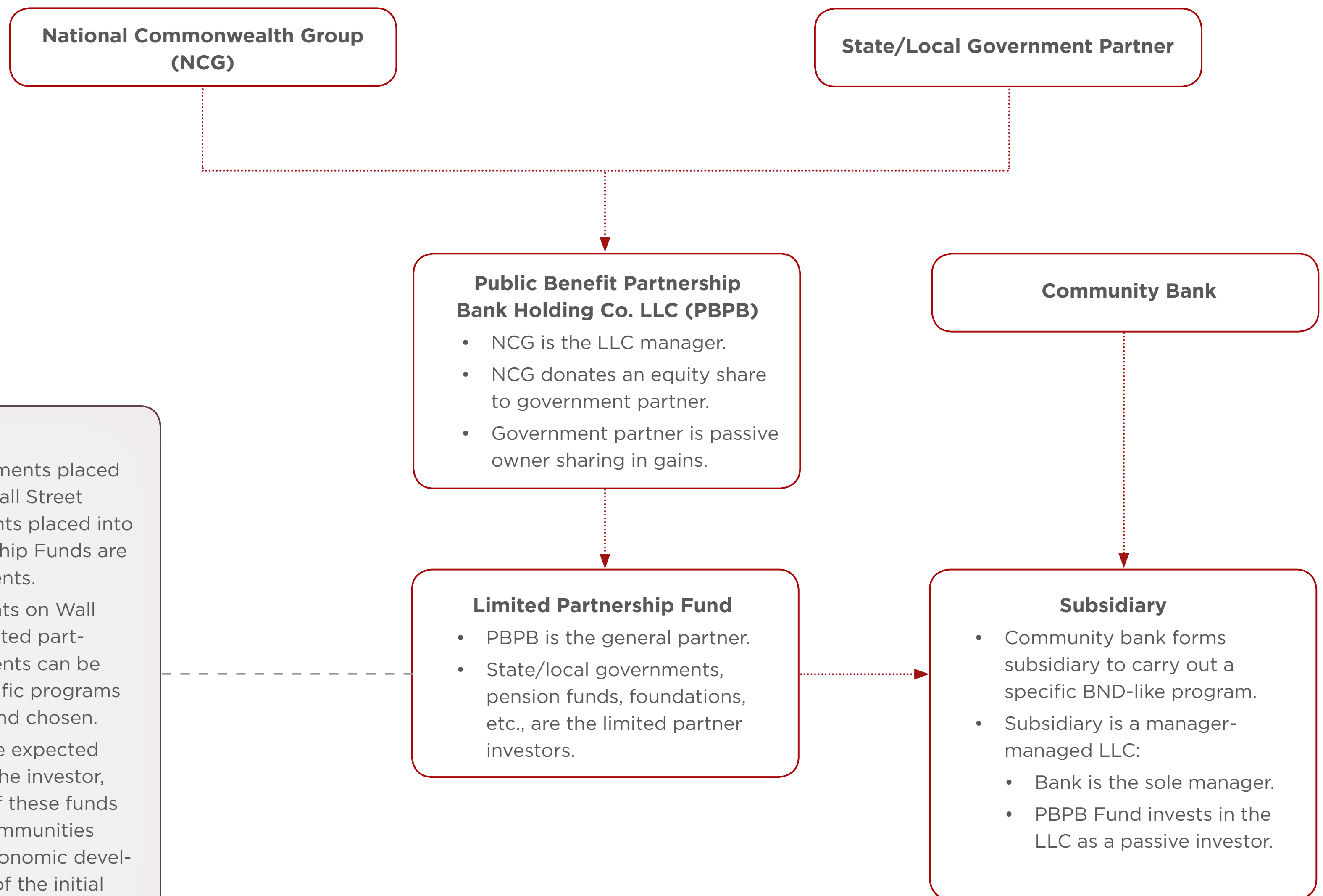
- NCG and any candidate partner bank determine:
  - Which BND-like service is to be provided, under what type of vehicle (corporation, LLC or limited partnership) and whether NCG investment will be via the bank's holding company or directly with the subsidiary.
  - How much startup capital is needed to launch the subsidiary.
  - How, where and by whom the program is to be administered, including expense allocations.
  - The terms of the investment, including profit and loss allocations, spinoff, sale or dissolution.

Phase 2: Implementation

- The bank forms the subsidiary, allocates the appropriate management and resources, and leads marketing efforts with assistance from NCG or its affiliates.
- NCG forms the initial limited partnership (LP).
- NCG raises the initial capital from a mix from state and local government funds, pension funds, foundations, education endowment funds and other similar sources.
- The LP invests the funds with the bank to be directed as agreed.
- NCG pursues additional funds as needed, through the existing LP or a new LP.

PUBLIC BENEFIT PARTNERSHIP BANKING SYSTEM

Proposed Structure



Note:

- Similar to investments placed currently with Wall Street banks, investments placed into Limited Partnership Funds are passive investments.
- Unlike investments on Wall Street, these limited partnership investments can be directed to specific programs based on the Fund chosen.
- In addition to the expected capital gain for the investor, the circulation of these funds through local communities multiplies the economic development effects of the initial investment.

Appendix

Investing in a bank holding company

- Partnering with a bank through its holding company is a more complicated approach than at the bank subsidiary level.
- This is particularly the case where the parties wish to restrict their economic relationship to just the new subsidiary.
- If the parties intend to have a permanent arrangement wherein the new investors put funds for the eventual subsidiary into the holding company (diluting the interests of the existing owners) and thereafter share pro-rata ownership in the bank and all its subsidiaries, this can be accomplished through a conventional investment round in the holding company by the new investors.

Considerations at the holding company level*

- If the existing owners do not want to dilute their interest and/or the parties wish to limit their common interests to the new subsidiary, the new investors will require different ownership rights.
  - If holding company is a corporation: new investors must likely receive a new class of stock that gives them different rights from the other shareholders (messy and difficult at best). Corporations are not very flexible in this regard.
  - If holding company is an LLC or a limited partnership: structuring unique ownership rights is a great deal easier as both allow for custom investment agreements.

*Click the “Banking & Credit in America” link at the end of this document for an in-depth exploration of investing through a holding company.

Investing at the bank subsidiary level

- Investing at the subsidiary level is much more straightforward:
  - No commingling of ownership interest in the bank or any of its other subsidiaries.
  - Flexibility structuring the terms of the arrangement.
- It must be determined whether the entity that provides the bank charter (a state or the federal government) will allow charters to cover the activities of partially owned subsidiaries.

State and federal charters may differ

- Banks chartered by the federal government under the Office of the Comptroller of the Currency (OCC, an independent bureau within the U.S. Treasury) are permitted to have partially owned subsidiaries covered by their charter, provided that the bank has more than 50% voting (management) control over the subsidiary.
- Banks chartered by a state may or may not be allowed to have partial ownership in a subsidiary and still have their charter cover the subsidiary's banking activities.

How to structure the arrangement

- We favor LLCs or limited partnerships over corporations as they provide for the greatest flexibility in structuring the financial terms of the agreement.
- Those vehicles provide us with the ability to define that the bank has sole management control over the subsidiary, while also allowing for the allocation of expenses, profits and losses according to any formula agreed to by the parties.
- The agreement should also provide for the possibility of converting the subsidiary to an independent entity with its own bank charter as well as the sale or dissolution of the subsidiary.

For more information:

PUBLIC BANKING: A Strategy Overview
http://www.commonwealthgroup.net/docs/PublicBankingStrategyOverview.pdf
An overview of NCG's public banking strategy

BANKING & CREDIT IN AMERICA: How Public Banks And Other Public Benefit Financial Institutions Can Rescue Our Communities And Revive Local Economies
http://www.commonwealthgroup.net/docs/Banking-Credit-in-America.pdf
An in-depth analysis of banking and credit, including the role public benefit financial institutions can play in reviving the nation's flagging economy

BANK OF NORTH DAKOTA: Services
http://www.commonwealthgroup.net/docs/BNDservices.pdf
A comprehensive list and description of the services provided by BND, with links to more information on the BND website

BENEFITS TO COMMUNITY BANKS of Bank of North Dakota model
http://www.commonwealthgroup.net/docs/BND_Benefits2Banks.pdf
A summary of some of the key benefits realized by the community bank customers of BND

Thank you!

NCG / National Commonwealth Group
Michael Sauvante
sauvante@commonwealthgroup.net
650 641 1246 | commonwealthgroup.net