

FROM SCARCITY TO PROSPERITY

The Critical Role of Community Banks

NCG / National Commonwealth Group

A think tank and consulting group dedicated to researching, developing and assisting with implementation of creative solutions focused on community banking and local economic development.

Community banks, vital to the health of local economies, are disappearing – in record numbers.

We have developed a strategy to reverse that trend.

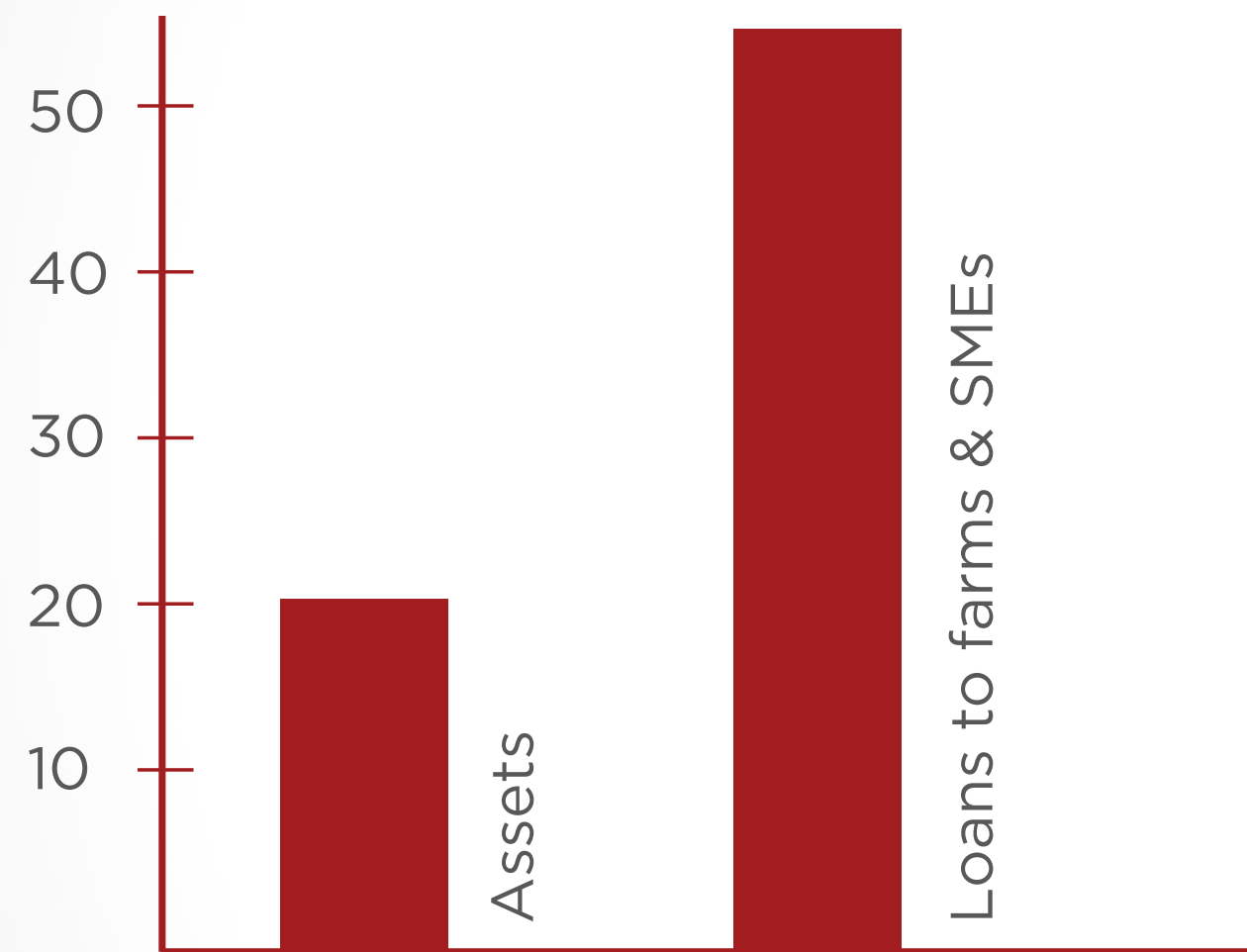
Community banks are critical

According to an FDIC study* released in December 2012:

“By carrying out the traditional banking functions of lending and deposit gathering on a local scale, community banks foster economic growth and help to ensure that the financial resources of the local community are put to work on its behalf.”

Source FDIC <http://fdic.gov/regulations/resources/cbi/study.html>. 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.

Main Street companies rely on local banks



As of 2012, community banks held 21% of banking industry assets, but 54% of small loans to farms and businesses.*

But ... post-2008, community banks have found themselves under increased regulatory scrutiny, primarily by FDIC, and as a result have been constrained from making credit available to local economies, thereby impeding economic recovery.

* Source FDIC

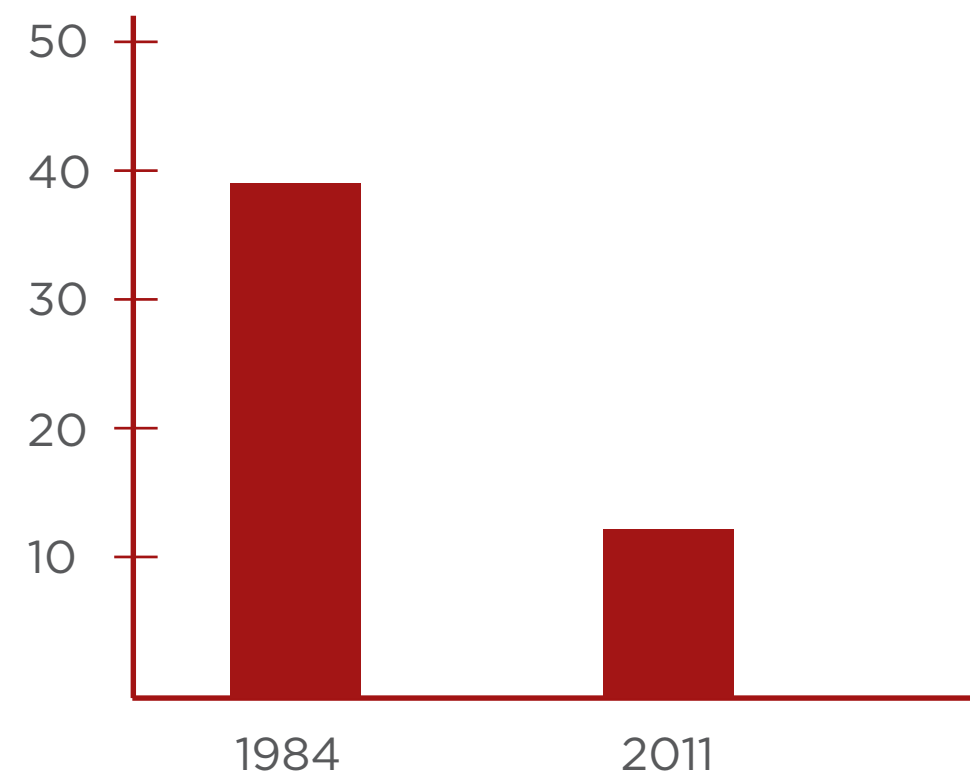
FDIC foresaw problems

- As early as 2004, the FDIC was warning Congress that complex new laws and regulations could spell the end of small community banks:
- *"The volume and complexity of existing banking regulations, coupled with new laws and regulations, may ultimately threaten the survival of our community banks."* – John M. Reich, Vice Chairman, FDIC.
- Reich's warning is proving all too correct

2004 testimony before the House Subcommittee on Financial Institutions and Consumer Credit

Community banks are disappearing

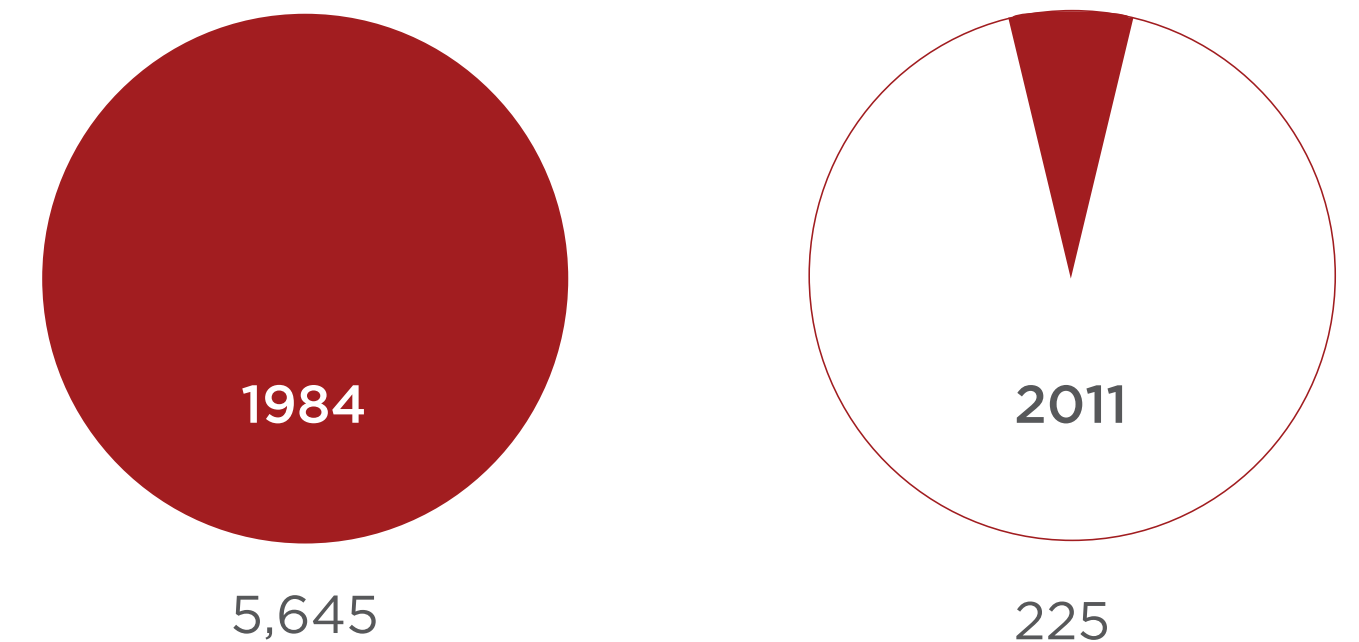
According to the FDIC, from 1984 to 2011:



The share of U.S. banking assets held by community banks fell from 38% to 14%

- Over 10,000 community banks have disappeared since 1984 (17,901 > 7,357 in 2011, ~ 60%) and that trend has greatly accelerated since 2008.

- Banks with assets less than \$100 million accounted for **all of the net decline** in total banking charters.



The number of banks with assets less than \$25 million **declined by 96%**.

Big banks are not an alternative

Wall Street banks (historically reluctant lenders to small and medium-sized enterprises) have drastically cut small business lending.

- Today Wall Street banks devote only 18% of their commercial loan portfolios to small business.
- Their approval rate for small business loans is below 10%.*

* Source FDIC

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.
- *“Making credit accessible to sound small businesses is crucial to our economic recovery and so should be front and center among our current policy challenges.”* –Ben Bernanke, Chairman, Federal Reserve*

* <http://www.federalreserve.gov/newsevents/speech/bernanke20100712a.htm>

What is needed?

- Two key components:
 - Prevent community banks from being shut down or absorbed by bigger banks.
 - Help those and other community banks to start lending again.
- To date, only one state, North Dakota, has kept its community banks healthy and pumping credit into the state's economy.

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.

How healthy are ND community banks?

- Zero bank failures in over 10 years.
- Provide as much credit as the state can use.
- 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!**

Replicating North Dakota's success

- 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.
- Around the nation, 22 bankers' banks provide somewhat similar services to BND. But they are funded by their customer banks. When those banks are short of capital, so is the bankers' bank.
- Other states need only find a way to provide BND-like services to their community banks — **with an independent source of funds to back them** — to achieve the same success as North Dakota.

Two keys to success

- In summary, the key to North Dakota's success is twofold:
 - A banking structure that provides services and financial support to the state's community banks.
 - An independent source of capital, i.e., not provided by the customer banks.

Adapting the North Dakota model

- NCG has developed a system that can emulate the benefits of the BND model without requiring the state to set up and run a bank.
 - It establishes a public benefit partnership banking structure run by a not-for-profit organization.
 - It is backed by **passive investors** that include state and local governments, foundations, pension funds, university endowment funds and others.
 - It also includes a means to rescue failing banks.

Next steps

1. Select an organization to lead

- Select a not-for-profit (NFP) to lead the effort. This can be an existing organization but it is probably best to establish a new 501(c)(3) tax exempt organization, whose exempt purpose with IRS is aligned with this public banking objective.
- This NFP should be based in the state and run by local leaders.
- We recommend two boards, along with at least two senior managers.
 - Governing board of directors and managers: Should include individuals with considerable community banking and non-profit, public service experience.
 - Advisory board: Should represent a broad cross section of the community to ensure that the governing board receives a comprehensive perspective on the needs of the state that will be served by this public benefit partnership banking system.

2. Establish a holding company

- Establish a business entity* that will serve as the central element in a new state public benefit partnership banking system.
- The state will be granted a passive ownership interest, (usually ~ 50%) with a local non-profit organization as the manager.
- That entity will then serve as the state's public benefit bank holding company (PBBHC) and general partner in a number of limited partnerships formed to fund public banking efforts throughout the state.

* The preferred vehicle is a manager-managed L3C; otherwise a conventional LLC. See Appendix for more information.

3. Acquire troubled banks

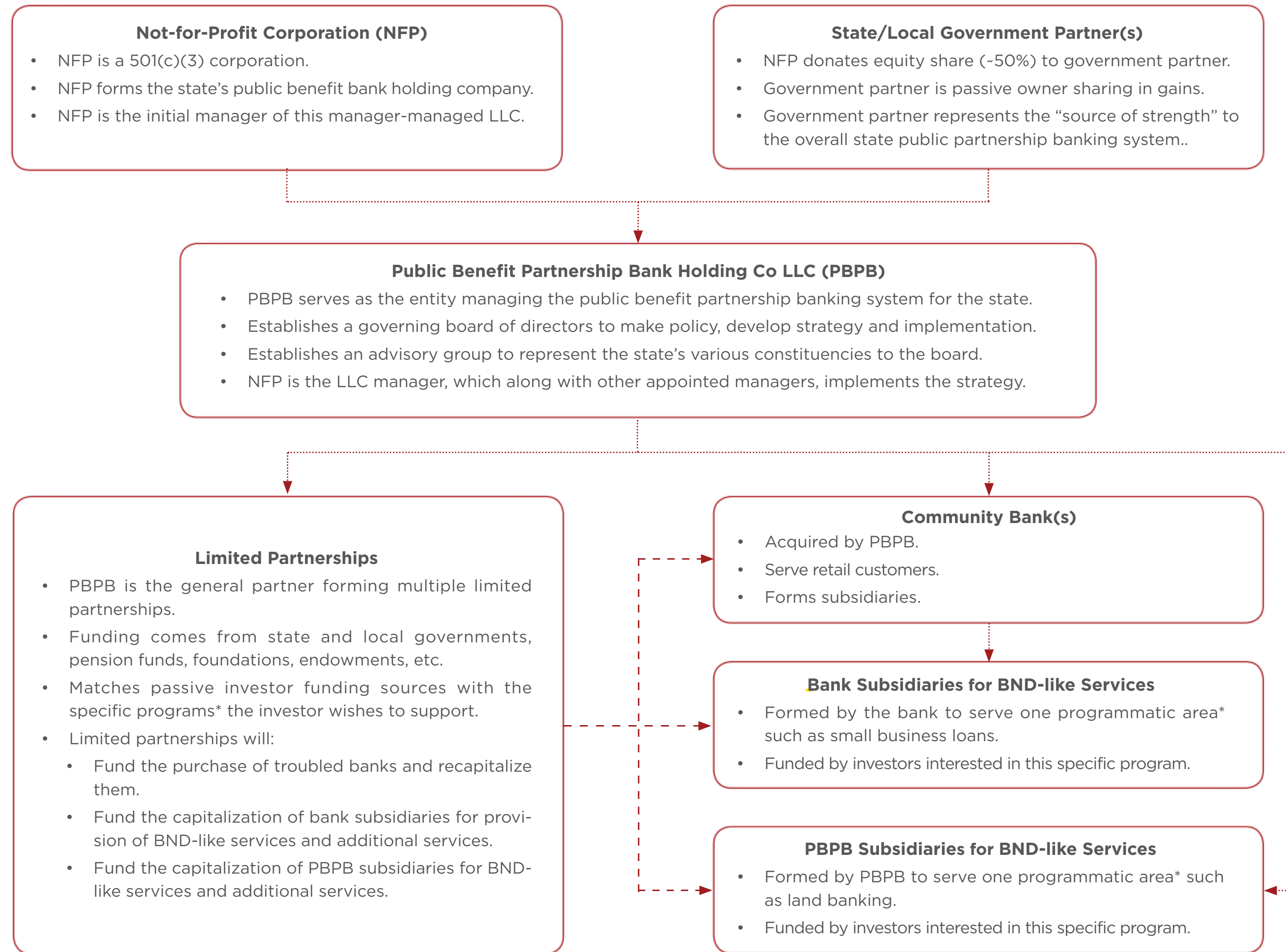
- This can be accomplished in any of three ways:
 - PBBHC negotiates to acquire a bank, funded by a limited partnership set up by PBBHC as the general partner.
 - Owners voluntarily turn over a bank to PBBHC rather than face seizure, analogous to a deed in lieu of foreclosure or returning a car to avoid repossession.
 - If a bank has gone into receivership with FDIC, PBBHC enters into a Purchase and Assumption Agreement (P&A) with FCIC to take over the bank from FDIC.

4. Establish dedicated units to provide services

- In contrast to being organized under one central bank, BND-like credit programs* can be organized as discrete subsidiaries under one or more existing banks (the fastest way), or established over time as free-standing, state-chartered specialized banks under the holding company. If those entities do not take retail deposits, they may not be required to be FDIC insured.
- Subsidiaries can manage a single program or several compatible programs. This approach facilitates funding targeted to specific programs and allows for management specializing in that program area.

*To view sample programs, see http://www.commonwealthgroup.net/docs/Potential_Programs.pdf.

PUBLIC BENEFIT PARTNERSHIP BANKING SYSTEM: Structure



* To view sample programs, see commonwealthgroup.net/docs/Potential_Programs.pdf

LEGEND: Organizational flow - - - - - Funding flow

Appendix

How to structure the arrangement

- We favor LLCs or limited partnerships because they provide:
 - The greatest flexibility for structuring the financial terms of the agreements with investors backing particular programs.
 - The ability to define that the managers have sole management control over the subsidiary and the investors are passive.
 - Allocation of expenses, profits and losses according to any formula agreed to by the parties.
 - The possibility of converting the bank subsidiary to an independent entity with its own bank charter under the holding company, as well as the sale or dissolution of the subsidiary.

State and federal charters: bank subsidiaries

- 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.
- Most states allow state-chartered banks to have partial ownership in a subsidiary and still have their charter cover the subsidiary's banking activities provided the bank has management and voting control over the subsidiary.

State and federal charters: specialty banks

- Specialty banks formed directly under a holding company would have their own charter from the state (or OCC).
- But ... most banking laws require that a bank be a corporation rather than an LLC or limited partnership. This makes custom funding agreements more difficult as corporations have less flexibility in defining custom investments.

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

PROSPECTIVE PROGRAMS

http://www.commonwealthgroup.net/docs/Potential_Programs.pdf

A comprehensive list of the kinds of programs that can be setup and administered under this public benefit partnership banking system

COMMUNITY BANKS: Essential and Endangered

http://www.commonwealthgroup.net/docs/FDIC_CommunityBankingStats.pdf

A quick summary of the December 2012 study on community banks that can be found here: <http://fdic.gov/regulations/resources/cbi/study.html>

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

Contact

National Commonwealth Group is the architect of the public benefit partnership banking strategy described in this document. NCG is available to assist interested parties in establishing such an organization in their state. This can include help in planning, implementing and growing the organization.

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