Public Banking Background

The U.S. economy is characterized by high unemployment, multi-decade flat wages and Main Street stagnation, set against massive wealth concentration in the hands of large financial institutions, other large corporations and wealthy individuals. How can we reverse those trends and funnel money back to the Main Street business upon which our economy depends?

As with any fundamental market shift, what is needed is a disruptive innovation[1] that changes the dynamics of the equation. Public banks[2] provide such an answer. Here's how.[3]

The country needs to get money flowing in our local communities and jobs created, but we cannot expect a top down solution to this problem. The political environment makes it nearly impossible to resurrect the 1930s style WPA and other works projects to create the millions of needed jobs. And large corporations having given no indication that they intend to expand their operations and create jobs with the piles of money they are sitting on.

The solution, then, must come from ourselves. The question is how? To answer, we need to examine the mechanics of the economy at the local level.

Jobs are the fundamental platform upon which rests the flow of money in our economy. If we have jobs we spend money and without jobs, money dries up everywhere. In times of high unemployment, the whole economy suffers.

And what drives job creation? Small businesses, which account for approximately 50% of all the jobs in the country and produce the vast majority of all net new jobs.[4] And what allows small businesses to create jobs? The availability of money, in the form of capital and credit.

What we find in today's economy is that big businesses have all the capital and credit they need, but the story is quite different for small local businesses. The spigots for both capital and credit have been nearly shut tight, each for different reasons.

Investment capital has all but dried up for small businesses,[5] a condition that led Congress last year to enact the *Jumpstart Our Business Startups (JOBS) Act*,[6] to try to open up those capital markets for small businesses, primarily through a new form of fundraising called "crowd funding" that makes use of social media platforms. Unfortunately the SEC has dragged its feet in coming up with new rules and regulations to implement crowdfunding and small businesses continue to struggle to raise money under the old rules.

That leaves credit as the only other potential source of much needed financial resources for small businesses. The primary source of credit has historically been local community banks. Unfortunately the Wall Street induced housing crisis has decimated community bank loan portfolios. And even though the problem was created by the big banks, regulators – especially FDIC, have responded with a broad brush clamp down on small banks, who had nothing to do with causing the problem and have actually been victims of it themselves. The real perpetrators, the big banks, have been left largely untouched by the regulators.

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[1] http://en.wikipedia.org/wiki/Disruptive_innovation

[2] A public bank is a bank owned by either a government entity such as a country, state, county or city, or a non-profit organization (or both), rather than by private shareholders.

[3] For an in-depth exploration of public banking and how each state can have it own public banking "eco system", see this document http://www.commonwealthgroup.net/docs/Banking-Credit-in-America.pdf by National Commonwealth Group, Inc. entitled "*Banking & Credit in America: How Public Banks And Other Public Benefit Financial Institutions Can Rescue Our Communities And Revive Local Economies*"

[4] http://www.kauffman.org/newsroom/u-s-job-growth-driven-entirely-by-startups.aspx

[5] http://online.wsj.com/article/SB10001424052748704648604575621061892216250.html?mod=WSJ_article_related

[6] http://en.wikipedia.org/wiki/Jumpstart_Our_Business_Startups_Act

Sadly, the resultant heavy handed reaction of the regulators has forced most community banks to drastically tighten up on their new loan requirements, yielding a massive drying up of credit for local communities and their businesses, exacerbating an already bad problem.

If we are to spur job growth, something has to be done to open up both capital and credit to small businesses. Community banks can be the solution for both of those objectives. However, they are unable to do so under current conditions. The only way to change those conditions is through the intervention and assistance that can be provided externally and the greatest hope for that lies with public banks. To understand how, let's first look at the community banking industry today.

Banks' Unique Function

Commercial banks can do something that no other institution can do other than the federal government. They can create money, which they do every time they provide a loan.[7] Banking laws allow them to issue credit as a multiple of their assets. The famous economist John Kenneth Galbraith acknowledge this feat by stating "The process by which banks create money is so simple that the mind is repelled."[8] On the average, a bank can create approximately $10 in credit money for every $1 they have in assets.

Thus a bank can take $1,000 in capital and produce $10,000 in loan money. Once injected into a local economy, it will further change hands a minimum of 2 – 7 times[9] in subsequent financial transactions for an overall multiplier of at least 20 to 70 times the starting capital. That multiplier effect is key to our strategy of bootstrapping our local economies. But loans have largely dried up in all but one state in the country, depriving local economies of that financial stimulus. What happened?

A recently released FDIC study[10] gives us some answers. First it is important to note that it states, "The value of community banks has always been associated with the unique combination of services they provide to their customers, as well as the manner in which they do business. Community banks tend to be relationship lenders, characterized by local ownership, local control, and local decision-making. 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."

However, that role is rapidly diminishing due to a precipitous drop in the number of community banks over the last couple of decades. Between 1984 and 2011, consolidation and closures reduced the number of federally insured banks in the U.S. from 17,901 to 7,357!

The number of banks with assets less than $25 million declined by 96%! The decline in the number of banks with assets less than $100 million accounted for ***all*** of the net decline in total banking charters, and the rate of decline has accelerated since 2008. Still, community banks currently hold the majority of banking deposits in U.S. rural and micropolitan counties. More than 600 counties – almost one in five – have no other physical banking offices except those operated by community banks, but their continued existence is threatened.

The problem is, banks with assets greater than $10 billion grew elevenfold in size, raising their share of industry assets from 27% to 80%, but they made a disproportionately smaller amount of loans to small business. As of 2011, community banks held only 14% of all banking industry assets, but provided 46% of small loans to farms and businesses. However, one state, North Dakota does far better than that.

North Dakota's small and medium-sized banks (under $10 billion in assets) account for 72% of deposits in the state compared to a national average of 30%. The state has not experienced a single bank closure in

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[7] P. 11 http://www.dallasfed.org/assets/documents/educate/everyday/money.pdf & *Dollar Deception: How Banks Secretly Create Money* http://www.webofdebt.com/articles/dollar-deception.php

[8] *Money: Whence It Came, Where It Went*, Chapter III, Banks, p.18, 1975

[9] http://www.unc.edu/depts/econ/byrns_web/Economicae/multipliereff.html

[10] http://fdic.gov/regulations/resources/cbi/study.html 12/18/2012

over a decade, the only state that can claim that success. In fact, 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! The North Dakota small business community has about as much credit available as it can possibly absorb and any enterprise needing credit that can show its credit worthiness can generally find it.

<u>The Bank of North Dakota – a wholesale public bank</u>

What can account for this dramatic difference, especially by comparing it to neighboring states with nearly identical economies? The only difference that can be identified of any consequence is the fact that the state of North Dakota has its own central bank (a wholesale or bankers' bank) whose primary customers are community banks and credit unions. That bank, the Bank of North Dakota (BND) is the primary driver behind the abundance of credit in the state. It stands behind the community banks and provides them a whole host of credit facilitating services.[11]

For example: a substantial portion of BND's $2.8 billion loan portfolio consists of participation loans 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.

Lastly we find that North Dakota has the lowest unemployment in the country, hovering around 3%, something many attribute to its oil production. However, adjacent states share in those same oil assets, but have nowhere near as low unemployment as North Dakota.[12] The bank is the only logical answer and if one asks North Dakota's community bankers, they will acknowledge that they would be nowhere near as healthy as they are were it not for BND. In fact, a number were asked and they readily shared that opinion.[13]

For more information on the Bank of North Dakota, see Chapter 3 in the *Banking & Credit in America* document[14] by National Commonwealth Group.

<u>Sparkassen Banks – retail public banks</u>

Let us now turn our attention to another type of public bank whose primary customers are the general public and small business in particular. Thus these kind of banks are retail banks as contrast BND which is more of a wholesale, bankers' bank.

The United States has a very limited number of such banks, all of which are owned by various non-for-profit organizations. To find a much larger selection of such banks, we have to look outside the United

[11] http://www.commonwealthgroup.net/docs/BNDservices.pdf
[12] North Dakota's Economic "Miracle" - It's Not Oil http://www.yesmagazine.org/new-economy/the-north-dakota-miracle-not-all-about-oil
[13] Read the transcript of a conference call held with current and former BND bank executives, community bankers and community bank associations and others discussing BND: http://www.publicbankinginstitute.org/notes-from-032312
[14] http://www.commonwealthgroup.net/docs/Banking-Credit-in-America.pdf

States. When we do, we find that there is one very prominent and highly successful group of retail public banks and they can be found in Germany.

What we find in Germany is that the U.S. form of community banks (owned by private investors) is nearly non-existent there. Instead, the many hundreds of local banks spread throughout the country are not-for-profit organizations owned by the community itself.[15] They are called Sparkassen (German for Savings) banks. Sparkassen banks exist to serve the needs of the local community and in particular it small business community (called SMEs or small and medium sized enterprises). The German SME community is one of the most vibrant and healthy group in the world and there are many who say that it is due to the level of support provided those SMEs by the Sparkassen banks.

[15] http://en.wikipedia.org/wiki/German_public_bank