- State Owned Banks -

DBA vs. Separate Corporation, Regulatory Oversight and Risks

by Michael Sauvante[1]

A number of other states, including Michigan, are contemplating the establishment of a state-owned bank similar to that in North Dakota (Bank of North Dakota or BND)[2], for the purposes of economic development of their respective states. The rationale for forming such a bank is explained in this article by Attorney Ellen Brown *Cut Wall Street out! How states can finance their own recovery*.[3]

Whether formed as a result of an executive order or by an enabling bill in the state legislature, there is a fundamental question concerning the structural approach to creating a state bank and the ramifications of that structure on jurisdictional oversight and risk factors.

Bank Charters and Regulatory Oversight

Banks are established in the United States through one of two means – they receive a charter (legal permission to be a bank and perform banking functions) from a state regulatory banking agency or from a federal agency. The banks so chartered are called state chartered banks or federally chartered banks. With rare exceptions, the entity granted such a charter is a corporation.

Banks also differ in forms of ownership. In general, if a bank is owned directly by individuals, then it is a free-standing bank that is directly chartered and regulated by one of the two chartering entities. Such a bank may have one or more branches, but would still be considered a single, stand-alone bank.

However, if the owners wish to own two or more banks (not considered branches of one bank), or a bank and some other financial institution, and they wish to do so with one controlling entity, they must form a bank holding company (known in the industry as a BHC). Holding companies in general are stand-alone entities whose principal business is owning other things like other companies, real estate holdings, airplanes, banks and the like.

A bank holding company is a special type of holding company that owns one or more chartered banks and may legally own other types of financial institutions such as insurance companies, investment banks, hedge funds and venture capital funds. The banks and other entities owned by the bank holding company are considered to be its subsidiaries. Such holding companies themselves can be corporations, LLCs or other legal vehicles.

[1] See Michael Sauvante's bio here http://www.ceedprogram.com/sauvante.html
[2] http://en.wikipedia.org/wiki/Bank_of_North_Dakota
[3] http://www.webofdebt.com/articles/cut-wallstreet.php

Bank holding companies fall under a different category from free-standing banks and are subject to separate rules and regulations, in particular at the federal level. Bank holding companies currently come under regulatory control and oversight by the Federal Reserve.[4] That means that a bank owned by a bank holding company has at least two regulators to deal with, whereas stand-alone banks, for the most part, only deal with their chartering agency (plus FDIC).

All banks (with the exception of the Bank of North Dakota) are further required to come under the oversight of the Federal Reserve Deposit Corporation (FDIC), whether they are free-standing banks or owned by a bank holding company, and are required to contribute to the FDIC fund.

Banks and Their Assets

The number one privilege enjoyed by banks is their ability to create new money, in the form of credit granted to their borrowers. Banking laws permit a bank to create that credit based on the assets of the bank (generally defined by the Basel II Accord[5]). This credit is not extracted from those assets (which remain untouched in the process), nor is it drawn from any other pool of money, but rather the assets serve strictly as the basis for calculating the total amount of new money that the bank is allowed to issue in the form of credit. That amount (usually a multiple of the assets, typically in the range of 10-12 times the value of the assets) is governed by regulators, and varies from bank to bank.

Thus the bank's assets (not deposits) are the key to its new money creation process, an important factor when contemplating whether a state should establish its own bank as a DBA of the state or as a separate, free-standing entity.

State Bank as DBA

According to North Dakota's statutes, BND is a DBA of the state.[6] If a state bank is chartered as a DBA of the state (which is a government corporation), then the assets and liabilities of the bank becomes synonymous with the assets and liabilities of the state (i.e., its balance sheet), thereby enabling the state to use all of its assets to determine the amount of new credit it can generate for the state's benefit. No assets would have to be assigned, pledged or transferred into the bank. This would be similar to an existing corporation obtaining a bank charter (like a license) from a regulatory agency, wherein all the corporation's existing assets would automatically be considered the assets of the bank once the charter has been granted.

In the process of creating new credit, the state bank would not be tapping the state's assets in any manner, but rather strictly using them to determine the legal amount of new money credit that the state can issue based on the assets it already owns. For example, Michigan has accumulated considerable assets over its 170-year existence, assets which could translate into several hundred billion dollars in potential new credit for the state.

[4] Given the current turmoil on Wall Street and the controversies surrounding the big banks and their relationship with the Federal Reserve, Congress is entertaining a number of legislative changes that could well alter the role of the Fed in regulating BHCs and a number of their other activities.

[5] http://en.wikipedia.org/wiki/Basel_II

[6] http://www.legis.nd.gov/cencode/t06c09.pdf and http://en.wikipedia.org/wiki/Bank_of_north_dakota

State Bank as Free-Standing Entity

Should the state elect to establish a free-standing entity (corporation) to be the state bank, it would have to transfer specific assets into the bank for the bank to have any lending ability (as corporations have no assets until assets are transferred into them). Thus the state would have to assign and transfer those assets (whether they were existing state assets or new assets such as proceeds from bonds issued to capitalize the bank) to the bank to enable it to conduct banking business.

In the process, the lending limits of the bank would be constrained to the multiple allowed by regulators. For example, if the bank corporation were capitalized with $20 million, then it would have an initial lending limit of approximately $200-240 million, a far cry from the hundreds of billions of dollars under the DBA alternative available to a state like Michigan.

The State as a Bank Holding Company

If the state set up a subsidiary corporation as the bank, then the state would automatically be considered a bank holding company. That would open up a legally complicated question that might require resolution of federal vs. state constitutional issues.

The legal question arises because according to current federal law, all bank holding companies come under the jurisdiction of the Federal Reserve. However, the Federal Reserve is a private corporation owned by other private corporations (the 12 Federal Reserve Banks). The Fed operates under privileges granted to it by the federal government, but it is not a federal agency and therefore does not have the authority of the federal government.

If a state-owned bank is a subsidiary of the state, a private corporation (the Fed) could be construed as having jurisdiction over a sovereign state, an unprecedented scenario. Most states would reject the idea that a private corporation has the right to exercise any control over a sovereign state, likely precipitating a legal battle.

FDIC and the State Bank

An additional area of potential dispute with respect to states' rights relates to whether a state has to join and contribute to the FDIC fund.[7] The FDIC exists for the purpose of protecting bank depositors from the potential loss of their deposits should their bank fail. This federal agency was formed in response to the problems created by bank failures during the Great Depression.

Originally, participation in the FDIC fund was voluntary but became mandatory in the early 1990s. The Bank of North Dakota was grandfathered as exempt from that requirement. North Dakota self insures its depositors and thus was excluded.

Other states could legitimately claim exemption from that obligation, especially given the precedent of North Dakota. That challenge may well rest on a states' rights question and the fact that states, unlike private banks, are in a completely different legal and financial category than free-standing private corporations. States have the ability to levy taxes, float tax exempt bonds

[7] http://en.wikipedia.org/wiki/FDIC

and do a number of things that private corporations cannot. Even their potential bankruptcy comes under a different section of the federal bankruptcy code.

FDIC participation thus seems to be a likely area of contention between the federal government and the states, unless Congress amends the laws pertaining to the FDIC to explicitly exclude state-owned banks from the system.

The Question of Risk

There are two levels to this question. One relates to the very broad risks to the state on implementing such a plan and conversely, of not implementing such a plan. The second level of potential risk to the state relates to the assets that are utilized by the state in the process of enabling this new credit machine (see below).

With respect to the first question, there may be some concern with things like potential inflationary pressures if the state turns on this credit spigot and floods the state with too much money. There is no way to prove this point one way or the other, and a number of historical examples can reinforce both sides of the argument (although more support the benefit side).

What is not in dispute is that the country is in a deep recession, if not depression. The lack of money in any economy is an automatic recipe for further economic problems, and tightening the belt further has never been shown to fix an economy in deep recession/depression. The problem tends to be exacerbated by the fact that in such tight financial times, economic disparities between the haves and have nots grows as those in need lose control over their assets to those with greater abundance, thus sowing the seeds of social instability.

In such times, an economy represents a very deep hole that needs to be filled, before it even remotely approaches conditions that could be considered inflationary. Therefore one would be very hard pressed to build a case that having the state provide a substantial amount of new credit to the state and its citizens can be anything but positive.

Making credit available to county and city governments, school districts and other agencies currently facing heavy debt loads that result in interest and principal payments filling the coffers of out-of-state lenders cannot help but benefit the state by keeping such moneys in-state.

One way to accomplish this is for the state to buy up the bonds and other debt instruments held by out-of-state parties and have the bond issuers pay the state instead. The state could then set whatever interest rate it deems appropriate, which in some cases may mean the difference between the agency being able to continue to support its debt or go into default. Regardless, the state and its citizens benefit by whatever interest is paid, as all of it would go to the state and not outside entities.

We can also look to the model in North Dakota where the state is buying up real estate loans from community banks. The collapse of the real estate market has had a huge negative effect on loan portfolio assets throughout the country, significantly impacting banks' ability to lend. With the Bank of North Dakota buying up these loans from their community banks, those banks are in a better position to provide lending to small businesses and others than they could with those loans still on their books.

In debating the question of systemic risk at the macro level, one factor points unfailingly at the benefits of a state bank: states have a major crisis on their hands and lack of money stands at the very center.

The Question of Risk and State Assets

That still leaves the valid question of potential risk borne by a state with respect to its current assets. To understand this, it's useful to recap the process by which assets enter into the banking equation.

As described above, assets are not deployed in the actual credit generating process, with the sole exception that they serve as a value benchmark for determining how much new credit money a bank might issue. The only time the assets really come into the equation and are at risk is when a bank fails. To date, as there is only one government-owned bank in the U.S., which is very healthy, we can only look to failures of private banks and what occurs when they are seized by regulators in order to gauge what could potentially happen to the state's assets.

Private banks can and sometimes do go into voluntary failure mode. However, more often than not, a bank is deemed by a regulator to be no longer viable and one or another of the regulators steps in and seizes the corporation, its charter and all its assets and liabilities. At that point, all the bank's assets are relinquished to the seizing regulators and the former owners no longer have any claim to them. In that case, all the assets are lost, but only because regulators took them, not because they were lost as a result of any kind of banking activities.

Which begs the question, what about a state-owned bank? If assets can only be lost as a result of a bank seizure, can a state bank be seized by regulators? That returns us to the question of whether the bank was established as a DBA of the state or through a separate subsidiary. It is further qualified by whether the state chartered itself or received a federal charter for its bank.

It is highly unlikely that a state would turn to the federal government to charter itself. If it did, it would then be subject to whatever the federal agency would require and place the state under that agency's jurisdiction for its banking activities. If it did so as a DBA, then that scenario would be further clouded with state's rights vs. federal rights issues, setting the state up for a potential jurisdictional dispute.

Given that every state has its own set of banking laws and is fully empowered to charter banks in a manner that it deems best for the state, it is inconceivable that any state would not have its own chartering agency grant the state its bank charter rather than turn to the federal agency.

It is helpful to note that there are no universals in the banking world, just general convention. Each sovereign country, and in our case states as well, decide what their rules will be. In fact, states established banking laws many decades before our federal government did, and as a result, the federal government tends to give a good deal of deference to the states in banking areas.

By chartering itself, the state can oversee its own bank and define any rules, policies, procedures and the like that it determines in its sole judgment is in the best interests of the state. The net result is that if the state charters itself and does so as a DBA of the state, the only external agency that might have any say would be the FDIC, as covered above.

Even if the state participated in the FDIC fund as contemplated in the preceding scenario, it is highly questionable if the FDIC could and would step in to attempt to shut down a state bank if it felt that the state was doing something that violated the mandates of the FDIC regulators.

To do so would mean that the agency would in essence have to seize the whole state and all its assets (remember that the bank is a DBA of the state so the state itself is the bank) in some form of bankruptcy-like proceedings. Nothing like that has even been remotely contemplated before, nor is there any realistic chance of it occurring.

That means that the state would look to itself for regulating its own bank and in this scenario, there would be no other outside party that could step in and seize the state's assets because of its banking activities.

The state could open itself up to seizure if it elects to create a separate corporation to house its banking activities. In that scenario, the bank would have both the Fed and FDIC to contend with, if the previously described states' rights issue were to be ignored.

In that case, if the Fed or FDIC felt the state bank had violated their regulations, it is conceivable that they could step in and seize that stand-alone corporation serving as the state bank. If that happened, only the assets transferred into that subsidiary would be lost to the federal regulators, and no other state assets would be at risk.

Even so, once again this is a highly unlikely situation. Regulators at both the state and federal level have a great deal of autonomy and flexibility when it comes to enforcing their regulations and it is quite improbable that federal regulators would take steps that would almost surely trigger a states' rights legal battle.

Therefore, it seems clear that any approach a state might take in establishing its own bank would not entail any real risk to the state's assets.

Commonwealth Group

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