PUBLIC BANKS AS INSTRUMENTS OF REINVESTMENT

Lawrence B. Rosser

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About the Author:

Lawrence B. Rosser has served as Executive Director of the Woodstock Institute since its founding in 1973. The Woodstock Institute is a non-profit organization which conducts research, training and education for the public, private and voluntary sectors about ways to ameliorate disparities in the availability of capital and credit.

Dr. Rosser served as a faculty member of the Sociology Department of the Central YMCA Community College, and has lectured on urban affairs at the University of Chicago, Lewis University, and the Northwestern University Graduate School of Management. He is currently an Adjunct Lecturer in Urban Affairs at the University of Illinois School of Public Health.

An honorary board member of the Chicago Suburban Chapter of the Southern Christian Leadership Conference, and a co-founder and former convenor of the Chicago Regional Housing Study and Action Group, Dr. Rosser also serves as a public interest member of the Illinois Savings and Loan Board.

His professional memberships include the American Society of Planning Officials and the National Association of Housing and Redevelopment Officials. His recent publications are as follows: Maintaining Viable Communities: The Investment-Disinvestment Process and Some Strategies for Housing Maintenance and Rehabilitation in the Pilsen Community of Chicago (with Calvin Bradford); "Aurora, Illinois: A Case Study of a Low- and Moderate-Income Housing Set-Aside Ordinance;" "Using State Regulatory Authority to Stimulate Prudent Lending in a Changing Environment" (with Calvin Bradford and Stanley Hallett); Demand, Supply and Marketing of Single-Family Mortgage Credit (with Calvin Bradford and Dennis Marino); "Tying Bank Privileges to Performance."

He completed his undergraduate studies at the College of William and Mary, Williamsburg, Virginia, and received his M.Th. and D.Mn. degrees at the University of Chicago Divinity School.

Dr. Rosser resides in Hyde Park on Chicago's South Side where he serves on the board of the local community organization.

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Summary

This paper is one of a series analyzing publicly initiated strategies to achieve reinvestment. It differs from those that preceded it by describing proposals and one operating program --the state-owned Bank of North Dakota--which put government in the business of directly providing thrift and credit services: a function which traditionally had been reserved to publicly regulated, but privately capitalized, financial institutions.

The author points out that public banks are not a new idea. Their roots in the United States can be traced to the late eighteenth century. He also describes the history and operations of the only extant state-owned and operated bank in the country, and surveys proposals from other states, municipalities and the federal government to establish public banks.

Finally, the paper discusses the compatibility of this strategy with other existing state initiatives, and it points out that some constitutional changes might be necessary in Missouri to establish a public bank.

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Introduction

Proposals to establish public banks are being discussed currently by all levels of government in many parts of the country.[1] Contrary to what many people believe, public banks are not a new idea. The State of Massachusetts' involvement with banking dates back to 1792 when the Commonwealth subscribed for one-third ($400,000) of the capital stock in the Union Bank at Boston. At least nine other states actually chartered state-owned banks between the years 1806 and 1836. Several of these states provided for the chartering of such banks in their state constitutions. In fact, the Indiana Constitution of 1816 was the first "to explicitly prohibit the establishment of banks, with the exception of a state bank with branches."[2]

The experience of these early experiments in public banking was mixed. Massachusetts, South Carolina and Indiana did well by their investments. When the monopolistic Indiana state bank concluded operations in 1857, for example, its supporters could not only boast that it had survived the Panic of 1837, but they also could point to the fact that "it had paid regular dividends with the state realizing a net profit of $3.5 million." Unfortunately, Vermont, Kentucky, Tennessee, Illinois, Alabama, Georgia and Arkansas had the opposite experience, and these states wound up their banking efforts with losses ranging up to $5 million--this figure being the amount of debt that the Bank of Arkansas left in its wake upon closing in 1842.[3]

The historical roots of current discussions about public banks can be traced to the Populist Movement which swept many agricultural areas of the country in the late nineteenth century. In the State of North Dakota, the Populists had a chance to put their theories about public banking into practice when their Non-Partisan League gained control of the state government in the elections of 1918.

Despite bitter opposition from business in North Dakota and financial centers in the East and Midwest, the legislature established a state bank in 1919. Now in its fifty-eighth year of operation, the bank's original enabling act reads as follows: "for the purpose of encouraging and promoting agriculture, commerce, and industry, the State of North Dakota shall engage in the business of banking, and for that purpose shall maintain a system of banking owned, controlled, and operated by it, under the name of the Bank of North Dakota."[4]

Bank of North Dakota

In remarks before the second annual meeting of the Conference on Alternative State and Local Public Policies held in Austin, Texas in June, 1976, Herbert Thorndal, President and Manager of the Bank of North Dakota, made the following observation:

> A Bank owned, operated by and for the people of a state, will not be a panacea for all of a state's economic and social problems. However, it can be of great help in alleviating many of these problems and can give leadership and financial input in isolated and special areas.[5]

The caveat is worth considering since a public bank--like any other single strategy--cannot be viewed as a magic formula for reinvestment. Nevertheless, the Bank does provide an interesting standard for state-initiated reinvestment programs, not only because of its accomplishments in providing credit and financial services to the public and private sectors in the state, but also because of its profitability. From 1919 to 1976, the Bank reported total net operating earnings of almost $101 million on an initial state investment of $2 million.[6]

Organization and Purposes

As North Dakota approached the end of the second decade of the twentieth century, the state had two major problems: marketing of farm products; and financing farms and farm operations. The widespread distribution of the state's predominately rural population made it expensive and inefficient for the private sector to provide these services. During the election of 1918, the Non-Partisan League included in its platform a pledge to provide for "the state ownership and control of marketing and credit facilities--at least to the extent necessary to stabilize market conditions and prices and the rates of interest on loans."[7]

Two state-owned businesses were created to honor that pledge: the Bank of North Dakota; and the state Mill and Elevator. Both were placed under the control of the newly created Industrial Commission, the purpose of which was "to conduct and manage on behalf of the state certain utilities, industries, enterprises and business projects...."[8] By statute, the Commission consists of the Governor, Attorney General and the Commissioner of Agriculture. It is this body which appoints the President of the Bank.

In 1975, an Advisory Board was added to the management structure of the Bank. This five-member Board, consisting of private sector business and financial persons from the state, is charged with "aiding in development of the Bank's role in the state's economy...." It also serves a liaison function between the Bank and the financial community to provide Bank management with "an indication of areas to develop and an establishment of priorities."[9]

Functions and Operations

The Bank of North Dakota provides a wide range of financial services to the public and private sectors. Principal among its services are the following: housing loans; farm ownership and agricultural loans; secondary market for Small Business Administration (SBA) and Farmers Home Administration (FmHA) loans; student loans; trust services for state-owned mineral rights and real estate; municipal bond underwriting; public depository; correspondent banking; and, retail banking. The Bank's legal lending limit on any single loan is $5 million, and it is currently lending at the rate of approximately $30 million per year.

In addition to "non-competitive"[10] direct origination of home loans throughout the state, the Bank created its own secondary mortgage market to buy mortgages from North Dakota's other financial institutions. Special emphasis is placed upon aiding low- and moderate-income persons in purchasing homes. The Bank was the first financial institution in the state to finance subsidized housing.[11] Currently, the Bank will purchase Federal Housing Administration (FHA) insured Section 235 construction or substantial rehabilitation loans, and the servicing for these loans, from any financial institution in the state.

In November, 1975, the Bank instituted its own Interest Supplement Program (ISP) to assist persons in the $12,000 to $15,000 income range in purchasing homes. All loans are insured by FHA or Veterans Administration (VA), and they carry interest rates as low as 6%. The interest subsidy--which is designed to assist families during the first six years of the mortgage term--is calculated by taking 80% of the household income, subtracting from this amount $300 per dependent, and determining 20% of the balance as the amount the household can afford for housing. Working backwards from ability to pay to amortization schedules, the Bank calculates monthly payments and interest rates which in no case can be more than 3% less than FHA rates. By the end of 1976, almost $354,000 in ISP loans had been made by the Bank.[12]

In addition to home ownership, the Industrial Commission and Advisory Board have mandated that the Bank give high priority to ranch and farm ownership. As a matter of policy, these loans are available only to the actual operators of agricultural and ranching enterprises. To hedge its risks on these loans, the Bank uses a tandem plan in which it will advance up to 50% of the appraised value of the land on a twenty-five year term with FmHA providing a second mortgage of up to $100,000 on a forty year term. Local banks furnish the farmer or rancher with an operating line of credit which the Bank of North Dakota participates in if asked to do so by the lead institution. During 1975, the Bank ranked fifteenth in the nation in providing farm and ranch real estate loans.[13]

Since 1967, the Bank's governing body and management have placed top priority on providing a secondary market for Federally Insured Student Loans (FISL). In fact, the Bank processed the first FISL in the nation in August of that year. Since that time, more than $50 million in FISLs to 55,000 students have been processed by the Bank. "The goal of the Bank of North Dakota is to provide the participation and leadership necessary so that NO North Dakota students will be denied the opportunity to further their educational desires."[14] At the end of 1976, the Bank had an annual default rate on FISLs of less than 3%--one of the lowest in the country.

The Bank provides three major financial services to the state. First, it serves as the sole depository for state funds. In addition, approximately 10% of the political subdivisions in

North Dakota use the Bank as their depository.

Second, the Bank provides trust services for state-owned mineral rights and real estate. Seven hundred fifty thousand mineral acres became Bank property as a result of foreclosures on farms during the Depression. When the farms were resold, the state reserved 50% of the mineral rights. Oil and gas royalties during 1976 alone amounted to more than $490,000.

The third area of financial service that the Bank provides the state is bond underwriting and marketing. In 1976, underwriting of municipal issues amounted to $14 million. In its role as paying agent for previous issues, the Bank handled almost $11.5 million.[15]

Six months after it became operational in 1919, the Chairman of the Bank's General Finance Committee, wrote to all banks and financial institutions in the state to clarify the public Bank's relationship to the private sector. His remarks included the following assurances:

> On its part, the Bank of North Dakota does not propose to enter into competition with existing banks, or to supplant any part of the existing financial system; but to co-operate with them; to assist in their development, and to co-ordinate all parts of the financial service of the State, so as best to meet the nedes [sic] of the people in the carrying on of their business and industry.[16]

This policy toward other financial institutions has remained constant, and as evidence of its success, every bank in North Dakota now maintains an account with the Bank, and most take advantage of its extensive correspondent banking services. In addition to serving as a clearinghouse for many banks, the

Bank serves other institutions as a money market center, provides participation loans, supplies coin and currency, and makes members of its staff available for technical assistance.

Taken together, the Bank's programs and services to both the private and public sectors, and its leadership role in providing housing, commercial and consumer credit make it an important contributor to reinvestment in the State of North Dakota. In addition, its profitability enhances its continued political acceptance in an otherwise conservative state. As Thorndal was quoted as saying in an article about the Bank in the New York Times, the Bank is an effective blend of provider and profit-maker: "The legislative intent was for our bank to function as a service organization and we feel we are giving that service. It just so happens that we are making a lot of money at the same time."[17]

Proposals for Other Public Banks

In his monograph entitled "Public Control of Public Money," economist Derek Shearer observed that the basic thrust of proposals to establish public banks is "to broaden the considerations in the placement of funds to include social costs and benefits." In his judgment, public banks "can fruitfully pursue" at least three general objectives:

> 1. They can be profitable for the government which owns and operates them;
>
> 2. They can lend to persons and enterprises considered "high risk" by commercial banks;
>
> 3. They can serve as a yardstick against which to measure the performance of privately capitalized financial institutions.[18]

Given the range of proposals that have appeared at all levels of government during the last seven years to establish public banks, there are apparently a number of persons who share Shearer's view of the desirability of such institutions. In addition to the federal proposals now pending to establish a national "Urbank," the states of California, Colorado, Florida, Massachusetts, Oregon, Vermont and Washington are officially reviewing state bank proposals, and local representatives in the cities of Austin, Texas, Chicago, Illinois and the District of Columbia have previously, or are currently, advocating the establishment of municipally-owned financial institutions.

National Development Bank Proposals

In the Spring of 1970, then President Nixon appointed a blue ribbon Commission on Financial Structure and Regulation which was charged with reviewing the regulation and operation of the nation's financial institutions, and making recommendations to the President about ways that this system could be improved. Late in 1971, the Hunt Commission--so-called because its Chairman was Reed O. Hunt, retired Chairman of Crown Zellerbach Corporation--presented its recommendations. Not surprisingly, the thrust of the Commission's recommendations were criticized as "containing no new ideas."[19] For those who had watched the Commission's work hoping for recommendations that would lead financial institutions to be more responsive to social needs, however, the dissenting views expressed by one of the Commissioners, Lane Kirkland, Secretary-Treasurer of the AFL-CIO, were of primary interest.

Kirkland labeled the Hunt Commission's findings as being designed "to promote the well-being of the financial institutions," and disassociated himself from them. In his dissent, he proposed several alternatives for "seeing to it that a fair share of financial resources are allocated for social priorities." Among *his* recommendations was the establishment of a National Development Bank. This institution would be capitalized by the United States Treasury, "authorized to make direct loans to state and local governments, public agencies, corporations, and individuals for social priority projects...[and] would be vested with the authority to guarantee loans made by financial institutions for such projects."[20]

Since that time, there have been a number of proposals made for an Urban Development Bank (URBANK). While a discussion of the variants in them is beyond the scope of this paper, the important thing is that these proposals are now being given serious consideration at the highest levels of government. As an example, what follows is a summary of the U.S. Department of the Treasury's proposal for a national URBANK.

> 1. URBANK would be an independent Federal entity, "Established to finance job intensive, private projects in eligible areas."
>
> 2. Its three basic functions would be as follows:
> a. approve projects to be financed by industrial revenue bonds of local economic development agencies;
> b. make direct loans to local economic development authorities to finance up to 75 percent of capital costs for eligible projects;
> c. serve as a secondary market for (1) the 25 percent share of loans to local EDA's made by financial institutions and for (2) commercial bank loans for capital expenditures to small- and medium-sized businesses.

3. URBANK would obtain funds for financing the 75 percent share of capital costs for eligible projects by seeking government-backed long-term debt to the Federal Financing Bank (FFB).

4. Funds to finance the secondary market for the 25 percent share and direct loans to small business would be obtained by packaging and selling debt securities, backed by these loans, to private investors.[21]

New York State Proposal

The New York proposal to create a state bank is worth noting primarily because it has received relatively broad-based political support within the state, and, as evidence thereof, passed the State Assembly in 1975. It was killed in the Senate, but its sponsors have pledged to continue their efforts to have it enacted.[22] In addition to its growing acceptance, the proposal also is interesting, because it represents a variation on the North Dakota model.

The New York Bank would be a privately managed institution under public policy control. Sponsors chose this structure not only because they thought that it would be more politically acceptable, but also because they wanted to avoid the possibility of "bureaucratic restraints and...political influence."[23] Like the Bank of North Dakota, the New York state bank is designed to complement, rather than compete, with existing commercial banks. As the sponsor of its enabling legislation pointed out, "The state public bank concept originated in a discussion of how to link state deposits to social needs...."[24]

Sponsors of the New York legislation envision six areas in which the public bank could assist in meeting social needs. They are as follows:

1. Making loans in areas redlined by private financial institutions.

2. Assisting political subdivisions in bond underwriting, and providing short-term debt financing.

3. Generating profits which could be used for community development projects.

4. Providing venture capital for enterprises which have some promise of alleviating economic and social problems within the state, but which are unable to go to established capital markets.

5. Preventing the drain of public resources from local areas of origin, and from the state, by providing a central investment vehicle for public deposits.

6. Providing financing for job-intensive industries, in conjunction with other financial institutions, and, thereby, reducing the state's unemployment rate.[25]

The Bank would be capitalized with $50 million of state funds, and would have access to state and municipal deposits. It would offer all of the services of a traditional bank, and would be governed by a Board of Directors consisting of the following: the Commissioners of Taxation and Finance, Housing and Community Renewal, and Commerce; the Superintendent of Insurance; and "fourteen other persons of recognized eminence and authority representing commerce, labor, industry, small enterprises, cooperative and housing groups, community development groups, local governments and the general public, to be appointed by the governor by and with the advice and consent of the senate."[26]

Chicago Public Utility Proposal

Illinois is a unit-banking state in which branching and multi-bank holding companies are prohibited by state law. Attempts in recent years, spearheaded by several of the state's largest financial institutions which are headquartered in Chicago, to change state law to permit branching have been met with skepticism, and in some cases outright opposition, from managers of small banks and community groups.

The proposal to establish a municipally-owned utility in Chicago grew out of attempts by the City Council to use the City's home rule authority under the state constitution to permit branching in Chicago. Several independent Democratic alderman, led by Dick Simpson, introduced amendments to the administration-backed ordinance to permit branching which sought to limit a financial institution's ability to branch, and to substitute a public utility which would provide commercial banks with publicly controlled access to neighborhoods. Although the administration version of the ordinance passed by a wide margin, it subsequently was declared unconstitutional by a state court on grounds that only the legislature could remove the prohibition against branching.

In spite of this fact, the proposals which were introduced to establish a publicly chartered corporation to own and operate a series of Neighborhood Banking Service Offices (NBSOs) are worth noting in this context. The rationale for the corporation was cited by sponsors as follows:

> Historically the public policy approach used to guarantee equal access to critical resources (such as electric power and natural gas) and services (communications) has been to create a utility. While this model is not without its faults--as recent litigation brought by consumers

> over utility rate increases, for example, demonstrates--the model has certain benefits to recommend it as one that should be seriously explored to redress the present inequities in the distribution of credit in our metropolitan area.[27]

The chief advantages of the model, according to proponents, were as follows:

> 1. Providing a structure for co-operative decision-making by lenders, government and consumers.
>
> 2. Generation of profits which could be reinvested in neighborhoods which lack adequate access to capital and credit.
>
> 3. Constancy of purpose deriving from public charter.
>
> 4. Providing a means to use neighborhood residents' deposits and public deposits to leverage private capital and credit into mature neighborhoods.
>
> 5. Restoring some measure of competition to the banking industry by providing neighborhood residents with an alternative depository for their personal savings.
>
> 6. Providing residents who participated in governing the utility with an education about community development finance.[28]

Three variations of the utility model were proposed. Under the first, the public corporation would own and operate NBSOs in unbanked or underbanked areas. Each NBSO would contain an electronic funds transfer terminal (EFTT), and a lending officer of the public corporation. The EFTT would permit neighborhood residents to carry out routine banking functions with their own commercial bank <u>if</u> that institution had qualified to be on-line with the utility's computer system by having met certain reinvestment criteria. The function of the NBSO representative and loan officer was to serve as a "banking services broker--similar to an insurance broker--for residents who lived or worked in the NBSO area."

The description of possible functions to be performed by the utility's representative follows:

> Since these utility employees could not make commitments on behalf of banks [who had qualified to participate in the system], their role would be confined to that of credit broker and advocate. They could record and process necessary information about a loan applicant, and transmit this information to an appropriate bank. If, in the bank's judgment, additional information was needed, the broker could secure it on behalf of the institution, or put the applicant directly in touch with the proper person at the institution. Once a loan was secured by an applicant, the NBSO representative would be well-situated to assist with servicing.[29]

Commercial banks' access to the utility's EFTT would be based on their having maintained for a certain period of time certain loan/deposit ratios in the neighborhood in which the NBSCO was located. Failure to maintain adequate ratios even after gaining access would result in their depositors losing access to them through that particular NBSO electronic terminal. Sponsors argued that this arrangement would have the effect of encouraging neighborhood residents to switch their accounts from a commercial bank that was not serving the area--and, thereby, would not be available through the neighborhood EFTT--to banks which were meeting the credit needs of that community.

Conclusions and Possibilities

In commenting about the possibilities for public banks to provide credit and financial services to sectors of the economy that are now unable to compete, Shearer made the following observation:

> In the drafting of public bank legislation, public accountability and participation should be built into the structure of the bank. This is important because public enterprises can be managed just as autocratically and unresponsively as private enterprises.[30]

This caveat is worth considering since there is a tendency to see various reinvestment strategies, in isolation, as panaceas. Even in the State of North Dakota, there is currently considerable controversy over what additional strategies need to be devised to insure adequate access to credit for residents, businesses and political subdivisions. Thorndal, for example, feels strongly that the state should create a housing authority that could issue bonds which would back mortgages issued under the Bank's Interest Payment Subsidy program. In addition, he advocates establishing the state housing finance agency under the Bank.[31]

Since an analysis of reinvestment needs in most states leads to the conclusion that both credit and <u>capital</u> are needed to revitalize failing neighborhood economies, states considering the establishment of public banks should consider also establishing publicly owned and operated venture capital corporations such as Massachusetts did in 1976.[32] Such entities could be established as separate agencies, or as subsidiaries of the Bank. In either case, the state would then have the capacity to provide equity to help developers qualify to receive financing from the state bank or from commercial banks, and states would also have the capacity to use their resources to provide all of the necessary capital and credit if no qualified developers are available.

Finally, states wishing to seriously consider the establishment of publicly owned and operated banks must evaluate the constitutional bars to such activity which may exist. In the State of Missouri, for example, it appears that both Article III and Article VI of the 1945 Missouri State Constitution prohibit the state from extending its credit to "any private individual, association or corporation" with the explicit exception of the authority to issue Industrial Revenue Bonds.[33] Policymakers obviously must consider whether the political difficulties of attempting to get the state constitution amended outweigh the added flexibility that creating a public bank may provide to the state.

<u>Footnotes</u>

1. See page 12 for current list of federal, state and local proposal to establish publicly owned and/or operated banking institutions.

2. "Historical Highlights of State-Owned Banks: 1792-1861" in <u>Business Conditions</u> (Federal Reserve Bank of Chicago: July, 1976).

3. <u>Ibid</u>.

4. North Dakota Century Code, Section 6-09-01.

5. H.L. Thorndal, President of the Bank of North Dakota, in remarks before the Conference on Alternative State and Local Public Policies, Austin, Texas, June 11, 1976, p.11.

6. Bank of North Dakota 1976 Annual Report, p.6.

7. "Purpose, History and Organization, Laws, Regulations, By-Laws, Orders, Rules, Directions, Advice and Information" (Bank of North Dakota Series of 1920: February 2, 1920), p.1.

8. Industrial Commission Act, Session Laws of 1919, Chapter 151.

9. BND 1976 Annual Report, p.5.

10. <u>Ibid</u>., p.8.

11. Thorndal speech, p.6.

12. BND 1976 Annual Report, p.9.

13. <u>Ibid</u>., p.10.

14. <u>Ibid</u>., p.16

15. <u>Ibid</u>., pp. 23, 24.

16. "Purpose, History and Organization...," p.2.

17. "The Only Bank of Its Kind," <u>New York Times</u>, April 13, 1975.

18. Derek Shearer, "Public Control of Public Money" (Conference on Alternative State and Local Public Policies, 1901 Q Street, N.W., Washington, D.C. 20009), p.3.

19. "Hunt Report Goes to Nixon, Stresses Need for Action as Single Integrated Proposal," American Banker, December 23, 1971.

20. "Dissents and Additional Views by Commission Members," American Banker, December 24, 1971.

21. "The Proposed Urban Development Bank," Memorandum from Department of Treasury to the Urban and Regional Policy Group, September 8, 1977, pp. 1-3.

22. James Rowen, "Public Control of Public Money," The Progressive, February, 1977, p.48.

23. Stanley Steingut, Speaker, New York State Assembly, in statement before the Assembly Standing Committee on Banks, New York City, April 24, 1975, p.1.

24. Ibid.

25. Ibid., pp. 3-4.

26. New York State Assembly Bill to Create New York State Public Bank Corporation, No. 6532-A, March 13, 1975, Section 3, p.4.

27. Lawrence B. Rosser and Calvin Bradford, "Bank Structures and the Public Interest in Urban Centers," mimeographed, June, 1976, p.4.

28. Ibid., pp. 4-5.

29. Ibid., p.6.

30. Shearer, p.8.

31. Thorndal speech, p.7.

32. See Woodstock Institute paper in this series entitled, "Massachusetts Community Development Finance Corporation as a Vehicle for Reinvestment."

33. Telephone interview with C.B. Burns, Civil Division, Missouri Attorney General's Office, December 8, 1977.