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FAQ on State Banks

1. **Wouldn't a state bank compete with private banks?**
   No:

   Competing over deposits
   Less than 2% of the Bank of North Dakota's deposits come from private individuals. And some state bank legislation would prohibit state banks from taking any private deposits.

   It is true that private banks would no longer receive short-term state deposits, but considering that most community banks receive little of this money to begin with and that many states are still requiring 100% to 110% collateral for these funds it is unlikely to have a great effect on private bank profits. And even if collateral requirements are a function of risk aversion brought on by economic downturns, and are thus in the process of easing, it is precisely when the economy slows down that a state bank can provide a boost in lending.

   Also, a state bank in the model of the Bank of North Dakota would not only *not* take local and municipal deposits, but would help local community banks secure these deposits through letters of credit.

   Competing over loans
   While a state bank could be set-up to originate loans, the Bank of North Dakota, as well as most proposed state banks, requires the state bank to operate in a participatory manner. In most cases a state bank would make participation loans with the private banks acting as the originators and servicers of those loans. The Bank of North Dakota does service some residential mortgages, but this is only after a local lender originates the loan and sells it to the Bank of North Dakota for servicing.

   Overall competitiveness of banking market
   If anything, a state bank helps to keep the banking market strong by supporting small and medium sized-banks (see question #2). In fact, North Dakota has a much smaller Herfindahl-Hirschmann Index (HHI) than such neighboring and comparably-sized states as Montana, South Dakota and Wyoming. [1]

[1] The Herfindahl-Hirschman Index is a commonly accepted measure of market concentration. It is calculated by squaring the market share of each firm competing in the market and then summing the resulting numbers. The HHI takes into account the relative size and distribution of the firms in a market and approaches zero when a market consists of a large number of firms of relatively equal size. The HHI increases both as the number of firms in the market decreases and as the disparity in size between those firms increases. See CSI Washington State Bank Analysis for full HHI figures.

2. **How could a state bank help the state banking industry?**

Participation loans

A state bank would primarily interact with the banking community through participation loans. These loans would help to increase a private bank's lending power and/or reduce the interest rates charged to borrowers. A state bank could also purchase part or all of a loan after it has been issued, to help a private bank stay within its capital adequacy and portfolio balance requirements. Or the originating bank could hold onto the loan and collect fees for servicing it. And because the state bank has no interest in competing for the origination or refinance of private loans, private banks need not fear that allowing participation will lead to a loss of customers.

Direct bank stock lending

A state bank could also provide capital to private banks through bank stock loans for M&A, capital refinancing or capital expansion.

Banker's bank functions

The Bank of North Dakota acts as a mini-reserve bank for its state and serves the functions of a bankers' bank. It is estimated that there are only around 20-25 bankers' banks in the country and a state bank could help provide private banks with lower cost/higher quality services. At worst, a state bank is simply another option for private banks to work with—they are still free to continue working with private banker's banks as they did before.

3. **Won't this just increase regulations on private banks in the state?**

No:

This does not add any regulatory hurdles to private banks. A state bank is NOT a financial bailout to private banks, a la TARP. Due to the prudent banking practices of a state bank (which is not pushed into risky lending instruments by stockholder-driven profit-maximization), we would expect that the private banking market would be affected by positive, stabilizing market-driven forces.

4. **Wouldn't this put state funds in a significant amount of risk? And wouldn't political interests end up forcing the state bank to make bad loans?**

No:

The Bank of North Dakota is staffed by a professional banking staff, not an economic development agency, and a state bank would be run based on prudent financial policies, not high risk practices.

The primary asset of a state bank based on the BND model is participation loans where the loan originator is a private bank. This not only serves the purpose of avoiding competition from a state bank, but it also provides market driven checks and balances against manipulation by political actors.

No loan portfolio is immune to loan failures, and a state bank would inevitably have some loan defaults. The Bank of North Dakota's allowance for loan loss ratio (allowance for loan loss/total loans) in Q3 2010 was 1.79%, while the average allowance ratio for comparably-sized (small- and medium-sized) private banks in the U.S. over the same period was about 2.03%. As with other banks around the world, a state bank would have a loan loss provision and would follow prudent banking practices. Thus, even if some loans held by a state bank fail, a state bank could not only cover its deposits, but provide a profit to both the bank and the state (beyond the deposit interest) – through state dividend payments. In 2009, the Bank of North Dakota showed a profit of $58 million—including loan defaults. And on average, the Bank of North Dakota has returned over $30 million per year to the state general fund over the past decade. Analysis suggests that this would be the case in other states as well.

Also, a state bank would work hand in hand with state bank regulators to evaluate its loan portfolio, risk exposure and profitability. A state bank would also be required to meet certain safety and soundness criteria in order to access its own liquidity sources to manage liquidity and interest rate risk (e.g., S&P ratings).

5. **Don't we already have economic development programs that do these things?**
A state bank is NOT an economic development program, and does not replace current state ED efforts. There is still a need for economic development programs and individuals to put together deals and work with businesses; a state bank can simply be a source of revenue to fund these programs as well as liquidity to help underwrite those deals. And because a state bank has the power to leverage funds (10 to 1 as a rule of thumb) it can increase the state's ability to fund economic development, along with helping to support private banks, consumers and businesses across the lending industry.

6. **The state treasurer already gets a good return on the investment pools we use, why change that?**
A state bank is NOT a substitute for an investment manager, and we would expect that the treasurer would retain these functions. For example, in North Dakota, BND does not manage the state pension fund investments.

7. **How can a state bank act as the state's fiscal agent (concentration bank); wouldn't it be cost prohibitive to set-up that operation?**
There is nothing to indicate that a state bank would not be able to handle the functions of a fiscal agent and still be profitable. The Bank of North Dakota has certainly done so for North Dakota. And state banks tend to have much lower overhead than comparable private banks due to the lack of branch offices, ATM services, marketing costs, etc. Over the last 15 years (1995-2009) the Bank of North Dakota averaged an efficiency ratio of about 28%, while small and medium sized banks in North Dakota averaged about 62%.

No matter the costs of operating the bank, the cost to the state is nil once the bank is up and running; indeed, as noted elsewhere, the bank should generally return money to the state. The primary difference is that while a concentration bank (like Bank of America) is the only bank to benefit from state deposits, a state bank would spread the benefit to small and medium sized banks throughout the state (through participation loans).

Also, as mentioned earlier, a state bank does not replace all functions of a state treasurer's office, and we would expect that the same procedures around investment funds would remain.

8. **Would a state bank impair the need for liquidity in state deposits?**
No. Just like any private bank, a state bank has to carefully manage liquidity in order to be able to meet all its operational needs. However, this is obviously equally true of any other depository institution a state would use to manage state monies. If state deposits are currently deposited at a private financial institution (say Bank of America), that institution has to manage liquidity so that funds are available to the

state to withdraw to meet payroll and other obligations as necessary. A state bank would be no different, and the Bank of North Dakota has demonstrated over the past 90+ years that it can do so capably—and still turn a profit.

9. **How much do you need to start a state bank?**
   There is no set minimum for start-up capital. Of course, a state bank would need to sustain its capital adequacy, so depending on how much state deposits will be held at the state bank, this could drive the capital needs. It seems likely that there will be a transition stage where the state bank's participation loan portfolio grows and there are arguments for growing the capital at a similar rate. Ultimately, a state bank can be thought of as an economic engine that will be greatly impacted by the inflow of state deposits and reinvestment of profits into state bank capital. CSI analysis shows that even after accounting for debt service obligations due to start-up capital, a state bank would still be profitable after a few years and a strong economic tool for a state.

10. **Where would the capital come from?**
    The likely sources of state bank start-up capital are the state General Fund, General Obligation Bonds, or other dedicated state funds.

11. **Isn't setting up a state bank just too complex?**
    While setting up a state bank is more complex than, for example, establishing a single revolving loan fund, and there is only one such bank in the country, there are thousands of banks in operation in the U.S. and new private banks are formed every year. In many ways a state bank would be more straightforward to set-up than a private bank. We expect that a state bank would have one location, no marketing, very little direct lending and a single source of deposits (the state). A reliance on participation loans would also reduce the need for bank loan officers and loan brokers.

12. **Isn't the reason that banks are lending less now due to a decrease in loan demand or good loans?**
    Not completely:

    While a reduction in lending during an economic downturn is in part a reflection of decreased demand for new loans (i.e. businesses holding off expansion plans), some part of the demand curve is directly tied to the cost of debt. As lenders tighten their underwriting standards and increase the interest cost to borrowers, demand for new loans naturally drops. This does not mean that there aren't any "good" loans available, only that there is heightened price sensitivity (especially during less stable economic conditions). CSI analysis shows that banks in North Dakota reduced lending 33%-45% less than comparable states, and we believe that this is in no small part due to the stabilizing effects of its state bank.

13. **Sure, a state bank works in North Dakota, but isn't my state completely different, both politically and economically?**

    No. Of course every state has a unique political and economic context. However, it is important to note that the Bank of North Dakota has enjoyed the support of both Democratic and Republican administrations and legislators. Sen. John Hoeven, the Republican former Governor of North Dakota, was President of the Bank of North Dakota earlier in his career.

Economically, it is, of course, difficult to separate the health of the lending market in a state from the overall economic health of the state. Over the past two years, North Dakota has been one of the states least impacted by the recession and it is difficult, if not impossible, to know to what extent that is due to the presence of the BND as opposed to other factors. However, attempting to tease apart the economy-lending linkage slightly, analysis has found that the health of North Dakota's small and medium sized bank lending market has been strong independent of other major components of the state's economic health (namely, the housing markets and oil and gas industries). This provides circumstantial evidence, at least, that the BND has played an important role in supporting the state's lending market.

It is also worth noting that oil and gas production and extraction tax revenues provided $71 million to the state general fund over the 2007-2009 biennium (the statutory cap), while the Bank of North Dakota returned $60 million; thus the bank's direct impact on the state budget surplus, anyway, has been almost as great as that of the oil and gas industries.[2] In sum, these figures suggest that while oil and gas revenues are certainly important to the state's economy and fiscal health, they are not the only factor driving it, and that a state bank likely plays some role as well.

[2] Source: North Dakota Office of State Tax Commissioner, Comparative Statement of Collections, available at http://www.nd.gov/tax/genpubs/49thbiennialreport.pdf.