

Rebuttal to Opposition Testimony on HB 1066/SB789

A bill to study the creation of a State Bank of Maryland

In their testimony against HB 1066/SB 789, **a study bill to spur small business lending** by creating a state bank, opponents seem to misunderstand key functions of a state bank.

A bank modeled on the successful Bank of North Dakota supports rather than competes with community banks, has no branches, and could pay significant dividends to the state even after the costs of capital are considered. Bank lobbyists in their recent testimony get all three of these fundamental issues wrong.

As the Bank of North Dakota shows, there is a public purpose served by a large, robust bank focused on small business lending through local banks. Maryland simply does not have one. That means **Maryland's small businesses are losing opportunities to grow and Maryland is losing jobs and revenue.**

Opponents also raise questions about how such a bank would operate. Some of these are answered below. Others are exactly the sorts of questions the commission will study. The following are some of the main questions and contentions from opponents' testimony, followed by responses and corrections.

Impact on Community Banks and Bankers' Banks

Claim: *Opponents claim that a state bank would "compete directly with banks," including the existing bankers' banks and correspondent banks.*

First, we should be very clear that a state bank would not compete with the community banks in Maryland. North Dakota bankers strongly support the Bank of North Dakota. The Bank also has wide, bipartisan support in North Dakota, and the state's conservative Republican U.S. Senator and former Governor John Hoeven—who is backed by both the Independent Community Bankers Association and the American Bankers Association —was CEO of the Bank of North Dakota from 1993-2000.

In broad terms, the Bank of North Dakota has helped keep Main Street banks serving local business borrowers in markets from which they would otherwise have been shut out by big out-of-state banks. A state bank supports local banks with the participation loans, bank-stock purchases, and interest rate buy-downs that make possible productive loans that would otherwise not be made.

Bankers' Banks

Bankers' banks are owned by investor banks and may provide services only to community banks, but an investor bank is not permitted to own more than 5% of the voting stock of a bankers' bank and may not invest an amount greater than 10% of its capital. Clearly, any given banker's bank does not account for a majority of a Maryland investor bank's portfolio.

Quarterly aggregated financial data compiled by the Bankers' Bank Council estimates that bankers' banks provide services to 58% of the banks in their respective markets. But this leaves a little over 40% of the banking market not being served by the very small number of bankers banks out there. Also, the bankers' bank market is dominated by one bank: about 30% of the market (in terms of deposits and assets) is controlled by TIB: The Independent Bankers Bank, headquartered in Texas.

Claim: *Opponents note that “four bankers' banks serve community banks in Maryland... The bankers' banks include the Community Bankers Bank, Atlantic Central Bankers Bank and Pacific Coast Bankers Bank which, while chartered in other states and regulated at the State and federal levels, provide services to many banks in Maryland and have bankers from Maryland serving as investors and on their boards of directors.”*

Maryland banks have little if any representation on the boards of these three out-of-state bankers' banks. For example, there are no Maryland chartered banks on the board of the Virginia-based Community Bankers Bank, and only 2 Maryland banks (whose assets accounted for about 1% of Maryland bank assets at the end of 2010) on the board of Pennsylvania-based Atlantic Central Bankers Bank. And while Pacific Coast Bankers Bank does not appear to disclose its board of director banks on its website, it is unlikely that this California-based bank is heavily represented by Maryland banks.

As to Maryland banks' investment position within these bankers' banks, we believe that Maryland banks will invest in the bankers' bank that provides the highest quality services in the most cost efficient manner, and as mentioned above, their exposure is limited. A better question for investors is which bank would be a safer investment?

Average Net Income (Q4 data 2008-2010)	
Atlantic Central Bankers Bank	\$1,998,000
Community Bankers' Bank	\$171,000
Pacific Coast Bankers' Bank	(\$1,601,000)
Bank of North Dakota	\$58,993,000

Claim: *Opponents claim that Maryland Financial Bank, a Maryland state-chartered bank headquartered in Towson would be driven out of business by a state bank, saying “[i]t would be virtually impossible for a bankers bank to compete with a tax-exempt, less regulated State Bank with unlimited access to capital from the State of Maryland.”*

Maryland Financial Bank is neither a large bank in Maryland, a large bankers' bank, or a well-performing bank over the last few years. FDIC data from the quarter ending 12/31/2010 puts Maryland Financial Bank's Assets at \$77,710,000 (which is 0.226% of total bank assets of Maryland chartered banks) and Deposits at \$50,370,000 (which is 0.1803% of total deposits in Maryland-chartered banks). Even though there are only 22 bankers' banks operating in the U.S., it appears that Maryland Financial Bank's assets make it one of the

smallest and account for no more than 1% of the bankers' bank market. Over the last seven years, Maryland Financial Bank had a net loss in all but one year, with a seven year net loss of about \$342,000.

The Bank of North Dakota prices its services at the average rate for a given market and does not use its 'tax-exempt' status to undercut prices. In fact, since a state bank returns most of its profits to the state, a state bank does in a sense pay taxes—more than many private banks. For instance, Maryland Financial Bank has had no applicable taxes in seven years according to FDIC data.

There is plenty of room for both a healthy state bank and a healthy bankers' bank the size of MFB in the Maryland market. Public institutions compete productively with private ones in a multitude of sectors: education, energy, mail service, student lending, library services. The Federal Reserve system provides services that private bankers' banks might also provide, but most agree that its existence is indispensable for the banking sector.

North Dakota is an excellent example: it has both a large, healthy, and long-running state bank and a private bankers' bank operating in the state's credit market. The Minnesota-based United Bankers' Bank works with community banks in North Dakota and is even a member of the North Dakota Bankers Association - who incidentally are very supportive of the Bank of North Dakota. And even though United Bankers' Bank and the Bank of North Dakota have some overlapping services, this does not mean that there isn't enough business for both banks.

In fact over the last 7 years, United Bankers' Bank has more than doubled its assets and deposit base and now has over \$640 million in assets and \$440 million in deposits. United Bankers' Bank has averaged about \$2.5 million in net income per year over the same period and paid an average of \$1.7 million in taxes per year - all while competing with a \$4 billion state bank. Another example of healthy competition for bank services within North Dakota is Fargo-based State Bank and Trust. While not a bankers' bank, they provide correspondent lending services to community banks in North Dakota – and do so profitably. Over the last 7 years, State Bank and Trust's assets have grown by over 70% and are now at over \$2 billion. It has earned a positive net income - averaging about \$13 million per year, and also paid taxes of about \$8 million per year, according to FDIC data.

The Bankers Association is asking the state to reject a study of an enormously successful model to protect a small bank in a market that, as the bankers' own numbers show, is underserved. FDIC data and survey results from small business owners contradict the claim that lending in Maryland is in fact being maximized. Small- and medium-sized bank lending (in terms of loans-to-asset ratios) in Maryland is down over 4.5 percentage points from Q4 2008 – Q4 2010.

North Dakota Is Unlike Maryland

Claim: Opponents claim that because the Bank of North Dakota is in North Dakota and has existed for 92 years, it could not possibly work in Maryland.

Teasing apart the economy-lending linkage in North Dakota, the Center for State Innovation’s analysis has found that North Dakota’s small- and medium-sized bank lending market has maintained its strength independent of the vicissitudes of the state’s housing markets and oil and gas industries, providing at least some evidence that the BND has played an important role in supporting the state’s lending market and the job growth that comes from it.

Claim: *Opponents claim that because North Dakota is smaller than Maryland, the model cannot work here.* Rejecting a model because North Dakota is small is akin to California or Texas rejecting a Maryland innovation because of our relative sizes. BND performs functions that strengthen community banks and the state’s economy that private banks never will—countercyclical lending, a massive expansion of affordable small business lending, bank-stock purchases, significant new revenues for the state, and lower debt costs for the state and local governments.

North Dakota actually has one of the healthiest banking sectors in the country. North Dakota has both more bank offices per capita and less market concentration than comparator states or the US average. And it has more than double the U.S. average. For the last 14 years, North Dakota has had the lowest Herfindahl-Hirschmann Index¹ (HHI)—a measure of market concentration used by the Federal Reserve—and in 2009 it was more than 300 points (or 47%) less than its closest comparator, Montana.

The extra leveraging ability that the state bank provides through participation loans, the increase in municipal deposits from letters of credit, and the other supports that a state bank can provide as a bankers’ bank are all critical in helping to strengthen small and/or young banks. These indicators would seem to suggest that BND has been effective in broadening and strengthening the banking market, leading to robust competition. It is also worth noting that North Dakota has had no bank failures during the financial crisis, while in Maryland six banks totaling close to \$1.6 billion in assets failed.

Tremendous Risk to Maryland Taxpayers

Claim: *Opponents say that “In considering the risk that creating a State Bank would cause to taxpayers, many questions emerge.”*

We agree that there are valid questions regarding the way that a state bank could be best configured in Maryland. The questions below and others should be explored by a study commission. Opponents seem to

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.

Markets in which the HHI is between 1000 and 1800 points are considered to be moderately concentrated and those in which the HHI is in excess of 1800 points are considered to be concentrated. Transactions that increase the HHI by more than 100 points in concentrated markets presumptively raise antitrust concerns under the Horizontal Merger Guidelines issued by the U.S. Department of Justice and the Federal Trade Commission. See *Merger Guidelines § 1.51*.

argue that having questions is a reason **not** to study a proposal. Answers to some of the questions raised are included in the comments below.

Can a state bank “compete with the bankers' banks and with the sophisticated, well-capitalized correspondent banks?”

This argument flatly contradicts the earlier statement that “[i]t would be virtually impossible for a bankers’ bank to compete with a Partnership Bank in Maryland.” Which is it – bankers’ banks can’t compete or a state bank can’t compete?

Without FDIC insurance will the bank have difficulty in attracting deposits or have to offer higher interest rates causing lower bank profits?

A state bank modeled after the Bank of North Dakota would receive all state deposits and would not compete in the traditional sense for private deposits. Less than 2% of the Bank of North Dakota’s deposits come from private individuals. And some proposed state bank legislation would prohibit state banks from taking any private deposits. Thus, the benefits of FDIC insurance—and detriments of not having FDIC insurance—are quite small to a bank that has very few depositors (you get \$250,000 of insurance per government custodian, which wouldn’t add up to much for a state bank), and isn't trying to attract private deposits.

The State Bank would make bank stock loans. These have created significant losses during the recent downturn to those banks that have provided this type of loan.

Bank stock loans are a relatively small portion of a state bank’s asset mix – the Bank of North Dakota estimated that they have a total bank stock portfolio of \$150-\$160 million out of about \$4 billion in assets. As noted above, the Bank of North Dakota has helped the stability of the banking market in its state and acts as a countercyclical force to lending rates during an economic downturn, thereby increasing bank strength and competitiveness.

Opponents raise concerns about the “timeframe for profitability” of the bank and ask about the “potential return of profits to the State.”

While both of these topics could be explored further by the commission, analyses of the economic impact of a state bank in Oregon and Washington State show profits in about 2-3 years; and while the growth of the state bank is based on decisions by the legislature (such as how much of bank profits to return to the state in a given year), this analysis estimates actual return on equity of about 7-10% per year.

A goal of the State Bank would be to reduce banking costs paid by the State. Will that be possible without scale and profitability?

Again, Center for State Innovation analysis indicates that a state bank would be profitable in about 2-3 years and could be scaled up to full operations within 5 years.

What impact will this new risk have on the State's credit rating? How would the rating agencies feel about the potential risk of the state operating a bank?

In 2010, Maryland issued about \$1.94 billion in general obligation bonds. Therefore, a \$100 million general obligation bond (enough capital to cover about \$1 billion in assets) would only have been about 5% of the 2010 bond issuance. More importantly, Center for State Innovation analysis shows that a state bank will cover its start-up capital debt obligation and still return a profit to a state.

Banks are either regulated by the State of Maryland and a federal banking regulator or they are regulated at the federal level by the Office of Thrift Supervision or the Office of the Comptroller of the Currency. Deposits in these institutions are all insured by the Federal Deposit Insurance Corporation up to \$250,000 per depositor per account.

As noted above, FDIC insurance makes little sense for a bank that holds state deposits and has few or no private depositors. \$250,000 is only a tiny portion of the deposits of the state which is virtually the sole client. A state bank would be closely regulated by state regulators, including the Maryland Commissioner of Financial Regulation. 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).

Moreover, a state bank is significantly more transparent and accountable than most private banks. 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. It's worth enumerating the various safeguards in place to make clear that BND operates like an independent financial institution rather than a state agency.

- Independent audits. The bank is audited annually by an outside firm, and biennially by the North Dakota Department of Financial Institutions. The outside auditor publicly presents its review of the bank's financial condition—perhaps the only public review in the country.
- Loan loss reserves. No loan portfolio is immune to loan failures, and BDN's loan-loss allowance was 1.79% in mid-2010 compared to the 2.03% average at similarly-sized banks. BND's Asset Liability committee constantly monitors loan-loss ratios.
- Capital standards. BND maintains its capital ratio at 8-10% for all levels of capital, higher than the Federal Reserve's standard.
- Lending limits, underwriting standards. All loans decision are reviewed by committee, senior management, and even the bank's Advisory Board and governing board.

- Credit review. An internal independent department reports directly to the bank president and Advisory Board on risk ratings.
- Risk management. BND does not carry below market-rate or above-average risk loans. Funds to buy down interest rates, for example, come from legislative economic development appropriations. These loans are administered by BND but are not part of its loan portfolio.

No loan portfolio is immune to loan failures, and a state bank would inevitably have some loan defaults. 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 over the past decade, the Bank of North Dakota has returned over \$30 million per year to the state general fund. Analysis suggests that this would be the case in other states as well.

Capital Investment

Banks are required to have 10% of their assets in capital. How will this new bank be capitalized?

This should be determined by the state, and is another good topic for a study commission. Likely sources of state bank start-up capital are state General Obligation Bonds or other dedicated state funds.

A state bank would need to maintain its capital adequacy, but there is no set minimum for start-up capital. There will be a transition stage during which 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. Center for State Innovation 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.

How many employees will be required to staff this bank? Will the State Bank be able to attract and retain qualified bankers and directors?

Another good question for a study commission. The Bank of North Dakota is staffed by professional bankers and has very good relationships with the banks in its state. In fact, before newly-elected U.S. Senator John Hoeven was Governor of North Dakota, he was the President of the Bank of North Dakota. And at least 3 out of the 7 members of the Bank of North Dakota's advisory board are statutorily required to be bankers.

How will the bank establish branches across the State?

A state bank modeled directly after the Bank of North Dakota will have no branch network—the Bank of North Dakota has only one, its headquarters in Bismarck. This is one reason that individual private deposits make up relatively little of its portfolio. In many ways setting up a state bank would be more

straightforward than setting up a private bank. A state bank requires only one location, no marketing, little or no direct lending, and a single source of deposits--the state Treasury.

A reliance on participation loans would also reduce the need for certain bank account executives and loan brokers. Due to this structure, a state bank would likely have a much smaller efficiency ratio (a measure of non-interest expenses) than private banks. The Bank of North Dakota averaged less than half of the efficiency ratio of the small and medium sized banks in its state over the last 15 years.

Similar study legislation has been considered, and rejected, in other states. Illinois and Washington State estimated the costs for creating a State Bank today at \$827 million and \$155 million respectively.

Opponents' use of these estimates is misleading. An analysis by the Center for State Innovation of a state bank in Washington State indicates that after taking interest expenses, non-interest expenses, and even opportunity costs of less interest income and lost tax revenues into account, the state bank would still return a profit to the state starting in year 3. (See: Washington State Bank Analysis by the Center for State Innovation, December 2010).

While we have not run an analysis for Illinois, it is clear that the "cost" estimate of \$827 million for a state bank in Illinois in the fiscal note attached to Illinois HB 5476 at best fails to understand the concept of a state bank, and at worst is deliberately misleading. This "cost" is based on the creation of a network of branches and capitalizing a bank at a 10% capitalization rate to cover about \$8 billion in state deposits. Thus, \$800 million of the projected \$827 million cost is for the bank's capital, used to leverage state deposits in order to create \$8 billion in assets (most of it earning assets). This \$800 million should be thought of as an investment, not a cost. Bank capital does not get "spent" in any sense: it remains under the control of the state and part of the state's assets, which like other state investments would be expected to grow over time. The opposition ignores the potential income from up to \$8 billion in assets. Also, as noted above, analysis suggests that the debt service obligation for start-up capital can be covered by these earnings and would result in a net income after including the interest and non-interest expenses (where the \$27 million would fall in the Illinois example). It should also be noted that the \$27 million cost on top of capital includes almost \$9 million to manage the state's investment portfolio – which is not a function of a state bank. In fact, 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.

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 economic benefit to small- and medium-sized banks throughout the state through, for example, participation loans.

Maryland's Banks Are Lending and Serve as Community Leaders

Proponents assert that banks aren't lending and therefore this new State Bank will increase access to credit.

Opponents contend that while the current recession has been a challenging environment for businesses and consumers, banks are in the business of lending and are lending to qualified borrowers. As of year-end 2009, Maryland banks made \$30.6 billion in residential loans, including \$22.3 billion in refinancing and \$4.6 billion in small business, community development and commercial loans.

There is no dispute that banks have failed to restore their lending to pre-crisis levels.² The large bank lending cutbacks have had a disproportionate impact on the Maryland economy due to high bank consolidation in the state. Here, two out-of-state banks—Bank of America and M&T—currently control fully one-third (1/3) of all deposits, up from 25 percent before the crisis. The five largest banks in Maryland control more than 57 percent of our state’s deposits, and none is chartered or based in Maryland.

The 2011 Demos study of the Maryland small business lending market shows that in 2010, Bank of America made just two Small Business Association 7(a) loans in Maryland – the flagship program for small business lending. That was a 99.4 percent decline from the bank’s 312 SBA loans in 2007, a drop that has pushed Maryland small businesses either out of business or onto higher-interest credit cards. The average business card interest rate is 16 percent, but quality SBA 7(a) loans average seven to nine percent. In 2009, 98 percent of the bank’s Maryland small business loans were on credit cards.

And 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.

Conclusion

In sum, opponents raise a number of questions, some of which are easily answered and some of which might call for further study. Opponents also argue that Maryland should not study the questions raised because they see no way for a promising model from another state to work in Maryland.

Maryland should study this promising model at a very modest cost and then decide if it might work here to strengthen our economy, spur small business lending, and save the state and local governments money.

² See, e.g., http://money.cnn.com/2011/02/11/smallbusiness/small_business_lending_drop/index.htm, <http://news.medill.northwestern.edu/chicago/news.aspx?id=177559>, <http://www.theepochtimes.com/n2/content/view/49954/>, http://www.huffingtonpost.com/2010/07/12/as-lending-to-small-busin_n_643450.html, <http://www.mcclatchydc.com/2010/03/12/90309/too-small-to-succeed-firms-still.html>.