Moving Our Money from Wall Street to Local Community Banks

The North Dakota Model

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The recent proposal to vote with our feet by shifting our deposits from Wall Street to community banks is a great start. However, community banks are not suffering from a lack of deposits so much as from a lack of the capital they need to make new loans, and investment capital today is scarce. There is a way out of this dilemma, demonstrated for over 90 years by the innovative state of North Dakota — a partnership in which community banks are backed by the deep pockets of a state-owned bank.

Arianna Huffington just posted an article on the **Huffington Post** that has sparked a remarkable wave of interest, evoking nearly 5,000 comments in less than a week. Called "Move Your Money," the article maintains that we can get credit flowing again on Main Street by moving our money out of the Wall Street behemoths and into our local community banks. This solution has been suggested before, but Arianna added the very appealing draw of a video clip featuring Jimmy Stewart in *It's a Wonderful Life*. In the holiday season, we are all hungry for a glimpse of that wonderful movie that used to be a mainstay of Christmas, showing daily throughout the holidays. The copyright holders have suddenly gotten very Scrooge-like and are allowing it to be shown only once a year on NBC. Whatever their motives, Wall Street no doubt approves of this restriction, since the movie continually reminded viewers of the potentially villainous nature of Big Banking.

Pulling our money out of Wall Street and putting it into our local community banks is an idea with definite popular appeal. Unfortunately, however, this move alone won't be sufficient to strengthen the small banks. Community banks lack *capital* – money that belongs to the bank — and the deposits of customers don't count as capital. Rather, they represent liabilities of the bank, since the money has to be available for the depositors on demand. Bank "capital" is the money paid in by investors plus accumulated retained earnings. It is the net worth of the bank, or assets minus liabilities. Lending ability is limited by a bank's assets, not its deposits; and today, investors willing to build up the asset base of small community banks are scarce, due to the banks' increasing propensity to go bankrupt.

It's a Wonderful Life actually illustrated the weakness of local community banking without major capital backup. George Bailey's bank was a savings and loan, which lent out the deposits of its customers. It "borrowed short and lent long," meaning it took in short-term deposits and made long-term mortgage loans with them. When the customers panicked and all came for their deposits at once, the money was not to be had. George's neighbors and family saved the day by raiding their cookie jars, but that miracle cannot be counted on outside Hollywood.

The savings and loan model collapsed completely in the 1980s. Since then, all banks have been allowed to create credit as needed just by writing it as loans on their books, a system called "fractional reserve" lending. Banks can do this up to a certain limit, which used to be capped by a "reserve requirement" of 10%. That meant the bank had to have on hand a sum equal to 10% of its deposits, either in its vault as cash or in the bank's reserve account at its local Federal Reserve bank. But many exceptions were carved out of the rule, and the banks devised ways to get around it.

That was when the **Bank for International Settlements** stepped in and imposed "capital requirements." The BIS is the "central bankers' central bank" in Basel, Switzerland. In 1988, its Basel Committee on Banking Supervision published a set of minimal requirements for banks, called Basel I. No longer would "reserves" in the form of other people's deposits be sufficient to cover loan losses. The Committee said that loans had to be classified according to risk, and that the banks had to maintain real capital – their own money – generally equal to 8% of these "risk-weighted" assets. Half of this had to be "Tier 1″ capital, completely liquid assets in the form of equity owned by shareholders – funds paid in by investors plus retained earnings. The other half could include such things as unencumbered real estate and loans, but they still had to be the bank's own assets, not the depositors'.

For a number of years, U.S. banks managed to get around this rule too. They did it by removing loans from their books, bundling them up as "securities," and selling them off to investors. But when the **"shadow lenders"** – the investors buying the bundled loans – realized these securities were far more risky than alleged, they exited the market; and they aren't expected to return any time soon. That means banks are now stuck with their loans; and if the loans go into default, as many are doing, the assets of the banks must be marked down. The banks can then become "zombie banks" (unable to make new loans) or can go bankrupt and have to close their doors.

The final blow to the easy credit provided by U.S. banks came with another stricture on capital, called Basel II. It manifested in the U.S. as the "mark-to-market" rule, which required a bank's loan portfolio to be valued at what it could be sold for (the "market"), not its original book value. In today's unfavorable market, that meant a huge drop in asset value for the banks, dramatically reducing their ability to generate new loans. When the announcement was made in November 2007 that this rule was going to be imposed on U.S. banks, credit dried up and the stock market plunged. The market did not begin to recover until 2009, when the rule was largely lifted. However, on December 17, 2009, the Basel Committee announced plans to impose even ***tighter capital requirements***. The foreseeable result is the collapse of yet more community banks and the drying up of yet more credit on Main Street.

Anchoring Community Banks to State-owned Banks

Where can our floundering community banks get the capital to make room on their books for substantial new loans? An innovative answer is provided by the state of North Dakota, one of only **two states** (along with Montana) expected to meet its budget in 2010. North Dakota was also the only state to actually *gain* jobs in 2009 while other states were losing them. Since 2000, North Dakota's GNP has grown 56 percent, personal income has grown 43 percent and wages have grown 34 percent. The state not only has no funding problems, but in 2009 it had a budget *surplus* of $1.3 billion, the largest it ever had – not bad for a state of only 700,000 people.

North Dakota is the only state in the union to own its own bank. The **Bank of North Dakota** (BND) was established by the state legislature in 1919 specifically to free farmers and small businessmen from the clutches of out-of-state bankers and railroad men. Its populist organizers originally conceived of the bank as a credit union-like institution that would provide an alternative to predatory lenders, but conservative interests later took control and suppressed these commercial lending functions. The BND now chiefly acts as a central bank, with functions similar to those of a branch of the Federal Reserve.

However, the BND differs from the Federal Reserve in significant ways. The stock of the branches of the Fed is 100% privately owned by banks. The BND is 100% owned by the state, and it is required to operate in the interest of the public. Its stated mission is to deliver sound financial services that promote agriculture, commerce and industry in North Dakota.

Although the BND is operated in the public interest, it avoids rivalry with private banks by partnering with them. Most lending is originated by a local bank. The BND then comes in to participate in the loan, share risk, buy down the interest rate and buy up loans, thereby freeing up banks to lend more. One of the BND's functions is to provide a secondary market for real estate loans, which it buys from local banks. Its residential loan portfolio is now $500 billion to $600 billion. This function has helped the state avoid the credit crisis that afflicted Wall Street when the secondary market for loans collapsed in late 2007 and helped it reduce its foreclosure rate. The secondary market provided by the "shadow lenders" is provided in North Dakota by the BND, something other state banks could do for their community banks as well.

Other services the Bank provides include guarantees for entrepreneurial startups and student loans, the purchase of municipal bonds from public institutions, and a well-funded disaster loan program. When North Dakota failed to meet its state budget a few years ago, the BND met the shortfall. The BND has an account with the Federal Reserve Bank, but its deposits are not insured by the FDIC. Rather, they are guaranteed by the State of North Dakota itself – a prudent move today, when the FDIC is verging on bankruptcy.

A New Vision for a New Decade

A state-owned bank has enormous advantages over smaller private institutions: states own huge amounts of capital (cash, investments, buildings, land, parks and other infrastructure), and they can think farther ahead than their quarterly profit statements, allowing them to take long-term risks. Their asset bases are not marred by oversized salaries and bonuses, they have no shareholders expecting a sizable cut, and they have not marred their books with bad derivatives bets, unmarketable collateralized debt obligations and mark-to-market accounting problems.

The BND is set up as a *dba*: "the State of North Dakota *doing business as* the Bank of North Dakota." Technically, that makes the capital of the state the capital of the bank. The BND's **return on equity** is about 25 percent. It pays a hefty dividend to the state, projected at over $60 million in 2009. In the last decade, the BND has turned back a third of a billion dollars to the state's general fund, offsetting taxes.

By law, the state and all its agencies must deposit their funds in the bank, which pays a competitive interest rate to the state treasurer. The bank also accepts funds from other depositors. These copious deposits can then be used to plow money back into the state in the form of loans.

Although the BND operates mainly as a "bankers' bank," other publicly-owned banks, including the Commonwealth Bank of Australia, have successfully engaged in direct commercial lending as well. This has proven to be a win-win for both the borrowers and the government. The public bank model also offers exciting possibilities for refinancing the state's own debts and funding infrastructure nearly interest-free. For a fuller discussion, see "**Cut Wall Street Out! How States Can Finance Their Own Recovery**."

For three centuries, the United States has thrived on what Benjamin Franklin called "ready money" and today we call "ready credit." We can have that abundance again, by generating our own credit through our own state and local banks. Just as George Bailey needed a visit from an angel to point the way, so we just need the vision to see the possibilities.

Arianna's vision for moving our money from the large banks into our local community banks is a very admirable first step. However, those community banks are not likely to have sufficient capital to free up credit for their local businesses and other customers without the partnership of state-owned banks, or the publicly-owned banks of counties and larger cities, which also have ample capital assets. A number of states, counties and cities are actively exploring this option. The BND model shows us how government-owned banks and community banks can work together to get money flowing back to Main Street again.

Ellen Brown *developed her research skills as an attorney practicing civil litigation in Los Angeles. In Web of Debt, her latest book, she turns those skills to an analysis of the Federal Reserve and "the money trust." She shows how this private cartel has usurped the power to create money from the people themselves, and how we the people can get it back. Her earlier books focused on the pharmaceutical cartel that gets its power from "the money trust." Her eleven books include Forbidden Medicine, Nature's Pharmacy (co-authored with Dr. Lynne Walker), and The Key to Ultimate Health (co-authored with Dr. Richard Hansen). Her websites are* ***www.webofdebt.com*** *and* ***www.ellenbrown.com****.*

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