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Preliminary Issue Brief

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Preliminary Review of Issues in Adopting a Bank of North Dakota (BND) Model in VT

The concept of a creating a state bank, similar to North Dakota (BND) has garnered considerable interest this legislative session in Vermont and nationally. Testimony on the BND model indicated a number of potential benefits, but many of these would be long term, while the transition would likely be complicated and controversial.

Potential benefits include:

- The BND has a high loan to deposit ratio and therefore has the capacity to increase credit availability in state, which is very desirable in the current economy. This should be tempered with the understanding that Vermont banks may have a higher loan to deposit ratio then North Dakota banks so research needs to be done to identify if a net improvement in loan to deposits would occur.

- The BND works in partnership with private sector banks to provide a source of capital.

- It is possible that the survival of the 94 small banks in North Dakota may be due to the support of BND. Vermont has only 14 local banks with 7 more out of state banks that operate in Vermont. While the difference may be due, in part to BND, in part it is due to early unit banking restrictions in North Dakota which did not allow multi-branch institutions

- The North Dakota General Fund has received substantial transfer of cash in the past several fiscal years.

  In the last 10-12 years it reportedly transferred a third of a billion dollars to the General Fund to offset taxes or to aid in funding public sector expenses. In the FY 2009-2011 budget period, North Dakota's legislature forwent a profit transfer of $60 million – reducing it to $1 million – to allow the bank to build up reserves which are now about $270 million.

- The state has used the capacity of the BND as a reserve fund for the state.

Any applicability or development of this concept in Vermont would need to address a number of issues:

1. **Capitalization:**
   - The BND was capitalized by $2 million in 1919. In current dollars that would be approximately $25 million which is the minimum capitalization required of Vermont banks at this time. The amount of capitalization and source of revenue would need to be explored.

- Vermont trust funds such as the Tobacco Trust Fund, the Higher Education Trust Fund, and State Pension Funds are currently handled by fund managers. These resources may not be immediately available for a new state depository institution.

- Vermont state government operating cash deposits available to capitalize a new institution are at extremely low levels. The State currently maintains the vast majority of its deposit dollars with TD Bank, through a banking services contract. Of note, the BND does not participate in the FDIC insurance program, the deposits are guaranteed by the full faith and credit of ND. Fiduciary responsibility could limit the ability to transfer funds to a state bank, and existing statutory investment requirements for some special funds, e.g. 32 VSA § 588, might need to be revised or replaced to allow such funds to be invested with a State bank.

- The State of Vermont and all local governments had $214.8 million deposited in the 14 banks headquartered in state (as of 9/30/09). This amount changes on a frequent basis due to the cash flow of the state and municipal governments. IT would be difficult to use these funds to provide a capital base for a bank in the current budget environment.

- The recipients of these cash deposits may be adversely affected if they were all directed toward a state bank.

2. **Profit Expectations:**
   - While today the BND is profitable and a key part of the North Dakota financial structure, it was created in 1919, but didn't make its first payment to the state general fund until 1945. A considerable portion of the BND profitability came from its student loan portfolio which is facing the same risk VSAC is facing with changing federal student loan law. BND has also profited from a secondary market mortgage program. We don't have a public equivalent in Vermont for this type of residential lending program. This is a concept that could be explored.

   - Deposits to the Vermont General Fund from a newly created state bank would likely be non-existent to minimal and of limited use in the near term. The impact of a state bank on the current fiscal situation would be minimal and it would not be advisable to create expectations of an immediate return.

3. **Transition Issues –** the process of transition has some potential strengths and issues that would need to be understood:
   - Combining VSAC, VEDA, and possibly others, into a state bank could create efficiencies and economies of scale. In addition to the BND North Dakota does have a separate housing finance agency and municipal bond bank. Some of the functions of VEDA and VSAC are part of the BND construct. VSAC, for example, has a much broader level of student service and involvement.

   - The Vermont institutions have differing portfolios, financial strengths, and missions. The new entity would need to absorb considerable debt as part of the reorganization and build a staff structure that met the mission of these institutions. VHFA and VSAC have fairly major liabilities to address.

   - What appears to be critical to the success of the BND is a conservative approach to management and limited outside influence.

   - The BND supports private state banks and also carries out several Federal Reserve Bank functions. The current context in Vermont is quite different, as the many of the state’s banks are nationally integrated and use Federal Reserve services. The specific functions, support, and relationships that the bank would have would need to be explored.

- There have been more bank mergers and acquisitions in Vermont and these institutions have extensive ties to regional markets and less geographic isolation than those in North Dakota. Banks in VT generally have significantly larger balance sheets than those in ND.

While the idea has considerable merit, it would also require capitalization and insulation of expectations which are difficult at this time. A full development of the concept and the issues involved would require study and review – beyond what is easily done in the session. The legislature might develop a study frame for the Treasurer and BISCHA to begin the exploration of the idea. The Treasurer’s office indicated a willingness to provide pertinent information about its operations as needed and to participate in a support role; but does not have the expertise or resources to effectively complete such a study. The Legislature may want to appropriate funds to have an external expert, such as a former president of the BND or a former high level financial officer of a bank complete the study and analysis of this idea.