



NEIL ABERCROMBIE
GOVERNOR

BRIAN SCHATZ
LT. GOVERNOR

STATE OF HAWAII
OFFICE OF THE DIRECTOR
DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS

335 MERCHANT STREET, ROOM 310
P.O. Box 541
HONOLULU, HAWAII 96809
Phone Number: 586-2850
Fax Number: 586-2856
www.hawaii.gov/dcca

KEALI'I S. LOPEZ
DIRECTOR

EVERETT KANESHIGE
DEPUTY DIRECTOR

Should Hawaii Establish a State Bank?
By the Division of Financial Institutions
Iris Ikeda Catalani, Commissioner
January 2012

Department of Commerce and Consumer Affairs

With the recent economic downturn and lack of financing available for new businesses, discussions on the establishment of state banks have increased. The only state bank that currently exists was established in 1919 in North Dakota. Its primary functions are to promote agriculture, commerce and industry, and to stimulate economic development through several lending programs.¹

In May 2011, the New England Public Policy Center of the Federal Reserve Bank of Boston published a research report entitled, "The Bank of North Dakota: A model for Massachusetts and other states?" (Research Report). The Research Report analyzed the Bank of North Dakota (BND) as a possible model for the state of Massachusetts. The Report did not find this to be a reasonable model for Massachusetts, concluding that:

- The willingness and capacity of a state-owned bank to offset a serious credit crunch has not been shown;
- With the possible exception of the Great Depression, BND contributions to stabilizing the state economy and finances appear to have been relatively minor;
- The potential costs of starting up a state-owned bank could be significant; and
- Massachusetts and other states should start any discussions of financial-sector reforms by identifying the problems that public policy needs to address.

¹ Morton, Heather. Are State-Owned Banks a Viable Option? NCSL LegisBrief November/December 2011.

One of the factors the Research Report looked at was the difference in the banking environment in North Dakota which consists of numerous small commercial banks and that in Massachusetts which consists of a few comparatively large commercial banks. In addition, the Research Report noted that there is only one state bank in the entire country with no others with which to compare it.

While it is difficult to provide a definitive conclusion based on analyses which are limited and complex, the following provides additional discussion on why the establishment of a state bank in Hawaii would be against sound fiscal policy at this time.

- **Bank of North Dakota**

Emphasizing safe and sound lending, BND has a largely favorable reputation in the state. It does not engage in risky activities such as community development funding and equity investments. Partnering with small community banks in North Dakota allows these small banks to make loans that exceed their legal or internal lending limits. The experience of BND is not comparable to Hawaii economic or banking environment as the two states are dramatically different. North Dakota is sparsely populated rural state with an agricultural base with numerous small, relatively isolated banks,² differing significantly from Hawaii which relies on tourism, is not predominantly rural, and has only eleven banks, which could not be considered isolated.

- **Access to credit by local businesses.**

During the financial crisis and recession of 2007-2009, credit availability in North Dakota for small businesses was unable to meet the demand. There is no evidence that BND helped to lower credit barriers during that time. However, there is "indirect evidence that BND viewed federal agencies as having the primary responsibility and capacity for providing the liquidity backstop."³ While BND was able to assist North Dakota banks through "record loan growth, letters of credit for public deposits, and a record amount of fed funds borrowed," the Federal Home Loan Bank (FHLB) system was a major source of liquidity during this time. FHLB advances funding to various financial institutions to support small business when other sources of capital are scarce.

In addition, two new federal programs were initiated to aid small businesses. The Small Business Lending Fund and the State Small Business Credit Initiative both

² Kodrzycki, Yolanda K. and Tal Elmatad. New England Public Policy Center, Research Report 11-2, May 2011. The Bank of North Dakota: A model for Massachusetts and other states?

³ Ibid

provide mechanisms to increase credit availability for small businesses. In addition, several loan guarantee programs of the Small Business Administration have been expanded and the Small Business Jobs Act of 2010 relaxed various SBA loan eligibility requirements.

- **Augmenting the lending capacity of local banks.**
While a state bank and BND in particular are able to augment local banks' lending capacities, Hawaii's banking industry does not mirror that of the small banks in North Dakota. Even if it did, the Massachusetts Commission Report pointed to "private bankers' banks" owned by and providing services to member institutions as an alternative model to a state bank. This model could provide services to smaller banks while not being viewed as a competitor of larger banks.
- **Stabilization of state economy and finances.**
When the North Dakota economy is doing well, BND has been able to help balance the state budget when it experiences shortfalls in other financial sources. However, during a severe agricultural crisis and recession, the poor performance of BND made the crisis worse. When North Dakota's economic experience was compared to that of South Dakota, a state similar in geographic location, size, population, and industry mix, it was found that North Dakota did not consistently outperform South Dakota. The conclusion of the Research Report, reflected in the Massachusetts Commission Report, is that having a state bank did not measurably affect the economic health of the North Dakota.
- **Start-up costs and considerations.**
In addition to the cost of possible legal and regulatory hurdles, including the time delays, basic start-up costs would probably be considerable, involving a sizeable bond issue. In addition, if a state bank were to be established quickly, it would most likely disrupt the operations of existing banks. This is because the state deposits state funds into various financial institutions and withdrawal of such deposits would be disruptive, requiring these institutions to reduce their lending and investment portfolios. However, a gradual phase-in, while perhaps more palatable to existing banks, would delay the benefits of state-owned bank lending. The Massachusetts study estimated that, based on the startup costs for BND which consisted of an initial capitalization through a \$2 million bond issue in 1919, the startup cost for a Bank of Massachusetts today would be around \$3.6 billion. This extrapolation included adjustments for inflation and for growth in the size of the economy from 1919 to today - assuming a 13-fold expansion.
- **Review of public policy issues.**
The Research Report recommended that, instead of planning for the establishment

of a state bank, the Commission:

- Identify the specific market failure it wishes to address and the degree to which a state-owned bank would address this failure; and
- Investigate ways to leverage the already existing network of quasi-public agencies to fulfill its objectives.⁴

- **Massachusetts state programs**

Many public and quasi-public agencies and nonprofits already exist in Massachusetts that offer "various lending programs and services, including lending to help support infrastructure."⁵

- **Hawaii state programs**

As in Massachusetts, a number of programs already exist to provide funding for various small businesses, etc. In addition, once the objectives for the creation of a state bank have been established, based on specific market failures, existing programs can be reevaluated and revised and new programs can be created, following the examples of other states.

Some of the programs already in existence in Hawaii include:

- Small Business
 - The federal Small Business Association in Hawaii offers services including helping small businesses find financing through loans, grants, and a variety of other methods, helping the business decide which method is best for each individual business. It does not provide loans but can help in filling out loan applications and provides numerous other services.⁶ The Hawaii banks provide the SBA loans to the small businesses.⁷
 - The Department of Business Development and Tourism (DBEDT) has developed a number of resources on how to start and grow a business⁸ and

⁴ Report of the Commission to Study the Feasibility of Establishing a Bank Owned by the Commonwealth; August 8, 2011.

⁵ Ibid

⁶ <http://www.sba.gov/about-offices-content/2/3112>

⁷ Hawaii banks that provide SBA loans are: American Savings Bank, Bank of Hawaii, Central Pacific Bank, First Hawaiian Bank, Hawaii National Bank, Ohana Pacific Bank, and Pacific Rim Bank.

⁸ http://hawaii.gov/dbedt/business/start_grow/

how to find financing.⁹ In addition to the small business resources above, the sources of financing on the DBEDT website include commercial lenders, Hawaii Strategic Development Corporation venture capital, Small Business Innovation Grants, OHA business loans, and agricultural loan programs.

- Hawaii Capital Loan Program

In 1963, the Hawaii Capital Loan Revolving Fund was created within the Hawaii Capital Loan Program (Program) to provide a variety of loans to aid certain businesses. In 2003, based on the downturn in the economy, the Fund was repealed as one of the funds which, according to Act 178, Session Laws of Hawaii 2003, no longer served the purpose for which it was created, was not an appropriate means of financing, or was not financially self-sustaining. According to DBEDT, in its 40 plus years of existence, the Program has assisted 561 borrowers providing financing of over \$96 million. Seventy-six loans were written off during that time totaling just under \$7.5 million.

In 2011, Senate Bill Number 757 (SB757) was introduced to appropriate funds for the Program. SB757 was amended to reestablish the Fund authorizing DBEDT to contract for servicing or administering loans from the Fund. The bill passed the Senate as SB757, Senate Draft 2, and passed out of the House Committee on Economic Revitalization and Business as SB757, House Draft 1. It has been referred to the Finance Committee. According to the committee reports for these two drafts, the only differences in the Senate and House versions are the effective dates, which were amended in both drafts to encourage further discussion. Neither bill provided the amount of the appropriation that would be attached to the Fund. However, House Bill 873 (HB873), also introduced in the 2011 session, reestablished the Fund and provided an appropriation of \$2,000,000. HB873 has not received a hearing.

Reestablishing this Fund would provide additional financial resources to small businesses that might otherwise be unable to find funding due to the recent downturn in the economy. Because the bill has passed the Senate and is in the final House committee, this could be accomplished reasonably quickly providing quick relief for small businesses that lack funding.

Finally, in 2010, the Massachusetts legislature passed legislation for a commission to study the establishment of a state bank. In August 2011, after six meetings and three

⁹ http://hawaii.gov/dbedt/business/find_financing/

public hearings, and considering many of the factors outlined above, the commission recommended against a state bank for Massachusetts because:

- There was no justification found for the initial capital costs;
- The BND did not offer adequate guidance because of the "vast" differences in the North Dakota and Massachusetts banking industries and economies;
- Public funds deposited into a state bank would be exposed to an unacceptably high risk when used for risky gap financing;
- Massachusetts infrastructure investment is substantially more established than that of North Dakota; and
- Massachusetts already has a network of public agencies, quasi-public agencies, and non-profits which offer lending programs and services.

Conclusion

Whether a state bank should be created in Hawaii needs careful consideration prior to outlining how this would be accomplished. Of the many factors to consider, the determination of what the state bank would accomplish for the state is critical. Once these factors are outlined, perhaps another avenue of financial assistance could be found that would better accomplish the state's goal. Only once it is clear that a state bank is necessary and is the best method to accomplish one or more of these goals should the concept of a state bank be fully discussed and methods to create it are worked out. In addition, the drawbacks of the establishment of a state bank must be thoroughly discussed and solutions to those found unless they are an acceptable cost of the creation of the state bank.

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Appendix A

	Hawaii	North Dakota
Economic Driver	Tourism	Agriculture, oil
Population	1,360,301 in 2010 - quadruple that of N.D. when the Bank of N.D. was established and over twice the current N.D. population	approx. 673,000 in 2010 - Just over 300,000 when the state bank was established
Number of banks	11 with 175 branches	95 banks with 442 branches http://www.moneyaisle.com/bank-browser/states/north-dakota/
Cost of start up	undetermined	\$325 million (estimated startup cost in today's dollars)
Community classification	Urban	Rural
Size in square miles	6,459	70,704
Unemployment rates ¹⁰	12 th (6.5%) ¹¹	1 st (3.4%) ¹²
Mortgage foreclosure rate ¹³	14 th	49 th
Nearest neighboring state	California - 2500 miles across the Pacific	South Dakota, Montana, Minnesota (on the border)
Climate	Warm, balmy	Cold

¹⁰ U.S. Department of Labor, Bureau of Labor Statistics

¹¹ Same for November 2011

¹² Same for November 2011

¹³ RealtyTrac, 2008 third quarter.