Policy Spotlight
Public Banking (Updated November, 2020)

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COVID-19 Update (November, 2020)

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As local businesses and economies struggle in light of COVID-19, public banking is continuing to gain traction as an attractive alternative to our current financial systems. Small business owners have seen large banks prioritize large, well-connected companies for government relief funding. Cities and states are facing massive revenue shortfalls, leading to layoffs and reduced services. And the economic crisis and efforts at relief have continued to perpetuate racial disparities in lending.

Meanwhile, in North Dakota, where a state-owned public bank has been operating for 100 years, public banking is once again proving its value in a time of crisis. For one, the state-owned Bank of North Dakota assisted small businesses in securing funds from the federal Paycheck Protection Program, which had a troubled roll-out. Thanks in part to that help, small businesses in the state secured more funds, relative to the state's workforce, than businesses in any other state, according to a Washington Post analysis. The bank has also established two COVID-19 relief–loan programs for North Dakota businesses in the state, offering low-interest loans in partnership with local financial institutions.

These developments in North Dakota and across the country have contributed to the public banking movement's growing momentum. From New York to California, advocates are pointing to public banking as a way to provide more immediate

and equitable emergency economic relief while keeping loan fees in-state. Although the efforts to establish public banks are not new, the COVID-19 crisis has lent new urgency to the movement.

COVID-19 and the flaws of our financial system

The COVID-19 economic crisis and attempts at relief have underscored the flaws of the current financial system and the alternatives public banking might offer.

Firstly, the rollout of the federal Paycheck Protection Program highlighted preexisting disparities in lending as large, well-connected businesses took precedence over smaller businesses in receiving loans and Black business owners faced disparate treatment compared to white business owners. The program was intended to help businesses with less than 500 employees keep workers employed, providing low-interest loans that can be forgiven if certain criteria are met. In order to receive the funds, businesses had to submit applications to banks. But smaller businesses had difficulty accessing that money – instead, larger companies with preexisting connections to major banks got "priority treatment," according to an Associated Press analysis. Although loans to smaller businesses picked up later on, the analysis shows they lagged behind larger companies.

Minority-owned businesses also likely faced steeper hurdles in securing PPP loans given historical disparities in lending. A study sending "testers" to banks to apply for PPP loans found that Black borrowers were offered different products and were treated worse than white borrowers with similar profiles in 43 percent of tests. Although it is not possible to fully analyze the racial breakdown of PPP loans due to lack of data collection, businesses located in minority communities were less likely to receive assistance than those located in majority-white communities, according to a Washington Post analysis.

Given the current design of the monetary system and the government's decision to distribute lending through commercial banks, these results are not surprising. From the start, the system favored large banks that had already worked with the federal Small Business Administration, more readily approving their ability to lend out PPP funds. Those banks then favored their existing customers, likely both because it was easier to vet applicants due to a preexisting relationships and because banks have their own financial interest in their customers' businesses — for example, some customers already had significant outstanding loans at the banks prior to seeking out PPP loans. Banks also prioritized larger customers, likely because they carry the most potential to generate revenue for the bank through loan fees and the possibility of a long-term relationship leading to later loans and interest payments. Finally, a system that favors large, well-connected players is likely to perpetuate existing disparities in our financial systems.

In North Dakota, meanwhile, the state-owned Bank of North Dakota assisted the state's local financial institutions in securing more PPP funds for local businesses, relative to the state's workforce, than any other state. According to a Washington Post analysis, small businesses in North Dakota secured more than $5,000 per private-sector worker as of May 8, the highest of any state. The contrast was particularly stark in the troubled first round of funding, when many small businesses throughout the country struggled to get loans. According to the Post analysis, North Dakota was the only state to secure more than $4,000 per private-sector worker during that period, which ran through April 16. More than half of states secured less than $3,000 per private-sector worker in that same period. Much of that success likely stemmed from the BND's ability to provide support to local banks, as well as local banks' deep ties to their communities — North Dakota has nearly six times as many local financial institutions per person than the country overall, according to the Institute

for Local Self-Reliance. So even if small banks were similarly prioritizing existing customers, their integration with small communities allowed them to more quickly connect with small businesses.

Second, the PPP has highlighted the fact that loan fees and interest payments serve to boost large banks' profits. Although that process generally draws little attention when the bank itself is the one making the loan, the fact that banks stand to receive $14.3 billion to $24 billion in fees from PPP loans has drawn prominent headlines. Loan fees generally cover the costs of administering loans and offer banks a way to profit on their lending in addition to charging interest on outstanding loans. To incentivize bank participation in the PPP, the Small Business Administration paid lenders loan fees, or "processing fees," ranging from 1 percent to 5 percent of the loan amount, depending on the size of the loan. Lenders will also earn 1 percent interest on PPP loans that aren't forgiven.

Although many banks don't expect to profit from the low rates and some have said they will donate any profits they do make, the set-up underscores another potential benefit of public banking: loan fees and interest payments are funneled back into the community instead of flowing to shareholders and high salaries. Although such fees and payments do similarly contribute to the operation expenses of a public bank, any profits beyond those operating costs can be directed back into the community through appropriations to a state general fund or through community development programs. For example, the Bank of North Dakota has contributed more than $1 billion back to the state's general fund since its first transfer of $1,725 in 1945. In the past decade, the BND's annual contribution has varied widely, from $2.8 million in 2011 to $186.9 million in 2017. Additionally, public bank employees may be more accountable to the public and earn much lower salaries than their private counterparts. For example, the Bank of North

Dakota's CEO had a salary of $310,000 in 2020, according to the North Dakota Office of Management and Budget. The JPMorgan Chase CEO's salary in 2019 was $31.5 million – that's roughly three times the entire payroll of BND.

Thirdly, the Bank of North Dakota has rolled out its own COVID-19 relief programs, augmenting the PPP and demonstrating how public banks can help respond to an economic crisis. Typically, when an economic crisis hits, access to credit becomes more difficult as banks become more reluctant to lend. This then leads to further economic decline. Central banks – like the U.S. Federal Reserve – generally try to counteract this credit contraction by buying up bank debt to provide more liquidity to banks so they keep lending. State and local public banks can provide a similar countercyclical effect in times of crisis, and they have the potential to respond in a more efficient and targeted manner given their community ties and smaller geographic scope. In North Dakota, BND has helped local financial institutions weather financial crises by buying up loans and residential mortgages, thereby expanding their capital ratios. BND also partners with local banks and credit unions to make joint loans, further expanding the lending capacity of smaller institutions. In response to COVID-19, BND has developed two low-interest lending programs, with one for small employers charging only 1 percent interest. Hundreds of North Dakota businesses have received loans under these programs.

Lastly, local and state governments are facing massive budget shortfalls in light of COVID-19, highlighting the need for sustainable local funding. Some estimate that the state and local government revenue shortfall could amount to nearly $1 trillion by the end of 2021. State and local efforts to balance budgets amid such a large revenue shortfall can stall economic recovery as governments lay off employees, cut services, and raise taxes. Local public banks have the potential to cushion this hit by increasing lending to

local and state governments. Given that public banks do not need to satisfy investors or cover high employee salaries, they can generally afford to charge lower interest rates. Public banks can also counter revenue shortfalls through the methods discussed above, including by fostering the overall financial health of the community and keeping loan profits within the community.

New urgency in the public banking movement

These concerns – along with some of the successes in North Dakota – have contributed to growing urgency and momentum around the public banking movement, which had already gained significant traction in recent years.

Public banking in the U.S. is not a new idea – early banks in the U.S. were sometimes owned partially or entirely by states, like in Vermont, and the Bank of North Dakota just celebrated its 100th anniversary last year. Since the 2008 crisis, the idea has gained new attention and momentum – American Samoa established a public bank in 2018; California passed legislation in 2019 providing municipalities the authority to establish public banks; the governor of New Jersey signed an executive order in 2019 creating a public bank implementation board; and 17 states and 12 municipalities, as well as Washington, D.C., had taken official steps to explore public banking by the end of 2019, according to the Public Banking Institute.

Now, the COVID-19 economic crisis is adding urgency to the movement. In New York, Massachusetts, and elsewhere, the economic downturn and the faulty response of big banks have galvanized efforts to enact public banking legislation that was already on the table. In California, legislators have introduced a new bill that would establish a state bank to help with recovery from the economic downturn.

California already has an infrastructure and economic development bank, IBank, that was created in 1994. The bill would expand IBank's lending authority, move 10 percent of the state's Pooled Money Investment Account into the IBank's loan fund, and convert the IBank into a depository institution, allowing it to leverage capital and engage in money creation. At the national level, a handful of U.S. Representatives have also pushed Congress to include a public banking option for state and local governments as part of COVID-19 relief packages.

There are still many challenges of public banking, and it won't be a quick fix to the current economic downturn. Many worry about the significant short-term costs of establishing a public bank, as well as public banks' susceptibility to political influence. The idea also faces steep opposition from some portions of the banking industry. Despite these challenges, public banking has the potential to increase accountability and provide governments with the ability to respond more nimbly to economic downturns – needs that have become particularly stark amid a global pandemic.

Public Banking

The public banking movement has gained significant momentum in recent years, with groups across the country looking into the viability of government-owned banks for their communities. From a "pot bank" in Los Angeles to a "public infrastructure bank" in Massachusetts, proponents of public banking view it as a way to address community needs and better leverage taxpayer funds to benefit the public.

The idea of public banking in the U.S. isn't a new one – the state-owned Bank of North Dakota has been operating for 100

years, gaining widespread bipartisan support despite initial political opposition. And early banks in the U.S. were sometimes owned partially or entirely by states, like in Vermont. But the idea has gained new momentum in the years since the 2008 financial crisis. According to the Public Banking Institute, 15 states and 11 municipalities are taking official steps to explore public banking, and more than 50 organizations are promoting public banks.

The public banking movement is not without its critics, however. In 2011, the Federal Reserve Bank of Boston produced a feasibility report advising against the idea, and members of the banking industry have mounted opposition to the idea in New Mexico and elsewhere. Some of the greatest challenges public banks face include high up-front costs, risks of corruption, and the overall difficulty of integrating a new institution into the banking industry.

This article will provide an overview of public banking, including a discussion of the Bank of North Dakota and the growing public banking movement nationwide.

What is a public bank?

Put simply, a public bank is a financial institution that is owned by the government and funded by public revenues. It has many characteristics similar to commercial banks but is run by the state, city, or other government entity and is beholden to the public rather than shareholders.

Understanding the structure of public banks therefore requires some discussion of the current design of commercial banking.

Commercial banks have three main functions that are important for this explanation: money creation, revenue production, and credit allocation.[1]

Money creation

Commercial banks create money through the joint use of loans and deposit accounts. (For more detail, see Roundtable No. 1 on Banking and Money Creation.) When a bank lends $100 to a customer, the bank does not lend out $100 of its own reserves. Instead, it "creates" the $100 by simultaneously recording a $100 loan that the customer owes the bank and crediting the customer's deposit account with $100. The customer can then start using that $100 that didn't exist prior to the transaction, although it must eventually pay $100 back to the bank. The bank's balance sheet meanwhile remains in balance because both its assets (the loan) and its liabilities (the deposit account) increase the same amount.

Revenue production

Banks profit from this money creation system by charging interest on loans. If the loan in the example above has an interest rate of 10 percent annually, the customer then owes $10 in interest by the end of the first year of the loan, in addition to the $100 principal. This $10 becomes the bank's revenue.

An additional way commercial banks earn revenue is through interest from the Federal Reserve. Banks have accounts at the Federal Reserve that function similarly to individual deposit accounts. In 2008, banks started earning interest on these

accounts, providing another source of revenue.

Credit allocation

With the ability to create money and profit from that money creation, commercial banks are then able to decide where to allocate credit. If, say, the housing sector seems very profitable, banks can expand credit in that sector while declining to extend credit in a less lucrative area. They additionally decide who to loan to and how much interest to charge based on markers like income, employment history, repayment history, and credit score.

Banks are the only way money enters the economy other than government spending, so this ability to inject money in certain sectors affords banks the opportunity to significantly shape the economic landscape. And this power comes with a past and present of discriminatory lending practices, both by private banks and by government organizations.

How public banks fit in

Public banks would function similarly to commercial banks, but all of these powers would be vested in the public and their representatives instead of shareholders and executives. This means that money creation would be done by the public, the public would earn revenues from that money creation, and the public could decide how and when to allocate credit. The exact way this operates depends greatly on the design and mission of the particular bank, but some options include prioritizing low-interest student loans, small business development, or agriculture loans. The Bank of North Dakota offers one example

of these principles in practice.

The Bank of North Dakota

The Bank of North Dakota was established in 1919 in response to frustration among farmers about high interest rates from big banks. Its founding mission was to promote agriculture, commerce, and industry in North Dakota while being helpful to and assisting in the development of other financial institutions.

In keeping with that mission, BND provides most of its services in partnership with local banks and credit unions instead of working directly with individuals. The main way it does this is through participation loans, which are originated by local banks and credit unions and funded in part by BND. In terms of money creation, these participation loans resemble individual loans to the banks originating the loans – the originating bank has an account with BND, and BND both creates a loan on its balance sheet and credits the originating bank's account with the funding. The difference is that the individual borrower, not the originating bank, is responsible for paying the principal plus interest. The originating bank then distributes that payment to BND according to the terms of their participation agreement. About half of the bank's $4.6 billion loan portfolio in 2018 consisted of this type of loan. The remainder was comprised of state loans, residential mortgages, and student loans. Student loans are the only significant area in which the bank works directly with borrowers. The bank's residential mortgages are mostly purchased on the secondary market, allowing local banks to free up lending capacity without giving new business to competitors.

The bank also operates in some ways like a small central bank, providing coin and currency, clearing checks, holding deposit accounts for banks, and offering the ability to settle Federal Reserve activity through BND accounts. It also assists local banks with short-term liquidity needs and buys up loans from banks during financial downturns to help increase their capital ratios.

In terms of design, the bank has several interesting features that distinguish it from commercial banks. Firstly, all state funds and funds of all state penal, education, and industrial institutions must be deposited in BND under state law. Consequently, the majority of BND's deposits come from state taxes and fees, with the rest coming from corporate accounts, city and county governments, and residents. Additionally, in contrast to most commercial banks, BND is not a member of the Federal Deposit Insurance Corporation, instead guaranteeing all BND deposits with the full faith and credit of the State of North Dakota.

Many agree that BND played a positive role in stabilizing the state's economy through the Great Recession, but there is uncertainty about how large that role was, especially given the state's oil boom and strong agricultural sector. The bank's more quantifiable impacts include contributing to the state's general fund and supporting local banks and credit unions. Since its first transfer of $1,725 in 1945, BND has contributed more than $1 billion back to the state's general fund. In the past decade, its annual contribution has varied widely, from $2.8 million in 2011 to $186.9 million in 2017. For reference, the state's 2017-2019 two-year budget was $13.55 billion, with $4.3 billion of that coming from the general fund.

BND's support to smaller banks has meanwhile fostered a diverse local lending market, with nearly six times as many local financial institutions per person than the country overall. According to the Institute for Local Self-Reliance, banks and credit unions with less than $10 billion in assets accounted for only 29 percent of deposits nationally in 2014 – in North Dakota, they accounted for 83 percent of the market.

The growing public banking movement

States and municipalities around the country are realizing the potential benefits that public banking may provide. As of early 2020, fourteen states, as well as Washington, D.C., and multiple municipalities, had initiated studies, task forces, or ballot initiatives to explore public banking feasibility. Much of this momentum has developed from efforts led by community groups. Local organizations opposed to major Wall Street banks have partnered with government officials, unions, and local businesses to advocate for public banks that will prioritize economic development and funnel profits back into the community.

In New Mexico, for example, community-based groups began to pursue the idea of public banking in 2012. After determining that New Mexico's political climate was not yet receptive to a statewide public bank, activists centered their attention on municipal efforts in Santa Fe and Albuquerque. Although an initial Santa Fe report found that a public banking initiative would be feasible, a city task force later determined that Santa Fe's finances were not sufficient to establish a bank at the municipal level. Consequently, multiple groups have united efforts in the Alliance for Local Economic Prosperity to pursue public banking at the state level.

In California, activists successfully advanced legislation that will make it easier for municipalities to establish their own public banks. Signed into law in October 2019, Assembly Bill 857 gives municipalities the power to establish public banks and provides a framework for that process. In tandem with that legislation, major cities like San Francisco and Los Angeles have been examining the feasibility of municipal banks, and New York legislators started considering a similar proposal for their state.

In Massachusetts, meanwhile, public banking advocates have galvanized the movement around local concerns about infrastructure. The Mass Public Banking working group has advanced legislation that would establish a public bank tailored to offer infrastructure financing to Massachusetts municipalities. The idea is currently being studied in the Massachusetts Legislature.

New Mexico, California, and Massachusetts are a small sample of the states where public banking movements have been growing. Efforts to establish a public bank in the U.S. territory American Samoa succeeded in 2018, and more than fifty organizations around the country are working to promote public banking.

Rationales for public banking

The touted benefits of public banking are numerous, including everything from spurring economic development to funding public infrastructure projects. The specific impact of a public bank would depend greatly on its structure, its mission, and the community in which it exists. Some of the potential benefits public banking proposals have focused on

thus far include:

- Enhancing accountability: Given that a public bank is owned by the government and funded by public revenues, including taxpayer money, proponents of the system view it as a way to enhance accountability and transparency in banking.
- Lowering debt costs for local governments and funding public infrastructure projects: Because public banks are dedicated to serving the public instead of investors, they can charge lower interest rates on loans to state and local governments, making enough revenue to operate without the need to pay high salaries or investors.
- Funneling interest profits back into the community: In commercial banking, interest payments on loans go to banks' and shareholders' profits. In public banking, interest payments on loans similarly go toward bank profits, but these can then be funneled back into the community through appropriations to a state general fund or through community development programs. In 2018, BND had a net income of $160 million, with a return on equity of approximately 18.5 percent. For reference, JPMorgan Chase's return on equity was 11.9 percent at the end of 2018.
- Strengthening local banks: In line with the Bank of North Dakota model, new public banks could partner with local banks and credit unions to boost their lending capacity.
- Benefitting from Federal Reserve interest rates: In 2008, the Federal Reserve started paying interest to depository institutions on their reserves. A public bank can similarly earn interest on its reserves, using that interest to further benefit the public. BND, for example, earned $1.545 million on its reserves in 2018.
- Spurring economic development: Depending on its structure and the needs of the community, a public bank

can provide additional credit to the community through small business loans or other types of funding. The Bank of North Dakota, for example, uses its profits to fund "mission-driven loan programs," including interest buydowns and below-market-rate loans for economic development and infrastructure projects.
- Providing banking access to the cannabis industry: In states where it is legal to grow and sell marijuana, processors and retailers are still operating largely on a cash-only basis due to ongoing federal prohibition. Some are looking to public banks as a way to fill that banking need, although the federal government is also considering a bill that would allow banks to maintain accounts for state-approved cannabis businesses.
- Stabilizing the economy: Although many agree a public bank would not single-handedly save an economy, it may have the potential to cushion the blow by expanding credit at a time when the rest of the economy is contracting.
- Lowering interest rates on student loans or other lending: Public banks could additionally provide low-interest loans directly to individuals if the community identifies such a need. The Bank of North Dakota, for example, expanded its services in recent decades to include student loans. Its loans for North Dakota students for the start of the 2019-2020 school year have a fixed interest rate of 4.74 percent, higher than the federal undergraduate rate of 4.53 percent but lower than many private lenders. Its variable interest rate is meanwhile 3.93 percent but hovered around 2 percent from late 2009 until 2016. Although the bank still encourages students to utilize federal loans first, it offers a state alternative to private lending.

Public banking challenges

With its growing momentum, public banking has also attracted a host of critics. Many worry that starting a public bank will have significant short-term costs that may not be outweighed by any long-term gains. A Los Angeles inquiry into public banking costs described the ultimate price of a public bank as "exorbitant." San Francisco similarly found that public banking would be an uncertain investment regardless of design.

Outside of the initial costs, some critics are concerned about public banks' susceptibility to political influence. Without proper safeguards, loans could be given based on political clout rather than creditworthiness, fostering corruption and potentially destabilizing the banks.

The idea of public banking has also faced opposition from the banking industry. The president and CEO of the Bank of North Dakota has stressed that the bank is successful because it partners with North Dakota's financial institutions instead of acting as a competitor. But some activists have specifically rallied around the idea of public banking as an alternative to big banks, setting up a potentially steep political hurdle.

Despite these challenges, the problems that the public banking movement intends to solve, whether economic inequality or infrastructure investment, are not going away. If designed well, public banks could offer one way to address these concerns.

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[1] For a more thorough discussion of these functions, see

Morgan Ricks, *The Money Problem: Rethinking Financial Regulation* (2015) and Andrew Jackson & Ben Dyson, *Modernising Money: Why Our Monetary System is Broken and How it Can be Fixed* (2012).