Responses to *State Bank: Proposed Advantages and Responses*

The State Treasurer and the Vermont Bankers Association have circulated a paper in rebuttal to reasons why those of us who support the creation of a state bank feel it is a worthwhile endeavor. We have examined the aforementioned paper and are responding to some of the points presented in it.

We have categorized areas of concerns that opponents of a state bank have listed and I will give our responses to those general areas. Before I do that, however, I would like to point out that the legislation that has been proposed does not suddenly require all state funds to be deposited in a state bank. It calls for VEDA to be chartered as a bank and for 10% of the state's unrestricted funds to be deposited in that credit facility. Any increase in the amount of state funds which would be deposited would require legislative approval. Therefore, many of the objections raised by opponents are premature.

As many are aware, the proposal to create a state bank in Vermont is not a new one and those of us who are proponents of such an entity have listened to what others have said and downsized what we have proposed in response to objections which have been raised. We feel that the more limited proposal contained in S.204 would allow exploration of how a public credit facility with full banking powers could benefit Vermont without exposing all of our state funds to the risks perceived by those who are opposed to a state bank. *Exploring a Public Bank for Vermont* provides the basis for S.204

Many of the objections listed in the aforementioned paper are aimed at specific language in S.204. We agree with some of the objections raised, particularly language in the original bill that could allow the proposed VEDA bank to compete with community banks for deposits. As we all know, bills of this scope rarely make it through the legislative process unchanged and we feel confident that the objections that we share with opponents would be addressed in a final bill.

What would a state bank do differently than what we are already doing today?

In a nutshell a state bank could create new money. This is one of the functions that banks perform. When a bank creates a loan, it does not per se lend out the money that customers deposit in the bank. Through fractional reserve lending it creates new money that it lends out. Of course, the amount of new money that banks can create this way is limited by rules regarding the amount of capitalization and other assets a bank has, but fractional reserve lending allows banks to create new money while still being able to fulfill withdrawal requests from depositors. Extending a banking license to VEDA and depositing $35 million in the bank would allow VEDA to create loans while still having the money on hand for the state to use to pay its bills. I know this sounds like a scam but fractional reserve lending is something that has been in use for centuries and most banks in existence today use it.

A state bank could buy down interest rates on loans to some businesses. This would be a win-win in that the community bank that makes the loans would get its full interest payment and the business would get the loan at much less of a cost.

Political Pressure on a state bank would be tremendous.

I am a bit perplexed that opponents are making this claim. I have no doubt that there would be political pressure on a state bank to help fund activities which may be extremely risky. I have no doubt that there is similar pressure currently placed on VEDA and other agencies of the state. The management of the proposed bank described in S.204 is the current voting members of VEDA. The membership of the Advisory Committee includes the State Treasurer and the CEO of VEDA. Are the opponents of extending full banking powers to VEDA suggesting that we cannot trust the voting members of VEDA and the CEO of VEDA and State Treasurer to withstand political pressure? It seems to me that they have done a pretty good job of it so far and we would expect that they would continue to do so regardless of the circumstances which they found themselves in.

Backing a state bank with the full faith and credit of the state would lower the state's credit rating.

We hear this statement often but we do not hear any evidence to verify that it would actually happen. We do know that the Bank of North Dakota is backed by the full faith and credit of the state, yet North Dakota has the same fine credit rating that Vermont has. As noted, in particular, by the State Treasurer, the state currently has a "moral obligation" to rescue VEDA and the other V-agencies in the event that they get themselves into serious financial trouble. She considers "moral obligation" less than a full faith and credit obligation. We have to wonder if the ratings agencies see it that way and if a court of law would see it that way. As Cairn Cross said in his testimony in 2010, "However, one might argue that this moral obligation is really no different than an express guarantee of state bank deposits. Would the state truly allow VSAC, VEDA or VHFA to fail? If the answer is "no," then why not guarantee the deposits in a state bank? It is essentially the same thing."

The State Treasurer and the heads of the V-agencies have done an excellent job at managing finances in a prudent manner. We wholeheartedly commend them for this and expect that they would continue to do so and, as noted previously, they would have a prominent role to play in the management of the state bank that would be created by S.204. In light of that, we have to wonder if the ratings agencies would actually lower our credit rating because we established a public bank backed by the full faith and credit of the state. If they did, what would be their justification? We must keep in mind that some of the rating agencies' credibility has taken a hit for their role in the 2008 collapse and the number of lawsuits that have been filed in this country and internationally because of that role and I would hope that they understand any lowering of credit ratings would have to be backed by impeccable reasoning lest they be challenged or ignored.

Other public banks have failed

Yes they have. Many private banks have also failed. In 2008 the entire banking system failed. The only thing that saved it from collapse was the massive infusion of money from the US Treasury and the Federal Reserve. Even today, the system is being partially buttressed by the Federal Reserve buying up underwater assets from financial institutions to supply them with liquidity they would not otherwise have.

Banks, whether they are public or private institutions, fail primarily because they are poorly managed and/or they are engaging in unwise investing. We trust that with the management structure that S.204 establishes the bank it would create would not fall victim to the types of activities that cause bank failures.

Risks of the Status Quo

This is one area that is not mentioned by the opponents of a state bank. We feel it is a very important part of the discussion. I have written a brief paper about the risks of continuing to outsource many of our banking functions to large private institutions which I enclose below.

Risks of Continued Outsourcing of VT's Banking Business

Gary Murphy, VT Partnership Bank Coalition

There has been much discussion about the options that creating a state bank would present for creating better economic outcomes for Vermonters. There has also been discussion of the risks that creation of a state bank might present. What has not been discussed to any length is the potential risks of maintaining the status quo of Vermont outsourcing much of its banking business to large multinational banks.

There is widespread belief among respected economists, analysts, former Wall St. Traders and others that there will be another financial crash which will be as bad if not worse than the crash of 2008. In that crash, many, many banks, including the Systemically Important Financial Institutions failed. The only thing that kept them from collapsing was the massive infusion of funds from the Federal Reserve, the US Treasury and other governmental institutions. In the US and many other countries, this method of saving the banks is no longer an option. The method the Financial Stability Board has suggested for use in the failure of major banks is a bail-in. This would require the shareholders and unsecured creditors (which include depositors) to absorb the losses of a failed institution. The bail-in regimes codified in the Dodd-Frank Law and the 2013 Canadian Budget act are similar.

While it may seem that secured creditors would not have their deposits or other interests in the bank confiscated to bail-in the institution, this is by no means a certainty. There is no specific prohibition of using secured creditors funds for a bail-in. The biggest elephant in the room, however, is derivatives. There is no mention of how derivatives factor into the equation in the US or Canadian bail-in regimes. Bankruptcy law in the US gives super-priority to derivatives which means counter-parties get to step in and take their money before the bankruptcy court even start bankruptcy hearings. If they get to do this in the bail-in regimes, in many cases, there will be no money left for secured, unsecured or any other kind of creditor to claim. TD Bank has derivative contracts which are 5 times its total assets.

There are some who seem confident that TD Bank will not fail. I believe that is an overly confident opinion. One of the immediate causes of the 2008 failures was the failure of institutions engaged in shadow banking which were interconnected with banks. Those interconnections, which could cause contagion, still exist today.

While I cannot say with any certainty when the next collapse will come or which institutions will fail and need to be bailed in, the risk is great enough that it makes sense to create an institution which will be available to handle our money if it needs to. A state bank would fill this need.

In the late 1980's the Bank of North Dakota was referred to as the Bank of No Deal because it primarily took in deposits and let them sit and grow. However, when it was needed to help get the Vision 2000 initiative off the ground, it was there. A VEDA bank could operate in the same manner at the outset.

Considering that it is possible, in the event of another failure of the financial system, that Vermont could find its funds gone and replaced with stock certificates in a new financial institution created out of the rubble of TD Bank, wouldn't it be prudent to create a state bank which we could move our money to if we needed to?