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STATE OF VERMONT
OFFICE OF THE STATE TREASURER

To: Senate Committee on Government Operations
From: State Treasurer Beth Pearce
Subject: Analysis of S.55 and S.204
Date: February 5, 2014

Thank you for this opportunity to submit written testimony. My comments relate to both S.55 and S.204 as requested by the Senate Government Operations Committee. S.55 is “An act relating to increasing efficiency in state government finance and lending operations.” This bill proposes to create a finance and lending efficiency task force to evaluate the costs and benefits of consolidating into one entity state finance and lending operations, investing, grant-making, and banking. While there are several possible configurations contemplated in this bill, it proposes to study consolidation into an “existing or new public institution” – i.e., a state bank concept. S.204 is a more recent proposal and is “An act relating to the establishment of the 10 Percent for Vermont Program.” It proposes to: (1) create statutorily the 10 Percent for Vermont Program within the Vermont Economic Development Authority for the purpose of establishing a banking system owned, controlled, and operated by the State of Vermont; (2) amend the statutory authority of the Vermont Economic Development Authority to permit it to engage in the business of banking; and (3) direct the State Treasurer to transfer 10 percent of the State government’s cash reserves to the 10 Percent for Vermont Program for initial funding (underline added).

Given the focus of consolidating a larger financial base into a financing entity in the first bill and that the latter bill is focused on a “state bank” model that also refers to initial funding, my comments relate both to the issues of a consolidated state bank concept and the 10% local investment objective.

First, in response to the request of the Committee, I have worked with representatives of the state instrumentalities, VHFA, VEDA, VMBB, and VSAC, to summarize some of the considerations relating to a state bank. We have identified state bank proponents’ stated advantages of a state bank and have provided responses and concerns (see attachment A). While this is a group effort, my office has summarized our findings with input from the various groups. VHFA, VEDA, VMBB, and VSAC can further clarify the attached overview specific to their understanding. My testimony covers many of these issues although I will stress elements from the focus of the State Treasurer’s Office.

I want to emphasize that I do support the local investment concept incorporated in S. 204. That said, I differ on significant portions of the proposed mechanics of achieving local investment through the creation of a state bank. The 10% of the state’s cash for local investment in Vermont is something I

support and I commend the bill's sponsors for raising this issue. While we may not agree on all points in the various studies, I believe our exercise in taking up these bills has raised some new issues and has certainly had an impact on my view of local investment.

The Treasurer's Office and its partners have been committed to this objective. Over the past year we have already made commitments that will get us to \$17 million in local investments from our treasury funds. That's roughly half way to the 10% objective. I am committed to getting us the rest of the way. But as fiduciary I want to address this in a way that is a win-win for Vermont. While I support the concept of 10%, will work to achieve it, and hope to even exceed it, there are portions of the bill that I believe need to be revised to make it a true win for Vermont. Without these changes, I believe there would be great risk—unnecessary risk—for Vermont taxpayers.

Some of the discussion of a state bank finds its roots in frustration with Wall Street. I share the public's anger with Wall Street and the resulting burdens the Great Recession has placed on everyday Vermonters. In the period leading up to the economic downturn, common sense risk management went by the wayside in favor of unrestrained profits and greed. It was and is unacceptable. But in denouncing this irresponsible risk management we should not flee to another model that could place undue risk on the state's finances. As a fiduciary of your tax dollars I am compelled to point out these risks, and do so with equal respect for the Vermont values of fairness and self-sufficiency and the promotion of local economies.

I would like to go back to our basic, core principles of cash management and banking. There are three key points we adhere to: safety, liquidity, and yield, in that order. We don't want to lose money and therefore safety; we want to have it available when we need it (liquidity) and, only after paying full attention to those two principles, and only then, do we seek to earn as high a yield as prudent.

Our other core financing principle is to maintain the state's high bond rating. As I have said many times before in testimony, our bond rating is like a personal credit rating. Having a good bond rating provides access to the financial markets at lower rates. It's good for the taxpayer and good for all Vermonters. Our bond rating in one way or another touches every citizen, every non-profit, every town and city, and every business in the state. Through the use of our moral obligation pledge with our partnering instrumentalities, our bond rating lowers the cost of financing for affordable housing, commercial economic development, municipal bonds, and student loans. We are the best rated state in New England, with the highest rating from two of the rating agencies and just a notch below with the third. We have worked very hard to maintain our rating and have the opportunity to improve it if we continue on a path of increased prudence. The 2014 legislative session is key to this effort.

So how do these core principles and our bond rating relate to the concept of a state bank? I believe the model generally presented in these discussions results in undue risk and puts pressure on the bond rating.

Safety

The first risk is safety. Under our current model the state's core operating funds are fully collateralized. We are provided, at the bank's cost, an irrevocable letter of credit with the Federal Home Loan Bank of Pittsburgh that provides security for all of our deposits with our bank of record, TD Bank. We also fully back our deposits with Peoples United Bank with collateral securities equal

or greater than our deposits. Your taxpayer dollars are safe. A state bank would not provide this security; losses would ultimately be borne by the taxpayer. This is an unnecessary risk.

Some may assert that a state bank cannot fail. This assertion is incorrect. I acknowledge that the State Bank of North Dakota (BND), which evolved under unique circumstances since its founding in 1919, is extremely well managed. I am very impressed with its current management. They are top notch. But to reach their present status, BND had to weather some unfavorable audits, and the fallout from unwise loans. I should also point out this may be the only state bank currently in existence but not the only such experiment.

In 1807, the Delaware General Assembly passed an act to establish the “Farmers’ Bank of the State of Delaware,” and in 1837, the General Assembly authorized the state’s purchase of 40% of the common stock of Farmers’ Bank. The Farmer’s Bank became the state’s exclusive depository and took on various revenue collection and accounting functions. The state’s ownership was later increased to 49.8% giving it effective control. While the Framers’ Bank was in operation for many years, the bank, according to one study, was “permeated by cronyism, politics, lack of oversight, and crisis management.”ⁱ In 1976, the bank became saddled with bad loans. This put the state’s uncollateralized deposits at risk. It escaped failure only after the FDIC bailed it out using extraordinary measures that had been used but five times since 1950.

The State of Delaware was also required to join in the bailout, tying up millions of dollars.ⁱⁱ The state’s purchase of a new class of preferred stock at Farmers’ Bank for \$20 million pushed its ownership up to 83.8% in exchange for the FDIC purchase of non-performing debt.ⁱⁱⁱ In the end, special legislation enacted by the General Assembly and signed by the Governor in 1978 permitted the expedited sale of the bank. Legislation authorizing the sale stated that “the sale of the state’s interest in the Bank will limit such financial jeopardy to the public.”^{iv} It was finally sold to Girard Bank of Philadelphia in 1981, which was subsequently acquired by Mellon Bank and is now Citizens Bank as a result of the Citizens/Mellon asset purchase.

Liquidity

Liquidity is an important consideration when analyzing the state bank concept. States need to have tax dollars on hand to pay the bills when they come due. Currently we average about \$350 million in funds. In 2012 the average was about \$357 million with approximately \$78 million in segregated or restricted funds and about \$279 million in unrestricted funds.

The state’s funds may appear sizeable, but it is also subject to significant variance over the course of the year. I have attached a chart that shows these trends. The state’s cash position will have many highs and lows beyond what is shown in the graph as we also have intra-month variances. This past December 9th, for instance, we had a cash position of \$394.2 million. But after making significant payments, including the Act 68 payments on December 10th, we dropped to \$170.9 million by December 14 with an unrestricted cash position of \$127 million. That’s about a \$223 million variance in just five days. Economic cycles in recent memory have led to very low points in unrestricted cash, including \$7.6 million on December 24, 2004; \$20.7 million on December 17, 2005; and \$19.9 million on April 30, 2009.

Models that predate the one contemplated in S.204 anticipate that Treasury funds would be deposited into a state bank or single entity irrespective of liquidity requirements. Since the funds would

presumably be used for illiquid investments in various proposed categories of economic development, public infrastructure, housing and educational loans, these would cause potential conflicts with our liquidity needs.

BND's portfolio includes a number of illiquid investments but their cash base supports this. The North Dakota treasury has receipts well in excess of operating needs. One informal number I hear is that they have, at any given time, cash on hand that is at least nine months of the cash needs for the entire fiscal year. It is clear they have more operating cash in their robust economy. We generally have one and a half month's cash at any given time, something we are keenly aware of when dealing with Washington's multiple threats and the recent government shutdown. The bottom line is that Vermont does not have the cash position to replicate the North Dakota model, even if all other risk and capitalization issues were remediated.

If we were to invest in illiquid investments, we might have to borrow funds at a cost to the taxpayer, or VEDA or another such instrumentality might be forced to sell them on the secondary market to raise funds needed for liquidity in tough economic times. Federal Reserve window borrowings are not intended to compensate for multi-year, long-term liquidity needs.

We may, in fact, have capacity to make local investments – we already have. But we have some limitations in both dollars and duration. While we were able to assist VHFA in doing energy retrofits and improvements in multifamily housing, and to lower the cost of that financing through the application of the state's moral obligation, we are not in a position to use state's operating cash to replace borrowing for purposes where 20 to 30 year terms are needed, something that they need to do through bonding.

Cost of Capitalization

The State of North Dakota initially capitalized BND with a \$2 million bond authorization in 1919. The New England Public Policy Center (NEPPC) of the Federal Reserve Bank of Boston estimated that in today's dollars BND's initial capitalization would be on the order of \$25 million. However, They also noted that U.S. gross domestic product was about 13 times higher in 2009 than in 1929, in constant dollars (earlier data not available), and were able to extrapolate a total capitalization of approximately \$325 million. They further scaled that up to \$3.6 billion for Massachusetts, the focus of their study, taking into account the larger size of the Massachusetts economy.^v The NEPPC report further noted that BND's initial capitalization proved to be inadequate. Several years after initial capitalization, BND withdrew funds from banks in the Western North Dakota area, contributing to the failure of 18 banks. An Oregon study advocating a state bank cites that \$42 million in Bank of North Dakota capitalization ultimately came from state bonds.

Any substantial state bank model would require capitalization and a review of existing literature authored by proponents of the state bank concept seems to indicate the issue of capitalization is still a sticking point in many such proposals. One proposal in Oregon suggested state bonding and appropriations from the legislature.^{vi} A Pennsylvania proposal suggested a "general obligation bond issue, or other dedicated state funds, such as 'rainy day' funds" and proceeds from a "controversial privatization and sale of state owned liquor stores."^{vii}

A Vermont fact sheet stated that Vermont has capital in many forms, including property, land, reserve funds, and other capital funds that could satisfy capitalization requirements. The authors

granted that while some restructuring might be necessary, “there should be no need to raise additional money from taxes to provide the capital for the bank.”^{viii} Relative to this latter assertion, I understand the concept but believe this to be a serious understatement of need. The Gund Institute's study seems to suggest that capitalization of the state bank could come from unrestricted assets of VEDA, VHFA, VMBB and VSAC – assets and reserves which these instrumentalities are already pledged to support through existing credit facilities, or are used for operations, new initiatives, or to support potential loan defaults. This is not a viable capitalization solution.

Capitalization would be expensive. Bonding would compete with our existing capital infrastructure needs and put downward pressures on our bond rating, or, in the alternative, require significant state appropriations, competing with other funding needs.

Misconception on Debt Payments

A recent document from one public bank advocate states that Vermont “sends roughly \$80 million per year to out of state financial institutions in interest costs and administrative fees. This money stays out of state.”^{ix} Treasurer’s Office debt payments to investors are in that approximate range, but in fact, many of those dollars go to Vermonters.

Vermonters buy our bonds and both the VMBB and the Treasurer’s Office have expanded their use of retail or “citizen bonds” providing Vermonters the opportunity to invest in Vermont. The Treasurer recently sold just under \$25M in bonds to Vermonters and approximately 80% of VMBB financings are sold to Vermont investors. Other instrumentalities have significant local investment. We hope to do even more with local investors. Further, when we sell bonds to investors outside of Vermont, capital actually surges into the state and then trickles back out as principal and interest are repaid. Replacing this outside capital with the state’s operating cash would actually represent a loss of state financing resources.

Purpose: To fill State Revenue Gaps or to serve as an Economic Development Tool?

Is the purpose of a state bank to generate revenue to the state or to act as an economic development tool? This is a question that has yet to be fully answered. When surveying material supporting the state bank concept, there are frequent references to the fact that it could generate revenues for the state. But in the history of BND there has been significant debate as to the extent its capital contributions to the state have impacted its mission.

BND is overseen by a state body called the state Industrial Commission. In 1999, the state Industrial Commission, over the objections of then-Governor Ed Schafer, ordered BND to resist the Governor’s proposal to spend as much as \$83 million in bank revenues during the next two years, citing the Governor’s budget recommendations as harmful to the bank's ability to promote North Dakota's economic growth. Assessing the situation, the Attorney General, a member of the state Industrial Commission, made the following observation: "I think that it's not healthy for the bank, and I think it limits our ability to be flexible in what might be difficult times ahead.”^x

In states such as Vermont, there is an understanding between the state and state instrumentalities such as VEDA, VHFA, VMBB and VSAC that provide services addressing the state’s economic and social needs and other state operations. Funds are retained and kept focused on their respective state missions. The political tug of war between capital needs and general budgetary needs is eliminated.

It took many years for BND to generate a profit and profitability has been uneven over the years. BND was and is subject to credit and market cycles (e.g., BND suffered during the 1980s agricultural bust, but is benefiting during the current oil boom). What has changed its recent situation is oil. As noted by Standard & Poor's, "since 2008, oil has boosted the state's growth and is largely responsible for the state's extraordinary low unemployment rate."^{xi} S&P further notes that the state routinely "pays a large appropriation to the state's general fund, which limits capital generation." Sizeable oil revenues have halted this practice as the bank has not been required to make payments in 2010, 2011 and 2012.

These observations raise the following question: If Vermont established a state bank, would there be pressure to claim short term-gains at the bank for revenue generation at the expense of long-term economic development?

BND's History Demonstrates it is Not Immune to Politics

As discussed above, BND's board of directors is the Industrial Commission, which is composed of, amongst others, the North Dakota governor, agriculture commissioner and attorney general. While I am impressed with its current management, BND struggled as it developed alongside changing political landscapes. In 1985 BND was criticized by an independent audit firm (then Touche Ross and Co.) for making loans against the advice of its top management and for inadequate loan documentation. The bank CEO at the time was quoted in news articles as saying that due to "political reasons" the bank got involved with "some loans that we probably wished we wouldn't have."^{xii} According to reports, auditors also "criticized BND for not having any long-range plans or any measure of departmental performance."^{xiii} In the mid-1990s there was significant discussion about questioned loans.

Political or external pressures to reap success in certain investments could take precedence over a state bank's long-term view and fiduciary responsibilities. The state might also be pressured to get projects off the ground by charging less for loans than the market rates. The State Treasurer is bound by the prudent investor provisions in state statute.

S.204 contemplates an advisory group to advise the Treasurer on possible investments and that input is welcomed. The proposed group is consistent with the ad-hoc local investment group process we have had in place since November 2012. But I wish to emphasize that any such body must be advisory and should not otherwise direct the Treasurer to make investments he/she does not consider prudent or advisable. Some reporting mechanism to the General Assembly on progress on local investments is recommended, but again, the Treasurer must have the freedom to conduct his/her statutory responsibilities.

The Bottom Line is our Bond Rating

While the Gund report describes the concerns about impact on our bond rating as unfounded (see pg. 19), I disagree. A state bank would represent a significant stretch to our full faith and credit and moral obligation. The Delaware experience should also cause concern. I asked our state's financial advisory firm, Public Resource Advisory Group (PRAG), to assess S.55 and S.204 and to provide comments as they relate to the state's risk and credit issues. Their memo finds that "The State of Vermont will continue to need to access the capital market for its infrastructure needs. Adding additional debt and financial obligations associated with the funding of a state bank, guarantee of

deposits, issuing new State debt to capitalize the bank and taking ultimate responsibility for covering riskier loans could make the State less credit worthy in the eyes of the rating agencies or investors.”^{xiv} To me this is an unwarranted risk since I believe we can achieve the same goals of local investment by employing pathways that use some elements of the S.204 model.

The Treasurer’s Recommendations

I support the concept of 10% for Vermont. I am aware that the House Committee on Commerce and Economic Development has introduced H. 737, which proposes to establish an interim committee to study existing gaps in capital availability throughout Vermont’s economy and suggest strategies to make capital more accessible.

I see S. 204 as having several components. First, it proposes an advisory committee to assist the Treasurer in identifying local investment opportunities. I would support the creation of a 10 Percent for Vermont Program Advisory Committee. I would view this as advantageous if structured not to conflict with my statutory and fiduciary obligations. I also believe, to the extent it dovetails with the proposed capital gaps study, it will provide a meaningful context to evaluate potential local investments.

Second, it establishes VEDA as an authority to make local investment. I believe we can do this through VEDA and our other partners, including VSAC and VHFA, without creating a state bank. Using the framework of H.395/Act 87, we have been successful in authorizing the Treasurer to provide credit facilities to VEDA and VHFA to facilitate local investment in energy. We can do this in other sectors if the Treasurer is afforded the flexibility to match investments to safety and liquidity needs, balancing short and potentially intermediate investment maturities to obtain the desired results. We won’t be able to meet all needs but we have a structure to support these instrumentalities in their missions.

What I do not recommend is expanding VEDA’s authority to accept deposits from municipalities or other entities, or to engage in banking operations for which it does not have any efficient economies of scale, for which it has no experience, and for which existing, cost-effective mechanism are available in the private sector.

I would also have concerns about placing a “full faith and credit” blanket on these investments. Indeed, one of the tenets of the \$17 million local investment authority granted by Act 87 is that we elicit a commitment from the entity utilizing the Treasury cash facility to repay the fund in full. We complete due diligence on each extension of credit, providing a safeguard to the taxpayer. Extending our full faith and credit would be counterproductive. We would be asking the instrumentality or other borrowing entity to guarantee repayment to the Treasury while at the same time offering to “pay up” with treasury dollars if it were to fail. It also obligates the state for transactions that have not had vetting through the appropriations process. Any such arrangement would limit the borrowing entity’s skin in the game.

We do support debt issuance by state instrumentalities on a case by case basis through moral obligation. In the case of VHFA, VSAC and VEDA, the general Assembly provides ceilings on our extension of moral obligation support, but the Treasurer has final approval on application of moral obligation to the specific financing transaction, having conducted stress tests, cash flow analysis and

other steps to assess the viability of the transactions. This should not be supplanted with a blanket full faith and credit.

Third, it establishes a 10% local investment threshold. I am supportive for this level of local investment, and more where feasible provided it will need to be tied to our unique investment portfolio parameters, including maturity length, but it is doable with our partners. We can identify options with the advisory committee, contingent upon treasurer due diligence and approval.

To conclude, I think it is fair to say that a capital gaps process and local investment initiative should include a component to review our current relationship with and amongst our state instrumentalities, the Treasurer's Office, and the private banking and financing institutions to identify additional cost efficiencies. In these times when cash is tight, we have an obligation to the taxpayer to find creative ways to stretch those dollars, and I agree with the general directions outlined in S.55 and S.204. I would like to work with the Committee to provide language that fits our mutual needs.

In summary, I support the objectives of S.204 but believe we can achieve them through other mechanisms. But we also need to recognize there are limits to the state's ability to finance investments with due care and prudence. No statutory changes should adversely alter our duty of prudence on behalf of the taxpayer.

ⁱ Boyer and Ratledge (2013), *Pivotal Policies in Delaware*.

ⁱⁱ See Voesar and McFadyen's (1983) *FDIC: The First Fifty Years- A History of the FDIC 1933-1983*; Boyer (2000), *Governing Delaware: Policy Problems in the First State*; Boyer and Ratledge (2013), *Pivotal Policies in Delaware*; Swayze and Schiltz (2013), Delaware Bankers Association, *State-Owned Banks*, Spring, 9:2, 10-16.

ⁱⁱⁱ Swayze and Schiltz (2013), Delaware Bankers Association, *State-Owned Banks*, Spring, 9:2, p. 15.

^{iv} See 63 Del. Laws, C. 186 (formerly House Bill 480, 1981).

^v Kodrzycki and Elmatad (2011), NEPPC, *The Bank of North Dakota: A Model for Massachusetts and Other States*, Research Report 11-2, p. 19.

^{vi} Oregonians for a State Bank, "Oregon State Bank: Putting Our Money to Work For Us," n.d.

^{vii} Pennsylvania Public Banking Project, "FAQs: A Pennsylvania Partnership Bank , Key Questions and Answers," n.d.

^{viii} Public Banking Institute, "Frequently Asked Questions about Public Banks," n.d.

^{ix} See "Vermont Partnership Bank" found at vtpublicbank.com

^x Dale Wetzel (1999), Associated Press, *Shaefer Gets Setback on Plans for Bank Profits*, January 17. For more, see Wetzel's article in the Associated Press (1998) *Shaefer Budget Counts on Continued Bank of North Dakota Profits*, December.

^{xi} Standard and Poor's (2013), *Ratings Direct: The Bank of North Dakota*, July. 2013

^{xii} The American Banker (1985) *Auditors Criticize Dakota State Bank*, August 8.

^{xiii} *Ibid.*

^{xiv} See the February 5, 2014 *State Bank Proposal* memorandum from Public Resources Advisory Group to the State Treasurer.

ATTACHMENT A

STATE BANK PROPOSED ADVANTAGES AND RESPONSES

In response to the request of the Senate Government Operations Committee, we have identified proponent stated advantages of a state bank and have provided responses and concerns.

Stated Advantage:

- Create new jobs and spur economic growth.

Response/Concern:

- Existing economic development lenders already assist in creating jobs.
 - Our economic development lenders make loans and take a second position, which would not be prudent with state funds.
 - VEDA currently accepts a higher risk position with their loans than the Bank of North Dakota (BND).
 - What would a state bank do differently than what we are already doing today?
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Stated Advantage:

- Generate new revenues for state directly.

Response/Concern:

- Is the purpose of a state bank to generate revenue to the state or to act as an economic development tool?
 - In states such as Vermont, there is a clear dividing line between state instrumentalities such as VEDA, VHFA, VMBB and VSAC that provide services addressing economic and social needs. These are not used to augment state revenues but funds are retained and kept focused on the mission. The political tug of war between capital needs and budget is eliminated.
 - It took many years for BND to generate a profit.
 - Franchise tax collections will be lower due to a state bank capturing state and municipal deposits.
 - Debt is a financing mechanism, not a revenue source.
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Stated Advantage:

- The Gund Institute's study seems to suggest that capitalization of the state bank could come from unrestricted assets of VEDA, VHFA, VMBB and VSAC.

Response/Concern:

- VEDA, VHFA, VMBB and VSAC assets and reserves are already pledged to support existing credit facilities, or are used for operations, new initiatives, or to support potential loan defaults.
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Stated Advantage:

- Taking state funds and investing them locally.
- BND does not imperil state funds or tax money but is self-funding and self-sustaining.

Response/Concern:

- The mission of all identified instrumentalities is local investment for Vermonters.
- It is not financially prudent to fund long-term lending with short-term capital.
- State funds deposited within TD Bank are protected by an irrevocable letter of credit from the Federal Home Loan Bank of Pittsburgh.

ATTACHMENT A

- Any losses associated with a state bank's portfolio ultimately would be borne by the taxpayers of Vermont.
- If bonds are issued to finance the state bank, they will be Private Activity Bonds and therefore will not be tax exempt, resulting in higher interest rates.
- Today we can invest state funds without creating a public bank.
- The Treasurer recently sold \$25M in bonds to Vermonters and approximately 80% of VMBB financing are sold to Vermont investors. Other instrumentalities have significant local investment.
- If funds are deposited in a state bank, there will be a need for an investment vehicle for monies that cannot be loaned out immediately.

Stated Advantage:

- No bank fees, state bank would earn interest on loans made.

Response/Concern:

- State may earn below market interest rates on deposits.
- It would cost the state considerably more to replicate the banking services currently being offered by the bank of record for the state. We do not currently have staff or operations in place, and would need to create services from scratch.
- The state bank would not be able to meet the daylight overdraft needs of the state.
- The state would have to borrow funds from some source to pay its bills when cash became tight. There would be borrowing costs associated with such transactions.

Stated Advantage:

- Lower debt costs for local governments.

Response/Concern:

- BND does not provide bond financing to North Dakota's municipalities. A separate state instrumentality, modeled after VMBB, does so.
- Municipal governments and school districts will experience a higher cost of funds if the bond rating of the state is downgraded.
- Municipal governments already enjoy an economy of scale with VMBB at very low costs.
- VMBB already receives all of the "state advantages" that a state bank would receive.
- Short-term borrowing needs of municipalities after Tropical Storm Irene were met by the banks in Vermont.
- Aggregating municipal deposits in a state bank will have a negative impact on other banking services provided to municipalities.
- Aggregating municipal deposits will reduce the amount of deposits banks have to lend in their local communities.

Stated Advantage:

- Strengthen local banks and even out credit cycles, and preserve real competition in local credit markets.
- Banks in North Dakota thrive because of BND.

Response/Concern:

- Vermont has been fortunate to not have a bank failure in many decades.
- Unit banking laws in North Dakota forced a one town one bank approach whereas Vermont has a strong branching environment.

ATTACHMENT A

- Banks in North Dakota found themselves in need of correspondent banking services. Banks in Vermont have no such needs due to partnerships with organizations like the Federal Reserve and the Home Loan Bank System.
- VEDA, VHFA and VMBB already work closely and partner with the banks in Vermont.
- BND was and is subject to credit and market cycles – i.e. suffered during the 1980s agricultural bust, but is benefiting during the current oil boom.

Stated Advantage:

- Build up small businesses.

Response/Concern:

- Currently banks in Vermont have funds to lend.
- The challenge is finding bankable projects.
- Demand is low because many businesses are still concerned about the economy.
- If a state bank were to lend to businesses that are currently not bankable, then the state would be holding onto a higher risk portfolio.
- The issue is matching small business needs with the right sources of capital.
- Capital financing needs have to be matched with the proper source of capital.

Stated Advantage:

- A state-owned bank on the BND model would not compete with community banks.

Response/Concern:

- As contemplated in S.204, a state bank making direct loans to individuals and businesses would be in competition with banks.
- A state bank providing banking services to the state is in direct competition with banks.
- Short-term needs of VEDA, VHFA, VMBB and VSAC are already being met by local and regional banks doing business in Vermont.
- VMBB is prohibited in statute from competing with banks per legislative intent.

Stated Advantage:

- BND does not compete for loans or for commercial deposits.

Response/Concern:

- Public deposits are not defined, so if they include municipal deposits the state bank would be in competition with banks.
- BND does take limited private deposits.

Stated Advantage:

- Although BND is a member of the Federal Reserve System, it is insured by the state rather than by the FDIC.

Response/Concern:

- Extending the state's full faith and credit or moral obligation to support the state bank will hurt the state's and VMBB's bond ratings.
- State funds deposited within TD Bank are protected by an irrevocable letter of credit from the Federal Home Loan Bank of Pittsburgh.
- Any losses associated with a state bank's portfolio would ultimately be borne by the taxpayers of Vermont.

ATTACHMENT A

Stated Advantage:

- Advocates for a Vermont state bank state that BND is run by bankers, not politicians bent on funding their favorite development projects or bestowing political favors.

Response/Concern:

- BND is run by the industrial commission, which includes the governor, commissioner of agriculture, and the attorney general.
- The current system of state instrumentalities, VEDA, VHFA, VMBB and VSAC, are run by individuals with financial expertise and boards with members selected for their experience and expertise.
- The Treasurer's office is concerned about losing independence, and about the ability to utilize the prudent investor rules incorporated in statute.
- There are concerns the state bank would circumvent the due diligence of existing boards when reviewing projects.
- Each existing organization has a statutory standard of care they must adhere to; the state bank proposal does not.

Stated Advantage:

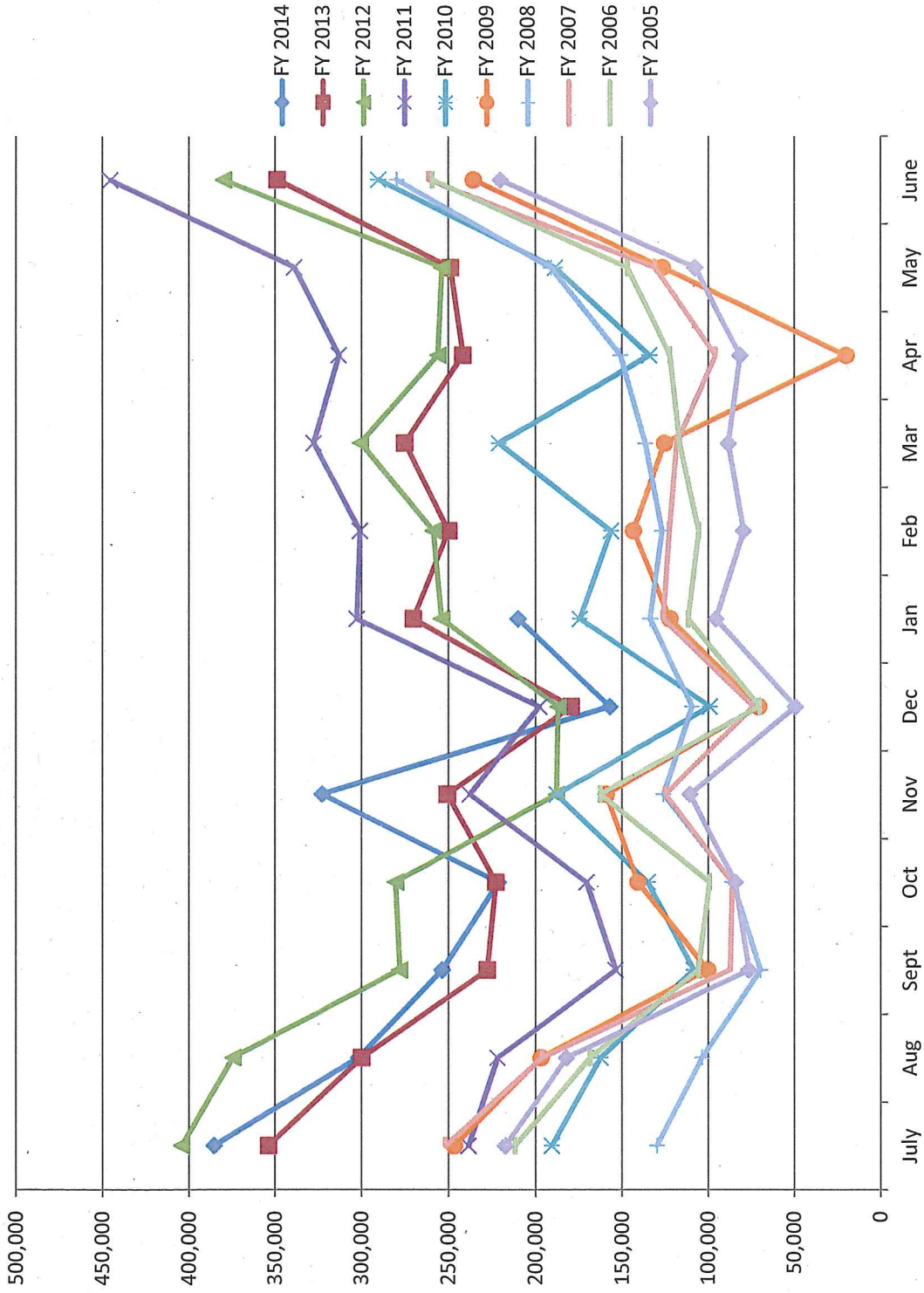
- Partnering with BND allows community banks to fund local projects in which Wall Street is not interested, leveraging municipal government funds that would otherwise not be available for loans.

Response/Concern:

- Banks in Vermont currently fund municipal projects at favorable rates.
 - Banks work closely with VMBB to meet long-term municipal needs.
 - There will still be a need to go to the capital markets as evidenced in North Dakota.
 - BND does not offer all the products necessary for long-term financing.
 - Transaction size is a challenge that will not be solved by a state bank.
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State of Vermont
 Unrestricted Cash Balance by Month in Thousands
 For the Fiscal Years 2005 through 2014

Unrestricted Cash - Month End Balance



PUBLIC RESOURCES ADVISORY GROUP

MEMORANDUM TO: Beth Pearce, Vermont State Treasurer

FROM: Public Resources Advisory Group

SUBJECT: State Bank Proposal

DATE: February 5, 2014

The purpose of this memo is to provide our views on proposals by members of the Vermont General Assembly to establish a state bank to be capitalized by the State of Vermont (the “State”) and structured similar to the Bank of North Dakota (“BND”). As you know, Public Resources Advisory Group (“PRAG”) is an independent financial advisory firm which represents over fifteen states and has been the financial advisor to the State of Vermont since 2011. Members of our firm have been involved with the credit analysis of state governments since the 1970’s.

In terms of background, our understanding is that the BND is currently the only state bank in existence in the United States. It was formed in 1919 primarily to provide capital for agricultural purposes as a result of limited commercial bank interest in providing agricultural loans. All state government and state institution funds are required to be deposited with the BND and are its primary source of capital. The BND does not pay federal or state taxes and its deposits are not guaranteed by the FDIC, but are guaranteed by the full faith and credit of the state. The BND makes loans consisting of student loans, and loans for commercial enterprises, residents of the state, farms and state institutions. Looking at the BND today, it has been active making a market for secondary loans in order to facilitate commercial borrowing and in making new loans for economic development, infrastructure and other loans that at times commercial banks in the state were not willing to make. In recent years the BND has generated significant returns for the state, reportedly over \$300 million over the past 10-years.

Other than the BND, the last state bank that existed was Farmers Bank, owned in part by the State of Delaware. During the mid-1970s the economic conditions created financial stress for both the State of Delaware and Farmers Bank. Farmers Bank at that time was taking additional risks and bank personnel were involved with corrupt and fraudulent activities. The State of Delaware in 1976 was forced to bail Farmers Bank out through the purchase of \$20 million in new stock and in 1978 the state sold off the second to last state bank losing most of its investment in the process.

Officials of the State of Vermont ultimately have the responsibility of determining if the existing institutions (VSAC, VEDA, VHFA, Bond Bank, etc.) and respective funding mechanisms are meeting the needs of the State in a manner consistent with the State’s risk tolerance. However, we feel that that the establishment of a state bank introduces additional risk to the State, which may in the future negatively affect the State’s credit rating and could increase the State’s cost of borrowing.



The State of Vermont and the State of North Dakota are very different in nature, consequently what works in one state may not in the other. For instance, the State of Vermont has a much higher debt and liability burden than the State of North Dakota. With a similar population size, the State of Vermont has more than twice the amount of net tax supported debt and supports over \$1 billion in moral obligation debt (while North Dakota has no moral obligation debt). The State of North Dakota and the BND have also benefited from the abundant natural resources, such as the oil and gas extraction industry, which have contributed to increasing tax revenues and reduced North Dakota's need to issue additional debt. The State of Vermont will continue to need to access the capital market for its infrastructure needs. Adding additional debt and financial obligations associated with the funding of a state bank, guarantying deposits, and taking ultimate responsibility for covering riskier loans could make the State less credit worthy in the eyes of the rating agencies and/or investors.

The financial fortunes of the state banks in North Dakota and Delaware and the sponsoring states have moved together. In the absence of fraud or mismanagement, serious financial stress typically occurs in times of economic difficulties. The requirement to maintain deposits at a state bank and to ultimately be responsible for maintaining the solvency of the bank may limit the State's financial flexibility in times when it needs it most.

The establishment of a state bank in Vermont may also introduce new political risks that could negatively affect the State:

- Risk that the pressure of generating short-term returns for the State would be done at the long-term risk of the bank (and the State),
- Pressure that the State bank pays less interest on deposits or charges less for loans than the market rates.
- Both the BND and Farmers Bank have experienced scandals in the last 40 years that have involved bank personnel and state officials which then affected the relative cost of borrowing for the respective state.

We appreciate the opportunity to provide advice to the State. Please do not hesitate to contact Tom Huestis at 610-565-5990 if you have any questions or need additional information. Thank you.