Testimony of Gary Murphy on S.55/S.204
February 25, 2014

I can appreciate the position of the state treasurer. She has a hard job. She has to make sure that the state is financially viable and that the state has the ability to meet its obligations and do the best it can in the short and long term. In her view, this means that we need to keep our bond rating to the highest level possible so we can have access to funding from a variety of sources. She feels that the creation of a state bank will hurt our bond rating and raise the cost of accessing outside funding. She obviously is more knowledgeable about what drives bond ratings than I am but North Dakota, which has a state bank, has the same credit rating as Vermont, which doesn't-yet so I am not certain that whether or not a state has a publicly owned bank is that much of a factor in setting bond ratings as other factors might be.

In the short term, even with the creation of a state bank as laid out in S.204, we will undoubtedly have to turn to outside sources for funding for necessary projects and, with interest rates as low as they are, the cost of bonding is low and that is a good source of funds at present. However, there is widespread feeling that interests rates will start to increase in the not too distant future and the bonding market will become a much less reliable source of funding.

The other thing that concerns me about bonding is that we employ firms such as Citigroup, JP Morgan, Morgan Stanley, Bank of New York and others to manage the bond offerings. These institutions have engaged in rigging Libor rates, commodity prices, interest rate swaps, and foreign exchange rates to name a few. Matt Tiabbi describes how the big banks rig interest rates that were paid to municipalities on municipal bonds in *The Scam Wall Street Learned from the Mafia.* While the circumstances described in the article are somewhat different than the way bonding is handled by the state of Vermont, given the fact that these banks are willing to rig everything they can to put more money in their own coffers, one has to wonder if they are somehow skimming money that should rightfully go into state coffers from these bond offerings.

My feeling and the feeling of others is that we should move as much as we possibly and prudently can into other methods of funding our future needs. Expanding VEDA into a bank and starting out by placing 10% of state unrestricted funds into this bank under the 10 percent for Vermont Program would be a good start. It would still leave the bulk of our funds in the current depositories we use but allow us to see what works and what doesn't work and expand the role of the state bank accordingly. While detractors of creating a state partnership bank contend that the Bank of North Dakota is just a minor player in that state's economic position today, it was instrumental in the Vision 2000 initiative which helped bring North Dakota's unemployment rate from the 6-7% range in the mid 1980's down to the 3-4% range by the mid 1990's. It has primarily stayed in that range for the last 20 years. This is not to say that we should recreate the BND here in VT. The BND is the only publicly owned state bank in the country so we have to look at what that entity has done for the ND and see whether and how we can apply those lessons here in VT.

In her 2/5 testimony, the State Treasurer alluded to public sector banking failures. There is always some risk that banks will fail regardless of whether they are publicly or privately owned. Indeed, in September of 2008, some, if not all, of the biggest privately owned banks in the country would have failed if it had not been for a large infusion of cash from the Federal Reserve and the US government. If a bank is well and prudently run, the chances of it failing are decreased greatly. In the case of a state bank, this means that all of us whether we are legislators, appointed officials or just citizens of the state would have a duty to ensure that the bank would not go off in detrimental directions. If we don't, then we reap what we sow.

Detractors are fond of pointing out the risks of a state bank. I do not deny that there are risks involved but there are also substantial risks that come along with allowing large privately owned banks to handle so much of our financial needs.

In general, over the last few years, we are seeing more and more evidence that the large banks are primarily concerned with putting money into their own coffers with little regard of the effects this has on the economic conditions under which most of us live. This attitude is showcased in an article that Emily Peyton alluded to in her testimony in which a former Wall St. trader describes his life as such and the greed that is rampant in that profession. He states:
"But in the end, it was actually my absurdly wealthy bosses who helped me see the limitations of unlimited wealth. I was in a meeting with one of them, and a few other traders, and they were talking about the new hedge-fund regulations. Most everyone on Wall Street thought they were a bad idea. "But isn't it better for the system as a whole?" I asked. The room went quiet, and my boss shot me a withering look. I remember his saying, "I don't have the brain capacity to think about the system as a whole. All I'm concerned with is how this affects our company.""

The risks enshrined in the financial system which caused the collapse in 2008 are still there just in different forms. Instead of the housing bubble, today we have the derivatives bubble. This thing is huge. It has been estimated at 20 times the entire Gross World Product. That is 20 times the value of all the goods and services produced in the entire world. There are many economists and other experts in the financial system (including several former Wall St. traders) who are convinced that this bubble will burst sometime in the coming years. Indeed, some are surprised it has not happened already. When this happens, they predict there will be severe, widespread problems in the banking industry and that many of the large banks will need massive infusion of liquidity to keep from failing and crumbling the global economy.

There is general consensus among governments and financial regulators that it would be politically unwise if not impossible to bail out the financial sector in the same manner as used in 2008 and 2009. They have come up with a plan for bail-ins whereby a Systemically Important Financial Institution (SIFI) which was rendered functionally insolvent would be bailed in by first by shareholders, then unsecured creditors and on down a line of priorities that are listed in the Dodd-Frank law. The Canadian bail-in regime is basically the same as the bail-in regime in the Dodd-Frank law and is laid out in the 2013 Canadian Budget. There is no specific guarantee in either regime that depositors funds would be excluded from bailing in distressed banks. The plan is to separate the assets of a failed institution from the liabilities and put these assets into a bridge company with the hope that some solvent institution would buy this bridge company. The shareholders and creditors of the failed bank would see their holdings converted to equity in the bridge company. While it does appear that secured creditors would be exempt from the bail-in regime, it is not an absolute certainty. A report on the Canadian bail-in regime by International Business Law Firm Fasken Martineau mentions secured instruments as simply a possible exemption from the bail-in regime.

The preferred method of resolving failed banks is through bankruptcy but the bail-in regimes recognize that there are Globally Systemic Financial Institutions which may be too big to be resolved through bankruptcy if they are failed or failing. TD Bank is not on the list of G-SIFIS or G-SIBs and therefore could be resolved through bankruptcy if distressed. In Bankruptcy and the bail-in regimes, derivatives have super-priority, meaning the counterparties get to the head of the line in claiming there money. TD Bank has $823.89 billion in total assets as of 10/31. In Q3/2013 it had 4.25 trillion in derivative contracts. If TD fails and the counterparties get their money out of it before even secured creditors do, there may be no money left for the secured creditors. In that case, the state of Vermont could find itself with equity in a financial institution created out of the rubble of TD Bank.

There are those who say that TD Bank will not fail. I hope they are right. Perhaps TD Bank will not, on its own, fail. But there is a distinct possibility that non bank financial institutions, such as asset management companies, which are not subject to the capital requirements that banks are, could fail and the interconnectedness between these companies and other financial institutions could cause contagion that might bring a host of banks down. If there is a failure of multiple banks, how successful would the OLA or bankruptcy courts be in dealing with them?

A report written for Gold Core, a group of international bullion dealers, acknowledges that there is a school of thought that believes the global financial system has been stabilized and another that believes many banks are still susceptible to insolvency and agrees with the second school. The report contains a list of “Considerations to protect your savings. One of the items on the list is “avoid banks with large derivative books”. I would say that TD bank falls into that category

I would not be surprised if some of you are thinking, who is this knucklehead and what does he know? That is a fair question. After all, there are a lot of people who have a lot more credentials than I who say that everything will be fine, that we have turned the corner and that there is nothing to worry about. There were a lot of people who have far more credentials than I who thought that the housing bubble would not burst. Among them were such luminaries as Alan Greenspan, Warren Buffet, President Bush and Ben

Bernanke. Although I don't get paid to do it, I engage in a lot of research and read many articles, papers reports and other materials about the financial sector. It seems to me that a bubble that is 20 times the GWP is not sustainable, just as the housing bubble was not sustainable, and that when the derivatives bubble bursts, it is not going to be pretty.

It is up to you who are involved in the legislative process to decide whether the risks involved in creating a state bank are greater than the risks of economic collapse caused by a burst derivatives bubble and the possibility of that collapse causing our money deposited in TD bank to disappear. In my view, it would be advisable to have the structure of a state bank in place into which we could deposit our monies where they would be much safer before a collapse happens.