TOM SGOUROS·15 Boston Neck Road·Wickford, RI·02852 USA·401-662-9668·tsgouros@gmail.com·www.sgouros.com

February 25, 2014

Chair Jeanette White and Members
Senate Government Operations Committee,
Montpelier, VT

Honorable Ms. White and committee members:

Thank you for the opportunity to appear before you today. I appear not as a banker, but as a longtime student of banking. I work freelance as a public policy consultant, offering advice and analysis about technical issues of public policy, such as budgeting, finance, and economics. I first wrote an analysis of a local banking market in 1991, after Rhode Island suffered the collapse of a private bank insurance scheme. Since then, I have done research and written proposals for bank projects in several different states. The city of Reading, Pennsylvania, is currently in the process of implementing a banking institution I designed for them. I recently wrote a book about banking, covering the nuts and bolts of finance, aimed for people who are dissatisfied with the current shape of the banking market.

I am here today to speak in favor of a proposal to expand the function of the Vermont Economic Development Agency and provide it with a new source of funds to loan to its customers. Last spring I had the pleasure of reviewing the conduct of that agency, and was pleased to discover the size and breadth of its loan portfolio. It seems, from my examination, to be a well-run agency, deserving of the trust you have placed in it.

I'd like to speak for a moment, not about the agency itself, but about why it exists. This agency exists because the private credit market here in Vermont was not working as advertised. In state after state, over the course of the last few decades, we have seen private credit facilities—banks and investment banks—pull back from supporting credit-worthy commercial borrowers in important industries, in favor of relatively simple and profitable real estate lending or securities market speculation. The result has been that perfectly viable businesses have been denied access to the credit they need to thrive. This is what economists call a market failure, and it is why agencies like VEDA exist in nearly every state and county in our country, along with every city of any size.

This is far from a new or unusual situation. Farmers who are listening now are probably aware that this country supports what is very nearly a parallel financial industry devoted exclusively to agricultural finance. The USDA, the Farm Service Agency, and a host of associated agencies, support a vast network of banks and other lenders whose job is to put farmers in touch with lenders who understand farming. That system exists because regular banks weren't providing what farmers needed. Dentists have similar access to specialized financing options through their professional association, as do some other medical specialties.

Bankers are not themselves entirely to blame for these market failures. Credit markets are complex and the incentives for the actors in it come from regulators as well as from the profit motive. Shortsighted regulations have done their share to push the banking market into the state it is in now.

The question before us all is what to do about it. To an extent, Vermont, along with all those other states, counties, and cities with agencies like VEDA have voted with their feet, and have established public credit facilities to take up the slack left by the private markets. My role here this afternoon is only to urge you to make your public lenders stronger by giving VEDA access to a relatively inexpensive source of funds that your state already has.

Across the country, our state and local governments control a vast amount of our collective wealth, well over half a trillion dollars. Even Vermont, a quite small state, has liquid assets of hundreds of millions of dollars at a time, and investments of a few billion beyond that. But with all that wealth on hand, Vermont is nothing more than a customer to the financial industry. Imagine for a moment that you controlled a fortune of $10 million. And further imagine that your accountant had locked all your money into long-term low-yield investments so that when you wanted to buy a new car you had to get a car loan at market rates. You'd fire that accountant, wouldn't you?

By making VEDA into the state's banker, you will give VEDA a source of low-cost funds it can lend, and you will give the state a little more clout in the local banking markets, as well as opening the door to a large number of other possibilities that can be of great benefit to the state's economy.

I understand that in order to forestall a bill like this last session, the Governor put a $10 million investment into VEDA. It seems to me curious to think that making a deposit into VEDA is a way to demonstrate that a bank isn't necessary. To me it demonstrates the opposite: that VEDA deserves the public's trust enough to merit accepting a deposit.

Banking, of course, carries some risk, and I am sure that questions about that risk are prominent in your minds as you consider this proposition. But there are well-known formulae for managing some kinds of banking risk, and well-known ways to avoid others. When you examine the entrails closely, you learn that almost all bank failures are due to managers choosing to ignore those formulae.

Take liquidity risk, for example. This is the risk that a bank wouldn't have cash the state needs when it needs it. From a banker's perspective, the good thing about a state's finances is that they ebb and flow in a highly predictable manner. Each source of revenue has its cycle and these can be charted with great accuracy. I understand that at present the state has most of its liquid assets in a bank. This is not the normal practice, but is a result of the low interest rates available at the moment.

In other times, the state would have been moving money in and out of higher-yield investments, with someone in the treasurer's office predicting demand for cash and determining the appropriate investment terms to provide that cash at the right time. Today, with all its assets in a bank, there is still someone doing that exact same job, but that someone is inside the bank, rather than inside the treasurer's office.

How does that bank insure against liquidity risk? The first line of defense is for that someone managing the investments to be good at their job, and for a system of checks and double-checks to be established to make sure the bank cannot be caught short. Beyond that, there are several layers of defense, ranging from short-term interbank lending, to loan-loss reserves, to short-term liquidity facilities like the Fed, or the FHLB. Regular examination by external regulators plays an important part in maintaining the defenses, too. Many states, including Vermont, require a bank to put up collateral before accepting public deposits, and that provides yet another line of defense, though I'm not sure that would be necessary for a VEDA bank. Ultimately, though, what will stand behind a VEDA bank is what currently stands behind VEDA: the faith and credit of the state of Vermont.

When VEDA goes out to the bond market to sell its bonds, investors are supposed to evaluate those bonds on the strength of VEDA. But they are really evaluating them on the strength of the state of Vermont, something you will discover if ever you are tempted to default on them, as my state is currently considering doing. The collective wealth of your state—your well-run, relatively prosperous state—is as good a guarantee as exists anywhere in the world today.

Finally, I am sure the committee has heard about the Bank of North Dakota, currently the nation's only state-owned bank. When you're looking into the operation of that bank and the good things that it has done for its state, it sometimes seems the lesson is that you should go back in time 90 years and found a bank. BND was originally envisioned as little more than a credit facility for a state-owned grain silo, but had grown into something much more substantial over the subsequent decades. That state owes a substantial share of its current prosperity to legislators of almost a century ago who could not foresee what the bank would become but were certain that asserting democratic control over some small piece of the financial system would be in the best interests of their state. They were right, and I would urge you to consider their example.

Yours sincerely,

Tom Sgouros