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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.