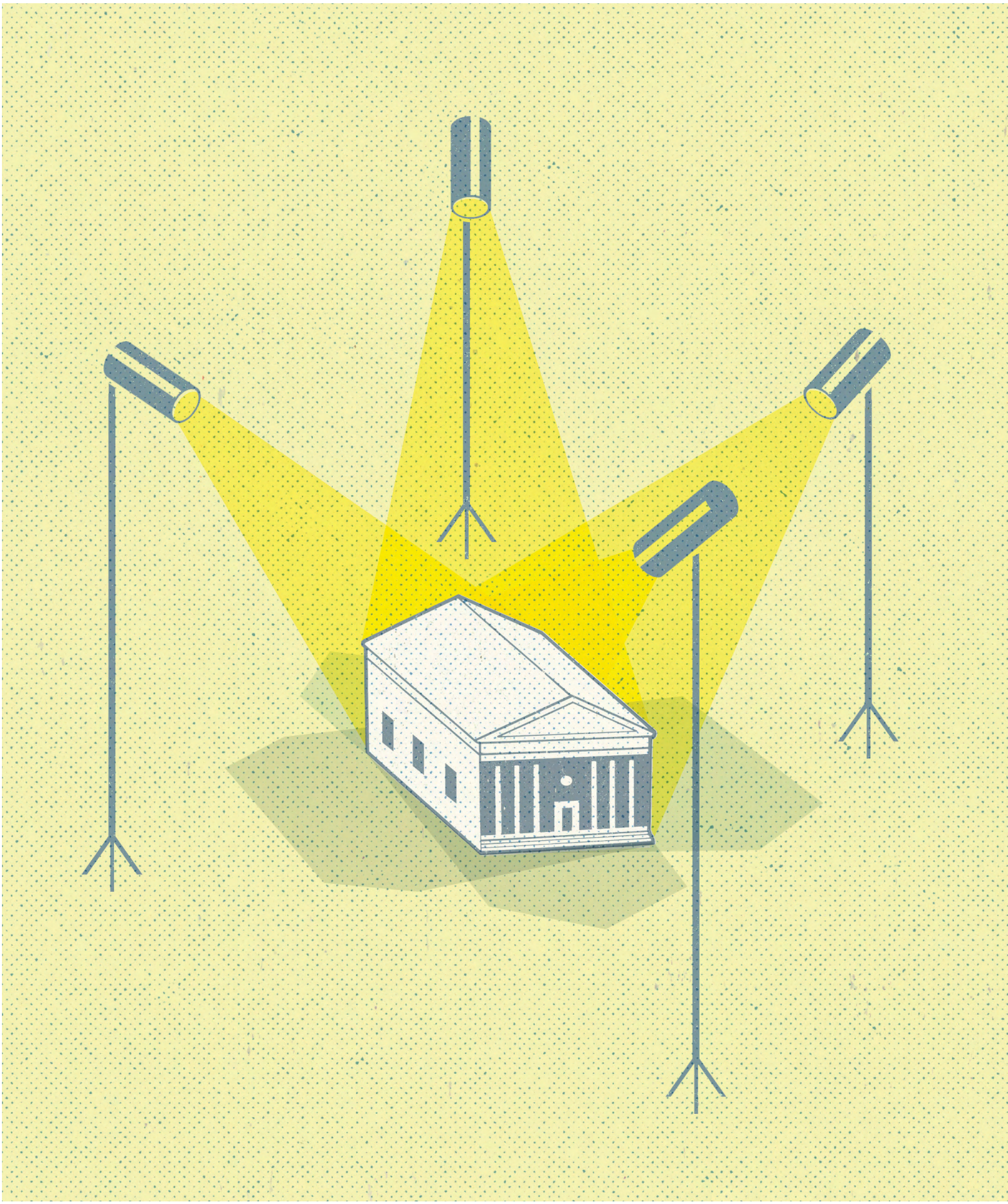


Is a State Bank a Useful Economic Development Tool?

BY ROBERT S. CHIRINKO

Healthy banks and a robust economy tend to go hand in hand. Banks perform three basic tasks—creating money, facilitating transactions, and allocating credit—that are essential for a well-functioning economy. But there has been a longstanding concern as to whether private banks operating in private markets are serving the public interest. So far in 2021, four states have introduced legislation to create a state bank, and in 2019, similar legislation was enacted in the State of California for municipal banks. This concern has been amplified by the disproportionate economic impact the COVID-19 pandemic has had on small businesses.

LESSONS FROM PRIOR PUBLIC BANKING EXPERIENCES

The Bank of North Dakota is a public bank that has been in existence for more than 100 years, and it is held by many as the prototype of a successful state bank. The states of Massachusetts and Illinois explored starting a state bank in 2010, and five states very recently introduced public bank legislative initiatives. Furthermore, public banks have been active in many countries outside the United States. Three states that had examined the merits of introducing a state bank—Vermont (2010), Maine (2011), and Hawaii (2012)—are not included in this review. Oregon (2010) is left out because the initiatives are somewhat dated and not as consequential as the others. Lastly, American Samoa has a state/territorial bank, but the island's size and unique location suggest that its experience will not be instructive for, say, the State of Illinois.

Bank of North Dakota, 1919

The Bank of North Dakota (BND), the only state bank in the United States, was founded in 1919. At this time, agriculture was the dominant sector in North Dakota's economy, and there was concern that the farmers were being exploited by out-of-state grain dealers, farm suppliers, and Chicago, Minneapolis, and New York banks. The BND was created to protect the farmers from these exploitive practices, caused by a lack of competition.

The bank's risk is borne by the State of North Dakota, "doing business as" the BND. Should the bank become financially distressed, all state assets would be vulnerable for providing financial support, especially since the deposits are not FDIC insured. But the bank's funding model is

2.1% **Bank of North Dakota's return on assets** (compared to 1.6% for federally chartered banks and 1.3% for state-chartered banks)

Founded in 1919, BND is the only state bank in the country. The original headquarters in downtown Bismarck, above, was torn down and replaced by a new building in 2008.

one of the reasons for its success: the BND is the depository for all state tax collections and fees. "And I would bet that that would be one of the most difficult things to wrestle away from the private sector—those opportunities to bid on public funds," said former president and chief executive officer Eric Hardmeyer. In light of this, along with the concern that it would compete with private banks, the BND has maintained only one office (in the City of Bismarck). It also now has satellite lending offices in three North Dakota cities.

The other key element of success is the bank's lending policy, which has changed focus over time: farms and municipalities (in the 1930s), managing state investments and servicing local banks (in the 1940s and '50s), and economic development and commercial loans (beginning in the 1960s). Again, Hardmeyer says: "But that's only one portion of it. We take those funds and then, really, what separates us is that we plow those deposits back into the State of North Dakota in the form of loans. We invest back into the state in economic development-type activities. We have specifically designed programs to spur certain elements of the economy."

The BND does not originate most loans (except for student loans). Instead, it frequently partners with North Dakota banks, serving as a "bankers' bank." Its major role seems to be more as a supplier of capital rather than a lead lender, finding lending opportunities based on its knowledge of local conditions. It supports local banks with participation loans and access to the federal funds market and the discount window. The BND lends to borrowers viewed as key to spurring economic growth, a strategy akin to an industrial policy in which a government agency attempts to pick winners—which is difficult to sustain on an ongoing basis. For example, in 2009, the BND favored investments in the energy sector. Over the past two decades this has been difficult to sustain, as the price of crude oil peaked in May 2008; in January 2020, it had fallen by more than 60 percent.

Still, BND's profitability has been notably robust for many years. Based on its total assets, the bank is about

PHOTO: TWITTER.COM/BANKOFND

the 200th largest bank in the United States. The return on assets is 2.1 percent, substantially higher than the 1.6 percent for federally chartered banks and 1.3 percent for state-chartered banks. Similar differences exist for the return on equity.

Let's explore two possible reasons for this impressive performance: the low cost of funds, or lending acuity. The first explanation is a prime suspect, as virtually all state funds must be deposited with the BND—but this conjecture doesn't bear up under scrutiny. The bank's interest expenses as a percentage of total liabilities are relatively higher than that of other banks. This is surprising, since 12 percent of the BND's deposits do not earn interest—although this effect may be counterbalanced by the absence of FDIC insurance and an added risk premium embedded in BND deposit rates. Moreover, the BND relies relatively less on deposits than commercial banks do. Low funding costs do not appear to be the reason for BND's high profitability.

The second reason for the favorable outcome relative to other banks may be prudent lending. An examination of the asset side of the balance sheets shows that the BND does not extend more loans than other banks. It is striking, however, that the funds set aside for loan losses are much larger for the BND. This may imply an aggressive approach to lending and the holding of a high-risk portfolio of loans. Consequently, the higher profits, net of expected loan losses, compensate for extra risk-taking. This interpretation, however, would be contrary to the conservative approach to banking mentioned in BND documents. An alternative interpretation is that the relatively high loan loss provision is consistent with the BND's conservative banking policies. However, this perspective would not explain its high profitability, instead implying that profitability should be relatively low.

> What separates us is that we … invest back into the state in economic development-type activities. **We have specifically designed programs to spur certain elements of the economy."**
>
> **ERIC HARDMEYER** | FORMER PRESIDENT OF THE BANK OF NORTH DAKOTA

A third possibility is that funds are set aside to cover expected losses in energy-sector loans. This interpretation is consistent with loan losses provisions becoming greater for the BND relative to commercial banks beginning in 2015. The BND was setting aside fewer resources for loan losses before that.

The BND also holds very little cash—two percent of total assets—compared to five percent for national banks and 6.2 percent to 16.5 percent for state banks. The BND is a very large net purchaser of federal funds; these purchases are netted against the reported cash/assets ratio. In contrast, national banks are net buyers of federal funds. The difference seems to be traceable to the BND's role as a "bankers' bank" for North Dakota. According to its founding charter, the BND shall be "helpful to and to assist in the development of state and national banks and other financial institutions and public corporations within the state…" (Additional services provided to North Dakota banks include check clearing, liquidity management, and bond accounting safekeeping.) There isn't enough information in the BND annual report to assess the profitability for the BND in its role as an intermediary between North Dakota banks and the federal funds market, but it may be an important channel explaining the BND's enviably high profitability and in need of further investigation.

Massachusetts, 2010

Legislation enacted in 2010 "… authorized a commission to study the feasibility of establishing a bank owned by the Commonwealth or by a public authority constituted by the Commonwealth." The legislative commission's report listed four potential benefits of a Massachusetts state bank: 1) stabilizing the state's economy, 2) providing local businesses improved access to credit, 3) augmenting the lending capacity of community banks, and 4) helping fund state government through profits.

The report also confirmed that the Bank of North Dakota helped support the lending capacity of community banks in the state. But it found that data did not support the other stated benefits: "The commission finds no compelling rationale, at this time, to establish a state-owned bank in Massachusetts."

Regarding placing state funds in a state bank, the commission expressed concern about the amount of equity capital needed to start the bank and the financial capacity of a bank to service the state's transactions needs, especially concerning negative intra-day balances. The commission confirmed that small businesses faced difficulties obtaining credit, but it believed that those needs would be better serviced by other state and quasi-state agencies.

Illinois, 2010

The State of Illinois explored the idea of establishing a state bank in 2010, contacting the University of Illinois Institute of Government and Public Affairs (IGPA) about the prospects. IGPA was not encouraging for several reasons:

- North Dakota is a thinly banked state where a state bank might add value. Illinois, on the other hand, has a broad and deep financial network.
- In many instances, small businesses had difficulty in obtaining credit, but those problems were linked to high levels of risk. There was no obvious market failure regarding small business lending.
- A state bank would likely compete with community banks, which would be expected to resist vigorously.
- The bank might be used for the political or personal advantage of public officials.

Recent U.S. State Initiatives, 2019 and 2021

California. There is a great deal of recent interest by state legislatures in starting a public bank either at the state or municipal level. (The Public Banking Institute maintains a website with a wealth of current information. Visit publicbankinginstitute.org.) The State of California enacted legislation that repealed the state's prior prohibitions on municipalities and counties from opening a public bank and from depositing their funds in such an institution.

Public credit is not defined in the legislation, but it would seem to refer to the funds held by state agencies. According to Assembly Bill 857, October 2, 2019, the public bank is intended to undertake an aggressive lending program that helps local economies and communities, complementing those undertaken by credit unions and local community banks. Before submitting an application for a public bank, a study must be conducted to detail start-up costs, the required amount of initial capital, "a downside scenario that considers the effect of an economic recession on the financial results of the proposed public bank," and "how the proposed governance structure of the public bank would protect the bank from unlawful insider transactions and apparent conflicts of interest." The public banks authorized by this legislation are to be owned by municipalities and counties, not the State of California.

Nine coastal cities and counties in California, including the City of Monterey pictured above, have approved resolutions to participate in a viability study for creating a regional Central Coast Public Bank under California's Public Banking Act AB 857.

New Mexico. Legislation was introduced in the State of New Mexico in February 2021 to create the Public Bank of New Mexico, which would receive a permanent deposit of $50 million from the state treasurer. These funds are not to be withdrawn and are, therefore, effectively equity capital. The state investment officer would also deposit $50 million from the severance tax permanent fund.

The public bank would engage in normal bank lending, with an emphasis on supporting the economic development of small businesses—presumably ones that have had difficulty obtaining credit from private banks. This lending is meant to complement existing

lending programs, not necessarily to pursue new credit initiatives. This entity would be distinct from the State of New Mexico, so the state wouldn't be responsible for the bank's financial liabilities. This separation could raise the cost of borrowed funds.

The Public Bank Feasibility Study was undertaken by the City of Santa Fe in 2016. Some weaknesses in city financial management were addressed by changes in the Santa Fe Treasury Office, and because of this study, the city has a framework for establishing a municipal bank, but it hasn't moved forward with it.

New York. The State of New York has three bills pending in its legislature pertaining to the creation of a state bank, all very similar. (Here we focus on the text of A3309.) The mission statement and legislative intent are similar to those from other states in this article. New York explicitly acknowledges the potential of using "the state's depository assets to generate additional benefit for the people and the economy of the state," according to the bill, and expresses concern about "institutional safety and soundness" and the need for "insulation from political influence." The public bank would invest in infrastructure; lend to students, businesses, communities, and low-income areas; and partner with extant institutions. It would be funded by state deposits, and the default risk would be borne by the state.

Washington. The State of Washington has a Senate bill pending. The bill cites market failure by private banks in meeting the financing needs of local and tribal governments and says the public bank/cooperative is intended to assist underserved communities, especially with regard to housing. The legislation is specific about the benefit of using state/local/tribal funds and is sensitive to the potential risks from a bank on state finances. Like New Mexico, the Washington state bank would be a government instrumentality. The bill explicitly creates substantial distance between the liabilities of the bank and state resources. Bonds couldn't be issued in the name of the state of Washington, but the initial equity capital would come from a state appropriation, so the state will bear some distress risk.

The city of Seattle commissioned a municipal bank study in 2018, but it was generally unfavorable to moving forward, especially given the complexity of the start-up process.

ShoreBank, Chicago, Illinois

Founded in 1973, ShoreBank was a mission-driven community bank that had a major positive impact in the area it served. Its mission was to invest in and revitalize inner-city communities. It focused its lending in the South Shore community in the southeastern part of Chicago. The area was in transition from predominantly White to predominantly Black residents and, while income was declining, the community was not in a perilous condition. Despite its social mission and thus occasional extension of credit to high-risk borrowers, ShoreBank was successful and apparently earned a rate of return on its assets comparable to similar financial institutions. This profitability was due in part to depositors attracted to its mission and, in part, to its superior knowledge of the community.

ShoreBank was in business for 35 years and had grown substantially, having assets of $2.6 billion prior to liquidation. There were two reasons for its financial distress. The bank had expanded from its original area to undertake similar mission-driven community banking in Chicago's west side; rural Arkansas; the cities of Cleveland and Detroit; the Upper Peninsula of Michigan; the Pacific Northwest; and with affiliates in 30 countries. The bank expanded beyond its competency. The 2008 Great Recession was a second contributing factor. As with most recessions, communities of color were more adversely affected, which had a severely negative effect on ShoreBank's cash flow. Its application for support from the federal Troubled Asset Relief Program was denied, and it was liquidated by the FDIC in 2010.

ShoreBank's expansion to the Pacific Northwest and other areas contributed to it's financial distress and ultimately led to its liquidation in 2010. In this photo from 2006, Dave Williams, president of ShoreBank Pacific and Bonnie Anderson, vice president for real estate stand outside a development that ShoreBank Pacific helped fund in Portland, Oregon.

LESSONS LEARNED

Six issues discussed here appear particularly germane to the issue of starting a state bank:

1. **DEPOSITS** held by the state treasurer are an attractive source of funds, but not all state funds would be eligible for transfer to a state bank because of laws dictating how government funds can be invested.

2. **ECONOMIC DEVELOPMENT** is a key motivating factor for starting a state bank. It takes the form of assistance to small businesses, students, and underserved communities, promoting infrastructure investments, or targeting critical sectors that will lead to sustained growth.

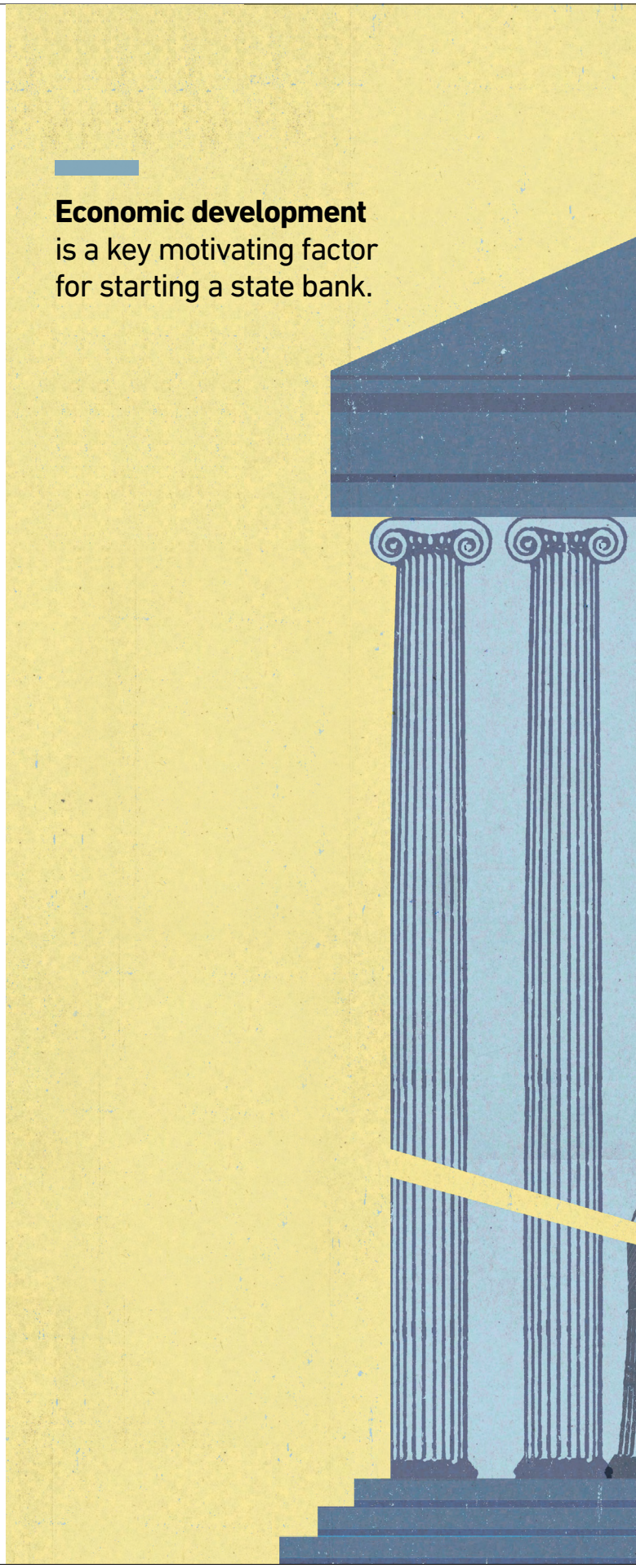
3. **RISK** is inherent with any bank, and financial distress characterizes many state banking experiences. The legislation introduced in the State of Washington explicitly recognizes and emphasizes the inherent risks with a state bank and attempts to insulate taxpayers from the negative effects of a financially distressed state bank. Risk is impossible to avoid. Even in the Washington case, the initial equity capital injection by the state would be vulnerable and could lose value if the state bank becomes financially distressed.

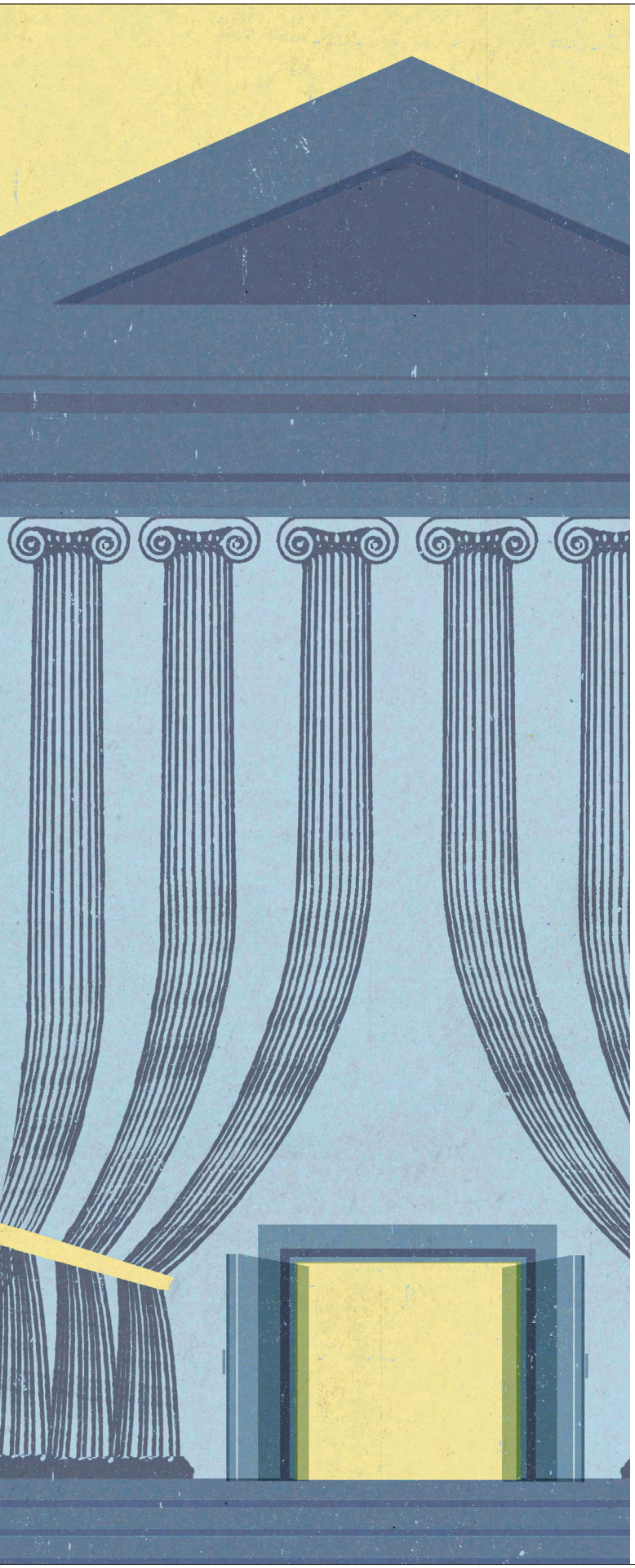
4. **EQUITY** is one way to attenuate (but not eliminate) distress risk by providing a permanent source of funds, but the equity required to start a bank might strain state finances. In 1919, the BND's startup capital was $2 million. This figure corresponds to $364 million in 2020. For the State of Illinois, for example—since Illinois had a 2019 population that was 16.6 times larger than that of North Dakota—the comparable figure for an Illinois State Bank is $6 billion, which is 14 percent of Illinois' 2022 proposed budget.

5. **MISSION CREEP AND POLITICAL INFLUENCE** are ongoing concerns. The history of Chicago's ShoreBank highlights how risk-bearing and mission creep can impede a state bank from fulfilling its original goals and can lead to financial distress. By contrast, the BND has an impressive record in this regard. Even though its board of directors comprises three state politicians (governor, agriculture commissioner, and attorney general), the BND has largely stayed on mission over its 100+ year history.

6. **PRIVATE BANK COMPETITION** is a potential concern. It can be attenuated by forming partnerships, focusing on underserved market gaps, and providing liquidity and other banking services (to small banks).

Economic development is a key motivating factor for starting a state bank.





PROS AND CONS

THE CASE FOR A STATE BANK. There are several reasons why creating a state bank might improve economic performance. A state bank would be well positioned to understand the pool of potential borrowers and therefore enjoy a lower default rate than private banks. The availability of state deposits provides a substantial and low-cost source of funds. Both factors would lower the cost of loans.

The resulting surplus could then be employed to support projects that would have a major beneficial impact on the community. A state bank would be positioned to undertake investments to start addressing the historic legacy of racism that creates large gaps in income and wealth in some underserved communities. The social return to these and other meritorious projects exceeds their private market return.

A state bank like the BND could provide liquidity and other banking services to smaller banks. It could also reduce credit risk by pooling loans from different small banks. Small business underfunding is an ongoing concern.

Creating a state bank would expand the competitive landscape. Households and firms seeking loans would have more banks to choose from, and the ability to access alternatives is important in securing a low-cost loan. The Bank of North Dakota presents an impressive model of how a state bank can work to the benefit of the citizens of its state.

THE CASE AGAINST A STATE BANK. There is no obvious market failure on the part of private banks in allocating credit and extending loans. Whether a state bank has superior information that will allow it to enjoy a lower default rate remains unproven. Existing studies showing a lower default rate for mission-driven banks may not control for the less risky pool of borrowers that work with community banks.

There are many meritorious projects that deserve support, but the advantage of pursuing these policy goals via a state bank, rather than direct legislation, has not been established.

While state deposits would create a low-cost source of funds, they come with a hidden cost: the value of the services that were being provided by private banks. These costs must be quantified and considered in an overall evaluation of a state bank.

The lending market, especially with the advent of electronic banking, is sufficiently developed that an additional bank will have minimal impact on the competitive environment.

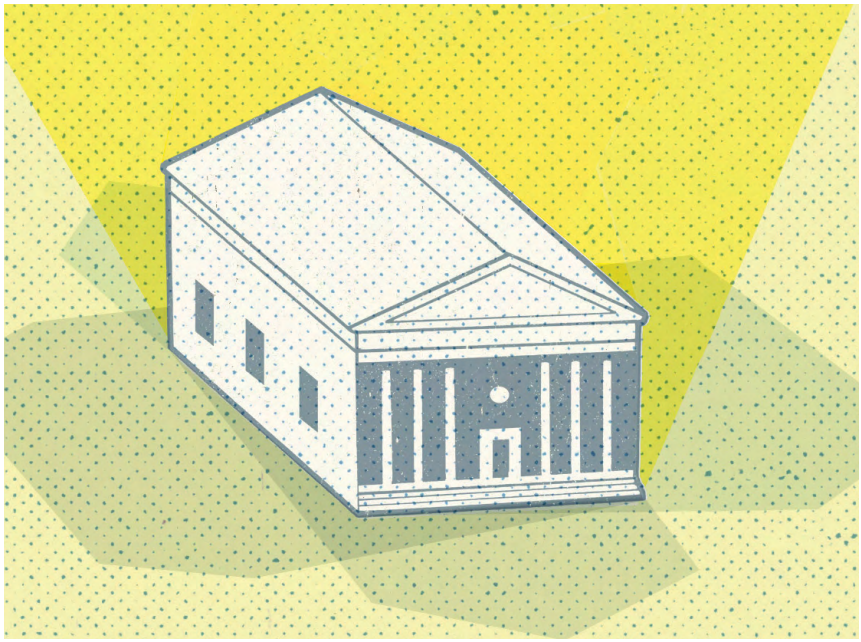
The political history of some states raises serious concerns about any activities where politicians might influence lending decisions in ways that aren't related to economic criteria.

Moreover, a state bank would be tempted to direct funds to sectors or projects deemed to be critical for growth, effectively trying to pick winners and losers. Such industrial policies have had a mixed record of success.

While state deposits would create a low-cost source of funds, they come with a hidden cost: the value of the services that were being provided by private banks.

Mission creep is a force that affects many institutions in the public and nonprofit sectors; the history of the Chicago ShoreBank is a worrisome example.

While the sustained profitability of the Bank of North Dakota is impressive, the general applicability of this model is limited because the financial sector in many states is well-developed, and the state's population of 762,000 residents is quite small, only seven percent larger than that of a typical congressional district.



FINAL QUESTIONS

Are state banks a useful economic development tool with future promise? The issues affecting the advisability of creating a state bank seem to hinge on four questions.

WHAT ARE THE TRUE COSTS OF STATE DEPOSITS?

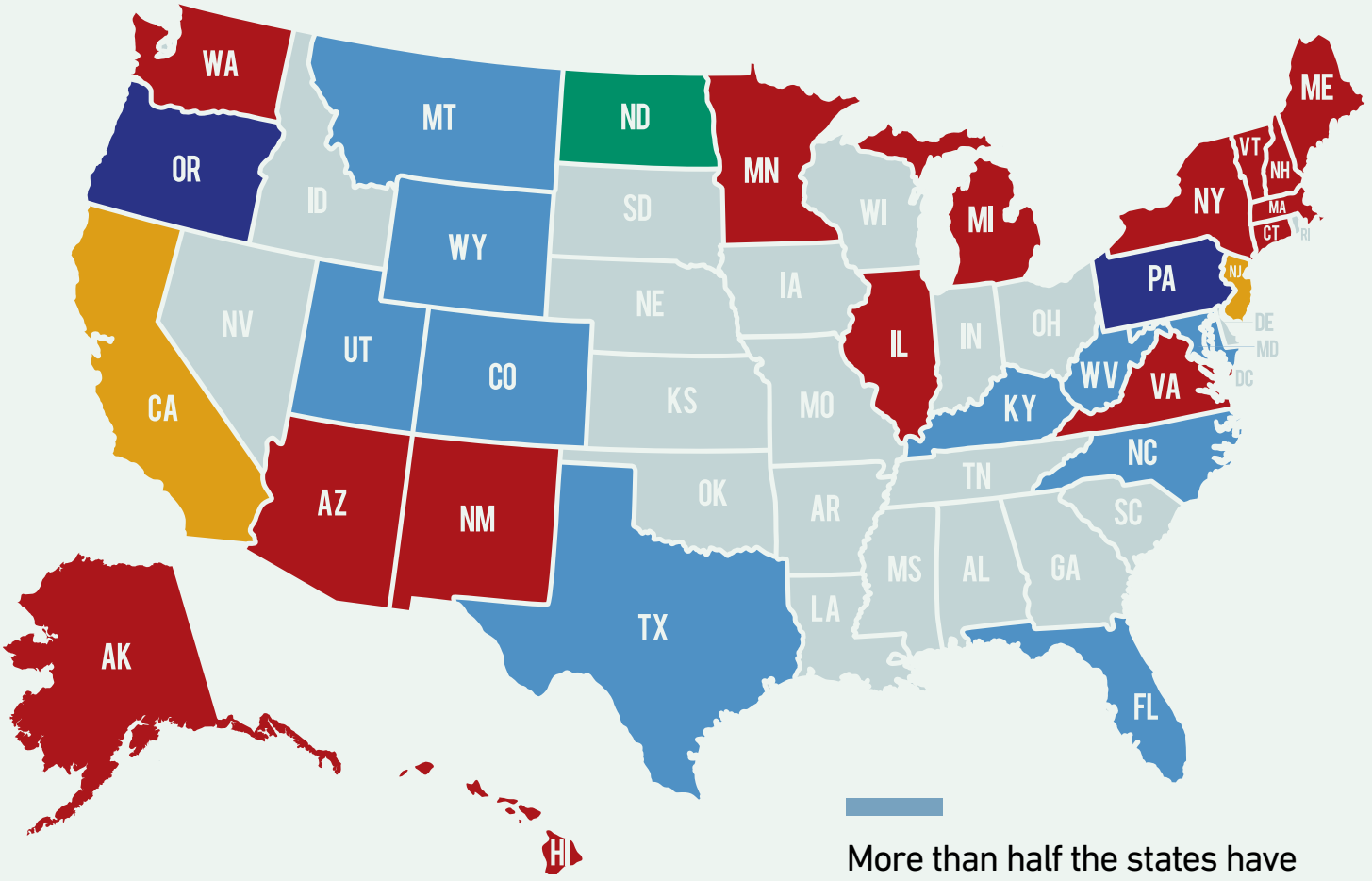
A crucial factor favoring the creation of a state bank is the transfer of the state deposits from private banks. These deposits are a sizeable and stable source of funds, and they are arguably the backbone of the success of the Bank of North Dakota. The pool of funds available in, for example, Illinois is extensive: $7.4 billion as of December 31, 2020. These funds are in the Illinois Public Treasurers' Investment Pool, which the 2020 Illinois State Treasurer's report describes as: "...a local government investment pool operated by the treasurer for state and local government agencies. This program provides a critical service for state and local agencies, enabling them to pool their money and invest in a safe, liquid investment vehicle that exceeds industry benchmarks. Created in 1975, The Illinois Funds was the first local government investment pool established in the nation. The Illinois Funds is comprised of over 1,500 participating entities, holding approximately 3,000 accounts with net assets of approximately $7 billion."

These assets are invested in liquid, short-term assets, and the fund must conform to SEC Rule 2a-7, which stipulates that the average, dollar-weighted maturity of the portfolio be 60 days or less. As of the end of 2020, the average maturity of the Illinois Funds was 58 days, so the return will be close to the return on money market funds.

These deposits, however, are not necessarily "free money." If transferred to a state bank, they come with three costs:

- The provision of financial transactions services for the state.
- The foregone value of non-transaction services received from private banks in which state funds had formerly been deposited, less any fees paid by the state. However, private discussions with

EXHIBIT 1 | LEGISLATION AND LOCAL EFFORTS BY STATE



More than half the states have proposed legislation in support of publicly-owned banks.

THE STATE OF PUBLIC BANKING IN THE U.S. TODAY

According to the Public Banking Institute, more than 25 initiatives for public banks are actively being pursued across the nation by progressives and conservatives. 30 of 50 states have proposed legislation in support of publicly-owned banks, and over 50 organizations are promoting public banks.

Source: Public Banking Institute, publicbankinginstitute.org

- State/Territorial Public Bank Established
- Legislation Passed, Executive Order Given
- Bill, Feasibility Study, Task Force or Ballot Measure Introduced 2017-20
- Pending Legislation
- Organized Public Bank Community Groups/ Candidates with Public Bank Platform

EXHIBIT 2 | FACTORS DETERMINING THE COST OF LENDING

Factors	Discussion	Advantages
Operating Costs	Many private banks would be larger than a newly established state bank. Economies of scale and scope suggest that private banks have a cost advantage.	**Private**
Loan Defaults	Lending is risky business, and loan defaults are expected. A state bank may be better embedded into neighborhoods, have superior knowledge about its customers, and therefore may suffer fewer loan defaults. The lower the expected defaults, the lower the cost of making a loan. This advantage may be attenuated if a state bank extends high-risk loans in underserved communities that are correlated with lower incomes.	**State**
Cost of Funds		
– Private Deposits	There is no obvious advantage enjoyed by one type of bank over the other.	None
– State Deposits	In the course of discharging its routine tasks, a state generates a large amount of core deposits. They are usually deposited in a private bank. State deposits channeled to a state bank would be an important and inexpensive source of funds for a state bank. Transferring funds from a private to state bank may have an opportunity cost if the state receives banking and other services as compensation for the deposits. This opportunity cost would effectively raise the cost of state deposits at a state bank. However, private discussions with five financial officers in public institutions, private banks, and private businesses did not uncover any substantial benefits flowing from bank deposits.	**State**
– Borrowed Funds	Borrowings from investors in the form of certificates of deposit (CDs) or other financial instruments, or from other banks, would likely be backed either implicitly or explicitly by the full faith and credit of the state. Due to the fiscal stresses that exist in many states, the interest cost of CDs and other bonds would likely be higher than those for private banks. Independent of the risk premium due to fiscal stress, private banks, due to their large size, would also have access to borrowed funds at a relatively lower interest rate.	**Private**
– Equity	It is frequently alleged that the amount of equity capital carried by private banks is a burdensome cost that a state bank can largely avoid, and there's an element of validity to this concern. But the conclusion that private banks are disadvantaged does not bear up under closer scrutiny.	None

Of the three main banking functions, allocating credit is the primary one in which a state bank might have a unique and constructive role to play. A state bank might be able to allocate credit at a lower cost than private lending to the existing pool of actual and potential borrowers. Profits from these projects would then be available to fund meritorious projects that can't be supported by private lending. Absent a cost advantage for a state bank, extending credit to underserved communities or projects with a high social but low market return via cross-subsidization is not sustainable.

The three factors that determine loan costs are operating costs, loan defaults, and the cost of funds, the latter further divided among private deposits, state deposits, borrowed funds, and equity (see Exhibit 1). The relative costs for private and state banks are discussed in column 2 and summarized in column 3.

Our analysis suggests that a private bank may have cost advantages due to lower operating costs and a low cost of borrowed funds. State banks may benefit from lower default rates and greater access to state deposits, both of which lower its cost of making loans.

five financial officers in public institutions, private banks, and private businesses did not uncover any substantial benefits flowing from bank deposits.

- The destabilizing effects of withdrawing state deposits from private banks, especially smaller institutions with limited access to alternative sources of finance.

Quantifying these three costs is important to confirm that state deposits are truly cheap money. When a full evaluation is completed, it is likely to show that there will be a substantial net benefit to the state bank from state deposits. With lower costs in extending loans, a state bank will be able to pursue social lending on a sustainable basis.

HOW VULNERABLE ARE TAXPAYERS TO STATE BANK RISK?

State banking is risky business; failure is frequent, and risk is omnipresent. The state faces three sources of risk:

- **Liability risk.** To attenuate liability risk, the state might commit its resources to guarantee the state bank's liabilities. This guarantee will lower funding costs, but the benefit must be balanced against the increased risk that the state and its taxpayers would now bear.
- **Equity risk.** Since the state bank is intended to be owned by the state, the initial equity capital must be provided by the state. To be comparable to the BND, an Illinois State Bank would need $6 billion of equity capital. This substantial sum is at risk, though the risk is capped by the value of the initial investment.
- **Legal risk.** The state bank faces legal risk if it is legally connected to the state, especially if it operates under the "doing business as" structure.

The costs associated with these risks need to be evaluated and quantified.

WHY WOULD A STATE BANK HAVE BETTER SUCCESS IN SUPPORTING UNDERSERVED COMMUNITIES?

Perhaps the key motivation for a state bank is that it would be able to help underserved communities, especially in providing loans and credit. Offering such assistance has been an ongoing policy goal for at least five decades. In 1964, President Johnson initiated actions in his War on Poverty and in the Economic Opportunity Act. The latter created work-training programs (including the Job Corps) and urban and rural community action programs. This same set of policy concerns has faced the Community Development Financial Institutions Fund (created in 1994), numerous enterprise zones, and many other federal, state, and local government policy initiatives. Unfortunately, geographically targeted or place-based programs "often fail to benefit the places and people they are intended to aid" because they are poorly targeted and poorly tailored to community needs. Will a state bank be more successful in overcoming past obstacles, supporting underserved communities, and pursuing other meritorious policy goals?

HOW CAN A STATE BANK BE INSULATED FROM POLITICAL INTERFERENCE?

There is a substantial concern about the politicization of credit and "mission drift." Political interference in public banks is widespread across the globe and leads to less growth and less development of the financial sector. In their chapter on "The challenge of keeping public banks on mission," author Christoph Scherrer is somewhat pessimistic: "Placing the mission drift in this larger framework precludes any easy panacea for keeping public banks to their public purpose." A bank-commissioned history of the BND notes that "The Bank of North Dakota is a financial institution, of course, but it is also a political institution." Nonetheless, following are two possible approaches, one conventional and one radical.

The conventional approach is to follow the lead of the Bank of North Dakota. As Hardmeyer said in an interview with American Banker: "If you are going to have a state-owned bank, you have to staff it with bankers. If you staff it with economic developers, you are going to have a very short-lived, very expensive experiment. Economic developers have never seen a deal they didn't like. We deal with that every day." It is still unclear how the politicians have been kept at bay in North Dakota.

The more radical approach appeals to naked economic interests. A state bank is under consideration because there is the possibility that it will generate surplus funds that can be employed to address social issues outside the scope of private markets. The radical idea is to have several state stakeholders with a financial interest in maximizing the size of this surplus. Consider the possibility of creating a consortium of six independently created state banks for the Upper Midwest states—Minnesota, Wisconsin, Illinois, Indiana, Michigan, and Ohio—that would undertake lending activity in the following manner:

1. Each state forms a state bank with the primary purpose of allocating capital via lending.
2. The state banks are funded by state deposits and state-provided equity capital. Each state is assigned a share determined by its contribution of deposits and equity.
3. At the end of each fiscal year, the profits of all six state banks are aggregated and distributed according to shares. In a given state, these surplus funds will be further divided between an additional contribution of X percent to equity (for example, retained earnings or accumulated surplus) and Y percent to a special social account that is segregated from the deposits and equity provided by each state. (n.b.., X percent plus Y percent sum to one, they are the same for all six state banks in a given year and can be changed in subsequent years.)
4. Based on its contributed deposits, equity, and accumulated surplus, each state bank proposes lending decisions, but the loans must be approved by at least four of the six state banks.
5. Each state bank can invest the special social account funds as they wish, perhaps in projects with a high social return but a low private return that would not meet the market test. The size of the special social account can be adjusted by altering Y percent in subsequent years.

This approval process would provide financial incentives for states to reject substandard, politicalized projects because they result in a lower aggregate surplus and therefore lower shares to all states. Moreover, these questionable projects do not provide, to any important degree, political or other non-pecuniary benefits to those outside the state. The proposed approach may not deter corruption and mission creep fully. But some mechanism is needed if a state bank is to be sustainable and largely unaffected by political pressures, and hence a useful economic development tool with future promise.

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Read the full report at gfoa.org/state_banks