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POLICY BRIEF

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Understanding the Partnership Bank Model

As the debate for creating public banks expands, it is important to understand the complexities of the banking system as a whole and how they relate to public finances. There are some basic terms and concepts that form the foundation of the conversation, and it is important that all stakeholders — from legislators to executives to advocates — learn these concepts for a productive conversation to take place.

This paper outlines key terms relevant to banking and, in particular, the partnership bank model. Outlines the functions of the partnership bank model and contrasts to the sole public bank that exists in the United States today. It also touches on important considerations for managing risk and describes what a successful public bank looks like.

Understanding Banking Vocabulary

Asset: Anything the bank owns or invests in including loans, reserves, investment securities, etc.

Capital: What is needed to start a bank. After initial capitalization it is measured in equity.

Capital Requirement: A bank regulatory body's standardized requirement put into place to ensure that they have enough capital to sustain operating losses. It shows the margin by which creditors are covered if the bank has to liquidate assets.

Deposits: Money placed in a bank account. For a commercial bank, this comes from individuals and businesses; in a partnership bank, this is a portion of the state's short-term funds. A portion of this money is lent out or invested. The bank must pay a return to the depositor and keep the funds safe and available, or liquid, when needed. Note that these are "liabilities" to a bank, since a bank owes these funds to the depositor.

Equity: After initial start-up costs, the capital invested in the bank that is available to cover loan losses, assets minus liabilities.

Economic Development: In the arena of public banks, economic development includes investment in public infrastructure, assisting students in need of low-cost student loans, and helping businesses obtain credit when credit is otherwise inaccessible. This aid can come in the forms of loans or loan guarantees (so others will lend) and usually carries higher-than-average risk. Economic development dollars are appropriated by the Legislature and are typically held in "revolving loan funds," which, when spent, must wait until loans are repaid in order to lend more. To be clear, this is not the function of a partnership bank.

Federal Reserve: Banks, including partnership banks, maintain a relationship with the Federal Reserve to borrow very short-term funds to balance its books.

Liquidity: The ability of a bank to meet its obligations or opportunities — whether having funds available when depositors make withdrawals or funds available to lend out when loan opportunities are presented.

Loans and Investments: This is what a bank does with deposits. Banks keep whatever they need in very liquid investments, like treasuries, and they maximize what they can lend. Note that loans and investments are "assets" to a bank, since they represent income-generating activities and can often be sold on the financial markets.

Quality (Credit Quality): What is the likelihood of default?

Risk: The possibility of loss.

Securities: Tend to be short-term, highly safe, investments that can be bought and sold quickly to meet liquidity obligations.

Treasuries: Refers to specific type of securities issued by the federal government. They are considered to be risk-free because they are backed by the full faith and credit of the federal government.

What Is the Function of a Community Bank?

On a basic level, banks accept deposits, make loans, provide a safe place for money and valuables, and act as payment agents between merchants and banks. Primarily, community banks accept deposits and, in turn, lend these funds to businesses, farmers, and individuals. There are some types of loans that community banks will typically sell a secondary market.

What Is the Bank of North Dakota?

Since 1919, the Bank of North Dakota has partnered with community banks and credit unions, providing a secondary market for mortgages. It also helps community banks compete with larger banks for larger loan opportunities though partnership. The bank also offers "wholesale" banking services such as check clearing and liquidity support to community banks. Bank of North Dakota has retail functions such as taking individual deposits.

The Bank of North Dakota typically lends at around 5%-6% after all its costs. Including paying the state on its deposits, it only makes 1.6% on all of its assets. But when looking at the state's investments (equity), it has averaged a 22% return, for just over a decade.

The Partnership Bank Model

The goal of a partnership bank is to keep public money in-state by partnering with the community financial sector. A resilient community financial sector helps ensure a robust small business and family farm sector. The partnership bank provides the mechanism to leverage state funds in-state. It does this through buying sound residential mortgages and partnering with community banks on larger commercial and agricultural loans.

Because the partnership bank uses public funds, it is extremely important to keep money safe, liquid, and earning a profit. Furthermore, the partnership bank does not have retail functions; therefore, it does not compete with community banks and sheds the higher-cost and lower-yield functions.

This design has two key benefits:

- Efficiency. This partnership model does not require the establishment of retail branches, ATMs, or loan officers. Partnership banks do not originate loans, but only buy, hold or sell loans or portions of loans local community banks make.
- Low loss rates. Partnership banks hold a low-risk loan portfolio. They only evaluate loans to purchase that community banks have deemed credit-worthy. Many of these loans are Federal Housing Authority (FHA) or Veteran Affairs (VA) mortgages with little to no risk. Since these loans were originated by community banks that will continue to service the loan, the community financial sector avoids moral hazard. With the larger commercial loans, the community banks have more of their money invested, ensuring sound credit decisions.

Risk Management in Banking

Care must be taken in developing a bank's mix of deposits and loans. Deposits are of a short-term nature, as depositors can withdraw them as needed. Loans are of a longer-term nature and lent with the purpose of generating revenue on interest over time, with funds that are lent out only coming back when loans are repaid or sold. This concept is especially relevant to the state, in that there are cyclically low times of funding prior to tax receipts coming in. If too much of the deposits are lent out in loans, then there would be a "liquidity crisis," in which important items like payroll for government employees — teachers, police, etc. — could not be paid.

Banks can manage for this by keeping a significant portion of their investments in securities that can be sold in a moment's notice, like U.S. treasuries, lending out only a portion of their total deposits. A bank will also maintain relationships with the Federal Reserve and Federal Home Loan Bank (FHLB) in case they need to borrow funds on a short-term basis for the days at the end of the month when state coffers tend to dry up. Such borrowing obviously has a cost associated with it, and these federal entities will quickly shut off an out-of-balance financial institution. This is why it is critical to have an experienced banker running a partnership bank.

When a bank experiences a loss on a loan, it still owes the depositor the money and must take it out of its equity. As a basic rule, regulators will shut down a bank if its capital is less than 10 percent of its assets. Said another way, a bank is in danger of not meeting regulatory requirements if one in 10 loans default, since it would quickly drain its capital and leave the bank with nothing to fall back on, resulting in lost deposits. Since in a partnership bank the deposits are the taxpayers' money, a very risk-adverse stance must be taken.