PUBLIC BANKING:

A MODEL FOR THE DISTRICT OF COLUMBIA

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Public banking model, specifically for DC

Much of the rest of this paper will discuss a model public banking structure for the District of Columbia. Structure, control, insurance for deposits, reserves, liquidity, and capitalization will be the issues, set in the context of both the District's credit needs and the resources of the city government. The District was chosen as the site for a model for two reasons: it is far easier to relate to, and give specifics for, a distinct situation rather than a more abstract model; and I had already done much work analyzing the possibilities for public banking in D.C. for an ad hoc committee of the City Council. As will be seen when the concepts are summarized, and the transferability of the concepts discussed, this model is useful in most states and municipalities in the country.

Structure

A primary criticism of the practices of existing institutions is that they short change credit-worthy individuals and small businesses because of the area of the city in which they are located; and thus these areas cannot get the credit they need to redevelop their commercial or residential sectors. Another criticism, voiced by minority business-people, is that they have not been able to set up a "responsive" relationship with a bank, important not only because of their credit needs, but also to obtain managerial assistance. A third criticism of the existing institutions is that residents of a community

have no input or control over the types of investment made in their neighborhood. Constructing large office buildings and speculating on residential real estate, for example - activities which are fueled by institutional lending practices - cause displacement of some residents, a markedly changed environment for others, without those being affected having any way to control these changes. In the District, these are the areas that must be satisfied by a public banking system. To be satisfied, they must first be understood, and this is done best on a local, not municipal, level. Local control of financing drives implementation toward the most accurate reflection of this understanding. Local participation in the process facilitates support of the system.

At the same time, decentralization cannot be the sole structural peg on which a municipal system would hang. Economies of scale are at work in many areas of financial practice - from necessary office space to the handling and processing deposit accounts. The technical ability to run a financial center may not be available - or affordable - in many neighborhoods. If the system is to have impact, enough capital for investment must be available to dent the existing residential and commercial picture, arguing against total decentralization of the capital accumulating and lending units. Also, the larger the resources of a unit, the better able it will be to survive a small number of loan defaults.

The planning by communities for their own projects must be

coordinated on a municipal - perhaps metropolitan - level. The finite capital available to a public bank will not be sufficient to fund the needs of all of the District's neighborhoods. This capital will have to be allocated between differing, and competing, projects and areas. Similarly, the plans and results of each neighborhood will affect adjoining areas, and the city as a whole. Development of a commercial strip could mean competition with a nearby strip fatal to both. Also, municipal and metropolitan undertaking such as Metro, or the National Visitors' center need to be taken into account when determining financial allocation and area lending practices.

A public financial system, then, must contain elements of both centralized and decentralized structure. The way to resolve this contradiction - to pinpoint the level of decentralization desirable - is to analyze the functions, economies and sources of capital of the proposed public system, and see how neighborhood and municipal needs are best met.

The public bank can assist the housing sector by providing residential mortgages, construction loans, and rehab credit, as well as facilitating these types of lending by private institutions through secondary mechanisms (insurance, mortgage purchase, high-risk coverage, etc.) Housing and home finance counseling can be provided. Planning can be done for restoration and development. These non-financial services indicate a neighborhood size and approach to the bank.

Mortgage and construction loans, on the other hand, require

large amounts of capital. One million dollars will buy only 50 homes, each selling at $25,000 and with 20% down. With standard mortgage loan tenures of 20 to 30 years, one million in deposits funding three to four home mortgages per year over 20 to 30 years, on the average. For areas of the District with minimal residential financing needs not already met by existing commercial banks and S&Ls the capital accumulated within the area should suffice. For other areas of the city - those areas in which the private institutions have neglected-the capital accumulated will not be enough. Rehabilitation, and home improvement credit, generally less than $10,000 per loan, with a maturity of two to four years, will be easier to obtain in a local area. For many of the areas of the District, then, housing related services and short term credit can be met on a neighborhood level, but much of the capital necessary for housing construction and mortgages will have to come from a more centralized source.

For the business sector a public bank could provide short-term credit, long-term credit, commercial counseling, and facilitative secondary mechanisms (like the S.B.A.). As with housing related services, commercial counseling and neighborhood business planning works best with a localized approach, down to one-to-one counsel. Short-term credit for small to medium-sized enterprises involve not-large amounts of capital which is paid back within a few years, at most, and turns over rapidly. Long-term credit for a small or medium business is quite analogous

to construction and mortgage loans. Larger than short-term credit, and with longer maturities, long-term debt capital is less likely to be accumulated on a community basis. In a parallel with housing, the more a community needs business credit, the less likely it will be accumulated in the local area.

The depository aspect of a public bank speaks to a highly decentralized approach. Convenience is a major determinent in gathering household and local business deposits. A highly decentralized network of deposit receiving institutions would be convenient to more individuals and business people than a more compact system. Services offered by a bank are another determinant of depository behavior. Many of the services potentially available - such as credit counseling - are most effective on a neighborhood basis (as testified to by the experience of the community credit unions).

The aspect of services which mitigates against a decentralized system is the economies of scale. A computer system, or a manual system, set up to process checking accounts, for instance, is far cheaper per account (or per dollar on deposit) for a large number of accounts (or dollars) than a small number. The vault used to store cash securities costs no more to buy if it is full than if it is half-full. A banking operation with four teller windows does not cost twice as much to set up as one with two windows. There are different economies of scale for each type of service offered. For many services a centralized approach is not only the most cost-effective, but the only way

to offer the service and still function as a banking institution.

This analysis of a municipal financial system breaks down the centralization/decentralization argument into one of manageable size. Some aspects will work better on a neighborhood scale; others on a municipal (even metropolitan) level. What follows will be an attempt to pull these aspects together into a workable structure.

Certain aspects of a public bank fit best within a neighborhood scale: convenience for depositors, neighborhood planning, credit counselling. Neighborhood branch banks would be the best-suited structures for these aspects. These banks would accept deposits, make loans, and provide services, much as private bank branches do, though with a different policy. The public bank, being novel to the District, would have to demonstrate its capability. Thus, the number of initial branches should be small, and should increase (or decrease) as the experience of the bank warrants.

Coordination of the planning and practices of neighborhood branches is a centralized, municipal function. If the unit which performed this task was considered a "central bank", many of the economic drawbacks of decentralized branches would be overcome. The capital resources available to the central unit will be substantial in comparison to the branches. The financial resources necessary to survive some defaults in a neighborhood could be backed by the central resources (making the central

bank a parallel to the Federal Reserve system's function as a "lender of last resort" to commercial banks, providing both objective security and confidence on the part of depositors in the neighborhood branches.

In addition to lending as a last resort, the central unit could allocate its resources to those neighborhoods which are most in need of additional capital. As a central bank, this unit could act as a depository in a financially dense area (such as downtown). Public and "socially conscious" deposits can be solicited and obtained by the central unit. Other sources of funds (bonds, notes, debentures, other deposits, etc.) can be focused on the central bank, increasing the monies available for the neighborhood branches. The central unit could also draw "surplus" funds from neighborhood branches in prosperous areas, and direct the money to "deficit" branches. This implies the legislation of stringent controls over where, and for what purposes, branches can make loans. The history of both mutual savings banks and savings and loan associations indicates this legislation will be necessary: both types of financial intermediaries were started specifically to fund local, owner-occupied home mortgages, and both have moved away from this intent to invest where the profit margins are highest. Branch banks which could not place all of their money in loan purposes defined as priorities could be required to channel their surplus deposits into the central bank, which would lend the money to branches needing additional capital for the priority loans in their area.

This is a concept many people will not accept, for it deviates from the equitability of local deposits funding local projects. Working class and middle income neighborhoods would benefit from public banking with or without funds drawn from surplus areas: they already generate enough investable capital, which is presently being misallocated. Poor areas would also benefit, but slowly. Without surplus areas funding projects in deficit neighborhoods, the line between poor and well-off areas will just be redrawn, rather than removed.

Aside from acting as a coordinating link between branch banks, the central unit would act as a lender for municipal-wide activities. Again, specific legislation would have to define the purposes these loans could fulfill, to keep the central bank within perceived boundaries of need.

Initiating the structure

The form of structure for a municipal banking system proposed here can occur through three different approaches. A new system can be undertaken by the public sector, corresponding in this blueprint; the city could establish a centralized capitalizing and insuring agent, and leave the decentralized branches to be formed, under new and rather stringent guidelines, by the private sector; or the centralized unit could be set up by the city, and the existing OEO community credit unions be permitted to transfer to (as yet unwritten) state charter, expanding the scope of powers and responsibilities permitted credit

unions in DC (currently, they can only take saving deposits, and only make short term loans), and bringing them underneath the centralized aegis for reasons of deposit insurance and additional capital sources.

The initiative on which of the above methods is preferable should rest with the existing community credit unions. Initially set up through the federal Office of Economic Opportunity, the nine in the District have labored hard to achieve a credible image in the areas they represent. The members of these credit unions are in large part people the private institutions have neglected, and a new public banking system would want to reach low to moderate income District residents. As the credit unions have increased their credibility, they have acquired skills in money and loan management, and in consumer counselling, as well as realistically understanding the credit needs, and credit paying capabilities, of the area residents.

There are arguments against setting up the community credit unions as the initial branches of a public bank. Many depositors in credit union areas prefer to use the existing private banks and S&Ls to hold their money, seeing these institutions as intrinsically more stable than the credit unions. Expertise in running a community credit union does not necessarily translate into running a branch bank, and the residents in credit union areas would not as quickly swell the deposit accounts of a public banking system as the residents in the

more affluent areas of the city.

Despite this, the credit unions would be the place to start. The system could start slowly, and incrementally expand the credit union powers until they corresponded with those of banks. The accrued experience of dealing with credit on a day to day basis in credit starved areas would be immensely valuable for a fledgling public system. In addition, any public banking system which did not coordinate with the D.C. credit unions would necessarily compete with these institutions as well as with the private banks and S&Ls for deposits.

If the credit unions chose not to participate in a municipal banking system, then either the city could set up the entire thing, or it could institute the centralized capitalizing and insuring part, and leave the private sector to set up the branches. By defining the private sector to mean communities, the area's initiative would then define its ability to fund its needed projects. "Private banking" would entail passing a fairly stringent set of banking laws, permitting state banks to be chartered in the District. Aside from the requirements for capital, and statements of responsibility and power, the D.C. state banking laws would differ from those in other states in requiring the newly chartered banks to be part of the public system, and in requiring that the loans offered by the state banks be consistent with the requirements of the area they are presumed to be serving.

Control

Where the control of the public banking system resides is important both to best maintain the integrity of the proposed goals, and to avoid the possible public perception of another bureaucratic monster, capable of misperceiving need, misallocating capital, and outright corruption. Control of the bank branches has to be maintained in local hands, to deal with both of these issues.

Local control, though, is not enough for the centralized parts of the banking apparatus. The conerns and demands of different localities would have to be balanced, within the citywide context. Nor would local control be enough even at the neighborhood level, without sufficient expertise in the day to day operations of a bank. As times banking is a complicated business, such as when determining the criteria for making a loan, and a system geared to local development would increase the complications. The effectiveness of the loan practices and the other operations of the bank on the community would be measured, along with whether or not a profit was made. It will be necessary to have capable managers: the bank, after all, will be lending out other peoples' money, and will be a prime focus for development in the area.

On a local level, then, where expertise has to be balanced with committment and responsiveness to the area, a mix of local residents and businesspeople with banking managers would be the

initial way to structure control. With time - as the bank proved itself, as more residents and businesspeople understood and approved the concept, as the locals developed among themselves expertise in banking - control would shift to be entirely upon the neighborhood.

The same difficulties arise for the centralized parts of the sturcture: the central banking depository; the deposit insures; the 'bank for the branch banks'. In addition, representatives with a city-wide perspective are needed, to balance the concerns of the various communities and to understand the credit needs of municipal level projects. The mix here would have representatives of the branch banks, city-wide representatives, and banking experts. As with the local branches, the experts would be phased out over time.

Deposit insurance, reserves and liquidity

A public banking system would have to insure the deposits of its customers against any possible loss, and guarantee that the bank will pay back to its depositors all of the money they leave there on deposit. Under the present private banking system the insurance on deposits in most commercial and mutual savings banks is given by the Federal Deposit Insurance Corporation. The objective surety of this insurance is mythical. The FDIC has as assets (easily saleable government bonds, and cash) totaling approximately 1% of the total deposits in the banks

it is insuring, or $6.7 billion to insure $704 billion in deposits. If this is not enough, the FDIC is eligible to draw upon the U.S. Treasury for another like amount. In the event many banks could not meet their obligations to their depositors, and the FDIC was required to make up the difference, this agency could not go it alone without additional governmental money. The primary point of the FDIC insurance on private banks is to provide the subjective certainty in the minds of depositors to prevent a run on the banks, as often occured during the Depression.

Without this confidence, however, few depositors would be willing to risk their money in a non-insured public bank. The District would have to convince its potential depositors that it was serious in protecting their money, and it had the resources to do so. The District public revenues would be appropriate insurance for these.

Deposit insurance will not be objectively necessary in any bank, public or private, unless a sizable share of the banks assets prove to be unredeemable. Bank assets consist of the loans they put out, government bills and bonds they buy, corporate bonds, and cash. A large portion of these assets will be unredeemable only if a large portion of the loans are worthless. Loans which are still paying off, but not fast enough to satisfy depositors, can generally be sold for a small discount to another financial instituiton in return for

cash. Under the (hopefully) reasonable assumption that a public banking system will not be making large numbers of worthless loans, the public revenues would work as a mechanism of insurance. These monies woul be available to pay back to depositors the money they should receive, in the case of a public banking failure. However, the monies would not be touched unless they were needed. The 1975 revenues of over $1 billion is one-seventh of the F.D.I.C. assets, which insures over 14,000 banks throughout the country. A similar system of insurance has worked well in North Dakota since 1919.

There are three other banking areas in which the question of insurance touches: reserves, capital, and liquidity. Capital will be considered in the section on capitalization. Reserves are part of the surplus monies derived from the normal operations of the bank. A public banking system would have three choices in determining its spread between the interest rates it offers depositors and the interest rates it collects from loan consumers: it could set the spread as low as possible, making no surplus, and directly benefitting the initial recipients of the loans; it could set the spread high enough to give additional money for reinvestment within the bank itself, fostering the growth of the instituions; or it could set the spread high enough to provide for money on reserve, to tap in the event of an emergency, and thus most promoting the confidence people will feel in the bank. Private banks, though regulations

set by state and federal agencies, opt for some mix of the second two (generating a surplus, and using it for both reinvestment and reserves). The more loan losses a private bank experiences, the more money from its surplus it would have to put into its reserves. The optimal choice for a public banking system would be to derive some surplus from its initial operations, and place most or all of this money into its reserves. After the bank gained experience, in knowing its own operations and the best way for expansion, and in knowing its loan consumers, and how the bank policies are effecting them, the public banking system could both grow and offer a better interest rate to its customers.

The liquidity of a bank is measuredby the percentage of its assets which can quickly (within a few days) be turned into cash. Government bonds and bills - especially U.S. Treasury issues, and the bonds of other federal agencies are as good as gold, and can be sold for cash to another institution or large investor with a minimum of trouble. Loan notes are not so liquid: if you got a loan for an automobile purchase, the bank giving the loan would not be able to quickly sell that note to another investor or institution without a great deal of trouble. The other institution would want to know about your credit rating, your income, your payment history, etc. Multiply this by thousands of loans - mortgage, business, and personal - and you multiply the amount of trouble. Despite inflation and recession, the investor can always buy the US Treasury bills and feel

confident without needing to check out the payment history of the federal government. Among other things, liquidity means the capability to respond quickly in an emergency. The other side is that liquidity means putting local deposit money into investments which only indirectly benefit (at best) the local areas. Most private commercial banks have about 40% of their assets in liquid investments, or outright in cash. Savings and loan associations, on the other hand, generally have about 90% of their assets in mortgages, the rest in a liquid state. For the purposes of depositor safety, which is mostly a subjective measure, reserves, capital and insurance should be the primary mechanisms: these will suffice unless the economy of the District experiences the equivalent of a flash flood, and using them will promote the efficiency engendered by using the money (or potentially using the budget) of the District, rather than promoting the conservatism of using investable capital to buy US Treasury securities.

Capitalization

In order for any bank, or banking system, to start in operation it needs capital. This is for two reasons: to set up the day to day facilities of the bank before the banking operations pay their way, and to provide another measure of security for the deposits residing in the bank. Most private commercial banks just starting take two to four years before

they can make a profit; the loss on their operations during that time is absorbed by the initial capital (which is generally $1 to $3 million for a national bank). After a bank starts to make a profit, it replenishes its stock of capital as well as adding to its reserves. The capital is then used to cushion the bank depositors in case of bank failure. Most commercial banks now have 10 to 20 times as much in assets as in capital, though with each wave of loan losses given publicity the ratio gets smaller.

The amount of capital a public banking system would need depends on how extensive the system would be initially, and on how the system would be made operational. If community banks or credit unions with expanded powers constituted the branches, each starting with capital of its own, then a smaller amount would be needed than if the city set up the entire system as a public agency. And if two branches were initially opened less capital would be needed than for twenty branches. Using the experience of the national commercial banks as a guide, a few million dollars would be adequate in starting the system, assuming that it started on a small scale.

Precedents

A public banking system for the District of Columbia would tie together three concepts not previously directly used in the city: a decentralized system of branches, with a centralized

insuring and funding source; a "special-purpose" banking system; and public banking.

It is critical for the successful operations of a public banking system that enough money be secured to sizably demonstrate the effectiveness of the system, and that the consumer offices be small enough, and autonomous enough, that the system can keep in touch and respond to the shifting economic, housing and credit markets in the communities of the city. As money is most readily obtained through a centralized body, this implies an umbrella function to the central bank. Money would be obtained on the large scale, for use on the autonomous community scale.

Precedents of this concept abound. If effect, the Federal Reserve System provides a similar service for its member banks. Through its Discount window, and through the Federal Funds market, the Federal Reserve operates both as a funding source for its members and as a clearinghouse for the exchange of money between the reserve members. The secondary mortgage market, with the Gederal National Mortgage Association (FNMA, or Fannie Mae), the Government National Mortgage Association (GNMA, or Ginnie Mae), and the Federal Home Loan Mortgage Company (FHLMC, or Freddie Mac) acting as principle intermediaries, also serves as a centralized capitalizing source for the autonomous mortgage lenders (S&Ls, commercial and mortgage banks, mutual savings banks, life insurance companies). These agencies sell bonds on the capital market, and with this money buy the mortgages

from participating institutions, which thus get to tap additional sources of capital. Federal S&Ls often borrow money from the Federal Home Loan Bank Board; the farmers' coops from the farmers' cooperative banks. All these methods have in common a large centralized pool of capital, generally obtained through the capital market offered to participating autonomous units. The units are eligible to participate once they meet certain criteria (such as meeting the requirements for membership in the Federal Reserve System), for a commercial bank, much as the public banking system would have to set up criteria as to the responsibilities of its members to the communities they are located in.

The second concept which seperates a public banking system described here from more traditional approaches to banking is that of special purpose banks. Commercial banks advertise that they are 'full service' facilities, offering checking and savings accounts, time deposits trust departments, international monetary exchange, loans for businesses, consumer, real estate, and securities purchases, and a myrial of other things. The public banking system envisioned here would not offer that range of services; rather, it would restrict itself, basically, to those areas of credit services and demands which are currently unmet by the private institutions. Again, precedents abound, both currently and in the past. Federal S&Ls, when they give loans, put the bulk (80 - 95%) of their money into real estate loans, and generally first mortgages. They are restricted by law to that field as their primary loan market. Credit unions which

are federally chartered must be primarily consumer lenders, rather than real estate or business creditors. The Morris Plan Banks of the earlier part of this century were, at the time of origination, consumer lenders to the working class. Dewey pointed out, in State Banking Before the Civil War, that:

> Frequently banks were organized to further the fortunes of an internal-improvement company, and were authorized to invest in some particular stock. For example, Rhode Island in 1831 chartered the Blackstone Canal Bank and empowered it to invest $150,000 in the stock of the canal company. In 1832 the Quinebang Bank of Connecticut was required to subscribe $100,000, or one-fifth of its capital, to the stock of the Boston, Norwich and New London Railroad Company. The Commercial Bank of New Jersey, 1822, was authorized to set apart a portion of its capital for carrying on seal fisheries. The extension of charters in Maryland in 1813 was conditioned on investments in the stock of a turnpike company, and later this method of securing financial support was frequently resorted to. Virginia, in 1833, authorized two of her banks to subscribe for stock in an internal-improvement company.

Special purpose banks, when using the term bank generically, comprise the majority of banking institutions operating today, as well as the majority operating in the past.

The third concept which separates the public banking system from the private institutions is simply the notion of public banking. As explained above, there are numerous examples of public capitalizaing sources, the bankers' banks, and of special purpose banks. There are also numerous instances of public depository institutions. The state bank of North Dakota, chartered in 1919, accepts both the deposits of state agencies and municipalities within North Dakota as well as the deposits of state residents and businesses. The Bank of British Columbia is also a public depository (and is looking to provide additional

capital to the province's credit unions), and was legislated into existence in 1975. US Government savings bonds, while not structured institutionally, still fall within the concept of public depositories. The First and Second Banks of the United States (started in 1791 and 1816), and the state banks of Indiana, Missouri, Illinois and Mississippi (started in the 1830's) were partially or fully owned and controlled by public bodies. As with the other two 'new' concepts in a District of Columbia public banking system, the concepts turn out not to be new at all, but rather well ingrained in past and current credit institutions.

Transferability

The system modeled here is designed for the District of Columbia. The urgent need for alternative credit initiatives in the city lends itself to the District adopting this model. Conceptually, though, the model for a public banking system need not be unique to the District. Public banking is feasible in all areas of the country.

The functions of public banking in other areas may be different than those proposed for D.C. States may use public deposits to purchase the gereral obligations, revenue and pollutions control bonds of its cities, or the bonds of its housing and business finance agencies. Municipal credit needs are far different from those in farming communities: in these areas states may use public deposits to fund loans to small and medium

sized farmers, or to farmers' cooperatives. States and cities may decide to use their banks to make loans to consumer cooperatives, or to give precedence to business development over housing needs. The functions of a public banking system would differ area by area.

The structure of public banking would also differ, depending partly on the funtioning of the system. Banks operating as a source of capital for cities or finance agencies would not need the extent of decentralized structure necessary for banks directly lending and counselling in municipal neighborhoods. States without strong community credit unions would not initially have credit unions as the branches. Any of these functions and structures, though, fits easily within the conceptual framework of special purpose public banking, with centralized capitalization and local control of the branches. The specific issues of capitalization, deposit insurance, reserves, liquidity and scale - as they relate to public banking in areas other than the District of Columbia - can be treated specific to those areas considering their own model for a public banking system.

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