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Public Banking: From Feasibility to Implementation

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Abstract

The purpose of this study is to explore the obstacles towards implementation of a public banking system within the United States through a review of the literature on public banking. A review of the literature on public banking demonstrates fluidity in the definition of public banking as legislative efforts attempt to take the path of least resistance towards implementation. This study provides macro and micro benefits and challenges for formation. Global examples of public banking systems are reviewed along with political challenges in coordination and cooperation learned from the COVID-19 pandemic. This literature review concludes with practitioner observations at the micro level on the potential impact in forming a public bank along with future research opportunities. The study also includes narrative around implementation challenges in determining capitalization requirements in the formation of a public bank.

Keywords: *Public banking; access to capital; small business lending, microfinance*

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1. Introduction

On March 10, 2018, in Loveland, Colorado a retreat on the topic of Public Banking was convened through an anonymous donation to the Public Banking Institute. This small group consisted of scholars, bankers, elected officials, public servants, and activists from all over the United States. The objectives of the retreat were to share best practices, identify strategies, and discuss potential obstacles towards implementation of public banks throughout the United States of America (USA). As a participant in the retreat, the experience provided foundational context, varied perspectives on the obstacles for implementation, and incentive towards future research opportunities. The strategies regarding implementation of a public bank require proficiencies in public policy, money, and banking, along with political savvy and/or agility.

In a study by Fairlie et al. (2022), data from the restricted-access version of the Kaufmann Firm Survey (KFS) was compared to the credit ratings from Dun and Bradstreet reports for black-owned businesses. Large racial differences in the sources and amounts of financial capital used to start a business continue with black-owned start-ups continuing to experience disparities in alternative sources of capital (Fairle et al., 2022). Minority entrepreneurship continues to experience barriers to acquiring work experience or corresponding education, access to debt and equity capital, and access to markets for their products and services (Bates et al., 2018). As large banks change their business models to larger and more profitable loan amounts, many small-business borrowers find themselves without viable options for bank funding (Zhu, 2022). Although the Community Reinvestment Act (CRA) and the Community Development Financial Institution Fund (CDFI Fund) were established as reforms to address the challenges of low-income communities with high minority populations, these reforms have had limited success in closing the access to credit gap for minority entrepreneurs (Zhu, 2022).

Public Banking has been a point of discussion throughout the United States as a resource for closing the gap on access to credit for small businesses and minority entrepreneurs. Firms owned by minorities continue to show a heavy reliance on debt capital and lower approval rates including the pandemic driven Paycheck Protection Program (PPP) loans (Wiersch & Misera, 2022; Wiersch & Shane, 2013). This review of the literature provides the conduit towards future research regarding implementation strategies around the creation and funding of a public bank.

2. Literature Review

Public banks are different from private banks as their mandate begins with the public's interest and are owned by the public since their funds come from a state or local governing body (Public Banking Institute, 2021). This concept of placing value in stakeholder's interests over shareholders' interests is also referenced as a stakeholder management theory (Parmar et al., 2010). Stakeholder theory is defined by assigning an economic unit of measure to stakeholders such as employees, customers, suppliers, financiers, and even competitors (Parmar et al., 2010). Although there is agreement that public banks are publicly funded and therefore publicly owned, there are discrepancies around whether the bank is controlled by a municipality, city, or state or run privately through a holding company (HR&A Advisors, 2020; Scherrer, 2017). In a feasibility study for the City of Philadelphia, HR&A Advisors (2020) provided a comprehensive list of resources for financial services divided by commercial banks, non-traditional banking services, mission driven institutions, and city efforts of programs and services. Even with the acknowledgement of a long list of resources for access to capital, demand for capital in underserved communities continues to be elusive (HR&A Advisors, 2020; Wiersch & Shane, 2013). In a survey of nearly 11,000 employer small businesses, it was demonstrated that firms owned by people of color reported lower approval rates for even the pandemic related Paycheck Protection Program (PPP) loans (Wiersch & Misera, 2022).

There are 32 states with active legislation around public banking and four pieces of legislation at the federal level being given consideration in the USA (Public Banking Institute, 2021). Additionally, eighteen public bank bills were introduced in 2021 (Public Banking Institute, 2022). These legislative efforts center around the feasibility of a public bank at a city or municipal level or at the state or commonwealth level (Public Banking Institute, 2021). Despite the recognized financial success and community impact of the Bank of North Dakota that has been in existence for over 100 years, no city or state has implemented a public bank in the USA (HR&A, 2020 & Public Banking Institute, 2021). The Bank of North Dakota remains as the only state-level public bank in the USA (Uğurlu & Epstein, 2021).

The creation of the Bank of North Dakota (BND) initially was a strategy to address access to capital for the underserved agriculture industry but evolved over time to become an economic development strategy with the first transfer of funds to the State's General Fund occurring in 1945 (Bank of North Dakota, 2021). The history of BND is a compelling one as examples of the bank focusing on their stakeholders as opposed to their shareholders is prevalent. From recovery funding during the floods of 1997, participations loans for development in 1967, to paying teachers during the Great Depression, BND has been a resource for North Dakota (Bank of North Dakota, 2021). The passion of activists' eager to find resources for the underserved communities of minority and women owned businesses is easy to understand, as public banking as seen through the BND model, appears to be a viable solution to the problem of access to capital. What can we learn from the success and failure of public banks outside of the USA? This study will review public banking from a global perspective to see if there are lessons to be learned from the success or failure of public banks outside of the USA.

3. Discussion

3.1. Problem or Challenge

There is empirical analysis around three different countries that share the commonality of a significant public sector in banking (Scherrer, 2017). Brazil, Germany, and India have significant differences with India having significant numbers of unbanked households, and Germany representing a mature financial market and one of the places where public banking started (Scherrer, 2017). Brazil provides an opportunity to research how public banking can provide stabilization to a financial market through anticyclical interventions (Scherrer, 2017). Most of the activist driven research and narrative around public banking looks to solve the challenges of access to capital in underserved or unbanked communities (Beitel, 2016; HR&A, 2020), but there is research that demonstrates an opportunity for public banks to play a role in macroeconomic policies or economic development strategies (Scherrer, 2017).

Flögel and Gärtner (2018) in their qualitative study found significant differences between banking systems in the United Kingdom (UK), Germany, and Spain. Of particular interest is the elimination of savings banks in 2017 along with failures of small and regional banks in the UK (Flögel & Gärtner, 2018). Comparatively, 3,400 U.S. based financial institutions have failed since the mid-1980s as of 2012, with 457 representing community banks (Parsons, 2013). The study by Flögel and Gärtner (2018) is a focus on centralized banking systems vs decentralized banking systems with a recommendation for the UK to consider a network of local and public banks. Restructuring of the Royal Bank of Scotland into a network of local and public banks is mentioned in the article as a potential strategy (Flögel & Gärtner, 2018). One of the challenges in implementing a public banking model in the U.S. is that a considerable number of feasibility studies are predicated on creating and starting a public bank as opposed to restructuring an existing bank (HR&A, 2020; & Public Banking Institute, 2021). The void left by the acquisition of community banks by the larger banks has been noted and documented (Fairlie et al., 2022; Zhu, 20222). Converting small community banks into locally owned but privately run public banks appears to coincide with the strategy of a network of local and public banks successfully implemented by the Royal Bank of Scotland (Flögel & Gärtner, 2018). Additionally, the study by Swack et al. (2012) suggests a policy recommendation to establish a network of CDFIs in order to build infrastructure and scale up resources to provide significantly more services to under-served populations.

There is also the challenge of cooperation among all the states and municipalities within the U.S. The COVID-19 pandemic illustrated the need for political cooperation as members of the World Health Organization (WHO) had trouble in coordination problems and cooperation problems (Benvenisti, 2020). Benvenisti (2020) articulates lessons learned from the SARS outbreak and the COVID-19 pandemic in terms of the effectiveness of the WHO and calls for the need to refit this organization with the power to secure interstate cooperation. This presents a possible need for an umbrella organization that ensures coordination and cooperation among a network of local and public banks as a public bank by definition would be outside of the Federal Reserve Banking System.

Uğurlu and Epstein (2021) point out that the BND model of public banking is a partnership model between the state funded bank and other financial institutions. A feature worth noting is that in the partnership model the public bank does not compete with private banks for retail deposits and relies primarily on interest and fees associated with lending activities (Uğurlu & Epstein, 2021). HR&A Advisors (2020) project a return on assets (ROA) of 1.42% to 1.46% in their feasibility study for a public bank in the City of Philadelphia, if the city were to incorporate a small business lending component to their small business support model. This ROA aligns with research from the Roosevelt Institute's 1% projected ROA (Beitel, 2016). This conservative estimate of a 1% ROA translates into $15 million in profit for a $15 billion portfolio, provides context on why elected officials are investing time and energy on public banking (Beitel, 2016). Profits that can be reinvested back into the community for challenges such as infrastructure, education, and public safety.

The worldwide public health emergency of COVID-19 has emerged as a global economic crisis as countries continue to struggle with the socioeconomic challenges in the short-term and long-term objectives of macroeconomic policies (Loayza & Pennings, 2020). Consumers have had first-hand experience with the USA's weaknesses in healthcare, supply chain management, economic development, and access to capital. "Change happens when the pain of staying the same is greater than the pain of change" (Robbins, 2021). The economic and social disparities that have been highlighted by the COVID-19 pandemic have activists re-energized around the role public banks can play as new economic policies start to emerge. One of the topics from the 2018 public banking retreat in Loveland, Colorado was on the need for banking services for the emerging cannabis industry. Medicinal and recreational cannabis is still considered illegal at the federal level but as more states and municipalities move towards the legalization of cannabis, the industry has been limited by having to do business on a cash basis only. The majority of merchants that provide credit card services and cash management services are part of the Federal Reserve Banking system thus creating legal challenges for cannabis distributors to accept credit cards. The strategic solution could be that a public bank can be set up to receive deposits from the cannabis industry and in return provide access to credit and merchant services enabling them to receive credit and debit card transactions.

3.2. Solution/Results

The recession of 2017 demonstrated the cyclical behavior of markets and the corresponding regional or sector inequalities that could be reduced through the alternative of a public bank (Falk & Blaylock, 2012; Scherrer, 2017). The impact of the COVID-19 pandemic has shown that businesses owned by people of color continue to experience disparity in access to capital (Wiersch & Misera, 2022). The definition of what constitutes a public bank appears to be fluid as control of the bank fluctuates depending upon the audience or legislative steps required for implementation (HR&A, 2020; & Public Banking Institute, 2021). There is agreement among the eighteen public bank bills that the bank is publicly funded (Public Banking Institute, 2022), but inconsistency as to the control of the bank. Feasibility studies fluctuate as to whether the proposed public bank be privately run, under government control, or a quasi-government agency. There is research that suggests the answers to these questions depends on whether the objective of the bank is to allocate resources to segments of the economy that will generate income and employment, or to meet the credit demands in underserved economic segments and geographical areas (Scherrer, 2017).

A considerable number of feasibility studies and research around public banks focuses on the impact of a public bank from a macro perspective. Missing from these feasibility studies is the potential impact of a public bank at the operational or micro perspective. In conversations with small business lenders or commercial lending officers there are often references to the credit policy of a financial institution. The credit lending policy determines a financial institution's standards, objectives, and risk parameters for lending activity and there is an opportunity to manage credit risk on the national financial system of the bank (Cociug & Postolache, 2019). When I was a Senior Vice President in banking, I would ask to review the credit lending policy during the exploratory phase of an interview and selection process for jobs in commercial lending. Consistently, I was denied access to the credit policy until employment was offered and accepted. Lessons learned from working for 4 top 10 US based financial institutions is there is consistency if not duplication of the credit policy from one institution to another. Furthermore, the credit policies of financial institutions still are weighted towards an industrial or manufacturing based economy. Typically, within the credit lending policy is a list of cautionary industries or industries that a commercial lender should proceed with extreme caution in advancing capital Over the years of leading various commercial lending teams it became apparent that the majority of growth in our (USA) economy was within the service or knowledge-based industries, but credit policies leaned in favor or in support of a manufacturing-based economy.

A public bank with a credit policy designed and written to the satisfaction of stakeholders as opposed to shareholders offers an opportunity to impact underserved communities and socio-economic objectives. The Carsey Institute conducted a detailed analysis of over 500 CDFIs from the period of 2005 through 2010 (Swack et al., 2012). Although CDFI banks saw a 7.9 percent annualized return on median assets compared to .63 percent for the comparison group of banks, 30-89 days' delinquency rates for business loans aligned with the comparison group at less than one percent (Swack et al., 2012). In my nine years of public service within the Commerce Department for the City of Philadelphia it was common to see CDFI underwriting and credit policies that were synonymous if not identical to the credit policies of privately owned banks. Low delinquency rates that align with comparable commercial lending banks support this observation (Swack et al., 2012). The formation of a public bank has the potential for positive economic impact as demonstrated by the BND, but attention needs to be given to the design of the public bank from a micro-perspective focusing on the credit policy of the proposed bank. A bank with a credit policy that focuses on the community's infrastructure, educational, or affordable housing needs and shifts the objective from the needs of the shareholder to the needs of the stakeholders would be following a stakeholder management theory as opposed to beholden to shareholder goals (Parma et al., 2010).

3.3. Conclusion/Future Research

Although there is inconsistency in the definition of a public bank as it pertains to the control or management of the proposed public bank, there is an opportunity to have the desired positive impacts on small businesses owned by people of color if attention is given to the operational aspects of extending credit. Public ownership of a bank by definition means that the bank operates in the interest of the public or a stakeholder management theory (Public Banking Institute, 2021; Parmar et al., 2010). Policy makers can be agnostic to the management and control of the operations of the bank if attention is given at the micro-level towards the proposed bank's credit policy and lending philosophies.

Opportunities for additional research are needed for the implementation of a public bank. Scherrer (2017) discusses the how microfinance institutions and financial credit cooperatives share the experience of public ownership but with a focus on stakeholder objectives as opposed to shareholder objectives. There is a need for research that explores the targeted capital or funding requirements for a public bank and the projected community impact of said capitalization. The study by HR&A (2020) and Beitel (2016) projects the financial impact of a 1% ROA, but what should be the initial capital need and will it require legislative approval.

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