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State-Owned Bank: How California Could Save $10 Billion on a $9 Billion Loan

California's Prop. 51

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School districts are notoriously short of funding – so short that some California districts have succumbed to Capital Appreciation Bonds that will cost taxpayers as much is 10 to 15 times principal by the time they are paid off. By comparison, California's Prop. 51, the school bond proposal currently on the ballot, looks like a good deal. It would allow the state to borrow an additional $9 billion for educational purposes by selling general obligation bonds to investors at an assumed interest rate of 5%, with the bonds issued over a five-year period and repaid over 30 years. $9 billion × 5% × 35 equals $15.75 billion in interest – nearly twice principal, but not too bad compared to the Capital Appreciation Bond figures.

However, there is a much cheaper way to fund this $9 billion school debt. By borrowing from its own state-chartered, state-owned bank, the state could save over $10 billion – on a $9 billion loan. Here is how.

A Look at the Numbers

First it would need to charter a bank. In California this can be done with an initial capitalization of $20 million; but for our purposes, assume an initial capitalization of $1 billion.

Where to get this money? The state's public pension funds are always seeking good investments. Today they are looking for a return of about 7% per year (although in practice they are getting less), and they have wide leeway in the sorts of things in which they can invest. So assume the capital comes from the pension funds, which are promised a 7% annual dividend and the return of principal after 35 years.

At a 10% capital requirement, $1 billion in capitalization is sufficient to back $10 billion in new loans, assuming the bank has an equivalent sum in deposits to provide liquidity.

Where to get the deposits? One possibility would be the California Pooled Money Investment Account (PMIA), which contains $68.3 billion earning a modest 0.61% as of the quarter ending September 30, 2016. This huge pool of rainy day, slush and investment funds is invested 46% in US Treasuries, 20% in certificates of deposit and bank notes, 11% in commercial paper, and 8% in time deposits, along with some other smaller investments. $10 billion of this money could be deposited into a savings account at the state-owned bank, on which the bank could pay 0.61% interest, the same average return the PMIA is getting now.

At a 10% reserve requirement, $1 billion of this money would need to be held by the bank as reserves. The other $9 billion could be lent or invested – a sufficient sum to provide the funds sought by Prop. 51.

The annual cost of financing this $9 billion loan would thus be $1 billion × 7% = $70 million for the pension funds, and $10 billion × 0.61% = $61 million for the PMIA. So the total cost of funds would be $131 million annually × 35 years = $4.585 billion. That is less than one-third of the $15.75 billion in interest anticipated under Prop. 51 – a savings of $11.165 billion over 35 years on a loan of $9 billion.

If at the end of the 35 year period, the bank repays the pension funds their $1 billion initial capital investment, the net savings will be $10.165 billion – a huge sum.

What about the other costs of setting up a bank – buildings, staff and the like? These would actually be minimal. Like the Bank of North Dakota (BND), currently the nation's only state-owned depository bank, the California state bank would not need to advertise, would not need multiple branches or tellers, and would not need ATMs. It would be a "bankers' bank" or "money center bank," providing capital and liquidity for local banks and large institutional investors.

For purposes of funding this one infrastructure loan, the bank could arguably be run by one man sitting in an office in the statehouse, shuffling numbers around on a computer screen. Bonds would not even need to be issued. The state could just make the loan to itself.

What about Risk?

The objection typically raised by legislators is, "We can't afford to lend our deposits. We need our revenues for our state budget." But those concerns assume that banks actually lend their deposits. They don't. In March 2014, in a bombshell report titled "Money Creation in the Modern Economy," the Bank of England officially set the record on this issue straight. The BOE economists wrote that many common assumptions about how banking works are simply wrong. Banks are not merely intermediaries that take in money and lend it out again. They actually create the money they lend in the process of making loans:

> The reality of how money is created today differs from the description found in some economics textbooks: Rather than banks receiving deposits when households save and then lending them out, bank lending creates deposits.
>
> . . . Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money. [Emphasis added.]

The BOE report said that private banks now create nearly 97 percent of the money supply in this way. David Graeber, writing in *The UK Guardian*, underscored the dramatic implications:

> . . . [M]oney is really just an IOU. The role of the central bank is to preside over a legal order that effectively grants banks the exclusive right to create IOUs of a certain kind, ones that the government will recognise as legal tender by its willingness to accept them in payment of taxes. There's really no limit on how much banks could create, provided they can find someone willing to borrow it.

If money is just an IOU, governments do not need to sell off public assets and slash public services in order to pay their debts. They can create money in the same way private banks do, simply with accounting entries on their books. That is the secret power of banking, a power that governments to date have given away to a private banking cartel. Federal governments could reclaim this power by simply issuing the money they need, as the American colonists did in the 18th century. State and local governments could reclaim the money power by forming their own banks and creating the money they lend on their books, as all depository banks do.

When deposited in its own state-owned bank, the state's revenues would be just as safe, liquid and available as they would be if deposited in a Wall Street bank. All banks attempt to be "fully loaned up," lending a sum equal to 90% of their deposits – or they did before the central bank started paying interest on "excess reserves" held on their books. The way they deal with a lack of liquidity when depositors and borrowers all come for their money at once is to borrow "wholesale" deposits from other banks or the money market. This borrowing is quite cheap – currently 0.39% from other banks overnight – and the loans can be rolled over and over until new deposits are acquired to balance the books.

In the case of our proposed California state-owned bank, if it comes up short of liquidity, a portion of the remaining $60 billion in the PMIA fund could be shifted into the bank as deposits. The bank could again pay 0.61% interest on these funds, the same return the PMIA is getting now.

The Model of the Bank of North Dakota

This proposal is not pie-in-the-sky. North Dakota has been doing it for decades, very profitably. In November 2014, the Wall Street Journal reported that the BND was more profitable even than J.P. Morgan Chase and Goldman Sachs. The author attributed this remarkable performance to the state's oil boom; but the boom has now become an oil bust, yet the BND's profits continue to climb. In its 2015 Annual Report, published on April 20th, it boasted its most profitable year ever. In fact the BND has had record profits for the last 12 years, each year outperforming the last. In 2015 it reported $130.7 million in earnings, total assets of $7.4 billion, capital of $749 million, and a return on equity of a whopping 18.1 percent. Its lending portfolio grew by $486 million, a 12.7 percent increase, with growth in all four of its areas of concentration: agriculture, business, residential, and student loans.

By increasing its lending into a state struggling with a collapsing oil market, the BND helped prop the economy up. In 2014, it was lending money for school infrastructure at 1%. In 2015, it introduced new infrastructure programs to improve access to medical facilities, remodel or construct new schools, and build new road and water infrastructure. The Farm Financial Stability Loan was also introduced to assist farmers affected by low commodity prices or below-average crop production, and the BND helped fund 300 new businesses.

Those numbers are particularly impressive considering that North Dakota has a population of only about 750,000. California, the largest state in the nation, has 50 times that many people and 50 times the profit potential.

A general rule for government bonds is that they double the cost of projects, once interest has been paid. By leveraging its massive revenue base through its own state-owned bank, California could fund its infrastructure needs at half the cost.

Another Look at Prop. 51

The San Jose Mercury News says of Prop. 51:

> The $9 billion initiative would lock in a costly, outdated and inequitable program that benefits builders at taxpayers' expense. . . . Bankrolled by $7 million mostly from the construction industry, Prop. 51 is an end run around calls from Jerry Brown and the nonpartisan Legislative Analyst's Office to reform school bond provisions.

While waiting for those reforms, voters could encourage their representatives to back a bill for a state-owned bank. Several California legislators are working on that possibility now.

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