
North Dakota's Development Bank

Author(s): Marvin Duncan, Laurence Crane and Cole Gustafson

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North Dakota's Development Bank

At a time when many rural states are searching for ways to spur economic development and job formation, North Dakota may have part of the answer—its own development bank. Most states have developed an array of business incentive programs to spur the pace of job formation and income generation for their citizens: community development block grants, industrial revenue bonds, job training, and economic development commissions, among others. But a state-owned bank is almost an anachronism.

The State Bank of North Dakota was born out of a wave of populism that swept across middle America between the two world wars. North Dakota wasn't the only state that tried state-owned enterprises as a counterbalance to corporate ownership. But North Dakota was more adventurous. The state founded its state-owned bank in 1919. Soon thereafter, it founded a state mill and elevator and an insurance company. The mill and elevator and the bank continue to exist, enjoying broad-based support across the state's political spectrum.

Bank functions

The bank's mission, while somewhat broader than a typical development bank, has historically encompassed much of that role. It seeks to encourage development of agriculture, commerce, and industry. Its programs promote the economic growth of North Dakota. It provides liquidity and correspondent banking services, assuring cost-effective banking services to community banks in the state. The bank, through loan programs and interest rate subsidies, seeks business growth and greater economic diversity.

The bank carries out its business development role primarily through its lending program. That program encompasses both direct lending and participation in loans originated by North Dakota lenders. The primary trade area lies within the state, although loan participation outside the state is authorized when it supports business development within the state. The bank requires sound underwriting before it extends loans. Loans to one borrower may not exceed 25 percent of the bank's capital and surplus. The bank participates in lending with commercial banks, savings and loan companies, credit unions, Farm Credit System (FCS) institutions, and other qualified financial institutions.

A number of programs support beginning farmers, family farms, farm ownership, and farm-based businesses. Some of these programs involve preferential interest rates, and all of them place upper limits on the dollars of participation in each loan. For example, the bank can participate only up to \$200,000 for operating loans and no more than \$300,000 for farm real estate purchase programs. While these amounts are substantial, they nonetheless restrict the bank to lending for family farm operations rather than larger-scale commercial farms. The bank's role is one of leveraging its limited loan funds by assuring participation by another lender in the project. Agricultural loans, though a slowly growing part of the bank's portfolio, increased to 21 percent in 1992.

The bank's commercial lending, primarily participation lending, has enjoyed steady growth. Several programs exist to support business development. These include small business loans with

- participation of up to \$187,500 in a

single loan, and business development loans with no more than \$500,000 of bank funds in a single loan. A loan participation program involving community and bank participation in interest buy-down focuses on lending for job creation. A special program exists to attract financially strong companies to North Dakota. This program permits loans of up to \$25 million to a company and an interest rate buy-down to 0.25 percent over an equivalent U.S. Treasury Note rate. Loan participations are also available to support oil and gas reworking, recompletion, and enhanced recovery activities. Commercial lending accounted for about 20 percent of total bank lending in 1992.

Finally, the bank makes direct loans to support bank stock purchase by North Dakotans. Bank stock loans have decreased to quite low levels and amount to less than \$3 million, only about one percent of the loan portfolio.

Two additional lending activities account for 58 percent of all bank lending activity. Residential lending, while sharply lower than a few years ago, still accounts for more than \$61 million, or 20 percent of all loans. Student loan lending activity has grown over 150 percent since 1990 to reach \$118 million, 38 percent of all loans. Most of the volume is in guaranteed student loans.

The bank manages a number of special loan programs for the State of North Dakota: a community water facility revolving loan fund, a developmentally disabled facility loan fund, and a mechanism to provide supplementary funds for Farmers Home Administration funded projects.

The bank provides certain other lending-related services for the state's lenders. The bank maintains a second-

ary market in student loans and will purchase the guaranteed portion of Small Business Administration (SBA) loans, Farmers Home Administration (FmHA) Business and Industrial Loans, and Bureau of Indian Affairs loans. The bank is one of the largest SBA partners in the state. In this way, lenders within the state are encouraged and supported in their use of these programs to benefit North Dakota business development.

In addition to its lending activities, the bank maintains an investment portfolio. That investment portfolio primarily contains government or U.S. government agency debt obligations. The bank seeks to earn a profit. Periodically, the state legislature uses part of bank profits to support legislated activities. While the bank is under the control of the state legislature, its day-to-day activities are under the direction of the State Industrial Commission made up of the governor, the attorney general, and the commissioner of agriculture. These persons collectively serve as the bank's board of directors.

The bank provides correspondent banking services to North Dakota banks, including check clearing, coin and currency service, foreign currency, wire transfer and traveler's checks, and drafts. The motivation for providing operations and retail services to banks in the state is to assure rural banks access to high-quality correspondent bank services at nondiscriminatory prices. Arguably, this service may no longer be as important to rural banks as it once was.

The bank's funding to support its lending activities is partially derived from deposits by individuals, banks, businesses, and government entities. Government entities within the state are required by law to maintain deposits with the Bank of North Dakota. The bank is also a net purchaser of federal funds, which are overnight loans from banks with excess reserves. From time to time, the bank discusses adding to its lendable funds by selling longer-term debt instruments. However, the liability side of the bank's balance sheet is principally composed of deposits and federal funds purchased.

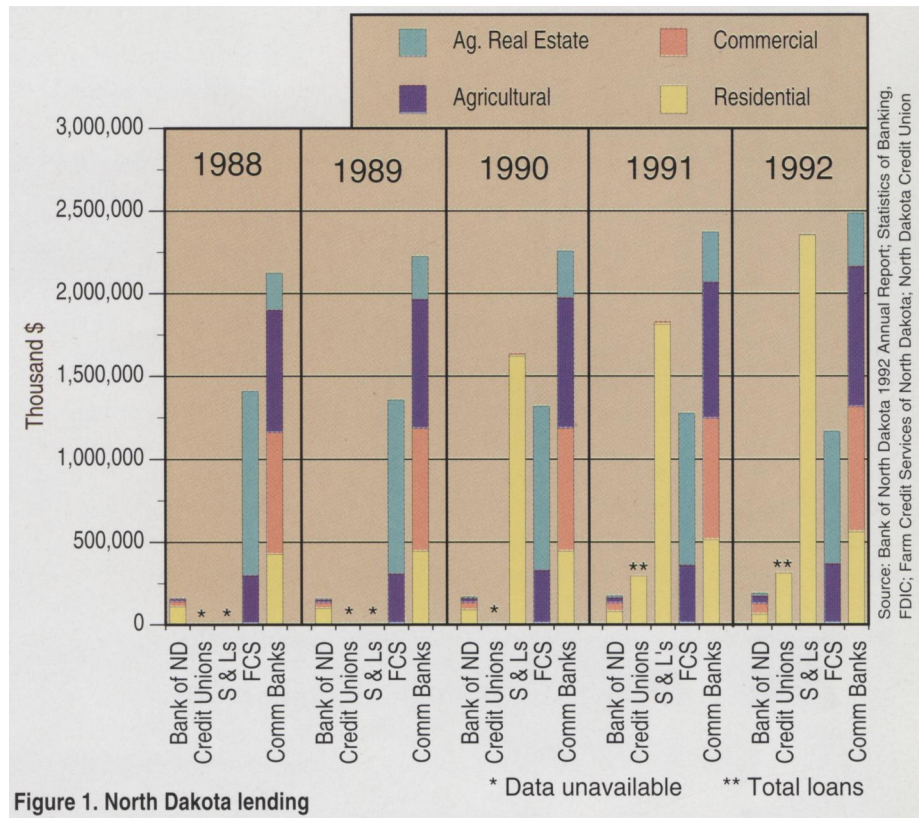


Figure 1. North Dakota lending

The bank continues to be responsive to the interests of the state's legislature. A number of special programs have been assigned to the bank and funded out of bank profits. The bank has carried out its responsibilities in a professional and effective manner. Its activities have focused on supporting the state's primary industry, agriculture, and spurring economic development and job formation.

In supporting economic development, the bank acts as a conduit between the public sector and private sector business projects. It serves three principal functions. First, it provides support in technical analysis on loan proposals for community-based lenders. Second, it partners with the SBA, FmHA, and community lenders in assembling debt capital packages for businesses. Third, it provides overline lending to community lenders when loan requests exceed their regulatory lending limits.

The bank's role is limited by its capital base. Its loan volume is very small relative to that of the state's commercial banks, savings and loan associations, and the Farm Credit System (figure 1).

It is also less than total credit union loan volume. Yet, North Dakota public officials believe the bank plays a positive and catalytic role in support of economic development.

Ways to improve bank success

Primarily limited by its deposit base to support its lending activities, the bank's contribution to larger projects is necessarily marginal. Most of the programs it offers focus on lending to farmers and small businesses. But, the ability to put more lendable funds into key projects may be critical to its economic development role. This is particularly true for business development unrelated to agriculture.

Since a number of its programs rely on subsidized interest rates, the bank may attract borrowers that have financial problems. Revamping programs to create attractive opportunities for financially able firms seems an important alternative to consider.

The programs primarily rely on providing debt financing. The bank often partners with the SBA in providing a debt capital package using SBA loan

guarantees. The absence of equity or quasi-equity financing among the bank's products limits its success as a development bank. However, limited equity capital is available through other state and local programs. The bank should possess the ability to pool both its equity and debt investments in businesses for resale either in private placement or in securitization to investors. Some carefully targeted credit enhancements would add to the market appeal of these equity, quasi-equity, and debt investments. Moreover, asset sales would serve to reliquify the bank for further development financing.

Greater capitalization for the bank of North Dakota would likely be necessary before the bank could fully exploit its role as a development bank. That implies a fundamental policy decision for North Dakotans. Should the legislature continue to tap bank profits to support other high-value programs for the state, or should the bank's profits be allowed to accumulate to support increased lending activity? Should the bank sell long-term debt instruments to support its lending role? And,

would the bank benefit from access to long-term, low-cost lendable funds from, for example, a linkage to the U.S. agency market?

Successful economic development requires more than debt capital and more than money. A means to bring high-quality, targeted management consulting to these businesses could substantially lower their risk of failure in early years of existence. The bank could, of course, include requirements for such consultancies in its loan agreements. In a development banking role, the bank would benefit from even greater capacity for analysis of complex, high-risk loan or investment projects. That capacity would also support the role of packager or securitizer of development loans and quasi-equity.

Filling a niche

The bank of North Dakota fulfills a very visible role in supporting economic growth and job formation in North Dakota. It is responsive to its citizenry and to the interests of the state's legislature. The bank has not grown larger, because its profits are periodically di-

rected by the legislature to other high-priority uses.

It does not have, however, the full range of authorities one might expect in a development bank. Attributes that would strengthen its role as a development bank include access to a larger volume of lendable funds at low cost, the capacity to secure an equity position or quasi-equity position in a start-up firm, and the ability to assure access to a range of business consulting and advisory services to support the start-up and growth firms it serves. Decisions on such services and capabilities lie outside of the jurisdiction of bank management. Within management's jurisdiction the bank fulfills an important, albeit specialized, niche in supporting North Dakota's economic growth. ■

Marvin Duncan is professor, Laurence Crane is assistant professor and an extension farm financial management specialist, and Cole Gustafson is associate professor and interim chairperson, all in the Department of Agricultural Economics at North Dakota State University.

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Note: *AJAE* is the *American Journal of Agricultural Economics*, *Agribusiness* is *Agribusiness: An International Journal*, and *JEEM* is the *Journal of Environmental Economics and Management*.