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Promoting State Financial Innovation

ENHANCING STATE BANKING POWERS

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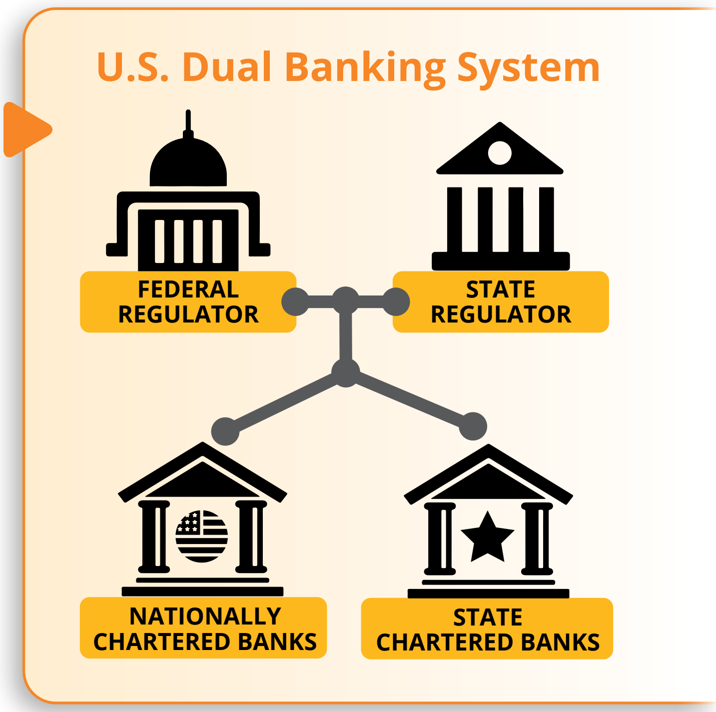
The generosity of these individuals in sharing their profound knowledge and experiences has been instrumental in shaping the narrative and conclusions of this report. It is our sincere hope that this paper duly reflects the richness of their contributions and helps advance understanding of this evolving field.

Executive Summary

States have always been key to supporting and developing financial innovation in America. The power of states to set up and manage financial institutions is crucial to our financial and federal systems. Over the past several years, while bank regulators in Washington, D.C. have been asleep at best—and antagonistic at worst—red and blue states alike have taken charge.

A vital part of our financial system and government is that both federal and state authorities oversee financial institutions. **The U.S. dual banking system consists of both state and nationally chartered banks, supervised by state and federal regulators.** Famed banking scholar Arthur Wilmarth noted the power of the dual banking system, saying, "Thus, as has often been true during the history of our dual banking system, state innovation may provide the basis for a new federal approach to bank regulation and the appropriate scope of bank powers."[1] More recently, Adrienne Harris, Superintendent for the New York Department of Financial Services (NYDFS) said, "there is a real role for states to play because we are here on the ground. We're often much nimbler and can act faster."[2]



This paper examines the actions of aggressive federal authorities, who create an environment that leaves banks unwilling or uncomfortable to serve particular clients or types of clients. More importantly, and frighteningly, they are constraining state powers, leaving them unable to charter fully operational banks within their own boundaries. States can develop novel solutions, rooted in their historical and current legal authorities, that can support fairness, technological and political neutrality, and allow for banks' safety and soundness to be secured.

Federal regulators continue to behave in harmful ways that affect customers (both businesses and individuals), making it difficult for them to acquire or keep bank accounts. Further, financial innovation severely slows when aspiring, novel financial institutions can't open their doors because of lack of permission from federal regulators to access critical payments infrastructure. These decisions from federal authorities have been purposefully opaque and very likely political. Perhaps, more importantly, many leading scholars of various political persuasions believe these decisions to be lacking in legal merit. Still, states have opportunities to reassert their authorities through creative policymaking.

This paper provides a brief history of state banking powers and our dual banking regulatory system. This is followed by an examination of a few recent case studies that demonstrate creative, forward-thinking efforts on the part of some states but also roadblocks built by federal actions, both active and passive. Finally, the paper offers some considerations for state policymakers, supporting their historical importance as regulators of financial institutions they charter and oversee within their own boundaries.

The dual banking system is at a crucial point and facing great pressure. The rapid progression and evolution of financial technology, including cryptocurrencies, necessitates a regulatory system that moves at similar speed. States are in a special position to act quickly. It's not just their right to use their power. It's their duty to accelerate economic growth, consumer protection, and political fairness. Further, they should maintain the right to ensure that the politics of the moment don't encroach on the ability of their banks to do business within the confines of the law. These laws and regulations are intended to be technologically—and politically—neutral. State policymakers should consider this paper and their significant role and responsibility to help solve the problems many face in our financial system today.

The Problem

In the United States today, businesses perceived to be controversial or politically sensitive face significant challenges in securing and maintaining bank accounts. This issue is prevalent across a range of sectors, including crypto companies, marijuana businesses, gun manufacturers, and abortion service providers.[3] Scorn from federal authorities has led to banks, who interpret the authorities' "concerns" as veiled threats, closing accounts of these businesses or individuals involved in the businesses. Federal agencies like the FDIC have been criticized for their lack of clear guidance and reasoning for these actions, particularly in relation to crypto companies. The U.S. dual banking system is unique, and there must be a recognition of the significant economic influence of individual states within this system. The history of state banking powers must be rediscovered, and recent regulatory developments that have eroded these traditional authorities should be countered. In light of the current banking climate, there must also be a reevaluation and utilization of state banking authorities' powers.

Currently in the United States, numerous industries face challenges in obtaining and maintaining bank accounts. In many cases, these industries are controversial or politically out-of-favor among some. You've seen this most markedly in the relationships between banks and online lenders, payments companies, crypto companies, etc., but it's also affecting marijuana businesses, gun manufacturers and stores, and abortion service providers. **Often, these banks are limiting or closing accounts with these customers to avoid "perceived regulatory concerns."**[4] Existing concerns and preconceived notions were only exacerbated by the implosion of FTX and well-publicized bank failures. These decisions have been capricious, arbitrary, and political, as noted by numerous lawmakers, academics, and industry observers of various political leanings.[5]

For example, the FDIC's own Inspector General ("IG") found that while the FDIC has voiced public concerns about banks who work with crypto companies, they've provided no ***evidence*** to back up these concerns. Moreover, the agency has not provided any clear guidance to these banks on how they might ***address*** their concerns. Instead, they have issued threatening "pause letters" to banks, "asking them to pause, or not expand, planned or ongoing crypto-related activities, and provide additional information."[6] The IG slammed the FDIC for not conducting a thorough risk assessment to inform and support their position. They also criticized the agency for providing no further information following the "pause letters, creating enormous uncertainty and leaving the banks with the impression that the FDIC is unsupportive of crypto related activities. Judging from their public work, communications with their regulated banks, and the government's own watchdog, this would appear to be a ***feature*** of their treatment of crypto and not a bug."[7]

In over a dozen interviews, crypto and fintech related business owners and users of all types told us their stories of losing their bank accounts. These were businesses of various types and sizes, but all had enormously confusing and negative experiences. In each case, one day, their bank emailed, or sent a letter, or called to inform them that their accounts were being closed and they needed to take their business elsewhere. While the reasons given to these customers differed (and in some cases, no reasons were given at all), it's clear that they lost their relationships because of federal regulators' concerns about the crypto and fintech industries.

This active and passive pressure from federal regulators has directly caused these businesses to struggle to keep their accounts. In some cases, these customers could be defined as merely "crypto adjacent." For example, many are customers of regulated U.S. exchanges, service providers for crypto related businesses, or bitcoin mining hardware companies. In most cases, they use these accounts to simply make payroll or pay vendors.

The result of this targeted debanking effort? Companies close shop or move their businesses overseas, while others remain in a constant scramble to find new banking relationships. Any of these lead to the stunting of financial innovation and economic growth in the United States.

Banks are enabled to do unique business activities via permission granted by either state or federal officials. In many cases, both state and federal authorities are involved. This is often referred to as the "dual banking system."[8] As the Office of the Comptroller of the Currency (OCC) has noted, "[D]istinctions between the national banking system and the state banking system are rooted deep in constitutional principles and our country's formative history. These distinctions are essential to the vitality of the dual banking system and should be encouraged and preserved, not blurred or undercut." (OCC)[9] As Professor Kenneth Scott wrote in his analysis of the dual banking system, the "very core of the dual banking system is the simultaneous existence of different regulatory options that are not alike in terms of statutory provisions, regulatory implementation and administrative policy."[10]

When it comes to the business of banking, financial regulators are primarily concerned with the following: protecting the financial system from illicit activities, promoting the safety and soundness of the financial system and its associated institutions, and protecting consumers from all varieties of scams and predatory conduct. While this list is simple, the entities that conduct oversight and enforcement of these activities are varied. In fact, the U.S. has the most fragmented regulatory structures for financial services. One need only compare the U.S. system with those of other major developed economies. For example, the United Kingdom (UK) has the singular Financial Conduct Authority (FCA), Singapore has the Monetary Authority of Singapore (MAS), and so on. Dan Awrey, well-known corporate and banking academic, recently noted at a Brookings Institution event that there are 27 federal systems in the world and 26 have a single financial regulator.[11] America is the only country missing from that list.

Thus, our dual banking system is a unique hallmark of our financial regulatory structure when compared to the rest of the world. This is important when considering the size of individual state economies, many of which rival some of the largest economies in the world. Far from merely representing small populations or parochial interests, many states have enormous economic strength. California's GDP rivals that of the UK or India, placing it among the world's top 5-6 economies if viewed as a country. Texas, fueled by energy and tech, surpasses nations like Canada or South Korea, situating it in the top 10-15. New York, a hub for finance and media, is on par with economies like Spain or Australia, while Florida, with its tourism, agriculture, and aerospace sectors, compares to the Netherlands or Turkey.

One of the valuable aspects of our financial regulatory system is that it is largely risk-based. Risk is a sliding scale and can be up for interpretation. Also, depending on the size of a bank's balance sheet or compliance department, the relative risk of one bank will not contain the same risk of another. Risk-based regulatory regimes can be useful, as they can adjust for time and evolution of the economy, business types, and technologies, without going back to legislative branches or regulatory agencies every time a new product or business type develops.

This paper recognizes that the power of state banking authorities has waned over the past several decades and believes that those powers should be explored and utilized again. The current climate and tenor around banking necessitate it.

With this in mind, the question then becomes: What role do states, whose banking authorities are powerful and historically critical, have at this current juncture?

In order to answer this question, the history of state banking powers and how recent events and regulatory developments have eroded these traditional authorities must be explored. As financial regulatory scholar Peter Conti-Brown has noted, in recent years, the Federal Reserve has used policy levers not clearly given to them by Congress to essentially "veto state banking authorities."[12] This has been most evident in the central bank's decisions regarding the granting of so-called "master accounts" to some financial institutions. Federal Reserve master accounts are central to the U.S. banking system.[13] When banks want to move money amongst themselves, whether to settle debts or conduct transactions, they do so through these accounts. Think of it like the backbone of interbank financial exchanges. Moreover, the balances in these accounts are closely watched, because they determine the amount of reserve balances banks have on hand, which can affect lending capabilities and interest rates. In essence, these accounts help keep the financial system stable and fluid. Their smooth operation ensures that banks can trust and transact with each other, and their health gives us a glimpse into the broader health of the economy.

The decisions to deny some state-chartered banks these master accounts have been seemingly arbitrary, political, and very opaque.[14] This evolution of policy discretion now puts the federal government in the position of "second guessing the chartering authority's original assessments about whether a financial institution can open its doors."[15]

State policymakers must examine their existing, historical powers and determine whether there are policy options available to them to exert greater authority over the financial institutions they've chartered or want to charter. In doing so, they can push back against moves that arguably "thwart…efforts at financial innovation."[16]

Bryan Schneider, Secretary of the Illinois Department of Financial and Professional Regulation, noted in Congressional testimony, "As a banking regulator, I expect state-chartered banks in Illinois to understand the risks of their customers and to effectively manage those risks. I do not expect, nor require, my supervised banks to reject entire classes of legally operating businesses."[17]

There are unexplored and underexplored policy options to be found at the state level. The rewiring of financial services demands a new perspective and examination of the risks and promises, coupled with a hard look at what is possible if states fully explore their authorities and think creatively.

History and Background of State Banking in the U.S.

Banks in the U.S. have three main jobs: taking deposits, giving loans, and handling payments. People and businesses deposit money in banks, which then use that money to lend to others. Banks also help with paying bills, managing investments, and processing payments, such as when you get your salary or when businesses pay their workers.

The history of banking in the United States dates to the late 18th century. In those early days, banks primarily existed on a state-chartered basis, with their main functions centered around safeguarding government funds and facilitating trade. The First Bank of the United States, created by the first Secretary of the Treasury, Alexander Hamilton, played a critical role in stabilizing the nation's finances, issuing currency, and managing federal debt.[18] However, it closed in 1811 due to concerns over too much federal control.

This era was marked by a lack of uniformity. To address these issues, the Second Bank of the United States was established in 1816. It did not go unopposed. In particular, President Andrew Jackson fought it vehemently and vetoed its recharter in 1832.[19] This event spelled the end for the Second Bank and ushered in the "Free Banking Era," during which state-chartered banks had the authority to issue their own banknotes.[20]

The Free Banking Era was a unique chapter in U.S. banking history. After the Second Bank of the United States lost its charter, states took on the role of chartering banks. While "free banking" sounds hands-off, it wasn't a total free-for-all; state regulations varied. But, without a unified system, some banks went wild, creating their own "wildcat" currencies backed by all sorts of assets.[21] This wild west of banking led to a rollercoaster of bank busts and fluctuating currency values. These weaknesses resulted in calls for a more centralized system to sit side-by-side with state regulations.

Thus, the "free banking era" came to an end with the National Banking Act of 1863. This act created a national system of banks.[22] These national banks were intended to create a uniform and stable national currency, which would replace the proliferation of state-chartered banks issuing their own banknotes. National banks were required to hold federal charters and adhere to a standardized set of regulations.

However, the United States didn't have a centralized and regulated banking framework until 1913. That's when the Federal Reserve System was established, laying the groundwork for today's contemporary banking system.

Since the establishment of the Federal Reserve, state banking has undergone significant evolution in response to regulatory, economic, and technological changes. The Banking Acts of the 1930s, especially the Glass-Steagall Act, created the Federal Deposit Insurance Commission (FDIC), which insured deposits in state banks. Before the FDIC, states like Oklahoma, Kansas, Nebraska, and Texas pioneered their own deposit insurance systems to bolster depositor confidence. By the early 19th century, eight states had adopted such systems, funded by bank assessments within their jurisdictions. However, these state-level schemes struggled during the economic downturns of the 1920s, with many unable to handle the bank failures. A notable collapse was the Bank of Tennessee in 1927, which led to Tennessee's entire deposit insurance system's downfall.

The Great Depression further highlighted these state systems' vulnerabilities, prompting the creation of the FDIC in 1933 and most states eventually abandoning their independent insurance systems. But the FDIC wouldn't exist without its state-based predecessors. Their trials and tribulations, successes and pitfalls, became a sort of blueprint. Drawing from these state-level efforts, it was evident that for any deposit insurance to work, it needed to be well-funded and equipped to assess risks accurately. Using this knowledge, the FDIC was formed with the added muscle of federal backing and a coast-to-coast reach. This model has spread throughout the world. In 2019, there were 145 national jurisdictions that had instituted some form of explicit deposit insurance. In 1974, that number was 12.

In recent decades, state banks have modernized, using ATMs, online banking, mobile apps, and advanced tech like data analytics and AI. **But there's been growing tension between state and federal banking regulators, with states losing some control over their banking systems as Washington encroaches on their historical powers.**

Powers that states have to establish and regulate banks within their borders

Targeted Chartering and Licensing

State governments have the authority to charter and license banks with specific goals in mind. For example, a state might charter a bank focused on providing payment services to other, smaller community banks. They could also charter a "public bank," as discussed later in the paper.

Encouraging Financial Innovation Locally

States can play a leading role in nurturing financial innovation. This could involve setting up experimental zones for new financial technologies, allowing for creative banking solutions like stablecoins or other blockchain-based payment systems.

Advocating for Regulatory Flexibility

States can advocate for regulatory changes at the federal level to better meet the needs of local banks. This might include seeking more flexible rules for small, community-focused banks.

Implementing Tailored Banking Policies

States have the power to create banking policies that address specific local challenges. For instance, they might introduce incentives for banks to support emerging financial technology companies, such as those focused on cryptocurrencies.

Promoting Specialized Banking Sectors

States can encourage the growth of banking sectors that cater to unique regional needs. An example is supporting banks that specialize in financing for local industries, like agriculture in rural states.

Case Studies

There have been a host of initiatives launched by state governments over the past several years. These initiatives range in size and scope but all have been intended to promote the financial technology sector as an economic driver and to attempt to keep up with the emerging landscape of financial innovations. Two states in particular are worth highlighting for the novel regulatory regimes they have implemented.

Wyoming

Wyoming is a leading light for blockchain and cryptocurrency regulation in the U.S. The state has pioneered the establishment of Special Purpose Depository Institutions (SPDIs), tailored for digital assets, offering services like asset custody and traditional banking functions, while adhering to strict regulatory standards. This progressive stance aims to attract blockchain businesses and promote economic growth, balancing innovation with financial stability and consumer protection. However, Wyoming's efforts faced a setback in early 2023 when the Federal Reserve Board denied Custodia Bank, a Wyoming-based SPDI, permission to launch certain crypto functions due to safety concerns. This decision, along with a unified, negative position from the federal government, limits banks' involvement in crypto-related activities, underscoring the tension between state sovereignty and federal regulatory caution.

Wyoming is widely regarded as a forerunner in blockchain and cryptocurrency regulation within the U.S., introducing a series of groundbreaking laws that cater to the sector. **The state has classified digital assets into three categories: digital consumer assets, digital securities, and virtual currencies, offering unique legal clarity for these assets.**

Wyoming's legislative and regulatory leadership has also underpinned property rights for digital assets, laying down legal frameworks that dictate the ownership, transfer, and operational dynamics of these assets.

Most importantly, Wyoming's legislature sanctioned the creation of Special Purpose Depository Institutions (SPDIs), a special purpose banking charter tailored specifically for digital assets. These institutions are not only intended to provide financial services to blockchain-centric entities but also have the capability to custody digital assets.

Wyoming's SPDIs represents a groundbreaking development in the world of blockchain and cryptocurrency finance. SPDIs are unique financial institutions that aim to provide a regulatory-friendly environment for businesses operating in the digital asset space. This innovative approach to banking regulation was designed to cater specifically to blockchain companies, cryptocurrency exchanges, and other entities involved in the burgeoning digital asset industry. By creating a dedicated framework for these businesses, Wyoming seeks to foster innovation while ensuring robust consumer protection. SPDI banks in Wyoming offer a range of services, including secure custody for digital assets and traditional banking functions like wire transfers. They must adhere to stringent regulatory standards, including anti-money laundering (AML) and know-your-customer (KYC) requirements, to maintain the integrity of the financial system.

The establishment of SPDI banks in Wyoming holds the potential to significantly impact the state's economy and the broader digital asset landscape. Wyoming's forward-thinking approach positioned it as a welcoming place for blockchain and cryptocurrency companies to build and operate, attracting economic growth and talent to the state. Its proactive stance on regulation is intended to balance the need for industry growth and innovation with the critical necessity of maintaining financial stability and consumer safety. That said, this state-level proactivity has been halted by federal authorities.

In early 2023, the Federal Reserve Board turned down the application from Custodia Bank, a Wyoming-based SPDI, citing concerns about its unique approach to crypto-assets and the associated safety risks.[23] Custodia aimed to launch innovative crypto functions, including the release of a crypto asset on public networks. The Federal Reserve Bank of Kansas City also disclosed its decision to reject Custodia's request for a master account, making Custodia's prior lawsuit about the delay in processing its application irrelevant. Essentially, Custodia's setback means it won't get permission to hold funds at the Fed or directly access its payment systems.

Simultaneously, the Fed issued a policy aligned with the Office of the Comptroller of the Currency (OCC) and the FDIC. This policy mandates that all banks under its watch, irrespective of their deposit insurance status, will face the same restrictions, especially concerning innovative banking activities linked to crypto assets.

In response to the Kansas City Fed's refusal of its master account application, Custodia filed a lawsuit amid allegations of suspicious coordination between the Board and the Kansas City Fed. In March 2024, the court rejected the bank's plea for summary judgment and dismissed its lawsuit against the Federal Reserve Bank of Kansas City and the Federal Reserve Board. The court ruled that Custodia had not challenged a final agency action on its Administrative Procedure Act (APA) claim, rendering any alleged APA violation moot. Furthermore, the court disagreed with Custodia's legal interpretations on other claims, affirming the Kansas City Fed's authority to deny the application. Despite this setback in Custodia's quest for equitable access to banking services for industry participants, the bank said it is considering appealing the decision. Wyoming State Senator Chris Rothfuss said, "I'm hopeful that Custodia will pursue an appeal…And I'd actually like to see the state of Wyoming step in directly if we're going to have our SPDI banks denied access to the Federal Reserve banking system."[24]

Nebraska

In May 2021, Nebraska's Financial Innovation Act authorized the creation of digital asset depositories for managing cryptocurrencies and other digital assets. Diverging from Wyoming's model, Nebraska's law aims to avoid the necessity for a Federal Reserve master account. Additionally, the Act allows state-chartered banks in Nebraska to issue stablecoins, reflecting a strategic move by state legislators to maintain state-level regulatory prowess in digital finance and support smaller banks' participation in the stablecoin market. This approach highlights Nebraska's effort to balance innovation with regulatory efficacy, contrasting with the more centralized, closed-minded federal oversight model.

Signed into law in May 2021, the Nebraska Financial Innovation Act[25] followed Wyoming's example, empowering the state to "charter digital asset depositories, a new type of financial institution that holds valuable, self-contained, uniquely identifiable, liquid financial assets— such as cryptocurrency and defined in the law as digital assets."[26]

Perhaps lesser known than Wyoming's efforts, the Nebraska law was intentionally designed to avoid some of the problems exhibited after the passage of the Wyoming legislation. Namely, it aimed to create a structure that would avoid the necessity of a Fed master account, which has created problems in Wyoming as described above.

At a high level, the Fed master account only provides access to the funds overnight. However, at a business account level, it is expected that Real Time Payments[27] and FedNow[28] will change that expectation, as it will allow many business accounts with access to clear funds faster than overnight. Thus, Nebraska policymakers recognize that a bank with a Nebraska Innovation Charter (NIC) must offer more than "faster," or this new, innovative bank is delivering nothing different from a traditional bank.

The law enables local "clearing" to provide funds to a very widely connected electronic market, thus allowing these institutions to operate without a Fed master account.

Perhaps most interestingly, the legislation permits state-chartered banks in Nebraska to issue stablecoins. During his recent speech in the U.S. House of Representatives, U.S. Congressman Flood emphasized Nebraska's pioneering efforts and challenges concerning stablecoins.[29] Rep. Flood, a former member of the Nebraska legislature, was the prime sponsor of the legislation. Now, as a member of the U.S. House, he celebrated the proficiency of state regulators, using the Nebraska Department of Banking as a prime example, advocating that it is well-suited to oversee state-chartered banks involved in stablecoin issuance. Drawing parallels with the dual banking system, he warned against sidelining state institutions and argued against the idea of having the Federal Reserve as the sole regulator for all state-regulated stablecoin issuers. Such an approach, he mentioned, could hinder small and mid-sized banks in Nebraska from entering the stablecoin market.

A stablecoin is a digital currency that is pegged to a "stable" reserve asset like the U.S. dollar or gold. Stablecoins are designed to reduce volatility relative to unpegged cryptocurrencies like Bitcoin.

Nebraska and Wyoming Compared

Issue Area	Nebraska	Wyoming
Banking and Financial Institution Definition	Defines digital asset depository institutions and incorporates them within the Nebraska banking framework.	Does not explicitly redefine banking institutions but integrates digital assets within existing legal frameworks.
Digital Asset Handling and Operations	Specific guidelines for handling digital assets, including non-lending banking activities and payment services.	Details on the classification and treatment of different types of digital assets.
Regulatory Compliance and Oversight	Emphasizes compliance with the Nebraska Financial Innovation Act and the role of the Director of Banking and Finance.	Outlines the regulatory framework, including the role of the Banking Commissioner, and emphasizes compliance with anti-money laundering laws.
Operational Structure for Digital Asset Institutions	Detailed procedures for the formation, operation, and dissolution of digital asset depository institutions.	Provides a framework for banks to opt into offering custodial services for digital assets, but less detail on the operational structure of these services.
Consumer Protection and Legal Standards	Not specifically highlighted.	Emphasizes consumer protection in the context of digital asset transactions and legal standards for digital asset custodial services.
Financial Innovation and Technology Integration	Focuses on the integration of digital assets in banking, with specific provisions for digital asset depository institutions.	Broadly integrates digital assets into the financial and legal system, without specific focus on technology integration.
Jurisdictional Scope and Enforcement	Primarily focused on Nebraska state laws and regulations.	Emphasizes the jurisdiction of Wyoming courts and the statewide applicability of the bill.
Stablecoins	Permits state-chartered banks to issue stablecoins.	The Stable Token Act allows Wyoming to create a government-issued stablecoin, backed by US dollars.[30]

Considerations and Recommendations

A public bank option for payments

SUMMARY

- Explore the establishment of state-level “banker’s bank” or correspondent bank to foster relationships with individual state-chartered banks, helping to reduce friction between federal and state regulations. This could be modeled after examples like the Bank of North Dakota.
- Examine innovative financial market approaches, such as niche banking for specific industries (e.g., Fourth Corner Credit Union for the marijuana industry), and incentivize the development of specialized banking systems that can reduce compliance costs and enhance risk management.
- Explore the implementation of state-level deposit insurance programs similar to the Depositors Insurance Fund (DIF) in Massachusetts, which complements federal insurance provided by the FDIC and offers additional protection for deposits exceeding federal limits. These programs can be developed in collaboration with industry partners to enhance financial stability.
- Advocate for regulatory changes at the federal level, such as pushing federal regulators to address legal issues surrounding the granting of Federal Reserve master accounts, to reduce tensions between state and federal banking regulators.

These strategies aim to enhance financial services, promote economic development, and address specific banking challenges within the state, while also navigating the complexities of state-federal regulatory interactions.

In recent years, the idea of so-called “public banks” have risen in prominence. Across the country, proposals have been made and/or enacted to allow the establishment of these governmental (or quasi-governmental) financial institutions.[31] [32] They’ve been primarily focused on financing infrastructure and economic development projects and initiatives, or intended to address the national unbanked and underbanked populations.

The Bank of North Dakota is currently the only state-level owned and operated bank in the nation, though some smaller sub-jurisdictions also operate banks. Interestingly, while the state of Texas does not operate a bank, it does have a master account with the Federal Reserve. In recent years, due to a mandate issued by state legislation, California has begun seriously exploring the creation and operation of a state bank that would make available to Golden State residents a “zero-fee, zero-penalty, zero-minimum-balance requirement public option for basic financial services.”[33]

States might consider exploring these existing models and tailor a public bank option to address the issue of banks rejecting particular customers or industries. Aside from providing direct accounts to businesses or individuals, another possibility would be to establish the state bank as a "Banker's Bank," or correspondent bank, for individual state chartered banks to hold relationships.

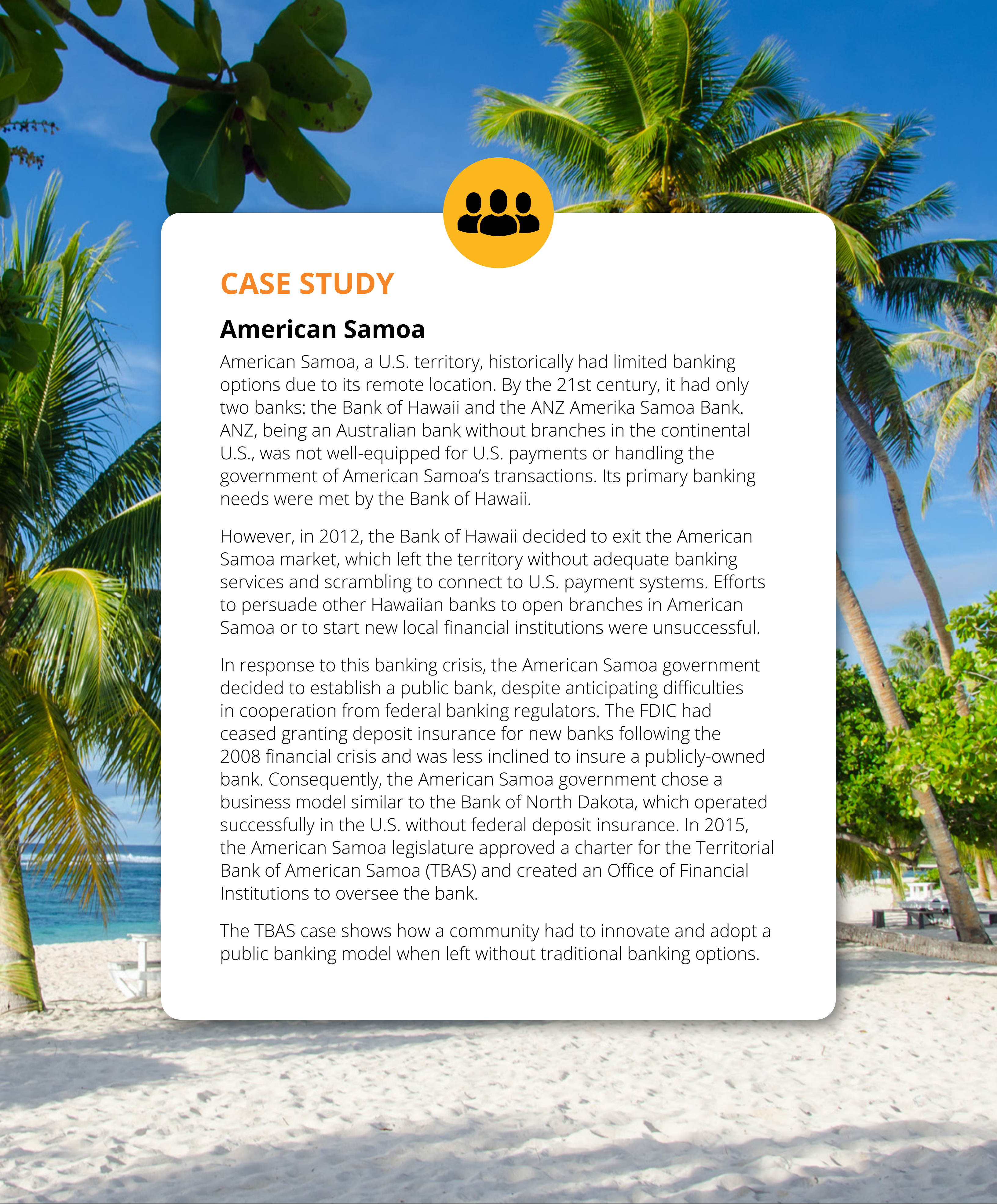
A 'Banker's Bank' functions as a specialized financial institution primarily serving the operational needs and interests of community and smaller banks. It's an important entity, offering services and support that these smaller banks might otherwise be unable to access or afford. Typically, a Banker's Bank does not serve the general public, but rather focuses on providing resources, such as loan participations, treasury management, and investment services, to its member banks. This model allows community banks to compete more effectively with larger institutions by leveling the playing field, especially in terms of accessing advanced financial products and services. Moreover, by fostering a collaborative environment among smaller banks, a Banker's Bank contributes significantly to the stability and efficiency of the broader financial system.

That said, it's also vital to ensure that public bank options don't undermine free-market principles or lead to governments picking winners and losers. The primary intention of these public banks is to reduce operational friction for smaller banks and to limit undue federal intervention. By doing so, they aim to create a more equitable and efficient banking ecosystem, where smaller institutions can thrive without disproportionate regulatory burdens or competitive disadvantages.

While an imperfect comparison, Colorado state banking regulators approved a charter for Fourth Corner Credit Union ("Fourth Corner"). Fourth Corner was specifically designed to serve the marijuana industry and has been offered as an example of an "innovative financial market approach[es] at the state level." Unfortunately, like other institutions, it has faced resistance from the Federal Reserve which denied Fourth Corner a master account.[34] While not a public bank, as Oxfam notes, "the development of this type of niche banking is an avenue worth exploring for Money Services Businesses and other debanked clients, particularly given the lack of state-federal legality conflicts for these customers. If it could be properly incentivized, such a specialized system could reduce overall compliance costs and help create a standardized system for risk management."[35]

To alleviate federal-state tension, states might consider limited state deposit insurance for targeted institutions, reinforcing state autonomy in financial matters. They could also model the Wyoming and/or Nebraska legislative proposal and continue to push federal regulators on the thorny legal issues surrounding the granting of Fed master accounts.

As it relates to state-level deposit insurance, the best-known program still in operation is the Depositors Insurance Fund (DIF), which plays a pivotal role in the financial infrastructure of Massachusetts.[36] Established in 1934, the DIF serves to complement the protections offered by the FDIC. While the FDIC provides coverage up to its specified limit, the DIF guarantees full insurance for deposits exceeding this threshold at its member savings banks in Massachusetts. It's important to note that the DIF is a private, industry-sponsored insurance company and is not backed by the federal government or the Commonwealth of Massachusetts. State policymakers should collaborate with industry partners to potentially develop similar programs, fostering a more competitive and decentralized banking landscape.



CASE STUDY

American Samoa

American Samoa, a U.S. territory, historically had limited banking options due to its remote location. By the 21st century, it had only two banks: the Bank of Hawaii and the ANZ Amerika Samoa Bank. ANZ, being an Australian bank without branches in the continental U.S., was not well-equipped for U.S. payments or handling the government of American Samoa's transactions. Its primary banking needs were met by the Bank of Hawaii.

However, in 2012, the Bank of Hawaii decided to exit the American Samoa market, which left the territory without adequate banking services and scrambling to connect to U.S. payment systems. Efforts to persuade other Hawaiian banks to open branches in American Samoa or to start new local financial institutions were unsuccessful.

In response to this banking crisis, the American Samoa government decided to establish a public bank, despite anticipating difficulties in cooperation from federal banking regulators. The FDIC had ceased granting deposit insurance for new banks following the 2008 financial crisis and was less inclined to insure a publicly-owned bank. Consequently, the American Samoa government chose a business model similar to the Bank of North Dakota, which operated successfully in the U.S. without federal deposit insurance. In 2015, the American Samoa legislature approved a charter for the Territorial Bank of American Samoa (TBAS) and created an Office of Financial Institutions to oversee the bank.

The TBAS case shows how a community had to innovate and adopt a public banking model when left without traditional banking options.

Encouraging coordination and cooperation among states

SUMMARY

- **Promote Transparency and Regulatory Clarity**
  Advocate for increased transparency in regulatory processes and provide clearer guidelines to businesses and financial institutions. This can reduce uncertainty and compliance challenges for these entities.

- **Foster Collaboration and Coordination**
  Encourage states to leverage existing organizations like the Conference of State Bank Supervisors (CSBS) to enhance coordination among state regulators. CSBS' Networked Supervision initiative can serve as a model for streamlining licensing, reducing regulatory burdens, and promoting responsible innovation.

- **Explore Regional Partnerships**
  States with shared interests should explore opportunities to establish regional partnerships or compacts. These partnerships can facilitate the exchange of expertise, market information, and regulatory experiences, leading to coordinated and uniform regulatory guidance.

- **Leverage the Federal Reserve's Novel Activities Supervisory Program (NASP)**
  Encourage states to actively engage with the Federal Reserve's NASP initiative to promote consistency, transparency, and coordination in regulatory efforts. Push for greater information sharing and shared responsibility for examinations involving entities under both state and federal oversight.

Enhancing transparency, clarifying regulations, and reducing conflicts between state and federal regulators is crucial for addressing the identified issues. States particularly have many opportunities to leverage existing organizations, forums, and tools to foster better coordination and collaboration. Additionally, creating new regional partnerships or compacts among neighboring states with common interests could be beneficial. By sharing expertise, market insights and regulatory experiences, and developing consistent guidance, both market participants and regulators, who need to keep pace with the rapid evolution of technology, stand to gain.

For years, the Conference of State Bank Supervisors (CSBS) has been a leading force for increasing uniformity amongst states and streamlining processes that can prove enormously burdensome for businesses and financial institutions.[37] CSBS has a number of programs and efforts that states could adopt or strengthen to make compliance easier and banking more accessible.[38] Most notably, the group has invested heavily in driving technology use through an initiative titled Networked Supervision, "a regulatory approach that encourages diversity in size and scope, streamlines licensing, reduces regulatory burden, and enables responsible innovation that benefits consumers and local economies alike.... This single strategic approach will evolve the state system to one where communication occurs in real time, knowledge and expertise flows across the states and regulation becomes streamlined throughout the industry."

The Federal Reserve's recent move to introduce a Novel Activities Supervisory Program (NASP) offers states a timely chance to advocate for more uniformity, transparency, and coordination. While this announcement hints at traditional joint examinations between state and federal regulators, the specifics of these collaborations are still vague. States should assertively seek more information about this program and advocate for a shared role in overseeing entities under both state and federal jurisdiction. It's essential for states to maintain their sovereignty in regulation and ensure that federal initiatives do not encroach upon nor complicate state-level oversight.

Summary and Recommendations for State Lawmakers

1 Reassert State Authority in Financial Regulation

States have historically played a crucial role in financial innovation and regulation. It's vital for state governments to reassert their authority in the dual banking system, especially given the current federal regulatory overreach.

2 Address Federal Regulatory Challenges

Federal authorities have increasingly constrained state powers, impacting the ability of states to charter and manage fully operational banks. State lawmakers should address these challenges by advocating for more balanced state-federal regulatory dynamics.

3 Embrace Innovative Financial Solutions

States like Wyoming and Nebraska have demonstrated the potential for innovative financial regulation, particularly in blockchain and cryptocurrency. Their support for stablecoin innovation at both the bank and government levels should be closely examined and explored. Lawmakers should consider similar innovative approaches to support emerging financial technologies within their jurisdictions.

4 Develop State-Specific Banking Models

States should explore the creation of state-level public banks or correspondent banks to foster a more supportive environment for state-chartered banks. This could include niche banking for specific industries and advocating for regulatory clarity at the federal level.

5 Adapt to Rapid Technological Changes

The rapid evolution of financial technology, including cryptocurrencies, necessitates regulatory systems that can adapt swiftly. State lawmakers should ensure their regulatory frameworks are agile and capable of supporting financial innovation while maintaining stability and consumer protection.

By focusing on these areas, state lawmakers can play a significant role in shaping the future of financial regulation, ensuring it is responsive to technological advancements and balanced in terms of state and federal powers.

It's imperative for states, either independently or in collaboration, to reassert their historical role in our financial system and shape their future contributions.

Closing

Our dual banking system has been a cornerstone of the strength and success of America's financial system. Despite appearing weakened over time, the significant powers granted to states within our federal system are very much alive. As noted by experts from various political backgrounds, there's a clear need for more transparency in regulation. Hidden procedures and unclear rules often support a narrative that prioritizes perceived political risk over actual financial risk, which goes against sound regulatory principles. It's imperative for states, either independently or in collaboration, to reassert their historical role in our financial system and shape their future contributions.   States have several options, ranging from legal actions to innovative policymaking, to define their duties in overseeing and regulating the financial entities they license. By doing so, they can ensure regulations are clear, fair, and focused on real risks, upholding the integrity of our financial system and preserving the balance of power between state and federal authorities.

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