ORGANIZATIONAL DIVERSITY AND REGULATORY STRATEGY IN FINANCIAL MARKETS: POSSIBILITIES FOR UPGRADING AND REFORM

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I. INTRODUCTION

Calls for reforming financial markets—and for reforming corporate capitalism more broadly—typically invoke state regulation and competition policy in the form of antitrust or privatization measures as the critical countervailing mechanisms for tempering corporate excess, protecting consumer and investor interests, and upgrading markets.[1] More recent calls emphasize lighter touch or softer forms of regulation and self-regulation, invoking information- based systems, enhancements in rating schemes, and changes in corporate governance that harness market forces and informed consumer choices to similar

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1. *See*, *e.g.*, Barry Eichengreen, *Origins and Regulatory Consequences of the Subprime Crisis*, *in* GOVERNMENT AND MARKETS: TOWARD A NEW THEORY OF REGULATION 419 (Edward J. Balleisen & David A. Moss, eds., 2010); Elizabeth Warren, *Redesigning Regulation: A Case Study from the Consumer Credit Market*, *in* GOVERNMENTS AND MARKETS: TOWARD A NEW THEORY OF REGULATION 391 (Edward J. Balleisen & David A. Moss, eds., 2010); John Geanakoplos, *Solving the Present Crisis and Managing the Leverage Cycle*, 16 FED. RESERVE BANK OF N.Y. ECON. POL'Y REP., Aug. 2010, at 101; SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 221-31 (2011); ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT 208-23 (2013); Eric Helleiner & Stefano Pagliari, THE END OF SELF-REGULATION? HEDGE FUNDS AND DERIVATIVES IN GLOBAL FINANCE GOVERNANCE, *in* GLOBAL FINANCE IN CRISIS: THE POLITICS OF INTERNATIONAL REGULATORY CHANGE 74 (Erich Helleiner et al. eds., 2010); Hubert Zimmermann, *Conclusion —Whither Global Financial Regulation?*, *in* GLOBAL FINANCE IN CRISIS: THE POLITICS OF INTERNATIONAL REGULATORY CHANGE 170 (Erich Helleiner et al. eds., 2010); *see generally* JOHN KENNETH GALBRAITH, AMERICAN CAPITALISM: THE CONCEPT OF COUNTERVAILING POWER (1952); THOMAS K. MCCRAW, PROPHETS OF REGULATION (1984); ELIZABETH SANDERS, ROOTS OF REFORM: FARMERS, WORKERS AND THE AMERICAN STATE, 1877–1917 (1999); Marc Schneiberg & Tim Bartley, *Organizations, Regulation, and Economic Behavior: Regulatory Dynamics and Forms from the Nineteenth to Twenty-First Century*, 4 ANN. REV. L. & SOC. SCI. 31 (2008) (discussing the role of state regulation and antitrust policy unions in counter-balancing and reforming corporate capitalism).

ends.[2] Common to many of these programs is their taking for granted elements of existing financial market architectures which were arguably sources of the financial crisis, including the reliance on private for-profit provision, the centralization of flows in giant money center institutions, an emphasis on securitization and transactional banking, and the globalization of financial markets.[3]

This Article considers an alternative, potentially complementary strategy for tempering corporate excess and upgrading financial markets. Specifically, it rejects institutional mono-cropping—the de facto policy of concentrating financial services within a small number of giant, similarly organized, and transactionally oriented investor-owned firms—in favor of promoting parallel and more locally based systems of community banking and cooperative, mutual, and state-owned enterprises in financial markets. The essence of this strategy is to work around, complement, compete with, and even partially displace investor-owned for-profit corporations by cultivating financial enterprises that are structured to serve different constituencies and aims than shareholder value or the pursuit of financial profits in global financial markets.[4] Such a strategy draws on enduring and surprisingly

2. *See, e.g.*, FRANK PARTNOY, INFECTIONS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS 397-419 (First Owl Books Edition, 2004); ROBERT J. SHILLER, THE SUBPRIME SOLUTION: HOW TODAY'S GLOBAL FINANCIAL CRISIS HAPPENED, AND WHAT TO DO ABOUT IT 115-59 (2008); *see also* ARCHON FUNG ET AL., FULL DISCLOSURE: THE PERILS AND PROMISE OF TRANSPARENCY 1-34 (2007); Bruce Kogut & J. Muir Macpherson, *The Decision to Privatize: Economists and the Construction of Ideas and Policies*, *in* GLOBAL DIFFUSION OF MARKETS AND DEMOCRACY 104 (Beth A. Simmons et al. eds., 2007); TRANSNATIONAL GOVERNANCE: INSTITUTIONAL DYNAMICS OF REGULATION (Marie-Laure Djelic & Kerstin Sahlin-Andersson eds., 2006); Tim Bartley, *Institutional Emergence in an Era of Globalization: The Rise of Transnational Private Regulation of Labor and Environmental Conditions*, 113 AM. J. SOC. 297 (2007); Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997); MARY A. O'SULLIVAN, WHAT OPPORTUNITY IS KNOCKING? REGULATING CORPORATE GOVERNANCE IN THE UNITED STATES, *in* GOVERNMENT AND MARKETS: TOWARD A NEW THEORY OF REGULATION 335 (Edward J. Balleisen & David A. Moss, eds., 2010); Edward J. Balleisen, *The Prospects for Effective Coregulation in the United States: A Historian's View from the Early Twenty-First Century*, *in* GOVERNMENT AND MARKETS: TOWARD A NEW THEORY OF REGULATION 443 (Edward J. Balleisen & David A. Moss, eds., 2010).

3. Marc Schneiberg & Tim Bartley, *Regulating or Redesigning Finance? Market Architectures, Normal Accidents, and Dilemmas of Regulatory Reform*, *in* 31A RES. IN THE SOC. OF ORGS. 281, 284-89 (Michael Lounsbury & Paul M. Hirsch eds., 2010); JOHNSON & KWAK, *supra* note 1, at 228-31.

4. For a general statement and application across financial and non-financial sectors, see Marc Schneiberg, *Toward an Organizationally Diverse American Capitalism? Cooperatives, Mutual, and Local, State-Owned Enterprise*, 34 SEATTLE U. L. REV. 1409 (2011) [hereinafter Schneiberg, *Organizationally Diverse Capitalism*].

well-developed legacies of cooperative, mutual, and public organization across a number of American industries.[5] It also draws on key insights developed by organizations and law and economics scholars about the importance of ownership and organizational form for the behavior of firms. Insofar as cooperative and related alternatives to investor-owned corporations eliminate independent shareholders, assign authority and residual claims in firms to consumers or citizens, or foster localism and relational exchange in financial markets, they transform relationships and incentives among stakeholders, tying firms more closely to the substantive economic interests of the sectors and communities they serve.[6] In so doing, they create possibilities for investments, business strategies, and activities that would otherwise not likely occur.

Below, this Article develops a proof of concept for this strategy by presenting two examples of the productive use of organizational diversity and mixed enterprise systems within the American financial system. The first involves the promotion of a system of consumer-

5. RICHARD B. HEFLEBOWER, COOPERATIVES AND MUTUALS IN THE MARKET SYSTEM (1980); JOSEPH G. KNAPP, THE RISE OF AMERICAN COOPERATIVE ENTERPRISE: 1620–1920 (1969); Elizabeth Hoffman & Gary D. Libecap, *Institutional Choice and the Development of U.S. Agricultural Policies in the 1920s*, 51 J. ECON. HIST. 397 (1991); AM. PUB. POWER ASS'N, PUBLIC POWER ANNUAL DIRECTORY & STATISTICAL REPORT 20, 22 (2011–12); STATISTICAL REPORT: RURAL ELECTRIC BORROWERS (1980–1992); CLAUDE S. FISCHER, AMERICA CALLING: A SOCIAL HISTORY OF THE TELEPHONE TO 1940 (1992); JOHN BAINBRIDGE, BIOGRAPHY OF AN IDEA, THE STORY OF MUTUAL FIRE AND CASUALTY INSURANCE (1952). For overviews across sectors, see Schneiberg, *Organizationally Diverse Capitalism, supra* note 4; Marc Schneiberg, *What's on the Path? Path Dependence, Organizational Diversity and the Problem of Institutional Change in the US Economy, 1900–1950*, 5 SOCIO-ECON. REV. 47 (2007) [hereinafter Schneiberg, *What's on the Path?*].

6. HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (Belknap Press, 1996); NONPROFIT AND CIVIL SOCIETY STUDIES: THE STUDY OF NON-PROFIT ENTERPRISE: THEORIES AND APPROACHES (Helmut K. Anheier & Avner Ben-Ner eds., 2003); Avner Ben-Ner, *On the Stability of the Cooperative Type of Organization*, 8 J. COMP. ECON. 247 (1984); Louis Putterman, *Some Behavioral Perspectives on the Dominance of Hierarchical over Democratic Forms of Enterprise*, 3 J. ECON. BEHAV. & ORG. 139 (1982); Eric Rasmusen, *Mutual Banks and Stock Banks*, 31 J. L. & ECON. 395 (1988); CAROL A. HEIMER, REACTIVE RISK AND RATIONAL ACTION: MANAGING MORAL HAZARD IN INSURANCE CONTRACTS (Univ. of Cali., 1985); Schneiberg, *Organizationally Diverse Capitalism*, *supra* note 4, at 1422-31. For professional-owned enterprises, see Ronald Gilson & Robert Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits*, 37 STAN. L. REV. 313 (1985); Jonathan Levin & Steven Tadelis, *Profit Sharing and the Role of Professional Partnerships*, 2005 Q. J. ECON. 131. For community and relational banking, see William Keeton et al., *The Role of Community Banks in the U.S. Economy,* FED. RESERVE BANK OF KAN. CITY ECON. REV., 2d Quarter 2003, at 15; Scott E. Hein et al. *On the Uniqueness of Community Banks,* FED. RESERVE BANK OF ATL. ECON. REV., 1st Quarter 2005, at 115 [hereinafter Scott E. Hein, *Uniqueness of Community Banks*].

owned mutual enterprises alongside for-profit corporations in property insurance markets through the first half of the twentieth century. The other involves the use of state owned banking to foster development and a thriving ecology of local, community banks in the commercial and industrial loan market. Both cases reflect Jeffersonian aspirations for structuring finance. Both reveal surprising possibilities for reforming financial markets and upgrading their performance via decentralization and organizational diversity.

Most simply, promoting alternative systems of supply via cooperative and related forms can subject for-profit corporations to direct competition from firms that prioritize the interests of consumers and local communities, tempering predatory behavior and risk-taking excesses associated with a one-sided pursuit of shareholder value. It can produce useful redundancies and decoupling in financial systems, buffering local economies from crises, speculative cycles and systemic risks, and reducing the network fragilities associated with organizing financial markets around a small number of firms, forms and business principles. It can expand access to capital for previously underserved groups and seed market creation, creating new opportunities for local and small business development, and re-harnessing financial markets to economic growth, local communities, and the expansion of the middle classes. And, by restructuring relations and incentives within firms and financial transactions, cooperative and other local, community based forms can induce new kinds of investments and services, introducing wholly new kinds of competition into financial markets. Indeed, strategies of promoting alternative, more locally based enterprises within financial markets can—and have been—productively combined with more conventional policies of regulation and antitrust to enhance capacities for public regulatory interventions without increased risks of capture or expanded bureaucratic controls.

The main objective in presenting these cases is to highlight potentially important, but generally neglected, possibilities for regulating and reforming financial markets. Yet this contribution also intersects with broader debates over institutional design and structure. A decade of comparative institutional scholarship has forcefully argued that economic performance depends not just on the types of institutions that regulate markets, but also on how the elements of those institutions fit or cohere together, producing convergent (or complementary) signals, incentives, and supports for investment and firms' business strategies.[7] Critics counter with arguments for institutional heterogeneity within markets, notably the benefits of having mixed, perhaps even mismatched institutional arrangement or hybrid systems within markets—"the mongrel over the pedigree" in Colin Crouch's terms.[8] Critics have even located the roots of the financial crisis in these relations. Incremental regulatory reforms since the 1970s produced too many complementary or convergent incentives for risk taking, innovation, and the engineering of complex financial instruments, while under producing or dismantling institutions (typically public regulatory schemes) that counterbalanced such incentives and compensated for the failures generated by new financial architectures.[9] The cases presented here extend this analysis of the productive use of heterogeneities. It traces how regulatory hedging has profitably linked the overlay of public controls on financial markets to foster prudence and rational risk assessment among existing providers with more radical forms of institutional heterogeneity and hybridity in

7. Peter A. Hall & David W. Soskice, *An Introduction to Varieties of Capitalism*, *in* VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ECONOMIC ADVANTAGE 1 (Peter A. Hall & David Soskice, eds., 2001); Margarita Estevez-Abe et al., *Social Protection and the Formation of Skills: A Reinterpretation of the Welfare State*, *in* VARIETIES OF CAPITALISM: INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE 145 (Peter A. Hall & David Soskice, eds., Oxford Univ., 2001); BRUNO AMABLE, THE DIVERSITY OF MODERN CAPITALISM (2003); Peter A. Hall & Daniel Gingerich, *Varieties of Capitalism and Institutional Complementarities in the Political Economy: An Empirical Analysis*, 39 BRIT. J. POL. SCI. 449 (2009).

8. COLIN CROUCH, CAPITALIST DIVERSITY AND CHANGE: RECOMBINANT GOVERNANCE AND INSTITUTIONAL ENTREPRENEURS 55 (Oxford Univ., 2005); Colin Crouch, *Complementarity and Fit in the Study of Comparative Capitalisms*, *in* CHANGING CAPITALISMS: INTERNATIONALIZATION, INSTITUTIONAL CHANGE, AND SYSTEMS OF ECONOMIC ORGANIZATION 167 (Glenn Morgan et al. eds., Oxford Univ., 2005); Glenn Morgan, Introduction: CHANGING *Capitalisms? Internationalization, Institutional Change and Systems of Economic Organization*, *in* CHANGING CAPITALISMS: INTERNATIONALIZATION, INSTITUTIONAL CHANGE, AND SYSTEMS OF ECONOMIC ORGANIZATION 1, 6-12 (Glenn Morgan et al. eds., Oxford Univ., 2005); Martin Höpner, *What Connects Industrial Relations and Corporate Governance? Explaining Institutional Complementarity*, 3 SOCIO-ECON. REV. 331 (2005); Schneiberg, *What's on the Path?*, *supra* note 5, at 72-74; Lane Kenworthy, *Institutional Coherence and Macroeconomic Performance*, 4 SOCIO-ECON. REV. 69 (2006); John L. Campbell, *The US Financial Crisis: Lessons for Theories of Institutional Complementarity*, 9 SOCIO-ECON. REV. 211 (2011). For examples of the gradual dismantling of legal and regulatory constraints on banking institutions' risk-taking, see Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking*,*"* 63 U. Miami L. Rev. 1041 (2009); Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683 (2011).

9. Campbell, *supra* note 8, at 226-27.

financial markets, including strategies of promoting alternative enterprises that directly alter the distribution, basic forms, and organizing principles of providers themselves.

II. MUTUAL ENTERPRISE AND REGULATORY HEDGING IN PROPERTY INSURANCE MARKETS

The property insurance industry from the late nineteenth century through the first decades of the twentieth century bore some striking resemblances to the contemporary financial system. National and international for-profit stock companies including Aetna, INA (later Cigna), and the Hartford dominated markets and were closely linked via rating associations.[10] Companies made money not from their insurance operations, via careful underwriting or reducing losses, but rather from "banking profits," via investing premiums collected in securities and other financial instruments.[11] They focused heavily on dense urban areas and large commercial risks, where premiums were easy to collect in volume or values were high, yielding correlated risks in cities and uneven coverage that left various regions and risk classes underserved.[12] And, they sold insurance though independent agents and brokers, who were paid on commission, did not see the costs of losses, and thus had incentives to lower underwriting standards, waive restrictions,

10. STATE OF N.Y., INTERMEDIATE REP. OF THE J. LEGIS COMM. ON HOUSING, H.R. DOC. NO. 60, AT 198-99, 202-05 (1922) [hereinafter *Lockwood Report*]; WILLIAM H. WANDEL, THE CONTROL OF COMPETITION IN FIRE INSURANCE (Art Printing Co., 1935); STATE OF N.Y., REP. OF THE J. COMM. OF THE S. AND ASSEMB. OF THE STATE OF N.Y., APPOINTED TO INVESTIGATE CORRUPT PRACTICES IN CONNECTION WITH LEGISLATION, AND THE AFFAIRS OF INSURANCE COMPANIES, OTHER THAN THOSE DOING LIFE INSURANCE BUSINESS S. DOC. NO. 30, at 28-35 (1911) [hereinafter *Merritt Report*]; ROBERT RIEGEL, FIRE UNDERWRITERS' ASSOCIATIONS IN THE UNITED STATES (Chronicle Co., 1916); Kent H. Parker, *Ratemaking in Fire Insurance*, *in* PROPERTY AND LIABILITY INSURANCE HANDBOOK 169-89 (John D. Long & Davis W. Gregg eds., 1965).

11. F. Harcourt Kitchin, *Fire Insurance Finance*, *in* YALE READINGS IN INSURANCE, PROPERTY INSURANCE FIRE AND MARINE 309, 311-12 (Lester W. Zartman, ed. 1921) (1909); *Rating in Fire Insurance*, W. UNDERWRITER (Chicago), Nov. 27, 1902, at 7; *Lockwood Report*, *supra* note 10, at 207-08; ALBERT H. MOWBRAY, INSURANCE: ITS THEORY AND PRACTICE IN THE UNITED STATES 422, 426-28 (McGraw Hill, 1946) (1930) (debating "banking profits" and the sense in which "insurance carriers constitute collecting reservoirs for investment funds.").

12. RICHARD M. BISSELL, *Organization of Companies*, *in* YALE READINGS IN INSURANCE, PROPERTY INSURANCE FIRE AND MARINE 121, 133 (Lester W. Zartman ed. 1921) (1909); Lester W. Zartman, *Discrimination and Cooperation in Fire Insurance Rating*, *in* YALE READINGS IN INSURANCE, PROPERTY INSURANCE FIRE AND MARINE 225, 236-37 (Lester W. Zartman ed. 1921) (1909); BAINBRIDGE, *supra* note 5, at 168-70, 205-38.

misclassify properties, and pass risks, good and bad alike, on to the companies (who then passed them on to largely unregulated reinsurance pools).[13]

Companies also treated their actuarial experiences as proprietary trade secrets and resisted efforts to pool loss data and create uniform classifications. Companies, as well as agents and regulators, were thus without key foundations for estimating loss costs, assessing the underlying risks of contracts, or knowing how far one could trim rates in competing for premiums.[14] Moreover, insurers and their rating bureaus were stubbornly indifferent to prevention efforts and the overall level of losses through the 1890s, which reinforced disincentives for individual firms, agents, and insureds to invest in loss cost reduction. It also fostered a general disregard for hazards associated with urban growth and industrialization.[15] In effect, the industry was organized as a vehicle for gathering premiums for investments and generated powerful incentives for high volume provision of insurance with excessive risk taking, inadequate reserves, and accumulating correlated risks in congested urban districts.

These features left nineteenth and early twentieth insurance markets vulnerable to scrambles for premiums and "rate demoralizations" that eroded reserves, amplified underwriting cycles and market instability, and magnified rather than reduced uncertainty

13. WANDEL, *supra* note 10, at 11-12, 86; *Merritt Report*, *supra* note 10, at 92-93; Zartman, *supra* note 12, at 243-44; Werner Sichel, *Fire Insurance: Imperfectly Regulated Collusion*, 33 J. RISK & INS. 95, 104-06 (1966); Joseph C. Samprone, Jr., *Rate Regulation and Nonprice Competition in the Property and Liability Insurance Industry*, 46 J. RISK & INS. 683, 687-88 (1979); Simon Whitney, *Insurance, in* 2 ANTITRUST POLICIES: AMERICAN EXPERIENCE IN TWENTY INDUSTRIES 342, 357 (Twentieth Cent. Fund, 1958); Two Kinds of Agents, W. UNDERWRITER (Chicago), Nov. 29, 1906, at 8.

14. WANDEL, *supra* note 10, at 60-62; Riegel, *supra* note 10, at 38; Parker, *supra* note 10, at 178-81; Zartman, *supra* note 12, at 232; *Merritt Report*, *supra* note 10, at 71-73; Miles Dawson, *Scientific Fire Rating*, *in* YALE READINGS IN INSURANCE, PROPERTY INSURANCE FIRE AND MARINE 181, 186, 193 (Lester W. Zartman ed. 1921) (1909); Fire Underwriters' Association of the Northwest has Successful Meeting, W. UNDERWRITER (Chicago), Oct. 1, 1903 at 13; Shows Shortcomings of the Blanchard Law, W. UNDERWRITER (Chicago), Aug. 22, 1907 at 18. Even the "wisest manager did know when they were underbidding the cost," one industry expert observed. Dawson, *supra* note 14, at 186. So, when firms vied for business, observed another, "They did not know . . . how low they could go and still allow a profit. [R]ates sank too low, and the companies lost heavily." Zartman, *supra* note 12, at 229.

15. HEIMER, *supra* note 6, at 53-54, 57-76; HARRY C .BREARLEY, THE HISTORY OF THE NATIONAL BOARD OF FIRE UNDERWRITERS: FIFTY YEARS OF A CIVILIZING FORCE 78 (Frederick Stokes ed. 1916); Riegel, *supra* note 10, at 19-24; *see also* WANDEL, *supra* note 10, at 108-09, 119-21; *Merritt Report*, *supra* note 10, at 50.

for insureds. Insureds frequently experienced rate hikes and insurance shortages after price wars and large fires.[16] When cities burned, companies lacked the reserves to pay in full (or at all), and experienced waves of bankruptcies that wiped out whole segments of the industry, followed by company reorganizations, new investments in rating associations and enforcement schemes, and steep rate advances.[17]

In response, consumer, business, and farm groups pursued antitrust measures and various forms of regulation, including measures that subjected rates and rating associations to public oversight and review.[18] They also turned *en masse* to organizing property insurance

16. BREARLEY, *supra* note 15, at 10, 26-35, 84; Robert Riegel, *Rate-Making Organizations in Fire Insurance*, 70 ANNALS AM. ACAD. POL. & SOC. SCI. 172, 183-85 (1917): WANDEL, *supra* note 10, at 41-45; F.C. Oviatt, *History of Fire Insurance in the United States*, *in* YALE READINGS IN INSURANCE, PROPERTY INSURANCE FIRE AND MARINE 70, 91-92 (Lester W. Zartman ed. 1921) (1909); National Board's Report on Cincinnati, W. UNDERWRITER (Chicago), Nov. 17, 1904, at 5; Rates Likely Will Advance, W. UNDERWRITER (Chicago), Aug. 26, 1906, at 23. The 1898 New York rate war was one of the worst in the industry's history. It reduced companies' New York premiums by 50%, saddled them with risks that showed losses for years, and led companies to pull back so tightly on the reigns that they created a three (3) year nationwide insurance shortage that left "tough risks" in Chicago without coverage, and prevented east coast merchants from exploiting customs rule changes. *See, e.g.*, N.Y. TIMES, Jan. 1, 1899, at 1, *available at* http://search.proquest.com/pagepdf/95700812/Record/1406EB20A3337735099/9?accountid=14244.

17. Nearly every U.S. city burned between 1830 and 1915, producing forty (40) major conflagrations. Historic Conflagrations, W. UNDERWRITER (Chicago), Aug. 31, 1905, at 13. Small conflagrations wiped out years' of profits; large ones like the 1906 San Francisco fire, exceed the entire system's surplus and reserves. BREARLEY, *supra* note 15, at 101-02; OVIATT, *supra* note 16, at 88 (discussing inadequate reserves); Reasons for the New Rates, W. UNDERWRITER (Chicago), Feb. 28, 1907, at 3. This left companies unable to pay, or pay in full. *Merritt Report*, *supra* note 10, at 105-06; BREARLEY, *supra* note 15, at 29-32; WANDEL, *supra* note 10, at 11; Michael Rose, *State Regulation of Property and Casualty Rates,* 28 OHIO ST. L.J. 669, 677 (1967). It also resulted in companies failing in droves, as was the case with the Chicago and Boston fires, which took out nearly 75% of the insurers in the industry, and the Baltimore fire of 1904, which wiped out every Maryland company. Bissell, *supra* note 12, at 121; Zartman, *supra* note 12, at 248-49; OVIATT, *supra* note 16, at 80, 91; Parker, *supra* note 10, at 170-01; Some of the Aftermath of the Baltimore Fire, W. UNDERWRITER (Chicago), Feb. 18, 1904, at 8; Meeting of the National Board, W. UNDERWRITER (Chicago), May 16, 1907, at 3; Spencer L. Kimball & Ronald N. Boyce, *The Adequacy of State Insurance Rate Regulation: McCarran-Ferguson Act in Historical Perspective*, 56 MICH. L. REV. 545, 547-48 (1958).

18. On the political responses to insurance industry organization, including anti-trust measures and the regulation of rates and policy contracts, see H. ROGER GRANT, INSURANCE REFORM: CONSUMER ACTION IN THE PROGRESSIVE ERA 71-133 (Iowa State Univ. Press, 1979); Daniel N. Handy, *Anti-Compact Laws*, *in* HISTORY OF THE NATIONAL BOARD OF FIRE UNDERWRITERS: FIFTY YEARS OF A CIVILIZING FORCE 282, 287-88 (Harry Brearley ed., 1916); Marc Schneiberg, *Political and Institutional Conditions for Governance by Association: Private Order and Price Controls in American Fire Insurance*, 27 POL. & SOC. 67 (1999) [hereinafter Schneiberg, *Governance by Association*]; Marc Schneiberg & Tim

mutuals, producing a "veritable tidal wave" of mutualism between 1870 and 1900 resulting in nearly 3200 insurance mutuals in operation between 1900 and 1903.[19] This was an alternative system of insurance provision structured along dramatically different institutional logics than for-profit stock insurers, nationally organized markets, and insurance provision for banking profits. Mutuals were consumer owned enterprises that were tied to the substantive interests of insureds and their economic needs as producers and property owners rather than to the interests of an independent class of owner-investor shareholders.[20] Mutuals collectively constituted a decentralized, locally based and organized system of insurance provision. They reflected Jeffersonian, producer-republican visions of order and efforts by Grangers and others to break dependence on combines, keep locally generated economic resources at home, and forge a more decentralized economy of independent producers, farmers, and regional markets.[21] And, they were a cooperative form of enterprise grounded in strategies of collective self-supply and self-organization among preexisting

Bartley, *Regulating American Industries: Market, Politics, and the Institutional Determinants of Fire Insurance Regulation*, 107 AM. J. SOC. 101 (2001) [hereinafter Schneiberg and Bartley, *Regulating American Industries*].

19. BAINBRIDGE, *supra* note 5, at 161-62. Statistics on the numbers, types and distribution of insurance mutuals were compiled from the annual directories of insurance companies published in "A.M. BEST, BEST'S INSURANCE REPORTS: FIRE AND MARINE (1993)," as calculated and reported in, Marc Schneiberg, *Organizational Heterogeneity and the Production of New Forms: Politics, Social Movements and Mutual Companies in American Fire Insurance, 1900-1930*, 19 RES. SOC. OF ORGS. 39 (2002) [hereinafter Schneiberg, *Mutual Companies*]; Marc Schneiberg et al., *Social Movements and Organizational Form: Cooperative Alternatives to Corporation in the American Insurance, Dairy, and Grain Industries*, 73 AM. SOC. REV. 635 (2008) [hereinafter Schneiberg et al., *Cooperative Alternatives*].

20. HANSMANN, *supra* note 6, at 265-85; HEIMER, *supra* note 6, at 65-66; HEFLEBOWER, *supra* note 5, at 5-10, 165-70; MOWBRAY, *supra* note 11, at 321-25; BAINBRIDGE, *supra* note 5, at 20-21.

21. Some insurance mutuals, especially "factory mutuals," were relatively large enterprises, held substantial assets, and operated on multi-state or even national scale. Yet virtually all of the mutuals operating in the early twentieth century were "class mutuals," small, locally organized and operated enterprises associated with farmers, small manufacturers, merchants, and independent producers that operated either on an assessment or advance premium basis. Schneiberg, *Mutual Companies, supra* note 19, at 43-46. On their relationship with Grangers, other social movements and producer-republican programs, see Schneiberg, *Mutual Companies, supra* note 19, at 61-63; Schneiberg et. al., *Cooperative Alternatives supra* note 19, at 637-38; *see also* GRANT, *supra* note 18, at 97; SOLON BUCK, THE GRANGER MOVEMENT: A STUDY OF AGRICULTURAL ORGANIZATION AND ITS POLITICAL, ECONOMIC, AND SOCIAL MANIFESTATIONS, 1870-1880 270-75 (1913); SPENCER L. KIMBALL, INSURANCE AND PUBLIC POLICY 45 (1960); BAINBRIDGE, *supra* note 5, at 166-68; KNAPP, *supra* note 5, at 46-68, 176-200.

communities of producers and consumers.[22]

The introduction of multiple, competing logics or models of provision altered—and upgraded—the dynamics of insurance markets. First and most simply, mutuals counter-balanced the "insurance combine" and corporate excess—overcharging, onerous terms and poor service—by directly competing with national stock insurers and their associations. Based on their ties to insureds, elimination of the agent-middleman, and distinct operating advantages in selecting risks and managing losses, mutuals could offer insurance at twenty-five percent (25%) to as much as seventy-five percent (75%) below stock company rates.[23] They forced stock companies to cut prices and temper rate advances as they "disturbed" the farm business in Ohio, "became quite a factor" in mercantile risks in the Dakotas, "gobble[d] up" grain elevator risks in Illinois, made "a hard drive" for sprinklered risks in West, and caused "trouble" and "competition keen" in Wisconsin.[24] Mutuals served as a potent check on stock company cartels. "The organization of fire mutuals," one observer noted in 1907,

> [S]hows that stock companies cannot charge excessive rates and expect to secure any large volume [of business]. Recently a number of mutuals to write various classes have been organized or are in the formative process and yet stock rates are not unduly high. The stiffest competition stock companies have today is the mutuals [which] goes to show the impossibility of any set of companies forming a monopoly and charging excessive rates.[25]

22. BAINBRIDGE, *supra* note 5, at 186-88; HEFLEBOWER, *supra* note 5, at 190-92; KNAPP, *supra* note 5, at 102; Sichel, *supra* note 13, at 96. Mutuals emerged both from both existing local communities, "especially in German communities" in Wisconsin, and from preexisting associations of local businesses or trades, including the Lansing Manufacturers and Jobbers Club, the American Druggists of Cincinnati, and the Indiana Retail Hardware Dealers Association. Druggist Company Incorporated, W. UNDERWRITER (Chicago), Feb. 15, 1906, at 21; Will Have Mutual Company, W. UNDERWRITER (Chicago), Feb. 25, 1904, at 13; Schneiberg, *Mutual Companies*, *supra* note 19, at 46, 65-66; Schneiberg et al., *Cooperative Alternatives*, *supra* note 19, at 650-53.

23. BAINBRIDGE**,** *supra* note 5, at 102-03; Bissell, *supra* note 12, at 122-23; *Merritt Report*, *supra* note 10, at 112-14.

24. Mutual Competition Seen—Problem is Confronting Wisconsin, W. UNDERWRITER (Chicago), Nov. 26, 1903, at 8.

25. How Competition Works, W. UNDERWRITER (Chicago), Aug. 29, 1907, at 10.

Moreover, unlike a regulatory overlay, mutuals allowed property owners, producers, large industrial concerns and farmers alike to opt out and effectively bypass the system of for-profit provision by stock corporations. A mutual company represented a form of backward "collective vertical integration" by consumers: it replaced a market transaction and dependence on supplier firms with an ownership relation and a strategy of local self-supply.[26] As mutuals developed in numbers, they emerged as an alternative, decentralized system of provision.[27] And, as a system organized along qualitatively different lines than stock corporations, they created diversity and institutional redundancy in insurance markets, providing business groups and regions with a buffer from the market turbulence, rate hikes, and "insurance famines" associated with the underwriting cycles and other ups and downs produced by profit seeking corporations and their rating bureaus in national markets.[28]

Mutuals also seeded market growth. As groups and communities scattered in different locations used mutuals to pool resources and supply themselves collectively with insurance, they expanded provision into previously under-served areas, even attracting stock corporations into newly developing regions and lines in the Midwest and plains states.[29] Such dynamics were not trivial. Property

26. HEFLEBOWER, *supra* note 5, at 9-10; Sichel, *supra* note 13, at 96; HANSMANN, *supra* note 6, at 267, 276-81.

27. Factory mutuals captured significant market share in commercial and industrial lines. Class mutuals, including farm, town, and county mutuals also wrote large volumes of business throughout the Midwest as well as western Pennsylvania and upstate New York, capturing approximately forty percent (40%) of the farm business by 1921. During the first two decades of the twentieth century, mutuals wrote roughly eleven percent (11%) of the nation's fire insurance business, with shares in some places, like Wisconsin, reaching as high as thirty-five percent (35%). Schneiberg, *Mutual Companies, supra* note 19, at 48-51 and sources cited therein.

28. Property owners routinely exercised this "opt out" option by flocking to mutuals in droves—or organizing new mutuals—when faced with rate hikes, insurance shortages, or policies after rate wars and conflagrations. Ohio and West Virginia—Mutual Company Begins Operations, W. UNDERWRITER (Chicago), May. 22, 1902, at 9-10; BREARLEY, *supra* note 15, at 8-10; OVIATT, *supra* note 16, at 82-83; Bissell, *supra* note 12, at 128-29; GRANT, *supra* note 18, at 96-99.

29. HANSMANN, *supra* note 6, at 281; BAINBRIDGE, *supra* note 5, at 168-78, 205-38. Farm, small business and mercantile risks in developing regions in the Midwest and plains states were often considered a distinct class of business whose character varied considerably by locality, which required extensive investments in local agent networks to win business from sometimes hostile insures, and which were strongly marked by local sentiments, leaving most general business stock insurers uninterested in the trade and creating

insurance was a condition for credit, and credit for commerce and trade, which made insurance an infrastructure resource on par with banks, railroads, and electrical utilities in credit-dependent sectors of the economy. Failures to provide a steady supply of insurance to businesses, farms and households were an impediment to economic development.[30] Moreover, as insurance mutuals proliferated, they did so regionally. As Figure One's geography of mutuals by state in 1903 shows, they emerged in greatest number in places like Wisconsin, Minnesota, Missouri, and Nebraska, creating possibilities for expanded credit and decentralized development in what were becoming the mixed economy regions of the upper Midwest and plains states.[31] Here, heterogeneity went beyond counterbalancing corporations or toning down excess to alter incentives in markets and foster market development, harnessing the insurance system to support regional development and middle class communities rather than simply serving financial profits.[32]

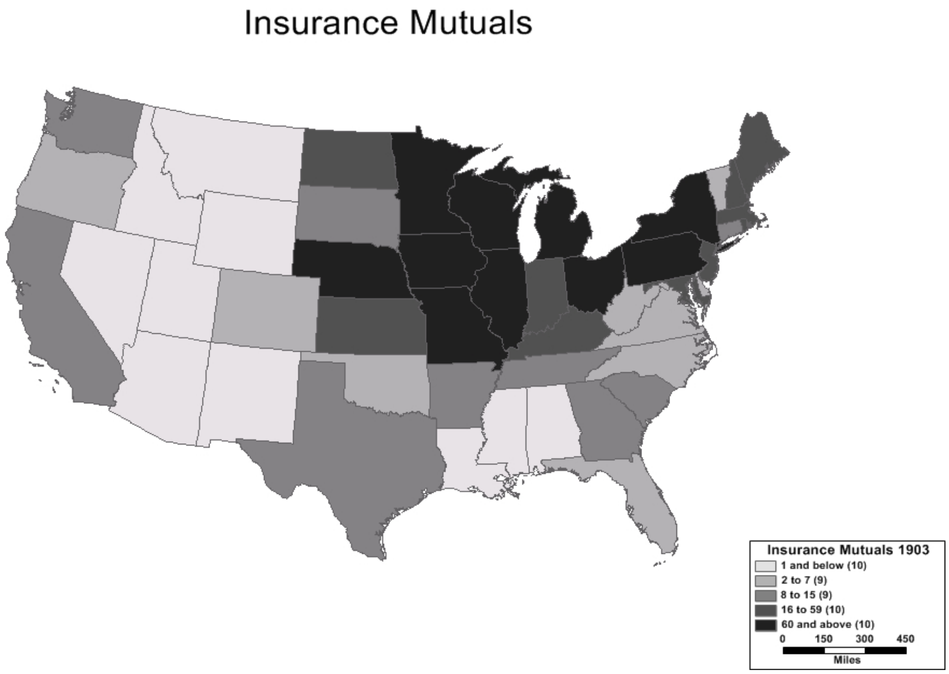
reluctance even among the two general insurers that did such business to commit fully to underwriting in Wisconsin and Michigan in the early 1900s. For additional information, see W. UNDERWRITER, Jan. 10, 1901, at 7-8. Underserved lines that also turned to mutuals also included electrical and traction companies, whose bondholders demanded more insurance that the stock companies' railroad men were willing to supply lumbermen, millers, and factories in the Midwest. For additional information, see W. UNDERWRITER Sep. 8, 1904, at 11; W. UNDERWRITER, Mar. 12, 1903, at 11; W. UNDERWRITER, July 3, 1902, at 9.

30. *Merritt Report*, *supra* note 10, at 26; MOWBRAY, *supra* note 11, at 8-9; BREARLEY, *supra* note 15, at 206-09.

31. The geography of mutuals partly reflected local economic conditions. Farmers and small business in the upper Midwest and plains states found themselves increasingly dependent on corporate combinations during the late nineteenth and early twentieth centuries, and mobilized mutuals and cooperatives as organizational weapons against predatory corporations and concentration in critical markets like fire insurance. But, the geography of mutuals also reflected the evolution in the region of social and political infrastructures for cooperative organization, including the development of stable and relatively homogenous local communities; the prevalence of German and Scandinavian immigrants, who brought cooperative templates and experiences from their home countries; and, anti-corporate and reform movements, including the Grange, which served as advocates, promoters and incubators for cooperative and mutual enterprise. *See generally* Schneiberg, *Mutual Companies, supra* note 19; Schneiberg et al., *Cooperative Alternatives*, *supra* note 19; Schneiberg, *Organizationally Diverse Capitalism, supra* note 4.

32. *See* Schneiberg, *Organizationally Diverse Capitalism, supra* note 4, at 1423-31 (discussing the role of mutuals and cooperatives more generally in making and expanding markets in infrastructure industries and fostering broader, more regionally balanced economic development).

NUMBER OF INSURANCE MUTUALS BY STATE IN 1903



Equally important, mutuals transformed the incentives firms and insurers faced regarding loss costs, and through those, the dynamics of competition in insurance markets. For-profit provision via investor-owned stock companies yielded disincentives for insurers and property owners to invest in reducing losses, whether by developing engineering expertise, redesigning factories and buildings, or installing prevention technologies.[33] Stock companies generally reckoned their underwriting operations in terms of loss (and expense) ratios, and were indifferent to the burning rates so long as they could use their rating machinery or sales forces to sustain acceptable ratios of premiums to losses. Until the 1890s, companies were indifferent to prevention and simply underwrote risks "as found."[34] Moreover, investments in prevention were costly, were subject to information asymmetries, and had collective goods or

33. *See* HEIMER, *supra* note 6, at 57-64, 68, 74-76; HANSMANN, *supra* note 6, at 276-84; *see also* BREARLEY, *supra* note 15, at 78-90; *Merritt Report*, *supra* note 10, at 73-74, 109; BISSELL, *supra* note 12, at 127; MOWBRAY, *supra* note 11, at 38.

34. BREARLEY, *supra* note 15, at 78 (quoting the President of the National Board of Fire Underwriters in 1892); *see* HEIMER, *supra* note 6, at 61.

transaction specific properties. Stock companies that invested in developing expertise or improving clients' facilities faced the risk that policyholders would switch firms rather than share those costs via accepting higher premium rates or other means. Companies were also at a disadvantage relative to clients in assessing both the hazards associated with particular plants, technologies, or processes, and the extent to which insureds invested or skimped on taking precautions. Companies were thus unwilling to make rate concessions when clients claimed they had reduced hazards or otherwise provide policyholders with incentives for prevention. Nor were any such incentives forthcoming where declining prices during rate wars decoupled rates from hazards or when commission agents vied to keep clients by relaxing underwriting standards.[35] Prior to mutuals, there was thus little systematic investment in prevention and accumulating frustration among insureds with companies' refusals to reduce rates for improvements in plants and the like.

Mutuals, in contrast, aligned incentives for prevention, improvement, and lost cost reduction by making consumers the owners of the enterprise. As associations of property owners in the same trade or area, mutuals could both tap into and develop specialized expertise about plants, processes and local business conditions, and exploit local networks to foster taking due care.[36] In addition, as owners of the association, insureds could use the company to support and reward investments by owner-insureds in prevention and loss cost reduction, whether through dividends, reduced or no assessments, or lower

35. *See*, *e.g.*, WANDEL, *supra* note 10, at 108-09 (discussing how commissions were "a corruption fun . . . which blinds at least some agents to every consideration outside their commission," inducing "a laxity in the transaction of the business on a scale so extensive as to produce an almost criminal increase in the fire waste."); *Merritt Report*, *supra* note 10, at 50 (discussing how price wars or "rate demoralizations" create situations in which carelessness "will not be penalized through the rate. . .which manifests itself in an increased burning rate.").

36. Edward Atkinson, *Factory Mutual Fire Insurance*, *in* YALE READINGS IN INSURANCE, PROPERTY INSURANCE FIRE AND MARINE 369, 370-75 (Lester W. Zartman ed. 1921) (1909); HEIMER, *supra* note 6, at 60-68; OVIATT, *supra* note 16, at 83-84; HANSMANN, *supra* note 6, at 280; BISSELL, *supra* note 12, at 123. "The policy holders, in a sense, constitute a family," wrote one contemporary observer. "They are bound together by neighborly ties, and this almost eradicates the moral hazard." Schneiberg, *Mutual Companies*, *supra* note 19, at 54. According to another, a policyholder "would naturally prefer not to make his neighbor pay his loss, and particularly pass upon it, when he could as easily work a corporation, which would send a stranger to make the adjustment. A farmer's character is known to his neighbors, and if not of the best, he would be more inclined to excite suspicion if they had to pay his loss." *Id.* at 53, 54.

insurance rates, while refusing to transact with clients that "neglect their own duty."[37] Mutuals established a quid pro quo of tying rates more closely to documented hazards and passing savings from reduced loses onto insureds. Moreover, as mutuals evolved and spread, they not only developed increasingly sophisticated engineering, research, and inspection facilities, and worked closely with insureds to redesign plants. They also developed and diffused a stream of new prevention protocols and technologies,[38] making serious inroads into both farm risks and large, commercial insurance lines.[39]

Mutuals' success forced stock corporations to follow suit, and fueled a new form of rivalry in insurance markets—competition based on improvement, consultation, and loss cost reduction—contributing to a roughly sixty percent (60%) reduction in the average loss costs from fires per $100 of coverage over the first four decades of the twentieth century.[40]

> [T]o the mill mutuals belong most of the credit for the inception of what is being done today toward the prevention of fire. The stock companies are now thoroughly committed to this work themselves, but they have been largely driven into by the competition and example of the factory mutuals.[41]

Indeed, it was largely in response to mutuals and the new

37. HEIMER, *supra* note 6, at 61; ATKINSON, *supra* note 36, at 369-70.

38. These included the refinement and installation of automatic sprinklers; fire doors and the enclosure of stairways and other vertical passages between floors; refinements and redesign of wooden posts, lubricating oil, and illumination methods; changes in the design of roofs, including the elimination of Mansard roofing; a revolution in factory, warehouse, and department store layout; and systematic record keeping about the sources of fires. ATKINSON, *supra* note 36, at 378-91; HEIMER, *supra* note 6, at 62-64, 70; BAINBRIDGE, *supra* note 5, at 189-98; *Merritt Report*, *supra* note 10, at 109-14.

39. After capturing much of the textile and paper mill businesses in the northeast, mutuals operating in the Midwest by 1900 had captured much and in some cases most of the grain and flourmill business, the lumber trades, traction and electrical power companies, and the hardware and drug retail trade. The factory mutuals also captured a roster of notables in the industrial belt, including Deering and McCormick, Allis Chambers, Western Electric, American Radiator, and Armor. Schneiberg, *Mutual Companies*, *supra* note 19, at 48-49 and references cited therein.

40. A.M. Best, *supra* note 19, at 27.

41. *Merritt Report*, *supra* note 10, at 111; OVIATT, *supra* note 16, at 94; MOWBRAY, *supra* note 11, at 38; ZARTMAN, *supra* note 12, at 245.

competition they fostered in insurance markets that stock companies organized the Factory Insurance Association for inspecting risks, the Underwriters Laboratories, and the National Fire Prevention Association. These organizations more broadly institutionalized the pricing principles, prevention efforts, and quid pro quos that mutuals had pioneered.[42] Such principles and quid pro quos even transformed the competitive game for agents.

> [P]roperty owners are making a study of fire protection and the agent stands to him as an expert adviser . . . . heretofore, the "personal equation" has been a large factor in soliciting . . . . [Now] the agent who can show the assured how to get a lower rate by making improvements will be the man who gets the business.[43]

Finally, in their progressive era struggles to create the public administrative machinery to regulate rates, lawmakers and state officials recognized these benefits. They coupled proposals for state regulation *of* stock corporations, rating associations and markets with hedging or hybridization strategies that deliberately cultivated mutual forms and diversity *within* insurance markets. "It is believed that there is enough competition [from mutuals and independents] to keep rates from becoming excessive," concluded New York's influential 1910 Merritt Committee investigation regarding how the states might regulate stock company associations:

> [I]t is important that this beneficial and regulative form of competition should be retained and increased if possible. This can be done, for instance, by opening the way to a free competition by the factory mutuals and the miscellaneous mutuals which have . . . so well justified their existence. Such companies can unquestionably, if they receive proper supervision, exert a very wholesome influence in the direction of economic and the prevention of fires . . . the Committee believes that

42. OVIATT, *supra* note 16, at 94-95; BREARLEY, *supra* note 15, at 78-83, 87-94, 104-14, 162-77; ZARTMAN, *supra* note 12, at 245.

43. Modern Fire Insurance Agents, W. UNDERWRITER (Chicago), Oct. 15, 1903, at 7.

> every reasonable effort should be made to induce these companies to enter the State of New York . . . and that therefore the law be so amended.[44]

The property insurance case highlights some important effects of organizational diversity on financial market performance—and some surprising prospects for productively using diversity as a means for reform. Insurance mutuals served as countervailing forces in markets, tempering predatory inclinations of stock company cartels. They created redundancy and decentralized circuits in the system, buffering local economies from volatility and crises in insurance markets, and reduced network fragilities associated with concentration and correlated risk. Moreover, their structural features made mutuals effective vehicles for making and upgrading insurance markets, both by broadening provision and expanding possibilities for local economic development, and by transforming incentives for innovation in loss reduction, which introduced new forms of competition into the industry. Nor did such effects pass unnoticed, particularly among the architects of prior approval regulation, who strove to enhance standard regulatory schemes by combining them with measures to promote mutual enterprise.

III. PUBLIC ENTERPRISE AND LOCAL COMMUNITY BANKS IN COMMERCIAL AND INDUSTRIAL LENDING

The Bank of North Dakota ("BND") and its links to community banks in the state constitute a second instance of using organizational diversity and multiple logics to reform and upgrade financial markets. The BND emerged from some of the same populist mixes of anti-monopoly politics and producer-republican movements for economic independence and local development that fueled insurance mutuals.[45] However, it went beyond state regulation to introduce public ownership into the heart of the state's financial markets, and was formed in 1919

44. *Merritt Report*, *supra* note 10, at 108-09, 114; *see* Schneiberg, *Governance by Association*, *supra* note 18, at 86.

45. ALVIN S. TOSTLEBEE, THE BANK OF NORTH DAKOTA: AN EXPERIMENT IN AGRARIAN BANKING, STUDIES IN HISTORY, ECONOMICS, AND PUBLIC LAW 36-67 (Columbia Univ., 1924); ROZANNE E. JUNKER, THE BANK OF NORTH DAKOTA: AN EXPERIMENT IN STATE OWNERSHIP iii-v, 1-11 (Fithian Press, 1989).

as a part of the Non-Partisan League's broader program of using public ownership of grain mills, terminal exchanges, insurance facilities, and the like to wrest control over economic infrastructure from out-of-state interests.[46] The BND is a wholly state owned and operated bank—the only one of its kind in the United States currently.[47] It is the bank for the state of North Dakota, serving as the depository for all of the state's funds, including taxes and fees collected by the state and its public subdivisions as well as working funds for state institutions (excepting pension funds and other trusts managed by the state).[48] And, it devotes those resources to funding development, agriculture, and small businesses within the state, mainly by working with and through the state's local community banks.[49] The BND is, in effect, the heart of a state/community bank hybrid—a case of public ownership in banking organized to foster local economic development, small business growth, as well as localism and relational banking via community banks and credit unions.[50] It thus stands out as a striking contemporary alternative

46. TOSTLEBEE, *supra* note 45, at 62-67; JUNKER, *supra* note 45, at 4-6; P. FISHER, PUBLIC BANKS IN AMERICA: HISTORY AND CURRENT OPPORTUNITIES (Univ. of Iowa Inst. of Urban and Regional Res., 1981).

47. JUNKER, *supra* note 45, at i; Rob Garver, *Reluctant Role Model*, AM. BANKER (Apr. 1, 2011), *available at* http://www.americanbanker.com/magazine/121_4/reluctant-role-model-1034650-1.html?zkPrintable=true); YOLANDA K. KODRZYCKI & TAL ELMATAD, NEW ENGLAND PUB. POL. RESERVE CTR., FED. RESERVE BANK OF BOSTON, THE BANK OF NORTH DAKOTA: A MODEL FOR MASSACHUSETTS AND OTHER STATES? 3 (2011).

48. Garver, *supra* note 47, at 1; INSTITUTE FOR LOCAL SELF-RELIANCE, BANK OF NORTH DAKOTA 1 (2011) [hereinafter ILSR], *available at* http://www.ilsr.org/rule/bank-of-north-dakota-2/; Josh Harkinson, *How the Nation's Only State-Owned Bank Became the Envy of Wall Street*, MOTHER JONES 1-2 (Mar 27, 2009), *available at* http://www.motherjones.com/mojo/2009/03/how-nation%E2%80%99s-only-state-owned-bank-became-envy-wall-street.

49. Harkinson, *supra* note 48, at 1-2; KODRZYCKI & ELMATAD, *supra* note 47, at 7; JUNKER, *supra* note 45, at iv-v; JASON JUDD & HEATHER MCGHEE, BANKING ON AMERICA: HOW MAIN STREET PARTNERSHIP BANKS CAN IMPROVE LOCAL ECONOMIES 2-4, 12 (Demos 2010) [hereinafter JUDD & MCGHEE, BANKING ON AMERICA], *available at* http://www.demos.org/publication/banking-america-how-main-street-partnership-banks-can-improve-local-economies; CTR. FOR STATE INNOVATION, WASHINGTON STATE BANK ANALYSIS 2-3 (2010) [hereinafter CSI], *available at* http://www.stateinnovation.org/statebanks.aspx.

50. JUDD & MCGHEE, BANKING ON AMERICA, *supra* note 49, at 2, 4; Christopher Matthews, *Are State-Owned Banks the Antidote to the Too-Big-To-Fail Epidemic*?, TIME, Jan. 15, 2013, at 1, *available at* http://business.time.com/2013/01/15/are-state-owned-banks-the-antidote-to-the-too-big-to-fail-epidemic/; Katrina vanden Heuvel, *Banking for the People*, THE NATION, Feb. 7, 2011, at 1, *available at* http://www.thenation.com/blog/158350/banking-people#; Marc Schneiberg, *Lost in Transposition? (A Cautionary Tale): The Bank of North Dakota Model and Prospects for Reform in American Banking*, *in* 39A INSTITUTIONAL LOGICS IN ACTION, RES. IN THE SOC. OF

to the market-oriented, increasingly global and centralized system of securitization and private, for-profit transactional banking that has come to dominate American finance.

In its over ninety years of operation, the BND has used the funds deposited with it by the state in three basic ways. First, it has provided short term and bond financing for local and state government infrastructure projects in North Dakota, lowering borrowing costs by using its access to low cost funds from regional Federal Home Loan Banks and providing letters of credits for tax exempt bonds.[51] Second, it does some direct lending to private borrowers in the state, playing a major role in financing farms and grain sales in the first half of the twentieth century. The BND also currently lends directly for student loans as well as new small business and agricultural start-ups.[52] But, third and most importantly, the BND is not a retail bank. It has no retail branches, has no ATM cards, has available—but does not market—checking and savings services to private individuals, does very few loans directly, and competes directly with other banks in only one major area—student loans.[53] Rather, the BND has and continued to serve mainly as a wholesale bank for the state's community banks and credit unions. It participates in loans originated by local banks (by expanding the size of the loan, providing loan guarantees, or buying interest rates down); purchases loans from local bank portfolios (including active participation in the secondary market for Small Business Administration, FHA, and student loans); and purchases and lends on community bank stock.[54] It also provides other bankers' bank services to local banks, including clearing checks, operating as their depository

ORGS. 277, 280-84 (Michael Lounsbury & Eva Boxenbaum eds., 2013).

51. JUNKER, *supra* note 45, at 112-14, 137; JUDD & MCGHEE, BANKING ON AMERICA, *supra* note 49, at 2, 7-8.

52. JUNKER, *supra* note 45, at 98; TOSTLEBEE, *supra* note 45, at 163-71; ANNUAL REPORT: 90 YEARS OF EVOLUTION, BANK OF NORTH DAKOTA 2, 6-7, 10-11 (2009) [hereinafter BND], *available at* http://banknd.nd.gov/financials_and_compliance/annual_reports.html.

53. Garver, *supra* note 47, at 4; KODRZYCKI & HELMSTAD, *supra* note 47, at 8; Interview with Ed Sather, Retired Senior Vice President of Treasury and Trust Services, Ctr. for State Innovation (Feb. 16, 2011), *available at* http://www.stateinnovation.org/statebanks.aspx.

54. KODRZYCKI & HELMSTAD, *supra* note 47, at 8; Harkinson, *supra* note 48, at 2; ILSR, *supra* note 48, at 2; JUNKER, *supra* note 45, at 137, 141, 148-49; CSI, *supra* note 49, at 2-3.

for reserves, bond accounting, and providing federal funds lines.[55]

Here, too, introducing institutional heterogeneity and an alternative to for-profit money-center banking reconfigured markets and upgraded their performance. First, the BND creates an alternative, decentralized, and regionally based circuit of capital for North Dakota's small business, farmers, and local governments, providing a dedicated source of funds for commercial and industrial loans and Main Street communities, and retying the financial sector to local economic and small business development. With the BND, state tax revenues and funds collected by other public subdivisions are kept within the state. They are deposited in the BND, recycled mainly though the state's community banks into local lending, and used to support local and longer term development, rather than being deposited with out-of-state banks, whisked away into national or global financial markets, loaned out of state, invested in derivatives, and used for the pursuit of financial profits as is virtually universal practice elsewhere.[56] As the BND President Eric Hardmeyer explained in an interview:

> Our funding model, our deposit model is really what is unique as the engine that drives that bank. And that is we are the depository for all state tax collections and fees. And so we have a captive deposit base, we pay a competitive rate to the state treasurer. But that's only one portion of it. We take those funds, and then, what really separates us is that we plow those deposits back into the state of North Dakota in the form of loans. We invest back into the state in economic development.[57]

In fact, while the BND did engage in some mortgage backed security transactions, it did no subprime lending. It largely avoided derivatives markets, credit default swaps, and the like during the run up

55. CSI, *supra* note 49, at 2-3; Sather, *supra* note 53, at 6-8.

56. Vanden Heuvel, *supra* note 50, at 1-2; Ellen Brown, *Whose Bank? Public Investment, Not Private Debt*, YES MAGAZINE, Feb. 19, 2010, at 1, 3, *available at* http://www.yesmagazine.org/new-economy/campaign-for-state-owned-banks; JASON JUDD & HEATHER C. MCGHEE, PUTTING OREGON'S MONEY TO WORK FOR OREGON: INTRODUCING THE VIRTUAL STATE BANK 2 (Demos, 2011) [hereinafter JUDD & MCGHEE, OREGON VIRTUAL STATE BANK], *available at* http://www.stateinnovation.org/statebanks.aspx; Garver, *supra* note 47, at 2, 4.

57. Garver, *supra* note 47, at 1-2.

to the financial crisis, and actually shifted away from investing in securities to expand substantially both its lending and its focus on traditional lending within the state from 1990 to 2005.[58]

Second, the BND has served as shock absorber, buffering the state's small business, farm, and public sectors from economic crises, financial meltdown, and natural disasters. During the Great Depression, the BND held farm mortgages, and like banks everywhere, ended up holding the farms themselves as farmers became unable to make mortgage payments. Roughly one third of the state's farm families lost every bit of equity they had in their farms, and the BND and other state agencies ended up owning nearly one-fifth of the entire state of North Dakota in the 1940s.[59] Yet, unlike banks in virtually every other state, which foreclosed and dispossessed farm families en masse, the BND pursued policies of keeping farmers on their land.[60] It pursued loan forgiveness and moratoriums on trying to collect on debts. When it did foreclose, or when farmers could no longer pay, it let farm families who were actually working the land stay on the farm through low or no cost rental schemes, and promised to extend loans to farmers if farmers promised to pay taxes. Moreover, when farm conditions recovered in the 1940s, the BND sold those farms back to farmers or their families, often at below market rates, cushioning the state from some of the worst consequences of the Depression and helping to preserve the state's small farm sector. In a parallel effort to buffer communities and their public institutions, the BND became an active lender to schools, welfare agencies, sanitation works, and other political subdivisions when falling tax revenues left them unable to pay bills, including providing teachers cash for the full face values of the warrants they had received in lieu of salaries.[61]

58. Garver, *supra* note 47, at 3; 2008 ANNUAL REPORT, BANK OF NORTH DAKOTA 5 (2008), *available at* http://banknd.nd.gov/financials_and_compliance/annual_reports.html); KODRZYCKI & ELMASTAD, *supra* note 47, at 8 (showing that investment securities as a percent of BND assets shrank from roughly fifty percent (50%) to ten percent (10%) between 1990 to 2005, while loans as a share of assets grew from roughly twenty percent (20%) to nearly seventy percent (70%)).

59. JUNKER, *supra* note 45, at 116.

60. JUNKER, *supra* note 45, at 116-31; KODRZYCKI & ELMASTAD, *supra* note 47, at 7-8; Peter Fisher, *The Role of the Public Sector in Local Development Finance: Evaluating Alternative Institutional Arrangements*, 17 J. ECON. ISSUES 133, 147 (1983); *see also* PRAIRIE PUBLIC BROADCASTING, BANK OF NORTH DAKOTA (2005), *available at* http://www.prairiepublic.org/television/prairie-public-on-demand/bank-of-north-dakota.

61. JUNKER, *supra* note 45, at 108-15.

Similarly, during the recent financial crisis, the BND increased its lending, unlike virtually every other bank, helping to mitigate credit crunches in the state's commercial and industrial loan markets, and providing financial support for small businesses to weather the storm. The recent crisis involved a wholesale collapse of liquidity and lending not just in mortgage markets, but also in commercial and industrial loans. Small businesses across the country had to scramble for funds and rely on credit cards charging over twice the average rates of small business loans as money-center banks abandoned small business commercial and industrial loan markets in favor of overseas investments and securities.[62] Between 2007 and 2010, JP Morgan Chase, Wells Fargo, Citigroup, and Bank of America cut the number of their small business SBA 7(a) loans overall by fifty-three percent (53%), with Citigroup slashing SBA loans by sixty-four percent (64%) and Bank of America going even farther, reducing them by ninety (90%) to one hundred percent (100%) in Oregon, Washington, Maryland, and Massachusetts.[63] In contrast, the BND more than doubled its industrial and small business lending from 2005 to 2011. It steadily increased its commercial and industrial (C&I) loan portfolio from $431 million in 2005 to $1.064 billion in 2008, with only small dips in 2009 and 2010 (from $1.039 to $1.022 billion) and a new height of $1.068 billion in 2011.[64] Furthermore, in its effort to avoid a credit freeze, the BND used

62. JUDD & MCGHEE, BANKING ON AMERICA, *supra* note 49, at 6; CSI, *supra* note 49, at 1.

63. JUDD & MCGHEE, BANKING ON AMERICA, *supra* note 49, at 5-6; JUDD & MCGHEE, OREGON VIRTUAL STATE BANK, *supra* note 56, at 1; JASON JUDD & HEATHER MCGHEE, PUTTING WASHINGTON MONEY TO WORK FOR WASHINGTON: INTRODUCING THE VIRTUAL STATE BANK 1 (Demos, 2011), *available at* http://www.stateinnovation.org/statebanks.aspx; JASON JUDD & HEATHER MCGHEE, PUTTING MASSACHUSETTS MONEY TO WORK FOR MASSACHUSETTS: INTRODUCING THE MASSACHUSETTS PARTNERSHIP BANK 1 (Demos, 2011), *available at* http://www.stateinnovation.org/statebanks.aspx; JASON JUDD & HEATHER MCGHEE, PUTTING MARYLAND MONEY TO WORK FOR MASSACHUSETTS: INTRODUCING THE MARYLAND PARTNERSHIP BANK 1 (Demos, 2011), *available at* http://www.stateinnovation.org/statebanks.aspx; JASON JUDD & HEATHER MCGHEE, PUTTING MAINE MONEY TO WORK FOR MAINE: INTRODUCING THE MAINE STREET ECONOMIC DEVELOPMENT BANK 1 (Demos, 2011), *available at http://www.stateinnovation.org/Initiatives/State-Banks-Materials/Demos_OPME_Maine_Street_Bank_paper.aspx.*

64. BND, *supra* note 52, at 3; 2011 ANNUAL REPORT, BANK OF NORTH DAKOTA 5 (2011), *available at* http://banknd.nd.gov/financials_and_compliance/annual_reports.html; John Nichols, *Banking for the People: Across the Country, The Notion of State-Owned Banks is Catching on*, THE NATION, Mar. 11, 2010, at 2, *available at* http://www.thenation.com/article/banking-people.

its access to the federal funds markets in 2007-08 to purchase a substantial number of loans from the state's community banks to enhance their capital position and lending capacities as the economy turned down.

Nor are the BND's capacities to buffer local communities and the state's economies from shocks restricted to economic or financial crises. It has also rapidly diverted resources to areas affected by flood and drought, even taking an anticipatory stance in advance of natural disasters to foster economic and community resilience.[65] For instance, in 1997, the BND promptly extended Grand Forks a $25 million line of credit to help it survive being economically crippled by massive flooding in that year, enabling it to hold onto its population while its sister city across the river, East Grand Forks, Minnesota, lost seventeen percent (17%) of its population over the following three years.[66]

Last, but hardly least, the BND has played and continues to play a vital role in fostering and anchoring a small bank sector of community based relational banking within the state, working against the broader trend in the American financial system in which community banks have steadily lost ground.[67] Part of this is rooted in the BND's policies of making loans to individual North Dakotans to buy bank stocks, which helps sustain local—and locally owned—banking.[68] But, pivotal here is the BND's role in participation lending.[69] Small community banks often need partners when their clients approach them for loans that exceed their capital or lending limits. In most states, small originating banks turn to large commercial banks like Wells Fargo, CITI, or Chase to participate in those loans. Partners at such commercial banks charge them fees and use their participation to gather information on borrowers and then poach clients away from the originating banks. This has put

65. Harkinson, *supra* note 48, at 2; KODRZYCKI & ELMASTAD, *supra* note 47, at 10; Interview with Karl Bollingberg, President Alerus Financial, North Dakota, Advisory Bd., Bank of North Dakota, Transcript of Interviews with BND Leadership (July 10, 2010), *available at* http://www.stateinnovation.org/statebanks.aspx.

66. Garver, *supra* note 47, at 1.

67. Keeton et al., *supra* note 6, at 19; KODRZYCKI & ELMASTAD, *supra* note 47, at 16.

68. ILSR, *supra* note 48, at 2; Garver, *supra* note 47, at 4.

69. *See* JUDD & MCGHEE, BANKING ON AMERICA, *supra* note 49, at 6-7; Sather, *supra* note 53, at 4-5; Bollingberg, *supra* note 65, at 7; *see also* ILSR, *supra* note 48, at 2; Harkinson, *supra* note 48, at 2; Interview with Gary Peterson, Lakeside Bank, North Dakota, Advisory Bd., Bank of North Dakota, Transcript of Interviews with BND Leadership (July 10, 2010), *available at* http://www.stateinnovation.org/statebanks.aspx; CSI, *supra* note 49, at 2-3.

pressure on small banks to withhold information and aggressively pursue growth and consolidation to stay in business. The BND, in contrast, does no direct lending in commercial and industrial loans. It only lends through the originating community bank, and thus never uses its loan participation to poach business from or cut out local banks, which means that the state's banks can stay smaller and local and remain in the C&I game.[70] Moreover, the BND charges its partners lower fees than traditional banks and rebates expenses, which helps with originators' cost structures and permits lower cost loans to small businesses in the state.

Overall, this has helped preserve an ecology of small, community based banks and relational banking networks between—and among—lenders and borrowers.[71] North Dakota's banking sector has far more branches per capita than banks overall or banks in states such as South Dakota, Wyoming, and Montana. It is also far less concentrated, and has steadily declined in its concentration since 1995.[72] The North Dakota banking sector is half as concentrated as Montana's and an order of magnitude less concentrated than South Dakota's, which recently came to be dominated by Wells Fargo.[73] In fact, small and local community banks in 2002 accounted for seventy-eight percent (78%) of the bank branches in North Dakota, more than in any other state, and fifty-nine percent (59%) of deposits, more than in any other state except Kansas and Iowa.[74] In 2009, money center banks accounted for fewer deposits (twenty percent (20%)) in North Dakota than in any other state.[75]

The preservation of a thriving ecology of small, local community banks has important effects on the state's financial markets. It brings with it an emphasis of relational over transactional banking networks between lenders and borrower, supporting ongoing personal ties, "thick" information from in-depth knowledge of client operations

70. Bollingberg, *supra* note 65, at 7.

71. Peterson, *supra* note 69, at 9; Bollingberg, *supra* note 65, at 8; ILSR, *supra* note 48, at 2-3; Sather, *supra* note 53, at 4; Matthews, *supra* note 50, at 1; KODRZYCKI & ELMASTAD, *supra* note 47, at 16.

72. CSI, *supra* note 49, at 3-5.

73. CSI, *supra* note 49, at 4; KODRZYCKI & ELMASTAD, *supra* note 47, at 13.

74. Keeton et al., *supra* note 6, at 22.

75. Thomas M. Hoenig, President of the Fed. Reserve Bank of Kan. City, Speech at the Am. Bankers Ass'n Gov. Relations Summit: Are Community Banks Important? 6 (Mar. 18, 2010), *available at* www.kansascityfed.org/SpeechBio/HoenigPDF/Hoenig.3.18.2010.pdf.

and local business conditions, longer term time horizons in lending, and the tailoring of loans and lending services.[76] It has also fostered a network of ongoing working relationships both between the BND and the eighty-five or so of the community banks with which it regularly meets, and among the state's banks, themselves, creating foundations for policy discussion and coordinated action that have proven instrumental in disaster relief and other matters.[77] Here, too, actors productively used multiple logics and organizational diversity to upgrade financial markets, and to accomplish things and make investments which money center banks seem unable or unwilling to pursue.

IV. CONCLUSION

Discussions of financial reform and high road capitalism typically focus on regulation and antitrust policies as the basic countervailing mechanisms for disciplining corporations and upgrading markets, broadening the options in this age of neoliberal governance to include softer touch regulation, self-regulation, enhanced information and rating schemes, and corporate governance reforms that harness market forces to similar ends. This Article documents an additional class of countervailing forces and reform: rejecting institutional mono-cropping and centralization in favor of promoting organizational diversity within financial markets via alternative, dedicated systems of community banking and cooperative, mutual and local, state-owned enterprise. Such systems display some surprising performance possibilities. They have provided small businesses and middle class communities with alternatives to for-profit provision of vital financial services, subjecting centralized financial institutions to direct competition, and creating redundancies in markets that help buffer small businesses, farmers, and local economies from crises. They have re-tied financial systems to small business and local economic development, tempering the one-sided pursuit of financial profits in national and

76. Keeton et al., *supra* note 6, at 24-29; Scott Hein et al., *Uniqueness of Community Banks*, *supra* note 6, at 15, 18-23 (2005); Allen N. Berger & Gregory F. Udell, *Small Business Credit Availability and Relationship Lending: The Importance of Bank Organisational Structure*, 112 ECON. J. 32, 37-40 (2002).

77. JUNKER, *supra* note 45, at 146-48; Garver, *supra* note 47, at 5; Peterson, *supra* note 69, at 9; Sather, *supra* note 53, at 4.

international securities markets, and helping to restore finance to its infrastructural role. They have also introduced new forms of competition and productive investment into financial markets, fostering rivalry based on innovation and improvement, and harnessing those markets to broader public purposes.

Equally intriguing, public officials have used mixed organizational systems and the leverage they provide to complement standard forms of regulation and to pursue strategies of regulatory hedging or hybridity. These might be particularly promising avenues for regulatory redesign in current circumstances, where threats of capture loom large and prospects for reform from above appear dim. Strategies of fostering enterprise formation and the organization of local, community based financial institutions rely heavily on private, voluntary organization and market dynamics to do the work of regulation. They may thus require less by way of building bureaucracies, developing administrative capacities, or making overt, detailed interventions than traditional forms of rule based regulation. Moreover, these are, at root, Jeffersonian strategies of reform, resting on community and local, small business development, rather than statism and bureaucratic centralism, which might provide important rhetorical and political leverage in public debates over reform. Lastly, the cultivation of Jefferson paths can enhance regulatory capacities from below, providing some leverage against capture, whether by fostering new enterprises and competitive forces that complement conventional regulation, by creating political constituencies to counterbalance corporate influence, or by promoting organizational communities that instantiate alternative visions of how financial systems can and should be organized.