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FISCAL IMPACT REPORT

Roybal
Caballero/Steinborn/
SPONSOR Thomson _____ **ORIGINAL DATE** 02/16/21
LAST UPDATED 02/17/21 **HB** 236 _____

SHORT TITLE Public Banking Act _____ **SB** _____

ANALYST Torres _____

APPROPRIATION (dollars in thousands)

Appropriation		Recurring or Nonrecurring	Fund Affected
FY21	FY22		
	\$50,000.0	Nonrecurring	Severance Tax Permanent Fund
	\$50,000.0	Nonrecurring	General Fund

(Parenthesis () Indicate Expenditure Decreases)

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY21	FY22	FY23	FY24	FY25		
		At least (\$480.0)	At least (\$968.0)	At least (\$1,492.0)	Recurring	General Fund

Parenthesis () indicate revenue decreases

HB236 is a duplicate of SB313.

SOURCES OF INFORMATION

LFC Files

Responses Received From

New Mexico Attorney General (NMAG)
New Mexico Finance Authority (NMFA)
State Investment Council (SIC)
State Treasurer's Office (STO)
Economic Development Department (EDD)
Regulation and Licensing Department (RLD)

SUMMARY

Synopsis of Bill

House Bill 236 (HB236) creates the Public Banking Act and the Public Bank of New Mexico (“Public Bank”) as a governmental instrumentality to be chartered pursuant to United States law. The bill establishes an 11-member Board of Directors to govern the Public Bank and vests powers with the Public Bank to, among other things, make contracts, acquire and dispose of property, accept deposits, borrow and lend money, make equity and debt investments, incur indebtedness, and generally to carry out provisions of the Act. A chief executive officer (“CEO”) will be hired by the Public Bank Board, and the CEO will hire a chief risk officer. The CEO will annually prepare an operating budget that must be appropriated by the legislature each year from assets of the state banking fund. HB236 creates a state banking fund (the “fund”) which consists of appropriations, gifts, grants, deposits, donations and investment income of the fund, and is exempt from reversion to the general fund at year’s end. All money credited to the fund is appropriated to, and retained by, the Public Bank for purposes of the Act. The Public Bank is initially funded by a \$50 million deposit by the State Treasurer and by the state investment officer’s commitment to invest \$50 million from the severance tax permanent fund (STPF).

If enacted, HB236 would become effective July 1, 2021.

FISCAL IMPLICATIONS

HB236 appropriates \$100 million to the newly created Public Bank, half of which is from the general fund and the other half from the severance tax permanent fund (STPF). It is unclear whether the deposits made will generate a return where they otherwise would have in management by SIC and STO. The fiscal impact tables reflect the returns lost by what would have otherwise been generated in the STPF and distributed to the general fund and would likely be greater when including returns generated in the general fund investment pool managed by STO.

Withdrawal of these funds comes at varying degrees of opportunity cost, differing but likely increased levels of risk-adjusted investment returns, and unknown ultimate financial returns on investment, in addition to the anticipated economic benefits to the New Mexico economy which the bank seeks to create.

Treasurer’s assets are intended for a short-term investment horizon of one-year or less. The investment horizon in the bill, however, is a permanent commitment, restricting state fund liquidity, and locking in an unknown return on investment, while receiving no premium for the illiquid nature of this commitment. Anticipated interest lost by this deposit from STO would generally be the short-term interest rate of between 2 to 3 percent.

In addition to the revenues lost, it is important to note the opportunity costs, or the difference between what the bank will earn versus what the STPF could have earned otherwise. One year’s STPF earnings on \$50 million at 6.75 percent is \$3,375,000.

There is also a question whether the STPF commitment to the bank would be allowed to remain an STPF asset. While other economically targeted investment programs (ETIs) have a requirement or mechanism that allows for repayment or investment returns to flow back to the STPF (See NMSBIC & NM Recovery Act Loans), the language in the bill would appear to make the \$50 million STPF commitment more like an appropriation than an investment – with no possibility of realizing investment gains or losses.

SIGNIFICANT ISSUES

The bank is governed by a board of directors consisting of 11 voting members consisting of the following:

- four members appointed by the NM Legislative Council
- four members appointed by the governor
- the chief executive office of the NM Finance Authority
- the State Treasurer
- the secretary of economic development

Noted by the State Treasurer's Office:

Concentration risk

The bank's greatest strength could be its greatest weakness. STO would likely be one of the largest depositors of the bank. As stated above, STO's funds are short-term in nature and can fluctuate dramatically and must be available to meet the day-to-day cash needs of the state. While the state general fund investment pool totals \$4.7 billion currently, as recently as 2017, it totaled less than \$1 billion as actual revenues fell short of projections.

Lending programs are anticipated to be longer-term loan programs geographically concentrated in New Mexico that could be outstanding several years. In adverse economic events, balances held by STO and other municipalities would need to be withdrawn rapidly to operate government. These withdrawals could occur at the same time that the bank's loan customers, New Mexico businesses and municipalities, are also experiencing stress and could struggle to pay existing loans or could have additional borrowing needs. The deposit run-off and loan demand both negatively impact the bank's liquidity. This could create a liquidity crunch for the bank due to its concentration of similar short-term depositors that also lack of geographic and industry diversification.

Fiscal agent bank

We are pleased to see that use of the public bank as the state's fiscal agent bank is not mandatory. STOs and the 140 other state agencies have treasury needs that are very sophisticated and complex. Large agencies like TRD, DFA, HSD utilize a wide variety of deposit, disbursement and card-based services. The state's current fiscal agent bank offers an array of products that provide the necessary security, interfaces and flexibility that state agencies need. These products have been refined over the years in various markets and industries so that we are receiving the latest and greatest products. A start-up bank would likely be ill-prepared to deal with these complexities to meet all of the needs of state government.

It's important that expectations are managed and stakeholders wouldn't expect an immediate migration of the fiscal agent banking relationship to the public bank.

Severance tax permanent fund investment

The proposed legislation does not restrict the severance tax permanent fund from selling or withdrawing its initial investment. What if the investment in the bank fails to meet the severance tax permanent fund's performance standards? This could result in a

sale/change in control of the bank or leave it undercapitalized? As currently drafted, STO can't withdraw its deposit to meet the state's operational needs but severance tax permanent funds have no restrictions at all. Bank regulators would likely want assurances not only that the initial equity investment will not be withdrawn but also a commitment to provide additional funding as needed to maintain sufficient liquidity and well capitalized status.

Equity investments

Section 5 C 2 on page 10 states that the bank may make equity or debt investments in New Mexico businesses. We question whether these are permissible investments for a bank.

The State Investment Council highlighted:

It is understood that the intent behind a public bank in New Mexico is to improve the state's economy, provide expansion of funding opportunities for under-served businesses and reduce predatory lending practices. There is also an assumption that a state bank could effectively reduce dollars paid to larger national banks that provide existing custodial services of state dollars, which presumably could help keep those dollars and possibly expertise in state. HB 236 offers the potential that a state bank may advance some or all of these goals. However, because HB236 provides no mechanism for the return of investment income or capital to the STPF, the \$50 million taken from the STPF to fund the PBNM cannot be deemed an investment of the STPF but must be deemed a distribution of the STPF funds, subject to the limitation of the New Mexico Constitution, Article VIII, Section 10 (C).

...Some of the expectations around creating a state bank in New Mexico, like eliminating predatory lending practices here, may be unrealistic or not directly impacted by the new bank entity. North Dakota in fact, still allows subprime lending practices, with an estimated 7 subprime lending businesses for every 100,000 North Dakotans, all offering high-rate, short-term loans with interest rates in some cases costing 520 percent APR.

...Though proposed in recent years by the legislature, there has thus far been no legislative study on the potential effectiveness or specific need for a state bank, nor an established fiscal assessment of whether these targets can be accomplished, even assuming successful execution of the ambitious concepts behind HB236.

Beyond that, there are potential legal concerns raised by the measure. The bill provides no mechanism for which these investment dollars would produce any financial returns to the STPF, raising the question whether these deposits/appropriations meet the definition of "investment" as determined by the New Mexico Constitution. Article VIII Section 10, which is the constitutional provision that established and governs the STPF. This section authorizes the Legislature to determine how money "in" the STPF will be invested but strictly limits the "distributions from" the STPF. HB236 provides no means by which either capital or earnings may be returned to the STPF from its \$50 million investment in the PBNM. Accordingly, the \$50 million taken from the STPF to fund the PBNM can only be taken as part of the annual distribution from the STPF as limited by section 10(C), of Article VIII of the New Mexico Constitution.

Even if HB236 were amended to provide returns to the STPF, it is unclear whether these

returns would constitute an investment of the STPF. Pursuant to the New Mexico Constitution (Article VIII, Section 10(A)), funds in the STPF must be invested “as provided by law.” Here, the applicable law, NMSA § 7-27-5, requires, among other things, that STPF investments shall be: 1) “intended to . . . provide income” to the STPF and, 2) “invested in accordance with the Uniform Prudent Investor Act [45-7-601 to 45-7-612 NMSA 1978].” There are reasons to question whether the \$50 million commitment from the STPF required by the bill satisfies either requirement for an STPF investment. While HB236, amends NMSA § 7-27-5 to include specific authorization for money invested in PBNM, by not meeting the general requirements for an investment of STPF funds, HB236 would create a new type of investment without the prudential safeguards applicable to other STPF investments.

Other differential rate investments allowed under NMSA Section 7-27-5 (including the 2020 New Mexico Recovery Act, and the 2 percent STPF allocated to the Small Business Investment Corporation) facilitate at least some component of income production or “return of excess capital” and there is potential that the investment shall or can produce some sort of financial return on investment to the STPF. HB236 seems to lack these elements, essentially making it a legislative appropriation from the STPF to a newly created entity that will be governed largely by political appointees.

...Other recent emergency pandemic-related legislation authorizing the NM Recovery Act stipulated that the STPF’s investment was to “be in compliance with” the Uniform Prudent Investor Act. HB236 lacks this provision. Given potential losses (both in start-up costs, potentially real financial losses related to bank operations, and relative opportunity costs compared to market-rate investments), the bill also fails to provide explicit Legislative findings which might be beneficial, i.e. NMSA § 7-27-5.14 (entitled “Findings and Purpose”), which explains the public policy supporting the SIC’s investment in the New Mexico private equity program. A similar explanation here would provide critical support for the conclusion that the STPF’s investment in the State Bank satisfies the prudent investor rule.

Other previous state bank proposals have raised the question whether a constitutional amendment would need to precede legislation to avoid conflict with the anti-donation clause, and that question will potentially be asked again in relation to HB236.

The New Mexico Finance Authority notes the following issues:

In order for the Public Bank to grow beyond the initial state commitment of \$100,000,000, its lending activity must capture new deposits. The State Treasurer has the option, but not the requirement, and likely not the incentive, to make deposits beyond the initial commitment specified in the Act. The Public Bank will need to attract deposits from either the public sector or the private sector, or both, with no market advantage in doing so. To be able to provide competitive deposit rates, the Public Bank will need to earn market competitive rather than subsidized interest from the loans that it makes. New Mexico public entities already have access to loans at AAA pricing levels through the NMFA, meaning the market for public lending in New Mexico is already quite competitive. In the public sector, particularly in New Mexico which has a number of highly subsidized funding programs, the issue containing infrastructure development is capacity to borrow and creditworthiness rather than the ability to find attractive interest

rates. Although the Public Bank might find a lending and equity investment niche in the private sector, it likely will not be at rates and returns that will support rapid deposit growth.

Under the Act, the Public Bank can act as a fiscal agent for some New Mexico public entities, but the Act does not define Fiscal Agent. Further the Act does not require that any public entity in the state use the Public Bank for this purpose. Thus, an entity like the NMFA that has bond indenture requirements to deposit most of its funds with an independent Trustee bank (selected through a competitive RFP process), and that relies on national banks to provide a \$100 million line-of-credit, is unlikely to hold funds voluntarily with the Public Bank. Other state public entities may have similar constraints.

The Public Bank will have the ability to issue bonds as an alternative to raising deposits, but prospects for a rating that will allow the Public Bank to raise highly competitive funds are not good in the foreseeable future. This is particularly so because the ability of the Public Bank to operate in any fiscal year is dependent on its budget being appropriated by the legislature, thus making the Public Bank an appropriation entity and capping possible ratings at one level below the state's rating. Thus, at best, Moody's likely would rate the public bank in the A category for the foreseeable future.

Under section 5.B. of the Act, the Public Bank "shall not make loans to a private individual or private legal entity except as provided in section 5.C." Section 5.C. then allows the Public Bank to make such loans. The purpose of section 5.B. is unclear.

The North Dakota public bank ("Bank of North Dakota"), founded in 1919, is often cited as a model for public banking. However, the Bank of North Dakota has advantages not available to the proposed New Mexico Public Bank. The most important advantage is that the Bank of North Dakota's business relationship with the Minneapolis Federal Reserve Bank allows it to do check processing, deposit excess cash balances, maintain a reserve requirement, safe keep all Fed book entry securities and have discount window borrowing authority. Texas also has similar Fed status. The Fed's current policy is not to allow similar state entities to have this status. Thus, it is unclear what section 3.N. of the Act, "*the bank shall be subject to all applicable regulatory and reporting requirements that allow access to the federal reserve ...* ", means in terms of potential competitive advantage for the Public Bank. Without Fed access, the Public Bank would need to contract with a national bank for many transactional services.

The Bank of North Dakota is not a member of the Federal Deposit Insurance Corporation (FDIC). All Bank of North Dakota deposits are guaranteed by the full faith and credit of the State of North Dakota (and all state funds are required to be deposited in the bank). Nothing in the Act provides for New Mexico Public Bank deposits to be guaranteed by the state of New Mexico, so FDIC insurance will be an added Public Bank cost compared to Bank of North Dakota as a public bank role model.

The state is committing \$100 million to, and establishing an expense infrastructure for a new entity that may both complement and compete with existing instrumentalities of the state and with community and national banks. To the extent that the Public Bank competes with other state instrumentalities without subsidy, funds dedicated to the Public

Bank are an unnecessary duplication of public resources. To the extent that the Public Bank competes with local and national banks, the Public Bank likely will be only able to do so to the extent that it is subsidized by the state from resources that might be more effectively used for other purposes.

As noted, the proposed Public Bank will not be competing in untapped sectors of the New Mexico economy. To the extent that the Public Bank can complement lending to the private sector for new ventures deemed too risky by existing lending institutions, value can be added. Furthermore, to the extent that the Public Bank becomes an equity investor in private businesses, that could be a relatively untapped niche.

HB236 does not provide the Public Bank with an exception to the Inspection of Public Records Act which may prove to be problematic if it is to participate in economic development lending.

The Regulation and Licensing Department adds:

HB236 provides that the public bank of New Mexico “shall be chartered pursuant to the laws of the United States.” The Financial Institutions Division (FID) of the RLD infers the identified language at Section 3 to mean that the PBNM shall seek a national bank charter from the Office of the Comptroller of the Currency (OCC) of the United States Department of the Treasury. The OCC is the federal entity that issues charters to national banks. The FID is the chartering and regulatory authority for banks chartered in the state of New Mexico. The State of New Mexico charters state banks pursuant to the New Mexico Banking Act, §58-1-1 NMSA 1978 *et seq.* Other U.S. states charter banks under their own state laws. Each chartering authority across the U.S., whether state or federal, has its own set of rules and requirements in order to grant bank charters. The language of HB236 at page 2, lines 10 – 11, should be amended to specifically state the jurisdiction under which the PBNM will seek to be chartered. Without a clear statement in the bill on who the chartering authority will be for the bank, the RLD is unable to adequately identify significant issues as to any requirements or hindrances to the chartering of the PBNM.

Looking broadly at the creation of the proposed PBNM, the FID suggests the following non-exclusive list of items/issues be addressed within any structure and processes of a state-owned public bank, alongside current Federal law, New Mexico law, and sound banking practices:

The formation of a “bank” being owned/run by any unit of government within the State of New Mexico using public funds to finance the “bank” may be in conflict with the language and intent of Article IX, Sect. 14 of the New Mexico State Constitution (commonly known as the “Anti-Donation Clause”). Legal certainty should be reached that the proposed structure and funding of the PBNM will not violate the Anti-Donation Clause prior to enactment of the provisions of HB236.

A clear determination should be made as to the appropriate entity to provide oversight and regulation of the proposed bank. In order to protect the safety and soundness of a bank, identify risk, prevent fraud, and ensure proper management, all banks should be routinely examined and supervised by an external regulator. To be effective, the

PBNM’s regulator should be able to exercise its supervisory authority independently and must have the unrestricted authority to review all accounts, books, and records of the PBNM.

An independent regulator must also have the tools necessary to seek and impose corrective measures through formal enforcement actions, civil money penalties, and removal of bank officers and directors.

Authority to take enforcement actions are critical to ensuring public confidence and protecting the state’s taxpayers who will ultimately need to cover any shortfall in the event of weak capital protection or insolvency of the PBNM.

A primary objective of all financial institutions regulators is to ensure the safety and soundness of financial institutions through compliance with laws, regulations, and supervisory policy. To maintain this standard, consideration should be given to:

The scope of the investment and lending authority of a state-owned bank. This authority should be carefully structured to avoid risks to the solvency of the institution and to prevent undue competition with privately owned banks and credit unions. Federal law requires that appropriate limitations are established on loans to insiders (individuals with power or control within/over the bank) and affiliated entities. Limitations are also required to establish limits on the total amount of funds that may be loaned to one borrower or group of affiliated borrowers.

Political influence over the lending and investment decisions of a government-owned bank is likewise a concern that should be specifically addressed. Lending and other banking decisions being affected by political concerns rather than strictly economic factors pose a risk to the financial security of a publicly held bank. For example, if the PBNM were to underprice risk or under-collateralize loans for new development projects due to the political popularity of such projects, the safety and soundness of the bank would be jeopardized.

In order to maintain a safe and sound financial status, banks need to be supported by sufficient monetary capital. Capital provides the foundation for the bank to operate through the ever-changing economic cycle. Banks generally add to capital during economically prosperous times and exhaust capital during periods of economic stress and unexpected losses. This countercyclical nature of capital is customary and desirable for privately owned institutions. The state will need to determine the source of this capital for the PBNM, recognizing the need for it to remain in the bank throughout the PBNM’s existence. Capital should be sufficient at inception to support anticipated start-up costs and expected growth. In addition, the state should make a provision for contingent capital in the event the PBNM experiences unexpected losses, requiring recapitalization. Banks generally find it necessary and desirable to hold significantly higher levels of capital than the minimum requirements that are imposed under federal law. The current average total capital ratio maintained by commercial banks in New Mexico was 17.91 percent as of September 30, 2021. By this standard, a bank projected to be \$1 billion in assets would need \$179.1 million in capital, just to open its doors.

The bill states that the bank will be funded with public money that will be “deposited in

the fund and shall not revert to the general fund.” The New Mexico constitution makes clear that no one legislature can bind the authority of a future legislature, especially on the issue of appropriation of funds. As a result, a regulator for the PBNM would never actually be able to calculate the capital of the bank so long as the capital of the bank could be re-appropriated by the legislature. As the law currently stands, any or all funds held within the State Banking Fund to be created by HB236 could be swept at the next legislative session (or special session), making the PBNM instantly insolvent.

PERFORMANCE IMPLICATIONS

The appropriations are unlikely to meet performance targets for investments by the affected state agencies. For example, the STPF’s long-term investment target of 6.75 percent has been largely achieved or exceeded over most time periods but may be negatively affected by this appropriation. Due to these effects and others, the STPF has been identified as being at long-term risk of being unable to deliver intergenerational equity benefits over time.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

HB236 is a duplicate of SB313.

HB11/a contains a \$200 million appropriation from the Severance Tax Permanent Fund. The \$50 million commitment of Severance Tax Permanent Fund from the State Investment Officer comes from the same class of funds as HB11/a.

TECHNICAL ISSUES

Section 8, page 12 line 17 should read “...except as provided”

POSSIBLE QUESTIONS

Identified by SIC:

While the SBNM would be required to hire both a CEO and Risk Officer as well as other appropriate staff, it is not clear what the costs of this would be both initially and on an ongoing basis. Previous state-bank estimates put start-up costs between \$5M-\$10M, but the infrastructure involved would also have a significant impact, either reducing or growing those overhead costs. How many physical bank branches are envisioned? Would a low-cost centralized structure meet the needs of the state’s rural residents?

Regarding the bank’s overseers, what would be the costs for Directors and Officers Insurance? Would it be achievable under the proposed structure of the bill? Under Federal Banking law, Title 12, US Code Section 503 (Liabilities of directors and officers of member banks) indicates: “If the directors or officers of any member bank shall knowingly violate or permit any of the agents, officers or directors of any member bank to violate any of the provisions of sections 375, 375a, 375b and 376 of this title or regulations of the board made under authority thereof, or any of the provisions of sections 217, 218, 219, 220, 655, 1005, 1014, 1906, or 1909 of title 18, **every director and officer participating in or assenting to such violation shall be held liable in his personal or individual capacity for all damages which the member bank, its shareholders or any other persons shall have sustained in consequences of such**

violations.”

IT/sb/rl/al