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## FISCAL IMPACT REPORT

**ORIGINAL  
DATE LAST** 02/16/11

**SPONSOR** Egolf **UPDATED** \_\_\_\_\_ **HB** 290

**SHORT TITLE** Small Business Development Bank Act **SB** \_\_\_\_\_

**ANALYST** Golebiewski

### REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY11	FY12	FY13		
	*	*	Recurring	Severance Tax Permanent Fund
	*	*	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

\*Please see Fiscal Implications section below.

Relates to HB 173

### SOURCES OF INFORMATION

LFC Files

#### Responses Received From

State Investment Office (SIO)  
 State Treasurer's Office (STO)  
 Economic Development Department (EDD)  
 Attorney General's Office (AGO)  
 New Mexico Finance Authority (NMFA)  
 Office of the State Auditor (OSA)

### SUMMARY

#### Synopsis of Bill

House Bill 290 would create the small business development bank, a state owned, controlled and operated business development bank. The bank would provide capital to the residents and small businesses of the state and would be managed by a board composed of seven members: 3 members appointed by the governor, 3 members appointed by the legislative council, and the chair appointed by majority vote of the governor, attorney general, commissioner of public lands,

speaker of the house and president pro tempore.

The small business development bank would have various powers which allow it to carry out its purposes. The state auditor is mandated to contract with an independent certified public accounting firm to annually audit the bank. The SIC will also be required to select an independent third party to examine the bank at least once every twenty-four months.

HB290 also allows for the severance tax permanent fund to be invested in the New Mexico small business development bank up to \$100 million. Up to \$5 million of the amount authorized for investment shall be used to establish the bank. The remainder will be used to fund the loan program.

The effective date of the bill is July 1, 2011.

### **FISCAL IMPLICATIONS**

The bank proposed by House Bill 290 would offer loans to New Mexico businesses in an effort to promote economic development. The funding is proposed to be sourced to the Severance Tax Permanent Fund, which statutorily must be invested according to the Uniform Prudent Investor Act. It should also be noted that to maintain the real value of the STPF, an approximate return of 7.7% is necessary (4.7% to cover distributions and approximately 3% for inflation). For the first six months of fiscal year 2011, the SIC reported returns in the STPF portfolio of 15.6%. Pulling \$100 million out of the STPF for deposit in the state bank would, at least in the short term, lose these investment returns.

Additionally, the STPF has a large proportion already diverted to economically targeted investments, which have historically slowed the performance of the STPF. In FY10, for example, the returns for the STPF were 220 basis points lower than that of the Land Grant Permanent Fund (LGPF) because of the ETIs.

House Bill 290 does not specifically address whether the loans are to be provided at market rate, or a differential rate of interest. If the intent was for the bank to provide loans at a differential rate of interest, then there will be losses associated with the opportunity cost of the funds. On top of the operating cost, as noted by the Treasurer's Office below, new businesses have a relatively low success rate, which may put the principal of the loan at risk. This would be even riskier than the film loans currently provided by the SIC, which require a personal or corporate guarantee or a letter of credit that protects the principal of the loans.

There are also potential revenue benefits associated with House Bill 290. If the state bank provides credit where it is necessary to spur on economic growth and this capital causes businesses to thrive, then the general fund and local governments would benefit from additional tax revenue.

SIO:

The bill draws up to \$100MM from the STPF to establish the New Mexico Small Business Development Bank, a completely brand new entity, tasked to act as a state-owned, controlled and operated business development bank. Up to \$5MM of the \$100MM will be used for start-up costs. Though not specifically identified as a

differential rate or ‘below market rate’ investment, such an entity would definitely be an “economically targeted investment” or ETI. Typically the ancillary economic benefits of ETIs are taken into consideration in addition to potential investment return when evaluating their worthiness and specific role in an investment portfolio.

As of 12/31/10 the Severance Tax Permanent Fund (STPF) has a market value of \$3.797 Billion, of which \$100MM would comprise approximately **2.6%**.

Currently the SIC has several legislatively-authorized STPF “carve outs” for New Mexico focused / economically-targeted investments (ETIs), including:

- Up to 9% of the STPF for the New Mexico Private Equity Investment Program
- Up to 6% of the STPF for the New Mexico Film Investment Program
- One-percent of the STPF is automatically allocated the New Mexico Small Business Investment Corporation (SBIC)
- Up to 20% of the STPF for bank certificate of deposit investments with NM Financial Institutions (NMSA 1978, Section 7-27-5.19). Policy allowing these investments was revised in 2010, and could soon become active again.

In addition, the following programs have been earmarked by the legislature for possible investment from the STPF, but are currently inactive:

- Up to 20% of the STPF for NM Farmers’ Home Administration Loans (NMSA 1978, Section 7-27-5.4)
- Up to 10% of the STPF for Educational Institution Revenue Bonds (NMSA 1978, Section 7-27-5.13)
- \$130MM (about 3%) of dollar specific STPF-authorized investments

In summary, the STPF currently has 69% of its funds earmarked for ETIs, though less than 15% is currently invested. It has been noted historically, and by the LFC as recently as last fall that ETIs have proven to be a drag on investment performance for the SIC. Returns for the STPF were 100 basis points below Land Grant Permanent Fund (LGPF) returns on a 5-year basis for the quarter ending 12/31/10, and have typically tracked 0.5%-1.5% below the LGPF over the past decade.

The newly constituted State Investment Council, which was restructured under 2010’s SB18 legislation, has voiced concern in recent months about a lack of hard data regarding the secondary benefits of ETIs in general, and has questioned whether it is the role of an investment agency to oversee such programs aimed at boosting the state’s economy, or whether it should focus solely on optimizing investment returns.

STO:

To the extent that Severance Tax Permanent Funds are diverted to the small business development bank contemplated by this legislation, earnings on that amount would impact revenues reverting to the General Fund.

In addition, it should be noted that 50% of small businesses do not survive past the first 4 years. This data has some significant fiscal implications regarding payment of the loans to the small business bank.

## SIGNIFICANT ISSUES

SIC Staff has identified several potential concerns as outlined here:

- **POTENTIAL FOR POLITICIZATION OF THE BOARD.** Section 5 paragraph B provides for politically-appointed members on the proposed bank board. While Section 8 sets forth prohibitions on conflicts of interest, additional fiduciary, ethical and conduct safeguards may be warranted. Perhaps a statutory emphasis on professional banking management and a highly-qualified independent board is advisable.
- **BANK INVESTMENT.** Section 14 paragraph A speaks to one hundred million dollars (\$100,000,000) from the severance tax permanent fund (“STPF”), of which five million dollars (\$5,000,000) may be used for initial capital projects. These amounts are significant with the former exceeding two and a half percent (2.5%) of STPF assets.
- **OPERATIONAL COSTS/POTENTIAL LACK OF FUNDING SOURCES.** There does not appear to be a statutory mechanism for the treatment of necessary operational expenses. Such costs include staffing, benefits, business and other appropriate insurance, attorneys, auditors, and accountants. The statute suggests that the bank will have the necessary resources to conduct business and manage local community bank loan participants, yet there may be a lack of enumerated funding sources other than a possible investment by the STPF.
- **SIC INVOLVEMENT.** Section 14 paragraph B indicates SIC may “work with the bank to invest the funds authorized for investment.” The second sentence requires that such investments “shall be made and administered” by the Council and state investment officer. The implication appears to be that SIC could be called upon to perform the administrative duties of the bank. SIC does not have the staff or resources to comply with such a reading of the proposed statute.
- **RETURN ON INVESTMENT.** The bank’s non-profit status may preclude SIC investment from being a participation security (*e.g.*, equity or preferred stock) as minimal profits could exist in which to participate. The proposed bank structure/status might implicate an existing political issue by negatively impacting STPF economic returns.
- **DEGREE OF RISK.** The effect of limiting bank lending to economic development projects increases risk. Reliance upon new businesses could be viewed negatively in the current macroeconomic environment.

EDD (which is similar to the statements submitted by NMFA):

House Bill 290 would be in direct competition with the business lending program of the Statewide Economic Development Finance Act (SWEDFA). SWEDFA, enacted in 2003, authorizes New Mexico Finance Authority to issue bonds, make loans and provide loan and bond guarantees on behalf of private for-profit and non-profit entities. In 2005, SWEDFA was amended to create the Smart Money Initiative, a business lending program designed to use a \$12 million appropriation to create greater access to capital throughout New Mexico

Unlike HB 290, SWEDFA requires a project to be certified by the Economic Development Department, loan proceeds may not be used for real estate and personal property, and projects must obtain authorization from the legislature.

## PERFORMANCE IMPLICATIONS

SIO:

While not a certainty, as there are some profitable banks run by state governments across the country (North Dakota for example), as with any ETI, there is a potential for diminished returns in contrast to other more attractive market-rate investments.

## ADMINISTRATIVE IMPLICATIONS

SIO:

In Section 9 of this legislation, the SIC is required to "...select an independent third party to examine the bank at least once every 24 months and conduct any investigation of the bank that may be necessary." This requirement is in addition to audit requirements also required in Section 9, and also apparently exclude any review by the State Bank Examiner under the Financial Institutions Division of Regulation and Licensing. It is not clear who would bear the burden of the related expenses, either for the audit or the biannual investigation and reporting, either the SIC or the new Bank entity.

## TECHNICAL ISSUES

STO:

Commissions and boards for entities relating to financial matters have historically had the State Treasurer involved at some level. This legislation does not include the State Treasurer as a committee member responsible for appointing the chair of the board

AGO:

Section 6(D) gives the Bank the power to acquire, hold, improve, mortgage, lease and dispose of real property for its public purpose. This would presumably be subject to NMSA 1978, Section 13-6-1 to -8 which pertains to the disposition of state property. Also, real property belonging to the state falls under the jurisdiction of Property Control. See NMSA 1978, § 15-3B-4. However, Section 4(D) of HB 290 states that "[t]he bank shall not be subject to the supervision or control of any other board, bureau, department or agency of the state except as specifically provided" in the Act. Therefore, this section might exempt the Bank from the jurisdiction of property control. These potential conflicts should be explored. Section 6(F)(3) gives the Bank the authority to prosecute and enforce judgments. The Bank may need a Commission from the Attorney General for its attorneys to commence such litigation. Section 6(K) allows the Bank to invest its money in community bank. The Bank should be aware of anti-donation issues with this. See N.M. Const. art. IX § 14. Section 8 of HB 290 contains conflict of interest provisions for board members. Obviously these would be in addition to the

Governmental Conduct Act, NMSA 1978, Sections 10-16-1 to -18. Section 10 should be read in conjunction with the Tort Claims Act. See Section 4(D)

OSA:

The bill requires the State Auditor to “contract with an independent certified public accounting firm for an annual audit of the bank.” If the intent of the bill is to require an annual financial audit of the Bank, then the more appropriate language would be to subject the Bank to the Audit Act by reference. Under the Audit Act, the financial affairs of every agency “shall be thoroughly examined and audited each year by the state auditor, personnel of the state auditor's office designated by the state auditor or independent auditors approved by the state auditor.” Additionally, the “audits shall be conducted in accordance with generally accepted auditing standards and rules issued by the state auditor.” Pursuant to the Audit Act, the State Auditor does not contract with an independent public accountant (IPA) to conduct the audit; rather, the agency procures an IPA, and then the State Auditor reviews and approves the contract between the agency and the IPA. Furthermore, upon submission and completion, the audit report is reviewed by the State Auditor and released to the agency audited, the Legislative Finance Committee and the Department of Finance and Administration.

#### **OTHER SUBSTANTIVE ISSUES**

STO:

To the extent Severance Tax Permanent Fund Balances are “public monies” of the State of New Mexico, this act would contemplate investment alternatives that are broader than the restrictions on public fund monies including, but not limited to, Sections 6-10-10 and 6-10-24.1 N[M]SA 1978.

OSA:

The bill requires the State Investment Council to select an independent third party to “examine” the Bank at least once every twenty-four months and conduct any “investigation” of the bank that may be necessary. The bill requires the SIC to report the results of the examination and any investigation to the board of the bank and legislature. It should be noted that, depending on the type of examination and investigation contemplated by the legislation, such examinations and investigations may be within the statutory authority of the State Auditor to conduct pursuant to the Audit Act (See “Alternatives” below regarding potential options on this issue).

JAG/mew