**New Mexico Regulation and Licensing Department**
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November 12, 2020

Honorable Members of the
New Mexico Indian Affairs Committee
c/o Lenaya Montoya
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Re: Public Bank Discussion

Dear Co-Chairs Sen. Pinto and Rep. Louis and Members of the Committee:

The Financial Institutions Division (FID) of the Regulation and Licensing Department approves, examines, and regulates banks chartered in the State of New Mexico pursuant to the New Mexico Banking Act, 58-1-1 NMSA 1978, *et seq*. As such, we have reviewed the issue in recent years when the subject of a public bank has been discussed by the Legislature. As the regulator for state chartered banks in New Mexico, the FID believes that the items and issues identified below should be addressed in any legislation related to the potential authorization of any public bank in New Mexico.

**SIGNIFICANT ISSUES**

The FID suggests the following non-exclusive list of items/issues be included within any study conducted when evaluating the structure and processes of the possibility of a state-owned bank alongside current New Mexico law and sound banking practices:

- "Anti-Donation Clause" of the New Mexico Constitution:
  - 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" appears to be in direct conflict with the language and intent of Article IX, Sect. 14 of the New Mexico State Constitution (commonly known as the "Anti-Donation Clause").
  - Prior to the establishment/chartering of a bank in the State of New Mexico that would follow a structure similar to that of the State Bank of North Dakota, a state constitutional amendment would be required.

- How would a "state bank" in New Mexico be insured?
  - All New Mexico state chartered banks are required to be insured:
    - §58-1-2 NMSA 1978, (A) "bank" means: (1) an "insured bank" as defined in Section 3(h) of the Federal Deposit Insurance Act.

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    - §58-1-61 NMSA 1978 (B) Before actually transacting any banking business or accepting any deposits, the applicant must file with the commissioner [director] satisfactory proof showing that insurance of deposits has been obtained through the Federal Deposit Insurance Corporation or other appropriate agency or instrumentality of the United States government.
    - §58-1-70 NMSA 1978 Deposit insurance; membership in the Federal Reserve System. "A state bank shall obtain insurance of its deposits by the United States or any agency thereof, and may acquire and hold membership in the Federal Reserve System."

- Deposits/Protections:
    - Most banks' lending/investing activities are funded substantially through deposits. The state needs to consider the source of protection for those deposits. Traditional banks rely on deposit insurance coverage, subject to certain limits, from the Federal Deposit Insurance Corporation (FDIC).
    - In the FDIC's Statement of Policy for Applications for Deposit Insurance (Federal Register Volume 63, Number 161, Thursday, August 20, 1998), the FDIC expresses its concern about institutions owned by domestic governmental units being controlled by the political process. Additionally, the FDIC notes, the institutions could raise special concerns relating to management stability, and the ability and willingness to raise capital. While not a definitive rejection of granting deposit insurance, the FDIC makes clear their concerns.
    - The deposits of the Bank of North Dakota and Territorial Bank of American Samoa are not FDIC insured, but are guaranteed by the full faith and credit of the State of North Dakota and American Samoa, respectively.
    - Currently, public funds are required to have securities to be "pledged" as additional protection for those funds. Depending on the specific governmental entity, this requirement can range anywhere from 50% to 102% of the deposited dollars, making those funds unavailable for lending activities.
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- Oversight:
    - U.S. banks are actively supervised by chartering authorities, including the FID, the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve, and/or the Office of the Comptroller of the Currency (OCC). The state needs to determine the appropriate entity to conduct this oversight. In order to be effective, the regulator should be able to exercise its supervisory authority independently and must have the authority to review all books and records.
    - An independent regulator must also have the tools necessary to seek corrective measures through formal enforcement actions, civil money penalties, and removal

of bank officers and directors. These authorities are critical to ensuring public confidence and protecting the state's taxpayers who will ultimately need to cover any shortfall in the event of insolvency.

- Safety & Soundness of the Bank:
    - Primary objectives of regulators should always be the safety and soundness of financial institutions, compliance with laws, regulations, and supervisory policy. This includes, but is not limited to:
        - Careful consideration should be given to the investment and lending authority of a state-owned bank in order to avoid risks to the solvency of the institution and prevent undue competition with privately owned banks. Federal law requires that appropriate limitations are established on loans to insiders and affiliated entities. Limitations are also required to be established on loans to one borrower or group of affiliated borrowers.
        - One concern about a government-owned bank is the possibility of lending and other banking decisions being affected by political concerns rather than strictly economic factors. For example, if the bank 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.

    - Governance and Managerial Factors:
        - Governance and managerial factors take into account the fiduciary duties of the board and management of the financial institution as well as the competence, experience, integrity, independence, and financial ability of the institution's organizers and staff.
        - Corporate governance is a critical component for all banks. Ultimately, the board sets the policies of the bank, determines the desired risk profile, and oversees management. The state needs to consider carefully the individuals who would be charged with this responsibility and their role, if any, in state government.
        - One of the most important decisions for any financial institution is selecting the executive management team, since there is a direct relationship between the overall conditions of a bank, the quality of its management team, and the future performance of the bank.

    - Capital Adequacy:
        - Banks need to be supported by monetary capital. Capital provides the foundation for the bank to operate through the 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, recognizing the need for it to remain in the bank throughout its 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 should the bank experience unexpected losses, requiring recapitalization. Federal regulations require total risk-based capital to be greater than 10% for a bank to be considered "well capitalized." The term, "well capitalized," refers to a category under Prompt Corrective Action. Banks with capital below this category are subject to certain mandated regulatory restrictions. Banks generally find it necessary and desirable to hold significantly higher levels. The current industry average is 14.74%. By this standard, a bank projected to be $1 billion in assets would need $147.4 million in capital, just to open its doors.

**EXISTING STUDIES**

Many cities and states have undertaken studies to determine the feasibility of state-owned banks. Provided below are facts from the two existing public banks, two failed public banks, and highlights from the multitude of studies already performed throughout the US. Of particular interest is the Washington State Treasurer's 2018 "Study of the Studies: A comprehensive review of state, municipal, city, and public banking" as it includes information compiled from all existing public bank studies at the time of its origination.

- Bank of North Dakota:
    - In May 2011, the New England Public Policy Center of the Federal Reserve Bank of Boston published a research report entitled, "The Bank of North Dakota: A model for Massachusetts and other states?" The Research Report analyzed the Bank of North Dakota (BND) as a possible model for the state of Massachusetts. The Report did not find this to be a reasonable model for Massachusetts, concluding that:
        - The willingness and capacity of a state-owned bank to offset a serious credit crunch has not been shown;
        - With the possible exception of the Great Depression, the Bank of North Dakota (BND) contributions to stabilizing the state economy and finances appear to have been relatively minor;
        - The potential costs of starting up a state-owned bank could be significant; and
        - States should start any discussions of financial-sector reforms by identifying the problems that public policy needs to address.
    - Emphasizing safe and sound lending, BND does not engage in risky activities such as community development funding and equity investments.
    - A state bank, and BND in particular, are able to augment local banks' lending capacities; however, the Massachusetts Commission Report pointed to "private bankers' banks" owned by and providing services to member institutions as an alternative model to a state bank. These relationships provide services to smaller banks while not being viewed as a competitor.
    - When the North Dakota economy is doing well, BND has been able to help balance the state budget when it experiences shortfalls in other financial sources. However, during a severe agricultural crisis and recession, the poor performance of BND made the crisis worse. When North Dakota's economic experience was compared

to that of South Dakota, a state similar in geographic location, size, population, and industry mix, it was found that North Dakota did not consistently outperform South Dakota. The conclusion of the Research Report, reflected in the Massachusetts Commission Report, is that having a state bank did not measurably affect the economic health of the North Dakota.

  - In addition to the cost of possible legal and regulatory hurdles, including the time delays, basic start-up costs would likely be considerable, perhaps involving a sizeable bond issue. In addition, if a state bank were to be established quickly, it would most likely disrupt the operations of existing local banks. This is because the state deposits public funds into various financial institutions, and withdrawal of such deposits would be disruptive, requiring these institutions to reduce their lending and investment portfolios. However, a gradual phase-in, while perhaps more palatable to existing banks, would delay the benefits of state-owned bank lending. The Massachusetts study estimated that, based on the startup costs for BND, which consisted of an initial capitalization through a $2 million bond issue in 1919, the startup cost for a Bank of Massachusetts would be around $3.6 billion. This extrapolation included adjustments for inflation and for growth in the size of the economy from 1919 to 2011 - assuming a 13-fold expansion.
  - The Research Report recommended that, instead of planning for the establishment of a state bank, the Commission:
    - Identify the specific market failure it wishes to address and the degree to which a state-owned bank would address this failure; and
    - Investigate ways to leverage the already existing network of quasi-public agencies to fulfill its objectives.

- Territorial Bank of American Samoa:
  - Bank of Hawaii announced in 2012 it was leaving the remote US territory in the South Pacific.
  - Though the Territorial Bank, which is backed by the government in American Samoa, opened its doors in October 2016, it was only been able to offer extremely limited services until 2018. It lacked access to the U.S. payments systems, which is necessary to offer banking basics such as debit cards, checks, and wire transfers.
  - Organizers applied in July 2016 to the American Bankers Association for a routing number, which is required to be a part of the U.S. payment system. To obtain that approval, the Federal Reserve had to sign off that the bank was eligible for central bank services. It took approximately 2 years to receive that approval, compared to the median processing time for a *de novo* financial institution applying for Federal Reserve membership in 2017, which was 14 days.
  - Key factors for obtaining Federal Reserve approval lie largely in the fact that there were no banking services available in the territory and not a single commercial loan had been made on the island in more than five years. These are issues not currently existing in New Mexico.

- Puerto Rico Development Bank:
  - Failed.
  - Established in 1942, liquidated in the summer of 2017.

- Delaware Farm Bank:
    - The state owned 49 percent of the bank from the 1800s to 1975.
    - In 1976, the state increased ownership to 80 percent.
    - In 1981, on the verge of failure, it was purchased by a private Pennsylvania bank.

- City of Seattle Feasibility Study, 2018:
    - In summary, the study found:
        - That while no law specifically precluded the City from establishing a public bank, state and federal laws would limit its operations and revenue potential, such that the value of such a bank must be carefully weighed vis-à-vis the City's goals.
        - A public, city-owned bank capitalized by City deposits and which does not lend money or offer retail banking services would guarantee independence from Wells Fargo (the city's initial goal), but would require an ongoing dedication of capital and, potentially, foregone income from the City's investment account. This ongoing funding requirement would likely exceed the $150-$200K the City pays for banking services currently.
        - Additionally, the approval of such a bank would require the sign-off of multiple state and federal regulators and would likely take several years to complete.
        - A public bank is feasible under current law, but should be weighed against alternative paths to addressing the City's primary goal of divestment.

- Washington State Treasurer's 2018 "Study of the Studies: A comprehensive review of state, municipal, city, and public banking"
    - Public entities had many different reasons for studying the issue; however, some common themes emerged as to why they looked into public banking:
        - Gain greater access to credit or capital.
        - Help fund state government with bank profits.
        - Stabilize the state/city economy during economic downturns.
        - Provide a stable source of infrastructure funding and economic development.
        - Provide better banking services for public entities at fair prices.
        - Fill in the gaps where there are not current financial services.
        - To set up participation loan programs and increase the lending capacity of their own community banks.
        - Provide cannabis-banking options.
    - The studies detailed why they considered state banking, but no study showed the exact market failure where a state bank could fill a need. Numerous studies indicate the market, need, or business plan is not identifiable. Most of the studies described "possible gaps" that a state bank could fill, however none of them conclusively provided a business plan, or complete market analysis, which would answer the question: "What is lacking and how would the state bank or city bank conclusively fill the gap?"
    - As a result of these studies, no entity or government had gone forward with public banking due to results that showed:

        - There are large legal and constitutional barriers that would have to be addressed.
        - There are already many state programs in place that fulfill the goals of a public bank.
        - Creating a public bank is too expensive – associated costs are far too high.
        - The risks to state, city, and taxpayer money are simply too great.
        - Cities and states concluded they would need to complete much more research on what market niche a public bank would fill and how it would be implemented.
        - None of the entities who completed the studies have created a public bank.
    - Most studies concluded that there is currently no money to start a public bank and that there needs to be a significant investment to start this enterprise.
        - The studies show entities considered different funding sources to start a state bank.
        - They looked at using bonds, general fund appropriations, initial public offerings, pension funds, and the Local Government Investment Pool.
        - Estimated costs of what would be needed to start a state bank range from a very small public bank of $15 million to a large institution of $3.6 billion.
        - Most studies indicate that capital is the main impediment to starting a public bank.
    - Examples of high costs found in the studies:
        - The State of Oregon study and the State of Washington study completed by The Center for Innovation note that a state bank would need $100 to $300 million. Sources include bonds, general fund revenue, bank stock IPO, and the state's pension funds.
        - While American Samoa is not a study, but a public bank example, it capitalized with a ten million taxable bond offering, $3.5 million appropriation, and now has $13 million in capital, which is a very small financial institution.
        - The Bank of North Dakota was capitalized with $2 million in 1919, which is $30 million in today's dollars.
        - Massachusetts says that it would cost $3.6 billion to start the public bank.
        - San Francisco estimates approximately $15 to $50 million would be needed based on bay area community bank capitalization: $1 million in regulatory startup costs, $10 to $30 million for capital, $500,000 to $1 million in IT and Data systems, and 15 employees with salaries totaling about $2 million per year.
    - Financial risks are substantial. Some of the biggest risks identified in the studies are:
        - The risk of placing all taxpayer money in one institution, with no banking partnerships to share the risk.
        - With no FDIC insurance, there is a serious risk of insolvency for the state and the possibility of a required taxpayer bailout.
        - A public bank could underprice risks, leading to risky loans to unqualified borrowers who may default on their loans.

    - A new bank would likely not have the sophistication, capacity, or volume of money to meet a state's banking needs.
- The studies identified the potential for risk:
    - Los Angeles: Their study finds the current system spreads risk among banking partners, and one state bank would consolidate all risk in the city, putting taxpayer money at risk.
    - Maine: This study indicates there would be a loss of interest income from moving all state deposits from higher yielding demand deposits, and lost tax revenue from moving funds into a nontaxable financial institution.
    - The City of Santa Fe: This study suggests it would be a long process to obtain regulatory permission for a state bank, and listed many reasons for concern. There would need to be an assessment of public bank integrity on multiple factors including political influences in lending decisions, self-dealings, and corruption considerations. Careful considerations of investment and lending authority would have to be taken as to avoid risks of insolvency, and private banks and credit unions from competition. The study finds that there should be limits considered on loans to one borrower. Government run banks could also underprice risk, and this could mean politically involved lending which could place the bank in peril.
    - Massachusetts: The Massachusetts Treasury needs a large amount of services for its office. The Treasurer's duty, to keep deposits secure and provide an adequate rate of return, cannot be met by a startup bank: $40 billion in cash flow, $20 billion in bonds, and another $9 million in municipal depository trust. The study shows a smaller state-owned bank could not meet the needs of the state.
    - Vermont: The study finds that there would be lost tax revenue, liquidity demands, and possible downgrading of Vermont's bond rating if they started a public bank.
    - The North Dakota State Treasurer's Office does not invest the state's tax dollars. They are required to deposit cash in the Bank of North Dakota, and in 2017 had $2.5 billion deposited, earning .05%.
    - In comparison, the Washington State Treasurer manages the state's reserves of approximately $7 billion, and over the last decade distributed $600 million in earnings at the average rate of 1.45%. That is twice what the Bank of North Dakota shared in profits with the State of North Dakota over the same period.

**ALTERNATIVES**

FID notes other existing avenues competing for much of the business outlined in previous public bank Legislative discussions and provides the following non-exclusive list to the Indian Affairs Committee to consider when evaluating the financing available to small, startup, and other existing businesses in our state:

- Existing community banks, credit unions, national and global banks, and existing government programs. Additionally, most banks use lines of credit and loan participation services available with existing relationships with banker's banks and other state banks who share similar lending philosophies.

- DreamSpring (fka Accion), an award-winning nonprofit organization, provides small business loans in amounts from $1,000 to $1,000,000, typically to higher risk businesses, which traditional banks may not finance without additional collateral securitizing the loan. Many state-chartered banks are currently more liquid and have lower loan volume than is preferable. As of year-end 2019, the loan-to-deposit ratio for New Mexico banks was one of the lowest in the nation at 60.08%. For comparison purposes, the average loan to deposit ratio in Texas sits at roughly 67%, Oklahoma 76%, Colorado 74% and Arizona is at 77%. A healthy financial banking sector should be between 75% and 80%.
- The market for quality loans to worthy borrowers is quite competitive. Again, related to the safety and soundness issue, only quality loans should be made for sustainability and public confidence, with or without public funds being involved.
- Farm Credit and USDA lending programs have continued to drive down rates and taken many agricultural loans away from state banks in recent years.

We appreciate your time in considering these important factors. Should you have any questions, please feel free to reach out to our office.

Sincerely,

Rebecca S. Moore

Rebecca S. Moore
Acting Director