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F I S C A L   I M P A C T   R E P O R T

SPONSOR HBIC **ORIGINAL DATE** 02/05/10 **LAST UPDATED** **HB** 66/HBICS

SHORT TITLE State Funds in Community Banks **SB**

ANALYST White

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY10	**FY11**	**FY12**		
$0.0	($0.1)	($0.1)	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY10	FY11	FY12	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
Total	$0.1	$0.1	$0.1	$0.1	Recurring	STO Operating Fund
	$0.1	$0.1	$0.1	$0.1	Recurring	DFA Operating Fund
	$0.1	$0.1	$0.1	$0.1	Recurring	SIC Operating Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Department of Finance and Administration (DFA)
State Treasurer's Office (STO)
State Investment Council (SIC)

SUMMARY

Synopsis of Bill

House Business and Industry Committee substitute for House Bill 66 attempts to give preferential treatment to New Mexico community banks when bidding for the state fiscal agent contract by requiring the Department of Finance and Administration (DFA) to multiply the

lowest bidding community bank's bid price "by a factor of .9."

The proposed legislation further requires the State Treasurer's Office (STO) and the State Investment Council (SIC), to promulgate rules in order to create certificate of deposit (CD) investment programs designed to increase community bank lending to New Mexico businesses and residents. The agencies are further charged with ensuring that these programs are accompanied with accountability and reporting provisions, and that they balance the investment priorities of the funds in question. Such programs would apply to those portions of the general fund operating cash depository account, bond proceeds investment pools, and the severance tax permanent fund (STPF) not needed for short-term liquidity purposes.

The proposed legislation also requires STO, DFA, and representatives of both the State Investment Council (SIC) and State Board of Finance (BOF) to study the feasibility "of dividing the general fund operating cash depository account between community banks and credit unions in order to ensure that state money benefits New Mexico residents." The results of such a study would then be reported to LFC and the Governor by December 1, 2010.

The substitute defines a community bank as a "federally insured depository institution organized under the laws of New Mexico or federal bank charter, or a credit union that is insured by the national credit union administration and is organized under the laws of New Mexico."

FISCAL IMPLICATIONS

The committee substitute requires both STO and SIC to create CD investment programs designed to increase New Mexico community bank lending. Anytime proposed legislation mandates investment criteria upon a fund, it has the potential to limit the investment opportunities available to the individual portfolio managers. This limitation in opportunities creates possible negative impacts to the respective portfolios. In the case of this substitute these portfolios would be the STO general fund portfolio, state bond proceed portfolios, and the STPF. Both the STO general fund portfolio and the STPF make direct distributions to the general fund. Therefore any legislation that could possibly harm their overall performance has the potential to negatively impact general fund revenue.

As noted by SIC and STO in their analyses, and by various respected investment experts, statutory mandates with respect to investment decisions often result in negative investment performance. Programs of this type, even in if they are allowed to be formulated to some extent by the agencies themselves, tend to crowd out other possibly more attractive investments from institutional portfolios. Evidence of such phenomena is presented below:

LGPF Performance vs. Policy Benchmarks (9/30/09)

Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
10.30%	12.00%	56	-7.10%	-3.40%	99	3.40%	3.30%	86

STPF Performance vs. Policy Benchmarks (9/30/09)

Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
9.50%	11.30%	65	-9.20%	-4.60%	99	2.70%	3.40%	91

When comparing the latest audited performance data from both the STPF and the land grant permanent fund (LGPF), it becomes evident that the STPF underperforms on a consistent basis. These numbers show that, for all three time periods presented, the LGPF has actually outperformed the STPF by an average of 1.2 percent. The primary difference between the investment strategies of the funds' are their portfolio allocations driven by the statutory mandates currently in place on the STPF. This is also evident in comparing the funds' policy benchmarks, which represent a fund's market performance based upon its asset allocation policy. Using these metrics for comparison which eliminate all other major variables except for portfolio allocation policies, the STPF underperformed for all three time periods by an average of 0.6 percent.

Both the STPF and LGPF make annual appropriations of 4.7 and 5.8 percent respectively to the general fund based upon their average market value for the preceding five calendar years. In FY10 the funds will distribute approximately $624 million to the general fund combined, representing more than 10 percent of all recurring general fund revenue.

Historical GF Distributions

	LGPF	STPF
FY09	$433.2	$191.3
FY08	$390.5	$177.2
FY07	$364.7	$171.0
FY06	$354.2	$171.8
FY05	$350.3	$173.2
FY04	$292.2	$172.4

While STO considers investment return to be a tertiary priority, after safety and liquidity, the performance of the general fund portfolio does impact overall general fund recurring revenue. The majority of interest earnings on the portfolio are credited to the general fund, and such earnings have been significant in the past.

Historical GF Interest Revenues

FY09	$	67,754,008.68
FY08	$	114,974,819.77
FY07	$	87,307,225.47
FY06	$	77,935,216.32
FY05	$	34,386,238.74

However, the fact that the substitute explicitly states that the respective CD programs must balance the funds' investment priorities and allows for the individual agencies to promulgate their own rules has the potential to mitigate these effects. To what extent these effects are mitigated depends largely upon the specific rules promulgated by the individual investment agencies with regard to the creation of such a program. Based upon the evidence above and the myriad of potential unknown variables at play, it can be inferred that the substitute could have an indeterminable but significant impact on general fund revenue.

Due to the increased contractual costs which would almost assuredly, through the use of "a factor of .9," accompany a fiscal agent contract entered into with a community bank, the proposed legislation would most likely have recurring operating impact to BOF. DFA notes in its analysis

that selecting a fiscal agent who bids ten percent more than the next lowest bid could cost the state in excess of an additional $50,000 to $100,000 per year. STO and SIC also report that the creation and maintenance of the investment programs set forth in the substitute would most likely create a recurring additional operating impact on their budgets. Furthermore the proposed legislation mandates that STO, DFA, BOF, and SIC perform a feasibility study due no later than December 1, 2010. The performance of this study will most likely have a non-recurring additional operating impact on all of the agencies involved.

From a financial perspective the proposed legislation, if enacted, may have a relatively small but not insignificant recurring negative impact on the state general fund. In order to justify such measures, assumptions must be proven that the proposed legislation would either create a net increase in state tax revenue or generate some positive externalities (non-financial benefits) that outweigh the financial loss to the general fund. Pieces of the proposed legislation would undoubtedly create more liquidity within New Mexico community banks and therefore could increase loan opportunities for New Mexico citizens and businesses. General studies, most recently by the Arrowhead Center at New Mexico State University, have stated that public deposits in community banks can increase lending practices. However, as there has been no dynamic analysis of the specific measures included in House Bill 66 in terms of resulting tax revenue increases or decreases, the negative impact could be looked upon as a subsidy to the New Mexico banking industry. Therefore legislative enactment of House Bill 66 would represent a conscious policy decision that the New Mexico banking industry should be favored versus other New Mexico and out of state industries, and that the probable loss to the general fund associated with such measures will yield net financial benefits and or positive externalities to the state.

SIGNIFICANT ISSUES

Fiscal Agent Bank: Both DFA and STO voiced serious concerns in their analyses of the original bill as to its implications on the state fiscal agent bank contract. The substitute addresses these concerns by allowing price to be one of just many factors in the fiscal agent bank selection process. The substitute would require the BOF to select a community bank only if:

- the community bank meets minimum capability requirements of BOF,
- the proposal price of the community bank, when multiplied by a factor of .9 is lower than the proposal of the non-resident bank; and
- the community bank proposal meets or exceeds the other evaluation criteria set out in the BOF procurement process.

The DFA analysis states with regard to the provisions laid out in the substitute that "(BOF) staff feels more comfortable that it is not going to be forced to select a community bank that may not be able to handle the complexity of the state's account.

Investments in Community Banks: The substitute requires STO and SIC to develop programs designed to invest monies not needed for short-term liquidity be invested in a CD program with community banks. As noted in the fiscal impacts section of this FIR, such investment strategy would most likely limit overall returns to the fund and thus have a negative impact on general fund revenue. Furthermore, STO already administers a CD program "whereby financial institutions may offer the State Treasury time deposits up to $30 million per financial institution with a maximum level in the (CD) portfolio not to exceed $350 million." Within that program is the "Linked Deposit Program" which allows STO to invest up to $10 million per qualified

community bank situated in an area with a population below 3,500 and a declining economy at a differential, or below market, rate. STO notes that this program is currently capped at $49 million. The STPF also already has a statutorily required CD program in place with community banks.

State Investment Council (SIC):

> "There is currently a mechanism in statute that allows the SIC to invest up to 20% of the STPF in New Mexico Banks. The existing statute (NMSA 1978 Section 7-27-5.19), allows investments to be made from the STPF into Certificates of Deposit held by qualified New Mexico financial institutions.
>
> Historically, this CD investment program has seen limited use for different reasons. Under the statute, banks would only qualify for these investments if rated A by the SIC, or if providing up to 102% collateralization. This collateralization requirement has made the program unattractive to NM banks. In addition, the amount invested by the SIC in CDs with any individual bank, was limited to the amount that they were loaning to New Mexico businesses. Depending on the number and size of the bank investments, this is potentially difficult for SIC staff to monitor adequately.
>
> It is notable that in recent months, there has been an initiative led by the State Land Commissioner to restart the CD investment program, loosen the existing policy and invest money through certificates of deposit with NM community banks. This "restart" has been hampered by two issues:
>
> First it was identified that the existing policy was similar, but not exactly the same as a previous Rule regarding this investment authority from 1993. This meant that to make a policy change regarding these investments (and make the program attractive to banks), was not possible as then the new policy would be in conflict with the old Rule. That Rule was repealed in late 2009 through the necessary but lengthy process. Future investments of this kind will be governed by statute and SIC policy, not Rule.
>
> Secondly, amid the current turmoil facing the Council relative to a federal investigation regarding outside marketer placement fees, in addition to the resignation and subsequent replacement of the state investment officer, several members of the Investment Council have voiced public concern over whether this program will be properly securitized to avoid putting permanent fund money at risk. The Council has asked that SIO Staff put together a proposed policy that would make changes sought by the bankers, while also addressing Council Members concerns over securitization and monitoring. This revamped policy is expected to be discussed once again and possibly voted on at the SIC meeting in February."

The proposed legislation also does not go into specifics as to whether or not these programs should consist of market rate investments or differential rate investments. If the investments were to be made at differential rates than negative performance impacts would be much more significant. Furthermore the substitute specifically states that the programs in question "shall balance the investment priorities, such as the preservations of the principal balance, the maintenance of liquidity and maximum return." These three facets of investment priorities relate well to the investment programs at STO, but not necessarily to those at SIC. As the SIO is required to operate under the Uniform Prudent Investor Act, it may be prudent to explicitly state

that any program created as per the substitute must be in compliance with that act. Such a requirement could mitigate potential negative performance impacts on the STPF.

TECHNICAL ISSUES

State Treasurer's Office (STO):

> "Paragraph A lists the minimum requirement of unimpaired capital to be $150,000 but should be $20,000,000, based on the current State Board of Finance administrative rule (See NMAC 2.60.7.3)."

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

If the HBIC substitute for House Bill 66 were not enacted, New Mexico community banks would not receive preference over out of state banks in the State's fiscal agent procurement process. Furthermore STO and SIC would not be required to create additional CD investment programs for funds not used to meet short-term cash flow needs. Also STO, DFA, SIC, and BOF would not be required to perform a feasibility study as to the maximization of benefits to New Mexico citizens resulting from state deposits in local banks.

DMW/mew