Fiscal impact reports (FIRs) are prepared by the Legislative Finance Committee (LFC) for standing finance committees of the NM Legislature. The LFC does not assume responsibility for the accuracy of these reports if they are used for other purposes.

Current and previously issued FIRs are available on the NM Legislative Website (www.nmlegis.gov).

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

SPONSOR	Roybal Caballero/Steinborn	**ORIGINAL DATE** / **LAST UPDATED**	1/26/22	**HB**	75
SHORT TITLE	Public Banking Act			**SB**	
				ANALYST	I. Torres

APPROPRIATION (dollars in thousands)

Appropriation		Recurring or Nonrecurring	Fund Affected
FY22	**FY23**		
	$110,000.0	Nonrecurring	General Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY22	**FY23**	**FY24**	**FY25**	**FY26**		
-	Indeterminate and minimal, likely negative				Recurring	General Fund

Parenthesis ( ) indicate revenue decreases

SOURCES OF INFORMATION

LFC Files

Responses Received From
State Investment Council (SIC)
Office of the State Treasurer (STO)
New Mexico Finance Authority (NMFA)
Economic Development Department (EDD)

SUMMARY

Synopsis of Bill

House Bill 75 (HB75) 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. HB75 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 $60 million deposit by the State Treasurer and an appropriation of $50 million from the general fund.

If enacted, HB75 would become effective July 1, 2022.

FISCAL IMPLICATIONS

HB75 appropriates $110 million to the newly created Public Bank, all of which is from the general fund. Of the $110 million appropriation, $60 million is described as a deposit from the State Treasurer who under the bill is not able to withdraw any of the initial deposit. In effect, this is also an appropriation to another fund.

It is unclear whether the deposits made will generate a return where they otherwise would have in management 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.

NMFA notes:

> NMFA has reviewed the bank business plan provided by the Alliance for Local Economic Prosperity and its accompanying financial projections. It is not clear to NMFA that the projections and the business plan narrative are aligned and the projected net income appears to be higher than the narrative supports.

The State Treasurer's Office reports:

> Leverage and contingent exposure: While the initial capitalization/appropriation request earmarks $50 million plus $60 million from the treasurer's operating funds, the state is also exposed for the full amount of the loans, investments and guarantees issued by the bank. Banks are generally leveraged 10 to 1. In other words, for each $1 of capitalization, banks typically make about $10 in loans and investments. So while the initial capitalization/appropriation is $50 million, the State's potential exposure could eventually grow to about $610 million. It's important that legislators understand that there is leverage which creates additional exposure.
>
> Many of the activities that are allowed by this legislation are more risky than the

activities that are allowed for traditional banks. The state bank would provide a backstop and fund or guarantee loans and equity investments to entities including start-ups that the market in general has found not to be viable. There's an inherent risk that the state could be committing to be the lender or investor of last resort and could fund the transactions that other lenders, bankers and investors in the market have passed on.

<u>The $60 million deposit:</u> The bill requires the State Treasurer's Office (STO) to fund a minimum deposit of $60 million. Without knowing the interest rate paid or term of commitment of these funds, we cannot determine whether there would be a potential opportunity cost. STO would be required to deposit these funds for an undetermined amount of time.

If the deposit is exempted from NMSA 6-10, this is uncharted water for STO. NMSA 6-10 provides a list of eligible investments for the public funds that STO holds. Would deposits be FDIC insured? Would collateral be provided for deposits in excess of the $250,000 FDIC insured maximum? If not, these funds would be at risk.

Without a rate, term or collateral, these funds cease to have the short-term/highly liquid characteristics of all other STO deposits and investments and begin to have the characteristics of an equity investment which does not meet STO investment objectives. There are no stated provisions for the failure of the bank to meet its obligations. STO holds deposits to meet the needs of state government and therefore has a relatively short time horizon for committing funds. Could a rate be indexed to treasuries and maximum term be added? Could an exit provision be added should STO have a funding need?

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 New Mexico Legislative Council
- four members appointed by the governor
- the chief executive office of the New Mexico Finance Authority
- the state treasurer
- the secretary of economic development

The following are issues identified by the respective state agency.

State Treasurer's Office:

<u>Charter/equity investments:</u> The bank would be authorized to invest in equity or debt investments in New Mexico businesses. We question whether these are permissible activities for a bank. Would the bank be chartered as a commercial bank? Bank regulators exercise significant oversight over the composition board of directors and planned activities.

<u>Overlap/need:</u> There are many banks, credit unions and lenders throughout the state that provide funding to New Mexico's businesses and citizens. The state has several existing entities that offer similar economically targeted niche products e.g. New Mexico Finance Authority, New Mexico Mortgage Finance Authority, State Investment Council, Board of

Finance, Small Business Investment Corporation (and the entities they fund) etc. Does a void really exist that justifies this investment? What can the proposed entity do that the others cannot?

<u>Deposit concentration risk:</u> STO would likely be the largest depositor of the bank. STOs 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 $7.4 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. The perfect storm would be a scenario where New Mexico is experiencing an adverse economic event such that 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 indirect 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 could negatively impact the bank's liquidity. This could create a liquidity crunch for the bank due to its concentration of similar short-term deposits that also lack of geographic and industry diversification that are used to fund long-term loans and investments.

<u>Fiscal agent bank:</u> 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 would not expect a migration of the fiscal agent banking relationship to the state bank.

State Investment Council:

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. HB75 offers the potential that a state bank may advance some or all of these goals.

North Dakota has seen some measures of success and independence with its state bank in its 100+ year history, though none of the other 49 states have been able to replicate this success (many have not tried, some have tried and failed). It is not clear whether the performance of the Bank of North Dakota can be duplicated in New Mexico.

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% APR.

There is a question whether a state bank in NM would compete with existing entities and programs in both the private sector and government. Would the PBNM compete with existing legitimate community banking institutions, as well as state entities like NMFA which already provide financing for state projects and loans to government instrumentalities. Much of this would be dependent on policies established by the Board, and how the state bank would actually be operated.

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 HB75.

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 HB75**.**

It is possible that a legislative study better defining the initial costs, needs, goals and potential effectiveness of a state bank could be performed during the interim. A public bank entity bill was first proposed at least 9 years ago, and a bill to study the issue was last proposed – and rejected - in 2018. Despite what appears to be growing interest in pursuing a public bank as a matter of policy, there has been no assessment by the legislature regarding the potential risks involved.

New Mexico Finance Authority:

The public bank is initially capitalized at $50,000,000, which would enable it to make loans of several times that amount, as defined under United States banking regulations, but which lending capacity is limited by cash available to lend. The $60,000,000 deposit from the State Treasurer provides the initial cash for lending and effectively puts a cap on lending capacity for several years unless new appropriations are made or other deposits or investment capital are found. The most likely candidates to provide funds to support the public bank's lending activities are public entities in New Mexico. However, no entities are required to do so and incentives to invest with the public bank are limited given that there is no market advantage in doing so. The public bank is given no authority to issue bonds to raise cash for lending or investment and would not be well rated with access to low cost borrowed funds if it were.

Under Section 5(A)(2)(C) the public bank can lend to "*instrumentalities or political subdivisions of the state*" but NMFA already does that for infrastructure ranging from fire engines to very large infrastructure projects through the Public Project Revolving Fund ("PPRF") passing on without a credit or other premium the interest rates the PPRF achieves by issuing AAA rated bonds into the national markets. The PPRF does not charge any fees. The PPRF lends about $50 million each quarter to New Mexico public entities – about equal to the public bank's total lending capacity. NMFA already has personnel and technology in place. New Mexico public entities are not required to borrow through the PPRF and could borrow from the public bank instead; however, lending to beat or even match the PPRF's terms is not likely to be a successful strategy for lending capacity growth based on revenue for the public bank. The public bank's public lending niche might be for non-infrastructure purposes but this is a more limited market already filled by community and other banks. More generally, in the public sector, particularly in New Mexico which has a number of highly subsidized funding programs, the issue is capacity to borrow and creditworthiness rather than availability of funds at acceptable interest rates.

Under Section 5(B), "*the bank shall not make loans to a private individual or private legal entity*". Under Section 5(C) the public bank is able to support New Mexico businesses by working through intermediaries such as local financial institutions. The NMFA is able to lend directly to New Mexico businesses while working with other financial institutions with existing tools authorized under the Statewide Economic Development Finance Act, such as loan participations and the federal New Markets Tax Credits program. There may be a market niche for the public bank to support local business while working through intermediaries, but it will have limited resources to do so and fewer tools to work with then the NMFA already has.

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 long-standing 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. In over 100 years, no other state has successfully duplicated North Dakota's success in creating a public bank.

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 or other obligations 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 should the public bank seek deposits.

Economic Development Department:

The public bank concept is interesting, and EDD would like to continue discussing the proposal as it develops. However, this bill and the supporting documentation from

advocates may need more vetting during the interim before the state pursues the strategy at this level of cost. It would be helpful for the proposal to receive a thorough vetting by interim legislative committees and public and private financing institutions.
A public bank in New Mexico that is not as profit driven as more traditional banks could lend to less traditional projects that carry a lower rate of return but are still feasible projects and may help to increase wealth for New Mexican residents and help diversify the local and state economy. This is, however, only possible if the bank and board develop a lending and investment policy oriented towards this. Additionally, this lower rate of return on loans might not generate the same level of return for investment of state funds as through existing mechanisms.

Advocates for the public bank have spent time with department staff and have not been able to prove that they would be able to provide below market rates for development purposes while simultaneously providing above market rate returns for state funds. Also, state funding has many different components that may require some deposits to have the highest rate of return while other deposits may require high liquidity. These concerns need to be addressed to ensure the state bank could meet the demands of a complex state funding system.

New Mexico already has multiple state investment institutions, and with the creation of the public bank, duplication and overlap with existing programs may take place. With the creation of a new institution that may duplicate what existing institutions already do, all institutions would have to be in sync to ensure success, and that does not appear to be specifically addressed in this bill. The public bank will likely also have significant administrative overhead costs.

The public bank will not make loans to private individuals or private legal entities and will instead have to make investments through a third party (local financial institutions) to eventually end up at the private entity. By having the additional step of including the local financial institution, this could limit one of the main goals of House Bill75, which is to make "financing accessible and equitably available to communities throughout the state as evidenced by outcomes including more jobs with sustainable wages."

ADMINISTRATIVE IMPLICATIONS

One intent of the Public Bank seems to be to save management/custody fees the state currently pays to larger national banks. These dollars could then potentially be repurposed into public investment. This would be ideal in theory, but it is not clear that it could be accomplished in practice, given the highly complex nature of banking and financial custody services, which require substantial and often expensive expertise to avoid financial, technical, and legal pitfalls.

While the Public Bank 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 $5 million and $10 million, 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."

The Public Bank would face a significant challenge in being able to attract well-qualified board members willing to work without compensation. Board members would need to be conflict-free fiduciaries and willing to take on significant personal liabilities associated with the bank's work (including the risk of being charged with a misdemeanor under the PBA itself).

Federal banking law also requires a more-strict and explicit conflicts-of-interest policy than the direct/indirect conflict public disclosure and misdemeanor penalty that is currently required under the Public Bank proposal. Given the political nature of the appointments of unpaid individuals to the board and the Public Banks's emphasis on economic and community development above financial returns, this could prove to be challenging from a governance perspective.

While the intents and purposes of the Public Bank are to benefit the state's financial infrastructure, expand banking access to the underserved, and build economic development capacity through leveraging the state's assets, there is a question as to what extent this plan will be able to accomplish this.

TECHNICAL ISSUES

Section 5(B) "the bank shall not make loans to a private individual or *private legal entity*" may conflict with Section 5(A)(2)(d) that provides that the public bank may "make, purchase, guarantee or hold loans" to 501(c)(3) non-profit organizations that are subject to the provision of the New Mexico Nonprofit Corporation Act.

Section 8-A (page 12, line 24) says "expect" rather than "except".

IT/acv