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FISCAL IMPACT REPORT

ORIGINAL DATE 02/12/11
 LAST UPDATED 03/09/11 **HB** 173/aHCPAC

SPONSOR Egolf

SHORT TITLE Community Bank Preference for State Funds **SB** _____

ANALYST Golebiewski

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY11	FY12	FY13		
	(\$3,125.0)	(\$3,125.0)	Recurring	General Fund
	(\$8,125.0)	(\$8,125.0)	Recurring	Bond Proceeds
	(\$11,250.0)	(\$11,250.0)	Recurring	Total

(Parenthesis () Indicate Revenue Decreases)

Duplicates, Relates to, Conflicts with, Companion to

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY11	FY12	FY13	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
		\$323.0	\$323.0	\$646.0	Recurring	State Treasurer's Office
		\$500.0		\$500.0	Nonrecurring	STO and SIC
Total		\$823.0	\$323.0	\$1,146.0	Recurring and Nonrecurring	STO and SIC

(Parenthesis () Indicate Expenditure Decreases)

SOURCES OF INFORMATION

LFC Files

Responses Received From

State Investment Office (SIO)

Economic Development Department (EDD)

State Treasurer's Office (STO)

SUMMARY

Summary of HCPAC Amendment

The HCPAC amendment removes the provision of HB 173 that would give preferential treatment to community banks when choosing a fiscal agent of the state. This change translates to a significantly lower impact in terms of the additional operating budget of STO because much less additional oversight associated with the deposit of state funds in community banks is needed in the absence of the preferential treatment provision. The revenue impact remains unchanged because those amounts reflect the lower returns on the certificates of deposit at community bank institutions, which remains unchanged by the amendment.

Summary of Original Bill

House Bill 173 would require the State Treasurer, the Board of Finance and the State Investment Council to promulgate rules that create certificate of deposit investment programs to encourage CD investments by the state in community banks. They would also oversee and analyze the effectiveness of the program, and ensure that proper safeguard and reporting requirements be implemented in the management of the investments.

House Bill 173 would also give New Mexico community banks preferential treatment in the bidding process for state fiscal agent contracts. This would be accomplished by authorizing the Department of Finance and Administration to use a 0.9 multiplier to the lowest community bank bid.

FISCAL IMPLICATIONS

The fiscal impact of House Bill 173 is dependent on a number of factors: the liquidity needs of the state, the differential returns between the certificates of deposit and other investment opportunities, and the size of the pools controlled by the Treasurer and the Severance Tax Permanent Fund, for example. It is unclear whether the bill intends to mandate that all of the STPF be invested in the CDs, so **the fiscal impact reflects only STO's calculation of the lost investment returns and depending on the intention with regard to the STPF, this calculation could be as low as 20% of the true impact.**

STO:

We estimate that the CD program as included in the proposed legislation will reduce investment income by approximately 62.5 basis points per year. On a combined balance of non-liquid General Fund investments and bond proceeds accounts of \$1.8 billion, this would result in a decrease of revenue of approximately \$11.25 million annually.

This analysis includes an estimate of revenues to the General Fund and the Bond Proceeds Fund only. The proposed legislation also includes the state's Severance Tax Permanent Fund. As STO is not responsible for the investment of this fund, it is not included in our analysis.

SIC:

There are several potential costs associated with the mandate under HB 173. Depending on its scope, a feasibility study to determine how this program might work, how the funds would be securitized, what requirements would be placed on the banks for their use, and how such a program would be executed and monitored could easily cost upwards of \$100k.

The ongoing cost of implementing and monitoring such a program will obviously be dependent on the details. Costs could be limited to additional staff needed to process and monitor such investments and assess the fiscal health of the participating banks. State Treasurer James Lewis has previously indicated that a similar CD/bank investment program run through his office requires a significant amount of work and multiple FTEs.

It appears there are elements of the legislation that would allow for “market rate” to be set not by the markets, but by the State Board of Finance. Over time, such pricing has the potential to negatively impact investment returns.

EDD:

HB 173 requires both STO and SIC to create CD investment programs designed to increase New Mexico community bank lending to New Mexico businesses and residents. The proposed legislation 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 proposed legislation 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.

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 certainly create more liquidity within New Mexico community banks and therefore could increase loan opportunities for New Mexico citizens and businesses. There has been no dynamic analysis of the specific measures included in House Bill 173 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.

SIGNIFICANT ISSUES

There are a number of important issues with House Bill 173. First, the STPF, by statute, must conform to the Uniform Prudent Investor Act. Investing all or even half of the permanent fund in one asset does not meet these requirements. Additionally, to preserve the value of the fund, it must earn an annual return of approximately 7.7% (to cover 4.7% distributions and an assumed 3% inflation). Certificates of deposit provide substantially lower investment returns than equities and other assets in the current STPF portfolio. Economically targeted investments (ETIs), of which House Bill 173 is one, has historically lowered the performance of the STPF, as

compared with the Land Grant Permanent Fund (LGPF), which has no ETIs.

The funds controlled by the Treasurer must be invested according to the guidelines of safety, liquidity and performance. With respect to the requirement to invest in CDs, the funds under the Treasurer must be adequately diversified and investing all of the fund balances in one asset is imprudent. More importantly, to have the liquid funds in community bank accounts is very risky, especially as the FDIC only insures deposits up to \$250,000. The size of the state funds would represent a much larger fraction of community banks' assets than it would of national banks' assets which is the source of the concern.

SIC:

A statutory authorization and investment policy already exists at the SIC that allows what HB 173 seeks to encourage, namely, greater investment in New Mexico community 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. The amount authorized under this Economically Targeted Investment (ETI) is up to 20% of the Severance Tax Permanent Fund (STPF).

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 in the past, made the program unattractive to some 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 May 2010 this investment policy was revamped to loosen the existing investment requirements and encourage a “restart” of this program to invest money through certificates of deposit with NM community banks. To date however, the banks have not sought out these investments from the SIC, perhaps finding the new requirements to also be overly cumbersome, or availability of other funds more practical for now.

STO:

▪ Legislation Changes Role of the State Treasurer/SIC

The Treasurer invests state funds in accordance with a defined investment policy (6-10-10 NMSA 1978) and is guided to observe three priorities in making investment decisions; preservation of principal, maintenance of liquidity and return on investments in that priority order. This proposed legislation would also add economic development as a goal of investment decisions, without regard to its priority in the investment process which could negatively affect STO's ability to manage liquidity and performance.

The adoption of this section will require the State Treasurer and the SIC to invest non-liquid assets in Certificate of Deposits with the various community banks of a period to be “not less than one year”. The State's investment guidelines will require that all investments will need to be fully collateralized due to the extended maturity of the CD investments as contemplated by the proposed legislation.

Section 6-10-24.1 NMSA 1978 requires that the state's deposits are limited to the lesser of a) 25% of a participating community bank's deposit base or b) 4 times an institution's equity. Further, any investments to be made in a financial institution at a level above 2 times the institution's equity is required to be collateralized at 102% of the investment (2.60.4.9 NMAC).

▪ Capacity of the Community Banking System to Hold the Depository Assets

The ... spreadsheet [below] details the capability for the current community banking institutions in New Mexico as defined by the proposed legislation¹. Using the most current information available from FDIC Call Reports (9/30/10), STO would need to work with *all remaining banks* in the state to ensure the required investments in certificates of deposit under the legislation are up to their statutorily approved maximums.

Given the limitations imposed by the state's investment policy, Attachment B shows that there is a maximum capacity of the community banking system to write CDs for \$2.4 billion in proceeds.

Non-liquid balances of STO and the Permanent Funds of SIC are in excess of \$6.4 billion, significantly larger than the community banks CD Capacity.

▪ Capacity of the Community Banking System to Re-Lend the Depository Assets

Of significant issue is whether there exists demand for the \$6.4 billion in proposed deposits. The legislation specifically aims that the deposits be lent to New Mexico businesses and residents.

A cash inflow of this magnitude will dramatically affect lending practices in the state.

▪ Non-Response to Fiscal Agent Procurement by Community Banks

Current law and the procurement process for fiscal agent services do not preclude local community banks from actively bidding to provide these services to the state. To date, no local institutions have responded to the BoF procurement process to provide these services.

▪ Complexity of the state's Fiscal Agent Bank Relationship (6-10-35 NMSA 1978)

It is imperative that the infrastructure of any financial institution bidding on the fiscal agent contract be such that it can provide required services in the scope of procurement.

All participating institutions will be required to conform to the SHARE system.

STO/Cash Management processes 230,600 transactions per month through various accounts. It is prudent that the fiscal agent banks maintain robust and cutting-edge banking systems capabilities to satisfy the state's requirements.

▪ Depository Locations

NM community banks would be required to offer their physical presence throughout the state; otherwise this would create logistical issues for depositing agencies throughout the state. Utilizing a community bank without statewide branches would in fact increase the number of standalone depository accounts in other financial institutions to perform the fiscal needs of the state and may increase the fees assessed at other institutions and create an overall increase in banking costs to the state.

STO/Cash Management practice dictates that stand alone depository accounts should be kept to a minimum. It is also important to match the size and sophistication of the state with the bank.

¹ Ibid.

<u>National and New Mexico Bank Branch Franchise Networks</u>		
<u>NM Based Financial Institution</u>	<u>Number of Branches 2010</u>	<u>Deposits in Market(\$M)</u>
First American	15	581.8
NM Bank and Trust	12	571.1
Trinity Capital Corp. (LANB)	6	1,339.3
<u>National Financial Institution</u>	<u>Number of Branches 2010</u>	<u>Deposits in Market(\$M)</u>
Wells Fargo (CA)	97	5,257.8
Bank of America (NC)	50	3,995.5
U.S. Banks (MN) ²	36	2,035.6
Beal Financial Corp. (TX)	8	847.6

▪ Impact on Current Providers

Current providers of Fiscal Agent Services employ many people locally.

▪ Additional Complexity of the Proposed Legislation

The proposed legislation assumes three banks will serve as the state’s fiscal agent. Intra-bank deposits and withdrawals will be significant in managing three banks versus the current one bank.

PERFORMANCE IMPLICATIONS

STO:

The intent of the current CD program used by the State Treasurer is to spur economic development in local communities; however the program does not currently require any reporting from financial institutions on the utilization of state funds.

Language in Paragraph B of the legislation will require community banks to report on how the funds are being used and will enable STO and SIC to evaluate program effectiveness.

Fiscal agent services must match the volume, systems, compliance and transactions (\$20 billion) of the state. Community banks and nonresident banks must ensure adequate protection of state monies to include:

- Blanket Bond Coverage -The bank must furnish at its expense a banker’s blanket bond per occurrence coverage in a minimum amount of ten million dollars (\$10,000,000)
- Securities for safekeeping of deposits – The bank must agree to maintain securities of the amount and kind specified by Sections 6-10-35D, 6-10-16 and 6-10-17 NMSA 1978.
- Indemnification - The Bank must agree to wholly indemnify the state for any and all loss, damage, cost, damages, expenses (including, without limitation, legal fees and expenses) and liability to the state resulting from errors, omissions, fraud, embezzlement, theft, negligence or neglect by the bank and its respective employees, officers, agents and directors in performing its duties.

² Formerly First State Bancorporation of Taos.

SIC:

As with any ETI, especially in bull markets, below market-rate investments will be a drag on the portfolio returns. The amount is indeterminate, as it depends on the amount of investment and the gains experienced by the markets. In bear equities markets, ETIs can actually help reduce portfolio losses. While this ETI must still meet the prudent investment standard, it would seem that HB 173 provides legislative guidance or intent to SIC that it should give preference to NM community bank CD investments over comparable investments with potentially more attractive terms or conditions.

ADMINISTRATIVE IMPLICATIONS

STO:

STO estimates at a minimum that 4.9 FTEs will be required to monitor the proposed CD program. Current costs/FTE for salary, benefits and rent expenses are estimated at \$66,000/year

$$\text{Recurring Costs} = \frac{\text{Potential Community Bank Participants}^3}{\text{Participants}^3} \times 0.1 \text{ FTE/Participant} \times \$66,000/\text{FTE}$$

$$\text{Recurring Costs} = 49 \text{ Potential Institutions} \times 0.1 \text{ FTE/Participant} \times \$66,000/\text{FTE}$$

$$\text{Recurring Costs} = \$323,400$$

This would require more oversight and additional STO resources to monitor the investments in financial institutions, specifically the maintenance of collateral for the proposed \$6.4 billion program. Collateral requirements at 102% of capacity will be in excess of \$6.5 billion and will need to be managed on a daily basis.

All investments of STO are done within the purview of the State Treasurer's Investment Committee (STIC). Each of the resultant investments of the proposed legislation will be required to be reported on a monthly basis to the STIC committee and then to the state Board of Finance including accountability reports provided by each participating bank.

Indirect Costs

If a community bank is awarded the contract to provide fiscal agent services, based on the ten percent preference granted in the bill, the cost of fiscal agent services to the state will be higher. The current annual cost to the state for fiscal agent services is approximately \$750,000. Based on the 10% preference amount included in the proposed legislation, adoption of this legislation could cost an additional \$75,000 per year.

Direct Costs

The State Treasurer's office estimates the additional costs to be approximately \$1.1

³ Potential participants excludes Vectra Bank Colorado, Bank of Albuquerque, Charter Bank and U.S. Banks as these institutions are headquartered out of state and are specifically excluded by the terms of the proposed legislation.

million and are broken out between recurring and non-recurring costs.

Non-Recurring Costs

Adoption of this bill and its subsequent implementation of a community bank as fiscal agents will require the addition of each of the proposed Community Banks to the state SHARE system (the state's accounting system) for transaction processing. This will require significant set-up and training time on SHARE for each of the institutions involved, estimated at a cost of \$125,000 per institution.

$$\text{Non Recurring Costs} = \frac{\text{Potential Community Bank Participants}}{\text{Bank Participants}} \times \$125,000/\text{Institution}$$

$$\text{Non-Recurring Costs} = 3 \text{ Potential Institutions} \times \$125,000/\text{Institution}$$

$$\text{Non-Recurring Costs} = \$375,000$$

In addition, STO will need to budget staff time to training and instruction for each of the potential community bank participants.

Recurring Costs

Adoption of this bill will result in significant additional FTE costs to STO in order to manage the increased activity related to the daily reconciliation of accounts at the institutions and the additional tracking of warrant activity. Cash transfers and collateral tracking at the institutions will result in additional FTE requirements.

$$\text{Recurring Costs} = \frac{\text{Potential Community Bank Participants}}{\text{Participants}} \times 4 \text{ FTE/Participant} \times \$66,000/\text{FTE}$$

$$\text{Recurring Costs} = 3 \text{ Potential Institutions} \times 4 \text{ FTE} \times \$66,000/\text{FTE}$$

$$\text{Recurring Costs} = 3 \text{ Potential Institutions} \times \$264,000$$

$$\text{Recurring Costs (staff)} = \$792,000$$

Community banks holding state funds would be required to submit quarterly call reports to STO for the purpose of determining risk assessment as well as monthly collateral reporting requirements.

This will require additional compliance monitoring by STO.

Significant staff hours and time will be required in order to work with consultants to perform the study from the agencies identified in the legislation.

There may be too little time to undergo a procurement effort in order to have the report delivered to the Legislative Finance Committee and the Governor by the proposed deadline.

There would be a cost of conducting a feasibility study and preparing a report on this

matter. That expense is currently estimated between \$400,000 and \$600,000⁴

SIC:

Should the SIC be required to make a financial assessment of every bank seeking these investments, rather than requiring full collateralization, it would potentially be burdensome to the agency. The SIC is currently exploring whether other avenues of collateralization and or formulating a rating system may be fiducially acceptable to the Council and the bankers.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

SIC:

There is a potential conflict between HB 173 and existing statute for SIC's CD investment program NMSA 1978 7-27-5-19 which limits SIC CD investments to 20% of the STPF. Verbiage in HB 173 indicates two potential issues:

HB 173 appears to not have any cap to the amount of investment that could be made from STPF into NM banks, contrary to existing law. In Section B, the investing agencies are instructed to use: "...the portion of the general fund operating cash depository account, bond proceeds investment pools and the severance tax permanent fund not needed to meet short term liquidity needs... and create an investment program *for the remainder* aimed at increasing community bank lending to New Mexico businesses and residents..."

The other potential conflict is that under HB 173 the market rate for CDs is to be determined by the Board of Finance (not the markets). When rates are set by a third party and not the investor, by definition there is potential this will be a below market rate or differential rate investment. While differential rate investments are allowed for certain investments made out of the Severance Tax Permanent Fund, they must be specifically authorized under statute. Currently the most similar types of CD investments to these under NMSA 1978 Section 7-27-5.19 are NOT differential or below-market-rate investments. While it is clear that they are ETIs – economically targeted investments – they also must meet the Uniform Prudent Investment Act standard, and cannot be given preference over a more attractive investment. Without a specific legislative authorization recognizing an economic development benefit to the state in exchange for a potentially degraded return on investment, this proposal may violate the Uniform Prudent Investment Act.

While this issue is potentially addressed through policy or rule, it raises another concern relative to existing SIC statute allowing market rate CD investments with NM community banks. These types of investments were initially authorized by statute in the 90's, and through a rule promulgated by the SIC in 1993. Over time however, requirements in that rule became unattractive to the banks who might participate, so in 2009 the Council decided to change the structure of these investments by adapting policy. To make the policy change however, the Rule from 1993 had to be removed from the NM

⁴ Estimated costs of study to determine scope, develop methodology, create and refine evaluation process and performance review process for local deposits measured against legislative goals.

Administrative Code, a process which took several months. This was a necessary by time consuming effort, followed by additional time revising policy.

Under HB 173, the SIC would be asked to recodify this investment practice rather than direct it through policy and procedures, something the Council itself is unlikely to support.

TECHNICAL ISSUES

SIC:

No matter how significant and rigorous a monitoring program is put in place, there will always be risk in this, as in any other investment. Banks can currently guarantee only \$250,000 under FDIC in the case of an individual bank failure, which is far short of the potential millions invested under this program.

EDD:

Section 2 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).

STO:

Would require an amendment to Section 6-10-10 NMSA 1978 to allow additional investment in certificate of deposits in community banks in order to place the required amounts in New Mexico institutions.

Would require some direction to STO Investment Division and Treasurer by BOF as to how the investment goal of economic development fits within current investment parameters of STO for safety, liquidity and return.

Would require an amendment to Section 6-10-24.1 NMSA 1978 to permit the contemplated investment activities included in the legislation.

May require additional STIC oversight of treasury funds, including monthly reporting to STIC and to Board of Finance.

OTHER SUBSTANTIVE ISSUES

SIC:

The current statute allowing STPF bank CD investments requires that the banks may only receive an amount equal to what they are loaning to NM businesses. HB 173 has no requirements that the banks make loans to local businesses, and appears to allow consumer loans under section B. Such requirements are assumed to be created through Rule, but as an establishing legislation, there is no stipulation in the bill itself that requires the banks make loans to New Mexico businesses or individuals, rather than putting it into other more lucrative investment vehicles.

STO:

A program currently exists to increase the ability of community banks to have access to state capital. It was increased from \$300 million to \$450 million in the last revision of STO's investment policy.

Currently, less than 20% of the capacity of that program is utilized by the community banks.

In addition, there is a CD program offered by SIC for the Severance Tax Permanent Fund. That program is also not fully utilized by the community banks.

JAG/mew