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

ORIGINAL DATE 02/06/19
SPONSOR Salazar **LAST UPDATED** 03/08/19 **HB** 393/aSFC

SHORT TITLE Investment in Tax Stabilization Reserve Fund **SB**

ANALYST Iglesias

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Nonrecurring	Fund Affected
FY19	**FY20**	**FY21**		
$0.0	$22,000.0	$24,000.0	Recurring	Tax Stabilization Reserve (General Fund Reserves)
$0.0	($13,000.0)	($13,500.0)	Recurring	General Fund Operating

Parenthesis ( ) indicate revenue decreases

Relates to SB399 and SB401

SOURCES OF INFORMATION
LFC Files

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

SUMMARY

Synopsis of SFC Amendment

The Senate Finance Committee Amendment to House Bill 393 establishes the tax stabilization reserve as a reserve fund of the state, addressing a technical issue raised by the Department of Finance and Administration and discussed on page 7 of this FIR.

Synopsis of Original Bill

House Bill 393 transfers the oversight and investment management of the general fund Tax Stabilization Reserve (also known as the state's "rainy day fund") from the State Treasurer's Office (STO) to the State Investment Council (SIC). Investments are to be made in accordance with the Uniform Prudent Investor Act, and in consultation with the State Treasurer. The bill allows for interest earnings of the rainy day fund to be reinvested into the fund, rather than allowing those earnings to flow into the general fund, which it does under current law.

This bill requires the SIC to report quarterly to the Legislative Finance Committee and to the council on the fund's investments, and the bill requires annual reporting to the Revenue Stabilization and Tax Policy Committee and other relevant interim committees. The effective date of this bill is July 1, 2019.

FISCAL IMPLICATIONS

Currently, the rainy day fund's investment earnings do not accumulate in the fund. Instead, as part of treasury balances, the fund's investment earnings are distributed to the general fund along with the other treasury investment earnings. Therefore, the only way for the rainy day fund to grow over time is through distributions made to the fund under two existing mechanisms: (1) funds in excess of the five-year average of the oil and gas emergency school tax, and (2) funds in the general fund operating reserve in excess of 8 percent of the prior budget year's recurring appropriations (see Attachment). This bill allows the rainy day fund to accumulate investment earnings and transfers the oversight and investment management of the fund to the SIC.

Because investment earnings on the rainy day fund are currently credited back to the general fund, the bill would result in less general fund operating revenue from STO interest earnings, estimated by LFC staff to be a reduction of about $13 million based on an assumed 2.5 percent STO return. However, the rainy day fund would gain not only these investment earnings, but also an additional premium on those investments based on SIC's proposed investment portfolios for the fund (see discussion below). Combined, the interest revenue to the rainy day fund is estimated at about $22 million.

The SIC currently invests about $24 billion, 95 percent of which is in the land grant permanent fund and severance tax permanent fund. The remainder is in the water trust fund, tobacco settlement permanent fund, over $1 billion belonging to 21 state entities that is invested in varying ways alongside the permanent funds. These investments range from very conservative low-risk bonds and US Treasury notes, to higher-risk private market investments, typically built into a diversified portfolio targeting appropriate levels of risk-adjusted returns, depending on each entity's long-term expectations.

The State Treasurer offers short-term, very safe, highly liquid, cash-like investments. However, SIC staff note there are limitations to the investment duration and strategies that are legally accessible to the Treasurer, while the SIC has fewer limitations of this kind, other than prudency.

The SIC has reviewed potential portfolio mixes for the rainy day fund, and while not yet defining a specific asset allocation, has a short list of the types of relatively low-risk investments it would make if managing the fund:

- Low Duration Fixed Income – Very high safety of principal and high, monthly liquidity.
- Core Fixed Income – Duration exposure and some modest credit exposure for an enhancement to return over short-term cash-like investments, with high, monthly, liquidity.
- Non-Core Fixed Income – Modest duration exposure and significant credit exposure for a meaningful enhancement to return in excess of short-term cash-like investments, with monthly liquidity.
- Real Estate – Exposure to return sources other than duration and credit for a meaningful return enhancement over short-term cash-like investments. Liquidity, which under some circumstances could be less than monthly would very unlikely be more than bi-monthly.

Because SIC can invest more diverse strategies than the State Treasurer, SIC staff project the rainy day fund could be managed to earn an additional 1.5 percent to 2.5 percent annually, while retaining adequate liquidity and prudent investment risk.

The following chart below shows potential avenues in which the rainy day fund could be invested, with various levels of risk and return, given most up-to-date analysis and expectations of the SIC's fiduciary advisor RVK.

			Frontier 1				
	Min	**Max**	1	2	3	4	5
Large/Mid Cap US Equity	**0**	**30**	0	0	1	3	4
Small Cap US Equity	**0**	**10**	0	0	0	1	1
Dev'd Large/Mid Int'l Equity	**0**	**30**	0	0	1	2	2
Emerging Markets Equity	**0**	**10**	0	0	0	0	1
Low Duration Fixed Income	**0**	**30**	30	30	30	30	26
Int. Duration Fixed Income	**20**	**100**	34	27	23	20	20
NMSIC Non-Core Fixed Income	**0**	**30**	26	29	28	26	25
NMSIC Real Estate	**0**	**30**	10	13	16	19	21
Total			100	100	100	100	100
Capital Appreciation			23	27	30	32	35
Capital Preservation			64	57	53	50	46
Alpha			8	9	8	8	8
Inflation			5	7	9	10	12
Expected Return			**4.13**	**4.32**	**4.52**	**4.71**	**4.90**
Risk (Standard Deviation)			**3.76**	**3.85**	**4.07**	**4.38**	**4.75**
Return (Compound)			4.06	4.25	4.44	4.62	4.79
Return/Risk Ratio			1.10	1.12	1.11	1.08	1.03
RVK Expected Eq Beta (LCUS Eq = 1)			0.11	0.12	0.14	0.17	0.19
RVK Liquidity Metric (T-Bills = 100)			62	58	57	57	55

Group Constraints:

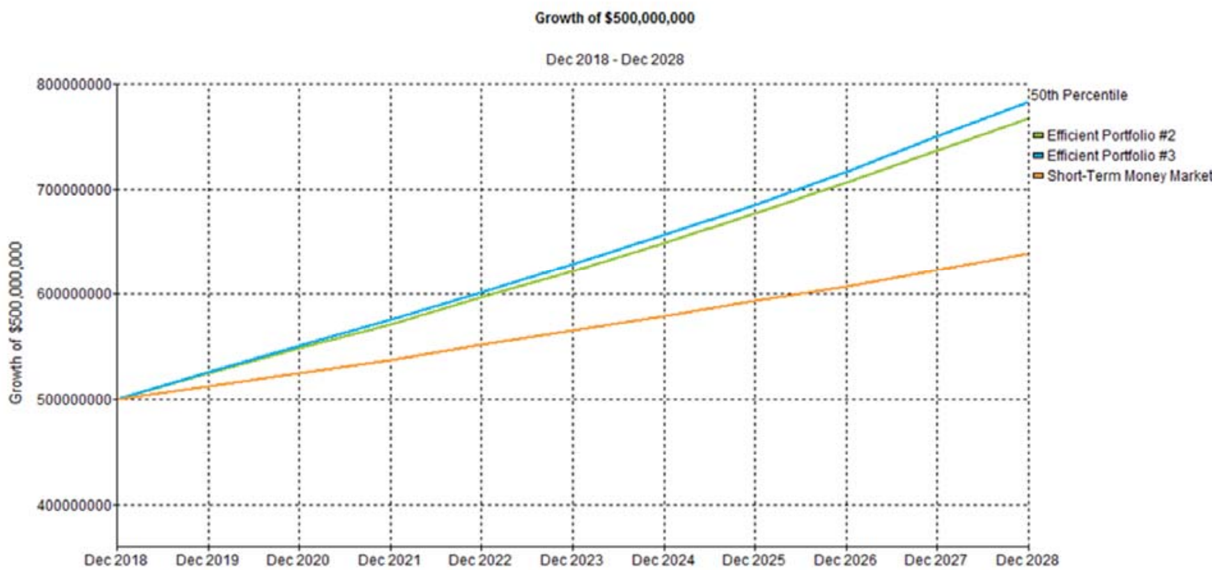
1. International Equity (Developed + Emerging) not to exceed 40% of Total Public Equity.
2. Emerging Markets Equity not to exceed 20% of Total International Equity.
3. Small Cap US Equity not to exceed 20% of Total Domestic Equity.
4. Public Equity (International + US) not to exceed 25% of Total.
5. Non-Core Fixed Income not to exceed Low Duration Fixed Income + Int. Duration Fixed Income.
6. Fixed Income (Low Duration + Int. Duration + Non-Core) at least 50% of Total.

For illustrative purposes, SIC staff focus on two of the most likely allocations, options #2 and #3. Both are a combination of low duration, intermediate duration and non-core fixed income, with a small exposure to the NMSIC real estate pool. Option #3 also has a 1 percent allocation to US large cap and 1 percent to international developed equity.

SIC staff estimate that either allocation on an average year would produce estimated returns of 4.3 percent to 4.5 percent, which would be approximately 2 percent more than what the short-term investments by the Treasurer could yield. SIC staff clarify risk levels would remain low, about 3.85 percent to 4.1 percent. While riskier than short-term fixed-income investments, these metrics are still far below those taken by most institutional investors – for example, the permanent funds by way of comparison have a volatility of about 13 percent.

The current value of the rainy day fund is $526.8 as of the end of FY18. As seen in the chart below, initially, two percent of additional investment returns delivered by options #2 and #3 would deliver about $12 million per year to the rainy day fund, compared to short-term money market investments. Over a ten-year period, however, the excess returns become more pronounced.

10 Year Growth of the Corpus ($500M)



Both Efficient Portfolios substantially outgrow the Short-Term Money Market fund under the most probable (median) outcome over a 10 year period.

Additionally, RVK analysis projects the following best and worst-case scenarios for one and 10 year periods. While these show that during a significant market downturn the riskier SIC portfolio could potentially lose $3 million to $8 million more than a short-term investment portfolio, over the 10-year period/full market cycle, both portfolio #2 and #3 will deliver excess returns of between $10 million to $22 million, even in the worst-case scenario.

Given average or above average market environments, SIC staff state the portfolios under options #2 and #3 should deliver considerably more capital back to the state (see Attachment).

The SIC has also considered portfolio mixes that have no exposure to real estate, only slightly longer-term investments in non-core and intermediate fixed income investments. These more conservative portfolios also appear to deliver excess returns above what could be expected from short-term money market-like investments.

SIGNIFICANT ISSUES

Tax Stabilization Reserve. At the end of FY18, due to a surge oil and gas revenues, $526.8 million was transferred to the rainy day fund from the operating reserve (see Attachment A for discussion of how transfers from the operating reserve to the tax stabilization reserve occur). This was the first transfer of funds to the reserve since FY12. From FY13 to FY15, the balance of the tax stabilization reserve was $147.5 million. With the oil price crash of 2015-2016 and substantial revenue declines in FY16 and FY17, the state was forced in the 2016 special session and 2017 regular session to cut budgets, sweep cash balances, and drawdown funds in the tax stabilization reserve and tobacco settlement permanent fund. The entire $147.5 million in the tax stabilization reserve was used to cover budget shortfalls in FY16.[1] This fund remained at $0 until the FY18 distribution, and the fund is now currently larger than it has been in fund's history.

Prior to legislative passed in the 2017 special session, the tax stabilization reserve was statutorily capped at 6 percent of recurring appropriations, meaning the fund could never truly grow. However, HB2 in the 2017 special session removed the statutory cap, allowing the fund to accumulate balances and become a true "rainy day fund".

Liquidity. In early vetting of the concept of having the SIC manage the rainy day fund, liquidity of the assets has been cited as a concern by both members of the Investments and Pensions Oversight Committee, and the State Investment Council. The State Treasurer's Office aptly points out that, in order to raise cash when needed, the investments of the rainy day fund should provide ample liquidity on relatively short notice.

The prospective investment strategies the Council may use in this portfolio range from highly-liquid, with monthly liquidity, to quarterly liquidity for real estate.

In addition, SIC staff indicate the permanent funds' natural cash flows could potentially provide a source of short-term liquidity without doing any long-term damage to the permanent funds, as through the normal course of business they invest monthly contributions, raise cash for distributions and rebalance permanent fund and client asset allocations.

Accessing the Fund. Given this bill's quarterly reporting requirements, there is little chance the rainy day fund would need to be accessed on short notice. Current law, unchanged by this bill, provides for only two mechanisms through which the rainy day fund may be accessed:

- The governor declares it "necessary for the public peace, health and safety" and the Legislature approves by vote of two-thirds of both the House and Senate, or
- If revenues are determined by the governor to be insufficient to meet authorized appropriations for the current and next fiscal year and the House and Senate approve a transfer to the general fund with a majority vote to cover the projected insufficiency for either or both fiscal years.

Because of the structure of these mechanisms, the SIC would likely have several months' notice of any legislative directive to access the fund.

Until the fund reaches a size greater than $1 billion, SIC staff expect the identified portfolios and permanent fund cash flows to allow for the full size of the rainy day fund to be available immediately. Above $1 billion, the fund would be somewhat less liquid, requiring more time to access the funds without suffering substantial losses. However, LFC staff note it is highly

[1] Prior to the oil price downturn in 2015-2016, the tax stabilization reserve was tapped in FY09 and FY10 to cover revenue declines following the Great Recession. The state withdrew $55.7 million from the fund in FY09 and $172.5 million in FY10.

unlikely that a $1 billion+ rainy day fund would need to be accessed on less than a few months' notice.

In the last 10 years, the most withdrawn from the tax stabilization reserve was about $173 million during the Great Recession. Additionally, in the event of a revenue downturn, current law requires the operating reserve (currently $484 million at the end of FY18) to be used before the rainy day fund may be accessed to shore up budgets. Thus, projected revenues would have to fall very far very fast to require a $1 billion+ fund to be entirely liquidated on short notice. Consensus revenue estimates are prepared months in advance by legislative and executive economists and are presented to the Legislature in August, December, and mid-legislative session. Aside from consensus revenue updates, legislative and executive economists track state revenues monthly, allowing for ample warning to be provided to the governor, LFC members, and the public if revenues are falling short of expectations.

For example, if the value of the tax stabilization reserve was $1 billion, and up to 20 percent was invested in less-liquid real estate investments, this would still leave up to $800 million in funds that could be accessed within about a month. To shore up budgets during the revenue decline of FY16 when oil prices plunged, the state transferred $485 million from the operating reserve, $147.5 million from the tax stabilization reserve, and $109 million from the tobacco settlement permanent fund – a total of $742 million. Legislative action in the 2016 special session and 2017 regular session gave the treasurer and the SIC (which manages the tobacco settlement permanent fund) several months' notice of the need to liquidate these funds. If this scenario were to occur again, SIC's proposed portfolios for the tax stabilization reserve would allow for the necessary funds to be liquidated and accessible in time to cover a similar revenue shortfall.

The governor is the chair of the State Investment Council, the secretary of the Department of Finance and Administration and the State Treasurer sit on the council, and the legislature appoints four of the 11 council members. Given that the council itself would be directing the asset allocation of the rainy day fund – which will determine the risk/return and liquidity profile of the investments – the involvement of the governor, the DFA secretary, the State Treasurer, and the legislatively-appointed council members well-situates the council in gaining advance notice of any impending drawdowns of the fund and allows the council to make sound decisions regarding necessary liquidity.

The bonding agencies that give the state credit rating based on financial health have recognized New Mexico's efforts to shore up reserves in recent times, including the tax stabilization reserve. It is not clear how an SIC-managed portfolio may affect the state's credit.

PERFORMANCE IMPLICATIONS

Management of the rainy day fund should not result in any negative performance implications to the SIC or its other funds. SIC staff indicate a great likelihood that SIC prudent management of the rainy day fund could deliver additional tens of millions of dollars to the state in the coming years. The State Treasurer's Office points out the performance projection of the proposed management of the tax stabilization reserve by SIC needs to include the cash liquidity component, the potential for overall return to fall short of expectations, as well as the management fees assessed by outside managers.

ADMINISTRATIVE IMPLICATIONS

SIC staff indicate there will be only limited resources required for the SIC to take on the additional responsibilities of managing the tax stabilization reserve.

TECHNICAL ISSUES

The Department of Finance and Administration (DFA) recommends a language change within the amending of Section 6-4-2.2 NMSA 1978. Currently Section A of the bill (lines 19 and 20) reads, "There is created within the general fund the "tax stabilization reserve". The general fund is currently housed at DFA, both in audits and SHARE. If SIC is going to take ownership of the fund for investment purposes, it will no longer be part of the general fund at DFA. Similar to the Tobacco Permanent Fund (Section 6-4-9, NMSA 1978), DFA recommends changing this language to read, the tax stabilization reserve is created in the state treasury as a reserve fund of the state.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

SB 399 and SB 401 both call for directing additional revenue streams into the tax stabilization reserve, either from a tax on sales of wind energy to out of state entities, or from the state's share of federal mineral leasing revenues, respectively.

OTHER SUBSTANTIVE ISSUES

The full State Investment Council at its January 2019 meeting was unanimous in endorsing the concept of placing the rainy day fund under SIC management; however, there remains some disagreement among Council members whether it should be the "Council", or the "Investment Officer" technically investing the fund. This issue is not specific to this bill, but arises due to vagueness and conflict in existing statute and the state constitution, as to the Council/Officer investment authority. The bill attempts to straddle this issue, with its new language instructing the Officer to invest the fund, but only with the approval of the Council. In addition, the investments must be allowable under the Uniform Prudent Investor Act and be made in consultation with the state treasurer.

ALTERNATIVES

If the Legislature would like to allow interest earnings of the tax stabilization reserve ("rainy day fund") to be reinvested in the fund without transferring management of the fund to the State Investment Council, the Legislature would need to amend Section 6-4-2.2 NMSA 1978 to allow for "all income from investment of the reserve" to be credited to the account. This could be done while still allowing the State Treasurer to manage the funds, if desired.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

Without Legislative action, investment earnings of the tax stabilization reserve will continue to flow to the general fund, rather than being reinvested in the reserve fund.

DI/sb

ATTACHMENT

Probability of Short Term Losses Mitigated

	1 Year					
	5th Percentile		50th Percentile		95th Percentile	
Efficient Portfolio #2	$	484,667,707	$	524,315,852	$	551,143,024
Efficient Portfolio #3	$	479,996,254	$	525,829,250	$	557,065,155
Short-Term Money Market	$	488,287,533	$	512,302,000	$	537,826,559
EP #2 Excess Wealth	$	(3,619,827)	$	12,013,852	$	13,316,465
EP #3 Excess Wealth	$	(8,291,279)	$	13,527,250	$	19,238,596

Over any 1 year period, the worst case scenario (5th percentile) shows modestly lower wealth compared to the Short-Term Money Market investment ($3.6M and 8.3M, respectively) compared to Efficient Portfolios #2 and #3. Normal (median) outcomes materially better.

	10 Years					
	5th Percentile		50th Percentile		95th Percentile	
Efficient Portfolio #2	$	571,176,205	$	767,723,766	$	932,115,822
Efficient Portfolio #3	$	559,267,036	$	782,793,138	$	979,162,928
Short-Term Money Market	$	549,013,452	$	638,592,956	$	741,353,393
EP #2 Excess Wealth	$	22,162,753	$	129,130,810	$	190,762,429
EP #3 Excess Wealth	$	10,253,584	$	144,200,182	$	237,809,535

Over a full market cycle (10 years) or longer, even under the most pessimistic outcome, both Efficient Portfolios outgrow the Short-Term Money Market.

Source: RVK analysis, submitted by SIC staff

NEW MEXICO
Legislative Finance Committee
FINANCE FACTS
Understanding State Financial Policy

General Fund Reserves

Because the New Mexico Constitution requires a balanced budget, state government maintains general fund reserves to cover any shortfalls if revenues are unexpectedly low or expenses are unexpectedly high. The general fund reserves are measured as a percentage of recurring appropriations – planned ongoing spending. They are made up of several distinct accounts: the operating reserve, tax stabilization reserve, appropriation contingency fund, and state support reserve fund.

Operating Reserve

Revenues left at the end of the fiscal year are transferred to the operating reserve. If revenues come up short, the governor may transfer money from the operating reserve to cover authorized expenses. The amount the governor can transfer is capped by the Legislature each year in the General Appropriation Act. Once the operating reserve fund hits 8 percent of the prior budget year's recurring appropriations, the excess must be transferred to the tax stabilization reserve by law.

Tax Stabilization Reserve

Money in the tax stabilization reserve may only be appropriated if (1) the governor declares it necessary because of a shortfall and the House and Senate approve it with a simple majority vote, or (2) two-thirds of both the House and Senate vote for it.

Additional funds are deposited into the tax stabilization reserve from the oil and gas emergency tax if annual revenue exceeds the five-year average income. This allows the state to capture windfall revenue from the oil and gas industry and moderate the volatility of that revenue source. Other state revenue that also spikes when the energy industry booms – including federal mineral leasing payments, trust land distributions, and gross receipts tax collections – are not captured.

Excess revenue left in the general fund at the end of the year goes into the operating reserve.

Operating reserves exceeding 8 percent of the ongoing appropriations are transferred to the tax stabilization reserve.

Oil and gas school tax revenues exceeding the five-year average are transferred to the tax stabilization reserve.

Until 2017, revenue in the tax stabilization reserve in excess of a specified threshold was transferred to another fund for possible distribution to taxpayers. However, several years of depleted reserves prompted lawmakers to transform the tax stabilization into a true "rainy day" fund.

Appropriation Contingency Fund

The Legislature authorizes revenue going in and out of the appropriation contingency fund. A limited amount of the revenue in the fund can also be spent when the governor declares an emergency. The fund is mostly used to set aside money for use if certain circumstances come into play, such as the start-up of a new program moving faster than funded.

State Support Fund

On the first day of each fiscal year, any balance in the public school district general obligation bonds loan fund over $1 million is transferred state support reserve fund and can only be used to augment certain appropriations to the public schools.

Tobacco Settlement Fund

The tobacco settlement permanent fund was created to hold payments to New Mexico from cigarette companies under the master settlement agreement of 1998. Under the enabling legislation, the settlement payments are split, with half going to the permanent fund and half spent directly on health and education programs. However, during economic hard times, the Legislature has temporarily suspended deposits into the permanent fund and put the entire amount into direct spending.

Money in the tobacco settlement permanent fund is invested by the State Investment Council and interest is credited to the fund. The Legislature may authorize spending from the fund for a budget shortfall only after balances in all other reserve accounts have been exhausted.

For More Information:
•The status of the New Mexico's reserve accounts can be found in the state's general fund financial summary, published on the State Board of Finance's website: http://nmdfa.state.nm.us/Board_of_Finance.aspx
•Statutes governing New Mexico's general fund reserves include 6-4-2.1, 6-4-2.2, 6-4-2.3, 6-4-4, 6-4-9, 7-1-6.61,12-11-24, 22-8-31 NMSA 1978.