ARROWHEAD CENTER

LEADING ECONOMIC DEVELOPMENT FOR NEW MEXICO STATE UNIVERSITY

New Mexico's Public Funds Investment Policies: Impact on Financial Institutions and the State Economy

A Report Submitted to the

Independent Community Bankers Association of New Mexico

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by

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Executive Summary

In July 2008 the State Treasurer's Office (STO) released a document titled "CD Program Enhancement – Due Diligence." In the document the STO expressed concern with regard to the return and safety of funds in the Certificate of Deposit (CD) Program managed by the State. The State now requires money market rates approximate to the London Interbank Offered Rates (LIBOR) for the CD program. Discounts or premiums can be negotiated depending on the risk profile of the institution participating in the program and automatic renewals will no longer take place.

The Independent Community Bankers Association of New Mexico (ICBA/NM) became concerned that this change in policy would have an adverse effect not only on the organization's members, but also on the State's economy. The ICBA/NM contracted with Arrowhead Center at New Mexico State University to analyze the impacts of the changes in policy.

Data for the analysis were obtained from FDIC reports and a survey of the members of the ICBA/NM. The purpose of the survey was not only to collect data for the impact analysis but to obtain information on the characteristics of the ICBA/NM institutions and the opinions of their administrators with respect to State policy.

Three-quarters of the institutions held state deposits and 83% held local public funds. The members of the ICBA/NM support the idea of collateralization and particularly the policy in its present form. Three-quarters of the respondents think that state funds should be collateralized and 82% indicated that 50% collateralization is an appropriate level. Eighty-one percent of the respondents are opposed to a 100% collateralization policy and 70% said that, if it were imposed, they would discontinue participation in the program. The rest of the respondents said that they would decrease participation by 40% if the policy was instituted.

The membership of ICBA/NM did not favor an in-state bidding process (71%). Seventy-two percent thought it would increase the cost of state funds, but there was no consensus on exactly by how much. The members thought that this type of process would redistribute funds from small institutions to large institutions (44%) and additional comments indicated that members thought there would be a shift from less risky to more risky institutions and from rural to urban institutions.

Given the choice, member institutions would rather see an increase in rates (58%) rather than an in-state bidding process (42%). Seventy percent of the respondents indicated that an increase in rates over the T-Bill rate would decrease participation in the program. Only a few respondents indicated how much they would decrease participation relative to an increase in rates. One member would decrease participation on any increase. All but one of the others commenting, reduced participation by at least 50% with a 75 to 100 basis point increase. And all but one drops all participation at 101 or more basis points.

Member institutions thought it was not in the best interest for the state 1) to go to all U.S. Treasuries (92%), 2) to go to a bidding system ((70%) or 3) go to an arbitrary increase in rates by 25-50 basis points (60%). They did indicate that a 100% collateral policy would be in the state's interest (77%) because that would place no risk on the State. Comments included indicated that the financial institutions would not find this very advantageous.

When asked whether state fund investment policies have achieved a proper balance between maximizing risk and economic development, the overwhelming majority (76%) said that state policies heavily favored rate of return.

Each of the policy changes proposed by the State will either increase the cost of public funds directly or indirectly. The response by the institutions will be a decrease in participation in the CD program. If these funds cannot, or would not, be replaced from other sources, a smaller amount of funds would be available to customers. This would result in less economic activity. The initial decrease in economic activity would have a multiplier effect on the local economies, decreasing economic activity by a greater degree than just the initial decrease.

A decrease in participation in the CD program of 25% by institutions result in a decrease in $17.5 million in value added, a decrease of $12.2 million in personal income and the loss of 320 jobs in the state. If the increase in cost of funds were to be high enough to have all participation in the program cease, the decrease in value added would be $70.2 million. The decrease in personal income would be equal to $48.8 million and the state would lose 1280 jobs.

If the financial institutions decreased their participation in the CD program by 25%, the state would lose a total of $746,000 in tax revenues. If the institutions discontinued using the program, the decrease in total revenues would be $2.985 million.

The STO is concerned with safety, liquidity and yield. The new policy changes are in response to recent changes in market conditions that indicate less safety and more risk. The question is whether or not the deposits of state funds in New Mexico banks and savings and loan associations are less safe and, therefore the State should charge a risk premium.

Only three (23%) of the non-ICBA/NM member institutions in the state (13 in total) qualify for the minimum collateralization requirement. Thirty-eight (73%) of the member institutions (52 in total) qualify for the minimum collateralization. Of the fourteen that do not qualify the only reason is that they do not meet the minimum standard of net operating income to total assets (greater than .61%). They meet the other two criteria. These data were calculated during a very stressful time in the economy. As each of the institutions failed to meet one of the criteria, the State responded by increasing the collateral requirement for that particular bank. The tool that the state uses to insure deposits is the collateral requirement based on performance. While the performance of all institutions may have deteriorated, the majority of them still meet the minimum collateral requirements.

By increasing the rate institutions must pay to participate in the CD Program and/or increasing the collateralization requirements the State is directly and indirectly increasing the cost to the institutions. This will lead to a decrease in the level of participation in the program, resulting in fewer loans to individuals and businesses in the state, and, therefore, less economic activity and less tax revenue generated.

If the STO charged the LIBOR instead of the U.S. Treasury rate, institutions would be paying approximately 100 basis points over the traditional rate charged. Survey results indicate many of the member institutions will begin to decrease their participation in the CD program. This will shift participation to the larger, non-member institutions, in the state, many of whom are not meeting the minimum performance criteria for collateralization.

Survey results indicate that ICBA/NM members feel that the STO is trying to maximize the rate of return of the State's portfolio at the expense of economic development in the state. They also feel that the new policies are not necessary for the majority of institutions and that the new policies applied across the board will only have adverse effects on the institutions and the state.

In the late 1980's, part of the purpose of placing State public funds in state banks, savings and loan associations and credit unions was for economic development purposes. It was required that a portion of the Severance Tax Permanent Fund be placed in financial institutions. In December of 1985, $974 million was held in certificates of deposit in financial institutions. Today, the State no longer does this with permanent fund balances. If the State can get the same rate of return from state financial institutions as it does by investing in treasuries and if the local institutions are safe as argued, placing more funds in local institutions would enhance economic development and assist in job creation.

New Mexico's Public Funds Investment Policies:
Impact on Financial Institutions and the State Economy

Introduction

In July of 2008 the State Treasurer's Office (STO) released a document titled "CD Program Enhancement – Due Diligence" (a copy of that document is included as Appendix A). In the document the STO expressed concern with regards to the return and safety of funds in the Certificate of Deposit (CD) Program managed by the State. The State now requires money market rates approximately equal to the London Interbank Offered Rates (LIBOR) for the CD program. Discounts or premiums can be negotiated depending on the risk profile of the institution participating in the program and automatic renewals will no longer take place. The risk profiles determine the collateralization requirement for participating institutions.

The Independent Community Bankers of America (ICBA/NM) became concerned that this change in policy would have an adverse effect not only on the organization's members, but also on the State's economy. The ICBA/NM contracted with Arrowhead Center to analyze the impact of the change in policy. One of the author's of this report was involved in a similar study published in 1986 sponsored by the New Mexico Bankers Association. The same concerns expressed by the STO mentioned above were the subject of that study. In essence, the ICBA/NM requested a replication of the 1986 study. The 1986 study estimated the effects of increasing 1) the cost of participation by some amount, 2) increasing the collateralization requirements and 3) instituting a bidding process to participate. In 1986, a survey of all banking and savings and loan associations in New Mexico was conducted asking for various data on institution performance, anticipated reactions to cost increases and attitudes toward state policy. A similar survey was performed for this study. Other data were collected from the FDIC website. This study will discuss the same issues.

The next section will discuss STO concerns and provide information on the CD program. Section III will present the answers to a selected set of the survey questions. Section IV will present an economic impact analysis of the changes in policy and Section V will present the conclusions of the study.

STO Concerns and the CD Program

Section 6-10-10 NMSA 1978 allows the State Treasurer and county and municipal treasurers to deposit funds in state banks and savings and loan associations. The CD Loan program was established by the State Treasurer's Office to comply with the regulations. The STO operates all investment funds following the principles of safety, liquidity and yield. Since 2006 the General Fund portfolio has been split into a CORE segment and a LIQUIDITY segment. The CORE funds are investments of to five years in length and the LIQUIDITY segment is for short-term investments not longer than one year. Oversight of these investments rests with the State Board of Finance.

Concerns

Historically, the funds in the LIQUIDITY segment were not actively managed. CDs were automatically renewed and set at the rate of comparable-term US Treasury rates. Since late 2007, the yields on US Treasury securities have fallen due to Federal Reserve policy. At the same time, yields on the London Interbank Offered Rate (LIBOR) increased due to credit concerns in the market. The LIBOR represents the interbank deposit rates between the world's most credit-worthy banks. The difference between the US Treasury rates and LIBOR (called the TED spread) is considered by many to represent a risk premium between the government rate (considered risk free) and what is occurring in the market.

Because of the increase in the TED spread, the STO has reevaluated its policies with regard to the rates charged in the CD program. The intent is to require returns that better reflect what is happening in the market and compensates for credit, liquidity and reinvestment risk.

LIBOR vs US Treasury Rates

The market conditions that have precipitated the change in policy by the STO are reflected in the TED rate. This is the difference between the LIBOR and US Treasury three-month bill rates. Table 1 provides an historical perspective on the levels and differences between the LIBOR and US Treasury rates. In the early part of this decade the TED rate was just over fifty basis points, about the long term average. In subsequent years the TED decreased substantially to about sixteen basis points. In the fall of 2007 the TED started to climb and in 2008 was triple the 2000 level.

In the last two months the TED has decreased, reflecting a change in conditions in the economy. While the rate may continue to drop, uncertainty in the markets will probably keep the rate higher than the fifty basis point long-term average for the near future.

Table 1 LIBOR Rates, US Treasury Rates and TED Three Month Bill Rate			
Year	LIBOR	US Treas	TED
2000	6.53	6	0.53
2001	3.63	3.47	0.16
2002	1.79	1.63	0.16
2003	1.22	1.03	0.19
2004	1.67	1.4	0.27
2005	3.63	3.21	0.42
2006	5.23	4.85	0.38
2007	5.30	4.47	0.83
2008	2.91	1.39	1.52
Jan-09	1.21	0.13	1.08
Feb-09	1.24	0.3	0.94
LIBOR obtained from: http://www.wsjprimerate.us/libor/libor_rates_history.htm US Treasury rates obtain from: http://dallasfed.org/data/data/hsm.htm			

The CD Program

The CD program is just one part of the investment portfolio of the STO. The CD program is in response to Section 6-10-10 NMSA 1978. This statute allows (and in some ways instructs) the STO to deposit funds in qualified New Mexico banks and savings and loan associations. Individual banks and savings and loan associations request funds from the STO and generally pay a rate that is equivalent to the corresponding US Treasury Bill rate.

Table 2 provides information on the amount of dollars the State has invested in the CD program over the last two years and a half years. The STO also manages funds for county and municipalities through the *New MexicoGROW* Local Government Investment Pool (LGIP). Late in 2006 the STO discontinued putting funds from this pool into the CD program. Late in 2008 the STO again started investing LGIP funds into the pool at an amount of $40,000,000.

Funds invested by the STO in the CD program increased during 2006 and 2007. Starting in 2008 the amount of dollars invested has decreased on a monthly basis.

Table 2 Investments by State and Local Government in CD Program			
Date	General Fund	LGIP	Total
Dec-08	$ 170,100,000	$ 40,000,000	$ 210,100,000
Nov-08	$ 180,100,000	$ -	$ 180,100,000
Oct-08	$ 180,100,000		$ 180,100,000
Sep-08	$ 195,100,000		$ 195,100,000
Aug-08	n/a		n/a
Jul-08	n/a		n/a
Jun-08	$ 201,800,000		$ 201,800,000
May-08	$ 215,800,000		$ 215,800,000
Apr-08	$ 218,800,000		$ 218,800,000
Mar-08	$ 215,800,000		$ 215,800,000
Feb-08	$ 273,900,000		$ 273,900,000
Jan-08	$ 297,400,000		$ 297,400,000
Dec-07	$ 313,000,000		$ 313,000,000
Nov-07	$ 280,000,000		$ 280,000,000
Oct-07	$ 279,000,000		$ 279,000,000
Sep-07	$ 249,000,000		$ 249,000,000
Aug-07	$ 249,000,000		$ 249,000,000
Jul-07	n/a		n/a
Jun-07	$ 245,000,000		$ 245,000,000
May-07	$ 238,000,000		$ 238,000,000
Apr-07	$ 238,000,000		$ 238,000,000
Mar-07	$ 239,000,000		$ 239,000,000
Feb-07	$ 239,000,000		$ 239,000,000
Jan-07	$ 239,000,000		$ 239,000,000
Dec-06	$ 248,000,000		$ 248,000,000
Nov-06	$ 252,000,000		$ 252,000,000
Oct-06	$ 239,500,000	$ 11,500,000	$ 251,000,000
Sep-06	$ 244,500,000	$ 11,500,000	$ 256,000,000
Aug-06	$ 245,850,000	$ 11,500,000	$ 257,350,000
Jul-06	$ 243,850,000	$ 11,500,000	$ 255,350,000
Jun-06	$ 217,850,000	$ 11,500,000	$ 229,350,000

In order to minimize the risk to public funds, participating institutions must meet collateral requirements pledged against such funds from the program. The amount of collateral pledged depends on the risk assessment ratios set by the STO. These risk assessment ratios have not changed since 1986.

The risk assessment for banks is based on three performance ratios: primary capital to assets, net operating income to total assets, and non-performing loans to primary capital. Two other ratios, the deposit ratio and equity ratio, are concerned with the ratio of state funds on deposit relative to total deposits and the amount of state funds relative to the total equity capital of the institution. Financial institutions meeting or exceeding the minimum standard must collateralize borrowed funds at a fifty percent rate. Those not meeting all of the minimum standards are required to have collateral requirements greater than fifty percent. The performance ratios and collateral requirements are given in Table 3.

Table 3
Risk Assessment and Collateral Requirements for NM Banks

Performance Ratios	Standard	Required Collateral
Primary Capital to Assets	6% or greater	50%
	5%-6%	75%
	Less than 5%	100%
Net Operating Income to Total Assets	.61% or greater	50%
	.51% to .6%	75%
	.5% or below	100%
Non-performing Loans to Primary Capital	34.9% or less	50%
	35% to 49%	75%
	50% and above	100%
Financial Deposit Ratio	Less than 10%	50%
	10% or greater	100%
Equity Ratio	Less than 200%	50%
	200% or greater	100%

In general the collateral must take the form of securities that are guaranteed by the government of the United States, the State of New Mexico and its subdivisions, revenue bonds rated BAA or better, bonds of the NM mortgage finance authority, federally guaranteed farmers' home administration loans, letters of credit issued by a federal home loan bank and surety bonds.

Institutional Responses to Selected Survey Questions

The primary concern of the members of the ICBA/NM are that the suggested changes in policy either directly, or indirectly, increase the cost of participating in the CD Program to the institutions. If those cost increase, a decrease in funds will be requested and fewer loans will be made. This affects the profitability of the institutions and also effects economic activity in the state. The responses to the questions below reflect these concerns.

The purpose of the survey was to collect data for the economic impact analysis and but to obtain information on the characteristics of ICBA/NM institutions and the opinions of their administrators with respect to state policy.

The survey was sent to all member institutions of the ICBA/NM for a total of 52 surveys. The response rate was 63%. A copy of the survey and responses is attached as Appendix B.

A series of questions was asked concerning whether or not the institution held state and local public fund deposits and what percent these funds represented of total deposits. Three-quarters of the institutions held state deposits and 83% held local public funds. On average state monies represented three percent of deposits and local public funds represented approximately 11.4% of deposits. It was also reported that, on average, 75% of institutions' portfolios would qualify as collateral against state funds.

While over half of the institutions do not match term of deposits with assets of similar terms, 90% preferred terms of maturity of state funds of less than one year. It was also reported by over 50% of the respondents that they thought that state funds were less stable than other funds to which they have access.

While it is obvious that most of the institutions participate in the CD program, almost 50% of the respondents said that public funds were more costly to administer than funds from other sources. The comments associated with these questions usually referred to the cost of collateralization. When it was reported that it was more costly, the average cost of administration was 27 basis points higher. This perception certainly has implications for the state if collateralization requirements become more restrictive.

The series of questions that asked about collateralization indicate that the members of the ICBA/NM support the idea of collateralization and, particularly, the policy in its present form. Three-quarters of the respondents think that state funds should be collateralized and 82% indicated that 50% collateralization is an appropriate level. Eighty-one percent of the respondents are opposed to a 100% collateralization policy and 70% said that, if it were imposed, they would discontinue participation in the program. The rest of the respondents said that they would decrease participation by 40% if the policy was instituted.

The vast majority of the respondents (96%) were satisfied with the list of assets that could be used for collateral and 70% considered the list provides adequate or more than adequate safety for state funds.

The membership of ICBA/NM did not favor an in-state bidding process (71%). Seventy-two percent thought it would increase the cost of state funds, but there was no consensus on exactly by how much. The members thought that this type of process would redistribute funds from small institutions to large institutions (44%) and additional comments indicated that members thought there would be a shift from less risky to more risky institutions and from rural to urban institutions.

Given the choice, member institutions would rather see an increase in rates (58%) rather than an in-state bidding process (42%). Seventy percent of the respondents indicated that an increase in rates over the T-Bill rate would decrease participation in the program. Only a few respondents indicated how much they would decrease participation relative to an increase in rates. One member would decrease participation on any increase. All but one of the others commenting, would reduce participation by at least 50% with a 75 to 100 basis point increase. All but one drops all participation at 101 or more basis points.

While 67% of the respondents indicated that the payment of interest on a monthly basis is no problem and reasonable, the requirement of a daily 'call' option is not well received. Eighty-eight percent of the respondents rated the 'call' option as unreasonable and either a major problem or somewhat of a problem. The comments included were mostly related to the risk associated with the potential of loss of funds. An unstable source of funds creates a liquidity risk to the bank and makes it very difficult to match assets and liabilities.

A set of questions asked opinions of what is in the State's best interest. Member institutions thought it was not in the best interest for the state: 1) to go to all U.S. Treasuries (92%); 2) to go to a bidding system ((70%); or 3) go to an arbitrary increase in rates by 25-50 basis points (60%). They did indicate that a 100% collateral policy would be in the state's interest (77%) because that would place no risk on the State. Comments included indicated that the financial institutions would not find this very advantageous.

When asked whether state fund investment policies have achieved a proper balance between maximizing risk and economic development, the overwhelming majority (76%) said that state policies heavily favored rate of return.

Economic Impact Analysis

The purpose of this section is to estimate the possible decrease in economic activity that would take place in response to a change in policy by the State Treasurer's Office. At this time that policy would increase the cost of funds obtained by the state's banks that participate in the CD program. In addition two other possible policy changes will be discussed. Those two policy changes will be a bidding process for funds and an increase in the collateralization policy. Although these last two policies have not been suggested recently, they have been suggested in the past. Results from the survey give an indication of how existing banks and savings and loan associations would respond to these changes in policy.

Each of the policy changes will either increase the cost of public funds directly or indirectly. The response by the institutions will be a decrease in participation in the CD program. If these funds cannot, or would not, be replaced from other sources, a smaller amount of funds would be available to customers. This would result in less economic activity. The initial decrease in economic activity would have a multiplier effect on the local economies, decreasing economic activity by a greater degree than just the initial decrease.

The Multiplier Process

Economic impact analysis measures the net changes in economic activity in a geographic area resulting from a change in spending. The central idea is that a one dollar change in spending results in more than a one dollar change in economic activity.

Economic impacts are generally measured in terms of changes in output, income, and employment. Output is measured in dollars and represents the dollar value of gross production. Income is also measured in dollars and contains several components –most importantly labor income including both wages and salaries and proprietors income. Employment is measured in terms of numbers of jobs. In many impact studies including this one, estimates of changes in state taxes as a result of the change in economic activity are also presented.

In most economic impact studies, three types of impacts are estimated: direct, indirect and induced. The direct effect is the increase/decrease in activity associated with the initial change in spending. Those individuals who were initially affected would then buy, or not buy, supplies, hire labor, etc. This also increases, or decreases, activity and this is called the indirect affect. Finally, if the workers are local residents (even temporarily), additional/ decreased spending by households will occur. The change in household spending is known as an induced effect.

This all sounds simple enough. There are only three basic ideas. First, a decrease in a dollar of spending (the direct effect) in a given area will generate more than a single dollar's worth of decreased economic activity in that area. Second, all industries will decrease purchases of inputs from other industries (the indirect effects). Third, households will decrease spending as income decreases (induced effects).

There are three main areas of concern in estimating local economic impacts. First, the change in spending must, in fact, originate from outside the geographic area being considered. Second, the size of the local economy matters. To the extent that the direct inputs are imported from other areas, a change in spending doesn't have much effect on the local economy. In general, the smaller the local economy under consideration, the more likely it is for firms operating locally to obtain inputs from outside the area. Third, supply constraints in the local economy are important. Given knowledge of a pattern in the change in spending, the direct, indirect, and induced effects of that spending can be calculated.

The three most commonly used modeling systems to perform the calculations are: RIMS II, REMI, and IMPLAN. The RIMS (regional input-output modeling system) system is produced by the U.S. Department of Commerce, Bureau of Economic Analysis (http://www.bea.gov/regional/rims/index.cfm). The REMI models are produced privately produced and customized to user specified geography by REMI (Regional Economic Models, Inc. http://www.remi.com/). The IMPLAN model was originally developed for the U.S. Forest Service but for many years it has been maintained and sold by the Minnesota Implan Group (http://www.implan.com/).

Each modeling system has well known advantages and disadvantages. The model used to produce the estimates in this report is IMPLAN PRO II with the latest (2006) data and structural matrices available.

Initial Decrease in Economic Activity

To calculate an overall change in economic activity, the initial change must first be determined. In this case the initial change in activity comes about because financial institutions experience an increase in the cost of obtaining funds from the state and, therefore, will ask for a smaller amount of funds.

The first step in the estimation process is to determine the amount of loans made by the institutions in the state that occur only because of the availability of State funds. The characterization of how banks and savings and loan institutions act with respect to State monies will be the basis of estimating the effect of raising the price of those funds.

Two important assumptions are being made. The first is that if the State did not provide funds to the local banks, the state would be investing the funds in other securities outside of the state. Therefore when the State provides funds through the CD program, they can be considered 'new monies' being used in the state. The second assumption is that the banks and savings and loan associations will not participate unless they can loan out the funds. It would not make sense for a financial institution to voluntarily accept a liability without being able to invest the funds somewhere else.

Representatives from the institutions reported the following information in the survey: State deposits, a loan to deposit ratio, the percentage of state monies used to make loans that would not have been possible without state monies, a percent of loans that would not be made by other institutions if not made by that particular institution and the percentage of loans that are made to customers in New Mexico. These percentages and ratios were used to calculate the effect on economic activity due to the availability of State funds.

Participation in the CD program does not guarantee that the total amount of dollars involved represent new changes in economic activity. Because of voluntary participation in the program, it is assumed that an institution will have someone to whom they can loan the proceeds. Given that the initiation of loans and the repayment of loans are not perfectly matched, the financial institution rarely has all deposits loaned out at one time. The loan to deposit ratio is usually less than one. Part of the funds received from the state will not be loaned out.

Voluntary participation in the program indicates that institutions find this source of funds to be equivalent to, or cheaper than, other sources of funds. It must be kept in mind that there are other sources of funds available to institutions. If the institution could have gone to those other sources than the total amount received from the State cannot be thought of as new monies. The survey provided information as to how much of State monies could have been replaced from these other sources.

The characteristics of the financial industry have changed from twenty-five years ago. If a customer could not get a loan from their local financial institution, he or she did not have much recourse. In 1986 there were 119 banks and savings and loan associations in New Mexico. All were local institutions. No intrastate and interstate banking was allowed. Today there are 65 financial institutions in New Mexico and intrastate and interstate banking is allowed. A short history of the changes in the financial markets is included in Appendix C. Customers now have other options than the local bank or savings and loan association. They may, however, not be perfect substitutes to the local institution. The survey provided data from the local institutions on the percentage of loans that would be made by other institutions if not made by them.

The last piece of information that needs to be taken into consideration is the amount of loans made to individuals in New Mexico. Because of the new nature of the industry, loans can be made throughout the United States and, even, the world. Those loans made by financial institutions outside of the state have no impact on the state economy. A response to a survey question provided this information

An example of the calculation of the effect of State funds on in individual bank may be appropriate. An individual bank participates in a $1000 CD from the State. The loan to deposit ratio for that bank is 90%. On average $900 would be loaned. Of this amount the bank could have found other funds instead of the State funds but could not have replaced them all. In this example the bank could have found 50% of funds from other sources. So the impact decreased to $450. Some other bank may have been able to make the loan instead of this institution if it did not get State funds. If 25% of the loans could have been made by a competing institution the impact decreases to $337.50. And lastly all loans are not made to customers in New Mexico. Assuming 10% of loans are made to someone outside of New Mexico, the impact decreases to $303.75. The result of these calculations indicates that because of the availability of $1000 in State funds, there was an increase in loan, and economic, activity equal to $303.75. About 30% of State funds invested in the CD loan program to this bank, instead of somewhere outside the state, generate an increase in economic activity. The opposite would also be true. A decrease in $1000 from the state would generate a decrease in economic activity of $303.75, or about 30% of the total.

Table 4 describes the above calculations. What is necessary is to make the calculations in a way that represents what is happening in all banks and savings and loan associations. Each of the ratios and percentages below were calculated by weighting each of the institution's ratios and percentages by the proportion of total deposits held by each. The weighted ratios (in decimals) for all survey respondents are included in the parentheses in Table 4. This calculation indicates that of the total funds borrowed from the State by financial institutions in the state, 36.8% represents economic activity that would not have occurred without the program.

Table 4
Calculation of Impact of State Monies

Total amount of state funds in CD Program
x loan to deposit ratio (.9576)
x percent of funds not replaceable (.5375)
x percent of loans not made by other institutions (.7796)
x the percent of loans to NM customers (.9174)
= the dollar impact on the economy

Total Amount of State Funds x .368 = the dollar impact on the economy

The proposed policy of increasing the cost of participating in the CDP will cause some of the financial institutions to decrease the amount of funds they want to borrow. Unfortunately not many individuals responded to the question on the survey asking how the banks and savings and loan associations would respond to an increase in cost. One individual said that any increase in cost would cause them decrease participation in the program. Others gave various answers to the question. Indications were that an increase of up to fifty basis points would have no effect, but that any increase above that would lead to some decrease in borrowing. An increase of one hundred basis points would lead all those that responded to the question to discontinue participation

The following analysis measures the effect of various decreases in participation in the State program. The actual reaction would depend on the increase in cost. If the difference between the LIBOR and US treasury rate falls to the normal difference of approximately 50 basis points the amount of borrowing could fall by 25%. If the difference remains at the most recent highs, charging the LIBOR could easily lead to a complete elimination of borrowing by the institutions. An analysis of the effect on the state's economy of a 25%, 50%, 75% and 100% decrease in participation follows.

In December of 2008, the State and LGIP placed $210 million with banks and savings and loan association in conjunction with the CD program. Table 5 provides information on the amount of participation that would not have occurred corresponding to a 25%, 50%, 75% and 100% decrease. It also shows the amount of initial economic activity that would not occur at those levels of decreases.

Table 5
Percent Decrease, Dollar Value of Decrease and Initial Decrease in Activity

Decrease in Deposits (percent)	Dollar Value of Deposits Decrease (Mil. of $)	Initial Decrease in Economic Activity (Mil. of $)
25%	52.5	19.32
50%	105	38.64
75%	157.5	57.94
100%	210	77.28

Impact of Initial Changes in Economic Activity

In order to estimate the overall effect on the economy, the initial decrease in spending is needed plus where that spending occurs in the economy. Banks and savings and loan associations loan monies to a variety of individuals for a variety of reasons. They lend to those who buy real estate, to those involved in agriculture, to those involved in commercial activities and to individuals for consumption.

Information was derived from FDIC reports for the last quarter of 2008 for all financial institutions in the state to determine the percentage breakdown of types of loans made. The result was that of all loans 70.36% were for real estate, 1.75% were for agriculture spending, 19.49% were for commercial spending and 8.06% were for consumer spending. These four percentages were applied to the initial decreases in economic activity calculated above and the dollar values were used as inputs in the IMPLAN model for New Mexico.

Table 6 indicates the direct, indirect and induced effects of the initial change in spending in terms of value added, income and employment for the four different decreases in participation in the CD program.

A decrease in participation in the CD program of 25% by institutions result in a decrease in $17.5 million in value added, a decrease of $12.2 million in personal income and the loss of 320 jobs in the state.

If the increase in cost of funds were to be high enough to have all participation in the program cease, the decrease in value added would be $70.2 million. The decrease in personal income would be equal to $48.8 million and the state would lose 1280 jobs.

Table 6
Multiplier Effects of the Initial Changes in Economic Activity

% Decrease in Participation	Effect	Value Added (Mil. of $)	Income (Mil. of $)	Employment (# of jobs)
25%	Direct	10.11	7.836	195.1
	Indirect	3.112	2.076	53.5
	Induced	4.316	2.282	71.2
	Total	17.549	12.195	319.8
50%	Direct	20.22	15.672	390.2
	Indirect	6.224	4.152	107
	Induced	8.632	4.564	142.4
	Total	35.098	24.39	639.6
75%	Direct	30.33	23.508	585.3
	Indirect	9.336	6.228	160.5
	Induced	12.948	6.846	213.6
	Total	52.647	36.585	959.4
100%	Direct	40.44	31.344	780.4
	Indirect	12.448	8.304	214
	Induced	17.264	9.128	284.8
	Total	70.196	48.78	1279.2

Results from IMPLAN

Estimation of Tax Revenues

This section describes the procedures followed to estimate the tax revenues that would be lost to the state as a result of the decrease in economic activity.

Three types of revenue will be considered: gross receipts taxes, personal income taxes and corporate income taxes. These three taxes represent nearly eighty percent of the tax revenues received by the state in any one year and can be estimated with a high degree of confidence. Table 7 provides an historical picture of these selected taxes relative to the total taxes in New Mexico. From 2001 through 2007, these three taxes, on average, generate 78.63 percent of all New Mexico taxes.

Table 7 Selected New Mexico Taxes 2001-2007								
YEAR	All New Mexico Taxes	GRT	GRT Percent of All Taxes	PIT	PIT percent of all taxes	CIT	CIT percent of all taxes	(GRT+ CIT+PIT) percent of all taxes
	($1,000s)	($1,000s)		($1,000s)		($1,000s)		
2001	4,002,246	2,083,196	52.05	830,006	20.74	190,673	4.76	77.55
2002	3,628,055	1,822,878	50.24	982,891	27.09	124,327	3.43	80.76
2003	3,607,156	1,873,420	51.94	923,113	25.59	101,546	2.82	80.34
2004	4,001,780	2,038,440	50.94	1,007,248	25.17	138,196	3.45	79.56
2005	4,478,321	2,170,521	48.47	1,086,015	24.25	242,462	5.41	78.13
2006	5,110,683	2,387,718	46.72	1,123,954	21.99	377,185	7.38	76.09
2007	5,205,322	2,483,021	47.70	1,149,805	22.09	425,087	8.17	77.96
Averages			49.72		23.85		5.06	78.63
Source: State tax data from U.S. Bureau of the Census http://www.census.gov/govs/statetax/								

There are a variety of techniques that could be used to estimate the revenues that would be lost by the decrease in economic activity resulting from the decrease in loans. The difficulty with most of the techniques either entail a lack of data or the fact the tax law changes virtually every year. The technique used in this study uses historical data and averages. The relationship of each of the taxes to personal income is used to estimate the revenue changes.

Personal Income Taxes

Table 8 provides historical data for personal income and NM personal income taxes. From 2001 to 2007, ratio of NM personal income taxes to NM total personal income varied from 0.01854 to 0.02185. This implies that the effective average tax rate over that time period was between 1.8% and 2.1%. The average effective tax rate over the period was 1.977%. It is this rate that will be used to estimate the change in personal income tax revenues lost because of the decrease in economic activity.

Table 8 New Mexico Personal Income Taxes and Personal Income			
PIT	NM PIT	NM Total Personal Income	PIT per $ of TPI
2001	830,006,000	44,138,165,000	0.01880
2002	982,891,000	44,986,517,000	0.02185
2003	923,113,000	46,650,275,000	0.01979
2004	1,007,248,000	50,707,317,000	0.01986
2005	1,086,015,000	53,714,363,000	0.02022
2006	1,123,954,000	58,131,416,000	0.01933
2007	1,149,805,000	62,001,991,000	0.01854
Averages			0.01977
Sources: PIT data from U.S. Bureau of the Census http://www.census.gov/govs/statetax/ TPI data from U.S. Department of Commerce, Bureau of Economic Analysis, Regional Economic Information System http://www.bea.gov			

Corporate Income Taxes

Table 9 provides historical data for personal income and NM corporate income taxes. From 2001 to 2007, ratio of NM corporate income taxes to NM total personal income varied from 0.002177 to 0.006856. This implies that the effective average tax rate over that time period was between 0.21% and 0.68%. The average effective tax rate over the period was 0.42%. The relationship between personal income and corporate income tax revenues is not very stable. The reason for this is that corporate profits are related to the business cycle. The decrease in CIT revenue from 2002 through 2004 is associated with the national downturn in economic activity in 2001 and the subsequent recovery. As the economy came out of recession, corporate profits increased. Given that the economy is again in a downturn, this study will use the average effective tax rate of .0004263 to estimate the corporate tax revenue lost by the decrease in economic activity.

Table 9 NM Corporate Income Taxes and Personal Income			
Year	CIT	NM Total Personal Income	CIT per dollar of TPI
	($1,000s)	($1,000)	
2001	190,673	44,138,165	0.004320
2002	124,327	44,986,517	0.002764
2003	101,546	46,650,275	0.002177
2004	138,196	50,707,317	0.002725
2005	242,462	53,714,363	0.004514
2006	377,185	58,131,416	0.006488
2007	425,087	62,001,991	0.006856
Average			0.004263
Source: U.S. Bureau of the Census and U.S. Department of Commerce, Bureau of Economic Analysis			

Gross Receipts Taxes

Table 10 provides historical data for personal income and NM gross receipts taxes. From 2001 to 2007, the ratio of NM gross receipts taxes to NM total personal income varied from 0.04005 to 0.04720. This implies that the effective average tax rate over that time period was between 4% and 4.7%. The average effective tax rate over the period was 4.1%. It is this rate that will be used to estimate the change in gross receipts tax revenues lost due to the decrease in economic activity. It should be noted that a portion of these gross receipt tax revenues, although collected by the state, are redistributed back to local government entities.

Table 10 NM Gross Receipts Taxes and Personal Income			
Year	GRT	NM Total Personal Income	GRT per dollar of TPI
	($1,000s)	($1,000s)	
2001	2,083,196	44,138,165	0.04720
2002	1,822,878	44,986,517	0.04052
2003	1,873,420	46,650,275	0.04016
2004	2,038,440	50,707,317	0.04020
2005	2,170,521	53,714,363	0.04041
2006	2,387,718	58,131,416	0.04107
2007	2,483,021	62,001,991	0.04005
Averages			0.04137
Source: U.S. Bureau of the Census and U.S. Department of Commerce, Bureau of Economic Analysis			

Estimate of Tax Revenues Lost Due to the Decrease in Economic Activity

The preceding discussion and data provide the building blocks for the estimation of tax revenues that would occur because of the decrease in economic activity. Given the effective tax ratios calculated above and using the decrease in personal income as a base, total revenue lost by the decrease in economic activity is shown in Table 11.

If the local financial institutions decreased their participation in the CD program by 25%, the state would lose a total of $746,000 in tax revenues. If institutions discontinued using the program, the decrease in total revenues would be $2.985 million.

Table 11
Decreases in
Personal Income Taxes, Corporate Income Taxes and Gross Receipts Taxes
Due to Decreases in Loans

Decrease in Participation	Tax	Personal Income (Mil. of $)	Effective Tax Rate	Taxes Lost (Mil. of $)
25%	Personal Inc. Tax	12.195	1.977%	0.241
	Corporate Inc. Tax	12.195	.04263%	0.005
	Gross Receipts Tax	12.195	4.1%	0.500
	Total Taxes Lost			0.746
50%	Personal Inc. Tax	24.39	1.977%	0.483
	Corporate Inc. Tax	24.39	.04263%	0.010
	Gross Receipts Tax	24.39	4.1%	1.000
	Total Taxes Lost			1.493
75%	Personal Inc. Tax	36.585	1.977%	0.724
	Corporate Inc. Tax	36.585	.04263%	0.015
	Gross Receipts Tax	36.585	4.1%	1.500
	Total Taxes Lost			2.239
100%	Personal Inc. Tax	48.781	1.977%	0.966
	Corporate Inc. Tax	48.781	.04263%	0.020
	Gross Receipts Tax	48.781	4.1%	2.000
	Total Taxes Lost			2.985

Calculations performed by authors

Safety of Public Funds

The STO is concerned with safety, liquidity and yield. The new policy changes are in response to recent changes in market conditions that indicate less safety and more risk. The question is whether or not the deposits of state funds in New Mexico banks and savings and loan associations are less safe and, therefore the State should charge a risk premium.

One way for the State to decrease its risk is to have varying collateralization requirements depending on the performance of the particular financial institution. It has those regulations and they have not changed since 1986. The authors calculated the performance ratios for all banks and savings and loan associations in the state for the fourth quarter of 2008, a time of financial crisis in the country. Those calculations are shown in Table 12. Those institutions which are not shaded are members of the ICBA/NM, those shaded are not members. Those banks and savings and loans that are not members are generally the larger institutions in the state.

Only three (23%) of the non-ICBA/NM member institutions (13 in total) qualify for the minimum collateralization requirement. Thirty-eight (73%) of the member institutions (52 in total) qualify for the minimum collateralization. Of the fourteen that do not qualify the only reason is that they do not meet the minimum standard of net operating income to total assets (greater than .61%). They meet the other two criteria. These data were calculated during a very stressful time in the economy. As each of the institutions failed to meet one of the criteria, the State responded by increasing the collateral requirement for that particular bank. The tool that the state uses to insure deposits is the collateral requirement based on performance. While the performance of all institutions may have deteriorated, the majority of them still meet the minimum collateral requirements.

Table 12
Calculations of Collateralization Requirements for Banks and Savings and Loan Associations in NM

Institution Name	All banks greater than minimum standard Primary Capital to Asset Ratio	Net operating Income Total Assets	Non-Performing Loans	Collateralization Requirement
	>6%			
WELLS FARGO BANK NA	yes	.5% or below	less than 34.9%	100
BANK OF AMERICA NA	yes	.5% or below	less than 34.9%	100
FIRST COMMUNITY BANK	yes	.5% or below	less than 49%	100
LOS ALAMOS NATIONAL BANK	yes	.5% or below	less than 34.9%	100
BANK OF ALBUQUERQUE NA	yes	over 0.51%	less than 34.9%	75
BANK OF THE WEST	yes	over 0.51%	less than 34.9%	75

CHARTER BANK	yes	.5% or below	50% or larger	100
COMPASS BANK	yes	.5% or below	less than 34.9%	100
FIRST NB OF SANTA FE	yes	over 0.61%	less than 34.9%	50
NEW MEXICO BANK&TRUST	yes	.5% or below	less than 34.9%	100
FIRST NATIONAL BANK	yes	over 0.61%	less than 34.9%	50
CITIZENS BANK	yes	over 0.61%	less than 34.9%	50
WASHINGTON FS&LA	yes	.5% or below	less than 34.9%	100
CENTURY BANK	yes	over 0.61%	less than 34.9%	50
PIONEER BANK	yes	.5% or below	less than 34.9%	100
CITIZENS BANK OF LAS CRUCES	yes	over 0.61%	less than 34.9%	50
WESTERN COMMERCE BANK	yes	over 0.61%	less than 34.9%	50
VALLEY NATIONAL BANK	yes	.5% or below	less than 49%	100
FIRST NB IN ALAMOGORDO	yes	over 0.61%	less than 34.9%	50
CITIZENS BANK OF CLOVIS	yes	over 0.61%	less than 34.9%	50
INTERNATIONAL BANK	yes	over 0.61%	less than 34.9%	50
CARLSBAD NATIONAL BANK	yes	over 0.61%	less than 34.9%	50
LEA COUNTY STATE BANK	yes	over 0.61%	less than 34.9%	50
FIRST NB OF NEW MEXICO	yes	over 0.61%	less than 34.9%	50
COMMUNITY BANK	yes	over 0.61%	less than 34.9%	50
WESTERN BANK ARTESIA NM	yes	over 0.61%	less than 34.9%	50
CENTINEL BANK OF TAOS	yes	over 0.61%	less than 34.9%	50
MY BANK	yes	over 0.61%	less than 34.9%	50
FIRST NEW MEXICO BANK	yes	over 0.61%	less than 34.9%	50
BANK OF LAS VEGAS	yes	over 0.61%	less than 34.9%	50
JAMES POLK STONE NB	yes	over 0.61%	less than 34.9%	50
FOUR CORNERS COMMUNITY BANK	yes	over 0.61%	less than 34.9%	50
BANK OF THE SOUTHWEST	yes	over 0.61%	less than 34.9%	50
PEOPLES BANK	yes	.5% or below	less than 49%	100
FIRST SAVINGS BANK	yes	over 0.51%	less than 34.9%	75
COMMUNITY 1ST BANK LAS VEGAS	yes	over 0.61%	less than 34.9%	50
FIRST STATE BANK	yes	over 0.61%	less than 34.9%	50
BANK 34	yes	.5% or below	less than 34.9%	100
BANK OF COLORADO	yes	over 0.61%	less than 34.9%	50
BANK OF CLOVIS	yes	over 0.61%	less than 34.9%	50
WESTERN BANK	yes	over 0.61%	less than 34.9%	50
VALLEY BANK OF COMMERCE	yes	over 0.61%	less than 34.9%	50
GRANTS STATE BANK	yes	over 0.61%	less than 49%	50
BANK OF THE RIO GRANDE NA	yes	over 0.61%	less than 34.9%	50
AMBANK	yes	over 0.61%	less than 34.9%	50
CITY BANK NEW MEXICO	yes	over 0.61%	less than 34.9%	50
HIGH DESERT STATE BANK	yes	.5% or below	50% or larger	100
IRONSTONE BANK	yes	.5% or below	less than 34.9%	100
BANK 1ST	yes	.5% or below	50% or larger	100
UNION SAVINGS BANK	yes	.5% or below	less than 34.9%	100
FIRST NM BANK LAS CRUCES	yes	over 0.61%	less than 34.9%	50
SUNRISE BANK OF ALBUQUERQUE	yes	.5% or below	less than 34.9%	100
FIRST NM BANK OF SILVER CITY	yes	over 0.61%	less than 34.9%	50
CITIZENS BANK in El Paso	yes	over 0.61%	less than 34.9%	50
WESTERN BANK	yes	over 0.61%	less than 34.9%	50
FARMERS&STOCKMENS BK CLAYTON	yes	over 0.61%	less than 34.9%	50
AMERICAN HERITAGE BANK	yes	.5% or below	less than 34.9%	100
FIRST NB OF RUIDOSO	yes	over 0.61%	less than 34.9%	50

MAIN BANK	yes	over 0.61%	less than 34.9%	50
WESTERN BANK OF CLOVIS	yes	over 0.61%	less than 34.9%	50
VECTRA BANK COLORADO NA	yes	.5% or below	less than 34.9%	100
IRWIN UNION BANK FSB	yes	.5% or below	less than 34.9%	100
TUCUMCARI FS&LA	yes	.5% or below	less than 34.9%	100
MESILLA VALLEY BANK	yes	.5% or below	less than 34.9%	100
DSRM NATIONAL BANK	yes	over 0.61%	less than 34.9%	50
Calculations by authors from FDIC reports for fourth quarter 2008				

Conclusions

The State Treasurer's Office has instituted new policies to safe guard the deposits of State funds in banks and savings and loan associations in the state. One of the primary reasons for the implementation of the new policies was the rise in the TED over the last year. The STO reasoned that the State faces increased risk and should be compensated. The ICBA/NM is concerned that these new policies will not only have an adverse impact on profitability but also on the State's economy.

By increasing the rate institutions must pay to participate in the CD Program and/or increasing the collateralization requirements, the State is directly and indirectly increasing the cost to the institutions. This may lead to a decrease in the level of participation in the program, resulting in fewer loans to individuals and businesses in the state, and, therefore, less economic activity and less tax revenue generated.

If the STO charged the LIBOR instead of the U.S. Treasury rate, institutions would be paying approximately 100 basis points over the traditional rate charged. Survey results indicate, with this increase in cost, many of the member institutions may begin to decrease their participation in the CD program. This will shift participation to the larger, non-member institutions, in the state, many of whom are not meeting the minimum performance criteria for collateralization.

Survey results indicate that ICBA/NM members feel that the STO is trying to maximize the rate of return of the State's portfolio at the expense of economic development in the state. They also feel that the new policies are not necessary for the majority of institutions and that the new policies applied across the board will only have adverse effects on the institutions and the state.

In the late 1980's, part of the purpose of placing State public funds in state banks, savings and loan associations and credit unions was for economic development purposes. It was required that a portion of the Severance Tax Permanent Fund be placed in financial institutions. In December of 1985, $974 million was held in certificates of deposit in financial institutions. Today, the State no longer does this with permanent fund balances. If the State can get the same rate of return from state financial institutions as it does by investing in treasuries and if the local institutions are safe as argued, placing more funds in local institutions would enhance economic development and assist in job creation.

Appendix A
CD Program Enhancement – Due Diligence

New Mexico State Treasurer's Office
CD Program Enhancements – Due Diligence
July 2008

<u>Background</u>

Section 6-10-10 NMSA 1978 establishes the guidelines for managing public funds. Paragraph A of that statute reads "*Upon the certification or designation of a bank, savings and loan association or credit union whose deposits are insured by an agency of the United States to receive public money on deposit, the state treasurer and county or municipal treasurers who have on hand any public money by virtue of their offices shall make deposit of that money in banks and savings and loan associations and may make deposit of that money in credit unions whose deposits are insured by an agency of the United States, designated by the authority authorized by law to so designate to receive the deposits of all money thereafter received or collected by the treasurers.*"

Additionally, paragraph C of that statute states "*The state treasurer may deposit money in one or more accounts with any such bank, savings and loan association or credit union, subject to the limitation on credit union accounts.*"

To comply with the guidelines set forth in this statute, the State Treasurer's Office (STO) established the CD Program. The State Treasurer makes a portion of General Fund money available for investment in certificates of deposit in New Mexico banks, savings and loan associations, trust institutions, and credit unions.

State Treasury investment is made in accordance with the State Treasurer's Investment Policy, a document that sets investment guidelines for all Treasury investments, as approved by the State Treasurer's Investment Committee and the State Board of Finance.
The policy mandates that, in accordance with the Treasurer's fiduciary responsibility, all investments made by the State Treasurer's Office must follow three fundamental principles: safety, liquidity, and yield. As funds held in the Treasury are operating in nature and callable at any time, safety and liquidity are the priority.

In 2006 the Treasurer's Office, under strict reform measures, contracted an investment advisor for expert assistance to evaluate portfolio management and to recommend improvements. Recommendations included that the General Fund portfolio be separated into two segments, the CORE and the LIQUIDITY, to more efficiently invest funds. The CORE segment holds longer-term funds capable of investment up to five years. The LIQUIDITY segment holds money needed for day-to-day cash requirements and is invested short-term, not longer than 1 year. As also recommended, both segments are reported against assigned benchmarks on a monthly and quarterly basis.

Oversight of Treasury investment activity, as well as all state banking, rests with the State Board of Finance. The legislature and the Legislative Finance Committee may also request that the Treasurer address inquiries or concerns regarding the safety and performance of the state's public funds.

<u>Prudent Investing</u>

As per the State Treasurer's Investment Policy, the standard of investment for the state's public funds is the *Prudent Person* rule which states "*Investments shall be made with the judgment and care, under circumstances then prevailing, that persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, but for investment considering the probable safety of their capital as well as the probable income to be derived.*

New Mexico State Treasurer's Office
CD Program Enhancements – Due Diligence
July 2008

Cause for Evaluation

Until January 2008, the State Treasury's CD investments under the CD Program were not actively managed assets within the General Fund LIQUIDITY segment. CDs were automatically renewed without regard for reinvestment risk (i.e. maturities were not laddered) and automatically purchased at the minimum rate set by the State Board of Finance Interest Rate Policy (SBOF Policy 08-02 Jan. 14, 2008), which is the comparable-term US Treasury rates.

In September 2007 the Fed began lowering the target lending rate and yields on U. S. Treasury securities followed. At the same time, however, yields on the London Interbank Offered Rate (LIBOR) increased due to credit concerns in the market, particularly in the financial sector. As LIBOR-based market rates climbed higher (compared to Treasuries), New Mexico financial institutions came to the Treasurer's Office seeking to borrow public funds at the lower Treasury-level rates. This caused rapid uncontrolled CD investment growth which expanded the program by $65 million, or 26%, within three months and adversely affected cash positions, resulting in a projected deficit. STO reacted by putting new CD investment on temporary hold and, in doing so, was able to avoid the deficit. STO also recognized that the rate of return it was accepting on CD investments (i.e. U.S. Treasury rates) had become significantly disconnected from the risk associated with holding financial/bank investments as reflected by all market rate indices. At this point, the program underwent a thorough evaluation.

CD Program Enhancements

Treasury investment in CDs, as with other state deposits, requires ongoing due diligence and risk assessment of the financial institution or creditor. As with other prudent investment, it also requires a rate of return commensurate with like-kind money market offerings and that compensates for credit, liquidity and reinvestment risk.

Effective July 2008, the State Treasurer's Office will require sector-specific money market rates approximated to the London Interbank Offered Rates (LIBOR) to determine acceptable rates for CD investment. STO is willing to negotiate a discount or premium versus LIBOR depending on the individual risk profile of the financial institution and the level and quality of collateralization. If an appropriate rate can be agreed upon, the CD term will be selected with laddered cash flow requirements in mind and will not be automatically renewed at maturity. Participation in the Treasury's CD Program is contingent on the state's liquidity requirements and early redemption (exercising of put option) is possible.

The State Treasurer's Office is committed to the continued success, as well as the prudent management and safe operation, of the CD Program. In light of recent market conditions which adversely affected available liquidity within the financial sector, the Treasurer understands the role that government can play to help mitigate such situations when they occur. Cooperation and collaboration between the State Treasurer's Office, on behalf of New Mexico taxpayers, and the New Mexico banking community to understand the strategy and benefits of this program will achieve the common goals of all parties.

The State Treasurer's trading desk is open from 8 a.m. to 4 p.m. Monday through Friday to accept offers for certificates of deposit from qualifying local financial institutions.

Appendix B
2008 Questionnaire for ICBA/NM Financial Institutions
Summary Statistics:

1. Are you a

   61% State Charter
   27% National Charter
   12% Thrift (25% state 75% national)

2. How long has your institution been in existence?

   48 Years average.
   106 max
   8 min

3. Is your institution a member of a holding company?

   91% Yes
   9% No

4. What part of the state are you located in?

   Various answers

5. At the end of June, your return on equity was $ __________

   17.33% average

6. At the end of June, your return on assets was $

   1.55% average

7. At the end of June, your average loan to deposit ratio with public funds was

   81.73% average

8. At the end of June, your average loan to deposit ratio without public funds was

   87.82 % average

9. What percent of your loan portfolio is placed with New Mexico borrowers?

93% average

10. What percentage of your investment portfolio is invested in New Mexico securities?

19.80 % average

11. What percentage of your total portfolio would qualify as collateral against state funds?

75 % average

12. Do you presently hold any state deposits?

75% Yes
25% No
Amount average 6.24 million

13. Do you presently hold any local public fund deposits?

86% Yes
14% No
Amount average 26.9 million

14. What percent of your total deposits do total state monies represent? __________

3% average (not weighted)

15. What percent of your total deposits do total local public funds represent?

11.41% average (not weighted)

16. What percent of your total deposits do severance tax funds represent?

0% for all respondents

17. What percent of your total deposits do general fund revenues represent?

0.7 average (not weighted)

18. Is your organization a participant in the state's overnight investment program?

0% Yes
100% No

19. Has the recent withdrawal of general fund revenues from New Mexico financial institutions affected your institution?

33% Yes
67% No

20. Do you presently match the term of your deposits with assets of a similar term?

55% Not at all
9% 0-5%
12% 26-50%
12% 51-75%
12% more than 75%

21. Given your experience, what has been the stability of state deposits compared to other types of deposits you receive?

52% less stable
36% equally stable
12% more stable

22. What original term to maturity do you prefer for state monies?

45% less than one year
45% 1-2 years
6% 2-3 years
0% 3-4 years
4% 4-5 years
0% 5-10 years
0% 10+ years

23. What is the approximate average original term to maturity of state monies that you presently hold?

less than one year	Less than 1 year	1 Year
less than one year	9 mos	1 year
Demand Deposits only	less than 1 year	12 months
1-2 years	Less than one year	less than one year
1-2 years	one year	less than one year
1-2 years	6 months to 1 year	6 months

24. What is the distribution of securities you presently use as collateral for state monies?

100 % state Municipals
FNMA 20% NM Munis 80%
Insured portion of SBA Debentures, 100%
Federal Home Loan Securities 30% FNMA 29% GNMA 41%
Federal Home Loan Securities 2% FNMA 93% GNMA 5%
Federal Home Loan Securities 8.88% FNMA 90.35% GNMA 0.77%

We primarily utilize New Mexico municipal securities, maturities vary 1 -20 years.
U.S. treasury- 100%
100% MBS
9.6% - Federal Home Loan Securities 90.4% - In-State Municipals
Federal Home Loan Securities 54.1 Federal Nat'l Mortgage Assn 26.8% GNMA 2.1% Securities of the State of New Mexico 17.1%
.40% in form of securities $1,000,000 in form of Standby Letter of Credit from FHLB
Treasury-32.92%, FNMA-13.56%, GNMA-20.60%,In-state 32.92%
FNMA
75% agencies, 25% in-state municipals
FHLB Securities 100%
100% FNMA MBS
covered by FDIC
FDIC
We use FHLB letter of credit, not securities

25. What is the approximate allocation of uncollateralized state funds by your institution? (averages reported below)

Use	Percent
Agricultural Loans	5.33
Commercial Property Loans	50.00
Other Commercial Loans	15.00
Residential Property Loans	28.33
Consumer Loans	10.00
U.S. Treasury Bonds	15.00
U.S. Treasury Bills	0.00
Other	8.50

Please specify what “other” includes: “securities, other”

26. What is your target spread over cost of funds?

3.92% (average)

27. What percentage of state deposits are used to make loans that you would not have been able to make without access to state monies?

56.5 % average

28. Given the loans you would not be able to make because of a decrease in state monies what % do you believe would be made by another institution?

18 % average

29. Please rank, in order of importance, sources of loanable funds that are available to your institution.

Demand Deposits Money market CD

1. Demand and Time under 100 2. MMkt 3. CD 4. FHLB 5. Fed Funds 6. Brokered CD

Demand and time deposits under $100,000 Money Market and variable rate certificates Certificates of Deposits Repurchase Agreements FHLB Advances Brokered CD's Federal Funds

demand and time under $100,000 "1" Money Market and variable rate certificates "2" Certificates of deposits "3" Federal Funds "4" FHLB Advances "5"

Demand & Time under 100,000 "1" Money market and variable rate certificates "2" Certificates of deposit "3" Federal Funds "4" FHLB Advances "5"

Demand and time deposits under $100,000 "1" Money market and variable rate certificates "2" Certificates of deposits "3" Federal Funds "4" FHLB advances "5"

1) DDA and time deposits under $110M; 2)Certificates of deposits over $100M; 3) Brokered CDs 4) FHLB advances; 5) Retail repourchase agreements

DEMAND DEPOSITS CD'S SAVINGS / MONEY MARKET REPURCHASE AGREEMENTS FHLB ADVANCES BROKERED CD'S

Demand and time deposits under $100,000 Money market and variable rate certificates Certificates of Deposits Federal Funds FHLB Advances Brokered CDs

dda,savings,mma,cd's,fhlb advance

Retail Deposits FHLB advances/ other borrowings Brokered Deposits Public funds

1 - Demand and time deposits under $100,000 2 - Certificates of Deposit 3 - Money Market and variable rate certificates 4 - FHLB Advances 5 - Federal Funds 6 - Brokered CD's N/A - Repurchase agreements N/A - Other Borrowings N/A - Capital Notes N/A - Other

Certificates of deposits; 1 Money market and variable rate certificates; 2 Demand and time deposits under $100,000; 3 Federal funds; 4 FHLB Advances; 5

Demand 1 Money Mkt 2 CD's 3 Fed funds 4 FHLB Adv 5

Borrow from Federal Home Loan Bank

1-Demand and time deposits, 2 MM, 3 CD, 4 Repurchase, 5 Fed Funds Purchased, 6 FHLB Advances, 7 Other borrowings, 8 Captial Notes, 9 brokered CDS

Demand & Time Deposits under $100,000, Money market and variable rate certificates, Certificates of Deposit, Federal Funds,FHLB Advances, Repurchase agreements, Capital notes, Brokered CDs', Other Borrowings

Demand deposits, Money market,Certificates of deposit, FHLB advances

Certificates of Deposit Demand & Time Deposits under $100,000 Money market and variable rate cd

Demand/time deposits < 100000 CD's FHLB advances MMDA

demand deposits, money markets, CD's

General core deposit base

Deposits from the community State Treasurer deposits Local municipal deposits CDARS/Brokered Deposits FHLB Advances
Demand and time deposits under $100,000; Money market and variable rate certificates; Certificates of deposits; Repurchase agreements; FHLB advances; Federal Funds; Other borrowings; capital notes; brokered CDs
Demand & Time under $100,000 50% MMA 10% CDs 25% Fed funds 10% other Non-Brokered Institution CDs 5%
Depositors (local) Public funds - Not State, i.e. County and Schools State Funds FHLB Advances Fed Fund Lines Brokered Funds (although we have never used

30. If state funds were no longer available, would you be able to easily replace them from the above sources? Yes _____ No _____

52% Yes
48% No

31. Are state deposits more _____ or less _____ costly to administer compared to private funds? By how much?

48% More: Basis points 22.7 (average)
32% Less: Basis points 37.5 (average)
20% No difference

32. Are local public fund deposits more _____ or less _____ costly to administer compared to private funds? By how much?

52% More: Basis points 25.125 (average)
20% Less: Basis points 50 (average)
28% No difference

33. If there is a difference, please explain.

Local Funds require significantly more interaction and education of local officials.
state plays wall street game
Time consumming/ low stste rates
Want preferred rate, need collateral for pledging
cost of collateral
Public Fund rates are too high
Municipal deposits come in larger blocks than consumer deposit and they are not transaction accounts so there is little administrative cost.
reporting requirements
The state has deposits in $5 mm or $10 mm increments. To replace that much deposits with customer deposits would require a much higher volume, therefore, increasing the cost. There is a costs for using Letters of Credit rather than securities, which is approx 12 basis points but allows us to use those funds to

make loans rather than purchasing securities to collateralize to the public units and only being able to loan a portion (50% per state regs). The Letters of credit allows us to loan out 100% of state funds.

34. Are the interest rates on state funds higher _____ or lower _____ compared to funds from other sources? By how much?

37.5% Higher: Basis points _50 (average)
37.5% Lower: Basis points _35(average
25% No difference

35. Do you think state deposits at New Mexico financial institutions should be collateralized?

77% Yes
23% No

36. If yes, by how much?

82% of respondents said 50%
18% of respondents said according to existing formula

37. Do you think the current collateralization policy is reasonable?

73% Yes
27% No

38. Would you be opposed to a 100% collateralization policy?

81% Yes
19% No

39. If there was a 100% collateralization policy, would you still ask for deposits of state monies?

70% No
15% Yes, but smaller amount
15% Yes, the same amount

40. If yes, but smaller amount, by how much?

Average 41%

41. Are you satisfied with the list of assets that can be used as collateral?

96% Yes
4% No

42. Does the present list of collateral provide for the safety of state funds?

30% less than adequately
43% adequately
27% more than adequately

43. Does the collateral requirement limit the return your institution earns on state monies?

54% Yes
46% No

44. If yes, by how many basis points? _____

Average response 25.50%

45. Should the list of assets that can be used as collateral be expanded?

30% Yes
70% No

46. If yes, list the assets you think could be added.

Responses:
- All Investments - All Loans
Guaranteed Portion of SBA, FSA & USDA loans
Letters of Credit from Qualified Banks.

47. By how much would this expanded list allow you to increase the return you earn on state monies?

Basis points _____ 4 responses (100,100,100,150-200)
No difference _____6 no difference

48. Do you participate in the CDARS (Certificate of Deposit Account Registry Service)?

22% Yes
78% No

49. Are you satisfied with the present allocation of state monies among financial institutions in the state?

38% Yes
62% No

50. If no, explain.

I don't see the need to invest any 4 outside the state.
The total distribution of state deposits is heavily weighted toward larger financial institutions, some of whom have minimal investment or lending relationships within the state. State deposits to local institutions have significantly declined over the last 20 years, and frankly, this redistribution of state moneys out of rural NM corresponds with a lack of economic development outside of the Rio Grande corridor.
Don't actually know how it is destributed.We have not been willing to pay the rate requested for State time money due to a low loan to deposit ratio.
Currently the process has forced institutions to lose these funds due to the bidding process recently implemented.
Would like to see more allocated to local FI's
Allocate to financial institutions predominately domiciled and headquartered in-state.
No monies allocated to banks.
Community banks lending in NM should have a higher allocation
No knowledge of state money allocation
Shift was made to bid process, taking us out of the market.
Don't know what it is.
most funds are going out of state and the ones that stay the distribution is unkown
not sure of the allocation. we have not had a liquidity issue in several years
Economic Development Factor
The state took out $10 million 3 months ago stating cash flow issues, however, after meeting with them it became evident that they changed there investment strategy to put their money on the street, where from the news appears they lost heavily. Putting state funds on the street may potetially increase the state's revenue, however, the effect of limitations placed on banks causes less availability of money to lend to the local community. Additionally, the state seemed to indicate their decision might be influenced by a NM bank having very bad financial press and seeing a need to change strategy. The state is happy with our institution and would like to place more funds with us but are restricted in certain funds by our institution not having a rating. Ratings are very expensive and not cost effective for just the state. Most communuity banks in New Mexico cannot obtain these ratings due to cost. This policy limits the State to large national banks (i.e. Wells and Bank of America) and maybe 1-3 that might have ratings.

51. Should the state review its policy concerning the maximum amounts that can be deposited within a financial institution?

77%	Yes
23%	No

52. Would you favor the allocation of state funds by an in-state bidding process?

29% Yes
71% No

53. Would an in-state bidding process increase the cost of funds to your institution?

72% Yes
28% No

54. By how many basis points? _____

Written Comments

Unknown since we have not used State funding
100+
Not sure
don't know
25 - 100 bp's
100+
.50 to 100
unknown
Don't know
unknown
?
50 – 100
Unknown, depends how valuable they are to banks in trouble

55. What type of redistribution do you believe would take place if an in-state bidding system were instituted? (Check all those you think appropriate.)

6% No redistribution
44% small institution to large institution
13% large institution to small institution
3% banks to savings and loans
0% savings and loans to banks
31% small city institution to large city institution
3% large city institution to small city Institution

Other :
Less risk adverse to more risk adverse institution
More risky instit. would bid higher for the money> risk to state
Unknown
redistribution would be desparate first to econ sound - NOT GOOD

56. Would an in-state bidding system increase the risk to the state?

42% Yes
58% No

57. If an in-state bidding system were introduced, and assuming that smaller institutions would be placed at a disadvantage, should there be a non-competitive allocation mechanism for smaller institutions?

80%	Yes
20%	No

58. Assuming that the state is either going to go to an in-state bidding system or arbitrarily increase the rates paid by financial institutions, which would you prefer they do?

42%	bidding system
58%	increase rates

59. If the state increased the required yield over the T-Bill rate, would this decrease the amount of public funds you would request?

70%	Yes
30%	No

60. If yes, by what amount?

(9 responses gave actual percents)

3 drop out at anything over T-Bill Rate 0-25
1 reduces 50% when rates increase 25-50; 51-75 reduces 75%; drops out 76-
3 reduces 50% when rates increase 76-100; drops out 101-
1 reduces 50% when rates increase 51-75; 76-100 reduces 75%; drops out 101-
1 reduces 25% when rates increase 76-100;101-125 reduces 50%;126-150 reduces 75%;drops out 151-

Written Comments

Unknow as we have not recently utilized State Deposits, however, any increase would make State Deposits less attractive relative other sources of funding.
don't know
unknown
DEPENDS ON MARKET RATES
Is this an old survey, they already did 4 months ago!!!!! They have clearly stated they cannot accept treasury and ask institutions to give their bid. Our institution has given them our straight customer rate and offered slightly lower rates if they want 105% collateralization, which is the requirement if you are not rated.

61. Should the state and local governments be required to deposit a certain percentage or dollar amount of public funds in New Mexico headquartered institutions?

96% Yes
4% No

62. Is the state's requirement that interest be paid monthly a problem for your institution?

21% Unreasonable or major problem
3% Unreasonable and somewhat of a problem
0% Unreasonable but no problem
9% A problem but reasonable
67% No problem and reasonable

63. Is the state's requirement that certificates of deposit be issued with a daily "call" option a problem for your institution?

60% Unreasonable or major problem
28% Unreasonable and somewhat of a problem
6% Unreasonable but no problem
6% A problem but reasonable
0% No problem and reasonable

64. Does a daily "call" option increase the risk to your institution?
93% Yes
7% No

65. If yes, how?

Unstable source of funds and does not meet the definition of a time deposit
Significantly increases liquidity risk and subjects the bank to potential, unanticipated shocks to our deposit base. In addition, the call option is not priced to market, and increases the interest rate risk to our institution.
Loss of money unexpectedly could cause a liquidity issue.
Can effect the funds available for daily lending.
If there is a daily call the deposits is effectively a demand deposit and should be priced accordingly, not as a time deposit.
Option Risk is one of the major risk components.
If the funds were called it would put us into a borrowing position and increase our interest rate risk.
it's called interest rate risk
We match assets to liabilities - it would create additional unreasonable risk to the FI
Interest Rate Risk, Liquidity Risk

May not be able to fund loans, Could force a recall of loans to meet lost of funds.
Great damage to bank's reputation.
Cannot rely on funds for match funding
liquidity concerns
This could and will put a drastic liquidity strain on many institutions. As the war for deposits heats up this "callable" option will sure cause a lot of worry on the banker's side and will certainly be a point of contention between them and their regulators as to proper liquidity management.
Very difficult to match assets and liabilities
Because its not available
no confidence to use for loans
By increasing our liquidity risk
Matching assets are purchased or funded which may not be immediately liquidated to fund a call.
Planning Uncertainty
Those funds must be treated as "hot" money for regulator analysis, meaning that in any interest rate planning or liquidity planning we must always assume those deposits could leave at any time. This obviously increases risk for any institution trying to adeqately manage assets and liability durations when trying manage interest rate risk

66. Are the quarterly collateral reports creating a problem for your institution?

18%	Unreasonable or major problem
3%	Unreasonable and somewhat of a problem
3%	Unreasonable but no problem
12%	A problem but reasonable
64%	No problem and reasonable

67. Do you believe that financial institutions should invest state or local public funds at a break even position, i.e., with no spread? The reason being that you are providing a service to the community and that through the multiplier effect you would in time likely experience an increase in deposits?

4%	Yes
96%	No

68. Do you treat state or local public funds in any special way?

33%	Yes
67%	No

69. If yes, explain

We insure that public funds are reinvested into local projects.
Because of the required pledge of securities.
Funds have to be collateralized and the reporting requirements
collateral tracking
Only through the collateralization process.
rate concession
Yes. They obvisouly have more needs than the common depositor. First all require collateral and a monthly collateral analysis. They also require much more monitoring as 1 small depositor taking their funds out of the bank has a small affect, but public deposits can leave at any time and can be much larger amounts.

70. Have you been asked to increase collateralization that your institution uses for state funds?

94% No change
6% Changed
0% Will change

71. If there has been or will be a change, please explain.

Based on existing rules of Non-performing to capital
The last quarter of 2008 I was told I had to bid for the state funds I wanted and required to up the collateralization from 50% to 100% on the new funds.

72. Do you believe a self-insuring collateralization program would be a reasonable program to pursue in New Mexico?

41% Yes
59% No

73. Do you understand the statutes relating to the state's public funds investment program?

24% Not at all
52% Somewhat Adequately
18% More than adequately
6% Complete understanding

74. Do you believe the State Investment Council and the Investment Officer handle the investment of funds efficiently?

38 % Very inefficiently
17% Inefficiently
28% Somewhat efficiently
13 % Efficiently
4 % Very efficiently

75. Do you believe the State Treasurer's Office handles the investment of state funds efficiently?

75% Very inefficiently
9% Inefficiently
16% Somewhat efficiently
0% Efficiently
0% Very efficiently

76. Do you believe that the state's public funds investment policies have achieved a proper balance between the two concerns of

a.) maximizing the rate of return, and
b.) investing for the economic benefit of the state?

76% Heavily weighted in favor of rate of return
9% Somewhat weighted in favor of rate of return
15% Reasonably balanced
0% Somewhat weighted in favor of economic development
0% Heavily weighted in favor of economic development

77. Do you believe that it would be in the state's interest to go to all U.S. Treasuries?

8% Yes
92% No

Explain:

<u>Those with a yes response:</u>

<u>Those with a no response:</u>

State funds should be invested back into the state through deposits to NM banks who invest in the communities they serve, and thus create more jobs, and opportunities for New Mexicans .
There is no economic, multiplier effect from US Treasury investments. New Mexico generated funds should be prioritized to reinvest in our state, not New York - Minnesota - California, etc.

Reduced yield for the State
The State should have various investment options, mindful of the risk to return, not for investment firms ho care nothing about New Mexico.
Not is the State's best interest. Look at current situation the State can get a significantly better return with marginally increase risk by not buying U.S. Treasuries, which are at all time low rates due to market fear and dislocations.
No real benefit to state financial institutions. Under current market conditions, revenue to the state would decline.
We would lose the economic benefit of funds invested locally.
It would greatly decrease the state's return on assets
No economic development would be achieved.
Over the long haul, U.S. Treasuries will yield a much smaller rate of return to the state. Not wise investing.
multiplier effect would be lost in NM and these funds are a major source of economic development
This is certainly the safest option, however there is enough safety built into other options that have a greater rate of return.
state funds need to be held in state
Community banks benefit from reinvesting the tax payers money into the local NM economies
Investment in a treasury security results in no reinvestment or economic stimulus in New Mexico.
Take money away from State financial institutions
Treasury rates are too low right now and limit the state's return on investment.
The state should do what any prudent investor does and diversify its investment, however, priority should be placed on the economic benefits from making investments in New Mexico, where risk might be higher, (still less than on the street), but the benefits from providing banks with money to lend allows businesses and individuals to spend their money, and in turn helps create jobs and contribute to the New Mexico economy, which should ALWAYS be more important than return, which in this example, would also bring a higher return as well. Investing in treasuries has an indirect effect on NM economy, while investing in New Mexico may help overall increase that state economy which is the source of revenue anyway.

78. Do you believe that it would be in the state’s interest to go to a bidding system?

23%	Yes
70%	No
7%	unsure

Explain:

Those with a yes response:

This would allow all banks the opportunity to participate

More competition.
A bidding system will cause the State to get a better return from financial institutions within the State.

Those with a no response:

Generally, weaker financial institutions who have decreased access to capital bid more for the deposits - and these institutions are subject to significantly greater risk in the long term.
The weakest and strongest would prevail and make the market more unstable.
would add unncecessary costs.
Puts the smaller/rural institutions at a competitive disadvantage.
Larger institutions would be given a competitive advantage.
Impossible to make it work efficiently. System response would be too slow for effective management of the bank' financial statement.
I believe this will create frustration and resentment between not only the state and particular institutions, but also potentially between institutions.
increases cost of funds
The benefits derived from a deposit in a New Mexico bank cannot be simply quantified by the interest rate earned by the state. The economic impact of loans funded to New Mexico consumers and business have a leveraging effect.
As mentioned above, here is the problem with a bidding system. As an example a few months ago a bank/thrift was offering a 4% CD. Very alluring to customer, when everyone else was below 3%. However, when we looked up the bank's financial they has over 150% loan to deposit ratio and for lack of better words needed deposits desparately. One could borrow from FHLB at the time for less that 2%. A bidding system would allow those banks that might be in trouble to make unreasonable bids that sound banks cannot and should not compete with. A bank must evaluate the costs of funds, i.e. deposits and borrowings. A bank can typically borrow from FHLB for less, unless their are other reasons. In a better economic environment, say a couple years ago a bidding system would probably work fine, but as an example look at Country Wide's CD rates before it failed, they would have won a CD bid, but their rates were high because of desperation, not a sound business decision. Basically, such a method would reward potentially failing institutions while punishing financially sound institutions.

Those with unsure response:

return yes-risk no
If out of state main banks bid - I do not see the process to be better for the state. It may give them a higher return but provide no benefit to the people who's money is being invested.

79. Do you believe that it would be in the states' best interest to require 100% collateralization?

77% Responded Yes
23% Responded No

Explain:

Those with a yes response:

There would be no risk to the state.
for obvious reasons to completely mitigate risk, but we do not believe it is necessary. The investments that the state has the most risk is NOT FI deposits.
There have been some losses at the state level unfortunately because of an excessively weak economy and extraordinary circumstances and I believe the state should require 100% as good stewards of the public monies. I believe pledging at 100% puts a strain on my institution and others, but we recognize the reasonable need for it.

Those with a no response:

New Mexico banks are statistically some of the strongest in the nation, and by increasing the collateralization simply means that none of the state's deposits would be lent locally in the communities served by the banks.
No advantage to the money if you have to have 100% collateral.
Collateralization should be based on the individual institution's financial stability
It may be in the States best interest if it does not eliminate participation by the banks. We absolutely would not participate with a 100% collateral requirement.
Only if an institution becomes "troubled".
Not necessary. Unfair burden as not all funds are 100% guaranteed. Limits return to the state.
no, not for well capitalized instate institutions
Would not provide funds for economic development.
Would foce a decrease in small banks' earnings, and ability to make loans.
would not want deposits
Only for banks that have weak camel rating
This limits leverage/economic impact.
There would be a problem meeting collateralization for ALL banks
No, that is unreasonable, since banks would not be able to loan out any of the money. They would just use the money to puchase securities and lending capacity would not increase what so ever. Using letters of credit would help, however, no all entities use them.

80. Do you believe that it would be in the state's best interest to arbitrarily require 25 to 50 basis points above the time equivalent T-Bill rate from state institutions for state funds?

35% responded Yes
65% responded NO

Explain:

Those with a yes response:

25 bp is a reasonable risk premium for the deposits.
They would make more money, but we would not take any.
again, obvious reasons
25 b.p.
Only if ALL funds were kept in State Financial Institutions
This compensates the state for the risk above a treasury.
Maybe, sometime it is sometimes, not

Those with a no response:

Again, local banks might not use the fund
Many banks do not use T-Bill rates as an index
Nothing arbitrary is good.
Would increase cost of funds to banks & restrict loans.
increases cost of funds
not competitive

81. Should the allocation of state funds be used as a key vehicle to foster regional economic development throughout the state?

85 % responded yes
15% responded no.

Explain:

Those with a yes response:

Funds deposited would be loaned back into the regional economy and promote opportunities.
New Mexico generated funds should be prioritized to reinvest in our state. Our state's citizens receive minimal benefit from funds that are invested outside of our communities. Locally created jobs, and the tax base that comes with them, benefits the state through greater overall state revenues, decreased healthcare and social costs, etc. Simply, reinvesting our money in NM is the smartest way to generate the greatest overall return to our citizens.
If a local area needs the liquidity to fund projects that create jobs it would be a good thing.

State funds at a known rate will provide a platform for economic development lending. The SBA 90-10 program through the Severance Tax Fund grew to $100mm or more before the State Investment Officer raised the rates to his idea of a market rate and killed the program with the advent of the Federal Home Loan Bank membership providing liquidity, the industry has kinda quit fighting the Treasurer and State Investment Officer allowing State funds to take a back seat.
to an extent - it cannot be tied 100%
It opens access throughout the state.
more funds available for development loans
allow funds to be used in community development projects
PROVIDE FUNDING
Banks have the ability to be a key economic driver that no other investment have the ability to achieve.
Absolutely, gross revenues are based on economic activity in the state. Investing monies in the state helps increase available funds for economic development while increasing the State's tax base.

Those with a no response:

smaller population areas would probably suffer.
Impossible to administer and/or enforce. Just check the Federal' s ability to do so under the TARP
Again, it would hurt smaller institutions and possibly their local economy eventually if the monies were directly to seemingly "hot" economic activity spots.
To foster perceived economic development in targeted areas of the state would be at best an arbitrary decision and at worst a political manuever.

Appendix C

Summary of Changes in the Financial Market since 1986

The Federal Reserve's initial involvement in the protection of consumers largely involved ensuring that banks were safe and sound. That changed in 1968 when Congress passed the Consumer Credit Protection Act. Under the act's "Truth in Lending" provisions, the Fed issued new regulations that require lenders to provide information about credit terms and to express the cost of credit as an annual percentage rate (APR). Other consumer laws and regulations followed, including the Equal Credit Opportunity Act. In 1977, the Community Reinvestment Act (CRA) encouraged banks to meet the credit needs of the entire communities in which they are located and required the Fed and other banking agencies to review banks' lending patterns. The Fed rates banks on their CRA performance, taking into account their lending to low- and moderate-income individuals and neighborhoods.

Since the 1970s, financial market innovations and competition have spurred state legislatures, Congress, and federal bank regulators to ease Depression-era restrictions on banks. Both banks and their holding companies were gradually allowed to increase their range of financial products, pay market interest rates on most deposits, and expand across state lines.

The banking crisis of the 1980's is a crucial part of this analysis. From 1980 through 1994, over 2900 banks and S&L's failed. 1,617 banks with total assets of 302.6 billion and 1,295 S&L's with total assets of 621 billion were among those that failed. On average, a bank or S&L failed every 15 days, and about one out of every six banks of S&L's (holding over 20% of the assets of the system) was closed or required government assistance. The crisis was caused by changes in the market environment, and looser regulations that gave S&L's more competitive options. Also, the banking industry was partially deregulated in the early 1980's. S&L's had mostly been restricted to home mortgage lending before, but now they were allowed to invest in commercial real estate and consumer loans. They were also allowed to invest in junk bonds and common stocks. As a result of the financial innovations in the 1960's and 1970's, banks and S&L's faced more competition from other financial firms. New kinds of financial assets made it possible for investors to take on more risk. Also, the financial market environment was more complicated and harder for regulators to monitor. As a result, S&L's held more risky assets, resulting in huge loan losses. Regulators and S&L management had little experience in monitoring these new risks.

In 1989 the government created the Resolution Trust Corporation to handle S&L's that were failing. The RTC took over assets of failing S&L's and sold them to recover as much of their value as possible, and issued bonds to fund the costs of covering S&L losses. Restrictions on assets holdings by S&L's were reinstated and they were required to raise their capital/asset ratios. Regulators hoped the crisis would pass quickly and they wanted to encourage the growth of the S&L industry rather than allow it to fail.

Since the 1980s, consumers have increasingly turned to debit cards, electronic fund transfers, and banking on home computers. Under the Electronic Fund Transfer Act, the Fed established new regulations that defined the rights and responsibilities of all parties and increased the level of consumer protection.

This trend toward deregulation culminated in 1999 when Congress reversed the Glass-Steagall Act separating banks from securities firms and insurance companies. Now banks can combine with these financial services firms in “financial holding companies.” Congress deregulated banking in three key ways:

- Interest rate deregulation: The Depository Institutions Deregulation and Monetary Control Act (1980) phased out restrictions on banks’ ability to pay interest on deposits.
- Geographic deregulation: The Riegle- Neal Interstate Banking and Branching Efficiency Act (1994) provided a framework that permitted interstate banking and branching as of 1997 but allowed states some flexibility in its implementation.
- Product deregulation: The Financial Modernization Act (1999), also called the Gramm-Leach- Bliley Act, repealed the prohibition against combining commercial banking, investment banking, and many insurance activities in the same organization.

In banking, the term geography refers to the area in which banking activities are allowed to take place, such as interstate banking, and intrastate and interstate branching. While even banking experts often confuse the terms, they have distinctly different meanings.

***Intra*state Branching**

Intrastate branching refers to branching within a particular state. Allowing banks to open more than one office or branch originated at the state level, and the states have directed the expansion of banks' geographic boundaries. Earlier in this century, few banks had more than one office. Today, most banks can open branches throughout their respective states.

A great majority of our 50 states allow statewide branching, and other states allow limited branching. Many banks have expanded their branch network to better meet the needs and convenience of their customers.

The 1927 McFadden Act sought to give national banks competitive equality with state-chartered banks by letting national banks branch to the extent permitted by state law. The McFadden Act specifically prohibited intrastate branching by allowing a national bank to branch only within the city in which it is situated. Although the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 repealed this provision of the McFadden Act, it specified that state law continues to control intrastate branching, or branching within a state's borders, for both state and national banks.

Of note, there are approximately 9,500 savings and loan branches that, because of preemptive authority in the law establishing the thrift charter, are subject to neither intrastate nor interstate branching restrictions. This preemptive authority was intended to foster a national market for home mortgages.

***Inter*state Banking**

Interstate banking refers to the ability of a bank holding company to own and operate banks in more than one state. Under the Douglas Amendment to the Bank Holding Company Act of 1956, states controlled whether, and under what circumstances, out-of-state bank holding companies could own and operate banks within their borders.

The need for the Douglas Amendment grew from the concern that bank holding companies were evading the McFadden Act and state branching laws by acquiring numerous subsidiary banks in various states, and then operating these banks as if they were branches. The development of these interstate bank networks was a significant factor leading to Congress' passage of the Bank Holding Company Act of 1956. Senator Douglas emphasized that a primary purpose of his amendment was "to prevent an undue concentration of banking and financial power, and instead keep the private control of credit diffused as much as possible."

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 repealed the Douglas Amendment. On September 29, 1995, federal law allowed full nationwide banking across the country, regardless of state law. Another provision of the Riegle-Neal Act allows affiliate banks within bank holding companies to effectively act as branches for each other, accepting deposits, collecting payments, and providing other customer services.

Interstate banking has resulted in increased consolidation and concentration in the banking industry. While the United States had 14,399 banks in 1940, the country has fewer than 9,000 banks today. However, while consolidation among banks has certainly been the trend, the number of branches in the U.S. has steadily increased. In other words, consumers have more banking outlets than ever in our country's history.

***Inter*state Branching**

Interstate branching means that a single bank may operate branches in more than one state without requiring separate capital and corporate structures for each state. The state of New York approved the first interstate branching statute in 1992. This law set several requirements and conditions on New York branches of out-of-state banks. It also required reciprocity; that New York banks were allowed to branch into the home states of banks that branch into New York. Other states passed similar laws.

The 1994 Riegle-Neal Interstate Banking and Branching Efficiency Act allowed national banks to operate branches across state lines after June 1, 1997. This federal law allows branching through acquisition only, which means that a bank must acquire another bank and merge the two structures in order to operate branches across state lines.

The Riegle-Neal Act allowed states to "opt-out" of interstate branching by passing a law to prohibit it before June 1, 1997. A state that "opted-out" of interstate branching prevented both state and national banks from branching into or out of its borders. Texas and Montana were the only states to "opt-out" of interstate branching.

States also have the power to authorize "de novo" branching across state lines, which would allow a bank to simply open a new branch in another state instead of having to acquire an entire bank. Several states have decided to allow de novo branching; however, most of them have done so on a reciprocal basis.

In 1997, the Riegle-Neal Amendments Act was signed into law ratifying an agreement between the states, the FDIC and the Federal Reserve allowing "seamless" supervision for state-chartered banks that branch across state lines.

In 1994, four banks; Sunwest Bank of Albuquerque, First Security Bank of NM, United NM Bank, and Bank of America, held 35% of the market share in terms of deposits, and only one bank, the Centennial Savings Bank, had offices and deposits outside the state of New Mexico. Currently, as of June 30, 2008, only two banks, Wells Fargo and Bank of America, hold about 37% of the market share in terms of deposits. Also, 15 banks currently have offices and hold deposits in the amount of $994,112,931 outside the state of New Mexico.

Year	# of Institutions in the Market	# of offices outside the Market	Deposits $$$ outside the market[1]	# of offices inside the Market	Deposits $$$ inside the Market[1]	Market share of top 3 banks
1994	93	6	157,979	448	12,104,317	30.08%
1996	80	1,619	70,683,559	487	12,722,688	36.02%
1998	72	5,428	310,527,576	507	13,891,657	39.99%
2000	66	4,834	314,379,662	499	14,079,302	45.62%
2002	68	5,141	362,652,515	480	15,496,260	44.26%
2004	67	8,103	690,200,790	490	18,172,242	44.68%
2006	64	10,065	916,179,103	498	20,930,166	45.75%
2008	65	10,503	994,112,931	512	22,304,646	44.85%

The consolidated table above shows many of the changes that resulted from the 1994 Riegle-Neal Interstate Banking and Branching Efficiency Act. When the original study was completed in 1986, interstate banking and branching was not permitted. This

[1] Deposits in thousands of dollars

explains why there were many more banks in New Mexico than there are today, and why there were no banks that held offices outside the state of New Mexico. By 1994, there were still 93 institutions in this state and only 6 banks held offices outside the market. Because there were so many banks, no one bank held the majority of the market share in terms of deposits. But because consumers only had access to the resources that were available here in New Mexico, the dollar amount of deposits inside the market was relatively low at around twelve million.

By 1998, a year after the Riegle-Neal Act had been signed into law, the market structure of the banking industry had changed dramatically. The number of institutions had fallen from 93 in 1994 to 72, and the number of banks holding offices outside the market rose from only 6 to 5,428. This brought the dollar amount of deposits outside the market to over 700 million dollars. As a result of interstate banking and branching, several banks grew in size and began to take over more of the market share. Four years earlier in 1994, the top three banks held a combined 30% of the market share, but by 1998, the top three banks held almost 40% of the market share.

The Financial Modernization Act of 1999, also called the Gramm-Leach- Bliley Act, repealed the prohibition against combining commercial banking, investment banking, and many insurance activities in the same organization. This led to even more changes for the newly deregulated banking industry. The number of banks by the year 2000 had continued to fall in New Mexico from 72 two years earlier to only 66. The banks that had been growing continued to gain more of the market share, and by this point, the top 3 banks held over 45% of the market share. Deposits outside the market had grown to over 314 million dollars, and deposits inside the market had grown to a little over 14 million dollars.

The interest rate, geographic, and product deregulation that had recently taken place in the late 1990’s has caused the banking industry to grow and changed in many dramatic ways. It seemed that consumers now had more variety when choosing who to bank with and who to receive a loan from, and therefore the total deposits inside and outside the market have continued to grow rapidly, and the structure of the market share held by certain banks has been affected. By 2008, there are currently 65 institutions in the state of New Mexico and there are over 22 million dollars in deposits made inside the market. There are currently 10,503 banks that hold offices outside the market, and they accumulate over 994 million dollars in deposits. In terms of market share, there are two banking giants, Wells Fargo and Bank of America that hold almost 40% of the market share between the two of them.

Since 1986, when the original study was completed, many things have changed in the banking industry, especially the market share of individual banks in terms of deposits, and in terms of the number of institutions that have offices outside the state of New Mexico.

It seems that the structure of the banking industry is changing and expanding in new ways that may allow individuals and businesses to have access to loans that they may have been denied in the 1980’s. But with the current financial situation, banking institutions are failing and individuals, including those with good credit, have not been granted loans because of the credit crisis involving sub-prime loans.