Alliance for Local Economic Prosperity

Keeping Our Public Funds Safe, Local and Working

PUBLIC BANK OF NEW MEXICO
FREQUENTLY ASKED QUESTIONS 2.0

Of the $50M investment request to capitalize the Public Bank of New Mexico, how much of that represents start-up costs?

- The start-up costs to make the bank fully operational in the first year, will initially be drawn to support salaries and office space from the $50M provided by appropriation to capitalize the Public Bank of New Mexico (PBNM). By the end of year two the bank's $50M equity, based on AFLEP's moderately conservative Pro-Forma will be fully restored and it will increase thereafter based on year to year retained earnings. By year seven, PBNM's Equity is projected to be $113M -- more than double the original $50M capitalization.

What percent of the funds can be loaned out?

- The "funds," meaning the $50M cannot be loaned out. State and Federal banking regulations and Basel III, an international banking standard, require that banks have a sufficient liquid reserve to be drawn on in the event there is a net loss caused by the bank's annual operational costs and/or loan defaults that exceed annual income. Federal and State banking oversight will also require that an adequate reserve be in place each year.

What are the risks of losing money with the PBNM?

- Risk is a critical question that deserves a thorough and thoughtful response.
  Assuming the bank has a competent board and officers that adhere to Federal and State regulations, the bank's risk of losing the State's capital investment is virtually zero. While any loan entails a degree of risk, the public bank, in pursuit of stimulating local economies without expending any public funds, would mitigate or reduce its vulnerability to fiduciary and lending risks as follows:

  1) External Standards & Requirements: The PBNM will be a state-chartered bank subject to federal and state banking laws, regulations, and oversight, including the FDIC. Accordingly, it will be audited for risk and impropriety on a regular basis by regulatory auditors, including the State Auditor and be subject to annual, independent, private-sector audit. Its annual financial reports and the independent audits will be

permanently available for public scrutiny. These legal and chartered bank regulatory requirements and oversight are more rigorous and extensive than what is now required of the state's existing financial system.

2) Internal Bank Structure: The bank would be governed by a qualified Board of Directors and operated by experienced, professional bankers. The Chief Executive (CEO) and Chief Risk Officer (CRO) would each report directly to the board.

3) Greater Loan Viability Due to Lower Interest Rates: Loans to new businesses are generally not even considered by small commercial banks because of their higher risk. Those few new businesses that do get loans from private banks are burdened with higher interest rates or variable rates, to compensate for the bank's higher risk; effectively making the risk even greater.

   In concert with the PBNM, however, a community bank or credit union could viably lend at lower than the high-risk rate. This is made possible because the PBNM can offer a lower interest rate on its portion of a participatory loan. This in turn lowers risk to all three entities involved -- the borrower, the participating private financial institution, and PBNM -- because the new business isn't burdened with the higher interest rate.

4) Selective Investment Strategies: The business model of the proposed PBNM purposes the "public good". To that degree it's a different business model – a financing system aimed at enhancing the public good, rather than maximizing profit and still makes a profit

   For example, one significant "public good" development strategy is to increase local community prosperity by advancing local and/or regional supply-chain security. Financing local and regional new businesses to fill product and service gaps in our food and clean energy supply chains, is a low-risk new business success strategy because the market demand for the product or service already exists in the local community. Public bank loan programs designed to finance strategic and supply chain business opportunities at local and regional levels would both enhance New Mexico's prosperity and reduce our vulnerability to the risks inherent in our dependence on financial and supply chain systems that are beyond our control or influence.

What are the loan default risks?

- The AFLEP Pro-Forma, seeking deliberately to be moderately conservative in its projections, assumes default allowances higher than prevailing private bank default rates. It projects a 2.37% default rate (with a standard deviation of 1.77%) on its agricultural and commercial loans, and up to 4.18% on its higher risk "administered" loans (with a standard deviation of 3.47%). Significantly, even incorporating these moderately conservative default assumptions, the average annual equity *growth rate* for PBNM is 12.8% over the initial seven years.

Testing this further, it found that the average *delinquency rate* would have to be 13% before the average equity growth rate would fall to zero. Regulators would step in before the bank would approach such a default rate.

To put these pro-forma default rates into perspective, data from the Federal Reserve show that the largest one-hundred banks in the U.S. had an average delinquency rate of less than 1.5% for the last five years; and at the height of the Great Recession it peaked at 4.5%. For all remaining, smaller U. S. banks, the average delinquency rate was slightly higher than 1.5%, but lower during the Great Recession, peaking at 3.59%.

What is the smallest initial investment that makes sense in starting a public bank? Why is $50M investment optimal?

- Investing $50M in the public bank's equity is an optimal amount because: 1) it allows the bank flexibility in meeting loan demand from the outset, and 2) it allows the bank to grow its lending capacity beyond the $50M without the legislature having to appropriate any more capital to the bank. After the $50M investment, which is not an expenditure, there are no further costs to the state; the bank is self-sufficient operationally and equity-wise.

  With regard to point one, loan demand is not fully quantifiable at the outset. It could be small as the Pro-Forma assumes at $45M in the first year. But if there is sufficient demand from the outset, it allows the bank to lend up to $500M, without having to ask the legislature for more capital. By year seven, because of retained earnings in preceding years, PBNM, as calculated in the AFLEP Pro-Forma, would have the capacity to lend more than $1Billion – again without any additional appropriation from the State.

  To put the $50M in perspective, the legislature appropriated $500M to State loan programs in 2020-21, in order to assist small and medium sized businesses to survive the Covid 19 crisis. If the bank had existed then with the State's $50M in equity, it could have loaned out $500M and the legislature would have saved appropriating $450M from the State's Permanent Funds.

Why can PBNM loan money out at lower rates to borrowers?

PBNM is a public entity, a nonprofit and a "bankers' bank," -- not a commercial bank servicing multiple customers and branch offices -- it does not have the costs of marketing, customer service, supporting multiple locations and taxes. The significantly reduced overhead for PBNM will allow it to lend at lower rates.

The borrower would apply for the loan and it would be serviced by the partnering community bank or credit union, but PBNM's involvement would be through taking the lead in developing the lending programs and participating in the loan. Thus, the private lender could charge the prevailing market rate for its percentage of the loan and PBNM would receive interest on its part of the loan at a lower rate, enabling the borrower to receive a lower than market rate. PBNM would also compensate the local, private lender for PBNM's portion of the costs of the due-diligence and loan servicing.

What are the burning public interest projects that could be targeted initially by the PBNM?

- New Mexico Economic Development Department's (EDD) 20-year strategic plan, "Empower and Collaborate" identifies nine priority business sectors for business and job expansion, as follows: Aerospace, Biosciences, Cybersecurity, Film and Television, Outdoor Recreation, Intelligent Manufacturing, Global Trade, Sustainable and Green Energy, and Sustainable Agriculture. It has been noted that implementation of this plan will require "significant appropriations" from the legislature.
- The New Mexico Finance Authority (NMFA) has loan programs, especially for small businesses, that need greater funding that currently comes from legislative appropriations.
- Filling supply chain voids -- financing businesses to fill food processing, packaging and distribution opportunities and underwriting Community Solar -- are examples of specific projects that will need difficult-to- obtain financing.
- Small and medium infrastructure project for municipalities and public-school districts can also be financed by PBNM rather than by Wall Street bonds at a significant savings (30% to 50%) advantage to New Mexico. The fees for a loan are much less than for bonds and the interest paid out over long terms – 10 to 20 years – stays in New Mexico to be reinvested in New Mexico.