



New Mexico Regulation and Licensing Department
FINANCIAL INSTITUTIONS DIVISION

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MEMORANDUM

Susana Martinez
Governor

RE: Legal Issues and Matters for Further Research and
Examination Regarding Proposed Public Bank of
Santa Fe

DATE: August 24, 2017

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Superintendent

Alex Sanchez
Deputy Superintendent

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Deputy General Counsel

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Acting Director

The content of this memo includes legal and regulatory issues and concerns identified by Kevin A. Graham, legal counsel for the Financial Institutions Division (FID), following his initial review in the Spring of 2016 of the "Public Banking Feasibility Study Final Report for the City of Santa Fe" produced by Katherine L. Updike and Christopher Erickson, January, 2016, as well as issues raised by the FID when considering memorial legislation which had been proposed to the New Mexico Legislature in 2017 regarding the potential for a publicly owned bank in the State of New Mexico. This memorandum should not be interpreted as a full or complete legal review of the numerous legal issues related to the establishment of a publicly owned bank in the State of New Mexico. The following subject areas of legal concern should be considered a starting point for a comprehensive legal review and assessment to be completed prior to further development of any proposal for the establishment of a publicly owned/operated bank in our State.

I. APPARENT CONFLICT WITH EXISTING NEW MEXICO LAW:

The Establishment of a Government Owned "Bank" in the State of New Mexico Appears to be a Direct Violation of the Terms of the Anti-Donation Clause of the New Mexico Constitution, Article IX, Sect. 14.

1.. The formation of a "bank" being owned/run by any unit of government within the State of New Mexico using public funds to finance the "bank" appears to be in direct conflict with the language and intent of Article IX, Sect. 14 of the New Mexico State Constitution (commonly known as the "Anti-Donation Clause.")

2. The "Anti-Donation Clause" reads as follows:

"Sec. 14. [Aid to private enterprise; veterans' scholarship program; student loans; job opportunities.]

Neither the state nor any county, school district or municipality, except as otherwise provided in this constitution, shall directly or indirectly lend or pledge its credit or make any donation to or in aid of any person,

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association or public or private corporation or in aid of any private enterprise for the construction of any railroad; except as provided in Subsections A through G of this section.

- A. Nothing in this section prohibits the state or any county or municipality from making provision for the care and maintenance of sick and indigent persons;
  - B. Nothing in this section prohibits the state from establishing a veterans' scholarship program for Vietnam conflict veterans who are post-secondary students at educational institutions under the exclusive control of the state by exempting such veterans from the payment of tuition. For the purposes of this subsection, a "Vietnam conflict veteran" is any person who has been honorably discharged from the armed forces of the United States, who was a resident of New Mexico at the original time of entry into the armed forces from New Mexico or who has lived in New Mexico for ten years or more and who has been awarded a Vietnam campaign medal for service in the armed forces of this country in Vietnam during the period from August 5, 1964 to the official termination date of the Vietnam conflict as designated by executive order of the president of the United States;
  - C. The state may establish by law a program of loans to students of the healing arts, as defined by law, for residents of the state who, in return for the payment of educational expenses, contract with the state to practice their profession for a period of years after graduation within areas of the state designated by law.
  - D. Nothing in this section shall be construed to prohibit the state or a county or municipality from creating new job opportunities by providing land, buildings or infrastructure for facilities to support new or expanding businesses if this assistance is granted pursuant to general implementing legislation that is approved by a majority vote of those elected to each house of the legislature. The implementing legislation shall include adequate safeguards to protect public money or other resources used for the purposes authorized in this subsection. The implementing legislation shall further provide that:
    - (1) each specific county or municipal project providing assistance pursuant to this subsection need not be approved by the legislature but shall be approved by the county or municipality pursuant to procedures provided in the implementing legislation; and
    - (2) each specific state project providing assistance pursuant to this subsection shall be approved by law. (As amended November 1, 1971, November 5, 1974, November 8, 1994, November 5, 2002, November 7, 2006 and November 2, 2010.)”
3. Due to the fact that this provision of New Mexico law is part of the State Constitution, in order to make any alteration or change to the wording of the

clause would require the passage of a State constitutional amendment – which entails a process significantly more involved than amending a state statute or regulatory provision.

4. Subsection (D) of Article IX, Sect. 14 does allow the state (or county or municipality) to work to create “new job opportunities by providing land, buildings or infrastructure for facilities to support new or expanding businesses...” Even if the term “infrastructure” in that provision were to be very broadly interpreted to include allowing a municipality to directly loan money to a private enterprise to create “new job opportunities,” there would still be the hurdle in place requiring implementation legislation to be approved by both houses of the State legislature before such a highly restricted “bank-type” entity could be approved (a “bank” created under this stretched definition of “infrastructure” would presumably only be able to make loans to entities that would create “new job opportunities”).
5. Phase Two of the “Strawman” section of the Feasibility Study directly calls for the City of Santa Fe to apply for a State Bank Charter.
  - (a) The City of Santa Fe is a “municipality” under the terms of Article IX, Sect. 14.
  - (b) The funding for the operation of the “Santa Fe Bank” would come from the city (and possibly later from investments from other governmental entities) which would reasonably be interpreted as involving the “credit” and resources of the City of Santa Fe (and any other government entities who might deposit money in the proposed bank.)
  - (c) In order to make loans or conduct other “bank” business as described in the Feasibility Study, the proposed bank would necessarily use municipal funds to “directly or indirectly lend or pledge [the city’s] credit or make any donation to or in aid of any person, association or public or private corporation.” Thus, without a specific amendment first being made to Article IX, Sect. 14, the proposed activities to be undertaken by the “Santa Fe Bank” would be in direct violation of the Anti-Donation Clause of the New Mexico Constitution.
  - (d) In light of this constitutional barrier to the operation of the proposed bank, the Director of the FID would not be able to issue a permit to the proposed bank to file with the Corporation Commission (§58-1-58, NMSA 1978) nor could the Director of the FID issue a certificate of authority to the bank to begin operation (§58-1-61, NMSA 1978).
    - (1) §58-1-58. Determination on application for permission to file with the corporation commission [public regulation commission]
      - A. When an application for permission to file with the corporation commission [public regulation commission] has been delivered to the commissioner [director of the

financial institutions division of the regulation and licensing department], he shall make or cause to be made a careful investigation and examination relative to:

(1) the character, reputation and financial standing of the organizers or incorporators;

(2) the character, financial responsibility of proposed directors and banking or trust experience, and business qualifications of those proposed as officers;

(3) the ability of the community to support the proposed bank, giving consideration to:

(a) the services offered by existing banks and other financial institutions;

(b) the banking history of the community; and

(c) the opportunities for profitable employment of bank funds as indicated by the demand for credit, the number of potential depositors, the volume of bank transactions, and the business and industries of the community, with particular regard to their stability, diversification and size;

(4) whether or not the full amount of the authorized capital structure has been subscribed;

(5) whether or not the proposed capital structure is adequate in the light of current and prospective banking conditions;

(6) whether or not the name of the proposed bank resembles so closely, as to be likely to cause confusion, the name of any other banks transacting business in this state; and

(7) such other facts and circumstances bearing on the proposed bank and its relation to the community as in the opinion of the commissioner [director] may be relevant.

(2) §58-1-61. Certificate of authority.

A. A request for a certificate of authority shall be made to the commissioner [director of the financial institutions division of the regulation and licensing department] after he has approved the application to file the articles of incorporation with the corporation commission [public regulation commission] and all requirements have been met. The request shall contain:

- (1) the address at which the bank will operate;
- (2) a statement that all of the bylaws adopted have been attached as an exhibit to the request;
- (3) a statement that the full amount of the authorized capital structure has been paid to the escrow agent;
- (4) the signed oaths of the directors; and
- (5) such other information as the commissioner [director of the financial institutions division] may require to enable him to determine whether a certificate of authority should be issued.

B. The commissioner [director] shall approve the request for a certificate of authority within twenty days after the request has been accepted by him and he has been satisfied that all requirements have been complied with and he shall issue a certificate of authority for the bank to transact business. Before actually transacting any banking business or accepting any deposits, the applicant must file with the commissioner [director] satisfactory proof showing that insurance of deposits has been obtained through the federal deposit insurance corporation or other appropriate agency or instrumentality of the United States government.

## **II. REQUIRED INDEPENDENCE OF A BANK BOARD OF DIRECTORS**

### **The Requirement of a Truly Independent Board of Directors (and Bank Officers) Does Not Appear to have Been Fully Considered; Authority of the Board Over Time; Potential for Conflict with City Council.**

1. The Feasibility Study only gives very brief attention to the fact that the model to be utilized by the bank (conventional equity model or mutual bank model) will depend “upon ongoing investigation with State regulators and legal counsel.” The Feasibility Study acknowledges that “[a]ny bank charter application will require a substantial and complete description of the governance mechanisms of a new bank. At a minimum, a Board will need to be described (and later appointed) which insulates the Bank from election cycles.” The Feasibility Study summarily concludes its analysis of this subject with the statement: “The Board’s most important function is that of selecting a CEO to run the bank. It is also relatively common for the Board to have one or more subcommittees that focus on operational policy, such as loans, audits or investments.”
2. New Mexico law places specific duties and responsibilities on members of Boards of state chartered banks, which may be generally summarized as a duty to work for the “best interests of the bank.”

(a) §58-5-1, NMSA 1978 requires members of a Board of Directors for a State chartered bank to take an oath pledging to “diligently and honestly administer the affairs of the bank. . .”

(b) §58-1-65 (A), NMSA 1978 “[t]he affairs of a state bank shall be managed by a board of directors, which shall exercise its powers and be responsible for the discharge of its duties.”

(c) §58-1-66, NMSA 1978. Directors; meetings and duties. This statute provides requirements for meetings of a Board of Directors as well as the multiple subject areas related to bank business that must be examined, approved and reported on by board members at those meetings.

### 3. Potential for Situation Where the Board of Directors of the Proposed Bank and the City Council of the City of Santa Fe Develop a Conflict Over the Operation of the Bank.

(a) The Feasibility Study does not appear to fully address the potential for a situation where the elected Board of Directors of the proposed Santa Fe Bank and the elected City Council of the City of Santa Fe may reach a future situation where the Board would make a decision(s) in regards to lending, interest rates, bank operations, etc., that the City Council does not support. Likewise, a situation could develop where the City Council would make a request of the bank/board to support a particular project or make a particular loan and the Board declines the request on a determination the project or loan is not in the best interest of the Santa Fe Bank.

(b) In either such hypothetical situation, the City Council could react to the disagreement/denial by taking action to withdraw its funds from the bank (just like any other bank customer.)

(c) The funding structure of the proposed Santa Fe Bank appears to be based heavily on funding from the City of Santa Fe; thus a sudden reduction of funding by the City of Santa Fe could result in immediate jeopardy to the financial security of the bank.

(d) While the current Santa Fe City Council may be completely supportive of the idea/operation of a Santa Fe Bank, there is no guarantee that any future city council (following an election cycle, or even just a change in opinion of a majority of city council members) would continue to deposit City funds with the bank.

### **III. OPEN MEETINGS / OPEN RECORDS:**

#### **Interplay of the New Mexico Open Meetings Act, §10-15-1, NMSA 1978, and the New Mexico Inspection of Public Records Act, §14-2-1, NMSA 1978, with the Operation of a Public Bank.**

1. The interplay of the Open Meetings Act and the Inspection of Public Records Act with the creation of a new bank “owned” by a government entity does not appear to have been fully considered under the Feasibility Study.
2. Consideration should be given to the idea that a government-owned bank would potentially be required to “open” the meetings of its Board as well as “open” the records of the bank beyond the requirements placed on privately held institutions. Such requirements may have an impact on the bank’s ability to be competitive in the industry.

#### **IV. ADDITIONAL CONCERNS REGARDING BANK OPERATIONS, SECURITY, STABILITY AND MANAGEMENT:**

1. How would a “public bank” in New Mexico be insured? All New Mexico state chartered banks are required to be insured:
  - (a) §58-1-2 NMSA 1978, (A) “bank” means: (1) an “insured bank” as defined in Section 3(h) of the Federal Deposit Insurance Act.
  - (b) §58-1-61 NMSA 1978 “(B) Before actually transacting any banking business or accepting any deposits, the applicant must file with the commissioner [director] satisfactory proof showing that insurance of deposits has been obtained through the federal deposit insurance corporation or other appropriate agency or instrumentality of the United States government.
  - (c) §58-1-70. Deposit insurance; membership in the Federal Reserve System. “A state bank shall obtain insurance of its deposits by the United States or any agency thereof, and may acquire and hold membership in the Federal Reserve System.”
2. What protections would exist for deposits?
  - (a) Most banks are funded substantially through deposits. The state needs to consider the source of protection for those deposits. Traditional banks rely on deposit insurance coverage, subject to certain limits, from the Federal Deposit Insurance Corporation (FDIC).
  - (b) The Bank of North Dakota is frequently cited as the example of how a publicly owned bank could be organized and operated. Deposits of the Bank of North Dakota are not insured by the Federal Deposit Insurance Corporation (FDIC) insured, but are guaranteed by the full faith and credit of the State of North Dakota.
  - (c) In the FDIC’s Statement of Policy for Applications for Deposit Insurance, the FDIC expresses its concern about institutions owned by domestic governmental units being controlled by the political process. Additionally, the FDIC notes, the institutions could raise special concerns relating to management stability, and the

ability and willingness to raise capital. While not a definitive rejection of granting deposit insurance, the FDIC makes clear their concerns.

(d) As a condition of receiving a state bank charter in the State of New Mexico, the FID requires every applicant bank have in place insurance guaranteed by the FDIC or some other “appropriate agency or instrumentality of the United States government.” (See §58-1-61 NMSA 1978, above.) As noted, a publicly owned bank may not be able to obtain this required, United States government backed, insurance.

3. What oversight would exist for the proposed publicly owned bank?

(a) U.S. banks are actively supervised by chartering authorities, including the FID, the FDIC, the Federal Reserve, and/or the Office of the Comptroller of the Currency (OCC). The state needs to determine the appropriate entity to conduct this oversight. In order to be effective, the regulator should be able to exercise its supervisory authority independently and must have the authority to review all books and records.

(b) An independent regulator must also have the tools necessary to seek corrective measures through formal enforcement actions, civil money penalties, and removal of bank officers and directors. These authorities are critical to ensuring public confidence and protecting the state’s taxpayers who will ultimately need to cover any shortfall in the event of insolvency.

4. Safety and soundness of the bank.

(a) Primary objectives of regulators should always be the safety & soundness of financial institutions, compliance with laws, regulations, and supervisory policy. This includes, but is not limited to:

(1) Careful consideration should be given to the investment and lending authority of a state-owned bank in order to avoid risks to the solvency of the institution and prevent undue competition with privately owned banks. Appropriate limitations should be established on loans to insiders and affiliated entities. There should also be limitations established on loans to one borrower or group of affiliated borrowers.

(2) When the government owns the banks, lending decisions could become increasingly driven by politics, rather than economics. Resources flow to those with influence. Government-owned banks may also tend to under-price risk in order to gain votes. If there is one lesson we should take away from the recent crisis, it is that when you under-price risk, bad things happen.



5. Governance and managerial factors.

(a) Governance and managerial factors take into account the fiduciary duties of the board and management of the financial institution as well as the competence, experience, integrity, and financial ability of the institution's organizers and staff.

(b) Corporate governance is a critical component for all banks. Ultimately, the board sets the policies of the bank, determines the desired risk profile, and oversees management. The state needs to carefully consider the individuals who would be charged with this responsibility and their role, if any, in state government.

(c) One of the most important decisions for any financial institution is selecting the executive management team, since there is a direct relationship between the overall conditions of a bank, the quality of its management team, and the future performance of the bank.

6. Financial factors.

The Bank of North Dakota is currently the only state-run and state-owned American bank. The Bank of North Dakota is generally considered a well-run institution. In the past, many have contended the Bank of North Dakota provided a massive subsidy to the fossil fuel industry in North Dakota. Reviews of past annual reports for the Bank of North Dakota show the bulk of the bank's below-market lending was to the fossil fuel industry. Obviously, a significant downturn in the fossil fuel industry could present a significant challenge to the stability of a bank that has heavily engaged in lending to that industry. This situation with the Bank of North Dakota is referenced as an example of a point of concern for any publicly owned bank which would be intended/directed by the public authority to have an emphasis or focus on the development of local industry/business.

7. Capital adequacy.

Banks need to be supported by monetary capital. Capital provides the foundation for the bank to operate through the economic cycle. Banks generally add to capital during economically prosperous times and exhaust capital during periods of economic stress and unexpected losses. This countercyclical nature of capital is customary and desirable for privately-owned institutions. The state will need to determine the source of this capital, recognizing the need for it to remain in the bank throughout its existence. Capital should be sufficient at inception to support anticipated start-up costs and expected growth. In addition, the state should make a provision for contingent capital should the bank experience unexpected losses,

requiring recapitalization. Federal regulations require Tier 1 Leverage Capital to be greater than 5.75% (and this number is expected to grow in coming years) for a bank to be considered “well capitalized.” The term, “well capitalized,” refers to a category under Prompt Corrective Action. Banks with capital below this category are subject to certain mandated regulatory restrictions. Banks generally find it necessary and desirable to hold significantly higher levels. The current industry average is just below 11%. By this standard, a bank projected to be \$1 billion in assets, would need \$110 million in capital, just to open its doors.