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February 12, 1992

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The Honorable Dan Morales
Attorney General
Supreme Court Building
Austin, Texas 78701

Dear General Morales:

I request an Attorney General's opinion relating to the Public Funds Investment Act of 1987 (Article 842a-2, Vernon's Texas Civil Statutes). The following is background information on this topic.

Entities and individuals that control and/or manage funds subject to the Public Funds Act of 1987 currently fulfill their responsibilities by use of the short term money market instruments clearly allowed by the Act.

Historically low short term interest rates (bank deposit rates), and price and yield volatility in the money markets have forced those entities and individuals to either accept lower earnings on their investment capital or to take a more costly labor intensive approach to attempt to achieve higher earnings.

An investment alternative that conforms to the Public Funds Investment Act of 1987 and provides a return of +125 basis points to +150 basis points above the current money market alternatives or TexPool would provide public entities with an additional $12,500 to $20,000 additional annual earnings for each one million of public funds invested, without subjecting the invested funds to undue risk or increasing the associated cost for those entities electing to utilize such an investment.

An adjustable rate mortgage (ARM) is a mortgage in which the interest rate on the loan is reset periodically. The interest rate may change each month, every six months, one year, two years, or three years. The interest rate at the reset date is equal to a reference or base index plus a spread, or "margin".

The base index is typically either a market yield (e.g., Treasury securities, prime rate) or a calculated measure such as a thrift cost of funds index or a moving average of mortgage rates. The two most popular indexes for ARM's are the one-year constant maturity Treasury rate (CMT) and the 11th District Cost of Funds Index (COFI). COFI is a calculated figure based on the monthly weighted average interest cost for liabilities of thrifts in the 11th Federal Home Loan Bank District. (This district includes the states of California, Arizona, and Nevada. The cost of funds is calculated by first computing the monthly interest expenses for all thrifts and FHLB correspondent banks included in the 11th District. The interest expenses are summed and then divided by the average of the beginning and ending monthly balance.)

The frequency with which the mortgage rate resets varies. For ARM's indexed to the one-year CMT, the mortgage is generally reset once a year. The monthly mortgage payments for the subsequent year are then based on the new indexed mortgage rate. For an 11th District COFI-based ARM, the mortgage rate typically adjusts monthly.

ARM's have become popular with investors because they shift interest-rate risk (the risk of loss in the event that general market rates change) from the lender to the borrower. Depository institutions, such as banks and credit unions prefer to hold ARM's in their investment portfolios rather than fixed-rate instruments because ARM's provide a better match with their liabilities, which tend to be short-term. (Attached as Exhibit "A" is a graphic illustration of the relative price volatility of an ARM versus several traditional fixed income U.S. Government instruments.) The reset feature of the mortgage rate replaces maturity as the primary factor in determining the market price of the security. Therefore, the reset date can be viewed as a maturity date with respect to price stability.

A mutual fund that invests only in U.S. Government agency ARM's and maintains an average portfolio reset of 120 days or less would satisfy the requirements of Article 842a-2, Subsection (d).

1. As an authorized investment the above referenced Act allows under Article 842a-2, Section 2(1) "obligations of the United States or its agencies and instrumentalities"

   (a) The Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Government National Mortgage Corporation (Ginnie Mae) are agencies of the United States Government.

   (b) Each of the above referenced U.S. Government agencies issues adjustable rate mortgage securities (ARM's).

   Are adjustable rate mortgage securities issued by U.S. Government Agencies permissible investments under the Public Funds Investment Act of 1987.

2. As an authorized investment the above referenced Act allows under Article 842a-2, Section 2, Subsection (d) "an S.E.C. no-load money market mutual fund with a dollar-weighted average portfolio maturity of 120 days or less whose assets consist exclusively of the obligations that are described by Subsection (a) of this section and whose investment

objectives include seeking to maintain a stable net asset value" provided that "no more than 20 percent of its monthly average fund balance, excluding bond proceeds, in money market mutual funds, described in this subsection or invest its funds or funds under its control, excluding bond proceeds, in any one money market mutual fund in an amount that exceeds 10 percent of the total assets of the money market mutual fund."

(a) A mutual fund is an S.E.C. registered mutual fund whose prospectus states that its investment objective is "to provide investors with a high level of current income, while reducing principal volatility, by investing primarily adjustable rate mortgage securities issued or guaranteed by the U.S. Government, its agencies and instrumentalities."

(b) A mutual fund allows no-load investment for institutions investing one million dollars.

If a mutual fund invests only in adjustable rate mortgage securities issued by the U.S. Government its agencies and instrumentalities; and, a mutual fund achieves its investment objectives in a manner consistent with Article842a-2, Subsection (d), is a mutual fund like the Overland Express Variable Rate Government Fund, which operates in the manner described above, a permissible investment under the Public Funds Investment Act of 1987?

I appreciate your consideration of this request.

Sincerely,

Jim Tallas

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