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The Senate of Texas

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RQ-887

April 15, 1996

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Opinion Committee

The Honorable
Dan Morales
Attorney General of Texas
300 West 15th St., 11th Floor
Austin, Texas 78701

Dear General Morales:

This is to request an opinion pursuant to Section 402.042 of the Texas Government Code.

The Webb County Treasurer would like to increase the yield the County earns on money in its Permanent School Fund (the Fund) by investing in "pass-through" mortgage-backed securities that will be rated "AAA" and unconditionally guaranteed or insured by the Federal National Mortgage Association (FNMA). The securities will be "pass through" securities because they will pay to the Fund a monthly stream of principal and interest income "passed through" to the County by FNMA from home loans that FNMA has purchased.

To purchase the securities, the County would sign an agreement with a bank located in the County to purchase a specified dollar amount of securities at an interest rate that will increase the yield earned on the Fund, but that is lower than the market rate for comparable securities. The County will purchase the securities at a rate below market to help provide housing for low income families within the County. The bank will enter into an agreement with FNMA that will ensure FNMA's guarantee on the home loans originated by the bank. The bank will originate the home loans and mortgages at an interest rate that is the sum of the interest rate specified by the County plus FNMA's guaranty and servicing fees. As the pool of funds is originated, the bank will obtain FNMA's guarantee and sell the securities to the Fund. The Fund then will begin receiving the monthly principal and interest paid by the borrowers, minus the fees charged by FNMA, on a "pass through" basis.

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Please provide an opinion regarding the following questions:

1. May the County invest a portion of the Fund in the securities, i.e., "pass-through" mortgage-backed securities, which are unconditionally guaranteed or insured by FNMA?

2. If so, may the County invest in the securities by negotiating a rate to be earned by the Fund with the bank that originates the home loans?

3. If the County may invest in the securities by negotiating a rate with the bank, may the County negotiate to earn an interest rate that will increase the yield earned on the Fund, but that is lower than the market rate for comparable securities?

Research and information that I received suggest the following:

1. The County is authorized to invest money in the Fund in the securities under Article VII, Section 6 of the Texas Constitution and Chapter 2256 of the Texas Government Code, the Public Funds Investment Act ("the Act").

2. Article VII, Section 6 of the Texas Constitution provides that the proceeds of the sale of county school lands are to be invested in "bonds of the United States, the State of Texas, or counties in said State, in such other securities, and under such restrictions as may be prescribed by law...."

3. According to Section 2256.003(1) of the Act, the Act governs the County's investment of the Fund as the County is within the definition of "local government," and the Act provides that the governing body of a local government "may purchase, sell and invest its funds and funds under its control in investments authorized under this subchapter in compliance with investment policies approved by the governing body and according to the standard of care prescribed by Section 2256.006."

4. Section 2256.009(a)(4) of the Act authorizes investment in "other obligations, the principal and interest of which are unconditionally guaranteed or insured by, or backed by the full faith and credit of, this state or the United States or their respective agencies and

instrumentalities...." The securities are authorized investments within this provision as they will be unconditionally guaranteed or insured by FNMA which is an "agency or instrumentality of the United States."

5. FNMA is described as a "federal government agency" in an opinion issued by your office that states that the Act authorizes public entities to invest in certain mutual funds which hold only adjustable rate mortgages issued by agencies of the United States. Federal courts have found that FNMA is an instrumentality of the United States for the following reasons:

a. FNMA is subject to the general regulatory power of the Secretary of Housing and Urban Development (12 U.S.C. Section 1723a(h);

b. Certain of FNMA's financial transactions are regulated by the Secretary of the Treasury (12 U.S.C. Section 1719);

c. Congress has exempted FNMA from having to qualify to do business in any state (12 U.S.C. Section 1723a(a);

d. FNMA is exempt from state taxation with the exception of real estate taxes (12 U.S.C. 1723a(c)(1);

e. FNMA performs a significant governmental function in its secondary mortgage market operations (12 U.S.C. Sections 1716(a) and 1719(a)(1); and

f. The federal government has an extensive interest and involvement in mortgage market assistance.

6. As FNMA is an agency or instrumentality of the United States, obligations unconditionally guaranteed or insured by FNMA are within Section 2256.009(a)(4) of the Act, and the securities are authorized investments under Section 2256.009(a) of the Act.

7. The securities do not come with the four exceptions to authorized investments listed in Section 2256.009(b) of the Act:

a. The securities are not "obligations whose payment represents the coupon payments on the outstanding principal balance of the underlying mortgage-backed security collateral and pays no principal" because the county will receive both principal and interest payments;

b. The securities are not "obligations whose payment represents the principal stream of cash flow from the underlying mortgage-backed security collateral and bears no interest" because, again, the County will receive both principal and interest payments;

c. The securities are not "collaterized mortgage obligations that have a stated final maturity date of greater than ten years" because they are pass-through securities where the investor receives the monthly interest and principal paid on the mortgages by the borrowers, minus guaranty and servicing fees. They are not collaterized mortgage obligations which are bonds paying interest and principal to the investor every six months which are collaterized by a pool of mortgages; and

d. The securities are not "collaterized mortgage obligations the interest rate of which is determined by an index that adjusts opposite to the changes in a market index" because they are not collaterized mortgage obligations, as discussed in (c) above, and the interest rate earned by the investor will not be determined by an index.

8. The answer to question 1 is "yes," since the securities fall within Section 2256.009(a)(4) of the Act as authorized investments and are not excepted from the category of authorized investments under Section 2256.009(a) by Section 2256.009(b) of the Act; they are authorized investments for the Fund.

9. The County intends to invest in the Securities by negotiating an interest rate to be earned on the securities with a bank that would originate the home loans as described above. The County may use this negotiated purchase procedure because: (1) Article VII, Section 6 of the Texas Constitution and the Act do not require that a competitive bidding process be used to purchase investments; and (2) Article VII, Section 6 of the Texas Constitution and the Act provide the County

with the authority to invest the Fund, and commissioners courts have broad discretion in exercising expressly conferred powers. Accordingly, the answer to question 2 is "yes."

10. The Fund currently is invested in TexPool because TexPool provides the County with access to a wide range of investment instruments with administrative ease. The Fund currently earns from 5.5 percent to 5.8 percent. It is contemplated that the securities will yield approximately .1 percent above the present investments, but could be sold in the open market at from 6 percent to 6.2 percent, based on current rates. The purpose of the program, however, is to assist in providing housing to a segment of Webb County's population that otherwise could not afford it.

11. The County may invest in the securities at a rate which is below market rate for comparable securities. By investing in the securities the County will increase the yield earned on the Fund, increase the amount of income earned for the Available Fund, unconditionally guarantee the interest to be earned on the Fund, and unconditionally guarantee the safety of the principal so invested for the Fund. Investment in the securities also will further the public purpose of providing low income housing in an area with an urgent need for such assistance. Accordingly, the answer to question 3 is "yes."

I look forward to receiving your response to this request. Feel free to contact me if I can provide additional information.

May God bless you.

Very truly yours,

Judith Zaffirini

Judith Zaffirini

JZ/mcr

XC: Rick Reyes, Webb County Commissioner
Billy Hall Jr., Webb County Treasurer