

Legal Q&A

Public Funds Investment Act and Deposits of Public Funds

May a city invest its public funds?

Yes, a city may invest its public funds, but only if the city complies with Chapter 2256 of the Texas Government Code, the Public Funds Investment Act (PFIA).

What does the PFIA require of a city before a city may invest its public funds?

Before a city may invest its public funds, the PFIA generally requires the following:

1. A city must adopt a written investment policy;
2. A city may only invest its funds in investments authorized under its written investment policy;
3. Authorized investments must come from the list of proper investments under the PFIA; and
4. An official from the city must complete training regarding the requirements of the PFIA.

What is the investment policy requirement?

A city must adopt a written investment policy by ordinance or resolution. TEX. GOV'T CODE § 2256.005(a). Therefore, regardless of a city's population, it must have a written investment policy if it has any cash or bank investments. A formal policy protects not only the cash assets of the city, but also the elected and finance management officials.

An investment policy must contain a statement emphasizing safety and liquidity. *Id.* § 2256.005(b)(2). If the policy applies to the financial assets of all funds or fund types, that fact should be clearly stated. A distinction should be made between shorter-term cash management and the management of longer-term investments.

The policy must also include a list of authorized investments and the permitted maximum maturity of any individual investment, as well as the maximum weighted average maturity (WAM) of funds. *Id.* § 2256.005(b)(4)(a) & (c). The policy must also include (among other things) the method used by the investing entity to monitor the market price of investments acquired, as well as procedures to monitor rating changes in investments acquired with public funds and the liquidation of such investments. *Id.* § 2256.005(b)(4)(d) & (f).

Although the actual investment strategy for smaller cities is vastly different from larger cities, the primary objectives, which should direct any investment strategy, are safety and liquidity. Safety is the most important objective, because public officials have a fiduciary responsibility to manage and maintain taxpayer funds. The PFIA requires governing bodies of local governments

and state agencies to invest public funds under their control with the same prudence and discretion as such entities would manage their own affairs.

Liquidity, the ability to sell or dispose of an investment, is equally important. Invested funds must be readily available if the need for cash arises and requires the city to liquidate the investment before maturity.

Yield refers to the rate of return received on a particular investment. Yield or income derived from an investment is important, particularly to a city grappling with declining or stagnant revenues or tax base. However, 1995 amendments to the Act significantly revised the ranking of investment objectives and put yield in last place. *Id.* § 2256.005(d). The first priority for consideration is the suitability of the investment to the overall cash flow and financial requirements of the entity. *Id.* § 2256.005(d).

The PFIA requires that the governing body of an investing entity review its investment policy at least once a year. *Id.* § 2256.005(e). Moreover, the governing body must take formal action stating that the policy and strategy have been reviewed. Any changes to either the policy or strategy must be recorded in the resolution and the investment policy. Changed policies should be sent to all brokers, pools, and advisors. The investing entity must also designate by ordinance or resolution the employee or investment officer(s) who will be responsible for the investment of its funds. *Id.* § 2256.005(f). The policy also should refer to training seminars conducted by independent sources, such as the Texas Municipal League.

What is the training requirement under the PFIA?

The treasurer, the chief financial officer (if the treasurer is not the chief financial officer), and the investment officer of a local government must attend at least one, ten-hour, training session in investment laws within twelve months after taking office. *Id.* § 2256.008. The PFIA is written in a way that requires all cities to appoint someone to one of these positions in order to receive the training. On a continuing basis, the investment training sessions must be attended at least once every two-year period for at least eight hours of instruction. The two-year period begins on the first day of the city's fiscal year and consists of the two consecutive years after that date. *Id.* § 2256.008(a-1).

As of September 1, 1999, the entity that provides training must report to the comptroller a list of the governmental entities that received training. Further, auditors and credit rating agencies are increasingly paying attention to whether a city is up-to-date on its required training. The Texas Municipal League offers training, as do other entities. City officials may check for upcoming PFIA workshops on the TML Web site at www.tmlpfia.org.

If a city does not invest any of its funds, or invests its funds only in interest-bearing deposit accounts or certificates of deposit, does a city official still need to attend training under the PFIA?

Yes and no. The relevant city officials still must take the initial ten-hour investment training session within twelve months of taking office or assuming duties, even if the city has little or no

investments. *Id.* § 2256.008(a)(1). Legislation passed in 2015 that eliminated any continuing investment training requirement for finance officials in a city that does not invest city funds or only deposits city funds in interest-bearing deposit accounts or certificates of deposit as authorized by the PFIA. *Id.* § 2256.008(f). However, due to the way the bill was drafted, it is not clear that this bill will have the intended effect. As a result, cities with little or no investments should consult with local counsel prior to making a decision about attending continuing investment training.

According to the PFIA, what are the legal investment tools that a city may include in its investment policy?

The PFIA limits the types of investments that a city may authorize under its investment policy. Essentially, an investment must be legal under the PFIA, and included in the city's investment policy, before a city may use that investment.

Following are the legal investments under the PFIA:

- (1) **Governmental Obligations.** United States (including the Federal Home Loan Banks) and State of Texas obligations, such as bonds, are legal investments. So are obligations of local governments, provided the obligations are "A" rated. Certain interest-backed banking deposits are permitted as well. Mortgage-backed obligations are not legal, however. *Id.* § 2256.009.
- (2) **Certificates of Deposit (CDs).** CDs are a legal investment provided they are issued by a bank or authorized broker with its main office or a branch office in Texas. *Id.* § 2256.010. CDs must be collateralized (secured) for amounts greater than FDIC insurance (\$250,000).
- (3) **Repurchase Agreements.** Certain fully-collateralized repurchase agreements are legal investments. *Id.* § 2256.011.
- (4) **Securities Lending Programs.** *Id.* § 2256.0115.
- (5) **Banker's Acceptances.** *Id.* § 2256.012.
- (6) **Commercial Paper.** Commercial paper is a legal investment if it has a maturity date of 270 days or less and is rated at least "A-1" or "P-1" by at least two credit rating agencies. *Id.* § 2256.013.
- (7) **Certain Mutual Funds.** *Id.* § 2256.014. (See below for details about legal mutual funds).
- (8) **Guaranteed Investment Contracts.** Guaranteed investment contracts are legal investments if they have a defined termination date, are fully secured, and are pledged to the city. *Id.* § 2256.015.
- (9) **Investment Pools.** Investment pools are legal investment vehicles if: (a) the city council passes an ordinance or resolution authorizing investment pools; (b) the investment officer of the city receives a detailed prospectus from the pool; (c) the pool makes detailed periodic reports to the city; and (d) the pool is continuously rated "AAA" or "AAA-m". Tex. Gov't Code §2256.016. An investment pool may invest its funds in money market mutual funds to the extent permitted by state law and the investment policies and objectives adopted by the pool. *Id.* § 2256.016.

- (10) **Municipal Utility.** A city that owns an electric utility may enter into a hedging contract and related security and insurance agreements in relation to fuel oil, natural gas, coal, nuclear fuel, and electric energy to protect against loss due to price fluctuations. *Id.* § 2256.0201.
- (11) **Municipal Funds from Management and Development of Mineral Rights.** A city may invest excess funds derived from contracts or leases made on city-owned mineral rights in any investment authorized to be made by a trustee under the Texas Trust Code. *Id.* § 2256.0202.
- (12) **Decommissioning Trust.** A city that owns an electric utility may invest funds held in a nuclear generation facility decommissioning trust in any investment authorized by the Texas Trust Code. *Id.* § 2256.0205.
- (13) **Hedging Transaction.** A city with a principal amount of at least \$250 million in outstanding long-term indebtedness or long-term indebtedness proposed to be issued that is rated in one of the four highest rating categories by a nationally recognized rating agency for municipal securities may invest in a hedging transaction, including a hedging contract. *Id.* § 2256.0206(a). Before investing in a hedging transaction, the governing body of an eligible entity must first establish the entity's policy regarding hedging transactions. *Id.* § 2256.0206(c).

May a city invest in corporate stocks?

No. Stocks, also known as equities, are not listed among the legal investments under the PFIA.

Which mutual funds may a city invest in?

It depends. Essentially, whether a city can invest in a mutual fund, and how much, depends on the type of mutual fund in question. An outline of the law for each type of permissible mutual fund follows, but it is recommended that the investment officer read the statute in question before making the investment (TEX. GOV'T CODE § 2256.014):

- (1) A city may invest in no-load money market mutual funds only if all of the following are true:
 - (a) the fund is registered and regulated by the Securities and Exchange Commission (SEC);
 - (b) the fund provides a certain type of prospectus;
 - (c) the fund complies with SEC rules related to money market mutual funds; and
 - (d) the city's investments do not exceed ten percent of the value of the fund.
- (2) A city may invest in other no-load mutual funds (that is, non-money market) only if all of the following are true:
 - (a) the fund is registered with the SEC;
 - (b) the fund has an average weighted maturity of less than two years;
 - (c) the fund either: (i) has a duration of one year or more and invests exclusively in obligations already approved elsewhere in the Public

- Funds Investment Act (thus excluding most stock funds); or (ii) has a duration of less than one year and the investment portfolio is limited to investment grade securities, excluding asset-backed securities;
- (d) the city invests no more than 15 percent of its eligible funds in the mutual fund (i.e., excluding the city's bond and debt funds);
 - (e) the city does not invest its bond or debt service funds in this type of fund; and
 - (f) the city's investments do not exceed ten percent of the value of the fund.

Of course, the PFIA does not permit investment of any city funds until the city adopts a written investment policy that authorizes each type of investment in question. A written investment policy that does not authorize mutual funds would thus exclude their use, despite state law.

Once the city has complied with the training and written investment policy requirements, can the city then invest in any certificates of deposit?

No. Eligible investment CDs must be issued by a Texas bank or a national bank domiciled in Texas, or a state or federal credit union domiciled in Texas. Further, the CD must be guaranteed or insured by the Federal Deposit Insurance Corporation (FDIC) or National Credit Union Share Insurance Fund, and must be secured by collateral, just as ordinary municipal deposits, for amounts greater than \$250,000. *Id.* § 2256.010.

What is the consequence of failure to comply with the PFIA training requirements?

Though the PFIA contains no penalty provision, auditors and credit rating agencies are increasingly knowledgeable about its requirements. Failure to obtain the necessary training could result in negative marks on the city's audit, or a downgrade in a city's credit rating, which could affect municipal borrowing.

Is a city required to have a depository for city funds?

Yes. Local Government Code Section 105.016(a) states that a city council "shall designate...the bank, credit union, or savings association to serve as a depository for the municipality's funds." Chapter 105 of the Local Government Code, which provides the process for selecting a depository and specifies the necessary components of a city's depository services contract, applies to the funds of any city or department or agency of the city. TEX. LOC. GOV'T CODE § 105.002.

What process must a city follow to select a depository for city funds?

A city is required to receive applications for the performance of depository services from one or more banks, credit unions, or savings associations. *Id.* § 105.011. Prior to receiving the applications, a city's designated officer (the treasurer or other officer designated by the city council) must publish notice in a newspaper of general circulation requesting the submission of

applications for the performance of depository services. *Id.* § 105.012. The notice must be published at least once no later than 21 days prior to the deadline for receipt of applications. *Id.*

The city may not consider an application that is received after the date specified in the notice. *Id.* § 105.013. The council may reject any and all applications and re-advertise if all applications are rejected. *Id.* § 105.015(b). The city council must designate the financial institution chosen to serve as the depository for the city's funds by an order recorded in the minutes. *Id.* § 105.016(a).

May a city select a depository not doing business in the city limits?

A city council may select any bank as its depository so long as the bank is a state bank or national bank that has its main office or a branch office somewhere in Texas. *Id.* § 105.001(1). The council may select any state credit union or federal credit union that is domiciled in the state. *Id.* § 105.001(2). A savings association that is organized under Texas law, the laws of another state, or federal law may be selected so long as the main office or a branch office is located in the state. *Id.* § 105.001(12). A city is prohibited from designating a financial institution located outside of Texas as the depository for city funds. *Id.* § 131.901.

A city that wishes to consider applications from an out-of-city bank, credit union, or savings association, must first adopt a written policy expressly permitting the consideration of applications received from a financial institution that is not doing business within the city, after taking into account what is in the best interest of the city in establishing a depository. *Id.* § 105.011(b)(2). Further, a city that adopts a policy to consider applications from out-of-city institutions must publish notice of its request for applications in a "financial publication of general circulation published within this state" in addition to publishing the notice in a newspaper of general circulation in the city. *Id.* § 105.012. The term "financial publication of general circulation published within this state" is not defined in the statute. Most city attorneys agree that the business pages of a large regional newspaper would suffice under the law.

There is no exception to the additional notice publication requirements for a small city that does not have any banks, credit unions, or savings associations within its city limits. Any city wishing to select an out-of-city depository must adopt the written policy and comply with the additional notice requirements, even if the city is required to use an out of city depository because there is no financial institution that would qualify within the city limits.

May the city select a bank if a mayor or councilmember has a financial interest in the bank?

The answer to this question depends on the mayor or councilmember's financial interest in the bank. A bank is disqualified from serving as the depository of the city if an officer or employee of the city who has a duty to select the depository owns or has a beneficial interest, individually or collectively, in more than 10 percent of the outstanding capital stock of the bank. *Id.* § 131.903(a)(2). In other words, a city council may not select a bank as the city's depository if a mayor or councilmember owns more than 10 percent of the bank.

If an officer or employee of the city is a director or officer of the bank, or owns 10 percent or less of the capital stock of the bank, the bank is not disqualified from serving as the city's depository so long as: (1) the interested officer or employee does not vote or take part in the proceedings; and (2) a majority of the other members of the city council vote to select the bank as the depository. *Id.*

The attorney general has concluded that Section 131.903 of the Local Government Code regarding conflicts of interest in the selection of banks as depositories is an exception to the general conflicts of interest statute in Chapter 171 of the Local Government Code. Tex. Att'y Gen. LO-97-093. That being said, TML attorneys advise that any local public official with a "substantial interest" in a bank, as that term is defined by Chapter 171 of the Local Government Code, comply with the Chapter 171 requirements of (1) filing an affidavit that discloses the potential conflict; and (2) abstaining from participating in the selection of the bank, even if the potential conflict doesn't trigger the specific conflict of interest provision under Local Government Code Section 131.903.

How long may a depository agreement last?

A city council may approve any depository services contract whose term does not exceed five years in length. TEX. LOC. GOV'T CODE § 105.017. Many cities include clauses in their depository services agreements for renewal of the contract for a defined period of time. Given the language of the statute, a renewal clause is permissible so long as it does not take the total length of the agreement beyond five years. For instance, a two-year initial contract term with the option for a three-year renewal would be permissible under the statute. An agreement with a five-year initial term and option to renew for an additional five years is not permissible due to the language in Local Government Code Section 105.017. A city must go through the request for applications process at the conclusion of the term agreed upon in the agreement, meaning that a city must undertake the depository selection process at least once every five years.

Is a city's depository required to provide security for funds held by the depository?

Yes. A depository is required to provide and maintain security at the level required by the Public Funds Collateral Act, located in Chapter 2257 of the Government Code. *Id.* § 105.034(a)(5). The Public Funds Collateral Act specifically requires a depository to pledge security to secure a deposit of public funds in an amount not less than the amount of the deposit of public funds increased by the amount of any accrued interest and reduced to the extent that the United States insures the deposit. TEX. GOV'T CODE § 2257.022. The FDIC insures up to \$250,000 per depositor. Therefore, for all funds in the city depository beyond \$250,000, the city must be collateralized up to at least 100 percent of the remaining amount.

The governing body must adopt a written policy to determine if an investment security is eligible to secure deposits of public funds. *Id.* § 2257.023. The policy may set forth the method by which an investment security used to secure a deposit of public funds is valued. *Id.* This can be incorporated into the entity's investment policy.

A depository services agreement must contain terms and conditions relating to the possession, substitution, or release of security. TEX. LOC. GOV'T CODE § 105.051(a). A city is authorized to

deposit the provided security with a third-party custodian, and many cities require the custodian bank to be unrelated to the depository institution to ensure the protection of the security. TEX. GOV'T CODE § 2257.041. If the depository fails for any reason to comply with the requirements regarding the possession, substitution, or release of security, the city council may select a new depository using the general depository selection process described in Chapter 105 of the Local Government Code. TEX. LOC. GOV'T CODE § 105.051(b).

Is a city required to have a policy in place for payment of funds held by the depository?

While a city is not required by law to have a policy in place regarding the payment of funds, cities are given discretion to adopt procedures: (1) governing the method by which the designated officer is authorized to direct payments from the funds of the city on deposit with a depository; (2) governing the method of payment of obligations of the city, including payment by check, draft, wire transfer, or other method of payment mutually acceptable to the city and the depository; and (3) that the city council determines are necessary to ensure the safety and integrity of the payment process. *Id.* § 105.074(g). Any policy adopted for the payment of funds must be filed with the city's depository. *Id.* § 105.074(h).

Most Texas cities have adopted some policy regarding the payment of funds under Local Government Code Section 105.074(g). State law requires those cities that have not adopted policies dealing with the payment of funds to follow a "warrant system" for payment of funds. This is an antiquated process that allows the city's designated officer to draw a check on a depository only if the officer receives a warrant signed by the mayor and attested by the city secretary. *Id.* § 105.074(b). If there is sufficient money in a fund in the depository, the designated officer may draw a check on the depository in favor of the legal holder of the warrant and charge the warrant against the fund on which it is drawn. *Id.* § 105.074(c).

Needless to say, few cities use the warrant system when making payments. A city without any "payment of funds policy" in place should consult with its city attorney about adopting such a policy.

What is the consequence of failing to comply with the legal requirements pertaining to depository selection and the depository services agreement?

Although there are no penalty provisions spelled out in Chapter 105 of the Local Government Code regarding the selection of the depository and structure of the agreement, failure to comply with the chapter's requirements could have significant consequences. Not only could a city receive negative marks on the city's audit or a downgrade in a city's credit rating, but the city would be open to a civil lawsuit requiring compliance with the state law and calling into question the validity of any existing agreement. Most importantly, the city funds being held in the depository may not be protected beyond FDIC limits in the event of a bank failure, which could have a devastating impact on the ability of the city to provide essential city services.