May 21, 1997

Members of the Legislative Audit Committee:

Substantial compliance with the Public Funds Investment Act (Act) was reported by the 50 Junior College Districts (Districts) subject to the Act in fiscal year 1996, the year of implementation. Thirteen Districts reported instances of noncompliance with the Act's requirements for Investment Policies, Training, Ethics Policies, Signed Broker/Dealer Acknowledgments, and/or Quarterly Investment Reports. These Junior College Districts maintain more than $821 million in investments.

Consistent reporting guidelines are needed to ensure that reported information can be accurately compiled. Recommended guidelines for reporting compliance information have been submitted to the Higher Education Coordinating Board for review and potential inclusion in its *Annual Financial Reporting Requirements for Texas Public Community Colleges*.

Nine Districts reported investments in derivatives in 1996. Five Districts reporting derivative investments in 1994 reported decreased concentrations of derivative investments in 1996, as identified in Figure 1. The decreased concentrations appear to be due primarily to increases in total investment portfolio balances.

Figure 1

**Decreases in Derivative Concentrations from 1994 to 1996**

| Junior College District | Book Value at July 31, 1994 | | | Book Value at August 31, 1996 | | | Increase in Total Portfolio Balance |
|---|---|---|---|---|---|---|---|
| | Total Portfolio | Derivatives | Percentage in Derivatives | Total Portfolio | Derivatives | Percentage in Derivatives | |
| Odessa College | $21,854,441 | $21,854,441 | 100% | $28,077,551 | $25,366,688 | 90.4% | 28.5% |
| Bee County College | $5,741,945 | $3,447,074 | 60% | $6,169,870 | $2,600,778 | 42.2% | 7.5% |
| Amarillo College | $9,623,490 | $4,194,230 | 43.5% | $24,180,301 | $2,778,284 | 11.5% | 151% |
| Temple Junior College | $2,487,362 | $571,878 | 23% | $7,000,709 | $319,347 | 4.6% | 181% |
| Alamo Community College | $81,759,538 | $930,518 | 1.1% | $102,281,185 | $0 | 0% | 25.1% |

Source: *A Briefing Report on Derivative Investments by Texas State Entities* (SAO Report No. 95-035, December 1994) and 1996 investment portfolio information submitted by each District.

Two Districts reporting derivative investments in 1994 reported increased concentrations of derivative investments in 1996, as identified in Figure 2. The increased concentrations appear to be due primarily to significant decreases in total investment portfolio balances.

Figure 2

| Increases in Derivative Concentrations from 1994 to 1996 | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Book Value at July 31, 1994 | | | Book Value at August 31, 1996 | | | |
| Junior College District | Total Portfolio | Derivatives | Percentage of Derivatives | Total Portfolio | Derivatives | Percentage of Derivatives | Decrease in Total Portfolio Balance |
| Lee College | $10,524,791 | $3,535,516 | 33.5% | $7,973,001 | $3,015,270 | 37.8% | -24.3% |
| McLennan Community College | $6,889,811 | $1,233,495 | 17.9% | $3,484,573 | $1,099,856 | 31.6% | -49.4% |

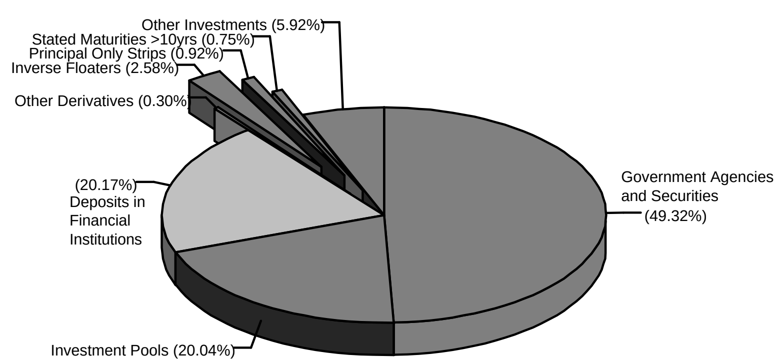
Source: *A Briefing Report on Derivative Investments by Texas State Entities* (SAO Report No. 95-035, December 1994) and 1996 investment portfolio information submitted by each District.

Two Districts reported investments in mortgage backed securities (MBS) in 1996. Angelina College reported $1,440,935 and Laredo Community College reported $766,383 invested in MBSs. Created by pooling together individual borrowers' mortgage loans, MBSs are generally securitized through a federal government agency and do not carry the risk associated with collateralized mortgage obligations.

The 50 Districts reported $821,387,868 in investments, with 4.55 percent, or $37,387,541, invested in derivatives, as identified in Figure 3. The majority of these derivatives (4.25 percent of the total investments) are inverse floaters, principal-only strips, and investments with stated maturities greater than ten years, which are investments now prohibited by the Act. However, the Act does not require entities to sell the prohibited investments if they were purchased prior to the effective date of the Act.

Figure 3

**Portfolio Composition for Texas Junior Colleges as of August 31, 1996**



We would like to thank the management and employees of the 50 Junior College Districts and the Higher Education Coordinating Board for their cooperation and assistance during our compilation of this information.

Sincerely,

Lawrence F. Alwin, CPA
State Auditor

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