Opinion No. 68-62

June 17, 1968

BY: OPINION OF BOSTON E. WITT, Attorney General

TO: Robert G. Mead State Investment Officer Legislative Executive Building Santa Fe, New Mexico

QUESTION

FACTS

The State Investment Council has been presented with A Proposed Purchase and Sale (Hereinafter called Proposal). The Proposal is that the State Investment Council sell U.S. Treasury Obligations and Municipal Bonds having a par value of $ 69,099,217.00 and a book value (original acquisition cost) of $ 67,601,898.00. The Proposal assumes that the Investment Council will realize approximately $ 52,280,000.00 from the sale of these securities. The Proposal is that the Investment Council purchase $ 52,280,000.00 par value Farmers Home Administration Insured Loans that contain a tender option at par at the end of twenty-five years from the date of purchase. The average interest rate to maturity of the securities to be sold is 3.490% and of the FHA insured loans to be purchased is 6.500%. The average life of the new investment will be at least nine years shorter than the average life of the investment to be sold. The Proposal states that the new investment will produce at least .39% more yield, after the capital loss has been amortized from the gross increase in yield, than the yield provided by the investment to be sold. The Investment Council will recover the $ 67,601,898.00 presently invested approximately twelve years earlier than if the investment to be sold is held to maturity. Each year the new investment provides approximately $ 1,900,000.00 of principal recovery with the balance maturing in twenty-five years. The recovery of principal each year will be reinvested. The Proposal does not use the income from investment of the recovery of principal to amortize the capital loss from the sale of the investment presently held by the Investment Council.

QUESTION

May the Proposed Transaction be accomplished under Article XII, Section 7 of the New Mexico Constitution?

CONCLUSION

See Analysis.

OPINION

*{*102}* **ANALYSIS**

Article XII, Section 7 of the New Mexico Constitution provides in part that:

The state investment officer, in order to realize increased *{*103}* income, may, with approval of the state investment council, sell interest-bearing notes or securities at less than their original acquisition cost, providing the proceeds are immediately reinvested in **sufficiently higher yielding** interest-bearing notes or securities, to provide for **a portion of the increased interest income** to be amortized over the life of the new investment which will restore to the corpus of the fund the amount of the capital loss realized on the sale of the original investment. (Emphasis added).

The phrase "capital loss" as it is used in Article XII, Section 7, supra is the difference between the original acquisition costs of the bonds to be sold and the proceeds of the sale of these bonds. Opinion of the Attorney General No. 68-3, dated January 8, 1968. The original acquisition cost of the bonds to be sold is $ 67,601,898.00. The Proposal assumes that the proceeds of the sale of these bonds will be $ 52,280,000.00. The Council will, therefore, have to amortize a capital loss of $ 15,321,898.00 over the life of the new investment.

Article XII, Section 7, supra provides that the proceeds of the sale of the bonds must be immediately reinvested in higher yielding notes or securities "to provide for a **portion** of the increased interest income to be amortized over the life of the new "investment" to restore to the corpus of the permanent fund the amount of the capital loss. It is our opinion that under Article XII, Section 7, the capital loss must be amortized from a portion of the increased interest income only and the new investment must yield an increase in income after the capital loss is restored to the corpus of the permanent fund.

The proceeds of the sale of the bonds must be immediately reinvested in sufficiently "higher yielding" interest-bearing notes or securities so that a portion of the 'increased interest income" from the new investment can be amortized to restore the capital loss to the corpus of the fund. It is our opinion that the phrase "increased interest income" means annual income rather than total income. Thus, the increase in interest income is determined by comparing the annual income of the new investment with the annual income of the old investment rather than by comparing total income of each investment. We note that the Proposal states that the capital loss will be restored to the corpus of the permanent fund from the increased annual income of the new investment and that the new investment will result in an increase in income. This statement is apparently based upon average yield of the new investment to maturity. Whether or not the capital loss can be restored to the corpus of the fund from a portion of increased interest income must be determined on the basis of the actual amount of increased interest income that will accrue from the new investment.

We note that the Proposal does not use income from investments of recoveries of principal to restore the capital loss. It is our opinion that the capital loss must be restored from the income accruing only from the new investment in FHA insured loans and that income accruing from investment of recoveries of principal cannot be used to restore the capital loss.

By: Edward R. Pearson

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