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ATTORNEY GENERAL
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FILE NO. 92-027

PENSIONS:
Investments in "Participating"
Mortgage-Backed Securities

Mr. James L. Stack
Executive Director
Municipal Employees' Annuity
and Benefit Fund of Chicago
221 North LaSalle Street, Room 400
Chicago, Illinois 60601

Dear Mr. Stack:

I have your letters wherein you inquire whether the board of the Municipal Employees' Annuity and Benefit Fund of Chicago (MEABFC) is limited to investing a maximum of 10% of the total assets of the fund in certain participating mortgage-backed securities which are insured or guaranteed by agencies or instrumentalities of the United States. For the reasons hereinafter stated, it is my opinion that the investments in question are authorized by subsections 1-113(1) or 1-113(6) of the Illinois Pension Code (Ill. Rev. Stat. 1991, ch. 108 1/2, par. 1-113(1),(6)), and, therefore, are not subject to the 10% limitation imposed by subsection 1-113(16) of the Code (Ill. Rev. Stat. 1991, ch. 108 1/2, par. 1-113(16)).

Section 8-201 of the Illinois Pension Code (Ill. Rev. Stat. 1991, ch. 108 1/2, par. 8-201) directs the Retirement Board of the MEABFC to invest the reserves of the fund in accordance with the provisions of section 1-113 of the Code, which provides, in pertinent part:

> "Investment Authority. The investment authority of a board of trustees of a retirement system or pension fund established in this Code, shall, if so provided in the Article establishing such retirement system or pension fund, embrace the following investments:
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> (1) Bonds, notes and other direct obligations of the United States Government; bonds, notes and other obligations of any United States Government agency or instrumentality, whether or not guaranteed; and obligations the principal and interest of which are guaranteed unconditionally by the United States Government or by an agency or instrumentality thereof.
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> (6) Notes secured by mortgages under Sections 203, 207, 220 and 221 of the National Housing Act which are insured by the Federal Housing Commissioner, or his successor assigns, or debentures issued by such Commissioner, which are guaranteed as to principal and interest by the Federal Housing Administration, or agency of the United States Government, provided the aggregate investment shall not exceed 20% of the total investment account of the board at book value, and provided further that the investment in such notes under Sections 220 and 221 shall in no event exceed one-half of the maximum investment in notes under this paragraph.

* * *

> (16) Up to 10% of the assets of the fund may be invested in investments not included in paragraphs (1) through (15) of this Section, provided that such investments comply with the requirements and restrictions set forth in Sections 1-109, 1-109.1, 1-109.2, 1-110 and 1-111 of this Code.
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> * * * "

According to the information with which we have been provided, the investments in question consist of two elements. Initially, the investor receives a mortgage-backed security, the payment of principal and interest of which is insured or guaranteed by an agency or instrumentality of the United States (e.g., the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation or other Federal instrumentality). In addition, the investor also participates in the "success" of the project by receiving additional interest or other payments contingent, for example, on such factors as occupancy rates, rental receipts or the increased property value of the project which is financed by the mortgage. In return for the investor's participation in the success of the project, the investor's mortgage-backed security pays interest at rates somewhat below current market value. Thus, the borrower is able to borrow at interest rates more favorable than market rates, while the investor is guaranteed a specific return on the investment plus an opportunity to earn a greater total return than would be possible in a non-participating program. The issue presented is, in essence, whether the fact that these investments include a federally-backed guarantee of the payment of principal plus specific interest (although additional, non-guaranteed income may also accrue) is sufficient to bring the investment as a whole within the purview of subsections 1-113(1) or 1-113(6) of the Illinois Pension Code.

The obvious intent of section 1-113 of the Illinois Pension Code is to safeguard the assets of pension funds by authorizing investments only in those types of instruments in which the payment of the principal and interest are guaranteed or insured, or which, by their character, are unlikely to suffer loss. A pension board is permitted, under subsection 1-113(16) of the Code, to invest up to 10% of the fund's assets in investments which may be more speculative, but may also promise a greater return. By limiting the amount of assets which may be invested in less secure investments, however, the General Assembly has assured, to a reasonable extent, that the assets of a fund cannot be wasted due to speculative investment practices by its board.

Examining the proposed investments with due regard for both the language and the purpose of section 1-113, it is my opinion that such investments may, consistently with the legislative intent, be considered to be authorized investments under subsections 1-113(1) or (6), depending upon the nature of the underlying security and guarantee. The payment of principal and the fixed rate of interest will be guaranteed by an agency or instrumentality of the United States government in each of the proposed investments. Although there is no guarantee of the additional return, if any, stemming from the participation aspect of the investment, that would not diminish the security for the investment or endanger the assets of the fund, assuming that the fixed return is not so insufficient as to constitute a breach of fiduciary duty on the part of the trustees who authorize the investment.

In this regard, under section 1-101.1 of the Code (Ill. Rev. Stat. 1991, ch. 108 1/2, par. 1-101.1), trustees of a fund are deemed to be fiduciaries of the fund. Section 1-109 of the Code (Ill. Rev. Stat. 1991, ch. 108 1/2, par. 1-109) provides, in pertinent part:

> "Duties of Fiduciaries. A fiduciary with respect to a retirement system or pension fund established under this Code shall discharge his or her duties with respect to the retirement system or pension fund solely in the interest of the participants and beneficiaries and:
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> * * *
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> (b) With the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like

> capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims;
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> * * * "

In fulfilling their duties as fiduciaries, the fund's trustees will be required to determine whether these investments, if additional returns do not materialize, would still be prudent investments. If the board determines that the base investment is prudent, then it is my opinion that the assets of the fund may be invested in such investments.

I must note, in conclusion, that because the characteristics of the actual investments may differ, when issued, from the proposals that you have furnished, it is not possible to conclude with certainty whether a specific offering will qualify for investment under either subsection 1-113(1) or (6) of the Code. Therefore, it will be the duty of the trustees of the fund to examine each proposed investment to determine whether it possesses the characteristics specified by statute. I would further note that subsection 1-113(6) does place a limitation upon investments thereunder, limiting total investments in such instruments to 20% of the total investment account of the board at book value.

Lastly, I have been informed that some of the proposed investments may be backed by mortgages which are insured by the Federal Housing Authority, but only to the extent of 99% of the principal amount (in contrast to GNMA, FNMA and FHLMC, each of which guarantees the payment of 100% of the principal). Clearly, subsections 1-113(1) and (6) of the Illinois Pension Code contemplate that qualifying investments will be insured or guaranteed in an amount equal to 100% of the principal and interest; therefore, a guarantee of repayment of less than 100% of the principal does not satisfy those requirements. Consequently, such investments will qualify under subsections 1-113(1) or (6) only if the remaining 1% of principal is also guaranteed or insured by the United States or an agency or instrumentality thereof. As has been suggested as one alternative, it would appear that the pledge of a United States Treasury security in the requisite amount which inures to the benefit of the investors could satisfactorily be employed to secure the uninsured principal.

Respectfully yours,

Roland W. Burris

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ATTORNEY GENERAL