NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

GC/VG:ccH
4660
12/24/85

OFFICE OF GENERAL COUNSEL

Mr. Glenn W. Callaway
Assistant Director
Department of Banking & Finance
State of Nebraska
Box 95006
Lincoln, NB 68509-5006

Dear Mr. Callaway:

This responds to your letter of November 12, 1985, to this Office concerning Federal credit union investment in the ~~National~~ Federal Securities Trust (the Trust), Prospectus dated November 26, 1984, as amended January 4, 1985.

Sections 107(7) and (8) of the Federal Credit Union Act (12 U.S.C. §§1757(7) and (8)) and Section 703 of the NCUA Rules and Regulations (12 C.F.R. §703) (copies enclosed) are the pertinent provisions of law regulating FCU investments and deposits. Although not expressly stated in these provisions, we have previously opined that investments in mutual funds or trusts are permissible for FCU's if all of the investments and investment practices of the fund or trust are legal if made directly by an FCU.

The Trust invests primarily in U.S. Government securities, namely GNMA's. The Trust also invests in the obligations of U.S. instrumentalities. There is insufficient information to determine whether the Trust's investments in these obligations are permissible. In any event, as more fully discussed below, the Trust engages in several activities that render it an illegal investment for FCU's.

First, the Trust enters into options and futures contracts. Section 703.4 of the NCUA Rules and Regulations states in relevant part:

> "(b) A Federal credit union may not buy or sell a futures contract."

We have previously stated that call or put options are a form of futures trading and are thus a prohibited activity for FCU's pursuant to Section 703.4.

FOIA Vol I E 5

Second, the Trust also engages in when-issued transactions, short sales and repurchase transactions. The Prospectus does not indicate whether there will be no more than 120 days from trade to settlement date with when-issued transactions as required by Section 703.3(b) of the Rules and Regulations. With respect to short sales, Section 703.4(d) of the Rules and Regulations states:

> "A Federal credit union may not engage in a short sale."

The repurchase agreements, on the other hand, appear to satisfy our regulatory requirements. NCUA has recently issued a policy statement regarding repurchase transactions. I have enclosed a copy for your convenience.

In conclusion, inasmuch as the Trust engages in options, futures contracts and short sales, all of which FCU's are prohibited from engaging in, and because there is insufficient information in the Prospectus to determine whether all of the investments and investment practices of the Trust are permissible, it is the opinion of this Office that the National Federal Securities Trust is an impermissible investment for Federal credit unions.

Sincerely,

STEVEN R. BISKER
Assistant General Counsel

YG:cch

Attachments

Part 703

Investment and Deposit Activities

§703.1 Scope

Sections 107(7) and 107(8) of the Federal Credit Union Act (12 U.S.C. 1757(7), 1757(8)) set forth those securities, deposits, and other obligations in which Federal credit unions may invest. Included are securities issued or fully guaranteed by the United States Government or any of its agencies, shares of central credit unions and any federally insured credit union, accounts in other federally insured financial institutions, and other specified investments. This Part interprets several of the provisions of sections 107(7) and 107(8) and places certain limits on the types of transactions that Federal credit unions may enter into in connection with the purchase and sale of authorized securities, deposits and obligations. This Part does not apply to investments in loans to members, which are governed by § 701.21 (12 C.F.R. 701.21). Also, other sections of NCUA's regulations affect certain specific investments. For example, investments in credit union service organizations are subject to § 701.27 (12 C.F.R. 701.27), and investments in fixed assets are subject to § 701.36 (12 C.F.R. 701.36).

§703.2 Definitions.

(a) *Adjusted trading* means any method or transaction used to defer a loss whereby a Federal credit union sells a security to a vendor at a price above its current market price and simultaneously purchases or commits to purchase from the vendor another security at a price above its current market price.

(b) *Bailment for hire contract* means a contract whereby a third party, bank or other financial institution, for a fee, agrees to exercise ordinary care in protecting the securities held in safekeeping for its customers.

(c) *Bankers' Acceptance* means a time draft that is drawn on and accepted by a bank, and that represents an irrevocable obligation of the bank.

(d) *Cash forward agreement* means an agreement to purchase or sell a security with delivery and acceptance being mandatory and at a future date in excess of thirty (30) days from the trade date.

(e) *Eurodollar deposit* means a deposit in a foreign branch of a United States depository institution.

(f) *Facility* means the home office of a Federal credit union or any suboffice thereof, including but not necessarily limited to a wire service, telephonic station, or mechanical teller station.

(g) *Federal funds transaction* means a short-term or open-ended transfer of funds to a Section 107(8) institution.

(h) *Futures contract* means a contract for the future delivery of commodities, including certain government securities, sold on commodities exchanges.

(i) *Immediate family member* means a spouse, or a child, parent, grandchild, grandparent, brother or sister, or the spouse of any such individual.

(j) *Market price* means the last established price at which a security is sold.

(k) *Maturity date* means the date on which a security matures, and shall not mean the call date or the average life of the security.

(l) *Repurchase transaction* means a transaction in which a Federal credit union agrees to purchase a security from a vendor and to resell the same or any identical security to that vendor at a later date. A repurchase transaction may be of three types:

(1) *Investment-type repurchase transaction* means a repurchase transaction where the Federal credit union purchasing the security takes physical possession of the security, or receives written confirmation of the purchase and a custodial or safekeeping receipt from a third party under a written bailment for hire contract, or is recorded as the owner of the security through the Federal Reserve Book-Entry System;

(2) *Financial institution-type repurchase transaction* means a repurchase transaction with a Section 107(8) institution;

(3) *Loan-type repurchase transaction* means any repurchase transaction that does not qualify as an investment-type or financial institution-type repurchase transaction.

(m) *Reverse repurchase transaction* means a transaction whereby a Federal credit union agrees to sell a security to a purchaser and to repurchase

the same or any identical security from that purchaser at a future date and at a specified price.

(n) *Section 107(8) institution* means an institution in which a Federal credit union is authorized to make deposits pursuant to Section 107(8) of the Federal Credit Union Act (12 U.S.C. 1757(8)), i.e., an institution that either is insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation or is a state bank, trust company or mutual savings bank operating in accordance with the laws of a state in which the Federal credit union maintains a facility.

(o) *Security* means any security, obligation, account, deposit, or other item authorized for investment by a Federal credit union pursuant to Section 107(7) or 107(8) of the Federal Credit Union Act (12 U.S.C. 1757(7), 1757(8)), other than loans to members.

(p) *Settlement date* means the date originally agreed to by a Federal credit union and a vendor for settlement of the purchase or sale of a security.

(q) *Short sale* means the sale of a security not owned by the seller.

(r) *Standby commitment* means a commitment to either buy or sell a security, on or before a future date, at a predetermined price. The seller of the commitment is the party receiving payment for assuming the risk associated with committing either to purchase a security in the future at a predetermined price, or to sell a security in the future at a predetermined price. The seller of the commitment is required to either accept delivery of a security (in the case of a commitment to buy) or make delivery of a security (in the case of a commitment to sell), in either case at the option of the buyer of the commitment.

(s) *Trade date* means the date a Federal credit union originally agrees, whether orally or in writing, to enter into the purchase or sale of a security.

(t) *Yankee Dollar deposit* means a deposit in a United States branch of a foreign bank licensed to do business in the state in which it is located, or a deposit in a state chartered, foreign controlled bank.

§703.3 Authorized Activities.

(a) *General authority.* A Federal credit union may contract for the purchase or sale of a security provided that:

(1) The delivery of the security is to be made within thirty (30) days from the trade date; and

(2) The price of the security at the time of purchase is the market price.

(b) *Cash forward agreements.* A Federal credit union may enter into a cash forward agreement to purchase or sell a security, provided that:

(1) The period from the trade date to the settlement date does not exceed one hundred and twenty (120) days;

(2) If the credit union is the purchaser, it has written cash flow projections evidencing its ability to purchase the security;

(3) If the credit union is the seller, it owns the security on the trade date; and

(4) The cash forward agreement is settled on a cash basis at the settlement date.

(c) *Loans, shares and deposits—other financial institutions.* A Federal credit union may invest in the following accounts of other financial institutions as specified in Section 107(7) and 107(8) of the Federal Credit Union Act (12 U.S.C. 1757(7), 1757(8)): loans to nonmember credit unions in an aggregate amount not exceeding 25 percent of the lending credit union's unimpaired capital and surplus; shares, share certificates or share deposits of federally insured credit unions; shares or deposits of any central credit union specifically authorized by the board of directors; and deposits of any Section 107(8) institution. Any such investment is subject to the other applicable provisions of this Part 703.

(d) *Repurchase transactions.* A Federal credit union may enter into an investment-type repurchase transaction or a financial institution-type repurchase transaction provided the purchase price of the security obtained in the transaction is at or below the market price. A repurchase transaction not qualifying as either an investment-type or financial institution-type repurchase transaction will be considered a loan-type repurchase transaction subject to Section 107 of the Federal Credit Union Act (12 U.S.C. 1757), which generally limits Federal credit unions to making loans only to members.

(e) *Reverse repurchase transactions.* A Federal credit union may enter into a reverse repurchase transaction, provided that either any securities purchased with the funds obtained from the transaction or the securities collateralizing the transaction have a maturity date not later than the settlement date for the reverse repurchase transaction. A reverse repurchase transaction is a borrowing transaction subject to Section 107(9) of the Federal Credit Union Act (12 U.S.C. 1757(9)), which limits a Federal credit union's aggregate borrowing to 50 percent of its unimpaired capital and surplus.

(f) *Federal funds.* A Federal credit union may

sell Federal funds to a Section 107(8) institution, provided that the interest or other consideration received from the financial institution is at the market rate for Federal funds transaction and that the transaction has a maturity of one or more business days or the credit union is able to require repayment at any time.

(g) *Yankee Dollars.* A Federal credit union may invest in Yankee Dollar deposits in a Section 107(8) institution.

(h) *Eurodollars.* A Federal credit union may invest in Eurodollar deposits in a branch of a Section 107(8) institution.

(i) *Bankers' acceptances.* A Federal credit union may invest in bankers' acceptances issued by a Section 107(8) institution.

§703.4 Prohibited activities.

(a) A Federal credit union may not purchase or sell a standby commitment.

(b) A Federal credit union may not buy or sell a futures contract.

(c) A Federal credit union may not engage in adjusted trading.

(d) A Federal credit union may not engage in a short sale.

(e) A Federal credit union's directors, officials, committee members and employees, and immediate family members of such individuals, may not receive pecuniary consideration in connection with the making of an investment or deposit by the Federal credit union.

APPENDIX I

Interpretative Ruling—Investment Activities

Deleted May 1984

2 Stat. 1091; April 17, 1952, § 1, 66 Stat. 63; 1[illegible] § 5, 73 Stat. 629; Mar. 10, 1970, [illegible]-[illegible], 84 Stat. 49; Oct. 19, 1970, Pub.L. 34 Stat. 1015; Nov. 10, 1978, Pub.L. 95-at. 3632; Oct. 15, 1982, Pub.L. 97-320, 96).)

6 § 106

rts and examinations.—Federal credit hall be under the supervision of the Board, l make financial reports to it as and when it uire, but at least annually. Each Federal ion shall be subject to examination by, and purpose shall make its books and records le to, any person designated by the Board. 3, 1934, § 6, 48 Stat. 1218; Dec. 6, 1937, § 1, 4; June 29, 1948, § 2, 62 Stat. 1091; Sept. 22, 6, 73 Stat. 629; Mar. 10, 1970, Pub.L. 84 Stat. 49; Oct. 19, 1970, Pub.L. 91-468, 84)15; Nov. 10, 1978, Pub.L. 95-630, 92 Stat.

57 § 107

ers.—A Federal credit union shall have suc- in its corporate name during its existence all have power—

[illegible]ke contracts;

to sue and be sued;

) to adopt and use a common seal and alter me at pleasure;

) to purchase, hold, and dispose of property ary or incidental to its operations;

) to make loans, the maturities of which shall ceed twelve years except as otherwise pro- nerein, and extend lines of credit to its mem- to other credit unions, and to credit union izations and to participate with other credit s, credit union organizations, or financial or- ations in making loans to credit union mem- n accordance with the following:

(A) Loans to members shall be made in rmity with criteria established by the board ectors: *Provided, That*—

(i) a residential real estate loan on a one- r-family dwelling, including an individual co- tive unit, that is or will be the principal ence of a credit union member, and which is ed by a first lien upon such dwelling, and may a maturity not exceeding thirty years or such limits as shall be set by the National Credit [illegible]inistration Board (except that a loan on individual cooperative unit shall be adequately red as defined by the Board), subject to the and regulations of the Board;

(ii) a loan to finance the purchase of a mobile home, which shall be secured by a first lien on such mobile home, to be used by the credit union member as his residence, or a second mortgage loan secured by a residential dwelling which is the residence of a credit union member shall have a maturity not to exceed fifteen years unless such loan is insured or guaranteed as provided in subparagraph (iii);

(iii) a loan secured by the insurance or guarantee of, or with advance commitment to purchase the loan by, the Federal Government, a State government or any agency of either may be made for the maturity and under the terms and conditions specified in the law under which such insurance, guarantee, or commitment is provided;

(iv) a loan or aggregate of loans to a director or member of the supervisory or credit committee of the credit union making the loan which exceeds $10,000 plus pledged shares, be approved by the board of directors;

(v) loans to other members for which directors or members of the supervisory or credit committee act as guarantor or endorser be approved by the board of directors when such loans standing alone or when added to any outstanding loan or loans of the guarantor or endorser exceeds $10,000;

(vi) the rate of interest may not exceed 15 per centum per annum on the unpaid balance inclusive of all finance charges, except that the Board may establish—

(I) after consultation with the appropriate committees of the Congress, the Department of Treasury, and the Federal financial institution regulatory agencies, an interest rate ceiling exceeding such 15 per centum per annum rate, for periods not to exceed 18 months, if it determines that money market interest rates have risen over the preceding six-month period and that prevailing interest rate levels threaten the safety and soundness of individual credit unions as evidenced by adverse trends in liquidity, capital, earnings, and growth; and

(II) a higher interest rate ceiling for Agent members of the Central Liquidity Facility in carrying out the provisions of title III for such periods as the Board may authorize,

(vii) the taking, receiving, reserving, or charging of a rate of interest greater than is allowed by this paragraph, when knowingly done, shall be deemed a forfeiture of the entire interest which the note, bill, or other evidence of debt carries with it, or which has been agreed to be paid

thereon. If such greater rate of interest has been paid, the person by whom it has been paid, or his legal representatives, may recover back from the credit union taking or receiving the same, in an action in the nature of an action of debt, the entire amount of interest paid; but such action must be commenced within two years from the time the usurious collection was made;

(viii) a borrower may repay his loan, prior to maturity in whole or in part on any business day without penalty, except that on a first or second mortgage loan a Federal credit union may require that any partial prepayments (I) be made on the date monthly installments are due and (II) be in the amount of that part of one or more monthly installments which would be applicable to principal;

(ix) loans shall be paid or amortized in accordance with rules and regulations prescribed by the Board after taking into account the needs or conditions of the borrowers, the amounts and duration of the loans, the interests of the members and the credit unions, and such other factors as the Board deems relevant;

(x) loans must be approved by the credit committee or a loan officer, but no loan may be made to any member if, upon the making of that loan, the member would be indebted to the Federal credit union upon loans made to him in an aggregate amount which would exceed 10 per centum of the credit union's unimpaired capital and surplus.

(B) A self-replenishing line of credit to a borrower may be established to a stated maximum amount on certain terms and conditions which may be different from the terms and conditions established for another borrower.

(C) Loans to other credit unions shall be approved by the board of directors.

(D) Loans to credit union organizations shall be approved by the board of directors and shall not exceed 1 per centum of the paid-in and unimpaired capital and surplus of the credit union. A credit union organization means any organization as determined by the Board, which is established primarily to serve the needs of its member credit unions, and whose business relates to the daily operations of the credit unions they serve.

(E) Participation loans with other credit unions, credit union organizations, or financial organizations shall be in accordance with written policies of the board of directors. *Provided*, That a credit union which originates a loan for which participation arrangements are made in accordance with this subsection shall retain an interest of at least 10 per centum of the face amount of the loan.

(6) To receive from its members, from other credit unions, from an officer, employee, or agent of those nonmember units of Federal, Indian Tribal, State, or local governments and political subdivisions thereof enumerated in section 207 of this Act and in the manner so prescribed, from the Central Liquidity Facility, and from nonmembers in the case of credit unions serving predominantly low-income members (as defined by the Board) payments on (A) shares which may be issued at varying dividend rates; (B) share certificates which may be issued at varying dividend rates and maturities; and (C) share draft accounts authorized under Section 205(f); subject to such terms, rates, and conditions as may be established by the board of directors, within limitations prescribed by the Board.

(7) To invest its funds (A) in loans exclusively to members; (B) in obligations of the United States of America, or securities fully guaranteed as to principal and interest thereby; (C) in accordance with rules and regulations prescribed by the Board, in loans to other credit unions in the total amount not exceeding 25 per centum of its paid-in and unimpaired capital and surplus; (D) in shares or accounts of savings and loan associations or mutual savings banks, the accounts of which are insured by the Federal Savings and Loan Insurance Corporation or the Federal Deposit Insurance Corporation; (E) in obligations issued by banks for cooperatives, Federal land banks, Federal intermediate credit banks, Federal home loan banks, the Federal Home Loan Bank Board, or any corporation designated in section 846 of Title 31 as a wholly owned Government corporation; or in obligations, participations, or other instruments of or issued by, or fully guaranteed as to principal and interest by, the Federal National Mortgage Association or the Government National Mortgage Association; or in mortgages, obligations, or other securities which are or ever have been sold by the Federal Home Loan Mortgage Corporation pursuant to Section 305 or Section 306 of the Federal Home Loan Mortgage Corporation Act; or in obligations or other instruments or securities of the Student Loan Marketing Association; or in obligations, participations, securities, or other instruments of, or issued by, or fully guaranteed as to principal and interest by any other agency of the United States and a Federal credit union may issue and sell securities which are guaranteed pursuant to section 306(g) of the National Housing Act; (F) in participation certificates evidencing beneficial interests in obligations, or in the right to receive interest and principal collections therefrom, which obligations have been subjected by one or more Government agencies to a trust or trusts for which any executive department, agency, or instrumentality of the United States (or the head thereof) has been named to act as trustee; (G) in shares or de-

posits of any central credit union in which such investments are specifically authorized by the board of directors of the Federal credit union making the investment; (H) in shares, share certificates, or share deposits of federally insured credit unions; (I) in the shares, stocks, or obligations of any other organization, providing services which are associated with the routine operations of credit unions, up to 1 per centum of the total paid in and unimpaired capital and surplus of the credit union with the approval of the Board: *Provided, however,* That such authority does not include the power to acquire control directly or indirectly, of another financial institution, nor invest in shares, stocks or obligations of an insurance company, trade association, liquidity facility or any other similar organization, corporation, or association, except as otherwise expressly provided by this Act; (J) in the capital stock of the National Credit Union Central Liquidity Facility; and (K) investments in obligations of, or issued by, any State or political subdivision thereof (including any agency, corporation, or instrumentality of a State or political subdivision), except that no credit union may invest more than 10 per centum of its unimpaired capital and surplus in the obligations of any one issuer (exclusive of general obligations of the issuer).

(8) to make deposits in national banks and in State banks, trust companies, and mutual savings banks operating in accordance with the laws of the State in which the Federal credit union does business, or in banks or institutions the accounts of which are insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation, and for Federal credit unions or credit unions authorized by the Department of Defense operating suboffices on American military installations in foreign countries or trust territories of the United States to maintain demand deposit accounts in banks located in those countries or trust territories, subject to such regulations as may be issued by the Board and provided such banks are correspondents of banks described in this paragraph;

(9) to borrow in accordance with such rules and regulations as may be prescribed by the Board, from any source, in an aggregate amount not exceeding, except as authorized by the Board in carrying out the provisions of title III, 50 per centum of its paid-in and unimpaired capital and surplus: *Provided,* That any Federal credit union may discount with or sell to any Federal intermediate credit bank any eligible obligations up to the amount of its paid-in and unimpaired capital;

(10) to levy late charges, in accordance with the bylaws, for failure of members to meet promptly their obligations to the Federal credit union;

(11) to impress and enforce a lien upon the shares and dividends of any member, to the extent of any loan made to him and any dues or charges payable by him;

(12) in accordance with rules and regulations prescribed by the Board, to sell to members negotiable checks (including travelers checks), money orders and other similar money transfer instruments; and to cash checks and money orders for members, for a fee;

(13) in accordance with rules and regulations prescribed by the Board, to purchase, sell, pledge, or discount or otherwise receive or dispose of, in whole or in part, any eligible obligations (as defined by the Board) of its members and to purchase from any liquidating credit union notes made by individual members of the liquidating credit union at such prices as may be agreed upon by the board of directors of the liquidating credit union and the board of directors of the purchasing credit union, but no purchase may be made under authority of this paragraph if, upon the making of that purchase, the aggregate of the unpaid balances of notes purchased under authority of this paragraph would exceed 5 per centum of the unimpaired capital and surplus of the credit union; and

(14) to sell all or a part of its assets to another credit union, to purchase all or part of the assets of another credit union and to assume the liabilities of the selling credit union and those of its members subject to regulations of the Board;

(15) to exercise such incidental powers as shall be necessary or requisite to enable it to carry on effectively the business for which it is incorporated. (June 26, 1934, § 7, 48 Stat. 1218; Dec. 6, 1937, § 2, 51 Stat. 4; July 31, 1946, § 1, 60 Stat. 744; June 29, 1948, § § 1, 2, 62 Stat. 1091; Oct. 25, 1949, § 1, 63 Stat. 890; May 13, 1952, 66 Stat. 70; Sept. 22, 1959, § 7, 73 Stat. 630; July 2, 1964, § 1, 78 Stat. 269; May 24, 1966, § 7, 80 Stat. 167; July 3, 1967, § § 2, 3, 81 Stat. 110; July 5, 1968, § 1, 82 Stat. 284; Aug. 1, 1968, § 80, 82 Stat. 545; Mar. 10, 1970, Pub.L. 91–206, 84 Stat. 49; Oct. 19, 1970, Pub.L. 91–468, 84 Stat. 1017; June 23, 1971, Pub.L. 92–318, 86 Stat. 270; Aug. 22, 1974, Pub.L. 93–383, 88 Stat. 739; Oct. 29, 1974, Pub.L. 93–495, 88 Stat. 1500; Dec. 31, 1974, Pub.L. 93–569, 88 Stat. 1866; Apr. 19, 1977, Pub.L. 95–22, 91 Stat. 49; Nov. 10, 1978, Pub.L. 95–630, 92 Stat. 3681, 3723; December 21, 1979, Pub.L. 96–153, 93 Stat. 1120; March 31, 1980, Pub.

BACKGROUND AND SUMMARY OF THE NATIONAL CREDIT UNION ADMINISTRATION SUPERVISORY POLICY ON REPURCHASE TRANSACTIONS

The bankruptcy of several securities dealers within the last year precipitated what some people consider to be a major crisis within the financial industry. These dealers' customers had entered into arrangements to purchase United States Government and Agency obligations under agreements to resell (NCUA has defined this type of transaction for credit unions as a repurchase transaction). Because the customers had failed to take adequate steps to protect themselves in these transactions, they incurred millions of dollars in losses when the dealers entered bankruptcy. Fortunately, only a very few credit unions had any loss exposure in these cases. This is partially due to the existing safeguards on repurchase transactions that are already built into Part 703 of the NCUA Rules and Regulations and partially due to the fact that credit unions simply have not been heavily involved in this type of activity.

The Federal Financial Institutions Examination Council (FFIEC) developed a supervisory policy for financial institutions involved in "repurchase transactions" to provide minimum guidelines to address the safety and soundness issues involved. The policy statement contains policies and procedures that any financial institution should adhere to if they are engaged in "repurchase transactions" and, therefore, the NCUA Board has adopted this supervisory policy as Interpretive Ruling and Policy Statement Number 85-2. The policy statement is attached, however, since it is written in somewhat technical and generic language directed to all financial institutions, NCUA is providing some highlights tailored for credit unions. The reader should first be thoroughly familiar with Part 703 of the NCUA Rules and Regulations

The policy statement uses the term "repurchase agreement" to refer to both repurchase transactions (repos) and reverse repurchase transactions (reverse repos). NCUA has defined a repurchase transaction as a transaction in which a Federal credit union agrees to purchase a security from a vendor and to resell the same or any identical security to that vendor at a later date. Part 703 of the NCUA Rules and Regulations further defines repurchase transactions as being of three types: investment-type, financial institution-type, and loan-type repurchase transactions. A repo is recorded on the books of a Federal credit union as a purchase of securities with notes to the financial statements reflecting the amount of the securities which are subject to resale and the date of resale. A reverse repurchase transaction is the other side of this activity and is defined by NCUA as a transaction whereby a Federal credit union agrees to sell a security to a purchaser and to repurchase the same or any identical security from that purchaser at a future date and at a specified price. A reverse repo represents borrowing activity and, therefore, is recorded on the credit union's books as a note payable. The securities used as collateral for the reverse repo are identified in a note to the financial statements reflecting both the book value and the market price on the statement date.

The supervisory policy contains minimum guidelines for managing credit risk exposure to counterparties (the vendors, dealers, corporate credit unions, banks, or other entities with which the credit union is conducting business) and for controlling the securities in those transactions. NCUA examiners will review written policies and procedures of credit unions to determine their adequacy in light of these minimum guidelines and the scope of each Federal credit union's operations.

Credit Policy Guidelines

Any Federal credit union engaging in securities repo and reverse repo activity should establish written credit policies and procedures governing these activities.

1. Written policies should establish "know your counterparty" principles. It is important to know the legal entity that is actually the counterparty to each transaction. The credit union should know about that entity's character, integrity of management, activities, and financial markets in which it deals. If the firm with which the credit union is dealing is a subsidiary of or related to a financially stronger or better known firm, in reviewing creditworthiness the credit union should know whether or not the stronger firm is legally obligated to stand behind the transactions of its related companies. Credit unions should not enter into undisclosed agency or "blind brokerage" transactions in which the counterparty's name is not disclosed. Credit unions should also be particularly careful in conducting repos or reverse repos with any firm that offers terms that are significantly more favorable than those currently prevailing in the market. (Page 2, item A of the supervisory policy.)

2. A securities dealer does not have to be a federally insured depository institution or a broker/dealer registered with the Securities and Exchange Commission. Currently there are a large number of securities dealer firms that are not subject to regulatory oversight. If a credit union does business with one of these firms, the credit union should be certain that the dealer voluntarily complies with the Federal Reserve Bank of New York's minimum capital guidelines, which currently call for liquid capital to exceed measured risk by 20 percent. Page 3 of the supervisory policy lists three forms of certification of capital standards compliance that should be obtained by a credit union doing business with an unregulated securities dealer. (Pages 2 and 3, item B of the supervisory policy.)

3. The credit union should periodically review the financial soundness and other creditworthiness factors of the firm or financial institution that is the counterparty in the repo and reverse repo transactions. Additional information concerning these periodic evaluations of creditworthiness can be found on pages 3 and 4 of the supervisory policy. (Pages 3 and 4, item C of the supervisory policy.)

4. The board of directors or investment committee must establish maximum position and temporary exposure limits for each counterparty based upon the evaluation of creditworthiness referred to above. These limits should be reviewed and updated periodically. Of course, the maximum position in reverse repos is limited by the Federal Credit Union Act to 50 percent of the credit union's unimpaired capital and surplus. (Page 4, item D of the supervisory policy.)

5. With regard to the lending limitations referred to on page 4 of the supervisory policy, Part 703 of the NCUA Rules and Regulations delineates three types of repurchase transactions. If a credit union is engaging in repo activity with a dealer/broker and fails to take adequate control of the securities collateralizing the transaction, then the transaction would probably be classified as a loan-type repurchase transaction. Since the Federal Credit Union Act generally limits Federal credit unions to making loans only to members, a loan-type repurchase transaction with a dealer/broker would probably be considered as a violation of the Federal Credit Union Act. (Page 4, item E of the supervisory policy.)

Guidelines for Controlling Repurchase Agreement Collateral

Failure to manage repurchase transactions appropriately could expose the credit union to serious risks. One of the first steps to controlling this risk is to negotiate written agreements with the counterparties and custodian banks and to monitor compliance with the terms of those agreements on a daily basis. One of the essential elements in this process that must be emphasized is establishing adequate control over the securities collateralizing the transaction. The credit union should obtain a written legal opinion as to the adequacy of the procedures utilized to establish and protect its interest in the underlying collateral.

1. The written agreement should specify all the terms of the transaction and the duties of both the buyer and the seller. Some of the provisions that should be contained in repurchase and custodial agreements are listed in Section A of "General Requirements" on page 5 of the supervisory policy. (Page 5, item A of the supervisory policy.)

2. Confirmations are received for repurchase and reverse repurchase transactions, and credit unions should make sure that the terms of these confirmations do not attempt to alter the credit union's rights in the transaction as specified in the written agreement. (Page 6, item B of the supervisory policy.)

3. Control of securities to protect the credit union's interest receives major emphasis in the supervisory policy and is required by Part 703 of the NCUA Rules and Regulations for a repurchase transaction to qualify as an "investment-type repurchase transaction." The steps for controlling the securities are set forth on pages 6 and 7 of the supervisory policy and in Section 703.2(l)(1) of the NCUA Rules and Regulations. If a Federal credit union engages in a repurchase transaction with a securities dealer, other than a Section 107(8) financial institution, and does not take control of the securities, then the transaction would be classified as a "loan-type repurchase transaction" and would probably be in violation of Federal laws and regulations governing the operations of Federal credit unions. (Pages 6 and 7, item C of the supervisory policy.)

4. Section 703.2(d) of the NCUA Rules and Regulations requires the purchase price of securities obtained in a repurchase transaction to be at or below market. The supervisory policy statement provides further narrative and guidance on margin requirements and prudent management procedures. (Pages 7 and 8, items D and E of the supervisory policy.)

5. The last item addressed in the supervisory policy is the issue of over-collateralization of reverse repurchase transactions. Different securities used as collateral as well as prevailing market conditions dictate reasonable margin levels. Should a credit union receive funds in an amount substantially less than the market value of their securities collateralizing the reverse repo, after deducting a reasonable margin, NCUA will view this as an unsafe and unsound act. (Page 8, item F of the supervisory policy.)

The guidelines established in the FFIEC's supervisory policy statement constitute sound business practices for any financial institution engaged in repurchase and reverse repurchase transactions. The NCUA Board adopted this policy because it provides additional guidance in the areas of safety and soundness that may not be addressed in existing laws and regulations governing the operations of Federal credit unions. The NCUA Board cautions that its adoption of this policy statement is not intended to encourage credit unions to begin engaging in this activity but rather to provide guidance to NCUA examiners and to those credit unions who find it to be a sound, prudent activity that will ultimately derive benefit to the credit union and its members.

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Ch. VII

Repurchase Agreements of Depository Institutions with Securities Dealers and Others; Interpretive Ruling and Policy Statement Number 85-2

AGENCY: National Credit Union Administration (NCUA).

ACTION: Interpretive Ruling and Policy Statement Number 85-2.

SUMMARY: The NCUA Board has adopted as its statement of general policy for Federal credit unions the Federal Financial Institutions Examination Council ("FFIEC") Supervisory Policy entitled "Repurchase Agreements of Depository Institutions with Securities Dealers and Others."

EFFECTIVE DATE: November 14, 1985.

FOR FURTHER INFORMATION CONTACT: Donald W. Sorrels, Office of Examination and Insurance, or Steven R. Bisker, Assistant General Counsel, NCUA, 1776 G Street, NW., Washington, DC 20456, or telephone (202) 357-1065 (Mr. Sorrels) or (202) 357-1030 (Mr. Bisker).

SUPPLEMENTARY INFORMATION: On October 21, 1985, the FFIEC approved a recommendation to each of the participating Federal financial institution regulatory agencies to adopt its Supervisory Policy entitled "Repurchase Agreements of Depository Institutions with Securities Dealers and Others." The NCUA Board, at its November 14, 1985, meeting, adopted the Supervisory Policy as its general policy for Federal credit unions. For the most part, the Supervisory Policy elaborates on what is already required of FCU's under NCUA's Rules and Regulations, Part 703--Investment and Deposit Activities. The Supervisory Policy sets out guidelines which are recognized to be safe and sound practices when engaging in repurchase and reverse repurchase transactions. FCU's involved in these transactions should follow the guidelines.

Federal Financial Institutions Examination Council Supervisory Policy

Repurchase Agreements of Depository Institutions With Securities Dealers and Others

Purpose

Depository institutions and others involved with the purchase of United States Government and Agency obligations under agreements to resell

(reverse repurchase agreement),[1] have sometimes incurred significant losses. The most important factors causing these heavy losses have been inadequate credit risk management and the failure to exercise effective control over securities collateralizing the transactions.[2]

The following minimum guidelines address the need for managing credit risk exposure to counterparties under securities repurchase agreements and for controlling the securities in those transactions, and should be followed by depository institutions that enter into repurchase agreements with securities dealers and others.

Depository institutions that actively engage in repurchase agreements are encouraged to have more comprehensive policies and controls to suit their particular circumstances. The examining staffs of the Federal bank, thrift and credit union supervisory agencies will review written policies and procedures of depository institutions to determine their adequacy in light of these minimum guidelines and the scope of each depository's operations.

I. Credit Policy Guidelines

The apparent safety of short-term repurchase agreements which are collateralized by highly liquid, U.S. Government and Federal agency obligations has contributed to an attitude of complacency. Some portfolio managers have underestimated the credit risk associated with the performance of the counterparty to the transaction, and have not taken adequate steps to assure control of the securities covered by the agreement.

All depository institutions that engage in securities repurchase agreement transactions should establish written credit policies and procedures governing these activities. At a minimum, those policies and procedures should cover the following:

A. *Written policies* should establish "know your counterparty" principles. Engaging in repurchase agreement transactions in volume and in large dollar amounts frequently requires the services of a counterparty who is a dealer in the underlying securities. Some firms which deal in the markets for U.S. Government and Federal agency securities are subsidiaries of, or related to, financially stronger and better known firms. However, these stronger firms may be independent of their U.S. Government securities subsidiaries and affiliates and may not be legally obligated to stand behind the transactions of related companies. Without an express guarantee, the stronger firm's financial position cannot be relied upon in assessing the creditworthiness of a counterparty.

It is important to know the legal entity that is the actual counterparty to each repurchase agreement transaction. A depository institution should know about the actual counterparty's character, integrity of management, activities, and the financial markets in which it deals. Depository institutions should be particularly careful in conducting repurchase agreements with any firm that offers terms that are significantly more favorable than those currently prevailing in the market.

In certain situations depository institutions may use, or serve as, brokers or finders in order to locate repurchase agreement counterparties or particular securities. When using or acting as this type of agent the names of each counterparty should be fully disclosed. Depository institutions should not enter into undisclosed agency or "blind brokerage" repurchase transactions in which the counterparty's name is not disclosed.

B. *Dealings with unregulated securities dealers.* A dealer in U.S. Government and Federal agency obligations is not necessarily a Federally insured bank or thrift, or a broker/dealer registered with the Securities and Exchange Commission. Therefore, the dealer firm may not be subject to any Federal regulatory oversight.

A depository institution doing business with an unregulated securities dealer should be certain that the dealer voluntarily complies with the Federal Reserve Bank of New York's minimum capital guideline, which currently calls for liquid capital to exceed measured risk by 20 percent (that is, the ratio of a dealer's liquid capital to risk of 1.2:1). This ratio can be calculated by a dealer using either the Securities and Exchange Commission's Net Capital Rule for Brokers and Dealers (Rule 15c3-1) or the Federal Reserve Bank of New York's Capital Adequacy Guidelines for United States Government Securities Dealers. To ensure that an unregulated dealer complies with either of those capital standards, it should certify its compliance with the capital standard and provide the following three forms of certification:

(1) A letter of certification from the dealer that the dealer will adhere on a continuous basis to the capital adequacy standard;

(2) audited financial statements which demonstrate that as of the audit date the dealer was in compliance with the standard and the amount of liquid capital; and

(3) a copy of a letter from the firm's certified public accountant stating that it found no material weaknesses in the dealer's internal systems and controls incident to adherence to the standard.[3]

C. *Periodic evaluations* of counterparty creditworthiness should be conducted by individuals who routinely make credit decisions and who are not involved in the execution of repurchase agreement transactions.

Prior to engaging in initial transactions with a new counterparty, depository institutions should obtain audited financial statements and regulatory filings (if any) from its counterparties, and should insist that similar information be provided on a periodic and timely basis in the future. Recent failures of government securities dealers have typically been foreshadowed by delays in producing these statements. Many firms are registered with the Securities and Exchange Commission as broker/dealers and have to file financial statements and should be willing to provide a copy of these filings.

The counterparty credit analysis should consider the financial statements of the entity that is to be the depository institution's counterparty as well as those of any related companies that could have an impact on the financial condition of the counterparty. When transacting business with a subsidiary, consolidated financial statements of a parent are not adequate. Repurchase agreements should not be entered into with any counterparty that is unwilling to provide complete and timely disclosure of its financial condition. As part of this analysis, the depository institution should make inquiry about the counterparty's general reputation and whether there have been any formal enforcement actions against the

---

[1] In order to avoid confusion among market participants who sometimes use the same term to describe different sides of the same transaction, the term "repurchase agreement" will be used in the balance of this statement to refer to both repurchase and reverse repurchase agreements. A repurchase agreement is one in which a party that owns securities acquires funds by transferring the securities to another party under an agreement to repurchase the securities at an agreed upon future date. A reverse repurchase (resale) agreement is one in which a party provides funds by acquiring securities pursuant to an agreement to resell them at an agreed upon future date.

[2] Throughout this document repurchase agreements are generally discussed in terms of secured credit transactions. This usage should not be deemed to be based upon a legal determination.

[3] This letter should be similar to that which must be given to the SEC by registered brok[illegible]

counterparty or its affiliates by State or Federal securities regulators.

D. Maximum position and temporary exposure limits for each approved counterparty should be established based upon credit analysis performed. Periodic reviews and updates of those limits are necessary.

Individual repurchase agreement counterparty limits should consider overall exposure to the same or related counterparty throughout the depository institution. Repurchase agreement counterparty limitations should include the overall permissible dollar positions in repurchase agreements, maximum repurchase agreement maturities and limits on temporary exposure that may result from decreases in collateral values or delays in receiving collateral.

E. *Lending Limitations.* Federally-chartered savings institutions and Federal credit unions are subject to all Federal regulations in this area. State-chartered banks or savings institutions should consult with their counsel and/or state banking or thrift authorities as to the applicability of state lending restrictions to repurchase transactions.

Except as otherwise provided in applicable agency regulations and State law, it should be assumed that unless the depository institution's interest in securities held as collateral under a repurchase agreement is assured, a repurchase agreement transaction with any single counterparty will be subject to the lending limitations applicable to that institution. Conversely, the market value of securities sold under a repurchase agreement in excess of the amount of proceeds received by the depository institution could be viewed as an unsecured extension of credit to the repurchase agreement counterparty subject to the depository institution's lending limits.

The application of lending limitations on loans by national banks to certain types of repurchase transactions is currently under review by the Comptroller of the Currency. Until this review is completed, national banks as a matter of prudent banking should treat repurchase agreements as if they are subject to the lending limit unless the bank has control of the underlying securities.

II. Guidelines for Controlling Repurchase Agreement Collateral

Repurchase agreements can be a useful asset and liability management tool, but repurchase agreements can expose a depository institution to serious risks if they are not managed appropriately. It is possible to reduce repurchase agreement risk if the depository institution negotiates written agreements with all repurchase agreement counterparties and custodian banks. Compliance with the terms of these written agreements should be monitored on a daily basis. If prudent management control requirements of repurchase agreements are too burdensome for a depository institution, other asset/liability management tools should be used.

The marketplace perceives repurchase agreement transactions as similar to lending transactions collateralized by highly liquid Government securities. However, experience has shown that the collateral securities will probably *not* serve as protection if the counterparty becomes insolvent or fails, and the purchasing institution does not have control over the securities. This policy statement provides general guidance on the steps depository institutions should take to protect their interest in the securities underlying repurchase agreement transactions (see "C. Control of Securities," page 6). However, ultimate responsibility for establishing adequate procedures rests with management of the institution. Management should obtain a written legal opinion as to the adequacy of the procedures utilized to establish and protect the depository institution's interest in the underlying collateral.

General Requirements

A. *A written agreement* specific to a repurchase agreement transaction or master agreement governing all repurchase agreement transactions should be entered into with each counterparty. The written agreement should specify all the terms of the transaction and the duties of both the buyer and seller. Senior managers of depository institutions should consult legal counsel regarding the content of the repurchase and custodial agreements. The repurchase and custodial agreements should specify, but should not be limited to, the following:

- Acceptable types and maturities of collateral securities;
- Initial acceptable margin for collateral securities of various types and maturities;
- Margin maintenance, call, default and sellout provisions;
- Rights to interest and principal payments;
- Rights to substitute collateral; and
- The persons authorized to transact business on behalf of the depository institution and its counterparty.

B. *Confirmations.* Some repurchase agreement confirmations may contain terms that attempt to change the depository institution's rights in the transaction. The depository institution should obtain and compare written confirmations for each repurchase agreement transaction to be certain that the information on the confirmation is consistent with the terms of the agreement. The confirmation should identify specific collateral securities.

C. *Control of Securities.* As a general rule, a depository institution should obtain possession or control of the underlying securities and take necessary steps to protect its interest in the securities. The legal steps necessary to protect its interest may vary with applicable facts and law and accordingly should be undertaken with the advice of counsel. Additional prudential management controls may include:

(1) Direct delivery of physical securities to the institution, or of book-entry securities by appropriate entry in an account maintained in the name of the depository institution by a Federal Reserve Bank which maintains a book-entry system for U.S. Treasury securities and certain agency obligations (for further information as to the procedures to be followed, contact the Federal Reserve Bank for the District in which the depository institution is located);

(2) Delivery of either physical securities to, or in the case of book entry securities, making appropriate entries in the books of a third party custodian designated by the depository institution under a written custodial agreement which explicitly recognizes the depository institution's interest in the securities as superior to that of any other person; or

(3) Appropriate entries on the books of a third party custodian acting pursuant to a tripartite agreement with the depository institution and the counterparty, ensuring adequate segregation and identification of either physical or book-entry securities.

Where control of the underlying securities is not established, the depository institution may be regarded only as an unsecured general creditor of the insolvent counterparty. In such instance, *substantial losses are likely to be incurred.* Accordingly, a depository institution should not enter into a repurchase agreement without obtaining control of the securities unless all of the following minimum procedures are observed: (1) It is completely satisfied as to the creditworthiness of the counterparty; (2) the transaction is within credit limitations that have been pre-approved by the board of directors, or a committee of the board, for unsecured transactions with the counterparty; (3) periodic credit evaluations of the counterparty are

conducted: and (4) the depository institution has ascertained that collateral segregation procedures of the counterparty are adequate. Unless prudential internal procedures of these types are instituted and observed, the depository institution may be cited by its financial supervisory agency for engaging in unsafe or unsound practices.

All receipts and deliveries of either physical or book-entry securities should be made according to written procedures, and third party deliveries should be confirmed in writing directly by the custodian. It is not acceptable to receive confirmation from the counterparty that the securities are segregated in a depository institution's name with a custodian; the depository institution should, however, obtain a copy of the advice of the counterparty to the custodian requesting transfer of the securities to the depository institution. Where securities are to be delivered, payment for securities should not be made until the securities are actually delivered to the depository institution or its agent. The custodial contract should provide that the custodian takes delivery of the securities subject to the exclusive direction of the depository institution.

Substitution of securities should not be allowed without the prior consent of a depository institution. The depository institution should give its consent before the delivery of the substitute securities to the depository institution or a third party custodian. Any substitution of securities should take into consideration the following discussion of "margin requirements."

D. *Margin Requirements.* The amount paid by a depository institution under the repurchase agreement should be less than the market value of the securities, including the amount of any accrued interest, with the difference representing a predetermined margin. Factors to be considered in establishing an appropriate margin include the size and maturity of the repurchase transaction, the type and maturity of the underlying securities, and the creditworthiness of the counterparty. Margin requirements of U.S. Government and Federal agency obligations underlying repurchase agreements should allow for the anticipated price volatility of the security until the maturity of the repurchase agreement. Less marketable securities may require additional margin to compensate for less liquid market conditions. Written repurchase agreement policies and procedures should require daily market-to-market of repurchase agreement securities to the bid side of the market. Repurchase agreements should provide for additional securities or cash to be placed with the depository institution or its custodian bank to maintain the margin within the predetermined level.

Margin calculations should also consider accrued interest on underlying securities and the anticipated amount of accrued interest over the term of the repurchase agreement, the date of interest payment and which party is entitled to receive the payment. In the case of pass-through securities, anticipated principal reductions should also be considered when determining margin adequacy.

E. *Prudent management* procedures should be followed in the administration of any repurchase agreement. Longer term repurchase agreements require management's daily attention to the effects of securities substitutions, margin maintenance requirements (including consideration of any coupon interest or principal payments) and possible changes in the financial condition of the counterparty. Engaging in open repurchase agreement transactions without maturity dates may be regarded as an unsafe and unsound practice unless the depository institution has retained rights to terminate the transaction quickly to protect itself against changed circumstances. Similarly, automatic renewal of short-term repurchase agreement transactions without reviewing collateral values and adjusting collateral margin may be regarded as a unsafe and unsound practice. If additional margin is not deposited when required, the depository institution's rights to sell securities or otherwise liquidate the repurchase agreement should be exercised without hesitation.

F. *Overcollateralization.* A depository institution should use current market values, including the amount of any accrued interest, to determine the price of securities that are sold under repurchase agreements. Counterparties should not be provided with excessive margin. Thus, the written repurchase agreement contract should provide that the counterparty must make additional payment or return securities if the margin exceeds agreed upon levels. When acquiring funds under repurchase agreements it is prudent business practice to keep at a reasonable margin the difference between the market value of the securities delivered to the counterparty and the amount borrowed. The excess market value of securities sold by a depository institution may be viewed as a unsecured loan to the counterparty subject to the unsecured prudential limitations for the depository institution and should be accordingly for credit po purposes.

By the National Credit Un Administration Board on No

Rosemary Brady,
Secretary of the Board.

[FR Doc. 85-28049 Filed 11-

BILLING CODE 7535-01-M

DEPARTMENT OF TRAN

Federal Aviation Admin

14 CFR Part 39

[Docket No. 85-ASW-20; A

Airworthiness Directive Aircraft Model S-76A He

AGENCY: Federal Aviatio Administration (FAA), D

ACTION: Final rule.

SUMMARY: This action pu Federal Register and mak to all persons an amendm new airworthiness directi was previously made effe known U.S. owners and certain Sikorsky Model S- helicopters by individual requires inspection and r certain tail rotor drive sh which may have been ins lubricant. The AD is need failure of critical tail roto bearings which could resu loss of directional control helicopter.

DATES: Effective Novemb to all persons except thos whom it was made immed effective by priority letter 15-08, issued July 30, 1985 contained this amendmen

The incorporation by re certain publications listed regulations is approved by of the Federal Register as 25, 1985.

Compliance: Required b flight after the effective da unless already accomplish

ADDRESSES: The applicab bulletin may be obtained Warren, Sikorsky Aircraft United Technologies Corp Main Street, Stratford, Co 06601.

A copy of the alert serv contained in the Rules Do the Regional Counsel, Fa