NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

September 5, 1986

GC/EOR:sg
4660

Office of General Counsel

Mr. Ross R. Pake
Account Executive
MCG Portoflio Management Corp.
2361 Campus Drive, Suite 201
Irvine, CA 92715

Dear Mr. Pake:

This responds to your letter of August 8, 1986, concerning the permissibility of pair-off transactions.

I have enclosed a copy of Section 6120.4.3 of the Accounting Manual for Federal Credit Unions. As you can see, pair-off transactions are not permitted.

I hope we have been of assistance.

Sincerely,

STEVEN R. BISKER
Assistant General Counsel

Enclosure
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unwilling to take the risk of purchasing the initial security. The credit union would sell at a price above market. Therefore, the broker requires that the credit union pay a fee, which is the difference in the commitment price, and the market price when they enter into the transactions. When the credit union purchases the new security, the broker returns the fee. Often, this type of transaction occurs repeatedly. The fee is usually recorded by the credit union as a receivable, deferred charge, or other asset.

The described transactions, under whatever name, constitute adjusted trading and thus are prohibited.

6120.4.2 YIELD MAINTENANCE CONTRACT

A yield maintenance contract, also known as a "pair-off" hedger, is the concurrent commitment to purchase a security via a cash forward agreement and to sell the same security on the same settlement date via a standby commitment. The credit union would be required to pay a commitment fee to the vendor that is generally exorbitant. The purpose of the transaction would be to "guarantee" a specified yield which is based upon the commitment fee paid. Generally, the purchase and sale prices are not related to the current market price.

Yield maintenance contracts are not permitted since they violate Section 703.3(b)(2) of the National Credit Union Administration Rules and Regulations. This section prohibits a Federal credit union from entering into a standby commitment. Such transactions also violate section 703.3(b)(10) which requires that all purchases and sales of securities be done at market prices. The yield maintenance contract is an unsecured loan to a broker (a non-member) and thus is in violation of Section 107(5) of the Federal Credit Union Act. These contracts prevent investment purchases and sales from being done at market prices.

6120.4.3 PAIR-OFF TRANSACTION

A pair-off transaction is the matching or netting of commitments to purchase and sell securities via cash forward agreements. Generally, a Federal credit union could commit to purchase a security and sometime thereafter commit to sell the security on the same settlement date. The purpose in engaging in pair-off transactions is not to take delivery of the security purchased, but to speculate that the market price will increase before settlement date and a gain will result from its sale. Many times the commitment to sell is made the same day as the commitment to purchase. There may even be a standard order with the vendor to sell when a certain market price is reached. Pair-off transactions are not permitted since Federal credit unions are prohibited from selling securities via a cash forward agreement that it does not own. In addition, pair-off transactions represent a speculative activity which is unsafe and unsound. There is strong evidence to show that it has been used as a means of "churning" credit union accounts to benefit broker's commissions.

6120.5 PERMISSIBLE INVESTMENT ACTIVITIES AND TRANSACTIONS SUBJECT TO SPECIFIED CONDITIONS

6120.5.1 DOLLAR PRICE REPURCHASE AGREEMENT (DOLLAR PRICE REPO)

A dollar price repurchase transaction is a contract whereby a Federal credit union sells a security that it owns and agrees to purchase another security on a future date. The dollar price repo does not represent borrowing by a Federal credit union as does a reverse repurchase transaction.

In the case of a reverse repurchase transaction, the transaction represents borrowing because ownership of the security "sold" does not change; that is, the "seller" of the security still has title and still receives the dividend or interest income from the security. Interest based upon the balance of the proceeds received from the transaction are paid by the "seller." Additionally, the same security "sold" must be "repurchased." As such the essentials of a sale and repurchase do not exist.

In the case of a dollar price repo, the essential elements of a sale do exist, i.e., ownership of the security does change. The buyer now receives the dividend or interest income on the security. No interest is paid by the seller for funds received. The same security sold is not required to be repurchased.

A dollar price repo represents the sale of a security and a simultaneous agreement to purchase another security at a future date by use of a forward placement contract. As such a Federal credit union may enter into such an agreement only if: