NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

October 28, 1986

GC/YG:sg
4660

Office of General Counsel

Mr. David Printy
President
Morison Asset Management, Inc.
P.O. Box 3709
Minneapolis, MN 55403

Dear Mr. Printy:

This responds to your letter dated August 18, 1986, to Mr. Robert Fenner of this Office concerning the permissibility of Morison Asset Management, Inc. (MAM) providing investment advisory services to Federal credit unions (FCU's). While NCUA does not normally render opinions on specific agreements between FCU's and third parties, we can assist you in making your own determination as to whether MAM is permissible for FCU's.

Two issues must be addressed in order to determine whether the program is permissible for FCU's. First, all of the investments and investment activities in which MAM engages on behalf of the FCU must be permissible for FCU's. Second, it must be determined that the delegation of investment authority by an FCU to MAM is permissible.

Sections 107(7) and (8) of the FCU Act, 12 U.S.C. §§1757(7) and (8) and Part 703 of the NCUA Rules and Reguations, 12 C.F.R Part 703, are the provisions of Federal law regulating FCU investments and deposits. A copy of those provisions is enclosed for your convenience.

Your letter indicates that MAM will invest in U.S. Treasury obligations, receipts, and CMO's. FCU authority to invest in CMO's is presently limited to Government-issued CMO's. In addition, the brochure enclosed with your letter discusses other investments and investment practices, some of which are not legal for FCU's, e.g., the use of options. Any agreement between MAM and an FCU must make clear that MAM will not make any investments or engage in any investment practices which are not legal for FCU's.

Assuming all of the investments made by MAM are determined to be legal, the second issue is whether it is permissible for an FCU to enter into an arrangement whereby it delegates its investment

FOIA - Vol, E.5 Non-permissible investment

decisions (or at least a part of such decisions) to an investment advisor (MAM). Section 113(6) of the FCU Act, 12 U.S.C. §1761b(6), provides that an FCU's board of directors shall be responsible for the FCU's investments.

Under the terms of the MAM Investment Management Agreement, MAM "will execute purchases and sales of securities at its discretion and prior advice to or consent from" the FCU. The question which must be answered is whether the authority granted to MAM is an improper delegation of investment authority or, instead, a proper investment decision made by an FCU (i.e., decision on the part of the FCU board to invest a certain sum of money in investments, with the individual buy and sell decisions made by MAM). The authority delegated to MAM in the Agreement can properly be viewed as an investment decision made by an FCU's board or investment committee and would, therefore, be a permissible delegation. Our determination that the delegation is permissible in no way reflects our opinion as to whether MAM is capable or suitable for FCU's. Our opinion is not to be presented as an endorsement or recommendation of MAM or its Management Agreement.

In conclusion, it is our opinion that as presently structured, FCU's cannot legally enter into the Management Agreement with MAM because some of the investments which MAM is authorized to make are not legal for FCU's.

I hope we have been of assistance.

Sincerely,

STEVEN R. BISKER
Assistant General Counsel

YG:sg

Enclosures

NCUA RULES & REGULATIONS

FINAL

Federal Register / Vol. 49, No. 63 / Friday, March 30, 1984

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 703

Investments and Deposits

AGENCY: National Credit Union Administration.

ACTION: Final rule.

SUMMARY: The NCUA Board adopts revised regulations concerning Federal credit union investments and deposits. The regulations authorize Federal credit unions to invest, under certain conditions, in bankers' acceptances, Eurodollars and Yankee Dollars. The regulations do not prohibit or restrict the use of brokers, as long as the transaction and underlying investment are legal. The regulations retain, but simplify and clarify, provisions of existing regulations prohibiting or restricting certain transactions because of their speculative nature. The regulations have been reorganized and rewritten in a manner that reduces their volume and makes them easier to understand and use.

EFFECTIVE DATE: May 21, 1984.

ADDRESS: National Credit Union Administration, 1776 G Street NW., Washington, D.C. 20456.

FOR FURTHER INFORMATION CONTACT: Robert M. Fenner, Director, or Steven R. Bisker, Senior Attorney, Department of Legal Services at the above address. Telephone (202) 357-1030.

SUPPLEMENTARY INFORMATION:

Background

On September 22, 1983, the National Credit Union Administration Board (Board) proposed a revised rule on Investments and Deposits for public comment. 48 FR 43182 (1983). The Board proposed various changes from its existing rules including: expanded authority for investment by Federal credit unions in Eurodollar and Yankee Dollar deposits; removal of outdated and ineffective rules restricting Federal credit unions' use of third parties when investing in certificates of deposit issued by other financial institutions; and, clarification and simplification of existing rules that restrict certain investment transactions because of their speculative nature. The Board specifically requested comment in three areas: (1) The use of brokers or money finders for investments in certificates of deposit; (2) whether Eurodollar deposits, if authorized as permissible investments, should be considered risk assets for purposes of the reserve requirements imposed by section 116 of the Federal Credit Union Act (12 U.S.C. 1762); and (3) whether, and to what extent, it would be appropriate to permit investments in futures contracts. In addition to these areas, the Board asked for comments concerning the entire proposed rule. A total of 60 comments were received—41 from natural person Federal credit unions, 15 from Corporate credit unions, and 4 from parties outside the credit union movement.

Based on the comments and its further review and analysis, the Board has adopted final rules. The Board has reorganized and simplified the previous rules in a manner that reduces their volume and makes them easier to understand and use. Specifically, the new rules begin with a Scope (§ 703.1) which explains that the statutory investment authority of Federal credit unions is limited, with certain exceptions, to government securities, shares of and loans to other credit unions, and deposit-type investments in other financial institutions. The Scope section explains that the investment rules do not apply to loans to members, which are governed by separate statutory and regulatory provisions. The Scope section is followed by a Definitions section (703.2) which defines the key terms used in the rules. The remaining two sections, §§ 703.3 and 703.4, set forth authorized and prohibited investment activities, respectively. The comments on these latter sections, and the changes from the present rules, are described in detail below in the *Analysis* portion of this discussion.

Among the more significant substantive changes reflected in the final rule are: (1) Authorization for Federal credit unions to invest in Eurodollars, Yankee Dollars and bankers' acceptances, on the condition that, in each case, the issuing institution is one in which a Federal credit union may legally make a deposit; (2) a determination not to regulate Federal credit union use of brokers or other third parties when investing in certificates of deposit issued by other financial institutions; (3) elimination of existing regulations concerning investments in loans to other credit unions; (4) a determination not to authorize Federal credit unions to invest in futures contracts; and (5) adoption of a provision prohibiting Federal credit union officials, employees and their family members from receiving compensation in connection with the making of an investment or deposit by the credit union.

Analysis

This section first addresses the two specific areas that the board has determined will not be subject to regulation and then the remainder of the rule:

Money Finders and Deposit Brokers

In the proposal, the Board suggested elimination of the previous rule which required that a Federal credit union, when investing in a certificate of deposit (CD), make payment "itself" to the institution issuing the CD. The Board requested comments, however, "concerning the extent of Federal credit union utilization of third parties in investing in deposits of other financial institutions, the negative aspects of such third party involvement with Federal credit union operations, the contribution that brokers may provide to the efficiency of Federal credit union operations, and the extent, if any, to which the National Credit Union Administration should regulate Federal credit union involvement in such activity."

A substantial majority of the credit union commenters stated that they have used services provided by money brokers. Many indicated that they use brokers for the bulk of their investments in CD's. A uniform criticism of broker use was that it can lead to dependence on advice of brokers and on $100,000 deposit insurance as the major bases of investment policy. Most commenters did, however, recognize that analysis of the soundness of the financial institutions issuing the CD's should not be solely dependent upon that provided by the brokers. These commenters recognized the potential conflict of interest of brokers recommending investments in financial institutions where the fee paid to the brokers for their service comes from those same

financial institutions. Almost all commenters who addressed the issue of brokers' effect on the efficiency of Federal credit union operations stated that the time saved by having a broker survey the market for the best CD rates is substantial.

In response to the issue of the extent, if any, to which NCUA should regulate the use of brokers for investments in financial institutions, the overwhelming majority of the commenters expressed the opinion that NCUA should not regulate. (One commenter argued that the current rules are inconsistent in that brokers may be used for purchases of GNMA's and other types of legal investments but cannot be used for CD investments.) The commenters did, however, recommend that NCUA stress the need for proper financial analysis of the issuing institutions and the soundness and integrity of the brokers through which they make investments. Numerous commenters recommended that NCUA require Federal credit unions to have written investment policies that include, among other things, the names of financial institutions and brokers that the Federal credit unions board has approved for its investment activity. Some commenters suggested that Federal credit unions only use the services of those brokers and investment advisers registered with the SEC. Others believed that NCUA should make a special effort to educate Federal credit unions regarding their use of brokers and should publish guidelines on the proper use of brokers when purchasing CD's.

Having reviewed all the comments, the Board continues to believe that the so-called "itself" requirement of the previous rule is unnecessary and ineffective. As discussed in the preamble to the proposed rule, this requirement did not prevent Federal credit unions from accepting the advice of "money finders" or other third parties, or even making payment through a broker or other third party by characterizing that party as the Federal credit union's agent. Further, after reviewing the comments and thoroughly reconsidering this issue, the Board has determined that it is neither necessary nor advisable for NCUA to issue new regulations concerning Federal credit union use of brokers in making investments.

Both the comment letters received by NCUA and recent developments in the marketplace regarding brokered deposits have shown that credit unions recognize the risks in relying on the advice of, and placing deposits through, money finders and deposit brokers. In response, many credit unions have turned to local institutions whose financial condition they are thoroughly familiar with, such as their corporate credit union or local banks, to place deposits. Others have minimized risk by placing deposits, through brokers or otherwise, in separately insured $100,000 increments in several different institutions. While the Board is not unmindful of the concerns that this latter practice presents to the Federal Deposit Insurance Corporation and Federal Savings and Loan Insurance Corporation, the Board defers to those agencies to address the issue of increased risk to their insurance funds.

Also, the Board urges Federal credit unions not to rely on deposit insurance alone, as that practice can, in the event of failure of the issuing institution, lead to loss of interest income and temporary loss of control of funds. Further, the lack of financial analysis that results from reliance solely on deposit insurance is not conducive to sound investment habits.

While the Board has chosen not to regulate in this area, the Board recognizes and stresses the need for written policies and it will instruct its examiners to particularly scrutinize those Federal credit unions where written investment policies do not exist in order to determine whether they are operating in a safe and sound manner. It is noted that section 6121 of NCUA's *Accounting Manual for Federal Credit Unions* contains detailed guidance concerning the nature and recommended content of investment policies. Also, the Board agrees that educational efforts are a high priority. In this connection, credit union associations have stepped up their efforts, resulting, for example, in the development of an educational videotape on investment practices. The Board firmly encourages these efforts.

Finally, the Board notes that there have been isolated instances of brokers channelling funds into Federal credit unions in a manner that contributes to supervisory problems. NCUA has been successful in early detection of and swift reaction to these problems, and the Board intends to continue to address any such situations through strong supervisory action.

Loans to Nonmember Credit Unions

The Board proposed to eliminate § 703.2 of the previous rule, concerning loans to nonmember credit unions. This section reiterated the statutory limitation that aggregate loans to nonmember credit unions may not exceed 25% of the lending credit union's unimpaired capital and surplus, and imposed loan documentation and maturity requirements that the Board considered a matter of business judgment that should not be controlled by regulation. The commenters agreed. Accordingly, that section of the previous rule has been eliminated as proposed. The 25% lending limit of the Federal Credit Union Act is, in the interest of clarity and comprehensiveness, referenced at § 703.3(c) of the final rule concerning loans, shares and deposits of other financial institutions.

Definitions

The definitions (§ 703.2 in both the proposed and final rule) have been alphabetized in the final rule. Also a definition has been added, at § 703.2(n), for the term "Section 107(8) institution." This term refers to institutions in which Federal credit unions may legally make deposits pursuant to section 107(8) of the Federal Credit Union Act (12 U.S.C. 1757(8)), i.e., any institution that either is insured by the Federal Deposit Insurance Corporation or 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. The term (or its equivalent) appeared throughout the proposed rule but was not defined. The inclusion of the definition in the final rule eliminates the need to refer to a copy of the Federal Credit Union Act in order to understand the term.

Authorized Investments—§ 703.3 of the Rule

Cash Forward Agreements. A cash forward agreement is an agreement to purchase or sell a security at an agreed-upon price, but at a future date. As a carry-over from the previous rule, the proposal would allow cash forward agreements if delivery and acceptance are mandatory and take place within 120 days from the date of the agreement. One commenter expressed disapproval of the 120 day limitation. Although acknowledging the possibility of speculative use of cash forward agreements, the commenter believed that the 120 days limitation was somewhat arbitrary and did not serve a useful purpose.

Agency experience has not shown that the 120 day limitation has caused problems for Federal credit unions. Further, without a time limitation, cash forward agreements can be used for speculative futures trading, posing safety and soundness concerns. The Board has adopted the proposed rule (§ 703.3(b)) without amendment.

Loans, shares and deposits—other financial institutions. Section 703.3 of the proposed rule addressed the authority of Federal credit unions to make *deposits* in section 107(8) institutions. This section of the rule is necessary primarily to clarify that the authority is generally limited to institutions that are either federally insured or operating in accordance with the laws of a state where the credit union does business. As proposed, however, the section omitted reference to the authority of Federal credit unions to establish share accounts and similar accounts with other federally insured credit unions and with corporate credit unions pursuant to section 107(7) of the Act (12 U.S.C. 1757(7)). Section 703.3 of the final rule has been revised to include reference to this authority.

Repurchase transactions. A repurchase transaction is a transaction in which a bank, broker or other third party sells securities to an investor (in this case a Federal credit union) with an agreement to "repurchase" the securities at an established time and fixed price. The transaction is functionally similar to a short term loan by the credit union that is collateralized by the securities, with the difference between the sales price and the repurchase price representing interest on the loan.

Since Federal credit unions may, with limited exceptions, make loans only to members, it has been necessary for a repurchase transaction to have the legal characteristics of an investment in the underlying security in order for a Federal credit union to participate. Thus, the previous rule distinguished between loan and investment type repurchase transactions, with only the latter being authorized for Federal credit unions.

The proposed rule carried over this distinction. The final rule carries it over with one significant exception: Since Federal fund transactions, which are essentially short term unsecured lending, have been authorized for Federal credit unions pursuant to the authority to make deposits in other financial institutions, it makes little sense to restrict repurchase transactions (which are secured) with those same institutions. Accordingly, the final rule has been amended to authorize Federal credit unions to engage in repurchase transactions with other financial institutions without regard to the distinction between loan-type and investment-type transactions. Of course, since the authorization is pursuant to the deposit authority, the financial institution must be a section 107(8) institution. (*See*, §§ 703.2(1), 703.3(d).)

Reverse repurchase transactions. A reverse repurchase transaction is a transaction whereby a Federal credit union borrows Funds for a fixed period and pledges securities (typically GNMA's or Treasury securities) owned by it as collateral. The borrowed funds are usually reinvested in other securities or in loans to members. The final rule, in a carry over from the previous rule and the proposal, requires that either the securities in which the borrowed funds are reinvested or the securities used as collateral have a maturity date not later than the repayment date on the reverse repurchase transaction. (*See*, § 703.3(e).) The purpose of the limitation is to avoid maturity mismatches that in past experience have resulted in serious losses during periods of interest rate swings. The commenters generally supported a continuation of this limitation. Some misunderstood the limitation, however, and believed that the rule would require that both the securities pledged as collateral and the securities in which the borrowed funds are reinvested would be required to have a maturity not later than the repayment date. The final rule has been revised to clarify that this is not the case.

Federal Funds. A Federal funds transaction is an overnight or short term loan to another financial institution. These transactions have been authorized, pursuant to NCUA Interpretive Ruling 81-2 (46 FR 14887), by interpretation of the deposit authority of section 107(8) of the Act. The proposed rule incorporated the Interpretive Ruling into the regulation, at § 703.3(f), in the interest of clarity and comprehensiveness. The commenters agreed with this proposal. Several commenters noted, however, that with the incorporation of the Interpretive Ruling, investment in "Term Federal Funds" (Federal funds having a maturity of more than one day), which had been authorized, had become restricted. This was unintended, and § 703.3(f) has been revised to allow both overnight and term Federal funds. With the inclusion of Federal funds in the final rule, IRPS 81-2 is unnecessary and is therefore repealed.

The Board takes this opportunity to alert Federal credit unions to at least one inherent risk of Federal funds investments that may not have been previously considered. There may be instances where under state law (e.g. West Virginia, Iowa, Oregon) if a Federal credit union sells Federal funds to a state bank (authorized as depositories under section 107(8) of the Act) and that bank is placed into liquidation, unlike other "depositors" who are given a priority in the payout under the state law, the Federal credit union would be paid after depositors along with other creditors. Under these circumstances a Federal credit union's risk of loss is greater than if it had purchased a CD from the state bank (even where the CD was in excess of the $100,000 deposit insurance limit), because of the priority given to depositors over other creditors. Therefore, the common perception that Federal funds have no greater risk associated with them than uninsured CD's is not accurate in all instances.

Yankee Dollars. A Yankee Dollar deposit is a dollar denominated deposit in a United States branch or subsidiary of a foreign bank. If the branch or subsidiary is federally insured or operating in accordance with the laws of a state in which the Federal credit union does business, then a Federal credit union deposit in the branch or subsidiary is authorized pursuant to section 107(8) the Act. Section 703.3(g) of the proposal set forth this authority. It has been carried over to the final rule without substantive change.

Eurodollars. A Eurodollar deposit is a dollar denominated deposit in either a foreign branch or subsidiary of a United States bank or in a foreign bank located outside the United States. The Board proposed authorizing such deposits, but only in foreign branches of parent U.S. banks and only if the parent U.S. bank is one in which a Federal credit union may make a deposit pursuant to section 107(8) of the Act. The Board also requested comment on whether such deposits should be treated as risk assets for purposes of the statutory reserve transfer requirements of section 116 of the Federal Credit Union Act (12 U.S.C. 1762).

The vast majority of commenters agreed that Eurodollar deposits in foreign branches of U.S. banks should be a permissible investment for Federal credit unions. However, the commenters were split on the issue of whether Eurodollars should be considered risk assets. While the commenters generally agreed that Eurodollars do involve credit risk, liquidity risk, sovereign risk, and general risk associated with increased operational complexity, their approach to the problem varied.

Those not in favor of treating Eurodollars as risk assets believe that with strong internal controls investment losses can be prevented. Commenters in favor of treating Eurodollar deposits as risk assets argued that classification as risk assets would help credit unions more accurately recognize the credit risk inherent in these investments.

The Board has determined to authorize Eurodollar deposits as

proposed; but not to treat them as risk assets at this time. Deposits and government securities generally have not been treated as risk assets for purposes of statutory reserve transfer requirements. Treatment of Eurodollar deposits as risk assets is a matter which may be more appropriately considered in the context of an overall review of statutory reserve transfer requirements and the regulatory definition of risk assets (*See*, 12 CFR 700.1(j)). Also, deposits in overseas branches of U.S. banks are generally considered to be legal liabilities of the domestic parent bank. There may, however, be instances where the foreign host government takes some action to freeze, stop, or delay payment of the deposits of the branch bank, and the U.S. parent bank may be relieved of its liability for the deposits of its overseas branch. Under these circumstances, the relied-on protection of the parent domestic bank against loss of the deposit may be of no avail. Therefore, the Board is alerting all Federal credit unions that Eurodollar deposits are not free of risk and that extreme care must be exercised in engaging in such investment activity.

Bankers' Acceptances. A bankers' acceptance is a time draft drawn on a U.S. bank and represents an irrevocable obligation of the bank. Bankers' acceptances arise in a variety of ways, but generally are used initially by a corporate customer of the bank to "pay" for goods or services, and are subsequently discounted and traded as money market instruments. The proposed rule included bankers' acceptances in the category of prohibited investments. A majority of those commenting on this issue recommended that Federal credit unions be permitted to invest in bankers' acceptances. These commenters argued that it is inconsistent to classify bankers' acceptances as prohibited investments when Federal funds, certificates of deposit, and Eurodollar deposits are held to be permissible investments. All of these investments (including bankers' acceptances) appear on the issuing bank's balance sheet as direct liabilities of the bank. Some commenters suggested that bankers' acceptances, which are obligations of both the accepting bank and its corporate customer, are less risky than Federal funds, Eurodollar deposits, and uninsured CD's.

The Board agrees and finds that bankers' acceptances may be authorized pursuant to the same rationale applied to Federal funds and repurchase transactions with financial institutions; i.e., by considering the acceptance to be a type of deposit liability. Also, it seems clear that bankers' acceptances present no greater risk than these other investments. Accordingly, the Board has incorporated into the final rule a new § 703.3(i) authorizing investments in bankers' acceptances issued by section 107(8) institutions.

Prohibited Investments—Section 703.4

Comments were received on three prohibited activities: standby commitments § 703.4(a)), futures contracts § 703.4(b)), and kickbacks (§ 703.4(e)).

Standby Commitments. A standby commitment is a commitment to purchase (or sell) a security at a set price at a future date, wherein the seller of the commitment receives a fee in exchange for agreeing to "stand by" to purchase (or sell) the security at the option of the buyer of the commitment. Several commenters suggested that the definition, now § 703.2(r), of standby commitment be reworded. They stated that the proposed definition was unclear as to who is the buyer and who is the seller of the commitment, and fails to include an additional element of the transaction—the predetermined price. The Board agrees and has revised the definition accordingly. In conformance with the amended definition, the Board has amended § 703.4(a) to clarify that a Federal credit union may not purchase or sell a standby commitment.

Some commenters recommended that the prohibition on standby commitments be amended to permit Federal credit unions to purchase standby commitments. They noted that the substantial risk in the transaction is always on the seller of the commitment, and that the buyer's loss can be restricted to the amount advanced to purchase the commitment, since the buyer has the option to either exercise the sale or purchase or do nothing. They suggested that standby commitments can be used as a hedging tool in asset/liability management.

The Board does not consider standby commitments an essential tool to reduce the potential risks that Federal credit unions may have because of maturity mismatches between their assets and liabilities. Because of their complexity and their inherently speculative nature, reliance on standby commitments to offset mismatching can only lead to confusion, uncertainty, and ultimately to safety and soundness problems. As explained below in the discussion of futures contracts, there are already a range of other business strategies available to Federal credit unions to manage their assets and liabilities.

Futures contracts. A futures contract is a standardized agreement offered on one of the futures exchanges to buy or sell an underlying investment at an established future date and at a specified price. While the proposed rule carried over the previous rule's prohibition on futures contracts, the Board requested comment on whether investment in futures contracts should be authorized as an asset/liability management tool.

The comments were mixed. Commenters in support believed that with increased competition, greater interest rate sensitivity of member shareholders, and recent fluctuation in interest rates, it is important that Federal credit unions have the flexibility to hedge interest rate risk through the use of interest rate futures.

Commenters in opposition to authorizing futures contracts believed that they are too complex and too often result in sizable losses. Further, they felt that with the relatively short maturities of credit union loans and the authority to make variable rate loans, Federal credit unions have adequate tools to protect against interest rate swings.

The Board has determined not to authorize investments in futures contracts at this time. To the extent that futures contracts are seen as tools to reduce the interest rate risk that results from a mismatch between asset and liability maturities, the Board believes that there are already a range of other business strategies available to FCU's. Such strategies include: (a) Not investing or lending at long term fixed rates; (b) using variable rate lending and floating rate investments; (c) using secondary markets to sell long-term loans to limit or manage the level of exposure; (d) using improved funds management strategies under deregulation to create a "basket" of share maturities which would compliment the duration of long term assets; and (e) using reserves (established for this purpose) to temporarily cover losses should rising interest rates lead to short-term mismatches. Further, it is the opinion of the Board that as long as Federal credit unions take in short-term funds and elect to invest or lend in long-term instruments, there is a risk. No option, including futures or standby commitments, eliminates the risk; they may, at best, just reduce some of the potential costs.

Kickbacks. The commenters were nearly unanimous in approving of the proposed rule (now § 703.4(e)) prohibiting a Federal credit union's directors, officials, committee members, employees, and immediate family

members of such individuals from receiving pecuniary consideration in connection with the making of an investment or deposit by the Federal credit union.

The Board has approved § 703.4(e) without substantive change, but has added a new § 703.2(i) which defines what is meant by the term "immediate family member." By specifically defining the term, the Board expects to minimize any uncertainty as to who may fall within the "immediate family" for purposes of the rule.

Adjusted trading and short sales. Both the previous regulation and the proposal contained prohibitions against engaging in adjusted trading and short sales. Adjusted trading is the sale of a security at an inflated price above market with the simultaneous purchase of another security, also at an inflated price. The purpose is to hide or defer losses and avoid recording the losses in the accounting period in which they occur. It is a misrepresentation on the balance sheet and is not in accordance with "full and fair disclosure" required in 12 CFR 702.3.

A short sale is the sale of a security not owned at the time of the sale. The seller is speculating that the price of the security will fall prior to his purchase and thus enable him to sell it at a higher previously agreed to price pursuant to the short sale. The practice is considered to be unsafe and unsound.

No commenters objected to the prohibition against these two types of transactions and the prohibitions have been carried over to the final rule, § 703.4 (c) and (d).

IRPS 79-4—Investments

NCUA Interpretive Ruling and Policy Statement 79-4 was originally issued to elaborate on the requirements of Part 703 and to establish accounting procedures to be used in conjunction with certain authorized investment transactions. In light of the fact that the accounting procedures are now covered in NCUA's *Accounting Manual for Federal Credit Unions* and considering the changes and clarifications in the proposed rule, NCUA proposed to repeal IRPA 79-4. The commenters agreed. Accordingly, IRPS 79-4 is repealed.

Delayed Effective Date

This final rule has been issued with a delayed effective date (May 21, 1984) in order to provide Federal credit unions a full opportunity to study the changes in investment authority and responsibilities and develop an understanding of the new investment vehicles before committing funds to any particular type of investment.

Regulatory Procedures

The NCUA Board has determined and certifies that the final rule will not have a significant economic impact on a substantial number of small credit unions because the rule would increase their management flexibility, enhance their competitive positions and reduce their paperwork burdens. A regulatory flexibility analysis is not required. 5 U.S.C. 603(a), 604(a).

List of Subjects in 12 CFR Part 703

Credit unions, Investments.

Dated: March 22, 1984.

Rosemary Brady,

Secretary of the Board.

1. 12 CFR Part 703, Investment and Deposit Activities, is revised to read as follows:

PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

Sec.

Authority: 12 U.S.C. 1757(7), 1757(8), 1766(a), and 1789(a)(11).

§ 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 CFR 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 CFR 701.27), and investments in fixed assets are subject to § 701.36 (12 CFR 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 institutions-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(a)), which limits a Federal credit union's aggregate borrowing to 50 percent of its unimpaired capital and surplus.

(f) *Federal funds.* A Federal credit unions 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 unions may invest in Eurodollar deposits in a branch of a Section 107(8) institution.

(i) *Bankers' acceptances.* A Federal credit unions 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.

3. NCUA Interpretive Ruling and Policy Statement 79-4—Investments (August 31, 1979, 44 FR 51195), is repealed.

2. NCUA Interpretive Ruling and Policy Statement 81-2—Federal Funds (March 3, 1981, 46 FR 14887), is repealed.

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1948 § 2, 62 Stat. 1091; April 17, 1952, § 1, 66 Stat. 63; Sept. 22, 1959, § 5, 73 Stat. 629; Mar. 10, 1970, Pub.L. 91-206, 84 Stat. 49; Oct. 19, 1970, Pub.L. 91-468, 84 Stat. 1015; Nov. 10, 1978, Pub.L. 95-630, 92 Stat. 3682; Oct. 15, 1982, Pub.L. 97-320, 96 Stat. 1469.)

§ 1756 § 106

Reports and examinations.—Federal credit unions shall be under the supervision of the Board, and shall make financial reports to it as and when it may require, but at least annually. Each Federal credit union shall be subject to examination by, and for this purpose shall make its books and records accessible to, any person designated by the Board. (June 26, 1934, § 6, 48 Stat. 1218; Dec. 6, 1937, § 1, 51 Stat. 4; June 29, 1948, § 2, 62 Stat. 1091; Sept. 22, 1959, § 6, 73 Stat. 629; Mar. 10, 1970, Pub.L. 91-206, 84 Stat. 49; Oct. 19, 1970, Pub.L. 91-468, 84 Stat. 1015; Nov. 10, 1978, Pub.L. 95-630, 92 Stat. 3683.)

§ 1757 § 107

Powers.—A Federal credit union shall have succession in its corporate name during its existence and shall have power—

(1) to make contracts;

(2) to sue and be sued;

(3) to adopt and use a common seal and alter the same at pleasure;

(4) to purchase, hold, and dispose of property necessary or incidental to its operations;

(5) to make loans, the maturities of which shall not exceed twelve years except as otherwise provided herein, and extend lines of credit to its members, to other credit unions, and to credit union organizations and to participate with other credit unions, credit union organizations, or financial organizations in making loans to credit union members in accordance with the following:

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

(i) a residential real estate loan on a one-to-four-family dwelling, including an individual cooperative unit, that is or will be the principal residence of a credit union member, and which is secured by a first lien upon such dwelling, and may have a maturity not exceeding thirty years or such other limits as shall be set by the National Credit Union Administration Board (except that a loan on an individual cooperative unit shall be adequately secured as defined by the Board), subject to the rules 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.