



NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

GC/TPM:sg
4660

March 14, 1988

Office of General Counsel

A.G. DeRusso, President
Eastern Airlines Federal Credit Union
P.O. Box 028532
Miami, FL 33102

Re: Bonds Borrowed/Securities Lending Program (Your
September 2, 1986, Letter)

Dear Mr. DeRusso:

You have asked us to examine the permissibility of the Bonds Borrowed/Securities Lending Agreement your Credit Union has entered into with Merrill Lynch. We view this program under the Federal Credit Union ("FCU") Act and NCUA's Rules and Regulations as a two-step reverse repurchase/repurchase transaction. It is permissible, provided the FCU limits the activity to 50 percent of its paid-in capital and surplus and obtains written confirmation and a safekeeping receipt for securities received as collateral.

We readily will agree that Merrill Lynch's and similar programs do not fit neatly into our regulatory structure. As we review our investment regulations this year, we will more directly address this type of program.

Bonds Borrowed/Securities Lending Program

The Agreement between Merrill Lynch and FCU describes the following arrangement: FCU gives Merrill Lynch specific securities in exchange for cash equal to 102 percent of the value of the securities. Merrill Lynch uses those securities to cover short sales, commitment failures, or other needs. FCU, through a custodian bank, exchanges the cash for securities [as defined in Section 703.2(o) of NCUA's Rules and Regulation] of equal value provided by Merrill Lynch. The custodian bank issues FCU a written confirmation of the transaction and a safekeeping receipt. Merrill Lynch and the custodian bank are required to assure on a daily basis that the market value of the securities given to FCU as security continues to equal at least 102 percent of the market value of the securities Merrill Lynch obtained under the Agreement.

FOIA - Vol I, E, 12
Securities Lending

A.G. DeRusso, President
March 14, 1988
Page Two

To close the transaction, the custodian bank gives Merrill Lynch back the securities held for FCU in exchange for cash equal to 102 percent of those securities' market value. The custodian bank then returns the cash to FCU, which exchanges it with Merrill Lynch for the original securities. Merrill Lynch also pays FCU a fee for use of the securities.

NCUA Regulation of Short-Term Securities Transactions.

1. Repurchase and Reverse Repurchase Transactions.

NCUA Rules and Regulations permit two types of short-term securities transactions with brokers: reverse repurchases ("reverse repos") and repurchases ("repos").

A reverse repo, which our Regulations define [12 C.F.R. §703.2(m)] 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," is permitted under these conditions [12 C.F.R. §703.3(e)]:

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.

The requirement that any securities obtained by an FCU in connection with a reverse repo have a maturity not later than the date the transaction is closed out has been imposed to "avoid maturity mismatches that in past experience have resulted in serious losses during periods of interest rate swings."
49 Fed. Reg. 12670 (March 30, 1984).

A.G. DeRusso, President
March 14, 1988
Page Three

A repo, defined in our Regulations [12 C.F.R. §703.2(1)] as a transaction "in which a Federal credit union agrees to purchase a security from a vendor and to resell the same or any similar security to that vendor at a later date", is permitted with a broker [12 C.F.R. §703.3(d)] as an "investment-type repurchase transaction . . . provided the purchase price of the security obtained in the transaction is at or below the market price."

An "investment-type repurchase transaction" is one where [12 C.F.R. §703.2(1)(1)]:

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.

The terms and conditions of repos and reverse repos -- e.g., the amount and kind of securities exchanged, periodic adjustment of the value of the collateral, the fee to be paid and to whom -- are contracted for and vary depending on the needs and bargaining power of the parties.

2. Bonds Borrowed/Securities Lending Transactions.

Though not directly dealt with in our Rules and Regulations, a bonds borrowed/securities lending transaction such as Merrill Lynch offers is similar to a reverse repurchase transaction in that one kind of securities is exchanged for another. But unlike the reverse repo envisioned by our Rules and Regulations (where the FCU assumes market risk on the securities obtained), the usual bonds borrowed/securities lending program requires the other party to maintain the value of the FCU's collateral on a daily basis. It is inappropriate in these circumstances to require that the securities received by the FCU mature prior to the transaction's termination date.

We believe the FCU Act and NCUA's Rules and Regulations will be complied with if these transactions are viewed as a two-step reverse repo/repo transactions -- i.e., as the FCU's receiving cash in exchange for securities and, independently, receiving securities in exchange for cash. The net effect of this characterization is to limit the activity to 50 percent of an FCU's paid-in and unimpaired capital and surplus (as required by Section 703.3(e)), and to require written confirmation and a

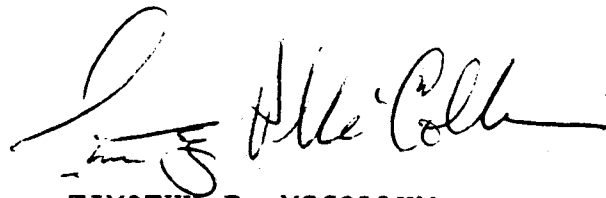
A.G. DeRusso, President
March 14, 1988
Page Four

safekeeping receipt (as required by Section 703.2(1)(1)) for securities received from a broker.

The Merrill Lynch Program

Since, under the Merrill Lynch program as we understand it, the FCU will not take on market risk as to the securities it holds as collateral and will receive written confirmation and a safekeeping receipt for the securities received, your FCU may participate in the program up to 50 percent of unimpaired capital and surplus.

Sincerely,

A handwritten signature in black ink, appearing to read "Timothy P. McCollum". The signature is fluid and cursive, with a large initial "T" and "M".

TIMOTHY P. MCCOLLUM
Assistant General Counsel

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