



NATIONAL CREDIT UNION ADMINISTRATION  
Washington, D.C. 20456

C/HMU  
4660

August 8, 1988

Office of General Counsel

Mr. Mitchell C. Glass  
Director of Finance  
Eastern Airlines Federal Credit Union  
P.O. Box 028532  
Miami, Florida 33102

Re: Securities lending (Your April 27, 1988,  
letter)

Dear Mr. Glass:

You have asked if the proposed securities lending arrangement between your Credit Union and Drexel Burnham Lambert is a permissible one for a Federal credit union ("FCU"). The sole difference of potential legal significance between this arrangement and the one we previously reviewed for your FCU is that this one eliminates the escrow, or trustee, and the formalized two-step exchange by the FCU of securities for cash and then cash for other securities. We view the two arrangements as functionally identical for purposes of determining permissibility under the FCU Act and NCUA's Rules and Regulations. Therefore, we will view the arrangement legally in the same way -- as if it were a two-step reverse repurchase/repurchase transaction, which is permissible so long as the FCU: (1) limits the activity to 50 percent of its paid-in and unimpaired capital and surplus; and (2) obtains: (a) physical possession of the securities received; (b) written confirmation and a custodial or safekeeping receipt from a proper third party; or (c) recordation as owner

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through the Federal Reserve Book-Entry System for securities received.

### The Proposed Arrangement

The proposed arrangement between Drexel Burnham Lambert and FCU is as follows: FCU gives up specific securities needed by Drexel Burnham in exchange for other securities equal to at least 100 percent of the value of the securities given up. If the market value of the securities FCU received falls below 100 percent of the securities FCU gives up, Drexel Burnham will deliver, upon FCU's request, additional securities to bring the total market value of the securities FCU has received up to par. As securities FCU has received approach maturity, Drexel Burnham substitutes other marketable securities with longer maturities. During the time the transaction is effective, Drexel Burnham has all incidents of ownership of the securities FCU has given up, except right to dividends, interest, and other distributions. FCU has only a security interest in the securities it receives.

Though not stated, we assume the FCU: (1) takes physical possession of the securities received; (2) receives written confirmation of transfer and a custodial or safekeeping receipt; or (3) is recorded as owner through the Federal Reserve Book-Entry System.

Drexel Burnham will pay FCU an agreed-upon fee at the transaction's close.

### 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)]:

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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 either any securities given up by an FCU or 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 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)]:

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, an arrangement such as Drexel Burnham proposes here is similar to a reverse repurchase transaction in which the FCU purchases securities with the cash received from giving up other securities. But unlike the reverse repo envisioned in our 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 unnecessary 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 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 physical possession, written confirmation and a safekeeping receipt, or recordation as owner through the Federal Reserve Book-Entry System (as required by Section 703.2(1)(1)) for securities received from the other party.

### The Proposed Drexel Burnham Arrangement

Under the Drexel Burnham program as we understand it, the FCU will not take on market risk as to the securities it receives. If the FCU obtains physical possession of the securities received, written confirmation and a safekeeping receipt, or recordation

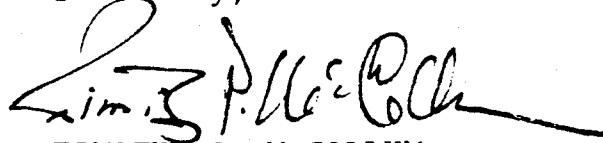
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as owner through the Federal Reserve Book- Entry System,  
an FCU may participate in the program up to 50 percent  
of paid-in and unimpaired capital and surplus.

Sincerely,

A handwritten signature in black ink, appearing to read "Timothy P. McCollum", with a long horizontal flourish extending to the right.

TIMOTHY P. McCOLLUM  
Assistant General Counsel

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