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NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

February 6, 1989

Office of General Counsel

Mr. Billy H. Thomas
Assistant Commissioner
State of Tennessee
Department of Financial Institutions
Fourth Floor, The John Sevier Building
500 Charlotte Avenue
Nashville, Tennessee 37219-5384

Re: Securities Lending (Your September 14, 1988, Letter)

Dear Mr. Thomas:

You have asked for our opinion on a securities lending program offered by First American National Bank, Nashville, Tennessee (the "Bank"). We have looked at two similar securities lending programs and determined that they should be viewed under the Federal Credit Union ("FCU") Act and NCUA's Rules and Regulations as two-step reverse repurchase/repurchase transactions. Such programs may be permissible provided the FCU: (1) limits the activity to 50 percent of its paid-in capital and surplus and (2) obtains (as required by Section 703.2(1)(1) of NCUA's Rules and Regulations for securities purchased pursuant to an investment-type repurchase agreement): (a) physical possession of the securities received; (b) written confirmation and a safekeeping receipt; or (c) recordation as owner through the Federal Reserve Book-Entry System. Before we would be able to determine the permissibility of the Bank's program for an FCU, it would have to be clarified that: (1) any cash collateral is invested only in investments that are permissible for an FCU; (2) any securities received as collateral are limited to those permissible for FCU investment; and (3) the collateral is maintained in accordance with Section 703.2(1)(1) of NCUA's Rules and Regulations [12 C.F.R. 703.2(1)(1)]. From a

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safety and soundness perspective, we would also advise an FCU to have the Bank's Security Lending Agreement ("the Agreement") amended to include the statement that the collateral will be marked to market value daily and will never be allowed to fall below 100% of the market value of the loaned securities.

You have also asked for our opinion of the Federal Financial Institutions Examination Council Supervisory Policy entitled "Securities Lending." Although this Policy has not been formally adopted by the NCUA, we would encourage FCU's engaged in securities lending to review it.

Securities Lending Agreement

You have provided us with copies of the Bank's Agreement and the Bank's brochure entitled "Preferred Safekeeping" ("the Brochure"). The Agreement would be entered into between an FCU and the Bank. The terms of the Agreement are as follows:

1. FCU would deposit securities ("Securities") into a safekeeping account (the "Safekeeping Account") with the Bank.

2. The Bank would lend a portion or all of the Securities in the Safekeeping Account from time to time (any such loan of an FCU's Securities is referred to as a "Loan"). All Loans will be made by the Bank through one or more financial institutions as agent ("Agent") for the Bank. Loans will be made to those persons, firms, or corporations identified by Bank or an Agent as eligible borrowers ("Borrowers"). The Brochure indicates that borrowers will be brokers/dealers. FCU may, upon request to the Bank, obtain the names of all Borrowers and all Agents.

3. FCU authorizes Bank or any Agent to receive from or on behalf of the Borrower collateral of a value equal to 102% of the then Market Value of the Loaned Securities plus accrued interest in the form of (i) cash or its acceptable equivalent, or (ii) securities issued or guaranteed by the United States Government or its agencies. Only cash or government securities shall be used to fully collateralize the loan of securities.

4. FCU authorizes Bank or any Agent to invest any cash collateral for a Loan received by Bank or the Agent in a manner Bank or the Agent reasonably deem prudent.

5. FCU will be compensated per a fee schedule for each Loan.

6. FCU is entitled to receive all distributions made by the issuer in respect of the Securities, including cash dividends and interest.

7. Upon termination of a Loan, the Securities are returned to the FCU. In the event any Loan is terminated and the loaned Securities have not been returned by the Borrower, the Bank shall return the FCU's Securities or the cash value of the securities as established by the market value.

NCUA Regulation of Short-Term Securities Transactions

1. Repurchase and Reverse Repurchase Transactions

NCUA's Rules and Regulations permit two types of short-term securities transactions with brokers/dealers: 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 repo is defined in our Regulations [12 C.F.R. 703.2(l)] 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." There are no regulatory restrictions on who an FCU may enter into a repo with when the repo qualifies as an investment-type repo. Hence, an FCU may enter into an investment-type repo with a broker/dealer ". . . provided the purchase price of the security obtained in the transaction is at or below the market price." (See 12 C.F.R. 703.3(d).)

An "investment-type repurchase transaction" is one where [12 C.F.R. 703.2(l)(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. Securities Lending Transactions

We have previously looked at two securities lending programs. In the first program, an FCU would give a broker securities in exchange for cash equal to 102% of the value of the securities. The broker would use the securities to cover short sales, commitment failures, or other needs. The FCU, through a custodian bank, would exchange the cash for securities [as defined in Section 703.2(o) of NCUA's Rules and Regulations]. The custodian bank would issue the FCU a written confirmation of the transaction and a safekeeping receipt. The broker 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% of the market value of the securities the broker obtained under the securities lending agreement.

In the second securities lending agreement we looked at, an FCU would give up securities to a broker 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 receives falls below 100 percent of the

securities FCU gives up, the broker would deliver, upon FCU's request, additional securities to bring the total market value of the securities the FCU has received up to par. As securities the FCU has received approach maturity, the broker would substitute other marketable securities with longer maturities. During the time the transaction is effective, the broker would have all incidents of ownership of the securities FCU has given up, except right to dividends, interest, and other distributions. The FCU would have only a security interest in the securities it receives. The FCU would either: (1) take physical possession of the securities received; (2) receive written confirmation of transfer and a custodial or safekeeping receipt; or (3) would be recorded as owner through the Federal Reserve Book-Entry System.

In reviewing these securities lending agreements, we stated:

> The sole difference of potential legal significance between [the second] arrangement and the one we previously reviewed . . . is that [the second] 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.
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> Though not directly dealt with in our Rules and Regulations, . . . [the security lending arrangements reviewed are] 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.
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> 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(l)(1) for securities received from the other party.

The Bank's Security Lending Program

The Bank's program is a combination of the two programs described above. FCU will either receive (i) cash which will then be invested in securities or (ii) securities in exchange for its Securities. As we understand it, an FCU will not take on market risk as to the securities it receives. Although this issue is not addressed in the Agreement, the Brochure provides that as securities are loaned, the Borrower sends collateral which must be cash or government securities at 102% of the market value of the security on loan. The collateral will be marked to market value daily and will never be allowed to fall below 100% of the market value of the loaned security. For this program to be permissible for an FCU, the following issues must be resolved:

1. FCU must obtain physical possession of the securities received, written confirmation and a safekeeping receipt, or recordation as owner through the Federal Reserve Book-Entry System.

2. Securities collateralizing the Loans must be securities authorized for investment for FCU's. The Agreement indicates that the collateral will be cash or government securities. The Agreement further states that the securities will be either issued or guaranteed by the United States Government or its agencies. To the extent that the securities are guaranteed by the United States or a Federal agency, Section 107(7)(E) of the FCU Act [12 U.S.C. 1757(7)(E)] requires that the securities be fully guaranteed as to principal and interest.

3. The Agreement provides that the Bank or any Agent may invest any cash collateral for a Loan in such manner as the Bank or Agent reasonably deem prudent. The cash must be invested in a manner that is permissible for an FCU. FCU's investment/deposit authority is contained in

Sections 107(7), 107(8), and 107(15) of the FCU Act [12 U.S.C. 1757(7), 1757(8), and 1757(15)]. Part 703 of NCUA's Rules and Regulations [12 C.F.R. Part 703] interprets these provisions and places certain limitations on them.

4. Participation in the program can not exceed 50 percent of an FCU's paid-in and unimpaired capital and surplus.

Finally, for safety and soundness reasons, we would encourage an FCU that is considering becoming involved in this program to request that the Agreement be amended to clarify that, as set forth in the Brochure, the collateral will be marked to market value daily and will never be allowed to fall below 100% of the market value of the loaned security.

Sincerely,

Hattie M. Ulan

Hattie M. Ulan
Acting Assistant General Counsel

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