NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

March 29, 1991

Murray L. Simpson
Thelen, Marrin, Johnson & Bridges
Two Embarcadero Center
San Francisco, CA 94111-3995

Re: FCU Investment In Investment Companies
(Your February 25, 1991, Letter)

Dear Mr. Simpson:

You state that the Franklin Adjustable U.S. Government Securities Fund (the Fund) currently invests in securities that federal credit unions (FCUs) may invest in directly. You propose to restructure the Fund into a so-called "Hub and Spoke" arrangement, in which 100% of the assets of the Fund will be invested in shares of the Franklin Institutional U.S. Government ARM Fund (the Hub), a newly formed open-end management investment company. The "Spokes" of the Hub will be the Fund and other institutional investors. You state that the Hub will invest in securities that FCUs may invest in directly. You ask whether the Fund will be a permissible investment for FCUs after the restructuring, when the Fund will invest in securities through the Hub rather than directly.

Analysis

As you know, the National Credit Union Administration (NCUA) has taken the position that mutual funds are permissible investments for FCUs provided that all of the securities in which the mutual fund invests are permissible investments for FCUs. Sections 107(7), (8), and (15) of the FCU Act, 12 U.S.C. §§1757(7), (8), and (15), and Part 703 of NCUA's Rules and Regulations, 12 C.F.R. Part 703, set forth the securities, deposits, and other obligations in which an FCU may invest. Prior to 1987, NCUA issued opinions regarding

the legality of particular mutual funds as FCU investments. For the reasons discussed in the enclosed Letter to Credit Unions No. 92 (August 13, 1987), NCUA no longer issues such opinions. Accordingly, we will not evaluate whether the current Fund or proposed Hub are permissible investments for FCUs. Considering just the Hub and Spoke arrangement, however, it is our opinion that if the Hub is a permissible investment for FCUs, and the Fund invests 100% of its assets in the Hub, then the Fund is a permissible investment for FCUs.

As a final matter, although we stated that we would not determine whether the Fund or Hub are permissible investments for FCUs, let us point out that NCUA has recently issued proposed revisions to Part 703 of its Rules and Regulations (see 56 Fed. Reg. 11944, March 21, 1991) which may affect that determination. A copy of the proposed regulation is enclosed. We note that among the Fund's possible investments, you list stripped mortgage securities. Please be advised that NCUA has proposed to prohibit FCUs from purchasing such securities. If the proposed prohibition becomes final, FCUs would not be permitted to invest in a mutual fund which invests in stripped mortgage securities.

Sincerely,

Hattie M. Ulan

Hattie M. Ulan
Associate General Counsel

Enclosures

GC/LH:sg
SSIC 4660
91-0234

Proposed Rules

Federal Register
Vol. 56, No. 55
Thursday, March 21, 1991

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

OFFICE OF PERSONNEL MANAGEMENT

5 CFR Part 300

RIN 3206-AB41

Employment (General); Employment Practices

AGENCY: Office of Personnel Management.

ACTION: Notice of withdrawal of proposed rulemaking.

SUMMARY: The Office of Personnel Management (OPM) is withdrawing its proposal to amend the appeal procedures set forth in the Code of Federal Regulations with respect to job analysis, relevance, and equal employment opportunity requirements currently applicable to Federal Government employment assessment procedures. The proposed amendment, issued on June 20, 1988 (53 FR 23123) would have removed certain nonstatutory appeals from the jurisdiction of the Merit Systems Protection Board and directed that requests for reconsideration of examination ratings be filed with OPM or with the agency applying the employment practice in question in appropriate cases. The amendment would have also avoided duplicative enforcement of equal employment opportunity requirements that are within the jurisdiction of and covered by procedures enforced by the Equal Employment Opportunity Commission. OPM is withdrawing its proposal due to the small number of 5 CFR part 300 cases handled by OPM and because these few cases may be handled under the Equal Employment Opportunity Commission (EEOC) procedures.

FOR FURTHER INFORMATION CONTACT: James S. Green, Deputy General Counsel, (202) 606-1700.

U.S. Office of Personnel Management.
Constance Berry Newman,
Director.

[FR Doc. 91-6669 Filed 3-20-91; 8:45 am]
BILLING CODE 6325-01-M

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 703

Investments and Deposits

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed rule.

SUMMARY: As part of its established policy of reviewing its regulations at regular intervals, the National Credit Union Administration (NCUA) is proposing to amend its regulations governing federal credit union investments and deposits. The proposal would prohibit or restrict access to certain high-risk investments that have been purchased by a limited number of credit unions. The proposal would also prohibit federal credit unions from investing in a corporate credit union that fails to meet certain regulatory criteria and require that each federal credit union establish written investment policies consistent with the Federal Credit Union Act, NCUA Rules and Regulations, and other applicable laws and regulations. In addition, the rule would establish conditions under which a federal credit union would be required to analyze the credit quality of an institution it is permitted to invest in under section 107(8) of the Federal Credit Union Act. Finally, the proposal would update the regulation to reflect the restructuring of the Federal Deposit Insurance System under the applicable provisions of the Financial Institution Reform, Recovery and Enforcement Act of 1989.

The NCUA Board is seeking comments on the proposed changes to part 703 of the NCUA Regulations. The NCUA Board is not seeking comments on those portions or sections of the regulation which would not be affected by this proposal

DATES: Comments must be received on or before May 20, 1991.

ADDRESSES: Send comments to Becky Baker, Secretary, National Credit Union Administration Board, 1776 G Street NW., Washington, DC 20456.

FOR FURTHER INFORMATION CONTACT: Lisa Henderson, Staff Attorney, Office of General Counsel (202-682-9630), or Charles Felker, Investment Officer, Office of Examination and Insurance (202-682-9640), at the above address.

SUPPLEMENTARY INFORMATION:

Background

As explained more fully below, the proposal would prohibit certain investments that expose credit unions to an inordinate degree of interest rate risk, including certain mortgage derivative products, such as Stripped Mortgage-Backed Securities (SMBS) and residual interests in Collateralized Mortgage Obligations (CMOs) or Real Estate Mortgage Investment Conduits (REMIC) (NCUA has previously determined that SMBS are unsuitable investments for the vast majority of credit unions (see appendix II to NCUA Interpretive Ruling and Policy Statement 88-1: Policy on Selection of Securities Dealers and Unsuitable Investment Practices, 55 FR 18288 (May 23, 1988)). The proposal would also require federal credit unions holding any of these high-risk investments to dispose of the investment within 1 year from the effective date of the regulation unless a longer period of time is approved in writing by the appropriate regional director.

The prohibition concerning corporate credit union investments is intended to prohibit federal credit unions from transacting business with corporate credit unions that do not operate in compliance with part 704 of the NCUA Rules and Regulations or are not examined by NCUA. Under the current regulation, a federal credit union may invest in any corporate credit union irrespective of its degree of compliance with part 704 and without regard to whether or not it is examined by NCUA.

Although clearly mandated by sound business practice, federal credit unions are not presently required to have written investment policies. As previously mentioned, the proposal would require each federal credit union to have written investment policies consistent with the Federal Credit Union Act, NCUA Rules and Regulations, and other applicable laws and regulations. In addition, the rule would require that those policies address certain minimum investment considerations.

A federal credit union is authorized to invest in certain depository institutions under section 107(8) of the Federal Credit Union Act (12 U.S.C. 1757(8)). At this time, federal credit unions are not required to analyze the credit quality of these institutions prior to investing funds. Prior to investing in one of these institutions under the proposed rule, a federal credit union would be required to analyze the credit quality of the institution if the contemplated investment, or any portion of it, is not federally insured.

As noted, section 107(8) of the Federal Credit Union Act authorizes federal credit unions to make deposits in certain depository institutions. This includes the authority to "* * * invest in banks or institutions the accounts of which are insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation * * *" This authority is restated in section 703.2(n) of the current rule which defines a "section 107(8) institution" as "* * * an institution that is either 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 the state in which the federal credit union maintains a facility." With passage of the Financial Institution Reform, Recovery, and Enforcement Act of 1989, both federally insured banks and savings institutions are now insured by the Federal Deposit Insurance Corporation. Accordingly, the proposed rule would amend section 703.2(n) to reflect this change.

As proposed, the regulation would consist of six sections. The first section (§ 703.1) contains a statement of the scope of the regulation. This section of the proposal has been carried forward from the current regulation unchanged. The second section(§ 703.2) contains a list of the key terms and definitions used in the regulation. This section of the proposal has been expanded to include the additional key terms and definitions necessary to implement the proposed rule. The third section (§ 703.3) would contain the new requirement that each federal credit union establish written investment policies consistent with the Federal Credit Union Act, NCUA regulations, and other applicable laws and regulations. It also lists the minimum investment considerations that those policies would need to address. The fourth section (§ 703.4) sets out certain authorized but restricted investment activities. This section would contain the new requirement that federal credit unions analyze the credit quality of a "Section 107(8) institution" when making an investment that is not fully covered by Federal deposit insurance. The fifth section (§ 703.5) contains a list of prohibited investment activities. Formerly § 703.4 of the current regulation, this section of the proposed rule has been expanded to include the prohibited investments discussed below. The sixth section (§ 703.6) is new and contains the requirement that federal credit unions holding certain prohibited investments must dispose of those investments within 1 year of the effective date of the regulation unless a longer period of time is approved in writing by the appropriate regional director.

The remainder of the Supplementary Information discussion focuses on the proposed major changes to the present rule.

Analysis of Proposed Major Changes to Part 703

Section 703.2 Definitions

This section has been expanded to include the following key terms:

Average life
Collateralized Mortgage Obligation (CMO)
Corporate credit union
Real Estate Mortgage Investment Conduit (REMIC)
Residual interest
Stripped Mortgage-Backed Securities (SMBSs)
Zero coupon bond

The key terms and definitions which appear in this section of the regulation are consistent with the terms and definitions used by the securities industry to describe the investment and deposit activities that are subject to part 703.

Section 703.3 Investment policies

Under section 113(6) of the Federal Credit Union Act, the board of directors is responsible for the credit union's investment program. Among other things, the board of directors is responsible for determining that investments comply with the Federal Credit Union Act and NCUA Rules and Regulations, and that all surplus monies are invested in a wise and prudent manner.

It has been NCUA's longstanding position that each federal credit union's board of directors should develop written investment policies in carrying out its responsibilities under section 113 of the Federal Credit Union Act. The Agency's position in this respect has been communicated to federal credit unions on numerous occasions through various NCUA Letters to Credit Unions and the Federal Credit Union Handbook (NCUA 8030). Nevertheless, some boards of directors have failed to develop written investment policies. In some cases, the board's failure to establish written policies has resulted in the credit union making illegal or unsuitable investments (or engaging in investment activities not intended by the board, such as trading) which subsequently resulted in losses to the credit union. NCUA believes that these problems could have been avoided had the board of directors developed written investment policies to control the investment of surplus funds.

Accordingly, the NCUA Board proposes to require each federal credit union to establish written investment policies consistent with the Federal Credit Union Act, NCUA Rules and Regulations, and other applicable laws and regulations, and to review them at least annually. The proposal would require the written policies to state the purposes and objectives of the investment program and to specifically state whether securities purchased are held for sale, investment, or trading purposes. The rule would also require the written policies to address the other investment considerations specified in proposed § 703.3.

Section 703.4 Authorized Activities

As noted previously, this section establishes conditions under which a federal credit union would be required to analyze the credit quality of financial institutions it is permitted to invest in under section 107(8) of the Federal Credit Union Act. Under the rule, a federal credit union would be required to make such an analysis whenever a contemplated investment in one of those institutions that is not fully covered by Federal deposit insurance. In promulgating this proposed rule, the NCUA Board is mindful of the deterioration in the credit quality of many of the domestic banking institutions in which federal credit unions are permitted to invest. It is also mindful of various legislative proposals that have been advanced to reform the Federal deposit insurance system and that some of these proposals would limit the amount of future deposit insurance coverage available to credit unions. While the NCUA Board believes that it is prudent for a federal credit union to analyze the credit quality of a section 107(8) institution irrespective of the existence or extent of Federal deposit insurance, the proposed rule would limit the requirement to investments in section 107(8) institutions where the

investment, or any portion of it, is not federally insured.

While the proposal does not specify a method or procedure to be followed in analyzing the credit quality of a section 107(8) institution, it is believed that most credit unions will want to rely, at least in part, on an outside rating service that specializes in banking institutions. A number of such services are currently available to credit unions in the marketplace. It is also noted that where foreign investments are concerned, such as Eurodollar investments, a federal credit union may need to subscribe to an international bank rating service.

The NCUA Board also recognizes that evaluating the credit quality of a financial institution is an on-going activity which must continue throughout the life of the investment. Accordingly, the NCUA Board anticipates that where a credit union makes an investment subject to the rule, it will establish minimum intervals at which the initial credit analysis will be updated.

The second requirement of this provision is that a credit union shall record its credit decision respecting the investment in the records of the credit union. A credit union could comply with this provision by noting in the records of the credit union that it has approved or disapproved the investment and that the decision was made in conformance with the credit union's written policies respecting the investment.

The credit quality and recording requirements would extend to any investment a federal credit union is permitted to make pursuant to its deposit authority under section 107(8) of the Federal Credit Union Act, including Eurodollars, Yankee Dollars, Bankers acceptances, Federal funds, financial institution-type repurchase agreements, and any other investment that the NCUA Board may subsequently deem to be a "deposit" for purposes of section 107(8) of the Federal Credit Union Act.

Section 703.5 Prohibited Activities

This section would contain several new investment prohibitions as detailed below.

Corporate credit unions. It has been NCUA's longstanding position not to take exception to a federally insured credit union's concentrating its excess funds in the corporate system, regardless of the amount involved. This position has applied to both federally and state-chartered corporate credit unions, whether or not the institution is examined by NCUA, or operates in compliance with part 704 of the NCUA Rules and Regulations.

The investment powers and authorities of federal corporate credit unions, and of state-chartered, federally insured corporate credit unions have been the same as those of federal credit unions and state-chartered, federally insured credit unions, respectively. Investments that were not permissible for federal corporate credit unions, but that were permitted by the laws of the state in which a state-chartered, federally insured corporate credit union was chartered, require that a valuation account be established and funded to the extent of the difference between the book and market value of the investment. NCUA has no statutory authority over state-chartered, privately or noninsured corporate credit unions and has been able to participate in the examination of these corporate credit unions through the National Association of State Credit Union Supervisors (NASCUS). In light of the millions of dollars of insured funds that are deposited in these corporate credit unions, NCUA is proposing to prohibit federally insured credit unions from investing in them unless they meet two conditions: (1) They must operate in substantial compliance with part 704 of the NCUA Rules and Regulations, and (2) they must be examined by NCUA.

Proposed revisions to part 704 of the NCUA Rules and Regulations expand the powers and authorities of federal corporate credit unions. The proposed revisions were developed with significant input from corporate credit unions, both federally and state-chartered. NCUA believes that the requirements, limitations, and parameters outlined in the proposed part 704 provide for a prudent and realistic regulation, one that emphasizes safety and soundness for all corporate credit unions, regardless of origination of charter or insurance status. Further, NCUA believes that all corporate credit unions must be examined by NCUA corporate examiners, a group of senior examiners, who are experienced in the examination of corporate credit unions.

Questions regarding the degree of compliance with part 704 will be determined by the appropriate regional director. If the regional director determines that a corporate credit union is not in substantial compliance with part 704 and, as such, is not permitted to do business with federally insured credit unions, the regional director will notify the federally insured credit union members of that corporate credit union's noncompliance. A corporate credit union will be deemed to be in substantial compliance with part 704 provided the safety and soundness of the corporate credit union is not threatened.

Under the proposed revisions to part 704, each corporate credit union will have 180 days to comply with that regulation. Part 704 sets forth a process by which a temporary waiver may be obtained from the regional director. Corporate credit unions deemed not to be in substantial compliance with part 704 will be considered impermissible investments for federally insured credit unions.

Mortgage derivative products. A mortgage-backed security (MBS) provides for ownership of a fractional undivided interest in a specific pool of mortgages that serves to collateralize the MBS. As the mortgages in the pool are repaid, principal and interest are "passed through" to each investor on a pro rata basis. Each MBS has a stated maturity, expected average life, and coupon rate. The stated maturity coincides with the longest contractual maturity of any mortgage loan in the pool. The expected average life, also called the weighted average life, represents an estimate of the weighted average length of time that each dollar of principal will be outstanding. The coupon rate is the rate of interest that will be periodically paid to the investor based on the outstanding principal balance in the pool.

Unlike most corporate and government bonds, which pay principal as a lump sum at maturity, the scheduled monthly principal payments and all principal prepayments of each pool of mortgages, are passed directly to the owner of the MBS. Investors therefore lack certainty regarding the timing and amounts of cash flows from these securities because most mortgage borrowers, whose loans underlie the MBS, have the option to prepay the loan at any time. To compensate investors for this uncertainty, these securities are generally priced to yield a spread over Treasury securities of comparable maturity, i.e., a Treasury security with a maturity that approximates the average life of the MBS.

During a period of declining interest rates, it may become economical for a homeowner with a fixed or floating rate mortgage to refinance at a lower rate. In such an interest rate environment, an MBS will achieve only limited price appreciation above par value due to the expectation of increasing prepayments. In other words, it is expected that the MBS will prepay at a time when investors most desire a fixed rate instrument. During a period of rising interest rates, fixed rate mortgage borrowers will be less inclined to refinance their mortgage loans, while the market price of a fixed rate MBS will

decline like most other fixed rate securities. Unlike the potential for price appreciation, the potential price decline will not be restricted by the expectation of prepayments; therefore, MBSs have greater downside risk than they do upside potential. As a result, price changes are not proportionate when interest rates rise or fall by equal amounts. Hence, an investor's assumptions regarding prepayments are simply projections that are largely based on the expected level of future interest rates and a related prediction concerning when and how MBS cash flows will occur. These assumptions drive an investor's expectation regarding the average life, market value, and yield of an MBS.

Most MBSs are issued through or guaranteed by the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA), or the Federal Home Loan Mortgage Corporation (FHLMC). These securities, having a U.S. Government affiliation, are considered to bear little or no credit risk. The near absence of credit risk, coupled with the size and depth of the MBS market, have established a significant level of liquidity for government-issued or government-sponsored MBS programs.

MBSs not issued or guaranteed by GNMA, FNMA, or the FHLMC are known as private issues and may be backed by pool insurance, letters of credit or other credit enhancements. In addition to bearing the interest rate risk associated with pass-through securities, privately-issued MBSs will present varying degrees of credit risk to the investor depending on the quality of the underlying mortgages and the security's credit enhancements. It should also be understood that the market for privately-issued MBSs is significantly less liquid than the market for MBSs issued or guaranteed by GNMA, FNMA, or the FHLMC.

In addition to the basic MBS, various MBS derivatives have been created. One such derivative is the Stripped Mortgage-Backed Security (SMBS). SMBSs consist of two classes of securities. Each class receives a different portion of the monthly interest and principal cash flows from the underlying mortgages or MBS. In its purest form, an SMBS is converted into an Interest Only (IO) and Principal Only (PO) class. With an IO, the investor receives 100 percent of the interest cash flow and no principal payments. With a PO, the investor receives 100 percent of the principal cash flow and no interest payments.

All IOs and POs have extremely volatile price characteristics based largely on the prepayment pattern of the underlying mortgages and consequently on the realized maturity of the stripped security. Generally, POs rise in value as mortgage commitment rates decline, while IOs increase in value as these rates rise. Accordingly, the purchase of an IO may serve, theoretically, to offset the interest rate risk associated with holding mortgages or similar instruments. Similarly, a PO may serve to offset the effect of interest rate movements on the value of mortgage servicing. However, when purchasing an IO or PO, the investor is essentially speculating on the movements of future interest rates and how these movements will affect the prepayment pattern of the underlying collateral and hence the market value of the SMBS.

The figure below provides projected yields for SMBS Certificates of the Federal National Mortgage Association issued on April 1, 1988. The projected yields are based on assumed PSA percentages ranging from 80% to 500%. As can be seen in the table, the IO/PO yields fluctuate widely as the prepayment speed of the underlying mortgages rises and falls. Moreover, at 500% PSA, the IO holder experiences a negative rate of return, meaning that the IO holder fails to recover his initial investment in the security.

	PSA Percentages [1]				
	80	100	146	280	500
	Yield to Maturity				
SMBS Class 1 Certificates (POs)	8.08	7.22	8.47	16.44	31.91
SMBS Class 2 Certificates (IOs)	15.80	12.89	9.76	2.74	15.08

[1] The term PSA Percentages refers to a model used to measure prepayment speeds in pricing CMOs and IOs and POs.

Because SMBSs are relatively new to the marketplace (the first SMBS was issued by FNMA in early 1987), the supply in existence is limited. As a consequence, holders of SMBSs may also be subjected to a high degree of marketability risk. Marketability risk is the risk that a security may not be readily convertible to cash (or cashed only at a significant loss), if it suddenly needs to be sold.

Due to the speculative nature of these securities, their extreme price volatility, and the limited market that may exist for the sale of IOs and POs, the NCUA Board has determined that SMBSs are generally unsuitable for all federal credit unions. Accordingly, the proposed regulation prohibits the purchase of SMBSs. This prohibition is reflected in § 70[illegible].5(f) of the proposed rule.

Another mortgage derivative product is the Collateralized Mortgage Obligations (CMO) or Real Estate Mortgage Investment Conduits (REMIC). CMOs and REMICs (hereafter referred to as CMOs) have been developed in response to investor concerns regarding the uncertainty of cash flows associated with the ability of the mortgage borrower to prepay the mortgage note. A CMO can be collateralized directly by whole loan mortgages, but more often is collateralized by MBSs issued or guaranteed by GNMA, FNMA, or FHLMC and held in trust for CMO investors. In contrast to MBSs, where cash flows are received pro rata by all security holders, the cash flow from the mortgages underlying a CMO is segmented, and paid in accordance with a predetermined schedule to investors holding various classes (tranches) of bonds. By prioritizing the cash flow from the underlying mortgages among the separate tranches, entirely different classes of bonds are created, each with their own stated maturity, estimated average life, coupon rate, and unique prepayment risk characteristics.

Many CMOs are designed to have one or more Planned Amortization Class (PAC) bonds. PAC bonds commonly have a fixed monthly principal amortization which is essentially guaranteed within a wide band of prepayment speeds, thus to that extent limiting the prepayment risk to the investor. This limiting process allows the investor to more accurately predict the average life of the investment, and in general, reduces the price volatility that would be assumed if the underlying MBSs themselves had been purchased.

The drawback is that when a CMO is structured with a PAC class, the PAC class transfers prepayment risk to other classes within the CMO which take on a level of prepayment risk above that which they would normally assume. These "higher risk" tranches may be referred to as "CMO support tranches", "subordinated tranches", or "companion bonds". Unlike the PAC tranche, which has been designed to provide a high degree of certainty regarding average life and final maturity, support tranches can have a highly volatile average life, yield, and market price.

CMO support tranches that have developed non-proprietary, industry wide labels in the secondary market include:

Targeted Amortization Class (TAC)—CMO tranches that are contractually protected against prepayments when prepayments are faster than expected.

Super or Turbo POs—Zero coupon tranches that absorb much of the volatility of CMOs with PACs by absorbing all prepayments after all scheduled PAC payments are met.

Inverse and Super Inverse Floaters—CMO tranches that have a yield that moves in the opposite direction of market rates.

Super Inverse Floaters do not move one for one as rates change; instead, they rise or decline in yield at a rate more rapid than market rates rise or fall.

Z Tranches—CMO tranches that accrue interest but do not begin payment of principal until all other earlier tranches have been retired. They are sometimes the only support tranches in a CMO.

Jump Z Tranches—Z Tranches that immediately begin to receive all prepayments after the scheduled PAC payment is made, provided that some trigger mechanism has been reached.

As indicated, based on the design of a CMO, certain individual tranches can display a high degree of interest rate risk and price volatility. Examples of "high risk" tranches are CMO support tranches which, as explained above, receive principal payments only after the PAC tranche has received its scheduled payment. However, this is only one type of CMO structure among many others that can display a high degree of interest rate risk and price volatility. Accordingly, the NCUA Board proposes to prohibit the purchase of any CMO tranche whose average life would expand or shorten by more than 6 years under modeling scenarios where mortgage commitment rates immediately rise or fall 300 basis points (see *§ 703.5(g) of the proposed rule*). To qualify as a permissible investment under the proposed rule, a CMO tranche must meet the average life standard at the time of purchase and on any subsequent review date, assuming market interest rates and prepayment speeds at the time that the standard is applied. The requirement that the average life standard must be met on the purchase date and any subsequent review date is also contained in § 703.5(h) of the proposed rule.

The NCUA Board recognizes that most credit unions do not have the software or database necessary to perform the test; however, there are a number of services available that can perform the calculations "on line". A federal credit union considering an investment in a CMO tranche will want to perform the test prior to making the investment. Application of the test on a post-acquisition basis would not comply with the regulation. Most government securities dealers subscribe to one or more of the above-mentioned services and can FAX a printout of the average life test to the credit union. Since the average life standard applies throughout the life of the investment, a federal credit union will need to periodically retest the investment in order to ensure that it continues to comply with the regulation until it matures or is sold in the secondary market.

Sometimes referred to as the "ultimate derivative", another mortgage derivative product is the CMO residual. CMO residuals represent claims on any excess cash flows from a CMO issue remaining after the payments due to bondholders and trust administrative expenses have been satisfied. The economic value of a CMO residual is a function of the present value of the anticipated cash flows under assumed prepayment speeds and rates of return associated with reinvesting payments from the underlying collateral before distribution to bondholders. This cash flow is extremely sensitive to prepayments and existing levels of market interest rates. Other factors affecting the market value of residuals include a lack of liquidity and broker/dealer profit.

Certain CMO residuals might be employed to offset declines in the value of fixed rate mortgages or an MBS portfolio in a period of rising interest rates. However, like an IO SMBS, the uncertainty regarding prepayments on the underlying collateral makes it extremely difficult to use these instruments as an effective interest rate risk reduction tool. In an environment of rapidly falling interest rates, the market value of a residual can completely disappear. Moreover, a complex CMO structure (e.g., multiple numbers or types of tranches) or unusual collateral characteristics (e.g., a blend of fixed and adjustable rate mortgages) can make both evaluating and accurately forecasting the cash flows of a residual even more difficult.

Based on the above factors, the NCUA Board has also determined that CMO residuals are generally unsuitable for all federal credit unions. Accordingly, the proposed rule would prohibit the purchase of these securities. The prohibition is contained in § 703.5(i) of the proposed rule.

Zero coupon securities. Zero coupon securities are securities that make no periodic interest payments but instead are sold at a discount from their face value. The holder of the instrument realizes the rate of return through the gradual appreciation of the security, which is redeemed at face value on a specified maturity date. Common examples of zero coupon securities available to federal credit unions are Treasury STRIPS and certain Treasury-backed proprietary products such as TIGRs, CATS, ETRs, GATORs, and TRs.

Although free from credit risk when backed by the U.S. Government, longer maturity issues of these instruments (generally, maturities exceeding 10 years) have exhibited extreme price volatility. (Small changes in interest rates have produced substantial swings in secondary market prices.) Due to their extreme price volatility, investments in longer term zero coupon securities may, over time, distort or produce unintended changes in a credit union's earnings, and its interest rate, liquidity and funding risk profile. Accordingly, the NCUA Board has determined that longer maturity issues of these securities are essentially speculative investments and, as such, are unsuitable holdings for all federal credit unions. Therefore, § 703.5(j) of the proposed regulation would prohibit the purchase of a zero coupon security with a remaining maturity of more than 10 years.

Section 703.6 Liquidation of Impermissible Investments

Impermissible investments will not be "grandfathered" under the proposed rules. The rules would require federal credit unions holding IOs or POs, CMO/REMIC residuals, CMO tranches that fail the average life standard, and zero coupon bonds with maturities greater than 10 years to dispose of the prohibited investments within 1 year from the effective date of the regulation. However, regional directors would have authority to approve extensions to the 1-year rule. Such approvals would have to be made in writing by the appropriate regional director. While it is the NCUA

Board's intent that the impermissible investments should be disposed of as quickly as possible, it is anticipated that extensions will be approved where the sale of the impermissible investment would produce an unacceptable level of losses. Each regional director will have the discretion to determine what would constitute "an unacceptable level of losses," taking into account all pertinent factors including the credit union's earnings and capital position.

Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact any proposed regulation may have on a substantial number of small credit unions (primarily those under $1 million in assets).

The proposed rule is grounded in NCUA concerns about the safety and soundness of certain investment practices and their effects on federal credit unions and the National Credit Union Administration Share Insurance Fund. Based on the experience of NCUA examiners, few small credit unions are engaging in the investment practices that are the subject of the proposed rule. Accordingly, the NCUA Board determines and certifies that the proposed rule, if adopted, will not have a significant economic impact on a substantial number of small credit unions and that a Regulatory Flexibility Analysis is not required.

Paperwork Reduction Act

The paperwork Reduction Act requirements do not apply to information collection requirements applicable to nine or fewer persons. Although proposed § 703.6 does require an application to the appropriate Regional Director, the information that we have at present indicates that relatively few applications will be received. NCUA, at this time, expects no more than nine applications per year. Therefore, the Board has determined that the requirements of the Paperwork Reduction Act do not apply to this provision of the proposed rule. NCUA does solicit comments from federal credit unions regarding whether they anticipate applying for an extension of the period given to dispose of prohibited investments. This information will aid NCUA in determining whether a Paperwork Reduction Act analysis of this section of the proposed regulation is necessary.

The proposed regulation also contains several collection of information requirements which apply to more than nine credit unions. Section 703.3 requires federal credit unions to establish written investment policies. Section 703.4(c) requires federal credit unions to analyze the credit quality of any uninsured deposits in section 107(8) institutions and to record their decisions regarding the investments. These recordkeeping requirements will be submitted to the Office of Management and Budget for review under the Paperwork Reduction Act. Written comments and recommendations regarding the collection requirements should be forwarded directly to the OMB Desk Officer indicated below at the following address: OMB Reports Management Branch, New Executive Office Building, room 3208, Washington DC 20503. Attn: Jerry Waxman.

Executive Order 12612

Executive Order 12612 requires NCUA to consider the effect of its actions on state interests. It states that: "Federal action limiting the policymaking discretion of the States should be taken only where constitutional authority for the action is clear and certain and the national activity is necessitated by the presence of a problem of national scope." Currently, part 703 directly applies only to federally chartered credit unions, and the proposed rule makes no change in its application. Although part 703 indirectly applies to federally insured state chartered credit unions through the insurance requirements at 12 CFR 741.9(a)(3) and (b)(3), the Board has determined that the proposed rule will not have a substantial direct effect on the States, on the relationship of the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Further, the new rule will not preempt provisions of state law or regulation.

List of Subjects in 12 CFR Part 703

Credit unions, Investments, Reporting and recordkeeping requirements.

By the National Credit Union Administration Board on March 13, 1991.

Becky Baker,

Secretary of the Board.

Accordingly, it is proposed that 12 CFR part 703 be amended to read as set forth below:

PART 703—[AMENDED]

1-2. The authority citation for part 703 continues to read as follows:

Authority: 12 U.S.C. 1757(7), 1757(8), 1757(15), 1766(a), 1789(11).

3. Section 703.1 is republished for the convenience of the reader.

§ 703.1 Scope.

Sections 107(7), 107(8) and 107(15) of the Federal Credit Union Act (12 U.S.C. 1757(7), 1757(8), 1757(15)), 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, certain mortgages and mortgage-related securities, and other specified investments. This part interprets several of the provisions of sections 107(7), 107(8) and 107(15)(B). It also places 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 under sections 107(7), 107(8) and 107(15)(B). This part does not apply: to investments in loans to members and related activities, which are governed by §§ 701.21, 701.22 and 701.23 (12 CFR 701.21, 701.22 and 701.23); to the purchase of real estate-secured loans pursuant to section 107(15)(A), which is governed by § 701.23; to investment in credit union service organizations, which is governed by § 701.27 (12 CFR 701.27); or to investment in fixed assets, which is governed by § 701.36 (12 CFR 701.36).

4. Section 703.2 is revised to read as follows:

§ 703.2 Definitions.

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.

Average life means the weighted average time to principal repayment with the amount of the principal paydowns (both scheduled and unscheduled) as the weights.

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.

Bankers' Acceptance means a time draft that is drawn on and accepted by a bank, and that represents an irrevocable obligation of the bank.

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.

Collateralized Mortgage Obligation (CMO) means a multi-class bond issue collateralized by whole loan mortgages or mortgage-backed securities (MBSs). CMOs usually consist of four or more classes of bonds which are commonly referred to as "tranches".

Corporate credit union means a financial institution that:

(1) Is a depository institution chartered or licensed under state or federal statute to operate as a credit union;

(2) Is operated primarily for the purpose of serving other credit unions; and

(3) Has a voting membership not less than 95 percent of which consists of credit unions.

Eurodollar deposit means a deposit in a foreign branch of a United States depository institution.

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.

Federal funds transaction means a short-term or open-ended transfer of funds to a section 107(8) institution.

Futures contract means a contract for the future delivery of commodities, including certain government securities, sold on commodities exchanges.

Immediate family member means a spouse or other family members living in the same household.

Market price means the last established price at which a security is sold.

Maturity date means the date on which a security matures, and shall not mean the call date or the average life of the security.

Real Estate Mortgage Investment Conduit (REMIC) means a nontaxable entity formed for the sole purpose of holding a fixed pool of mortgages secured by an interest in real property and issuing multiple classes of interests in the underlying mortgages.

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.

Residual interest means the remainder cash flows from a CMO or REMIC transaction after payments due bondholders and trust administrative expenses have been satisfied.

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.

Section 107(8) institution means a 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 is insured by the Federal Deposit 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.

Security means any security, obligation, account, deposit, or other item authorized for investment by a Federal credit union pursuant to section 107(7), 107(8), or 107(15)(B) of the Federal Credit Union Act (12 U.S.C. 1757(7), 1757(8), 1757(15)(B)), other than loans to members.

Senior management employee means the credit union's chief executive officer (typically this individual holds the title of President or Treasurer/Manager), any assistant chief executive officers (e.g., Assistant President, Vice President or Assistant Treasurer/Manager) and the chief financial officer (Comptroller).

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.

Short sale means the sale of a security not owned by the seller.

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.

Stripped Mortgage-Backed Securities (SMBSs) means securities that represent unequal proportions of the cash flows of an underlying pool of mortgages. In their purest form, SMBSs represent mortgage-backed securities (MBSs) that have been converted into interest only (IO) securities, where holders receive 100 percent of the interest cash flows, and principal only (PO) securities, where holders receive 100 percent of the principal cash flows.

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.

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.

Zero coupon bond means a debt obligation that makes no periodic interest payments but instead is sold at a discount from its face value. The holder of a zero coupon bond realizes the rate of return through the gradual appreciation of the security, which is redeemed at face value on a specified maturity date.

5. Section 703.3 is revised to read as follows:

§ 703.3 Investment policies.

The board of directors of each federal credit union shall establish written investment policies consistent with the applicable provisions of the Act, NCUA's regulations, and other applicable laws and regulations, and review them at least annually. At a minimum, the written policies shall address the following:

(a) Purposes and objectives of the credit union's investment activities, including a statement whether securities purchased are held for sale, investment, or trading purposes;

(b) Persons or committees to whom investment authority has been delegated and the extent of their authority;

(c) Limits on the amount of funds that may be committed to any particular investment or securities transaction;

(d) Maturity limits;

(e) Interest rate risk (as applicable);

(f) Credit risk (as applicable);

(g) Securities dealers/brokerage firms approved for use by the board of directors together with any limitations that the board has established with

respect to the amount of funds that may be placed or invested with any of the approved broker/dealers (as applicable;

(h) Safekeeping of securities, including a list of approved safekeeping facilities.

8. Section 703.4 is revised to read as follows:

§ 703.4 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, provided that where any such deposit, or any portion of it, is not federally insured, a credit union shall analyze the credit quality of the issuing institution prior to making the deposit. Where the deposit, or any portion of it is not Federally insured, a Federal credit union shall also record its credit decision respecting the investment in the records of the credit union.

(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 institution-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(9)), which limits a Federal credit union's aggregate borrowing to 50 percent of its unimpaired capital and surplus.

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

(i) *Bankers acceptances.* A Federal credit union may invest in bankers' acceptances issued by a section 107(8) institution.

7. A new § 703.5 is added to read as follows:

§ 703.5 Prohibitions.

(a) Except as provided in § 701.21(l) of this chapter, 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 may not purchase shares or deposits in, or otherwise transact business with a corporate credit union that does not operate in compliance with part 704 of this chapter in significant respects, or is not examined by NCUA.

(f) A Federal credit union may not purchase a Stripped Mortgage-Backed Security (SMBS).

(g) A Federal credit union may not invest in any CMO or REMIC tranche whose average life would extend or shorten by more than six years under modeling scenarios where mortgage commitment rates immediately rise or fall 300 basis points.

(h) The average life standard contained in paragraph (g) of this section shall apply to CMO/REMIC investments at the time of purchase and on any subsequent review date, assuming market interest rates and prepayment speeds at the time the standard is applied.

(i) A Federal credit union may not purchase a residual interest in a CMO or REMIC transaction.

(j) A Federal credit union may not purchase a zero coupon security with a maturity date that is more than ten years from the settlement date for purchase of the security.

(k) A Federal credit union's directors, officials, committee members and senior management 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.

(l) The prohibition contained in paragraph (k) of this section also applies to any employee not otherwise covered if the employee is directly 33 involved in investments or deposits unless the board of directors determines that the employee's involvement does not present a conflict of interest.

(m) All transactions with business associates or family members not specifically prohibited by paragraph (k) of this section must be conducted at arm's length and in the interest of the credit union.

8. A new § 703.6 is added to read as follows:

§ 703.6 Liquidation of impermissible investments.

Any federal credit union holding securities that are not in compliance with §§ 703.5(f), 703.5(g), 703.5(h), or 703.5(j) shall have 1 year from the effective date of the final regulation to dispose of such securities unless a longer period of time is approved in writing by the appropriate regional director.

[FR Doc. 91-6628 Filed 3-20-91; 8:45 am]

BILLING CODE 7535-01-M

NCUA

NCUA LETTER NO. 92

TO CREDIT UNIONS

DATE: August 13, 1987

TO THE BOARD OF DIRECTORS OF THE FEDERAL CREDIT UNION ADDRESSED:

In the past, NCUA has responded to requests from broker/dealers, mutual funds, Federal credit unions (FCU's), and others for a determination as to the legality of particular mutual funds (Funds) as FCU investments. For the reasons discussed below, NCUA will no longer issue such opinions.

As you are aware, NCUA has taken the position that mutual funds are permissible investments for FCU's provided that all of the investments and investment practices of the mutual fund are legal if made directly by an FCU. Sections 107(7) and 107(8) of the Federal Credit Union Act set forth the securities, deposits, and other obligations in which an FCU may invest. Part 703 of the NCUA Rules and Regulations places certain limits on the types of transactions that FCU's may enter into in connection with the purchase and sale of authorized securities, deposits, and obligations.

NCUA is aware that some FCU's have invested in mutual funds solely on the basis that NCUA has determined that the Fund is a legal investment. Use of NCUA's legal opinion as the criterion for making an investment raises several concerns. First, an FCU relying solely on NCUA's legal opinion is not determining whether the Fund is an appropriate investment in light of the FCU's current investment portfolio and liability structure. Second, NCUA is concerned that the routine issuing of opinions on mutual funds has indirectly encouraged investment in the funds. Such a result was not intended. The decision to invest in mutual funds should be made based on the individual needs of each FCU. Last, although NCUA has consistently stated that its opinions on the legality of particular mutual funds are not to be interpreted as recommendations or approval of the Funds by NCUA, the opinions have been used by brokers and Funds as a marketing tool. The prospectuses or marketing materials of some Funds incorrectly state that they have been "approved by NCUA", and FCU's have invested in the Funds on this basis.

Accordingly, NCUA has decided that it will no longer issue opinions on the legality of particular funds. NCUA believes that this decision will have a positive effect on FCU investment policies. Those boards of directors which may in the past have

simply relied on NCUA's legal opinions will be encouraged to explore the full range of investment options available, and then make an investment decision that is in the best interests of the FCU. In so doing, they will become more knowledgeable about FCU investment authority and investment restrictions, as contained in the FCU Act and the NCUA Rules and Regulations.

This new policy should not be viewed as NCUA's "abandonment" of FCU's in this area. To the contrary, NCUA's Office of General Counsel and the NCUA Investment Hotline will continue to respond to investment questions requiring an interpretation of the FCU Act and the NCUA Rules and Regulations, in particular the legality of specific direct investments and investment practices. However, the FCU will be responsible for establishing and supporting the legality of any of its investments. If in doubt about a particular investment, FCU's are encouraged to obtain the opinion of qualified legal counsel.

Finally, NCUA is considering requiring that a Fund's prospectus or statement of additional information provide that the type of investments the Fund will make and the Fund's investment practices may only be changed if authorized by majority shareholder vote. Thus, if a Fund changes its investment authority or practices in a manner that will make the Fund impermissible for FCU's, the FCU will have knowledge of the change and can take appropriate steps to divest itself of the Fund.

In the interim, FCU's investing in mutual funds should either invest only in Funds that feature the shareholder vote notice, or continually monitor the Fund to ensure that it remains a legal investment. If the Fund does invest in securities or engage in activities not authorized for FCU's, the credit union must immediately divest its interest in the Fund.

Sincerely,

FOR THE NCUA BOARD

ROGER W. JEPSEN
Chairman

RWJ:sg