NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

May 4, 1992

Carolyn J. Murphy
Regional Vice President
Field Service
Cash Equivalent
Clearing Corporation
Pacific Fianancial Plaza
840 Newport Center Dr.
Suite 680
Newport Beach, CA 92660

Re: Denial of Request for Endorsement
(Your Letter of April 8, 1992)

Dear Ms. Murphy:

You requested an NCUA endorsement of investment products, including certificates of deposit and time deposits, offered by Cash Equivalent Clearing Corporation ("CECC"). NCUA does not endorse specific individual investment products. Investment decisions should be made by the board of directors of a federal credit union ("FCU") in accordance with guidelines within legal parameters reflecting each FCU's particular needs.

Nor does NCUA opine upon the legality of specific investment schemes. We suggest that counsel for each FCU investing in your products make the determination of the legality of such investments in accord with relevant law, regulations and NCUA policy.

ANALYSIS

FCU investment and deposit authority is governed by Sections 107(7), (8) and (15) of the FCU Act and Part 703 of the NCUA Rules and Regulations. See 12 U.S.C. §§1757(7), (8), and (15) and 12 C.F.R. Part 703 (both enclosed). Under Section 107(8) of the FCU Act, an FCU may make deposits in national banks and in state banks, trust companies, and mutual savings

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banks operating in accordance with the laws of the state in which the FCU does business, or in banks or institutions the accounts of which are insured by the Federal Deposit Insurance Corporation. Several prior opinion letters regarding investments in certificates of deposit, time deposits and like products are enclosed for your guidance. See NCUA Opinion Letter from me to Tobias E. Timm, McDonald & Company, entitled "Bank Notes," dated December 3, 1991; NCUA Opinion Letter from me to Morgan Reed, U.S. Sterling Capital Corporation, entitled "Federal Credit Union Investment Authority," dated January 2, 1991; NCUA Opinion Letter from me to Carl A. Bright, Irwin Union Bank and Trust, entitled "Irwin Union CD Program," dated November 30, 1990; NCUA Opinion Letter from me to Mitchell C. Glass, Eastern Airlines Federal Credit Union, entitled "Investment in Yankee Dollars," dated May 16, 1989; and Letter from Valerie J. Best, Senior Attorney, FDIC, to me, dated November 16, 1990.

An FCU is required to establish written investment policies consistent with the FCU Act, NCUA's regulations and other applicable laws and regulations which are to include policies regarding the FCU's: investment purposes and objectives; delegations of investment authority; investment limits; maturity limits; interest rate risk; credit risk; approved securities dealers/brokerage firms; and securities safekeeping and safekeeping facilities. 12 C.F.R. §703.4. Any involvement by an FCU with CECC must be in accord with the FCU's investment policies.

The products and services offered by CECC comprise an investment program. The discussion in NCUA Letter to Credit Unions No. 92 (August 13, 1987) (enclosed) applies to investment programs as well as mutual funds. NCUA does not issue opinions on the legality of particular investment programs. FCUs are "encouraged to explore the full range of investment options available, and then to make an investment decision that is in the best interests of the FCU." NCUA Letter to Credit Unions No. 92, p.2. FCUs are 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." Id. NCUA does not endorse specific investment programs.

It is unclear to us whether your products or services involve a delegation of investment authority from FCUs to CECC. Sec-

tion 113(6) of the FCU Act (12 U.S.C. §1761b(6)), provides that the board of directors of an FCU "shall have charge of investments." It has long been NCUA policy that the board of directors of an FCU may delegate its investment authority only if certain conditions are met. Before delegating its investment authority, the board should investigate to its satisfaction the integrity and financial condition of any third party investment manager. The delegation should be noted in the FCU's investment policies, the extent of the delegation of investment authority must be specifically stated, and the delegation must be made in writing by board resolution. Under no circumstances should the third party be given total authority to invest credit union funds with no FCU board of director oversight. The determination as to the permissibility of a particular investment program, as well as its suitability for a particular FCU, should only be made by the board of directors of the FCU, with the advice of counsel. FCU boards may also want to contact their bonding company for further guidance.

This letter should not be interpreted as either an approval or endorsement of your products. It is merely a discussion of the issues to be addressed in making a determination on the legality and suitability of a particular program.

Sincerely,

Hattie M. Ulan

Hattie M. Ulan
Associate General Counsel

Enclosure

GC/MEC:sg
SSIC 4660
92-0424

(3) the names and addresses of the subscribers to the certificate and the number of shares subscribed to each;

(4) the initial par value of the shares;

(5) the proposed field of membership, specified in detail;

(6) the term of the existence of the corporation, which may be perpetual; and

(7) the fact that the certificate is made to enable such persons to avail themselves of the advantages of this chapter.

Such organization certificate may also contain any provisions approved by the Board for the management of the business of the association and for the conduct of its affairs and relative to the powers of its directors, officers, or stockholders.

## § 1754 § 104

**Approval of organization certificate.**—The organization certificate shall be presented to the Board for approval. Before any organization certificate is approved, an appropriate investigation shall be made for the purpose of determining (1) whether the organization certificate conforms to the provisions of this chapter; (2) the general character and fitness of the subscribers thereto; and (3) the economic advisability of establishing the proposed Federal credit union. Upon approval of such organization certificate by the Board it shall be the charter of the corporation, and one of the originals thereof shall be delivered to the corporation after the payment of the fee required therefor. Upon such approval the Federal credit union shall be a body corporate and as such, subject to the limitations herein contained, shall be vested with all of the powers and charged with all of the liabilities conferred and imposed by this chapter upon corporations organized hereunder.

## § 1755 § 105

**Fees.**—(a) In accordance with rules prescribed by the Board, each Federal credit union shall pay to the Administration an annual operating fee which may be composed of one or more charges identified as to the function or functions for which assessed.

(b) The fee assessed under this section shall be determined according to a schedule, or schedules, or other method determined by the Board to be appropriate, which gives due consideration to the expenses of the Administration in carrying out its responsibilities under this Act and to the ability of Federal credit unions to pay the fee. The Board shall, among other things, determine the periods for which the fee shall be assessed and the date or dates for the payment of the fee or increments thereof.

(c) If the annual operating fee is composed of separate charges, no supervision charge shall be payable by a Federal credit union, and the Board may waive payment of any or all other charges comprising the fee, with respect to the year in which its charter is issued, or in which final distribution is made in its liquidation or the charter canceled.

(d) All operating fees shall be deposited with the Treasurer of the United States for the account of the Administration and may be expended by the Board to defray the expenses incurred in carrying out the provisions of this Act including the examination and supervision of Federal credit unions.

(e)(1) Upon request of the Board, the Secretary of the Treasury shall invest and reinvest such portions of the annual operating fees deposited under subsection (d) as the Board determines are not needed for current operations.

(2) Such investments may be made only in interest bearing securities of the United States with maturities requested by the Board bearing interest at rates determined by the Secretary of the Treasury, taking into consideration current market yields on outstanding marketable obligations of the United States of comparable maturities.

(3) All income derived from such investments and reinvestments shall be deposited to the account of the Administration described in subsection (d).

## § 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.

## § 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, a loan for the repair, alteration, or improvement of a residential dwelling which is the residence of a credit union member, 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 15 years or any longer term which the Board may allow;

(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 1% 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, representing equity, 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 deposits 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 invest in securities that—

(A) are offered and sold pursuant to section 4(5) of the Securities Act of 1933 (15 U.S.C. 77d(5)); or

(B) are mortgage related securities (as that term is defined in section 3(a)(41) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(41)), subject to such regulations as the Board may prescribe, including regulations prescribing minimum size of the issue (at the time of initial distribution) or minimum aggregate sales prices, or both;

**(16) subject to such regulations as the Board may prescribe, to provide technical assistance to credit unions in Poland and Hungary; and**

**(17) 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.**

## § 1758 § 108

**Bylaws.**—In order to simplify the organization of Federal credit unions the Board shall from time to time cause to be prepared a form of organization certificate and a form of bylaws, consistent with this chapter, which shall be used by Federal credit union incorporators, and shall be supplied to them on request. At the time of presenting the organization certificate the incorporators shall also submit proposed bylaws to the Board for its approval.

## § 1759 § 109

**Membership.**—Federal credit union membership shall consist of the incorporators and such other persons and incorporated and unincorporated organizations, to the extent permitted by rules and regulations prescribed by the Board, as may be elected to membership and as such shall each subscribe to at least one share of its stock and pay the initial installment thereon and a uniform entrance fee if required by the board of directors; except that Federal credit union membership shall be limited to groups having a common bond of occupation or association, or to groups within a well defined neighborhood, community, or rural district

[illegible] and the system features and capabilities of paragraph (d) of this section have been met and maintain these records in an auditable form, available for inspection, for at least 3 years, unless a longer retention time is required by part 75 of this chapter.

(2) Records that must be maintained pursuant to this part may be the original or a reproduced copy or a microform if such reproduced copy or microform is duly authenticated by authorized personnel and the microform is capable of producing a clear and legible copy after storage for the period specified by Commission regulations. The record may also be stored in electronic media with the capability for producing, on demand, legible, accurate, and complete records during the required retention period. Records such as letters, drawings, and specifications must include all pertinent information such as stamps, initials, and signatures.

(3) The licensee shall maintain adequate safeguards against tampering with and loss of records.

Dated at Rockville, Maryland, this 24th day of October, 1991.

For the Nuclear Regulatory Commission.

Samuel J. Chilk,

*Secretary of the Commission.*

[FR Doc. 91-26137 Filed 10-30-91; 8:45 am]

BILLING CODE 7590-01-M

## NATIONAL CREDIT UNION ADMINISTRATION

### 12 CFR Part 703

### Investment and Deposit Activities

**AGENCY:** National Credit Union Administration (NCUA).

**ACTION:** Final rule.

**SUMMARY:** This final rule will restrict access to certain high risk investments that have been purchased by a limited number of federal credit unions. The rule will also prohibit federal credit unions from investing in corporate credit unions that fail to meet certain regulatory criteria and requires 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. The rule also establishes conditions under which a federal credit union must analyze the credit quality of an institution it is permitted to invest in under section 107(8) of the Federal Credit Union Act. Finally, certain provisions of the regulation have been updated to reflect the restructuring of the federal deposit insurance system, and to clarify that federal credit unions have the authority to invest in a mutual fund if the investments and investment transactions of the fund are legally permissible for federal credit unions under the Federal Credit Union Act and NCUA Rules and Regulations.

**EFFECTIVE DATE:** December 2, 1991, except that the effective date of the prohibition contained in § 703.5(e) is delayed until March 1, 1992.

**ADDRESSES:** National Credit Union Administration, 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:**

### A. Background

On March 21, 1991, the NCUA Board published proposed changes to part 703 of the NCUA Rules and Regulations (See 56 FR 11944, Mar. 21, 1991). The changes were proposed pursuant to NCUA's established policy of reviewing its regulations at regular intervals. The proposal was issued with a 60-day comment period.

### B. Comments

Forty-three comment letters were received: Twenty-four from federal credit unions, six from state chartered credit unions, one from a corporate credit union, three from state leagues, two from national trade associations, one from a state credit union regulator, one from a credit union bonding company, three from securities brokerage firms, and two from mortgage-related corporations. Six commenters approved of the proposal as written, while one commenter objected to it in its entirety. Thirteen commenters generally approved of the rule as written, suggesting only minor changes. The remainder of the commenters discussed specific provisions without expressing an opinion on the regulation as a whole.

### C. Discussion and Authority

*Section 703.1 Scope*

No changes were made to this section. Two commenters noted, however, that although this section states that part 703 applies to federal credit unions, the supplementary information discussion of § 703.5 contained references to federally insured state credit unions.

The NCUA Board wishes to clarify that the provisions of part 703 apply to federal credit unions. The Board notes, however, that federally insured state credit unions are required to establish an additional special reserve for investments if those credit unions are permitted by their respective states to make investments beyond those authorized by the Federal Credit Union Act and NCUA Rules and Regulations. This requirement is contained in part 741 of the NCUA Rules and Regulations (Requirements for Insurance), which applies to federal credit unions, federally insured state credit unions and credit unions making application for insurance of accounts pursuant to title II of the Federal Credit Union Act.

The NCUA Board also notes that federally insured state credit unions operating under state statutes that have "parity provisions" with respect to the investment powers conferred by the Federal Credit Union Act and NCUA Rules and Regulations will also be impacted by the final rule.

*Section 703.2 Definitions*

This section of the proposal included a number of new key terms and definitions. No comments were received relative to this section; accordingly, this section of the proposed rule has been carried into the final rule unchanged.

*Section 703.3 Investment Policies*

The proposed rule required 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.

Eight commenters specifically agreed with this section. One commenter suggested, however, that the term "interest rate risk," which is listed in paragraph (e) as a consideration that must be addressed by written investment policies, be clarified in the supplementary information section. In response to this suggestion, the Board notes that "interest rate risk" is the risk that the general level of interest rates may rise, this causing the market value of outstanding obligations to fall. Federal credit unions can limit this risk by establishing written policies controlling the maturity distribution of the investment portfolio. Several commenters questioned the meaning of the term "approved" used in paragraph (h) when referring to the list of safekeeping facilities. The NCUA Board notes that the term "approved" was meant to refer to safekeeping facilities approved by the credit union's board of directors. The NCUA Board has clarified the meaning of the word "approved" in the final rule.

One commenter objected to the proposed provision, stating that NCUA should deal with the credit unions that have invested improperly rather than proposing a rule which will unnecessarily affect all credit unions. As indicated in the preamble to the proposed rule, NCUA has continually encouraged federal credit unions to develop written investment policies. Unfortunately, a significant number of federal credit unions have not developed written investment policies or have developed written policies that are inadequate because they fail to address certain basic investment considerations. Recognizing that such fundamental inadequacies can result in losses to credit unions and the National Credit Union Administration Share Insurance Fund (NCUSIF), the NCUA Board continues to believe that the proposed rule is justified.

*Section 703.4 Authorized Activities*

A proposed amendment to paragraph (c) established 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. Under the proposed rule, a federal credit union is required to make such an analysis whenever a contemplated investment in one of these institutions is not fully covered by federal deposit insurance.

Nine commenters were in favor of the proposed revision although a number suggested changes or requested clarifications. One commenter suggested that the phrase "deposit in a section 107(8) institution" be defined in the regulation rather than merely discussed in the supplementary information section. The Board notes that the term "deposit" cannot be precisely defined for purposes of the regulation. Any attempt to construct such a definition would be frustrated by the growing universe of bank liability products that may be permissible investments for federal credit unions. Rather than attempting to define the term "deposit" in part 703 of the NCUA Rules and Regulations, NCUA has generally looked to the Federal Reserve's Regulation D for guidance. Regulation D contains the reserve requirements for depository institutions, including federal credit unions, and also defines the term "deposit." NCUA has followed this definition in determining what constitutes a deposit liability for purposes of section 107(8) of the Federal Credit Union Act. A collateral benefit of this approach is that it has allowed NCUA to expand federal credit union deposit authority from time to time without having to amend its own regulation.

Two other commenters stated that their board of directors, not NCUA, should determine credit quality. The NCUA Board agrees with this statement and emphasizes that it does not intend to determine credit quality for federal credit unions. The credit quality of the issuing institution must be determined by the credit union itself consistent with the written policies and procedures established by the board of directors.

Another commenter requested clarification on what is to be included in the credit analysis and when such an analysis should be done. While the regulation does not specify a procedure to be followed in making a credit analysis, it is believed that most federal credit unions will want to rely, at least in part, on an outside rating service that specializes in evaluating the credit quality of financial institutions. Federal credit unions are also encouraged to review copies of the institution's current financial statements, as well as any other data deemed relevant to the review. As noted in the preamble to the proposed rule, evaluating the credit quality of a financial institution is an ongoing process which must continue throughout the life of the investment. While the rule does not establish minimum intervals at which the initial credit analysis must be updated, the NCUA Board anticipates that most credit unions will want to update the initial analysis no less frequently than every 90 days. The credit quality of the financial institution should also be carefully monitored between periodic updates.

The final rule also contains a new paragraph (j), which clarifies that federal credit unions have the authority to invest in mutual funds if the investments and investment transactions of the fund are legally permissible as direct investments for federal credit unions under the Federal Credit Union Act and NCUA Rules and Regulations.

*Section 703.5 Prohibitions*

Corporate Credit Unions

The proposed rule prohibited federal credit unions from investing in a corporate credit union unless the corporate credit union meets both of the following conditions:

(1) The corporate credit union must operate in substantial compliance with part 704 of the NCUA Rules and Regulations; and

(2) The corporate credit union must be examined by NCUA.

NCUA has proposed revisions to part 704 of the NCUA Rules and Regulations, expanding the powers and authorities of federal corporate credit unions. NCUA believes that all corporate credit unions should be examined by NCUA corporate examiners. Questions regarding the degree of compliance with part 704 will be determined by the appropriate NCUA regional director with the concurrence of NCUA's Washington Office. Under the proposed rule, corporate credit unions deemed not to be in substantial compliance with part 704 are impermissible investments for federal credit unions.

Eight commenters supported this proposal although some suggested minor changes or requested clarifications. Several commenters were confused about whether a nonfederally insured corporate had to operate in substantial compliance with part 704 and be examined by NCUA in order to be a permissible investment for a federal credit union. The NCUA Board notes that the above criteria apply to all corporate credit unions, meaning that a nonfederally insured corporate credit union must also meet the above-mentioned criteria in order to be a permissible investment for a federal credit union.

As noted in the preamble to the proposed rule, questions regarding the degree of compliance with part 704 will be determined by the appropriate regional director. Under currently proposed revisions to part 704, each corporate credit union will have 180 days to comply with that rule. Where a regional director subsequently determines that a corporate credit union is not in substantial compliance with part 704, and, as such, is not permitted to do business with federal credit unions, the regional director will notify the federal credit union members of that corporate credit union's noncompliance. The NCUA Board also notes that a corporate credit union will be deemed to be in substantial compliance with part 704, provided that the safety and soundness of the corporate credit union is not threatened.

In response to the concerns of a state regulator, the Board wishes to emphasize that NCUA does not anticipate any changes in the present arrangement for examining state-chartered corporate credit unions. Under the current arrangement, NCUA and state examiners jointly conduct the examination. At the conclusion of the examination, the examination report is prepared by NCUA and/or the state regulator depending on the arrangement with the particular state. As before, any

state-chartered corporate credit union that disagrees with the examination findings may appeal the findings to the state regulator and/or NCUA.

Mortgage Derivative Products

The proposed rule prohibited federal credit unions from purchasing the following mortgage-backed security (MBS) derivatives: Stripped Mortgage-Backed Securities (SMBS); Collateralized Mortgage Obligation (CMO) and Real Estate Mortgage Investment Conduit (REMIC) tranches whose average life would extend or is shortened by more than 6 years under modeling scenarios where mortgage commitment rates immediately rise or fall 300 basis points; and residual interests in CMO and REMIC transactions. An important principle underlying this section of the proposed rule is that SMBSs, CMO and REMIC tranches which fail the average life test, and CMO and REMIC residuals possess average life or price volatility in excess of the average life or price volatility typically associated with a whole MBS.

Eight commenters approved of the proposal to prohibit investment in SMBS and five opposed it. One commenter questioned NCUA's authority to prohibit the purchase of SMBS, since they are authorized investments under the Federal Credit Union Act. Three commenters indicated that SMBS may be appropriate holdings for credit unions where they are used to reduce interest rate risk. Eight commenters agreed with the proposal to prohibit investment in CMO and REMIC tranches that fail the average life test, although several requested clarification regarding the application of the test. Ten commenters opposed the proposal, several expressing concern that it would prohibit investments that can enhance the performance of a credit union's investment portfolio. Two commenters suggested that the average life test should not be applied to floating rate tranches. Four commenters supported the proposal to prohibit investment in CMO and REMIC residuals, while an equal number opposed it. One commenter stated that the CMO/REMIC marketplace has evolved rapidly during the past few years and that not all residuals exhibit the same amount to risk.

The NCUA Board again emphasizes that SMBS, CMO and REMIC residuals, and CMO and REMIC tranches that fail the average life test typically have a higher degree of average life or price volatility than whole MBS. Since most of these "high risk" derivatives tend to trade in "thin markets," a federal credit union holding any of these securities may also be subjected to a significant degree of marketability risk, or the risk that the security may have to be disposed of at a significant loss if it suddenly needs to be sold. In addition, as mentioned in the preamble to the proposed rule, with the IO portion of an SMBS or a typical CMO residual, it is possible for the investor to experience a loss of principal even when the security is held to maturity.

For all of these reasons, the NCUA Board continues to conclude that SMBS, CMO and REMIC tranches that fail the average life test, and CMO and REMIC residuals are unsuitable investments for the vast majority of federal credit unions.

At the same time, the NCUA Board recognizes that these "high risk" derivatives may be suitable investments for some federal credit unions where they are used to reduce interest rate risk. For example, a federal credit union with a sophisticated and well-managed securities or mortgage portfolio might employ the IO portion of an SMBS or a bearish residual to offset a decline in the market value of the portfolio in a rising interest rate environment. Similarly, a federal credit union that makes mortgage loans and then sells them in the secondary market might employ certain types of CMO tranches that fail the average life test to protect the market value of the mortgages prior to selling them in the secondary market.

Based on the foregoing analysis, the NCUA Board has decided to prohibit the purchase of SMBS, CMO and REMIC tranches that fail the average life test, and CMO and REMIC residuals, except where these securities are acquired solely to reduce interest rate risk. Under the final rule, a federal credit union purchasing any of these "high risk" derivatives to reduce interest rate risk must have a monitoring and reporting system in place that provides the documentation necessary to evaluate the expected and actual performance of the securities under different interest rate scenarios. The credit union must use this system to conduct and document an analysis that shows, prior to purchase, that the proposed acquisition of the security will reduce the credit union's interest rate risk. Subsequent to purchase, the credit union must evaluate the document, at least quarterly, whether the security has actually reduced interest rate risk. Federal credit unions acquiring any of these "high risk" derivatives to reduce interest rate risk must also report the securities as trading assets at market value or as held-for-sale assets at the lower of cost or market value until their disposition.

Recognizing that variable rate investments can afford federal credit unions some protection against interest rate risk, the NCUA Board has also decided to exclude certain variable or floating rate CMO tranches from the average life test. To qualify for the exclusion, the interest rate of the instrument must reset, at least annually, and the instrument must have a maximum allowable interest rate at least 300 basis points above its interest rate at the time of purchase. The exclusion does not apply to floating rate instruments whose interest rate varies inversely with the related interest rate index or whose interest rate adjusts as a multiple of the change in the related index (i.e., inverse floating or super floating CMO tranches).

As noted above, a number of commenters requested clarification regarding the application of the average life variability test. A number of these commenters wondered how often a CMO tranche should be retested after it has been purchased. While the rule does not specify a minimum retesting period for these investments, the NCUA Board recommends that federal credit unions retest these investments at least annually. As one commenter noted, such a test could be carried out in connection with the board of director's annual review of its investment policies.

This same commenter suggested that the final regulation contain a liquidation schedule for CMO tranches that fail the average life test on a subsequent review date. The NCUA Board is concerned that such a schedule might prove to be too rigid, depending on the particular circumstances of the case under review. NCUA prefers to handle these situations on a case-by-case basis under existing supervisory politics and procedures. Generally, existing supervisory policies and procedures would allow NCUA and the affected credit union to agree to a liquidation schedule appropriate to the particular circumstances of the case, taking into account all relevant factors, including the dollar amount of the investment, the remaining time to maturity, and the credit union's earnings and capital position where the sale of the investment would result in a significant loss to the credit union.

For purposes of determining whether or not a particular CMO tranche passes the average life test, federal credit unions may use standard industry calculators (Bloomberg, etc.) employed in the mortgage-related securities marketplace. NCUA examiners will review the credit union's calculations

for reasonableness. Where the results of a credit union's calculations differ significantly from those results produced by standard industry calculators, the examiner may use a standard industry calculator to determine whether or not the investment passes the average life test.

Finally, in response to the comment that the NCUA Board does not have the authority to prohibit or restrict access to investments authorized by the Federal Credit Union Act, the NCUA Board notes that it has previously determined that it does have such authority where it determines that any such investment presents significant safety and soundness concerns.

Zero Coupon Bonds

The proposed regulation prohibited the purchase of a zero coupon bond with a remaining maturity of more than 10 years. Five commenters agreed with the prohibition, while seven disagreed with it. One commenter opposing the proposal stated that it was arbitrary.

The NCUA Board does not agree with the statement that the proposed prohibition is arbitrary. To the contrary, as pointed out in the preamble to the proposed rule, longer maturity issues of these securities (generally, maturities in excess of 10 years) have exhibited extreme price volatility and may cause unintended changes in a credit union's earnings and its interest rate, liquidity and funding risk profile. Therefore, the NCUA Board continues to believe that these investments are generally unsuitable for all federal credit unions. Accordingly, the proposal to prohibit the purchase of zero coupon securities with remaining maturities of more than 10 years is carried into the final rule unchanged.

Section 703.6 of the proposed rule required federal credit unions holding SMBS, CMO/REMIC residuals, CMO/REMIC tranches which fail the average life test, and zero coupon securities with remaining maturities of more than 10 years to dispose of the prohibited investments within 1 year of the effective date of the regulation.

Thirty-one commenters disapproved of the proposal, the majority stating that it could force federal credit unions to take unnecessary losses. In light of these comments, the NCUA Board has decided to "grandfather" existing investments in SMBS, CMOs/REMICs, and zero coupon securities that do not conform to the final rule. The final rule contains a "grandfather" provision at the beginning of § 703.5, and § 703.6 has been deleted.

The NCUA Board wishes to emphasize, however, that the "grandfather" provision only applies where a prohibited investment has been purchased prior to publication of this rule in the Federal Register. The Board also notes that NCUA examiners will seek the orderly disposal of these "grandfathered" investments, where, in their opinion, such investments constitute a significant threat to the continued sound operation of a federal credit union.

D. 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).

Based on the experience of NCUA examiners, few small credit unions are engaging in the investment practices that are the subject of the final rule. Accordingly, the NCUA Board determines and certifies that the final rule 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.* Section 703.3 of the final rule 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. The Board determines that the final 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.

List of Subjects in 12 CFR Part 703

Credit unions, Investments.

By the National Credit Union Administration Board on October 17, 1991.

Becky Baker,

*Secretary of the Board.*

For the reasons set forth in the preamble, 12 CFR Part 703 is revised to read as follows:

## PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

1. Part 703 is revised to read as follows:

Sec.



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

### § 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 § 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).

### § 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 (MBS). CMOs usually consist of four or more classes of bonds which are commonly referred to as "tranches".

*Corporate credit union* means a credit union that conforms to the definition of "corporate credit union" as contained in part 704 of this chapter.

*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; and

(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 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 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 (SMBS)* means securities that represent unequal proportions of the cash flows of an underlying pool of mortgages. In their purest form, SMBS represent mortgage-backed securities (MBS) 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 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.

### § 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); and

(h) Safekeeping of securities, including a list of safekeeping facilities approved by the credit union's board of directors.

**§ 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 sections 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 1 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) *Banker's acceptances.* A federal credit union may invest in banker's acceptances issued by a section 107(8) institution.

(j) *Mutual funds.* A federal credit union may invest in a mutual fund if the investments and investment transactions of the fund are legally permissible for federal credit unions under the Federal Credit Union Act and NCUA Rules and Regulations.

**§ 703.5 Prohibited Activities.**

The prohibitions contained in paragraphs (f), (g), (h) and (k) of this section shall not apply to securities purchased prior to the effective date of those prohibitions.

(a) Except as provided in § 701.21( federal credit union may not purcha sell a standby commitment.

(b) A federal credit union may not 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 this chapter in significant respects, c not examined by NCUA.

(f) Except as provided in paragrap of this section, a federal credit unior may not purchase a Stripped Mortga Backed Security (SMBS).

(g) Except as provided in paragra of this section, a federal credit unior may not invest in a CMO or REMIC tranche whose average life would extend or is shortened by more than years under modeling scenarios wh mortgage commitment rates immedi rise or fall 300 basis points. The ave life standard contained in this subsection shall apply to the investr at the time of purchase and on any subsequent review dates, assuming market interest rates and prepayme speeds at the time the standard is applied.

(h) Except as provided in paragra of this section, a federal credit unio may not purchase a residual interes CMO or REMIC transaction.

(i) The prohibitions contained in paragraphs (f), (g) and (h) of this sec shall not apply where an investmen made solely to reduce interest rate r and where:

(1) A monitoring and reporting sy is in place that provides the documentation necessary to evalua the expected and actual performanc the investment under different inter rate scenarios;

(2) The monitoring and reporting system is used to conduct and docu an analysis that shows, prior to purchase, that the proposed investm will reduce the credit union's intere rate risk;

(3) The investment, subsequent to purchase, is evaluated at least quar to determine whether or not the investment has actually reduced the credit union's interest rate risk;

(4) The investment is reported as trading asset at market value or as a held-for-sale asset at the lower of c or market value until its disposition.

(j) The average life standard contained in paragraph (g) of this section shall not apply to a floating

adjustable rate CMO/REMIC tranche that has all of the following characteristics, irrespective of whether or not it has been purchased to reduce interest rate risk:

(1) The interest rate is reset at least annually.

(2) The maximum allowable interest rate on the instrument is at least 300 basis points above the interest rate of the instrument at the time of purchase.

(3) The interest rate of the instrument varies directly (not inversely) with the index upon which it is based and is not reset as a multiple of the change in the related index.

(k) A federal credit union may not purchase a zero coupon security with a maturity date that is more than 10 years from the settlement date for purchase of the security.

(l) 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. The prohibition contained in this subsection also applies to any employee not otherwise covered if the employee is directly 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 (l) of this section must be conducted at arm's length and in the interest of the credit union.

[FR Doc. 91-25928 Filed 10-30-91; 8:45 am]

BILLING CODE 7535-01-M

## DEPARTMENT OF TRANSPORTATION

### Federal Aviation Administration

### 14 CFR Part 71

[Airspace Docket No. 91-ANM-9]

### Establishment of Transition Area, Anaconda, MT

**AGENCY:** Federal Aviation Administration (FAA), DOT.

**ACTION:** Final rule; correction.

**SUMMARY:** This action corrects an error in the legal description of a final rule concerning establishment of a transition area at Anaconda, Montana that was published in the **Federal Register** on September 23, 1991 (56 FR 47903). Airspace Docket No. 91-ANM-1.

**EFFECTIVE DATE:** October 31, 1991.

**FOR FURTHER INFORMATION CONTACT:** James E. Riley, ANM-537, Federal Aviation Administration, Docket No. 91-ANM-1, 1601 Lind Avenue SW., Renton, Washington 98055-4056, Telephone: (206) 227-2537.

**SUPPLEMENTARY INFORMATION:**

#### History

**Federal Register** Document 91-22802, Airspace docket No. 91-ANM-1, published on September 23, 1991 (56 FR 47903), established a 700-foot Transition Area at Anaconda, Montana. An error was discovered in the legal description of the 700-foot Transition Area. This action corrects that error.

#### Correction to Final Rule

Accordingly, pursuant to the authority delegated to me, the legal description for the Anaconda, Montana 700-foot Transition Area, as published in the **Federal Register** on September 23, 1991 (56 FR 47903), FR Doc. 91-22802, page 47904, column 1 is corrected as follows:

**§ 71.181 [Corrected]**

**2. Anaconda, Montana 700-foot Transition Area [new] [Corrected]**

By removing "Starting at-" and substituting "That airspace extending upward from 700 feet above the surface beginning at-".

Issued in Seattle, Washington, on October 15, 1991.

**Temple H. Johnson, Jr.,**

*Manager, Air Traffic Division.*

[FR Doc. 91-28233 Filed 10-30-91; 8:45 am]

BILLING CODE 4910-13-M

## DEPARTMENT OF THE TREASURY

### Customs Service

### 19 CFR Part 4

[T.D. 91-89]

### Addition of Bahrain to the List of Nations Entitled to Special Tonnage Tax Exemption

**AGENCY:** Customs Service, Department of the Treasury.

**ACTION:** Final rule.

**SUMMARY:** Pursuant to information provided by the Department of State, the Customs Service has found that Bahrain does not impose discriminating duties of tonnage or imposts upon vessels belonging to citizens of the United States, and that, accordingly, vessels of Bahrain are exempt from special tonnage taxes and light money in ports of the United States. This document amends the Customs Regulations by adding Bahrain to the list of nations whose vessels are exempt from the payment of any higher tonnage duties than are applicable to vessels of the United States and from the payment of light money.

**EFFECTIVE DATE:** The reciprocal privileges for vessels registered in Bahrain became effective on June 4, 1991. This amendment is effective October 31, 1991.

**FOR FURTHER INFORMATION CONTACT:** Jeffrey B. Whalen, Carrier Rulings Branch (202-566-5706).

**SUPPLEMENTARY INFORMATION:**

#### Background

Generally, the United States imposes regular and special tonnage taxes, and a duty of a specified amount per ton, called "light money", on all foreign vessels which enter United States ports (46 U.S.C. app. 121, 128). However, vessels of a foreign nation may be exempted from the payment of special tonnage taxes and light money upon presentation of satisfactory proof that no discriminatory duties of tonnage or impost are imposed by that foreign nation on U.S. vessels or their cargoes (46 U.S.C. app. 141).

Section 4.22, Customs Regulations (19 CFR 4.22), lists those nations whose vessels have been found to be exempt from the payment of any higher tonnage duties than are applicable to vessels of the United States and from the payment of light money. The authority to amend this section of the Customs Regulations has been delegated to the Chief, Regulations and Disclosure Law Branch.

#### Finding

On the basis of the information received from the Department of State regarding the absence of discriminatory duties of tonnage or impost imposed on U.S. vessels in the ports of Bahrain, the Customs Service has determined that vessels of Bahrain are exempt from the payment of the special tonnage tax and light money, effective June 4, 1991, and that the Customs Regulations should be amended accordingly.

#### Inapplicability of Public Notice and Delayed Effective Date Requirements, the Regulatory Flexibility Act and Executive Order 12291

Because this amendment merely implements a statutory requirement and confers a benefit upon the public, pursuant to 5 U.S.C. 553(b)(B), notice and public procedure thereon are unnecessary; further, for the same reasons, good cause exists for dispensing with a delayed effective date

NCUA

# LETTER TO CREDIT UNIONS

NCUA LETTER NO. 92

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

NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

December 3, 1991

Tobias E. Timm
McDonald & Company
Credit Union Asset Management Group
4660 S. Hagadorn Road, Suite 190
East Lansing, MI 48823

Re: Bank Notes (Your October 8, 1991, Letter)

Dear Mr. Timm:

You have asked whether bank notes are permissible investments for federal credit unions (FCUs). If the notes constitute "deposits" under the Federal Reserve Board's Regulation D, they are permissible investments.

Analysis

FCU investment and deposit authority is governed by Sections 107(7), (8), and (15) of the FCU Act, 12 U.S.C. §§1757(7), (8), and (15), and Part 703 of the National Credit Union Administration Rules and Regulations, 12 C.F.R. Part 703. Under Section 107(8) of the FCU Act, and FCU may 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 FCU does business, or in banks or institutions the accounts of which are insured by the Federal Deposit Insurance Corporation.

In determining what constitutes a "deposit" under Section 107(8), we have generally looked to the Federal Reserve Board's Regulation D, 12 C.F.R. Part 204, for guidance. Regulation D sets forth the reserve requirements for depository institutions, including FCUs, and contains a definition of the term "deposit," see 12 C.F.R. §204.2. Even if a bank investment is not considered a "deposit" as that term is generally understood, it may still be considered a

deposit for Regulation D purposes. If the notes constitute deposits under Regulation D, they are permissible investments for FCUs.

Enclosed, for your information, are two prior opinion letters on the same issue.

Sincerely,

Hattie M. Ulan

Hattie M. Ulan
Associate General Counsel

Enclosures

GC/LH:sg
SSIC 4660
91-1016

NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

November 4, 1991

Jeanne McGinley, Vice President
Portfolio Strategies Department
Vining-Sparks IBG
6077 Primacy Parkway
Memphis, TN 38119

Re: Floating Rate Notes (Your September 11, 1991, Letter)

Dear Ms. McGinley:

You have asked whether an offering of floating rate notes issued by First Federal of Michigan (First Federal) and supported by an irrevocable letter of credit issued by the Federal Home Loan Bank of Indianapolis is a permissible investment for federal credit unions (FCUs.) Assuming the accounts of First Federal are insured by the Federal Deposit Insurance Corporation (FDIC) and the proceeds of the notes were used for making loans or investments, maintaining liquid assets, or other similar purposes, the notes are permissible investments.

Analysis

Section 107(8) of the FCU Act, 12 U.S.C. §1757(8), provides FCUs with the authority to make deposits in banks or institutions, the accounts of which are insured by the FDIC. Assuming the accounts of First Federal are insured by the FDIC, the next question is whether the notes constitute "deposits." In determining what constitutes a "deposit" under Section 107(8), we have generally looked to the Federal Reserve Board's Regulation D, 12 C.F.R. Part 204, for guidance. Regulation D sets forth the reserve requirements for depository institutions, including FCUs, and contains a definition of the term "deposit." See 12 C.F.R. §204.2.

Although the circular states that the notes "are [not] . . . deposits in First Federal," they may nevertheless fit within the definition of "deposit" under Regulation D.

Paragraph 2(a)(1)(vii) of Regulation D provides that, with a few exceptions, "any liability of a depository institution on any promissory note . . . or similar obligation . . . that is issued or undertaken by a depository institution as a means of obtaining funds" constitutes a "deposit." The notes appear to be promissory notes or similar obligations of First Federal. Since none of the exceptions are applicable here, the notes constitute "deposits" unless paragraph 2(a)(2)(iii) of Regulation D applies. That paragraph states that "deposit" does not include "obligations, the proceeds of which are not used by the depository institution for purposes of making loans, investments, or maintaining liquid assets . . ." It further states, "An obligation issued for the purpose of raising funds to purchase business premises, equipment, supplies, or similar assets is not a deposit." As long as the proceeds of the notes were used for the appropriate purposes, the notes are permissible investments for FCUs.

This letter is not an endorsement of the notes; rather, it is our opinion that the notes, if they meet the above requirements, are a legal investment for FCUs. We have enclosed, for your information, a letter which addresses the permissibility of investment in a similar type of note.

Sincerely,

Hattie M. Ulan

Hattie M. Ulan
Associate General Counsel

Enclosure

GC/LH:sg
SSIC 4660
91-0916

NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

May 4, 1987

Office of General Counsel

C. Thomas Kunz, Esq.
Seward & Kissel
Wall Street Plaza
New York, N.Y. 10005

Dear Mr. Kunz:

This is in response to your letter of December 19, 1986. We apologize for our delay in responding.

Your letter raised the issue of whether it is permissible for Federal credit unions (FCU's) to invest in certain medium-term notes (Notes) issued by Gibraltar Savings, a California-chartered savings and loan association. The accounts of Gibraltar Savings are insured by the Federal Savings and Loan Insurance Corporation (FSLIC). The Notes are not insured by FSLIC. You took the position that the Notes are a permissible investment under Section 107(7)(D) and/or Section 107(7)(E) of the FCU Act.

The Notes, which mature from one to five years from the date of issue, are supported as to principal and interest by the Federal Home Loan Bank of San Francisco. The interest rate on the Notes is determined with reference to certain specified interest rates.

Section 107(7)(D) of the FCU Act provides, in part, that FCU's can invest their funds in shares or accounts of savings and loan associations, the accounts of which are insured by the FSLIC. In your letter you stated that the Notes should be viewed as accounts of a FSLIC-insured institution, and thus a permissible investment for FCU's, because "the Notes rank pari passu with, and are thus equal in safety to, large bank deposits." In reaching this conclusion, you analogized FCU investment in the Notes to investment in bankers' acceptances and the sale by FCU's of Federal funds, both of which have been determined to be permissible for FCU's pursuant to their Section 107(8) deposit authority. See Sections 703.3(f) and (i) of the NCUA Rules and Regulations. You then argued that the savings and loan account investment authority should not be interpreted more narrowly than the bank deposit investment authority.

It is clear to us that the Notes are not accounts in a FSLIC-insured institution. As you stated in your letter, the term

"accounts," when used in reference to savings and loan associations, is generally interpreted to mean deposit or share accounts. The Notes do not fall within this definition, nor do they fall within any NCUA interpretation of the term "accounts." Therefore, the Notes are not a permissible investment for FCU's under §107(7)(D) of the FCU Act.

While you analogized investment in the Notes to investment in bankers' acceptances and the sale of Federal funds, you did not argue that the Notes would similarly be permissible under Section 107(8). It is our opinion that if the Notes are a permissible investment for FCU's, the source of this authority would be Section 107(8). The issue then is whether Section 107(8) is broad enough to encompass investment in the Notes.

Section 107(8) provides, in part, that FCU's have the authority to make deposits in banks or institutions, the accounts of which are insured by the Federal Deposit Insurance Corporation (FDIC) or the FSLIC. IRPS 81-2, 46 Fed. Reg. 14887 (March 3, 1981), which was incorporated into Part 703 of the NCUA Rules and Regulations and thereby revoked, authorized the sale of Federal funds by FCU's. In IRPS 81-2, the NCUA stated that the sale of Federal funds to a bank is permissible under the Section 107(8) deposit authority. Section 703.3(f) of the NCUA Rules and Regulations codifies this statement, providing, in part, that an FCU may sell Federal funds to a Section 107(8) institution.

Section 703.3(i) of the NCUA Rules and Regulations provides that an FCU may invest in bankers' acceptances issued by a Section 107(8) institution. The rationale for authorizing investment in bankers' acceptances was the same as that for the authorization of the sale of Federal funds, i.e., by considering the acceptance to be a type of deposit liability. 49 Fed. Reg. 12668, 12671 (March 30, 1984). It was further stated that bankers' acceptances, like Federal funds, certificates of deposit, and Eurodollar deposits, which are all permissible investments, appear on the issuing bank's balance sheet as direct liabilities of the bank, and that bankers' acceptances present no greater risk than these investments. Id.

In determining whether investment in Federal funds and bankers' acceptances was permissible under FCU's deposit authority, reference was made to Regulation D, 12 C.F.R. §204. Regulation D sets forth the reserve requirements for depository institutions, including FCU's, and contains a definition of the term "deposit."

Section 204.2(a)(1)(vii) states in part that a deposit includes:

> Any liability of a depository institution on any promissory note, acknowledgement of advance, bankers' acceptance, or similar obligation (written or oral), including mortgage backed bonds, that is issued or undertaken by a depository institution as a means of obtaining funds.

The above definition contains six exceptions, (a)(1)(vii)(A) through (E) and (a)(1)(viii), in which the obligations listed above would not constitute deposits. Many bankers' acceptances are within the Regulation D definition of deposits, with some being excepted by Section 204.2(a)(1)(vii)(E) and Section 204.2(a)(1)(viii). Similarly, some Federal funds transactions are within the deposit definition, and others are excluded by Section 204.2(a)(1)(vii)(D). After contrasting the definition of deposit with Section 204.2(a)(2), which lists transactions that are not within the definition of deposit, it was determined that, for purposes of Section 107(8) of the FCU Act, Federal funds and bankers' acceptances constituted deposits. A similar argument can be advanced for including the Notes within the definition of deposit.

The liability of a depository institution on a note is generally included in the definition of deposit, with exceptions. If the Notes do not fall within the exceptions contained in §204.2(a)(1)(vii), they can constitute deposits. The applicable exception to the Notes, Section 204.2(a)(1)(vii)(C), provides that the liability of a depository institution will be considered a deposit unless the obligation is:

> not insured by a Federal agency, is subordinated to the claims of depositors, has a weighted average maturity of seven years or more, is not subject to Federal interest rate limitations, and is issued by a depository institution with the approval of, or under the rules and regulations of, its primary Federal supervisor.

The exceptions contained in §204.2(a)(1)(vii)(A) may also affect the determination of whether a promissory note is a deposit, but are not relevant to the instant Notes.

As the Notes have a maturity of less than 7 years, the liability of Gibraltar Savings on the Notes can be considered a deposit under the Regulation D deposit definition. The Notes, like Federal funds and bankers' acceptances, are direct liabilities of the issuing bank. Furthermore, it does not appear that the Notes present a greater risk than these other investments. As the Notes do constitute deposits, we believe that they would be authorized pursuant to the same reasoning applied to Federal funds and bankers' acceptances, i.e., by considering the Notes to be a type of deposit liability.

Your alternative argument for the permissibility of FCU investment in the Notes was that the Notes were guaranteed by an agency of the United States. The basis of your argument was that the Notes are fully secured as to principal and interest by a letter of credit from the Federal Home Loan Bank of San Francisco. While our resolution of your first argument renders the alternative argument moot for all practical purposes, we will briefly address it at this time.

Section 107(7)(E) provides that, inter alia, FCU's can invest:

> "in obligations issued by Federal home loan banks;
>
> * * *
>
> 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." (Emphasis added.)

Whether or not Federal home loan banks are agencies of the United States is, based on the quoted language, irrelevant. With respect to Federal home loan banks, it is only obligations issued by them that Congress deemed permissible for FCU's. The use of the term "other" in modifying the term "agency" clearly means other than any agency previously enumerated (which includes Federal home loan banks) in Section 107(7)(E). In the case of certain other entities enumerated in the Section, for example the Federal National Mortgage Association, Congress went beyond merely those obligations issued by the Association and instead specifically included obligations or instruments fully guaranteed thereby. Congress clearly could have afforded the same treatment for Federal home loan banks but did not do so.

Based on the foregoing analysis, it is our opinion that FCU's may invest only in obligations issued by Federal home loan banks.

It would not be a permissible FCU investment if the obligation is merely guaranteed by Federal home loan bank, unless the issuing entity is the United States or "any other" agency thereof. However, as opined above, the Notes would be considered deposits for purposes of Section 107(8) of the FCU Act and would be permissible investments.

Our opinion that the Notes are a permissible investment for FCU's should not be interpreted or represented as NCUA's recommendation or endorsement of the investment. Before investing in the Notes or similar obligations, an FCU should evaluate the investment from a safety and soundness perspective. Factors to consider are the financial condition of the issuer, the maturity and repayment terms of the obligation, and the rate of return. Generally, it is advisable to have the obligation guaranteed by a financially responsible party.

We trust this has been of assistance.

Sincerely,

STEVEN R. BISKER
Assistant General Counsel

JT:sg

GC/JT:sg
-650

NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

April 5, 1989

Office of General Counsel

Stephen A. J. Eisenberg, Esq.
General Counsel
Pentagon Federal Credit Union
P.O. Box 1432
Alexandria, Virginia 22313

Re: Federal Credit Union Investment in Commercial Paper (Your December 27, 1988, Letter)

Dear Mr. Eisenberg:

You have asked whether a Federal credit union ("FCU") may invest in commercial paper issued by institutions identified in Section 107(8) of the FCU Act (12 U.S.C. 1757(8)). An attachment to your letter indicates that your specific question is whether an FCU may invest in promissory notes issued by Section 107(8) institutions. We have previously determined than an FCU may, pursuant to its deposit authority, invest in promissory notes issued by those types of institutions set forth in Section 107(8) of the FCU Act. This continues to be our position. Due to the risks associated with this type of investment, we expect an FCU to carefully evaluate the investment from a safety and soundness perspective. Factors that must be considered are the financial condition of the issuer and the maturity and repayment terms of the obligation.

ANALYSIS

Section 107(8) of the FCU Act provides, in part, for an FCU:

> 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. . . .

In determining what constitutes a "deposit" under Section 107(8) of the FCU Act, we have generally looked to the Federal Reserve's Regulation D for guidance.[1] (See 12 C.F.R. 204 and enclosure.) Regulation D sets forth the reserve requirements for depository institutions, including FCU's, and contains a definition of the term "deposit." After reviewing what is and is not a deposit for purposes of Regulation D, (see Sections 204.2(a)(1) and (2)), we determined that for purposes of Section 107(8) of the FCU Act, FCU investment in Federal funds and bankers' acceptances should be authorized as a type of deposit liability. These transactions are therefore permissible under Section 107(8), provided they are entered into with a Section 107(8) institution (see Sections 703.3(f) and (i) of NCUA's Rules and Regulations, 12 C.F.R. §§703.3(f) and (i)).

We have further interpreted Section 107(8) to permit FCU investment in promissory notes issued by Section 107(8) institutions on the basis that the notes can be considered for purposes of Section 107(8) as a type of deposit liability. Regulation D views the following as deposits, with certain exceptions:

> any liability of a depository institution on any promissory note, acknowledgment of advance, bankers' acceptance, or similar obligation (written or oral), including mortgage-backed bonds, that is issued or undertaken by a depository institution as a means of obtaining funds. . . . (See 12 C.F.R. 204.2(a)(1)(vii).

We should point out that FCU's should not be using this investment authority as a method of making loans to nonmember banks. This is an investment tool to be utilized for funds in excess of loan demand.

SAFETY AND SOUNDNESS CONCERNS

While we believe that it is legally permissible for an FCU to invest in promissory notes issued by Section 107(8) institutions, we expect an FCU to thoroughly review any such investment from a safety and soundness perspective. The review should include review of the maturity and repayment terms of the obligation, as well as an evaluation of the financial condition of the issuer.

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[1] note that we look to Regulation D for a definition of deposits but e not bound by it.

While investment in promissory notes is permissible as a type of deposit liability, an FCU should be aware that, unlike a traditional deposit, the investment is probably not insured. Recently, there has been some confusion as to what constitutes a deposit for purposes of deposit insurance coverage. Certain bank instruments are currently being marketed as "bank notes" and "deposit notes." While the provisions of these instruments are the same or similar, the deposit notes are being marketed by issuers as being covered by Federal deposit insurance while the bank notes are not. To help alleviate any confusion, the FDIC has issued a proposed rule to clarify what type of bank liabilities would be subject to insurance coverage by the FDIC (see 53 Fed. Reg. 47723 [November 25, 1988]). Prior to investing in promissory notes, an FCU should determine whether or not the notes are covered by deposit insurance.

Lastly, we emphasize that FCU's do not have the general authority to invest in commercial paper. This authority is limited to promissory notes or similar obligations issued by Section 107(8) institutions.

Sincerely,

Hattie M Ulan

HATTIE M. ULAN
Assistant General Counsel

JT:sg

Enclosure

NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

January 2, 1991

Morgan Reed
U.S. Sterling Capital Corp.
20 Peachtree
Holbrook, NY 11741

Re: Federal Credit Union Investment Authority
(Your November 29, 1990, Letter)

Dear Mr. Reed:

You have asked whether federal credit unions (FCUs) may purchase negotiable certificates of deposit (CDs) and deposit notes, both of which are issued by FDIC insured national banks. The purchase is made for the FCU through a clearing agent, who owns the investment and is offering it to you for sale to your customers. After the transaction is made, the clearing agent holds the investment as agent for each beneficiary (FCU).

Analysis

Federal credit union investment and deposit authority is governed by Sections 107(7), (8) and (15) of the FCU Act (12 U.S.C. §§1757(7), (8) and (15)) and Part 703 of the National Credit Union Administration (NCUA) Rules and Regulations (12 C.F.R. Part 703). Under Section 107(8) of the FCU Act, an FCU may 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.

In determining what constitutes a "deposit" under Section 107(8), we have generally looked to the Federal Reserve Board's Regulation D (12 C.F.R. §204) for guidance. Regulation D sets forth the reserve requirements for

Not I.F Deposits

depository institutions, including FCUs, and contains a definition of the term "deposit" (see 12 C.F.R. §204.2). Negotiable CDs are clearly "deposits" within the meaning of Regulation D (see 12 C.F.R. §204.2(c)(1)) and are permissible investments for FCUs under Section 107(8). As to deposit notes, we have determined that deposit notes that are called and recorded by the issuing bank as deposits, where the issuing bank is FDIC insured, constitute "deposits" under Regulation D and are permissible investments for FCUs under Section 107(8) (see Horner Letter, dated September 30, 1988, enclosed). We have also determined that negotiable time deposits are permissible investments for FCUs (see Brush Letter, dated July 16, 1987, enclosed). Since the definition of "deposit" is quite specific, however, we have not stated generally that all deposit notes are permissible investments.

You have not provided us sufficient information regarding the nature of the deposit notes in which you are interested for us to determine whether they qualify as deposits under Regulation D. If you wish to provide a more complete description of the notes and where they fit within the Regulation D definition of deposit, we will evaluate whether they constitute permissible investments for FCUs.

As to the mechanism by which the FCU invests in the CDs, we note that while there is no legal requirement that the FCU make the purchase directly or hold the investment itself, NCUA examiners may take exception to certain practices based on safety and soundness considerations.

Sincerely,

Hattie M. Ulan

Hattie M. Ulan
Associate General Counsel

Enclosures

GC/LH:sg
SSIC 4660
90-1201

NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

September 30, 1988

Office of General Counsel

Ms. Becky Horner
Corporate Funds Manager
Independent Federal Credit Union
P.O. Box 629
Anderson, Indiana 46015

Re: Permissibility of Federal Credit Union Investment in Bank Deposit Notes (Your July 13, 1988, Letter)

Dear Ms. Horner:

An FCU may invest in bank deposit notes issued: (1) by national banks; (2) by state banks, trust companies, and mutual savings banks operating in accordance with the laws of the state in which the FCU does business; and (3) by banks or institutions the accounts of which are insured by the Federal Deposit Insurance Corporation.

Background

You have asked whether an FCU may invest in medium term bank deposit notes. The material you submitted with your letter indicates that the notes will be FDIC insured up to $100,000, and that the only structural difference between a certificate of deposit and a deposit note is the interest payment schedule. The deposit notes will be classified on the bank's balance sheet as a deposit.

Analysis

Section 107(8) of the FCU Act [12 U.S.C. 1757(8)] authorizes an FCU to:

> make deposits in national banks and in State banks, trust companies, and mutual savings banks operating in accordance with the laws of the

FCDA

VOL. I F Deposit

> 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 . . . .

Inasmuch as the deposit notes are called and recorded by the issuing bank as deposits (presumably with the permission of the FDIC), and the issuing bank is FDIC insured, they are a permissible investment for an FCU pursuant to the Section 107(8) deposit authority.

Sincerely,

TIMOTHY P. McCOLLUM
Assistant General Counsel

JT:sg

NATIONAL CREDIT UNION ADMINISTRATION
Washington DC 20456

July 16, 1987

LCU RD Ltr 4660

Office of General Counsel

Mr. Robert C. Brush
Assistant Treasurer
LMSC Federal Credit Union
P.O. Box 3643
Sunnyvale, California 94086-3643

Dear Mr. Brush:

This is in response to your letter requesting our opinion as to whether Certificate of Deposit Notes issued by a national bank (Bank) are permissible investments for Federal credit unions (FCU's).

Your letter and the accompanying materials describe the Notes as negotiable instruments evidencing time deposits in the Bank. The materials state that holders of the Notes are covered by FDIC insurance to the same extent as holders of any deposit in the Bank. The deposit evidenced by the Note ranks equally with all other deposits of the Bank. The Notes will be issued either in underwritten blocks of $25 million or more, or in response to investor inquiry. The maturities will range from eighteen months to five years or occasionally longer. The minimum denomination will be $250,000. The Notes may be split without charge to the investor so long as such splits result in no certificates being less than the $250,000 minimum denomination.

The issuing and transfer agent for the Notes is a trust company in New York.

Federal credit union investment and deposit authority is governed by Sections 107(7) and (8) of the Federal Credit Union Act (12 U.S.C. §§1757(7) and (8)) and Part 703 of the NCUA Rules and Regulations (12 C.F.R. Part 703). Under Section 107(8) of the FCU Act, an FCU may 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.

Inasmuch as the national bank's Deposit Notes are deposits (they are negotiable time deposits) they would be a permissible deposit for FCU's.

FCU Vol I Part F

Prior to placing a deposit in such Notes, we would suggest that you confirm with the FDIC the extent to which the $100,000 FDIC insurance will cover your deposit. It should be noted, the entire FCU deposit in such a Note would not need to be covered by FDIC insurance to be a permissible FCU deposit under Section 107(8) of the FCU Act. However, deposit amounts over the $100,000 insurance coverage pose potential safety and soundness issues that your FCU would need to address.

I hope we have been of assistance.

Sincerely,

STEVEN R. BISKER
Assistant General Counsel

RD:sg

NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

November 30, 1990

Mr. Carl A. Bright
Irwin Union Bank and Trust
P.O. Box 929
Columbus, IN 47202-0929

Re: Irwin Union CD Program (Your September 27, 1990, Letter)

Dear Mr. Bright:

You have asked us to review materials you provided regarding the Irwin Union Certificate of Deposit Program (the Program) and render an opinion on whether federal credit unions (FCUs) may participate in the Program. You state that concerns have been raised about the fact that certificates of deposit (CDs) are not issued in the FCU's name and that Irwin Union does not issue physical certificates or allow FCUs to wire funds directly to the issuing institution. You have enclosed a copy of a 1982 opinion from this Office in which we stated that our objection to the Program's not complying with the requirement that an FCU "itself" purchase a CD was satisfied by a third party acting as agent for the FCU in its purchase.

FCU investment authority is contained in 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). Pursuant to Section 107(8) of the Act, FCUs are authorized "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."

In 1984, the requirement in then Section 703.1(a)(1) of the Rules and Regulations that an FCU "itself" purchase a CD was deleted from the regulation. Any concerns generated by that requirement are therefore unwarranted. We note that there is

no legal requirement that CDs be issued in the FCU's name, that physical certificates be issued at all, or that FCUs be permitted to wire funds directly to the issuing institution. NCUA examiners may, however, take exception to certain practices based on safety and soundness considerations.

As a final matter, we have enclosed a copy of NCUA Letter to Credit Unions No. 92 (August 13, 1987), in which we stated that NCUA would no longer issue opinions on the legality of particular mutual funds.

Sincerely,

Hattie M. Ulan

Hattie M. Ulan
Associate General Counsel

Enclosure

cc: Regional Director, Region IV

GC/LH:sg
SSIC 4660
90-1014

NCUA

# TO CREDIT UNIONS

NCUA LETTER NO. 92

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

NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

May 16, 1989

Office of General Counsel

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

Re: Investment in Yankee Dollars (Your February 9, 1989, Letter)

Dear Mr. Glass:

Your have asked whether a Federal credit union ("FCU") may invest in Yankee Dollar deposits offered by state-licensed branches of foreign banks that are not insured by either the Federal Deposit Insurance Corporation ("FDIC") or the Federal Savings and Loan Insurance Corporation ("FSLIC"). FCU's are not permitted to invest in Yankee Dollars offered by such institutions.

BACKGROUND

Eastern Airlines FCU has been purchasing Yankee Dollar Bankers' Acceptances and Certificates of Deposits issued by state licensed branches of foreign banks. It is your opinion that state licensed branches of foreign banks operating in accordance with the laws of a state in which a credit union maintains a facility are equivalent to Section 107(8) institutions as defined in the FCU Act and the NCUA Rules and Regulations.

LAWS

Section 107(8) of the FCU Act (12 U.S.C. §1757(8)) provides, in part, that FCU's have the power:

> 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....

Section 703.3(g) of the NCUA Regulations (12 C.F.R. §703.3(g)) provides:

> (g) A Federal credit union may invest in Yankee Dollar deposits in a branch of a Section 107(8) institution.

Section 703.2(u) of the NCUA Regulations (12 C.F.R. §703.2(u)) defines Yankee Dollar deposit as:

> (u) 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.

ANALYSIS

On March 30, 1984, the NCUA issued a revised Part 703 of its Regulations (49 Fed. Reg. 12668). The preamble to the final rule discussed Yankee Dollar deposits:

> 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) [of] the [Federal Credit Union] Act. Section 703.3(g) of the proposal set forth this authority. It has

> been carried over to the final rule without substantive change. (Emphasis added.)

The preamble to the proposed rule issued on September 22, 1984 (48 Fed. Reg. 43182) also discussed Yankee Dollar deposits:

> Yankee Dollar deposits are deposits in United States branches of foreign banks and in United States subsidiaries (of foreign banks) chartered under state law. If the branch or subsidiary is FDIC or FSLIC insured, or is a state bank, trust company or mutual savings bank operating in accordance with the laws of the state in which the FCU maintains a facility ... investment in such an institution (a "Yankee Dollar deposit") is authorized pursuant to the plain language of sections 107(7)(d) and 107(8) of the Act....

Taken alone, a reading of the preamble to the final rule would appear to permit FCU's to invest in Yankee Dollars in federally-insured institutions, state-chartered institutions and state-licensed institutions. This is not the correct result in light of the authority found in the FCU Act and the preamble to the proposed rule. In the preamble to the final rule the NCUA Board stated that there were no substantive changes from the proposed rule. The preamble to the proposed rule restricts FCU investment in Yankee Dollars to FDIC- and FSLIC-insured or state-chartered institutions (banks, trust companies or mutual savings banks) operating in accordance with the laws of the state in which the FCU maintains a facility.

The definition of Yankee Dollar found in 703.2(u) is a general commercial definition and describes what types of institutions offer such investments -- a United States branch of a foreign bank licensed to do business in the state or a state-chartered, foreign-controlled bank. FCU's are permitted to invest in Yankee Dollars offered by specific institutions (Section 107(8) institutions) -- not all institutions offering Yankee Dollars. In our opinion, the FCU Act and NCUA Regulations permit FCU's to invest in Yankee Dollars provided that the financial institution is: (1) insured by the FDIC or FSLIC; or (2) is a state-chartered (i) bank, (ii) trust company, or (iii) mutual savings bank, operating in accordance with the laws of a state in which the FCU maintains a facility.

The Yankee Dollar investment you describe -- a deposit in a foreign bank licensed to operate in the State of New York, not FDIC or FSLIC insured, and not chartered or incorporated by the State of New York -- does not meet either of the two classifications set forth above. Therefore, such activity is not permissible under the FCU Act or NCUA's Rules and Regulations. If the foreign bank created a subsidiary bank chartered by the State of New York or obtained FDIC or FSLIC insurance, then an FCU could make a permissible Yankee Dollar investment in the institution.

We have consulted with the NCUA's Office of Examination and Insurance concerning this issue. They concur with our opinion. In addition, they believe Yankee Dollar investments in state-licensed institutions would present safety and soundness concerns.

Sincerely,

Hattie M. Ulan

HATTIE M. ULAN
Assistant General Counsel

RRD:sg

FDIC
Federal Deposit Insurance Corporation
Washington, D.C. 20429

Legal Division

November 16, 1990

Ms. Hattie M. Ulan
Associate General Counsel
National Credit Union Administration
Washington, D. C. 20456

Dear Ms. Ulan:

I am writing in response to your letter dated October 31, 1990 concerning deposit insurance provided by the Federal Deposit Insurance Corporation. In your letter you referred to 12 U.S.C. § 1757. That section provides in part:

> A Federal credit union shall have succession in its corporate name during its existence and shall have power--
>
> ....
>
> (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 ....
>
> 12 U.S.C. § 1757(8).

You ask if bank holding companies and bank holding company affiliates (other than banks and savings associations) would qualify as "institutions the accounts of which are insured by the Federal Deposit Insurance Corporation." The answer to your question is no. The FDIC does not insure bank holding companies or their affiliates (other than banks and savings associations).

The insurance provided by the FDIC extends only to insured deposits. The term "insured deposit" is defined by the Federal Deposit Insurance (FDI) Act to mean "the net amount due to any depositor ... for deposits in an insured depository institution (after deducting offsets) less any part thereof which is in excess of $100,000." 12 U.S.C. § 1813(m)(1). The term "deposits" is defined, in part, as "the unpaid balance of money or its equivalent received or held by a bank or savings association in the usual course of business and for which it has

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given or is obligated to give credit, either conditionally or unconditionally, to a commercial, checking, savings, time, or thrift account, or which is evidenced by its certificate of deposit, thrift certificate, investment certificate, certificate of indebtedness, or other similar name, or a check or draft drawn against a deposit account and certified by the bank or savings association, or a letter of credit or a traveler's check on which the bank or savings association is primarily liable ...." 12 U.S.C. § 1813(l). The phrase "insured depository institution" refers to any bank or savings association the deposits of which are insured by the FDIC. 12 U.S.C. § 1813(c)(2). The term "bank" generally refers to national banks or State banks, and includes trust companies, savings banks, and industrial banks. 12 U.S.C. § 1813(a). The term "savings association" generally means Federal savings association or State savings associations, and includes building and loan associations, savings and loan associations, and Federal savings banks. 12 U.S.C. § 1813(b).

To summarize, the FDIC insures only banks and savings associations. It does not insure bank holding companies or their affiliates (other than banks and savings associations). Furthermore, the FDIC insures only deposits. The FDIC does not insure securities, mutual funds, and similar types of investments, whether issued by a bank, a savings association, a bank holding company, or a bank holding company affiliate.

I trust this has been responsive to your inquiry. Please call me at (202) 898-3743 if you have any questions.

Sincerely,

Valerie J. Best

Valerie J. Best
Senior Attorney