Rules and Regulations

Federal Register
Vol. 62, No. 117
Wednesday, June 18, 1997

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 703

RIN 3133–AB73

Investment and Deposit Activities

AGENCY: National Credit Union Administration (NCUA).

ACTION: Final rule.

SUMMARY: The final regulation clarifies a number of areas, adds restrictions on some securities which have been determined to be inappropriate for credit unions, broadens authority in certain areas, and requires that a credit union's staff and board of directors meet certain safety and soundness standards with respect to the potential risks of the credit union's investment options.

DATES: This rule is effective January 1, 1998. However, early participation in the pilot program in § 703.140 may begin on or after July 18, 1997.

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SUPPLEMENTARY INFORMATION:

A. Background

In recent years there have been significant advances in modeling and measuring the risk factors of debt instruments. During this same period, financial market innovations severed any necessary link between the cash flows of an instrument and its underlying collateral. Based on these developments, which deal directly with safety and soundness issues, NCUA has shifted the focus of Part 703 from emphasis on specific instruments to the characteristics that affect risk management of investment activities.

Proposed Rule

On November 16, 1995, the NCUA Board issued a proposed rule to significantly revise Part 703. 60 FR 61219 (November 29, 1995). The proposal (i) emphasized credit union board and staff understanding of the potential risks associated with a credit union's investment activities and (ii) established new procedures to value and monitor instruments in the investment portfolio. The comment period was to have expired on March 28, 1996, but was extended three times. 61 FR 8499 (March 5, 1996); 61 FR 29697 (June 12, 1996); 61 FR 41750 (August 12, 1996). The comment period expired on November 18, 1996.

Comments

Federal credit unions, state-chartered credit unions, corporate credit unions, trade organizations, securities broker-dealers, investment advisors, state credit union regulators, law firms, banks, and individuals delivered a total of 596 comments to NCUA on the proposed rule. A majority of the commenters supported the general approach of the proposed rule but suggested specific changes. A sizable minority of the commenters disagreed with substantial portions of the proposed rule. NCUA thoroughly evaluated the comments and incorporated many of the suggested changes into this final rule.

CMO Study

The preamble to the proposed rule noted an NCUA study of approximately 300 credit unions with investments in collateralized mortgage obligations (CMOs) and Real Estate Mortgage Investment Conduits (REMICs) in excess of capital (CMO Study). The CMO Study revealed that in 39 percent of the credit unions, credit union managers did not fully understand and appreciate the interest rate risk of CMOs/REMICs, 24 percent of credit unions were taking unacceptable risks, and 47 percent did not have acceptable asset-liability management policies. A number of commenters stated that the CMO Study, by itself, did not justify all of the proposed changes to Part 703.

NCUA notes that while the CMO Study provided important information regarding the management and understanding of some individual investments, it was not the primary impetus for the proposed changes. The safety and soundness concerns raised by the prospect of continuous innovation in the financial marketplace and increasing interest rate risk to credit union balance sheets, together with technical innovations that aid the analysis of risk, motivated NCUA to amend the rule to place greater emphasis on risk management.

Final Rule

This final rule establishes parameters for risk assessment and permits credit unions to operate flexibly within those parameters. At the same time, it minimizes the regulatory burden on those credit unions that choose to maintain a simple portfolio of investments.

A credit union's balance sheet risk only partially arises from its investment activities. In fact, on average, investments constitute approximately one-third of all credit union assets. Comprehensive risk management should include an ongoing risk evaluation of the entire balance sheet and appropriate asset-liability management (ALM) policies and procedures. NCUA has decided not to develop an ALM rule at this time because of the diversity of approaches that could be appropriate for credit unions. Instead NCUA will evaluate a credit union's ALM through the examination process.

An underlying premise of the regulation is that a credit union must establish its own risk limits and measure, monitor, and control the risks it decides to undertake. Credit unions that have the capacity for minimal risk management will necessarily set conservative risk parameters in order to meet the requirements of the rule. On the other hand, credit unions that have the capacity to measure, monitor, and control greater risks may set broader parameters.

Many credit unions will, as part of their standard business practice, establish policies and procedures which properly go beyond the minimum requirements of this rule. In fact, one of the primary conclusions of the six focus groups conducted in the early stages of development of the rule was that the rule reflected sound business principles and would impose little additional burden on most credit unions.

Format

Although the proposed rule was written in the traditional regulatory format, this final rule uses plain language drafting techniques that have been promoted by the Vice President's Regulatory Reinvention Initiative. The goal of plain language drafting is to decrease confusion, inadvertent errors, the need to seek clarification in correspondence and phone calls, and the amount of staff time credit unions must devote to understanding the regulations. Plain language drafting emphasizes the use of informative headings (often written as a question), lists and charts where appropriate, sections and paragraphs, non-technical language (including the use of ''you''), and sentences in the active voice. This final rule is written as a series of questions and answers, asked by a federal credit union and answered by NCUA. The words ''I'' in a question and ''you'' in an answer refer to a federal credit union. Occasionally, the regulation refers to ''you'' performing some action in relation to ''your'' board of directors. This should be read as a credit union's staff and/or management performing the action in relation to the credit union's board.

One plain language drafting technique is to move definitions away from the beginning of a regulation, to avoid bombarding the reader with terms for which there is no context. In this final rule, a number of definitions have been moved to the end of the part, and others to where the term is used.

Although commenters did not have the opportunity to express opinions on the plain language format prior to its use in this final rule, NCUA believes that the benefits of using the format justify this omission. NCUA welcomes comments on the format, however, and suggestions on how to improve it. NCUA is committed to converting more of its regulations to the plain language format in order to reduce regulatory burden and notes that the recently issued proposed rules governing credit union service organizations, 62 FR 11779 (March 13, 1997), and production of nonpublic records and testimony of NCUA employees in legal proceedings, 62 FR 19941 (April 24, 1997), and an upcoming proposed rule governing member business loans use plain language drafting.

B. Section-by-Section Analysis

Section 703.10 What Does Part 703 Cover?

The proposed rule deleted some sentences in the scope section as unnecessary, and added the provision that Part 703 does not apply to corporate credit unions. Investment activities of corporate credit unions are governed by Part 704. The proposed rule, however, did not change the format of the section. To improve readability, this final rule divides the section in two, with Section 703.10 addressing what Part 703 *does* cover and Section 703.20 addressing what it does *not* cover. The language in Section 703.10 is a slight rewording of the first two sentences in the scope section of the proposed rule to provide further clarification, with no change in meaning intended.

Section 703.20 What Does Part 703 Not Cover?

In the scope section of the proposed rule, the clauses addressing the activities and entities not covered by Part 703 follow one another as part of one dense paragraph. To improve readability, Section 703.20 of this final rule sets out each activity or entity separately.

As noted above, the proposed rule added the provision that Part 703 does not apply to corporate credit unions. The preamble explained that the investment activities of corporate credit unions are governed by Part 704 of NCUA's regulations. There was no objection to this proposal, and it has been retained in the final rule.

One commenter suggested that the rule should expressly state that Part 703 does not apply to state-chartered credit unions. NCUA agrees and has added paragraph (f) to Section 703.20. That paragraph states that Part 703 does not apply to state-chartered credit unions, except as provided in Section 741.3(a)(3) of NCUA's regulations. Under Section 741.3(a)(3), a state-chartered credit union must establish a separate reserve if it invests in instruments not permitted for federal credit unions by Part 703 or the Federal Credit Union (FCU) Act. In a limited sense, therefore, Section 703.110, which sets forth activities that are prohibited for federal credit unions, ''applies'' to state-chartered credit unions. Paragraph (f) clarifies, however, that the other requirements of Part 703 do not apply to state-chartered credit unions.

Section 703.30 What Are the Responsibilities of My (a Federal Credit Union's) Board of Directors?

Section 703.3(a) of the proposed rule expanded on the current rule's requirements regarding investment policies. Section 703.3(b) of the proposed rule established a new list of required investment practices. This final rule divides policies and practices into two sections; Section 703.30 addresses policies and Section 703.40 addresses practices. In addition, the final rule modifies many of the specific policies and practices that were proposed. Of the commenters who addressed this section generally, most agreed with the need to have investment policies.

Purposes and Objectives of Investment Activities

Proposed Section 703.3(a)(1) required that the board of directors state in the credit union's policies the purposes and objectives of the credit union's investment activities. The intent was that the policy provide a clear statement of the credit union's investment goals. For example, a credit union's primary goals may be to minimize risk, provide liquidity, and generate a reasonable rate of return. The emphasis placed on each goal will vary based on individual credit union constraints or needs. NCUA received no comments on this provision and has retained it in Section 703.30(a) of the final rule.

Characteristics of Authorized Investments

Proposed Section 703.3(a)(2) required that a credit union's investment policy set out the investments that the credit union may make, by issuer and characteristics. The definitions section of the proposed rule defined an investment characteristic as a feature of an investment such as its maturity, index, cap, floor, coupon rate, coupon formula, call provision, or average life. The preamble stated that a policy could, for example, authorize investments issued or guaranteed by the U.S. Treasury, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association, or could limit investments to instruments with a maximum maturity of 5 years, or those with a fixed coupon, or those tied to a particular index. A few commenters expressed concern that the requirement was too restrictive and would not allow management sufficient flexibility in making investment decisions.

NCUA did not intend for boards to specify the parameters of each approved investment. The intent was for boards to establish guidelines for investment characteristics. NCUA believes that it is imperative for a board, which sets the overall ALM strategy for the credit union, to set investment guidelines and risk parameters that are consistent with that strategy. Further, for the guidelines to be meaningful, they must be fairly specific. Therefore, the requirement has been retained in the final rule, at Section 703.30(b). The language has been modified, however, to clarify that

the issuer is another type of characteristic.

The following additional examples may prove helpful in illustrating the types of policy statements that NCUA might see boards establish: 3-year bullets (securities that make one principal payment at maturity) with a fixed coupon; variable rate securities linked to the 3-month Treasury bill yield or U.S. dollar-denominated LIBOR that, at the time of purchase, are at least 300 basis points below their cap; and fixed rate federally insured deposits of one year or less. With respect to the last, NCUA would not view as necessary that the policy go on to list specific authorized depository institutions.

As an alternative to the type of limits discussed above, or in addition to such limits, a board could specify acceptable interest rate risk for individual investments. For example, a policy could restrict the credit union to purchasing instruments that are predicted to experience a price change of less than a certain percentage for an immediate and sustained parallel shift in the yield curve of a certain amount. A credit union choosing this approach must be confident it has the methodology to assess this potential risk.

Interest Rate Risk

Section 703.3(a)(3) of the proposed rule required credit unions to develop policies on interest rate risk management. One commenter noted that the rule did not define ''interest rate risk.'' Stated in the broad context of ALM, interest rate risk is the exposure of a credit union's current and future earnings and capital arising from adverse movements in interest rates. Changes in interest rates affect a credit union's earnings by changing its net interest income and the level of other interest-sensitive income and operating expenses. Changes in interest rates also affect the underlying economic value of the credit union's assets, liabilities, and off-balance sheet items. These changes occur because the present value of future cash flows, and in many cases the cash flows themselves, change when interest rates change. The combined effects of the changes in these present values reflect the change in the credit union's underlying economic value as well as provide an indicator of the expected change in the credit union's future earnings arising from the change in interest rates. While interest rate risk is inherent in the role of credit unions as financial intermediaries, a credit union that has a high level of risk can face diminished earnings, impaired liquidity and capital positions, and, ultimately, greater risk of insolvency.[1]

Since this rule is limited to investment activity, it only addresses interest rate risk in the investment portfolio. Several commenters observed that a credit union should manage interest rate risk through its ALM policies and procedures, which additionally take into account its loan portfolio and liabilities. NCUA recognizes that interest rate risk can be more fully evaluated this way but, for reasons discussed in the background section of this preamble, has decided to limit the rule to investments. A credit union with an ALM policy that addresses interest rate risk across the balance sheet, however, need not establish a separate policy addressing interest rate risk in the investment portfolio.

No commenters objected to the requirement that a credit union develop a policy on how it will manage interest rate risk in its investment portfolio, and the requirement has been retained in Section 703.30(c) of the final rule. Based on the comments and further NCUA discussion, a sentence has been added requiring that a credit union's interest rate risk management policy establish the amount of risk that the credit union can take with its investments in relation to its net capital and earnings.

A credit union's interest rate risk policy must be commensurate with the scope, size, and complexity of the risks the credit union assumes. The policy of a credit union with a simple portfolio and conservative risk parameters might specify that net capital, earnings, or investment income, may not vary by more than a certain percentage for a parallel shift in interest rates. The policy of a credit union with a complex portfolio, however, might also set limits that reflect changes in the shape of the yield curve, credit spreads, prepayment patterns, and volatility.

Liquidity Risk

Section 703.3(a)(6) of the proposed rule required credit unions to develop policies on liquidity risk management. Liquidity risk is the risk that a credit union will have insufficient liquid assets to meet immediate cash demands. A liquid asset is one that can be converted quickly into cash with minimal loss. The intent was that the board assess the potential for cash demands, document how it arrived at this assessment, and establish a liquidity policy that will enable it to meet the demands. Only one commenter opposed the requirement, and it has been retained in the final rule, in Section 703.30(d).

In assessing the potential for immediate cash demands, credit unions may use a simple estimate, based upon the history of prior cash flows. Credit unions also may use a more elaborate approach. Two commenters suggested that the occasional, temporary use of alternative balance sheet funding sources (short-term borrowing) is a reasonable part of liquidity management. NCUA does not disagree but emphasizes that borrowing should be part of a well thought-out liquidity plan.

Credit Risk

Section 703.3(a)(7) of the proposed rule required credit unions to develop policies on the management of credit risk, including approved issuers, or criteria for issuers, and limits on the amounts that may be invested with each issuer. As noted in the preamble to the proposed rule, a credit union may rely on credit ratings to manage credit risk. However, boards should be aware that ratings may fail to timely reflect a creditor's deteriorating ability to repay its obligations and is only one source of credit information. A credit union without the ability to evaluate credit risk may choose to limit its investments to those that are fully guaranteed or insured. The provision is located at Section 703.30(e) of the final rule.

Concentration Risk

Section 703.3(a)(4) of the proposed rule required credit unions to set concentration limits in their investment policies. The preamble stated that the board must develop concentration limits for, among other things, shares and deposits in corporate credit unions. The commenters generally supported the requirement to establish concentration limits, but a number asked whether NCUA would continue its policy of not taking exception to credit unions placing 100 percent of their investments in corporate credit unions. Examiners will not automatically object to 100 percent concentration in a corporate credit union, but will require all but the smallest credit unions investing more than the insured amount in a corporate to perform an appropriate credit analysis. The scope of credit analysis for investments in corporates and other institutions and issuers is addressed in the discussion of credit analysis under Section 703.40(e).

[1] This discussion of interest rate risk comes from a joint agency policy statement on interest rate risk issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation in May 1996. *See* 61 FR 33166, 33167 (June 26, 1996).

Concentrations can increase a credit union's vulnerability to unforeseen market, credit, and liquidity risks. Each credit union must evaluate concentration risk in relation to its financial condition and its ability to analyze the risks of all investments. The provision is located at Section 703.30(f) of the final rule.

CMO/REMIC Prepayment Models

Section 703.3(a)(5) of the proposed rule directed credit unions to identify in their investment policies the specific CMO/REMIC prepayment models they would use when performing the tests required to purchase or hold CMOs/REMICs. This was to control the practice of selecting the prepayment model that would allow a particular CMO/REMIC to pass the tests. The preamble noted that each credit union had the flexibility to choose the prepayment models it believed were the best measures of potential risk, as long as they were reasonable and supportable.

One commenter stated that NCUA should specify which models are permissible and accept the fact that models are imperfect and will sometimes give different results.

Since the forecasting of prepayments is an evolving science, NCUA prefers to leave to each credit union the decision as to which models it will use. For consistency, it is essential that a credit union use the same models for testing all CMOs/REMICs.

This final rule moves some material that was in the CMO/REMIC testing section to the policy section. It clarifies that a credit union board's first policy decision will be whether the credit union will use a median prepayment estimate or individual, proprietary estimates. Once that determination is made, the credit union may use only that method. If the choice is to use a median estimate, the board then must determine the source of that estimate, whether it be Bloomberg or another similar source. If the choice is to use individual estimates, the board then must determine the sources of those estimates. In response to a comment, the final rule uses the less confusing term ''prepayment estimate'' rather than ''prepayment model.'' Finally, in response to a comment, the final rule clarifies that a board must set policies for prepayment sources for CMO/REMIC testing only where it has authorized the purchase of CMOs/REMICs. The provision is located at Section 703.30(g) of the final rule.

Investment Authority

Section 703.3(a)(8) of the proposed rule required a credit union to state in its investment policy the persons in the credit union to whom investment authority was delegated, the knowledge and experience required of such persons, and the extent of their authority. The provision also stated that this requirement could be met by the board's approval of position descriptions that address the same criteria. In addition to this policy requirement, Section 703.3(b)(2)(i) of the proposed rule required that a credit union follow certain practices regarding investment authority. It stated that any official or employee of a credit union who had discretionary investment authority had to ''demonstrate'' an understanding of the risk characteristics of investments and investment transactions under that authority. It provided that only a credit union's officials, employees, and members could be voting members of its investment and/or asset-liability management committees. Finally, it explicitly affirmed that the ultimate responsibility for supervising a credit union's investment activities rested with the board of directors.

There was some confusion regarding the burden that would be imposed on directors with respect to understanding the risk of authorized investments. It was never NCUA's intention to require volunteers to understand all of the factors that affect the risks of each instrument. This appropriately remains the responsibility of the individuals to whom investment authority has been delegated. It is the responsibility of the board, however, to set policy limits, approve procedures, understand the overall risks associated with the investments, and receive reports assessing whether the portfolio has remained within established limits.

The final rule combines proposed Sections 703.3(a)(8) and 703.3(b)(2)(i) into a policy requirement at Section 703.30(h). That provision requires the investment policy to specify who, of the credit union's officials and employees, has investment authority and the extent of that authority. The final rule does not explicitly provide that the requirement may be met by approving appropriate position descriptions. NCUA omitted the provision because it was unnecessarily detailed and might suggest that there was no other way to meet the requirement. It remains a permissible way to meet the requirement.

Section 703.30(h) also states that individuals given investment authority must be professionally qualified, by education and/or experience, to exercise that authority in a prudent manner and to fully comprehend and assess the risk characteristics of investments and investment transactions under that authority. Rather than requiring that persons with investment authority ''demonstrate'' an understanding of the risk characteristics of the investments under that authority, the final rule simply requires that they be qualified to exercise that authority. It is the responsibility of the board to ensure such qualification.

Section 703.30(h) states that only a credit union's officials and employees may be voting members of a credit union's ''investment-related committee.'' Credit unions use a variety of terms for the committee that is primarily concerned with investments. The proposed rule used ''investment committee,'' ''asset-liability management committee,'' or a combination of the two. To avoid inadvertently excluding a committee with a different name, the final rule uses the term ''investment-related committee'' throughout.

The final rule also does not include ''member'' in the list of individuals who can be voting members of that committee. The proposed rule intended to allow credit union members who serve on such committees to be able to vote. To lessen confusion, however, the final rule redefines ''official'' to include a member of a credit union's investment-related committee.

Finally, Section 703.30(h) does not contain the statement that the ultimate responsibility for supervising a credit union's investment activities rests with the board. It is not necessary to make the statement in the regulation, as Section 113(6) of the FCU Act, 12 U.S.C. 1761b(6), provides that a federal credit union's board of directors shall have charge of investments.

Broker-Dealers

Section 703.3(a)(9) of the proposed rule required that a credit union's investment policy list approved broker-dealers and limits on the amounts and types of transactions for each. The preamble noted that although the proposal did not require approval of more than one broker-dealer, reliance on a single individual or firm could be disadvantageous to the credit union. A credit union might choose to approve one broker-dealer for the full range of its investment activities and another for only certain of the investments authorized by policy. For example, the credit union may permit one broker, with more limited knowledge, to sell to

the credit union only Treasury securities with less than 1 year maturity, while permitting another, with more knowledge and ability, to sell longer term securities or securities with embedded options issued by U.S. government agencies, as well as Treasury securities. The preamble stated that details for these authorizations should be established by policy.

In response to comments, NCUA has deleted the language regarding establishing limits on the amounts and types of transactions. In addition, Section 703.30(i) of the final rule clarifies that the requirement to list approved broker-dealers applies only if the credit union uses third parties to purchase or sell investments. A credit union could purchase an investment without using a third party by, for example, obtaining a certificate of deposit (CD) directly from a bank or a Treasury security through the Treasury Direct program. The final rule defines any such third party as a ''broker-dealer,'' even if that third party only buys and sells investments that do not meet the formal definition of ''security,'' such as CDs. Section 703.30(i) also requires that the credit union maintain the documentation the board used to approve a broker-dealer as long as the broker-dealer is approved and until the documentation has been both audited and examined. That requirement was located at Section 703.3(b)(10) of the proposed rule.

Safekeeping

Section 703.3(a)(10) of the proposed rule required that a credit union's investment policy list approved safekeeping entities and limits on the amounts and types of investments that could be safekept with each entity. In response to comments, NCUA has deleted the language regarding amounts and types of investments and the requirement to maintain documentation used to approve a safekeeper. Section 703.30(j) of the final rule clarifies that the requirement to list approved safekeepers applies only if a credit union uses such entities. Also in response to comments, NCUA wishes to make clear that corporate credit unions may serve as safekeepers.

''Failed'' Investments

Section 703.4(b)(3) of the proposed rule required that management notify the board by the next board meeting of any investment that, because of changing market conditions, falls outside of board policy after purchase. The proposed rule also created an entire section, Section 703.7, which established divestiture requirements for a credit union holding an investment that, because of a credit downgrade or failure to meet an interest rate shock test, no longer meets regulatory mandates. Many commenters stated that the proposed requirements, particularly those regarding ''failed'' investments, preempted the board's right to establish its own policies in those areas.

NCUA has determined to retain only a few simple requirements for investments that fail board policy or part 703. They are contained in Section 703.40(f) of the final rule. Other than these, Section 703.30(k) requires that the board establish its own policies for such investments.

Trading

Section 703.3(a)(11) of the proposed rule required that a credit union establish trading policies, if it engages in trading. The provision listed a number of items that the policies should address. In 1987 NCUA issued Letter to Credit Unions No. 89, which discussed trading activities. This Letter is still effective. No significant comments having been received on this provision, it is retained in the final rule, at Section 703.30(l).

Section 703.40 What General Practices and Procedures Must I Follow in Conducting Investment Transactions?

As noted earlier, Section 703.3(b) of the proposed rule established a list of required investment practices. Those practices, many of which have been modified, are found in Section 703.40 of this final rule.

Classification of Securities

Section 703.3(b)(1) of the proposed rule required that a credit union classify securities in accordance with generally accepted accounting principles (GAAP). The applicable principle is Statement of Financial Accounting Standard (SFAS) 115. The preamble stated that deposits and shares in depository institutions are not securities and are not subject to SFAS 115. In response to comments, NCUA notes that the Financial Accounting Standards Board has stated that jumbo CDs may meet the definition of security and may be subject to SFAS 115. A credit union should review the relevant disclosure documents to determine whether a CD meets the definition of security. The classification provision has been retained in the final rule, at Section 703.40(a).

Delegation of Discretionary Investment Authority

Section 703.3(b)(2)(ii) of the proposed rule established a general prohibition against delegating discretionary control of investment authority to a person other than an official or employee of the credit union. However, proposed Section 703.3(b)(2)(iii) permitted a credit union to delegate such control to an investment adviser who is registered with the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940. Proposed Section 703.3(b)(2)(iii) limited the total of a credit union's delegation of discretionary investment control and investment in mutual funds to 100 percent of capital.

The commenters strongly opposed the limitation on delegation of discretionary investment control, particularly the inclusion of investments in mutual funds in that limitation. Some of the concern stemmed from confusion over the concept of ''delegation of control.'' Although Section 703.3(b)(2)(ii) stated that control was not considered delegated if the credit union authorized each purchase and sale, several commenters thought that a traditional relationship with a broker-dealer was included in the concept. A credit union has not delegated discretionary investment control where its broker-dealer recommends purchases and sales but does not act until it has received the credit union's approval for the specific transaction. Likewise, if a credit union is receiving investment advice from an investment adviser but is still approving each purchase and sale, it has not delegated discretionary investment control.

For example, if a broker proposed that a credit union purchase a specific security, and the credit union authorized the purchase, the credit union has not delegated discretionary control. On the other hand, if a broker informed a credit union that CMOs/REMICs with 2-year weighted average lives looked like good investments, and the credit union responded that the broker should purchase one that ''looks good,'' the credit union has delegated discretionary control.

NCUA has determined to retain the general prohibition against delegation of discretionary investment control, except under certain conditions. Section 703.40(b) establishes the prohibition, and Section 703.40(c) establishes the conditions under which delegation is permitted. No commenters objected to the proposed requirement that delegations of discretionary control be limited to investment advisers registered with the SEC, and it has been retained in paragraph (c)(1). Paragraph (c)(2) makes explicit what is a part of normal business practices; that is, analyzing a potential investment adviser's background.

Section 703.3(b)(2)(iii) of the proposed rule restricted how an investment adviser could be compensated, to keep his or her interest allied with that of the credit union. Several commenters suggested that the provision be modified to make it clear that there are no restrictions on compensating a registered investment adviser who does not have discretionary investment control. NCUA agrees and has made the change. The provision is located at paragraph (c)(3) of Section 703.40.

Proposed Section 703.3(b)(2)(v) required that investments under the discretionary control of an investment adviser be classified as either available-for-sale or trading. One commenter was opposed to this provision, but NCUA continues to believe it is necessary and has retained it, at paragraph (c)(4) of Section 703.40. Paragraph (c)(5) codifies what should be a part of normal business practices, that is receiving a monthly statement from an adviser.

Finally, as noted above, proposed Section 703.3(b)(2)(iii) limited the total of a credit union's delegation of discretionary investment control and investment in mutual funds to 100 percent of capital. In response to the commenters' concerns, NCUA has determined not to include investments in mutual funds in the limitation. Also in response to the comments, NCUA has clarified that the limitation is the aggregate of a credit union's delegation of discretionary control, that is, regardless of the number of investment advisers a credit union uses, it may delegate discretionary control over the portion of its investment portfolio that represents 100 percent of its capital. This provision is located at paragraph (c)(6) of Section 703.40. NCUA notes that whenever a credit union uses any third party, such as investment adviser, broker-dealer, or safekeeper, to carry out investment transactions on its behalf, it must ensure that the third party complies with the restrictions of Part 703 and the FCU Act. This could be accomplished through written agreement with the third party.

Credit Analysis

Section 703.3(b)(6) of the proposed rule required credit unions to perform credit analyses of issuing entities unless the investment is issued or guaranteed by the U.S. government or is covered by share or deposit insurance. Recognizing that it often is difficult for credit unions to perform detailed credit analyses, the proposed rule established a minimum rating of B/C for financial institutions that are rated. The preamble noted that credit unions should perform credit analyses for uninsured investments in nonrated financial institutions, including corporate credit unions.

A number of commenters expressed concern regarding the proposed requirements, particularly credit analyses of corporate credit unions. They argued that credit analyses were too burdensome and that credit unions should be permitted to rely entirely on ratings. Many wondered how credit analyses of corporate credit unions could be conducted, while others believed it was not necessary, since corporate credit unions are examined by NCUA.

NCUA recognizes that a small credit union may be unable to perform a detailed credit analysis. For a small credit union, investing funds in corporate credit unions is an appropriate risk management alternative to investing in securities. NCUA will not take exception to a small credit union investing all of its surplus funds in a corporate credit union.

NCUA expects a larger credit union, however, to perform a credit analysis whenever there is credit risk. The uninsured portion of an investment in a corporate credit union presents such risk. NCUA supervises corporate credit unions and is primarily concerned with their safe and sound operations and adherence to applicable laws, rules, and regulations. This supervision does not serve as a guarantee of the investment products a corporate credit union may offer, nor as assurance against potential loss.

A credit union's membership relationship with its corporate should assist it in evaluating the corporate's operations and financial condition. A credit union should review the corporate credit union's earnings performance, capital level, and investment portfolio. A credit union also should be aware of the corporate's operating level under Part 704 and its exposure to a 300 basis point shift in interest rates.

In addition to uninsured investments in corporate credit unions, investments with credit risk include uninsured CDs, federal funds, bank notes, municipal securities, and repurchase transactions. As with investments in corporate credit unions, a credit union must conduct a credit analysis of these other investments that is commensurate with the risk of the exposure. The analysis should include a review of capital, ratings, financial trends, earnings, and loan losses. While the proposed rule required that this analysis be updated semiannually, the final rule requires only an annual update. The final rule, located at Section 703.40(d), also does not establish a minimum financial institution rating. The commenters noted that the ratings from the various rating agencies are not consistent and that too many institutions are unrated.

''Failed'' Investments

As noted above in the discussion of Section 703.30(k), the proposed rule required board notification of investments that fall outside of board policy after purchase and also established divestiture requirements for investments that fail the regulation. In response to comments, NCUA determined to retain the board notification requirement for investments failing board policy and to eliminate all of the requirements for investments failing the regulation except board and NCUA notification. These requirements are located at Section 703.40(e) of the final rule. To the extent that Section 703.40(e) conflicts with Letter to Credit Unions No. 169, governing CMOs/REMICs that fail the stress test, the Letter is superseded. Credit unions should not interpret the removal of specific divestiture requirements from the final rule as NCUA's tacit approval to hold a failed investment indefinitely. On the contrary, NCUA will continue to review the safety and soundness of failed investments to determine whether divestiture is necessary. As always, instruments that were impermissible when purchased may be subject to immediate divestiture.

Documentation

Proposed Section 703.3(b)(10) required that documentation be maintained through the examination and audit cycles. The preamble noted that there had been instances where credit unions failed to maintain enough documentation for the examiner and auditor to properly analyze the security or determine the relationship of the investment decisions to the credit union's policies. There were few comments on this section, and it has been retained in the final rule, at Section 703.30(f). A credit union must maintain sufficient information to demonstrate that it has exercised prudent judgment in making investment decisions.

Section 703.50 What Rules Govern My Dealings With Entities I Use To Purchase and Sell Investments (''Broker-Dealers'')?

Section 703.3(b)(7) of the proposed rule required that any broker-dealer used by a credit union be either a federally regulated depository institution or registered with the Securities and Exchange Commission

(SEC). The proposed rule also required that credit unions conduct an analysis of the financial condition and reputation of the broker-dealer and sales representative. The comments on this section were mixed, with some in favor of the proposed requirements and others objecting that they were too burdensome. NCUA continues to believe that credit unions should do business only with broker-dealers that meet a certain minimum standard of conduct and has retained the requirement. This means that even when purchasing a CD through a broker who only sells CDs, the broker must be either registered with the SEC or a federally regulated depository institution.

NCUA also believes that credit unions should exercise due diligence in determining whether to transact business with a broker-dealer and/or sales representative. As an additional control, a credit union should consider prohibiting any official or employee with discretionary investment authority from maintaining a personal account with the same sales representative that the credit union uses. If the broker-dealer acts as a credit union's counterparty in transactions, introducing credit risk, the credit union must increase its level of due diligence.

Section 703.60 What Rules Govern My Safekeeping of Investments?

Section 703.3(b)(8) of the proposed rule established new safekeeping requirements for credit unions. It required that a credit union maintain its securities independently of its broker-dealer and that it receive a safekeeping receipt for each investment held in safekeeping. It permitted an investment to be held in street name as long as the credit union and/or safekeeper maintain documentation establishing that the credit union is the beneficial owner of the investment. It required a credit union to review the financial condition of approved safekeepers at least annually and that purchases and sales be ''delivery versus payment,'' where payment for an investment occurs simultaneously with its delivery.

In response to comments, NCUA has eliminated the requirement to obtain safekeeping receipts, the requirement to review the financial condition of approved safekeepers, and the language regarding street name. A credit union may permit investments to be held in the name of a broker or nominee and should maintain documentation showing that it is the true owner of the investments. The credit union should be listed as owner on the individual confirmation statements and monthly safekeeping statements required by the final rule.

The proposed requirement for investments to be held by a safekeeper under a written custodial agreement has been retained in the final rule. In response to comments, however, NCUA wishes to clarify that the provision does not require that the agreement be between the credit union and the custodian. The agreement may be between the broker and the custodian, although in that case, the credit union should obtain a copy.

Section 703.70 What Must I Do to Monitor My Non-Security Investments in Banks, Credit Unions, and Other Depository Institutions?

One of the challenges of this rule was establishing criteria to ensure that credit unions with portfolios of securities know the risks of those instruments, while permitting credit unions that restrict their investments to CDs and corporate credit union deposits to do so without undue burden, even though those instruments can present some credit and interest rate risk. Sections 703.3 (b)(4) and (b)(5) of the proposed rule required credit unions to perform certain actions to value and monitor their securities. The GAAP definition of ''security'' includes marketable instruments such as Treasuries, agencies, mortgage backed instruments, and as previously discussed, certain jumbo CDs. The only monitoring provision that addressed investments that were not securities, such as ordinary CDs and corporate deposits, was at proposed Section 703.3(b)(4)(ii)(A), which required credit unions to prepare monthly reports listing the characteristics of each investment held.

Some commenters expressed concern that the requirements for securities also applied to ordinary CDs and corporate deposits. This final rule maintains the proposed rule's distinction between ''securities'' and ''investments,'' but to make it clearer that a credit union that chooses to invest only in ordinary shares and deposits need not worry about the requirements for securities, this final rule establishes a separate section for investments in depository institutions that do not constitute securities. Further, the regulatory burden itself has been reduced. Section 703.70 requires a credit union to list, quarterly rather than monthly, the dollar value of only those non-security shares or deposits that have embedded options, remaining maturities greater than 3 years, or coupon formulas related to more than one index or inversely related to, or multiples of, an index. A credit union's board should be aware of the potential risk of shares or deposits with these characteristics.

Section 703.80 What Must I Do to Value My Securities?

Proposed Section 703.3(b)(5)(i) required that before purchasing or selling a security, a credit union obtain a price quotation from a second broker or from an industry-recognized information provider. The preamble noted that credit unions have been known to pay or receive prices that were significantly different from market prices because their brokers knew they were not verifying prices with other sources.

A number of commenters objected to the requirement to obtain a second price, arguing that it was burdensome and unrealistic. NCUA continues to believe that it is imperative for credit unions to ensure that they know the market prices of the securities they buy and sell, and has retained the requirement, at Section 703.80(a). Again, to minimize burden, the rule allows a credit union to obtain a second price from an industry-recognized information provider. This may be an electronic service that provides market information (Bloomberg, Reuters, etc.) or a newspaper of general and regular circulation (Wall Street Journal, New York Times, etc.). NCUA recognizes that prices from information providers are indicative only, but they should show whether a broker's price is reasonable. To further reduce burden, and in response to comments, an exception has been added for new issues purchased at par.

The rule does not require that the credit union use the broker with the best price. NCUA understands that a credit union can receive ancillary services from a broker that are not reflected in fees, and a credit union may choose to compensate the broker by occasionally accepting a poorer price than that available from another broker. However, credit unions should be aware of the implicit cost of these services. Therefore, as discussed earlier, Section 703.40(g) requires that a credit union document the prices it pays or receives for securities. NCUA understands that prices received from broker-dealers generally will not be in writing; however, the credit union should document who was called, the date and time of the call, and the quoted price or spread to the relevant security. A phone note with the identified information would meet this requirement.

Proposed Section 703.3(b)(5)(ii) required a monthly review of the fair value of each security in a credit union's

portfolio. The preamble noted that this information generally is provided by broker-dealers or safekeepers. There was virtually no opposition to this requirement, and it has been retained in the final rule, at Section 703.90(b).

To ensure some independent verification of a broker's or safekeeper's prices, proposed Section 703.3(b)(5)(iii) required credit unions to obtain semi-annual prices on their securities from another broker or an industry-recognized information provider. In response to comments, Section 703.80(c) of the final rule simply requires a credit union's supervisory committee to comply with existing auditing standards and annually assess the reliability of prices received from a broker or safekeeper. Credit unions or their auditors should refer to the practices and procedures discussed in the investments chapter of the American Institute of Certified Public Accountants guide Audits of Credit Unions.

Proposed Section 703.3(b)(5) provided, throughout, that where a credit union could not obtain the price of a particular security, it could obtain the price of one with substantially similar characteristics. Rather than repeating this each time a price is required, Section 703.80(d) of the final rule states it generally.

Section 703.90 What Must I Do to Monitor the Risk of My Securities?

Monthly Report

Proposed Section 703.3(b)(4)(ii) (A) and (B) required a federal credit union to prepare a monthly report showing the characteristics of each investment in the portfolio and the change in the fair value or total return of each security since the date of purchase and for the last month. In response to comments, NCUA has eliminated the requirement to list the characteristics of each investment each month. In addition, since several commenters were confused about the total return concept, NCUA has deleted all references to total return from the rule, although credit unions may choose to calculate it in addition to fair value.

A number of commenters questioned the need to calculate the fair value of securities classified as hold-to-maturity. NCUA has determined to retain the requirement for a credit union to report the fair value and dollar change since the prior month-end of all its securities, since those changes can affect future earnings. For example, in a rising interest rate environment, with rate-sensitive members, a credit union may be compelled to increase its share rates. A credit union with fixed coupon investments experiences no equivalent increase in interest income. The resulting decline in earnings occurs regardless of whether the securities are classified as hold-to-maturity or available-for-sale. Therefore, it is important for the investment-related committee and board to know what has happened to the value of all those securities. The requirement is located at Section 703.90(a) of the final rule. A credit union that chooses to keep all of its investments in CDs and corporate credit union shares and deposits is not required to price its investments and therefore is not subject to the requirement.

Quarterly Report

Proposed Section 703.3(b)(4)(ii)(C) required a credit union to calculate, quarterly, the value of securities that NCUA determined represented greater potential interest rate risk. They were: (1) Securities that amortize; (2) securities with embedded options; (3) securities with maturities greater than 3 years; and (4) securities where contract rates are related to more than one index or are inversely related to, or multiples of, an index.

In response to comments, NCUA has removed amortizing securities from the list, located at Section 703.90(b) of the final rule. Most amortizing securities that represent greater potential interest rate risk will be included because they contain embedded options. NCUA includes all securities with embedded options because even put provisions and interest rate floors can affect the price of a security independent of actual changes in interest rates. To be consistent with market terminology, NCUA also has changed the term ''contract rate'' to ''coupon formula.''

A number of commenters urged that the maturity threshold be extended to 5 years, to be consistent with the definition of risk asset in Section 700.1(i) of the NCUA Rules and Regulations. NCUA notes that the proposed requirement and the risk asset regulation have different purposes and effects. The classification of a security as a risk asset under Section 700.1(i), results in a credit union having to transfer additional income to reserves under Section 116 of the FCU Act. In contrast, the only result of classifying a security as representing greater potential risk under Part 703 is that a credit union might have to test its securities to gain important information about the interest rate risk on its balance sheet. NCUA believes that significant risk would be missed by failing to include securities with maturities from 3 to 5 years in the category that could trigger testing requirements and has determined to leave the threshold at 3 years. NCUA has clarified, however, that maturity means remaining maturity.

Several commenters suggested excluding U.S. Treasury and agency securities from the group that represents greater potential risk. This comment reflects a misunderstanding of the risk being evaluated. The securities at issue are those that represent greater potential interest rate risk, not credit risk. Although Treasury and agency securities do not present credit risk, they can have considerable interest rate risk depending on their characteristics. To some extent, this risk can be estimated by subjecting these securities to interest rate shock tests.

Shock Test

Under Section 703.3(b)(4)(iii) of the proposed rule, if the total value of securities determined to represent greater potential risk was greater than a credit union's capital, the credit union was required to calculate the potential impact, on the fair value and/or total return of each security in the portfolio and the portfolio as a whole, of parallel shifts of plus and minus 300 basis points. The purpose of the analysis was to determine the impact of potential shifts in interest rates on the credit union's future capital position.

NCUA recognized this was a naive test and that substantial risks could be missed by credit unions holding potentially more risky securities in a total amount less than capital. NCUA believed, however, that the requirement represented a reasonable compromise between imperfect risk assessment and the burden that would result if every credit union had to test every security.

As limited as the testing was, a number of commenters argued that it would be too burdensome, suggesting that the threshold of 100% of capital be raised to 150% or 200%. To determine the impact of the requirement on federal credit unions, NCUA analyzed data from December 1995 call reports. NCUA used assumptions about the characteristics of Treasury and agency securities that probably caused more of such securities to be included than would actually be the case. The results of the analysis are described in the following table:

Asset size (in millions)	A	B	C
<$2	18	2,173	0.8%
$2–$10	90	2,507	3.6%
$10–$50	351	1,769	19.8%
>$50	462	795	58.1%

Asset size (in millions)	A	B	C
Total ..	921	7,244	12.7%

A—Number of federal credit unions that would be required to complete the 300 basis point stress test.

B—Total number of federal credit unions in the respective asset ranges.

C—Percentage of A to B (A÷B=C).

The analysis shows that, at most, only 921, or 12.7 percent, of all federal credit unions would be required to subject their portfolios to the test. The vast majority of these have assets greater than $10 million. NCUA believes that the test would not be a significant burden to these credit unions and that it is imperative for these credit unions to monitor their potential interest rate risk. Therefore, it has retained the test, at Section 703.90(c). Credit unions that are either unwilling or unable to monitor their risk through the test should rethink their investment strategy. In response to comments, however, NCUA has reduced their frequency of the test from monthly to quarterly. Further, as discussed earlier, to avoid confusion, there is no longer any reference to total return.

NCUA understands that credit unions with deteriorating securities in the hold-to-maturity portfolio may have less and less likelihood of meeting the shock test ''hurdle'' due to the use of fair value versus amortized cost in the calculation. Since securities classified as hold-to-maturity are not adjusted to fair value, when their value goes down, there is no corresponding decrease in net capital. As a result, the ratio of potentially more risky securities to net capital declines. This may lead to the anomalous situation of a decreasing requirement to test, because the threshold is less likely to be triggered when hold-to-maturity values are declining substantially. However, the purpose of the test is to show potential problems with the portfolio, and securities rapidly losing value will already be reported under Section 703.90(a).

Some commenters suggested that a test that applies to securities but not deposits could induce some credit unions to purchase deposit instruments that have the same risk characteristics as the securities that trigger the test. If the test is not triggered, the credit unions will be ignorant of the interest rate risk of their investments. NCUA was aware of this trade-off, and chose not to impose the test on credit unions with minimal investments in securities. However, Section 703.70 requires credit unions to list shares and deposits with the relevant risk characteristics. This information should make credit union boards aware of the possibility of interest rate risk. In addition, NCUA intends to collect the information through the call report.

Section 703.100 What Investments and Investment Activities Are Permissible for Me?

Contracting for Securities

Current Section 703.4(a) permits a credit union to contract for the purchase or sale of a security provided that the delivery of the security is to be made within 30 days from the trade date. This accommodates the settlement of U.S. government and agency securities. Section 703.4(b) permits a credit union to enter into a cash forward agreement to purchase or sell a security provided that the period from the trade date to the settlement date does not exceed 120 days. This was designed to accommodate the settlement of mortgage-backed securities. Section 703.4(a) of the proposed rule deleted these specific time frames, and the authority to enter into cash forward agreements, and simply provided for a credit union to contract for the purchase or sale of a security provided that delivery of the security was by ''regular-way'' settlement.

The current regulation had created some problems distinguishing between regular delivery and forward commitments. The proposed regulation was intended to permit a credit union to contract for the purchase of a security no matter when it settles, as long as the settlement date is within the normal time frame that the securities industry has established for that type of security. Regular-way settlement varies, depending on the type of security and whether it is being purchased or sold on the secondary market or is a new issuance.

Securities industry practices for regular-way settlement have become well-defined for most types of investments that are permissible for credit unions. The time frames arise from customary practice in the securities industry among brokers and dealers, guidelines established by the Public Securities Association, and requirements of the Securities and Exchange Commission and the Municipal Securities Rulemaking Board.

Regular-way settlement for the most common types of secondary market securities purchased or sold by credit unions is either one or three business days after the trade date. For securities that are just being issued, the time frame from trade date to settlement date can be considerably longer, depending on the period between the announcement of the offering and the issuance of the security. Although several commenters expressed concern about being bound by regular-way time frames, NCUA is not convinced that it is necessary to go beyond regular way. Therefore, it has retained the requirement, at Section 703.100(a).

Indexes

The current rule is silent as to the types of indexes to which variable rate instruments can be tied. Section 703.4(h) of the proposed rule limited permissible indexes to those tied to domestic interest rates only. These include, for example, constant maturity Treasury and U.S. dollar-denominated LIBOR rates, Prime, and the 11th District Cost of Funds. The preamble noted that this would prohibit a credit union from purchasing an investment linked to an equity index, either as a speculative investment or to match against a product offered to a member. NCUA continues to believe that it is not appropriate for a credit union to invest in an instrument that does not correlate to its cost of funds, and has retained the prohibition, at Section 703.100(b). The provision also prohibits a credit union from purchasing the new inflation-indexed Treasury bonds.

Corporate Credit Unions

Proposed Section 703.4(f) addressed credit union investments in corporate credit union capital shares and deposits. The proposed rule limited credit union investment in the capital shares of a corporate credit union to a total of one percent of the investing credit union's assets, due to the potential risk associated with such investments.

A number of commenters seemed confused by the provision, believing that NCUA was proposing a limit on all investments in corporate credit unions. That is not the case. The proposed limit does not apply to regular shares or deposits in corporate credit unions; it applies only to capital shares, which can come in two forms:

Membership capital and member paid-in capital. To clarify the scope of the limitation, the final rule expressly uses those terms. NCUA intends that a credit union be limited to investing a total of 1 percent of its assets, all in membership capital, all in member paid-in capital, or divided between them, in each corporate credit union in which it invests. A few commenters expressed concern that some credit unions might now have more than 1 percent of assets in capital shares in one corporate credit union. Any such investment will be grandfathered.

A credit union must fully understand the risks associated with paid-in and membership capital before making such investments. An investing credit union must be aware that its funds are at risk and that it may not have access to them for 20 years, in the case of paid-in capital, and 3 years, in the case of membership capital. Corporate credit unions are required to fully disclose the conditions of their capital instruments, and a credit union should review the disclosures carefully before deciding to invest.

Common Trust Funds, Mutual Funds, and Other Investment Companies

Section 703.4(j) of the current regulation provides that a federal credit union may invest in a mutual fund, provided that the investments and investment transactions of the fund are legally permissible for federal credit unions under the FCU Act and NCUA regulations. Proposed Section 703.4(d) broadened this authority by permitting investment in an investment company that was registered with the Securities and Exchange Commission under the Investment Company Act of 1940.

The proposal retained the requirement that the investments and investment transactions of the investment company be permissible for federal credit unions and clarified that this limitation be established by the company's prospectus and/or statement of additional information, changeable only by shareholder vote. One method of establishing that a fund was a permissible investment was for the prospectus to state that it was ''a legal investment for federal credit unions'' or ''legal under the FCU Act and NCUA Rules and Regulations.'' The proposed rule also limited the aggregate of a credit union's investment in investment companies and delegation of discretionary investment control to an investment adviser to 100 percent of capital.

In response to comments, NCUA has eliminated the shareholder approval requirement in Section 703.100(d) of the final rule. NCUA also has determined that Section 703.100(d) need not explicitly mention the statement of additional information, since it is generally incorporated by reference into the prospectus. In addition, NCUA has removed the limitation on how much a credit union may invest in an investment company.

NCUA also has deleted the sentence that described how a mutual fund can establish that it is a permissible investment for federal credit unions. Some commenters mistakenly concluded that it meant that for a mutual fund to be legal for federal credit unions, the prospectus was *required* to say that the fund complies with the FCU Act and NCUA Rules and Regulations. The sentence was intended to make it clear that NCUA was departing from the position taken in Letter to Credit Unions No. 155, which required that a prospectus detail every investment and transaction authorized for a fund, so that a credit union could determine whether the fund was a permissible investment. As noted in the preamble to the proposed rule, NCUA found it difficult to establish how much detail was necessary to determine that a fund engaged only in activities that were permissible for credit unions. The proposed sentence intended to convey that one way of meeting that requirement was for a prospectus to state that the fund was permissible. Federal securities laws require that a prospectus accurately represent the activities of the fund.

To avoid confusion, NCUA has deleted the sentence. The position remains the same, however. A credit union should review the prospectus of any mutual fund in which it is considering investing. If the prospectus lists the authorized investments and investment activities of the fund in sufficient detail for the credit union to determine that all of them are permissible, it may invest in the fund. If the prospectus lists the activities of the fund generally, and none of them are impermissible for federal credit unions, but also states that the fund is ''legal under the FCU Act and NCUA Rules and Regulations,'' or something to that effect, a credit union may invest in the fund. Regardless of whether a prospectus states that a fund is legal for federal credit unions, if it is clear that some of the activities are impermissible, a credit union may not invest in the fund.

A final change to this section was the addition of bank-managed collective investment funds, also known as common trust funds, as permissible investments. Such funds are subject to the same rules as are mutual funds regarding the underlying investments and content of the prospectus.

CMOs/REMICs

Section 704.4(e) of the proposed rule addressed the high risk securities test (HRST) for CMOs/REMICs. The most significant change was the application of the entire test to variable as well as fixed rate CMOs/REMICs. NCUA had determined that the price sensitivity portion of the HRST failed to reflect adequately the impact of basis and cap risk. Although a number of commenters objected to applying the average life and average life sensitivity tests to variable rate CMOs/REMICs, NCUA has concluded that the requirement should substantially reduce the risk exposure for these securities and has retained it at Section 703.100(e).

Municipal Securities

Section 703.4(g) of the proposed rule established minimum credit ratings for municipal bonds. Credit unions were limited to purchasing bonds rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization (NRSRO). In response to comments, NCUA has expanded the category of permissible municipal bonds to those rated in one of the four highest rating categories, that is, those that are investment grade. NCUA also has added language to explain NRSROs. The provision is located at Section 703.100(f).

Depository Institutions

Section 703.4(c) of the proposed rule permitted a credit union to sell federal funds to a Section 107(8) institution, and Section 703.4(h) provided that a credit union could purchase yankee dollar deposits, eurodollar deposits, and banker's acceptances. NCUA received no comments on these sections and has retained them in Sections 703.100 (g) and (h), respectively, of the final rule. To clarify and standardize positions it has taken in opinion letters, NCUA also has added the authority to purchase deposit notes and certain bank notes.

Repurchase Transactions

Section 703.4(b) of the proposed rule simplified the language authorizing credit union investment in repurchase transactions. NCUA received no negative comments on the provision and has retained it at Section 703.100(i) of the final rule. The provision has been clarified to require daily assessment of the market value of the repurchase securities and explicitly includes the standard practice of entering into signed contracts with approved counterparties. Credit unions should review NCUA Interpretive Ruling and Policy Statement (IRPS) No. 85–2 for a detailed discussion of appropriate controls for repurchase transactions.

Reverse Repurchase Transactions and Securities Lending

Proposed Section 703.6 established a new section addressing the pledging of securities through reverse repurchase transactions, securities lending, and collateralized borrowing. In response to a comment, the final rule establishes separate sections for reverse repurchase

transactions and securities lending, Sections 703.100 (j) and (k), respectively. The final rule does not explicitly address collateralized borrowing. The new sections have been clarified to require daily pricing of any securities received in the transaction. The sections also include the standard practice of entering into signed contracts with approved counterparties and borrowers. IRPS 85–2, discussed above, provides guidance for reverse repurchase transactions and may also be consulted when lending securities.

Trading

The current regulation does not specifically address trading practices. Section 703.3(b)(9) of the proposed rule incorporated trading practices from Letter to Credit Unions No. 89. NCUA received no comments regarding the proposed trading practices but did receive several comments urging that when-issued trading and pair-off transactions be permitted in the trading account. NCUA agrees, and in addition to describing required trading practices, Section 703.100(l) of the final rule authorizes when-issued trading and pair-offs. NCUA notes that IRPS 92–1 states that federal credit unions engaging in when-issued trading must follow NCUA's regulation on cash forward agreements. When this rule becomes effective, that statement will no longer be accurate. Cash forward agreements will be impermissible, and when-issued trading will be permissible without restriction, except for being accounted for in accordance with GAAP. In general, when IRPS 92–1 conflicts with this rule, the IRPS is superseded.

Section 703.110 What Investments and Investment Activities Are Prohibited for Me?

Section 703.5 of the proposed rule added prohibitions against engaging in when-issued trading and pair-off transactions and purchasing or selling options, interest rate swaps, stripped mortgage-backed securities, CMO/REMIC residuals, commercial mortgage related securities, and small business related securities. It also prohibited credit unions from purchasing mortgage servicing rights directly. As noted above, NCUA has determined to permit credit unions to engage in when-issued trading and pair-offs, when conducted in the trading account. These activities have been deleted from the prohibitions section, located at Section 703.110 of the final rule.

Several commenters urged that credit unions be permitted to engage in financial derivatives. NCUA recognizes that in a dynamic financial environment it will be desirable for credit unions to consider a broader range of financial alternatives. The most likely extension will be into swaps, futures and options, which can be used to reduce interest rate exposure. NCUA has decided to consider allowing a limited number of individual credit unions to expand into these areas through the investment pilot program, described in Section 703.140.

Other than comments regarding financial derivatives, only a few commenters opposed the proposed prohibitions. NCUA continues to believe that the listed investments are inappropriate for federal credit unions, and has prohibited them in the final rule. NCUA notes, however, that a CMO/REMIC with the characteristics of a stripped mortgage-backed security is permissible if it meets the CMO/REMIC stress tests in this regulation. NCUA also notes that the prohibition against small business related securities does not prohibit credit unions from purchasing investments in securities issued or guaranteed by the Small Business Administration. Finally, NCUA notes that the prohibition against purchasing mortgage servicing rights directly does not affect a credit union's authority to retain servicing rights of loans that it sells, whether the loans have been made by the credit union or purchased to complete a pool for sale or pledge on the secondary market.

Section 703.120 May My Officials or Employees Accept Anything of Value in Connection With an Investment Transaction?

No commenters objected to Section 703.8 of the proposed rule, which addressed prohibited fees, and it has been retained at Section 703.120 of the final rule.

Section 703.130 May I Continue To Hold Investments Purchased Before January 1, 1998, That Will Be Impermissible After That Date?

To assist credit unions in determining what regulations govern investments purchased prior to January 1, 1998, the effective date of this final rule, Section 703.9 of the proposed rule set out various provisions that have governed certain investments since 1991. Minor corrections have been made to these provisions, and they have been retained at Section 703.130 of the final rule.

Section 703.140 What Is the Investment Pilot Program and How Can I Participate in It?

A number of commenters asked for authority to engage in certain investment activities that NCUA does not believe are appropriate for all federal credit unions at this time. However, certain activities that are permissible under the FCU Act but prohibited under this rule, such as financial derivatives, may be appropriate for some credit unions. As credit unions and NCUA gain experience with the activities, NCUA may determine that they are appropriate for all credit unions, are suitable only for some, or remain inappropriate for all credit unions. To assist credit unions and NCUA in gaining experience with these activities, NCUA has developed the investment pilot program.

Under the program, a credit union that wishes to engage in an otherwise prohibited activity must apply to NCUA for permission to engage in the activity. Section 703.140 sets out the requirements and procedures for the application. NCUA will assess the credit union to determine its ability to safely and soundly engage in the activity. NCUA will determine the scope of the activity to assess its impact on the credit union industry as a whole. If NCUA determines that a particular activity is appropriate for all credit unions, it will consider amending Part 703.

The pilot program also provides for NCUA to approve a third party's investment program. In such a case, a credit union would not be required to obtain individual approval to participate in the program, although NCUA might limit the number of credit unions to which the third party may market the program.

NCUA notes that the pilot program is not equivalent to a waiver process. That is, once there are enough credit unions engaging in an activity for NCUA to assess it, no more credit unions will be approved to engage in the activity. An important factor in the number of credit unions and activities that will be approved for the program is the availability of NCUA staff resources.

Although commenters did not have the opportunity to express opinions on the investment pilot program, NCUA notes that without adding it to the final rule, credit unions would have no ability to engage in these activities, which may benefit the credit union industry and NCUA. NCUA believes that the benefits of the program justify adding it at this late date. NCUA welcomes comments on the program, however, and suggestions on how to improve it.

Section 703.150 What Additional Definitions Apply to This Part?

NCUA proposed to add a number of new definitions, to clarify certain already-defined terms by re-definition,

and to delete several unnecessary definitions. In the final rule, some of the proposed terms are not used, some new terms have been added, and, based on comments, some definitions have been modified. In addition, NCUA has deleted definitions for some terms, believing them to be of such common usage as to no longer require definitions.

C. Derivation Table

Original provision	New provision	Comment
703.1	703.10 & 703.20	Modified.
703.2	703.150	Significantly Changed.
703.3(a) ..	703.30(a)	Modified.
703.3(b) ..	703.30(h)	Modified.
703.3(c) ..	703.30(f)	Modified.
703.3(d) ..	703.30(b)	Significantly Changed.
703.3(e) ..	703.30(c)	Modified.
703.3(f) ...	703.30(e)	Modified.
703.3(g) ..	703.30(i)	Modified.
703.3(h) ..	703.30(j)	Modified.
N/A	703.30 (d), (g), (k), & (l).	Added.
N/A	703.40 (a), (b), (c), (e), & (f).	Added.
N/A	703.70, 703.80, & 703.90.	Added.
703.4 (a) & (b).	703.100(a)	Significantly Changed.
703.4(c) ..	703.40(d) & 703.100(c).	Significantly Changed.
703.4(d) ..	703.100(i)	Significantly Changed.
703.4(e) ..	703.100(j)	Modified.
703.4(f) ...	703.100(g)	Modified.
703.4 (g), (h), & (i).	703.100(h) (1), (2), & (3).	No Change.
703.4(j) ...	703.100(d)	Modified.
N/A	703.100 (b), (f), (h) (4) & (5), (k), & (l).	Added.
703.5(a) ..	N/A	Removed.
703.5(b) ..	703.110(a)	No Change.
703.5 (c) & (d).	703.110(b)	No Change.
703.5(e) ..	703.100(c)	Modified.
703.5 (f) & (h).	703.110(c)	Modified.
703.5 (g) & (j).	703.100(e)	Modified.
703.5(i) ...	N/A	Removed.
703.5(k) ..	703.110(d)	No Change.
703.5 (l) & (m).	703.120	Modified.
N/A	703.130 & 703.140	Added.

D. Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact any final regulation may have on a substantial number of small credit unions, defined as those having less than $1 million in assets. The NCUA Board has determined and certifies that the final rule will not have a significant economic impact on a substantial number of small credit unions. Approximately 1,300 federal credit unions, out of 7,200, have assets of $1 million or less. Of these 1,300, only 95 have investments in treasury or agency securities, which are the investments that are subject to the majority of the policy, reporting, and monitoring requirements of the final rule. Accordingly, the NCUA Board has determined that a regulatory flexibility analysis is not required.

Paperwork Reduction Act

The information collection requirements of the proposed rule were submitted to the Office of Management and Budget. Fifteen commenters addressed NCUA's estimates of the burden of those requirements, with all but one stating that the estimates were too low. Credit unions range in asset size from less than $100,000 to over $9 billion, however, and the estimates were based on averaging the time it would take both small and large credit unions to comply with the requirements. Although the estimates may be understated for larger credit unions, the reverse is true for smaller institutions.

The final rule has been modified from the proposed rule in ways that reduce the burden estimates. The requirement to prepare a monthly written report of investments was reduced by eliminating the obligation to list all characteristics. The frequency of the interest rate shock test was changed from monthly to quarterly. The requirement to semiannually verify the pricing of all securities held was changed to annually and only the amount necessary to satisfy generally accepted auditing standards. The credit analysis requirement was changed from semiannually to annually. Finally, the requirement to prepare and provide to the Regional Director a written divestiture plan was eliminated.

A revised Paperwork Reduction Act estimate will be sent to the Office of Management and Budget (OMB). The NCUA Board invites comment on: (1) Whether the collection of the information is necessary for the proper performance of the functions of NCUA, including whether the information will have practical utility; (2) the accuracy of NCUA's estimate of the burden of collecting the information; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) ways to minimize the burden of collecting the information. Send comments to Attn: Alexander Hunt, OMB Reports Management Branch, New Executive Office Building, Rm. 10202, Washington, DC 20530, with copies to Betty May, Acting Paperwork Reduction Act Coordinator, NCUA, 1775 Duke St., Alexandria, VA 22314–3428.

Under the Paperwork Reduction Act of 1995, no persons are required to respond to a collection of information unless it displays a valid OMB control number. The control number will be displayed in the table at 12 CFR Part 795.

Executive Order 12612

Executive Order 12612 requires NCUA to consider the effect of its actions on state interests. The final rule applies directly only to federal credit unions, with § 704.110 of the final rule applying indirectly to state-chartered credit unions, through the insurance provisions at 12 CFR Part 741. NCUA has determined that the final rule does not constitute a ''significant regulatory action'' for purposes of the Executive Order.

Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Fairness Act of 1996 (Public Law 104–121) provides generally for Congressional review of agency rules. The reporting requirement is triggered in instances where NCUA issues a final rule as defined by Section 551 of the Administrative Procedure Act, 5 U.S.C. 551.

OMB has determined that this final revision to Part 703 does not constitute a ''major'' rule as defined by the statute. A ''major'' rule is defined as being any final rule that the Administrator of the Office of Information and Regulatory Affairs of OMB finds has resulted in or is likely to result in: (1) An annual effect on the economy of $100 million or more; (2) A major increase in costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or (3) Significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States based

enterprises to compete with foreign-based enterprises in domestic and export markets.

List of Subjects in 12 CFR Part 703

Credit unions, Investments, Reporting and recordkeeping requirements.

By the National Credit Union Administration Board on June 12, 1997.

Becky Baker,

Secretary of the Board.

For the reasons set forth in the preamble, NCUA revises 12 CFR part 703 to read as follows:

PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

Authority: 12 U.S.C. 1757(7), 1757(8), 1757(15).

§ 703.10 What does this part 703 cover?

This part 703 interprets several of the provisions of Sections 107(7), 107(8), and 107(15) (B) and (C) of the Federal Credit Union Act (''Act''), 12 U.S.C. 1757(7), 1757(8), 1757(15) (B) and (C), which list those securities, deposits, and other obligations in which a federal credit union (''you'') may invest.

§ 703.20 What does this part 703 not cover?

This part 703 does not apply to:

(a) Investment in loans to members and related activities, which is governed by §§ 701.21, 701.22, and 701.23 of this chapter;

(b) The purchase of real estate-secured loans pursuant to Section 107(15)(A) of the Act, which is governed by § 701.23 of this chapter;

(c) Investment in credit union service organizations, which is governed by § 701.27 of this chapter;

(d) Investment in fixed assets, which is governed by § 701.36 of this chapter;

(e) Investment by corporate credit unions, which is governed by part 704 of this chapter; or

(f) Investment activity by state-chartered credit unions, except as provided in § 741.3(a)(3) of this chapter.

§ 703.30 What are the responsibilities of my (a federal credit union's) board of directors?

Your (a federal credit union's) board of directors must establish a written investment policy that is consistent with the Act, this part, and other applicable laws and regulations. The investment policy may be part of a broader, asset-liability management policy. Your board must review the policy at least annually. The policy must address the following items:

(a) The purposes and objectives of your investment activities.

(b) The characteristics of the investments you may make. The characteristics of an investment are such things as its issuer, maturity, index, cap, floor, coupon rate, coupon formula, call provision, average life, and interest rate risk.

(c) How you will manage your interest rate risk, including the amount of risk you can take with your investments in relation to your net capital and earnings.

(d) How you will manage your liquidity risk.

(e) How you will manage your credit risk. The policy must list specific institutions, issuers, and counterparties you may use, or criteria for their selection, and limits on the amounts you may invest with each. Counterparty means the party on the other side of a transaction.

(f) How you will manage your concentration risk, which can result from single or related issuers, lack of geographic distribution, holdings of obligations with similar characteristics, such as maturities and indexes, holdings of bonds having the same trustee, and holdings of securitized loans having the same originator, packager, or guarantor.

(g) If you purchase CMOs/REMICs, whether you will use a median prepayment estimate or individual prepayment estimates for the CMO/REMIC testing required in § 703.100(e). Once the board makes that determination, you may use only that method.

(1) If the policy states that you will use a median estimate, it must identify the industry-recognized information provider that will supply the estimate.

(2) If the policy states that you will use individual estimates, it must identify at least two specific sources for those estimates. One source may be the median estimate from an industry-recognized information provider.

(h) Who of your officials or employees has investment authority and the extent of that authority. The individuals given investment authority must be professionally qualified by education and/or experience to exercise that authority in a prudent manner and to fully comprehend and assess the risk characteristics of investments and investment transactions under that authority. Only your officials and employees may be voting members of any investment-related committee.

(i) If you use third-party entities to purchase or sell investments (''broker-dealers''), the specific broker-dealers you may use. You must maintain the documentation the board used to approve a broker-dealer as long as the broker-dealer is approved and until the documentation has been audited in accordance with § 701.12 of this chapter and examined by NCUA.

(j) If you use a third-party entity to safekeep your investments, the specific entities you may use.

(k) How you will handle an investment that either is outside board policy after purchase or fails a requirement of this part.

(l) If you engage in trading activities, how you will conduct those activities. The policy should address the following:

(1) The persons who have purchase and sale authority;

(2) Trading account size limitations;

(3) Allocation of cash flow to trading accounts;

(4) Stop loss or sale provisions;

(5) Dollar size limitations of specific types, quantity and maturity to be purchased;

(6) Limits on the length of time an investment may be inventoried in the trading account; and

(7) Internal controls, including appropriate segregation of duties.

§ 703.40 What general practices and procedures must I follow in conducting investment transactions?

(a) You (a federal credit union) must classify a security as hold-to-maturity, available-for-sale, or trading, in accordance with generally accepted

accounting principles and consistent with your documented intent and ability regarding the security.

(b) Except as provided in paragraph (c) of this section, you must retain discretionary control over the purchase and sale of investments. NCUA does not consider you to have delegated discretionary control when you are required to authorize a recommended purchase or sale transaction prior to its execution and you, in practice, review such recommendations and authorize such transactions.

(c)(1) You may delegate discretionary control over the purchase and sale of investments, within established parameters, to a person other than your official or employee, provided that the person is an investment adviser registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940 (15 U.S.C. 80b).

(2) In determining whether to transact business with an investment adviser, you must analyze his or her background and information available from state or federal securities regulators, including any enforcement actions against the adviser or associated personnel.

(3) You may not compensate an investment adviser with discretionary control over the purchase and sale of investments on a per transaction basis or based on capital gains, capital appreciation, net income, performance relative to an index, or any other incentive basis.

(4) When you have delegated discretionary control over the purchase and sale of investments to a person other than your official or employee, you do not direct the holdings under that person's control. Therefore, you must classify those holdings as either available-for-sale or trading.

(5) You must obtain a report from your investment adviser, at least monthly, that details your investments under his or her control and how they are performing.

(6) Your aggregate delegation of discretionary control over the purchase and sale of investments under this paragraph (c) is limited to 100 percent of net capital at the time of delegation.

(d) Except for investments that are issued or fully guaranteed as to principal and interest by the U.S. government or its agencies, enterprises, or corporations or fully insured (including accumulated interest) by the National Credit Union Administration or the Federal Deposit Insurance Corporation, you must conduct and document a credit analysis of the issuing entity and/or investment before you purchase the investment. You must update the analysis at least annually as long as you hold the investment.

(e) You must notify your board of directors as soon as possible, but no later than the next regularly scheduled board meeting, of any investment that either is outside board policy after purchase or has failed a requirement of this part. You must document the board's action regarding the investment in the minutes of the board meeting, including a detailed explanation of any decision not to sell an investment that has failed a requirement of this part. Within 5 days after the board meeting, you must notify the appropriate regional director in writing of an investment that has failed a requirement of this part.

(f) You must maintain documentation regarding an investment transaction as long as you hold the investment and until the documentation has been both audited and examined. The documentation should include, where applicable, bids and prices at purchase and sale and for periodic updates, relevant disclosure documents or a description of the security from an industry-recognized information provider, financial data, and tests and reports required by your investment policy and this part.

§ 703.50 What rules govern my dealings with entities I use to purchase and sell investments (''broker-dealers'')?

(a) You (a federal credit union) may use a third-party entity to purchase and sell investments (a ''broker-dealer'') as long as the broker-dealer either is registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) or is a depository institution whose broker-dealer activities are regulated by a federal regulatory agency.

(b) In determining whether to buy or sell investments through a broker-dealer, you must analyze and annually update the following factors:

(1) The background of any sales representative with whom you are doing business.

(2) Information available from state or federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers and the North American State Administrators Association, about any enforcement actions against the broker-dealer, its affiliates, or associated personnel.

(3) If the broker-dealer is acting as your counterparty, the ability of the broker-dealer and its subsidiaries or affiliates to fulfill commitments, as evidenced by capital strength, liquidity, and operating results. You should consider current financial data, annual reports, reports of nationally recognized statistical rating agencies, relevant disclosure documents, and other sources of financial information.

§ 703.60 What rules govern my safekeeping of investments?

(a) Your (a federal credit union's) purchased investments and repurchase collateral must be in your possession, recorded as owned by you through the Federal Reserve Book-Entry System, or held by a board-approved safekeeper under a written custodial agreement. A custodial agreement is a contract in which a third party agrees to exercise ordinary care in protecting the securities held in safekeeping for its customers.

(b) You must obtain an individual confirmation statement for each investment purchased or sold.

(c) You may not allow the selling broker-dealer to safekeep purchased investments or repurchase collateral, except that where the broker-dealer is a bank or corporate credit union, you may allow a separately identifiable department or division of the bank or corporate credit union to safekeep investments or collateral.

(d) You must obtain and reconcile monthly a statement of purchased investments and repurchase collateral held in safekeeping.

(e) All purchases and sales of investments must be delivery versus payment (*i.e.*, payment for an investment must occur simultaneously with its delivery).

§ 703.70 What must I do to monitor my non-security investments in banks, credit unions, and other depository institutions?

(a) At least quarterly you (a federal credit union) must prepare a written report listing all of your shares and deposits in banks, credit unions, and other depository institutions, that have one or more of the following features:

(1) Embedded options;

(2) Remaining maturities greater than 3 years; or

(3) Coupon formulas that are related to more than one index or are inversely related to, or multiples of, an index.

(b) The requirement described in paragraph (a) of this section does not apply to your shares and deposits that are securities.

(c) Where you do not have an investment-related committee, each member of your board of directors must receive a copy of the report described in paragraph (a) of this section. Where you have an investment-related committee, each member of the committee must

receive a copy of the report, and each member of the board must receive a summary of the information in the report.

§ 703.80 What must I do to value my securities?

(a) Prior to purchasing or selling a security, except for new issues purchased at par, you (a federal credit union) must obtain, either:

(1) Price quotations on the security from at least two broker-dealers; or

(2) A price quotation on the security from an industry-recognized information provider.

(b) At least monthly, you must determine the fair value of each security you hold. You may determine fair value by obtaining a price quotation on the security from an industry-recognized information provider, a broker-dealer, or a safekeeper.

(c) At least annually, your supervisory committee (itself or through its external auditor) must independently assess the reliability of monthly price quotations you receive from a broker-dealer or safekeeper. Your supervisory committee (or external auditor) must follow Generally Accepted Auditing Standards, which require either recomputation or reference to market quotations.

(d) Where you are unable to obtain a price quotation required by this section for the precise security in question, you may obtain a quotation for a security with substantially similar characteristics.

§ 703.90 What must I do to monitor the risk of my securities?

(a) At least monthly, you (a federal credit union) must prepare a written report setting forth, for each security you hold, the fair value and dollar change since the prior month-end, with summary information for the entire portfolio.

(b) At least quarterly, you must prepare a written report setting forth the sum of the fair values of all fixed and variable rate securities you hold that have one or more of the following features:

(1) Embedded options;

(2) Remaining maturities greater than 3 years; or

(3) Coupon formulas that are related to more than one index or are inversely related to, or multiples of, an index.

(c) Where the amount calculated in paragraph (b) of this section is greater than your net capital, the report described in that paragraph must provide a reasonable and supportable estimate of the potential impact, in percentage and dollar terms, of an immediate and sustained parallel shift in market interest rates of plus and minus 300 basis points on:

(1) The fair value of each security in your portfolio;

(2) The fair value of your portfolio as a whole; and

(3) Your net capital.

(d) Where you do not have an investment-related committee, each member of your board of directors must receive a copy of the reports described in paragraphs (a) through (c) of this section. Where you have an investment-related committee, each member of the committee must receive copies of the reports, and each member of the board must receive a summary of the information in the reports.

§ 703.100 What investments and investment activities are permissible for me?

(a) You (a federal credit union) may contract for the purchase or sale of a security as long as the delivery of the security is by regular-way settlement. Regular-way settlement means delivery of a security from a seller to a buyer within the time frame that the securities industry has established for that type of security.

(b) You may invest in a variable rate investment, as long as the index is tied to domestic interest rates and not, for example, to foreign currencies, foreign interest rates, or domestic or foreign commodity prices, equity prices, or inflation rates. For purposes of this part, the U.S. dollar-denominated London Interbank Offered Rate (LIBOR) is a domestic interest rate.

(c) You may purchase shares or deposits in a corporate credit union, except where the NCUA Board has notified you that the corporate credit union is not operating in compliance with part 704 of this chapter. Your aggregate purchase of member paid-in capital and membership capital in one corporate credit union is limited to one percent of your assets. Member paid-in capital and membership capital are defined in part 704 of this chapter.

(d) You may invest in a registered investment company or collective investment fund, as long as the prospectus of the company or fund restricts the investment portfolio to investments and investment transactions that are permissible for federal credit unions. For the purposes of this part, the following definitions apply:

(1) A *registered investment company* is an investment company that is registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a). Examples of registered investment companies are mutual funds and unit investment trusts.

(2) A *collective investment fund* is a fund maintained by a national bank under 12 CFR part 9.

(e)(1) You may invest in a fixed or variable rate CMO/REMIC only if it meets all of the following tests:

(i) *Average Life Test.* The CMO/REMIC's estimated average life is 10 years or less.

(ii) *Average Life Sensitivity Test.* The CMO/REMIC's estimated average life extends by 4 years or less, assuming an immediate and sustained parallel shift in interest rates of up to and including plus 300 basis points, and shortens by 6 years or less, assuming an immediate and sustained parallel shift in interest rates of up to and including minus 300 basis points.

(iii) *Price Sensitivity Test.* The CMO/REMIC's estimated price change is 17 percent or less, as a result of an immediate and sustained parallel shift in interest rates of up to and including plus and minus 300 basis points.

(2) You must retest CMOs/REMICs at least quarterly, more frequently if market or business conditions dictate.

(3) If you use individual prepayment estimates for testing, you must obtain estimates from all of the prepayment sources listed in your investment policy. When you purchase a CMO/REMIC, it must pass the tests for each estimate. When you retest the CMO/REMIC, it must pass the tests for a majority of the estimates.

(4) If you use a median prepayment estimate, the median estimate when you purchase a CMO/REMIC must be based on at least five prepayment sources. When you retest the CMO/REMIC, the median estimate must be based on at least two prepayment sources.

(f) You may purchase and hold a municipal security only if a nationally recognized statistical rating organization (NRSRO) has rated it in one of the four highest rating categories. A municipal security is a security as defined in Section 107(7)(K) of the Act. An NRSRO is a rating organization that the Securities and Exchange Commission has recognized as an NRSRO.

(g) You may sell federal funds to Section 107(8) institutions and credit unions, as long as the interest or other consideration received from the financial institution is at the market rate for federal funds transactions.

(h) You may invest in the following instruments issued by a Section 107(8) institution or branch:

(1) Yankee dollar deposits;

(2) Eurodollar deposits;

(3) Banker's acceptances;

(4) Deposit notes; and

(5) Bank notes with original weighted average maturities of less than five years.

(i) A repurchase transaction is a transaction in which you agree to purchase a security from a counterparty and to resell the same or an identical security to that counterparty at a specified future date and at a specified price. You may enter into a repurchase transaction as long as:

(1) The repurchase securities are legal investments for federal credit unions;

(2) You receive a daily assessment of the market value of the repurchase securities, including accrued interest, and maintain adequate margin that reflects a risk assessment of the repurchase securities and the term of the transaction; and

(3) You have entered into signed contracts with all approved counterparties.

(j) A reverse repurchase transaction is a transaction in which you agree to sell a security to a counterparty and to repurchase the same or an identical security from that counterparty at a specified future date and at a specified price. You may enter into reverse repurchase and collateralized borrowing transactions as long as:

(1) Any securities you receive are permissible investments for federal credit unions, you receive a daily assessment of their market value, including accrued interest, and you maintain adequate margin that reflects a risk assessment of the securities and the term of the transaction;

(2) Any cash you receive is subject to the borrowing limit specified in Section 107(9) of the Act, and any investments you purchase with that cash are permissible for federal credit unions and mature no later than the maturity of the transaction; and

(3) You have entered into signed contracts with all approved counterparties.

(k) You may enter into a securities lending transaction as long as:

(1) You receive written confirmation of the loan;

(2) Any collateral you receive is a legal investment for federal credit unions, you obtain a perfected first priority interest in the collateral, you either take physical possession or control of the collateral or are recorded as owner of the collateral through the Federal Reserve Book-Entry Securities Transfer System; and you receive a daily assessment of the market value of the collateral, including accrued interest, and maintain adequate margin that reflects a risk assessment of the collateral and the term of the loan;

(3) Any cash you receive is subject to the borrowing limit specified in Section 107(9) of the Act, and any investments you purchase with that cash are permissible for federal credit unions and mature no later than the maturity of the transaction; and

(4) You have executed a written loan and security agreement with the borrower.

(l)(1) You may trade securities, including engaging in when-issued trading and pair-off transactions, as long as you can show that you have sufficient resources, knowledge, systems, and procedures to handle the risks.

(2) You must record any security you purchase or sell for trading purposes at fair value on the trade date. The trade date is the date you commit, orally or in writing, to purchase or sell a security.

(3) At least monthly, you must give your board of directors or investment-related committee a written report listing all purchase and sale transactions of trading securities and the resulting gain or loss on an individual basis.

§ 703.110 What investments and investment activities are prohibited for me?

(a) You (a federal credit union) may not purchase or sell financial derivatives, such as futures, options, interest rate swaps, or forward rate agreements, except as permitted under § 701.21(i) of this chapter.

(b) You may not engage in adjusted trading or short sales.

(c) You may not purchase stripped mortgage backed securities, residual interests in CMOs/REMICs, mortgage servicing rights, commercial mortgage related securities, or small business related securities.

(d) You may not purchase a zero coupon investment with a maturity date that is more than 10 years from the settlement date.

§ 703.120 May my officials or employees accept anything of value in connection with an investment transaction?

(a) Your (a federal credit union's) officials and senior management employees, and their immediate family members, may not receive anything of value in connection with your investment transactions. This prohibition also applies to any other employee, such as an investment officer, if the employee is directly involved in investments, unless your board of directors determines that the employee's involvement does not present a conflict of interest. This prohibition does not include compensation for employees.

(b) Your officials and employees must conduct all transactions with business associates or family members that are not specifically prohibited by paragraph (a) of this section at arm's length and in your best interest.

(c) Senior management employee means your 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).

(d) Immediate family member means a spouse or other family member living in the same household.

§ 703.130 May I continue to hold investments purchased before January 1, 1998, that will be impermissible after that date?

(a) Subject to safety and soundness considerations, your (a federal credit union's) authority to hold an investment is governed by the regulations in effect when you purchased the investment. Paragraphs (b) through (d) of this section describe past regulations governing certain investments.

(b) Subject to safety and soundness considerations, you may hold a CMO/REMIC purchased:

(1) Before December 2, 1991;

(2) On or after December 2, 1991, but before July 30, 1993, if its average life does not extend or shorten by more than 6 years if interest rates rise or fall 300 basis points;

(3) On or after December 2, 1991, but before January 1, 1998, if for the sole purpose of reducing interest rate risk and:

(i) You have a monitoring and reporting system in place that provides the documentation necessary to evaluate the expected and actual performance of the investment under different interest rate scenarios;

(ii) You use the monitoring and reporting system to conduct and document an analysis that shows, before purchase, that the proposed investment will reduce your interest rate risk;

(iii) After purchase, you evaluate the investment at least quarterly to determine whether or not it actually has reduced your interest rate risk; and

(iv) You classify the investment as either trading or available-for-sale.

(c) Subject to safety and soundness considerations, and notwithstanding paragraph (b) of this section, you may hold a variable-rate CMO/REMIC purchased:

(1) On or after December 2, 1991, but before July 30, 1993, if:

(i) The interest rate is reset at least annually;

(ii) 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; and

(iii) 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; or

(2) On or after July 30, 1993, but before January 1, 1998, if:

(i) The interest rate of the instrument is reset at least annually;

(ii) The interest rate of the instrument, at the time of purchase or at a subsequent testing date, is below the contractual cap of the instrument;

(iii) The index upon which the interest rate is based is a conventional widely-used market interest rate such as the London Interbank Offered Rate (LIBOR);

(iv) 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; and

(v) The estimated change in the instrument's price is 17 percent or less, due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

(d) Subject to safety and soundness considerations, you may hold a CMO/REMIC residual, SMBS, or zero coupon security with a maturity greater than 10 years, if you purchased the investment:

(1) Before December 2, 1991; or

(2) On or after December 2, 1991, but before January 1, 1998, if for the purpose of reducing interest rate risk and you meet the requirements of paragraph (b)(3) of this section.

(e) All grandfathered investments are subject to the valuation and monitoring requirements of §§ 703.70, 703.80, and 703.90.

§ 703.140 What is the investment pilot program and how can I participate in it?

(a) Under the investment pilot program, NCUA will permit a limited number of federal credit unions to engage in investment activities prohibited by this part but permitted by statute.

(b) Except as provided in paragraph (c) of this section, before you (a federal credit union) may engage in additional activities, you must obtain written approval from

NCUA. To begin the approval process, you must submit a request to your regional director that addresses the following items:

(1) Board policies approving the activities and establishing limits on them.

(2) A complete description of the activities, with specific examples of how you will conduct them and how they will benefit you.

(3) A demonstration of how the activities will affect your financial performance, risk profile, and asset-liability management strategies.

(4) Examples of reports you will generate to monitor the activities.

(5) A projection of the associated costs of the activities, including personnel, computer, audit, etc.

(6) A description of the internal systems to measure, monitor, and report the activities, and the qualifications of the staff and/or official(s) responsible for implementing and overseeing the activities.

(7) The internal control procedures you will implement, including audit requirements.

(c) You need not obtain individual written approval to engage in investment activities prohibited by this part but permitted by statute where the activities are part of a third-party investment program that NCUA has approved under this paragraph (c). A third party seeking approval of such a program must submit a request to the Director of the Office of Examination and Insurance that addresses the following items:

(1) A complete description of the activities, with specific examples of how a credit union will conduct them and how they will benefit a credit union.

(2) A description of any risks to a credit union from participating in the program.

§ 703.150 What additional definitions apply to this part?

The following definitions apply to this part:

Adjusted trading means selling a security to a counterparty at a price above its current fair value and simultaneously purchasing or committing to purchase from the counterparty another security at a price above its current fair value.

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

Bank note means a direct, unconditional, and unsecured general obligation of a bank that ranks equally with all other senior unsecured indebtedness of the bank, except deposit liabilities and other obligations that are subject to any priorities or preferences.

Banker's acceptance means a time draft that is drawn on and accepted by a bank and that represents an irrevocable obligation of the bank.

Commercial mortgage related security means a mortgage related security where the mortgages are secured by real estate upon which is located a commercial structure.

Deposit note means an obligation of a bank that is similar to a certificate of deposit but is rated.

Embedded option means a characteristic of an investment that gives the issuer or holder the right to alter the level and timing of the cash flows of the investment. Embedded options include call and put provisions and interest rate caps and floors. Since a prepayment option in a mortgage is a type of call provision, a mortgage-backed security composed of mortgages that may be prepaid is an example of an investment with an embedded option.

Eurodollar deposit means a U.S. dollar-denominated deposit in a foreign branch of a United States depository institution.

Fair value means the price at which a security can be bought or sold in a current, arms length transaction between willing parties, other than in a forced or liquidation sale.

Industry-recognized information provider means an organization that obtains compensation by providing information to investors and receives no compensation for the purchase or sale of investments.

Investment means any security, obligation, account, deposit, or other item authorized for purchase by a federal credit union under Sections 107(7), 107(8), or 107(15) (B) or (C) of the Federal Credit Union Act, or this part, other than loans to members.

Maturity means the date the last principal amount of a security is scheduled to come due and does not mean the call date or the average life of the security.

Mortgage related security means a security as defined in Section 3(a)(41) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(41)), i.e., a privately-issued security backed by mortgages secured by real estate upon which is located a dwelling, mixed residential and commercial structure, residential manufactured home, or commercial structure.

Mortgage servicing means performing tasks to protect a mortgage investment, including collecting the installment payments, managing the escrow accounts, monitoring and dealing with delinquencies, and overseeing foreclosures and payoffs.

Net capital means the total of all undivided earnings, regular reserves, other reserves (excluding the allowance for loan losses), net income, accumulated unrealized gains (losses)

on available-for-sale securities, and secondary capital as defined in § 701.34 of this chapter.

Official means any member of a federal credit union's board of directors, credit committee, supervisory committee, or investment-related committee.

Pair-off transaction means a security purchase transaction that is closed or sold at, or prior to, the settlement date. In a pair-off, an investor commits to purchase a security, but then pairs-off the purchase with a sale of the same security prior to or on the settlement date.

Prepayment estimate means a reasonable and supportable forecast of mortgage prepayments in alternative interest rate scenarios. Broker-dealers and industry-recognized information providers are sources for these estimates. Estimates are used in tests to forecast the weighted average life, change in weighted average life, and price sensitivity of CMOs/REMICs and mortgage-backed securities.

Residual interest means the remainder cash flows from a CMO/REMIC, or other mortgage-backed security transaction, after payments due bondholders and trust administrative expenses have been satisfied.

Section 107(8) institution means an institution in which Section 107(8) of the Act authorizes you to make deposits, 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 you maintain a facility. A facility is your home office or any suboffice, including, but not necessarily limited to, a credit union service center, wire service, telephonic station, or mechanical teller station.

Security means a share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer that: (1) Either is represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer;

(2) Is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment; and

(3) Either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Settlement date means the date to which a purchaser and seller originally agree for settlement of the purchase or sale of a security.

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

Small business related security means a security as defined in Section 3(a)(53) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(53)), i.e., a security that represents ownership of one or more promissory notes or leases of personal property which evidence the obligation of a small business concern. It does not mean a security issued or guaranteed by the Small Business Administration.

Stripped mortgage-backed security (SMBS) means a security that represents either the principal-only or the interest-only portion of the cash flows of an underlying pool of mortgages or mortgage-backed securities. Some mortgage-backed securities represent essentially principal-only cash flows with nominal interest cash flows or essentially interest-only cash flows with nominal principal cash flows. These securities are considered SMBSs for the purposes of this part.

When-issued trading of securities means the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities.

Yankee dollar deposit means a deposit in a United States branch of a foreign bank licensed to do business in the state in which it is located, or a deposit in a state-chartered, foreign controlled bank.

You means a federal credit union.

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

[FR Doc. 97–15915 Filed 6–17–97; 8:45 am]
BILLNG CODE 7535–01–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 71

[Airspace Docket No. 97–AGL–6]

Modification of Class E Airspace; Spearfish, SD, Black Hills—Clyde Ice Field; Correction

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Final rule; correction.

SUMMARY: This action corrects an inadvertent omission in the legal description of a final rule that was published in the **Federal Register** on May 21, 1997 (62 FR 27690), Airspace Docket Number 97–AGL–6. The final rule modified Class E airspace at Spearfish, SD.

EFFECTIVE DATE: 0901 UTC, July 17, 1997.

FOR FURTHER INFORMATION CONTACT: Manual A. Torres, Air Traffic Division, Operations Branch, AGL–530, Federal Aviation Administration, 2300 East Devon Avenue, Des Plaines, Illinois 60018, telephone (847) 294–7568.

SUPPLEMENTARY INFORMATION:

History

Federal Register Document 97–13263, Airspace Docket No. 97–AGL–6, published on May 21, 1997 (62 FR 27690) modified the description of the Class E airspace area at Spearfish, SD, and Black Hills-Clyde Ice Field, SD. An inadvertent omission was discovered in the legal description for the Black Hills-Clyde Ice Field. This action corrects that error.

Correction to Final Rule

Accordingly, pursuant to the authority delegated to me, the legal description for the Class E airspace area at Black Hills-Clyde Ice Field, SD, as published in the **Federal Register** on May 21, 1997 (62 FR 27690), (FR Doc. 97–13263), is corrected as follows:

PART 71—[CORRECTED]

§ 71.1 [Corrected]

* * * * *

AGL SD E5—Spearfish, SD [Corrected]

On page 27690, in the Class E airspace designation for Black Hills-Clyde Ice Field incorporated by reference in Sec. 71.1, add the following immediately after AGL SD E5 Spearfish, SD [Revised]:

''Black Hills-Clyde Ice Field, SD
(Lat. 44°28′49″ N, long. 103°46′37″ W)''

* * * * *

Issued in Des Plaines, Illinois on June 3, 1997.

Maureen Woods,

Manager, Air Traffic Division.

[FR Doc. 97–16002 Filed 6–17–97; 8:45 am]
BILLING CODE 4910–13–M