Proposed Rules

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

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 703

Investment and Deposit Activities

AGENCY: National Credit Union Administration (NCUA).

ACTION: Advance notice of proposed rulemaking.

SUMMARY: NCUA is soliciting public comment on whether it should revise its rules governing federal credit union (FCU) investment authorities and practices. As part of its regulatory review process, NCUA has identified provisions that may warrant clarification or revision. NCUA is also considering permitting certain activities that are currently prohibited by its rules.

DATES: Comments must be received on or before January 24, 2002.

ADDRESSES: Direct comments to Becky Baker, Secretary of the Board. Mail or hand-deliver comments to: National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314–3428. You may fax comments to (703) 518–6319, or e-mail comments to *regcomments@NCUA.gov*. *Please send comments by one method only*.

FOR FURTHER INFORMATION CONTACT: Scott Hunt, Senior Investment Officer, Office of Investment Services at the above address or telephone (703) 518–6620; Dan Gordon, Senior Investment Officer, Office of Investment Services at the above address or telephone (703) 518–6620; Kim Iverson, Program Officer, Office of Examination and Insurance, at the above address or telephone (703) 518–6360; or Frank Kressman, Staff Attorney, Office of General Counsel, at the above address or telephone (703) 518–6540.

SUPPLEMENTARY INFORMATION:

A. Background

The NCUA has identified areas of part 703 that it is considering revising or clarifying and believes it would be helpful to receive public comment before preparing proposed changes to the rule. NCUA also welcomes comments on other issues related to part 703 not specifically addressed in this advance notice.

B. Areas for Review

As explained more fully below, NCUA seeks comment on the following issues: broker requirements, safekeeper requirements, expanded investment authorities, limitations on accounts under discretionary control of an investment advisor, investment credit ratings, borrowing repurchase agreements, variable rate investments, and purchasing options to offer equity-linked certificates of deposit.

In addition, NCUA is also seeking comment on ways to change the format of part 703 to make it more user friendly. To that end, NCUA seeks comment on whether the current ''Question and Answer'' format is beneficial. We also seek comment on whether part 703 would be easier to read if existing sections were divided into smaller sections each covering fewer topics, and whether incorporating additional topic headings would make information easier to find.

Broker Requirements

Section 703.50(a) describes the minimum criteria a broker must meet in order for an FCU to purchase and sell investments using a broker. 12 CFR 703.50(a). NCUA is considering more clearly defining these requirements to remove ambiguity and establish suitable minimum standards. NCUA is concerned that the current language may permit a broker to engage in purchasing and selling activities with an FCU without having demonstrated it possesses the skills, knowledge, and understanding to conduct investment transactions. In particular, NCUA has identified cases where brokers have engaged in deceptive practices in the sale of investments to FCUs, such as misrepresenting yields, providing misleading information about the terms of the investment, and inducing purchases of unsuitable investments. FCUs have asked NCUA to intervene and pursue remedies on their behalf.

NCUA is considering setting standards for FCUs so that any brokerage firm that transacts purchases or sales of investments with an FCU must have at least one General Securities Principal (refer to the National Association of Securities Dealers'(NASD) Manual, section 1022 (a)) registered with the NASD. Alternatively, if a depository institution transacts purchases and sales of securities with an FCU, its broker-dealer activities must be regulated by a federal or state regulatory agency. An individual broker (whether the broker works for a brokerage firm with a General Securities Principal or a depository institution where its brokerage activities are regulated by a state or federal regulatory agency) who conducts purchases or sales of investments with an FCU must be registered with the NASD as a General Securities Representative (refer to the NASD Manual, section 1032 (a)). These requirements would extend to an FCU using an introducing broker or a person who receives financial remuneration from a broker for referring an FCU to a broker to transact a purchase or sale of an investment.

NCUA would not require an FCU that uses a person or firm to purchase and sell investments to comply with the above requirements if the person or firm acts only as a certificate of deposit or share certificate finder. In this regard, a finder would only identify the institution offering the certificate of deposit or share certificate and would not take custody of funds or the investment at any time. The FCU would be required to remit payment to the financial institution directly, the account would be established in the FCU's name at the financial institution, and all principal and interest payments would be remitted directly to the FCU or the FCU's designated account.

NCUA seeks comments on whether these standards represent prudent minimum criteria for FCUs to adopt when using a broker or whether there are other standards NCUA could put in place. NCUA is interested in commenters' views on the effect these standards would have on an FCU's ability to purchase and sell securities at competitive prices.

Safekeeper Requirements

Section 703.60 states the minimum criteria for safekeeping firms FCUs may use. 12CFR 703.60. Because safekeepers that do not operate safely and scrupulously can pose a risk to FCUs, NCUA is considering clarifying these requirements to remove ambiguity and

establish suitable standards. NCUA is concerned that the current language may not fulfill its intended purpose to ensure that the safekeeper is an independent entity, either in form or in function, that protects the FCU's beneficial ownership interest in its investments. FCUs incur significant risk of loss when a safekeeping firm does not maintain independence from the broker, is not bound by prudent practices, or is not subject to sufficient supervisory oversight. Therefore, NCUA is considering requiring that a safekeeper must be either a clearing broker-dealer (i.e., a broker-dealer that clears trades from its own inventory) that is registered, regulated, and supervised by the Securities Exchange Commission, or a depository institution regulated by a state or federal depository institution regulatory agency, if it is used to hold investments for an FCU.

NCUA seeks comments on whether this standard represents prudent minimum criteria and if this standard affords FCUs protection from dealings with safekeepers that have not adopted prudent practices. NCUA is also interested in understanding how this standard may impede an FCU's ability to engage a safekeeping firm at a reasonable cost, and if there are alternative standards NCUA could establish to reduce the risk an FCU would face if it engages a safekeeper that has not adopted prudent practices.

Expanded Investment Authorities

The Federal Credit Union Act specifies the statutory investment powers for FCUs. 12 U.S.C. 1757. NCUA has adopted regulatory prohibitions against certain investments and investment activities on the basis of safety and soundness concerns. 12 CFR 703.100 and 703.110. These include variable rate instruments where the interest rate is not tied to a domestic interest rate (e.g., foreign currencies or interest rates, commodity prices, equity prices, or inflation rates), financial derivatives, short sales, mortgage-backed security interest and principal strips, residual interests in collateralized mortgage obligations, mortgage servicing rights, commercial mortgage-related securities, and zero coupon securities with remaining maturities greater than 10 years.

Section 703.140 provides for investment pilot programs permitting FCUs, on a limited basis, to engage in investment activities permitted by statute, but prohibited by part 703. 12 CFR 703.140. Currently, pilot programs have been approved such as permitting credit unions to engage in derivative activities and to purchase equity-linked options in order to offer their members share certificates where the dividend is tied to the performance of the S&P 500 equity index. In keeping with the agency's objective of providing regulatory relief while maintaining safety and soundness standards, NCUA is considering streamlining the process and expanding investment authorities.

While expanding the authorities would permit more flexibility for FCUs, these transactions bear considerable risks. NCUA is not considering granting blanket approval to all FCUs. Instead, NCUA would consider permitting an FCU to engage in an activity after it has demonstrated it has the ability and expertise to manage these investments or investment transactions in a safe and sound manner. This approach is similar to the procedures for corporate credit unions applying for expanded authorities.12 CFR part 704, Appendix B.

NCUA is considering developing minimum standards and criteria that an FCU would have to meet to gain approval through an application process. By developing these standards for credit unions, NCUA believes it may encourage credit unions to seek expanded investment authorities. These standards would be made publicly available to assist FCUs in preparing an application for approval. This differs from the current pilot program approach where a credit union submits proposed standards to NCUA for approval.

NCUA would develop standards based on the experience gained from previously approved pilot programs and standard industry practices. By way of example, a credit union that requests approval to engage in derivative authority to hedge interest rate risk may be subject to standards such as:

1. Thorough policies and procedures pertaining to derivatives and risk management.

2. Minimum reporting requirements including a pre-execution analysis of risk, monthly evaluation of hedge effectiveness, and quarterly analysis of the earnings and value impact from +/− 100, 200, and 300 basis point interest rate shocks.

3. Approved counterparties must have a rating of AAA, or equivalent, and the credit union must perform annual credit reviews.

4. Pre-execution approval of each derivative transaction by executive management.

5. Maximum notional amounts of derivatives in total and by counterparty.

6. Staff experienced with analyzing and purchasing derivatives, including requirements for on-going training.

7. An independent audit of accounting systems to ensure compliance with generally accepted accounting principles pertaining to derivatives (i.e., FAS 138).

8. Risk measurement systems capable of measuring the interest rate risk associated with derivatives (e.g., option pricing or option-adjusted spread functionality).

9. Sound internal control systems that provide for adequate segregation of duties, independence of the risk measurement and risk taking functions, and performance monitoring by executive management and the board.

These standards and criteria may differ for each type of investment dependent upon the pertinent risks.

NCUA seeks comments on whether there are investments or investment transactions identified in §§ 703.100 and 703.110 that NCUA should continue to prohibit. NCUA seeks comments on whether the proposal to develop an application and approval process to engage in the currently prohibited activities is appropriate and reasonable, and what criteria or standards NCUA should require to participate in these activities.

NCUA is also interested in commenters' views on whether certain investments or investment transactions should be permitted without having to submit an application for approval and reasons supporting such a position.

Discretionary Control of Investments

Currently, an FCU may delegate discretionary control of investments to an investment advisor so long as the aggregate amount does not exceed 100 percent of the FCU's net capital at the time of delegation. 12 CFR 703.40. NCUA is considering raising the cap to provide FCUs more flexibility in managing their investments. An investment adviser can augment an FCU's investment expertise and assist the FCU in making sound and prudent investment decisions. However, NCUA also recognizes that raising the cap can lead to safety and soundness concerns for FCUs that may abdicate responsibility for making responsible investment decisions, and fail to understand and manage the risks associated with these investments.

Should NCUA raise the cap, it may set minimum criteria FCUs must meet or require FCUs to seek approval prior to exceeding the limit. Criteria that may be considered include the FCU's financial performance, policies and procedures governing the investment advisor, an assessment of management's ability to monitor the investment advisor's

actions, and the quality of the credit union's risk management procedures.

NCUA is seeking comments whether the cap should be raised. If the cap should be raised, commenters should address whether it is appropriate for NCUA to set minimum criteria in its rules or require FCUs to seek NCUA approval prior to exceeding the current cap. For those commenters supporting minimum criteria, NCUA is interested in specific criteria that would be appropriate.

Investment Credit Ratings

Currently, an FCU must conduct a credit analysis for any investment that is not issued by or fully guaranteed as to principal and interest by the U.S. government or its agencies, enterprises, or corporations, or fully insured by the NCUA or the FederalDeposit Insurance Corporation. 12 CFR 703.40(d). FCUs are not required to express credit exposure in terms of risk to capital and, except for municipal bonds and privately issued mortgage related securities, FCUs are not required to obtain or monitor credit ratings on the issue or issuer.

FCUs are not exposed to significant credit risk if they invest in obligations of or guaranteed by the U.S. government or its agencies, or if investments are insured by federal deposit insurance or are collateralized by high quality assets. However, credit risk exposure increases as FCUs purchase certificates of deposit and deposit notes exceeding insured limits, and invest in obligations that are not insured or guaranteed, such as bank notes and sales of federal funds. Also, in 2001, the Federal NationalMortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) began issuing subordinated debt. While national credit rating organizations have assigned high quality ratings to both FNMA's and FHLMC's subordinated debt, the subordinated debt rating is lower than the senior unsecured debt rating.

NCUA is contemplating refining the requirements for evaluating credit risk, such as requiring FCUs to establish limits in terms of capital at risk or setting minimum credit criteria for all investments not fully guaranteed or insured. Many FCUs have adopted one or both practices as part of their credit analysis procedures. By establishing a regulatory requirement, NCUA would establish consistency in approach for all FCUs.

NCUA is seeking comments on whether it is reasonable to require credit risk to be expressed in terms of minimum credit ratings, risk to capital, or other standards. For those commenters supporting credit ratings, NCUA is interested in their views on acceptable minimum credit ratings and if FCUs should be permitted to define the minimum acceptable credit ratings. For those commenters in support of requiring credit exposure to be stated in terms of capital-at-risk, NCUA is seeking comments on whether NCUA or the FCU should establish the minimum capital-at-risk standards.

Borrowing Repurchase Agreements

Borrowing repurchase agreements enable an FCU to sell securities under an agreement to repurchase in order to borrow funds. Section 703.100(j)(2) prohibits an FCU from purchasing an investment with the proceeds from a borrowing repurchase agreement if the purchased investment matures after the maturity of the borrowing repurchase agreement. 12 CFR 703.100(j)(2). This restriction was initially adopted years ago to address problems where FCUs incurred significant interest rate risk by borrowing funds at short-term interest rates and investing in long-term fixed rate instruments. 44 FR 42673, July 20, 1979. Problems resulted when changes in interest rates adversely impacted earnings and capital.

NCUA has not established similar prohibitions for other borrowing arrangements. For example, if an FCU borrowed funds without engaging in a borrowing repurchase agreement, it would not be limited by the maturity limit of § 703.100(j)(2) when it invests the proceeds. Also, many FCUs have improved their understanding and management of balance sheet risk since the time the restriction was enacted, and NCUA can address safety and soundness concerns pertaining to borrowing during supervisory examinations. For these reasons, NCUA is considering removing this prohibition so that an FCU has the flexibility to invest the proceeds from a borrowing repurchase agreement at its discretion.

NCUA seeks comments on whether removing this restriction would raise any liquidity or safety and soundness concerns. If an approval process is recommended instead of removing the restriction, NCUA seeks comments on suggested standards that an FCU should meet in order to be excluded from the current restriction.

Purchase of Equity-Linked Options

While § 703.110(a) prohibits an FCU from purchasing financial derivatives, including options,12 CFR 703.110(a), NCUA has approved an investment pilot program permitting a vendor to act as an agent for FCUs to purchase equity-based options. In the pilot program, FCUs can offer share certificates where the dividend rate is tied to the performance of the S&P 500 stock index. NCUA established constraints to minimize risks, and prohibit FCUs from investing in options for their own accounts.

NCUA is considering expanding part 703 to permit FCUs to purchase equity options for the sole purpose of offering equity-linked dividends to their members. Because options bear considerable risks, NCUA would likely develop regulatory guidelines and constraints based on the experience gained from the pilot program. Based on NCUA's experience in overseeing the pilot program, these guidelines and constraints may include the following:

The FCU may purchase financial options contracts to fund the payment of dividends on member share accounts provided:

a. The option is a European option;

b. The option is based on a domestic equity index;

c. Dividends on the share accounts are derived solely from the change in the domestic equity index over a specified period;

d. Proceeds from the option are only used to fund dividends on the share accounts, and counterparty expenses and broker commissions associated with the option transaction.

e. The counterparty to the transaction is a domestic counterparty with a long-term senior unsecured debt rating from a nationally recognized statistical rating organization in one of the two highest rating categories (e.g., higher than A+ by Standard & Poors or higher than A1 by Moody's) and,

f. The program must be structured such that there can be no loss of principal to the member as a result of changes in the value of the option; and,

g. The options must be entered into pursuant to written policies and procedures pertaining to this program.

NCUA is interested in receiving comments on these and other standards an FCU should meet to engage in this activity. Also, NCUA would like to receive comments on what other indices would be appropriate for FCUs.

By the National Credit Union Administration Board on October 18, 2001.

Becky Baker,

Secretary of the Board.

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