

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: Proposed rule.

SUMMARY: The regulation governing the investment and deposit activities of natural person credit unions was last revised effective July 30, 1993. Recent events and significant changes in the investment products available in the marketplace have prompted a review of the rules regarding credit unions' investment and deposit activities. The proposed regulation clarifies a number of areas, adds restrictions on some securities which have been determined to be too risky for credit unions, broadens authority in certain areas, and requires that a credit union's staff and board of directors fully understand the potential risk characteristics of its investment options.

DATES: Comments must be received on or before March 28, 1996.

ADDRESSES: Comments should be directed to Becky Baker, Secretary of the Board. Mail or hand-deliver comments to: National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428. Fax comments to (703) 518-6319. Post comments on NCUA's electronic bulletin board by dialing (703) 518-6480. Please send comments by one method only.

FOR FURTHER INFORMATION CONTACT: David M. Marquis, Director, Office of Examination and Insurance, (703) 518-6360, or Daniel Gordon, Senior Investment Officer, (703) 518-6620, or at the above address.

SUPPLEMENTARY INFORMATION:

Background

The Federal Credit Union Act (the Act) permits federal credit unions to purchase investments that, in general,

have little default risk (e.g., securities of the U.S. Treasury, government agencies, and government-sponsored enterprises). However, rapid changes in financial markets have altered the once simple characteristics of many of these investments. The innovations have increased the potential interest rate, market, and liquidity risk of credit union investments, putting a greater burden on credit union board to understand and manage such risks.

To estimate credit union understanding of investment risks, NCUA conducted a study of approximately 300 credit unions with investments in collateralized mortgage obligations (CMOs) and Real Estate Mortgage Investment Conduits (REMICs)¹ in excess of capital. The study revealed that management in more than a third of the credit unions did not understand the risks of CMOs, that more than a quarter of the credit unions were taking unacceptable risks, and that almost half did not have acceptable asset-liability management policies. From this and other evidence, NCUA concluded that investment policies with well-defined parameters and enhanced monitoring and reporting of investment risks are needed to strengthen credit union investment risk management.

The proposed rule recognizes that credit union investment risk is largely interest rate, rather than credit (default) risk, and that a regulation designed to prohibit particular securities can fail to reflect the changing financial environment. It is based on the belief that the responsibility for making investment decisions rests with the credit union board, not NCUA, and that credit unions which assume more potential risk should meet higher standards.

The proposed rule allows a credit union to operate on one of three levels. At the most conservative level, a credit union could invest in fully-insured certificates of deposit (CDs) and shares and deposits in corporate credit unions. If limited to these investments, the credit union would not be required to approve CMO prepayment models, conduct CMO testing, develop a divestiture plan for failed CMOs, establish a trading policy, report on trading activities, prepare a monthly

report showing the fair value of each investment, calculate the impact on its portfolio of a 300 basis point parallel shift in interest rates, obtain independent valuations of each investment, or evaluate credit risk.

At the next level, a credit union could invest in potentially more risky securities in an amount up to capital and would have to comply with most of the proposed rule's policy and reporting requirements. However, it would not be required to evaluate the impact on its portfolio of a 300 basis point shift in rates.

Finally, at the most sophisticated level, a credit union investing in potentially more risky securities in an amount exceeding capital would be subject to all of the policy and reporting requirements, including calculating the impact of a 300 basis point shift in rates.

NCUA sought input from various sources during the process of revising Part 703. In six "focus group" meetings, NCUA staff met with board members, CEOs, and CFOs of credit unions of various sizes and with representatives of trade organizations. The focus groups provided valuable input on the proposed rule. As a result of the meetings, a number of changes were made, including the following: (1) Clarification was provided that the knowledge and skills of individuals making investment decisions could be documented in position descriptions instead of being set out in the investment policy; (2) The amount of information required to be provided in the monthly investment report was reduced, and provision was made for an investment or asset-liability management committee, rather than the board, to receive the full report; (3) Selling broker-dealers were permitted to provide monthly valuations of securities, and some discretionary investment authority was permitted to be delegated to an outside party; and (4) Time periods for notifying NCUA of nonconforming investments and preparing a divestiture plan were expanded.

Section 703.1 Scope

The proposed rule deletes some sentences in the Scope section, as unnecessary. In addition, it adds the provision that Part 703 does not apply to corporate credit unions. Corporate credit unions are subject to the same laws and rules as natural person credit

¹ Hereafter, in this supplementary information section, "CMO" means "CMOs and REMICs."

unions, except where those laws and rules are inconsistent with Part 704 of the NCUA regulations, 12 CFR Part 704, which specifically governs corporate credit unions. Although Part 704 contains a detailed investment section, it does not cover all aspects of corporate credit union investment activities.

Accordingly, corporate credit unions are subject to certain provisions of Part 703. This occasionally has caused confusion, however, as it is not always clear when a general law or rule is "inconsistent" with Part 704. Part 704 is currently being revised, and plans are for it to incorporate all of the applicable NCUA rules governing investment activities, even if this means duplicating portions of Part 703. Therefore, proposed Section 703.1 clarifies that Part 703 is not applicable to corporate credit unions.

Section 703.2 Definitions

NCUA is proposing to add a number of new definitions, to redefine certain already-defined terms, and to delete several definitions.

The proposed rule treats amortizing securities and securities with embedded options as investments that have the potential to present significant interest rate risk. The proposed rule does not prohibit credit unions from purchasing such investments, but it does subject a credit union holding these and other potentially risky investments to an amount greater than capital to additional measures of interest rate risk. To ensure consistency, the proposed rule provides definitions of "amortizing security" and "embedded option."

The proposed rule substitutes the term "custodial agreement" for the current regulation's "bailment for hire contract," using an almost identical definition. Based on questions that have been received, it appears that the current term may no longer widely be used.

The dollar amount of capital is used as a threshold in a number of places in the proposed rule. Therefore, a definition of capital has been provided. The allowance for loan losses is excluded from capital for the purposes of Part 703 since the balance in this account has already been allocated to specific loan losses and is not available to absorb investment losses. Capital for the purpose of determining CAMEL ratios includes the allowance for loan losses.

The proposed rule discusses securities in terms of fair value rather than market price to conform to guidance in recent statements of the Financial Accounting Standards Board (FASB). Market price is the best evidence of fair value; if a market price

is not available, fair value may be estimated based on the market price of a security with similar characteristics or on valuation techniques, including calculating the present value of estimated future cash flows using an appropriate discount rate, option pricing, or matrix pricing.

"Industry-recognized information provider" refers to an entity which provides information regarding investments, but which is not, for instance, a broker or dealer. An example of such an entity is Bloomberg, L.P., an electronic service which provides market information to subscribers, who must lease a specialized terminal to access the information. Other examples are the Wall Street Journal and other bona fide newspapers, news magazines, or business or financial publications or electronic services of general and regular circulation.

The proposed rule provides separate definitions for "investment" and "security," as the terms are not used interchangeably. "Investment" is a broad category that includes securities, deposits, and shares in credit unions.

The proposed rule simplifies the definition of "repurchase transaction," because the current definition has proved confusing. The safekeeping element of the current definition has been moved to proposed section 703.3(b)(8).

The term "counterparty" in the proposed definition of "reverse repurchase transaction" has been substituted for "purchaser" in the current definition. This reflects current market terminology.

The proposed rule deletes some sentences in the definitions of "standby commitment" and "stripped mortgage-backed security," as being unnecessarily detailed.

Definitions are provided for the following new terms used in the proposed rule: "business day," "commercial mortgage related security," "delivery versus payment," "interest rate swap," "investment characteristic," "maturity," "mortgage related security," "mortgage servicing," "municipal security," "official," "option," "pair-off transaction," "parallel shift," "prepayment model," "regular-way settlement," "securities loan," "small business related security," "street name," "total return," "U.S. government agency," "U.S. government-sponsored enterprise," and "when issued trading."

The proposed rule deletes the following definitions, as the terms are no longer used: "cash forward agreement" and "maturity date."

Section 703.3 Investment Policies and Practices

Policies

Section 703.3(a) of the proposed rule requires that the board of a federal credit union establish written investment policies consistent with the Federal Credit Union Act, the NCUA Rules and Regulations governing investments, and other applicable laws and regulations. The policy must address the purposes and objectives of the credit union's investment activities. The policy must provide a clear statement of the credit union's investment goals. 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.

The policy must also list authorized investments for the credit union, by issuer and characteristics. Characteristics of an investment include its maturity, index, cap, floor, coupon rate, coupon formula, index, call provision, and average life. For example, a policy statement may authorize investments issued or guaranteed by the U.S. Treasury, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association. The policy statement could also stipulate that no investment may have a maturity of more than 5 years, or that only investments with a fixed coupon, or those indexed, without caps, to 3-month LIBOR or the 3-month Treasury rate, will be permitted. The complexity of amortizing securities may cause the board to exclude any securities or deposits with amortizing cash flows.

The policy is also required to address interest rate risk management. A credit union's interest rate risk management policy should be related to its existing and potential cost of funds. In addition, for credit unions holding securities with potential interest rate risk, the policy may state that total return or average price cannot vary by more than a certain percentage of capital for a specific parallel shift in interest rates. The policy may state that capital should not be permitted to decline below a specific minimum level when the portfolio is subjected to a particular interest rate shock. Consistent with NCUA's intent to place more responsibility with credit union boards, the proposed rule does not specify particular limits. The policy should be tailored to a credit union's activity level and portfolio sophistication. Less complex

institutions will have a less complicated policy statement.

The board must also develop prudent concentration limits for all investments, including deposits in Section 107(8) institutions and shares and deposits in corporate credit unions. Concentrations can result from single or related issuers, lack of geographical distribution, holdings of obligations with similar characteristics, such as mortgage-backed bonds, zero coupon bonds, and bonds linked to the same index, holdings of bonds having the same trustee, and holdings of securitized loans having the same originator, packager, or guarantor. 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.

Of all securities available in recent years, credit unions have purchased more inappropriate CMOs than they have any other type of instrument. For this reason, NCUA has decided to retain specific testing requirements for CMOs. These are set forth at proposed section 703.4(e). To control the "cherry picking" that has accompanied such testing (selecting the prepayment model that will allow a particular CMO to pass the tests), the proposed rule requires potential purchasers of CMOs to identify in their investment policies the specific prepayment models that will be used in the tests. Each credit union has the flexibility to choose the prepayment models it believes are the best measures of potential risk, as long as the models are reasonable and supportable.

Liquidity risk is the risk that a credit union will have insufficient liquid assets to meet immediate cash demands. The board must assess the potential for such demands, document how it arrived at this assessment, and establish a liquidity policy that will enable it to meet the demands. A credit union may use either a simple estimate, based upon the history of prior cash flows, or a more sophisticated approach.

Credit risk is the risk of default. The board must establish a policy to manage this risk, if the credit union entertains any. While it is not impermissible to rely on credit ratings, boards should be aware that ratings may fail to timely reflect a creditor's deteriorating ability to repay its obligations. A credit union without the ability to fully evaluate credit risk may choose to limit its investments to those that are fully guaranteed or insured by the U.S. government and its agencies.

The board has the fiduciary responsibility to ensure that any person

authorized to make investment decisions has the knowledge and experience necessary to carry out this function. The proposed rule requires that the board establish criteria for such persons, either in the investment policy or by approving appropriate position descriptions.

The proposed rule requires that the policy statement indicate approved broker-dealers and limits on the amounts and types of transactions for each broker. Although the rule does not require that the credit union approve 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 details for these authorizations should be established by policy.

The proposed rule expands the requirements for credit union policies regarding the safekeeping of investments. The policy statement should include the amount and type of investments that can be safekept. The proposed rule does not require more than one safekeeping agent. Thus, all of a credit union's investments may be held by one safekeeper if this authorization is set forth in the policy statement.

Most credit unions do not engage in trading, because it requires a great deal of sophistication, market knowledge, and strong controls. Credit unions that choose to enhance their income through this method may do so, provided they have established appropriate policies and controls.

Practices

In addition to expanding the requirements for the establishment of investment policies, the proposed rule requires that credit unions follow certain practices designed to ensure that officials and employees involved with investment activities have adequate information regarding investments to make appropriate decisions to manage and control risk.

Section 703.3(b)(1) of the proposed regulation requires that a federal credit union classify its securities as held-to-

maturity, available-for-sale, or trading, in accordance with generally accepted accounting principles (GAAP) and consistent with the federal credit union's documented intent and ability regarding the security. Deposits and shares in Section 107(8) institutions and corporate credit unions are not securities and therefore are not subject to these classifications.

It is NCUA's view that a credit union should not hold an investment unless its board of directors, chief financial officer, investment committee, and investment manager understand the risks reflected in the policy statement. Proposed Section 703.3(b)(2)(a) requires that any official or employee of a federal credit union who has discretionary investment authority be able to demonstrate an understanding of the risk characteristics of investments and investment transactions under that authority. The board must recognize its responsibilities in this area. Directors must be able to fully understand the risks associated with investment products that are authorized by policy. While not a specific requirement, NCUA recommends that in credit unions with more sophisticated portfolios, one or more board members serve on the asset-liability management and/or investment committees.

The NCUA examiner may request that individuals with investment authority demonstrate their understanding of that authority. If they are not able to do so, the credit union may be required to alter its policy statement or take other appropriate action.

To ensure the board maintains control over the credit union's investment activities, proposed Section 703.3(b)(2)(B) establishes a general prohibition against delegating discretionary control of investment authority to an outside party. However, proposed Section 703.3(b)(2)(C) allows a credit union to delegate such control to an investment advisor who is registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. Registration imposes a number of requirements designed to ensure that an adviser acts in the client's best interest. Nevertheless, to ensure that the transactions being made by the adviser are consistent with the credit union's policies and objectives, a credit union must establish specific, detailed parameters and reporting procedures when delegating investment authority.

Proposed Section 703.3(b)(2)(D) limits the total of a credit union's delegation of investment authority and investment in mutual funds and other investment companies to 100 percent of capital.

Proposed Section 703.3(b)(3) requires that the board be notified when an investment has fallen outside board-approved policy parameters. For instance, if the credit union has established a minimum issuer credit rating of B, and during the course of holding an investment, the issuer's rating falls to B/C, the board must be notified and some decision regarding the investment or policy made and documented in the minutes.

Proposed Section 703.3(b)(4) addresses the reporting of interest rate risk. It requires a federal credit union to prepare a monthly report showing the characteristics of each investment in the portfolio and the net increase or decrease in the fair value or total return of each security, and the portfolio, in sufficient detail to ensure that all of the securities, and the portfolio as a whole, remain within board policy. The change in fair value of held-to-maturity securities must be included because losses from such securities reflect future losses of income. Where the credit union has an active asset-liability management or investment committee, the report may be provided to such committee, with a summary to the board. Where the credit union does not have such a committee, the full report must be provided to the board.

A credit union that chooses to keep all of its investments in CDs and corporate credit union shares and deposits would not be required to price these investments and therefore would not be subject to this reporting requirement. Only those credit unions that have marketable securities would be required to report this information. Credit unions that purchase securities with greater potential risk may have additional reporting requirements.

Section 703.3(b)(4)(ii)(C) sets forth the securities that NCUA has determined represent greater potential risk. They are: (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. If the total of securities that have any one of these characteristics is greater than capital, proposed Section 703.3(b)(4)(iii) requires that the credit union 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 this analysis is to determine the impact of potential shifts in interest rates on the credit union's future capital position. Current investment decisions must be made in the context of this

analysis. Credit unions that do not want to conduct this analysis can restrict the total of these potentially risky investments to less than capital. For purposes of this rule, adjustable rate securities with a final maturity of 3 years or more are considered securities which represent greater potential risk.

This interest rate shock test reflects a trade-off between ensuring a credit union board's full awareness of the risks of its portfolio and reducing the burden on small and medium-sized credit unions. The rule could have included long-term CDs and term investments in corporate credit unions in the list of investments that trigger the test, since such investments can present a high degree of interest rate risk. The rule also could have required a credit union holding even one of the triggering securities to subject its portfolio to a 300 basis point shock, because of the potential for greater interest rate risk. The rule also could have required more complex interest rate tests. Since financial markets do not change in parallel shifts, a 300 basis point parallel shift is inadequate to truly evaluate potential risk. More accurate tests would consider factors such as twists in the yield curve, lags, changes in volatility, the reinvestment rate of cash flows, and institutional factors affecting prepayment patterns. Finally, NCUA could have required credit unions to subject their entire balance sheets, including loans and shares, to an interest rate shock test, since testing only the investment portfolio yields an incomplete picture of the interest rate risk on a credit union's balance sheet. The NCUA Board determined, however, that more complex or additional tests would be too burdensome for small and medium-sized credit unions. However, it is NCUA's judgment that holders of large portfolios of more complex securities cannot manage interest rate risk adequately without conducting additional testing, and examiners will anticipate that additional evaluations be done.

NCUA is proposing to permit credit unions the choice of using either changes in the fair value or total return to establish risk parameters and assess return. Changes in fair value can provide an approximation of risk exposure and return. However, credit unions may prefer to calculate and report total return since it is a more comprehensive measure. Managers with more sophisticated portfolios will likely calculate total return. The method used for calculating total return should be documented for review purposes.

A credit union should always compare prices among broker-dealers

for similar securities. In some instances, the price a credit union has paid or received for a security has been significantly different from the market price because the credit union conducted transactions with only one broker, who knew that the credit union was not verifying the price with another source. Proposed Section 703.3(b)(5)(i) requires that prior to purchase or sale a credit union obtain a price quote from a second broker or from an industry-recognized information provider. The information provider can be a pricing service or simply a newspaper with a financial section. These latter sources provide only indicative prices, however, and generally are not sufficient to ensure the credit union has received the best price quote. Where a credit union wishes to purchase a security that cannot be competitively priced, it should obtain a price on a comparable security. It is understood that the prices received from broker-dealers will generally not be in writing; however, the credit union should maintain documentation of who was called, the date and time of the call, and the quoted price or spread to the relevant Treasury security.

Proposed Section 703.3(b)(5)(ii) requires a monthly review of the fair value of each security in a credit union's portfolio. This information is generally provided by broker-dealers or safekeepers. Although such information may not be as accurate as a real bid, the NCUA Board recognizes that obtaining real bids on a monthly basis is impractical and burdensome. To ensure some independent verification of these prices, however, Section 703.3(b)(5)(iii) requires that at least semiannually the credit union obtain a price on each security from another broker or an industry-recognized information provider. A credit union may eliminate the burden of valuing securities by restricting its portfolio to CDs and shares and deposits in corporate credit unions. In addition, a credit union can lessen its burden of valuing securities by restricting its portfolio to securities whose market prices are readily available.

Proposed Section 703.3(b)(6) provides that credit unions must perform credit analyses of issuing entities unless the investment is issued or fully guaranteed by the U.S. government or its agencies or enterprises or is insured by the Federal Deposit Insurance Corporation or NCUA. The NCUA Board recognizes that it is often difficult for credit unions to perform a detailed credit analysis. Therefore, the proposed rule establishes a minimum issuer rating for financial institutions of B/C (or equivalent) or

better. Credit unions should ensure that the rating is the issuer rating and not the issue rating. The issuer rating takes into consideration the entire operation, while an issue rating will take into consideration any credit supports accompanying an instrument.

Credit unions are not necessarily excused from performing their own, independent credit analyses. Credit ratings are slow to adjust to rapid changes in the financial viability of an issuer. The extent of the credit analysis necessary is dependent upon the amount of the investment in relation to the credit union's total investments and capital. An analysis should include, at a minimum, a review of ratings and financial trends, including the capital to asset ratio, earnings, and loan losses.

Credit unions should perform a credit analysis for investments above the insured amount in financial institutions that are not rated, including corporate credit unions. The NCUA Board specifically seeks comment on the issue of performing credit analyses on corporate credit unions.

NCUA has observed substantial problems with broker-dealers. While most of the decisions on the choice of a broker-dealer should be left to the credit union's board, a minimum level of analysis should be conducted prior to selection. Section 703.3(b)(7) of the proposed rule requires that, at the least, the broker-dealer be a Section 107(8) institution or registered with the Securities and Exchange Commission (SEC). There will be many unscrupulous brokers who satisfy this requirement but still should not be used by credit unions. However, the requirement will exclude some brokers who sell only CDs and are not required to register with the SEC. The proposed rule also requires that credit unions also conduct an analysis of the financial condition and reputation of the broker-dealer and sales representative.

Section 703.3(b)(8) addresses safekeeping. For control purposes, the proposed rule requires that securities be maintained independently of the broker. This is a change from the current regulation, which requires that only securities involved in repurchase transactions be held by an independent third party.

Recent years have seen some problems with the failure of some brokers, and credit unions have been required to devote substantial resources to recover securities from some safekeepers. Because of the potential that some safekeepers may not be appropriate, this section requires that the credit union review an independent audited statement for the safekeeper.

NCUA is also proposing that the purchase and sale of investments be "delivery versus payment." This method of settlement guarantees that the investment will not be paid for until it is received by the safekeeping institution.

Trading policies and practices are not specifically addressed in the current regulation. According to the latest call report data, very few credit unions engage in trading activities. Activity in this area could increase, however, and if not properly controlled, could pose a significant risk. The details, in proposed section 703.3(b)(9), are from Letter to Credit Unions No. 89, dated April 1987. NCUA has determined that, for convenience, these requirements should be included in the regulation.

Proposed Section 703.3(b)(10) requires that documentation be maintained through the examination and audit cycles. There have been instances where credit unions failed to maintain enough documentation for the examiner/auditor to properly analyze the security or determine the relationship of the investment decisions to the credit union's policies. Credit unions must maintain sufficient information to demonstrate that they have exercised prudent judgment in making investment decisions.

Section 703.4 Authorized Activities

Current Section 703.4(a) permits a credit union to contract for the purchase or sale of a security provided that the delivery of a 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. If the credit union is the purchaser, it must have written cash flow projections evidencing its ability to purchase the security. This was designed to accommodate the settlement of mortgage-backed securities. NCUA is proposing to delete these specific time frames and simply provide for a credit union to contract for the purchase or sale of a security provided that delivery of the security is by "regular-way" settlement.

The current regulation has created some problems distinguishing between regular delivery and forward commitments. The proposed regulation will 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 for that type of security. Currently, regular-

way settlement for Treasury securities is the next business day after the trade date and for agency securities and secondary market mortgage-backed securities is the third business day. For new mortgage-backed securities, regular-way settlement can be considerably longer. Under the proposed rule, where delivery of an investment extends beyond regular-way settlement, the investment will be considered an unauthorized forward commitment.

The NCUA Board notes that proposed section 703.5(c) prohibits when issued trading. This is not intended to prohibit a credit union from contracting to purchase securities in the period between the announcement of an offering and the issuance of the securities. Rather, it is designed to prohibit a credit union from contracting to purchase securities during that time and then selling those securities before settlement. NCUA specifically seeks comment on how the removal of the authority for credit unions to enter into cash forward agreements and engage in when issued trading affects the ability of credit unions to enter into certain transactions, such as dollar rolls, which have been permitted for credit unions.

Proposed section 703.4(b) simplifies the language authorizing credit union investment in repurchase transactions. Repurchase transactions can be viewed as relatively safe secured borrowing and lending. However, credit unions can incur losses on such investments if they do not exercise proper care in controlling and valuing their collateral. Repurchase transactions may be considered unsecured transactions if the purchaser does not take the appropriate steps to perfect an interest in the collateral. Credit unions should review NCUA Interpretive Ruling and Policy Statement (IRPS) 85-2 for a detailed discussion of the controls that should be followed when engaging in repurchase transactions.

Section 703.4(j) of the current regulation provides that a federal credit union may invest in a mutual fund, provided that the investment and investment transactions of the funds are legally permissible for federal credit unions under the Act and NCUA regulations. Proposed section 703.4(d) broadens this authority by permitting investment in an investment company which is registered with the Securities and Exchange Commission under the Investment Company Act of 1940. A mutual fund is the most common type of registered investment company, but credit unions have been authorized by opinion letter to invest in other types, such as money market mutual funds and

unit investment trusts. The regulatory language has been changed to clarify that these other types are permissible investments for credit unions.

The proposed rule retains the requirement that the investments and investment transactions of the investment company must be permissible for credit unions and clarifies that this limitation must be set out in the company's prospectus and/or statement of additional information. For several years, NCUA has struggled with how much detail a prospectus/statement must contain in order for a credit union to determine that the investments and transactions are permissible for credit unions. Last year, NCUA issued Letter to Credit Unions No. 155, which attempted to provide guidance in this area for investments in mutual funds.

The Letter stated that NCUA was taking the position that a credit union could invest in a mutual fund "only when the prospectus indicates that the fund's authority is *strictly* limited to investments and investment transactions that are legal for federal credit unions." The Letter provided the example of a fund authorized to purchase CMOs, without restriction; it stated that the fund would be an impermissible investment for credit unions because the prospectus/statement would have to declare that only CMOs passing the HRST could be purchased. The Letter was intended to set forth the position that statements about a fund being "a legal investment for federal credit unions" or "legal under the Federal Credit Union Act and NCUA Rules and Regulations" were insufficient. A prospectus/statement of additional information was to set forth the specific investments and investment transactions authorized for the fund, in sufficient detail that credit unions and examiners could see that fund management clearly understood the limits of credit union investment authority and that the activities of the fund were within that authority.

The Letter has led to more questions concerning the level of detail required in a prospectus, such as, for example, whether a prospectus must address the actions a fund will take if a CMO fails the stress tests upon retesting. Since it is not NCUA's intent that a mutual fund prospectus recite all of Part 703, and it is difficult to draw a line about what must be specifically included, the proposed rule provides that one method of establishing that a fund is a permissible investment for federal credit unions is for the prospectus simply to assert that the fund is "a legal investment for federal credit unions" or "legal under the Federal Credit Union

Act and NCUA Rules and Regulations." A credit union that has invested in a mutual fund should monitor the activities of the fund to determine that they do not exceed the limits of credit union authority. The NCUA Board specifically requests comments on this issue. To the extent that a provision of Letter 155 is inconsistent with this rule, that provision would be superseded by this rule.

Section 704.4(e) of the proposed rule addresses the high risk securities test (HRST) for CMOs. The most significant change is the application of the entire test to variable as well as fixed rate CMOs. A number of credit unions have been unaware of the risks associated with variable rate CMOs. They owned securities linked to lagging market indexes, frequently the 11th District Cost of Funds (COFI). The weighted average lives of these securities extended 20 years or more following the last interest rate increase, and the securities suffered substantial price deterioration. Under the proposed regulation, both variable rate and fixed rate CMOs would be subject to all three tests. However, credit unions should still be aware of the limitations of the HRST, particularly as applied to variable rate securities based on lagging indexes. When testing a variable rate CMO, the credit union must be aware that a "thumbs up" on the HRST may not mean it passes the tests imposed by this rule. The credit union must review the results of each part of the test (average life, average life sensitivity, and price sensitivity) to ensure compliance.

There has been some confusion regarding the applicability of the current regulation when a CMO has passed the HRST for one prepayment model, but failed for another. NCUA does not want to specify which of the prepayment models a credit union must use to evaluate the risks associated with the CMO. However, as discussed earlier, the proposed rule requires that the credit union board specify, in its policy statement, an approved list of prepayment models that will be used when purchasing or retesting a CMO. At the time of purchase, a CMO will be required to pass the HRST for all the prepayment models listed in the policy statement. At any subsequent retesting date, the CMO must pass the HRST for the majority of the prepayment models specified in the policy statement and used in the purchase decision.

This provides a credit union's board of directors with several options: (1) Where the policy specified the use of the median prepayment estimate alone, the subsequent failure of the HRST upon retest, using the same median,

would make the security impermissible. (2) Where the policy specified three specific prepayment models, for example, the CMO could fail the HRST for one prepayment model and still be held by the credit union. Where five prepayment models were specified, the CMO could fail two and still be held. (3) Where the policy specified the use of a median prepayment model in addition to proprietary models, the CMO would not be subject to divestiture unless it failed a majority of the prepayment models used rather than the median alone.

A majority cannot be interpreted as half of the prepayment models. If the credit union specifies only two prepayment models in its policy statement, then the CMO must pass the HRST for both prepayment models if the security is to remain in the portfolio and not be subject to the divestiture requirement of proposed Section 703.7.

Proposed Section 703.4(f) addresses federal credit union investments in corporate credit union capital shares and deposits. In a slight rewording of the current rule, it provides that such investments are permissible except where the NCUA Board has provided notice that the corporate credit union is not operating in compliance with the NCUA regulations governing corporate credit unions. This should address concerns regarding investing credit unions' knowledge of corporate compliance. The proposed rule also limits 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. Membership capital share deposits, as defined in Section 704.2 of the NCUA Rules and Regulations, 12 CFR 704.2, are currently the only type of capital shares corporate credit unions are authorized to offer. The NCUA Board specifically requests comment regarding the appropriateness of this one percent limit.

Proposed section 703.4(g) establishes minimum credit ratings for municipal bonds. Credit unions would be limited to purchasing bonds rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization. In the existing rule there is no limitation on credit quality, exposing credit unions to potentially unacceptable risk.

The prior rule was silent as to the types of indexes to which variable rate instruments could be tied. The proposed rule limits permissible indexes to those tied to domestic interest rates only. There is no correlation between a credit

union's cost of funds and, for instance, foreign currencies or equity prices.

This will prohibit credit unions from purchasing investments linked to the Standard & Poor's 500 and other equity indexes, either as speculative investments or to match against Individual Retirement Accounts (IRAs) offered to members. NCUA recognizes that this may present a hardship to credit unions who wish to offer such accounts; however, the potential risk associated with credit unions purchasing investments that are not linked to interest rates supports this restriction. NCUA considered requiring a credit union to match equity-linked investments to shares but rejected this alternative because of the difficulty of ensuring that such investments were actually matched in this manner.

Section 703.5 Prohibitions.

The proposed rule adds prohibitions against purchasing or selling option and interest rate swap contracts and engaging in pair off transactions. These activities all have been prohibited by opinion letter. The proposed rule also prohibits the purchase of stripped mortgage-backed securities and CMO residuals. Currently, credit unions are permitted to purchase these securities for hedging purposes. NCUA has found that credit unions holding these securities generally have been unable to demonstrate that they were using them as a hedge. The high risk of these securities justifies their prohibition. The Board notes, however, that a CMO with the characteristics of a stripped mortgage-backed security is permissible if it meets the CMO stress tests in this regulation. The proposed prohibition against when issued trading is discussed above, in conjunction with cash forward agreements.

The Riegle Community Development and Regulatory Improvement Act of 1994 amended the definition of "mortgage related security," as defined in Section 3(a)(41) of the Securities and Exchange Act of 1934, to include securities backed by commercial mortgages. Federal credit unions are authorized to invest in mortgage related securities pursuant to section 107(15)(B) of the Act. Thus, the Riegle Act provided statutory authority for federal credit union investment in securities backed by commercial mortgages. However, it is NCUA's view that this authority is not self-implementing, that is, it requires action of the NCUA Board to become effective. This proposed rule would clarify that credit unions are not permitted to invest in commercial mortgage related securities. The NCUA Board is declining to implement the

statutory authority at this time because the market for these securities is undeveloped, and the potential timing of cash flows from these securities is not widely disseminated.

In addition to amending the definition of mortgage related security, the Riegle Act amended the Act by adding section 107(15)(C), which provides the statutory authority for federal credit unions to invest in small business related securities as defined in Section 3(a)(53) of the Securities and Exchange Act of 1934. These are privately issued securities backed by loans to small businesses. Again, this statutory authority is not self-implementing, and the proposed rule clarifies that credit unions are not permitted to invest in these types of securities. As with commercial mortgage related securities, the market for small business related securities is undeveloped. The NCUA Board notes that this does not prohibit credit unions from purchasing investments in securities issued or guaranteed by the Small Business Administration.

The proposed rule also clarifies that credit unions may not purchase mortgage servicing rights directly, as there is no express or incidental authority for such purchase. This prohibition does not affect the right of a credit union to retain servicing rights of loans that are sold, 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 703.6 Pledging Securities

Proposed section 703.6 establishes a new section which addresses the pledging of securities. Although a reverse repurchase transaction can be characterized as a sale and repurchase of securities, it is considered a secured borrowing for purposes of the proposed rule. The proposed rule clarifies the authority of federal credit unions to participate in securities lending and subjects securities lending and collateralized borrowing to several provisions which currently apply only to reverse repurchase transactions.

A credit union engaging in reverse repurchase transactions and securities lending must ensure that it has adequately investigated the financial stability and character of any counterparty with which it deals. IRPS 85-2, discussed above in the context of repurchase transactions, sets out the controls that should be followed when engaging in reverse repurchase transactions. These controls should also be followed when lending securities.

Section 703.7 Divestiture Requirements

The NCUA Board is proposing to codify specific divestiture requirements for investments which do not meet the requirements of the proposed rule. When an investment is downgraded below the minimum credit requirements of proposed sections 703.3(b)(6)(ii) and 703.4(g), or fails the HRST, proposed Section 703.7 requires that the credit union either sell the investment or develop a plan that supports the intention to hold it. While awaiting response from the regional director to a proposed plan to hold a downgraded or failed investment, a credit union must continue to manage and monitor the investment as required by this part. NCUA retains the right to require immediate divestiture when an investment constitutes a significant threat to the continued sound operation of the credit union. To the extent that a requirement of Letter to Credit Unions No. 169 is inconsistent with this rule, it would be superseded by this rule.

Section 703.8 Prohibited Fees

The language in proposed section 703.8 is currently found at Section 703.5(l). No changes were made, but the material has been put into a separate section to ensure that it is not overlooked. It should be noted that the prohibition against committee members receiving pecuniary consideration in the making of investments means that a broker-dealer or consultant may not serve as a voting member of an investment or asset-liability management committee. It should also be noted that this provision does not exclude credit union employees involved in making investments or deposits from receiving salary for those activities.

Section 703.9 Grandfather Provisions

The NCUA Board anticipates that any final rule addressing Part 703 will be made effective 30 days after it is published in the Federal Register. The proposed rule provides that credit unions holding investments that will become impermissible when the final rule takes effect will be allowed to continue holding those investments. The proposed rule also sets out grandfather provisions that have been established in conjunction with prior regulatory changes.

Regulatory Procedures

Regulatory Flexibility Act

The NCUA Board certifies that the proposed rule, if made final, will not have a significant economic impact on

small credit unions (those under \$1 million in assets).

Such credit unions generally do not purchase potentially risky investments and hence would not be subject to the majority of the policy and reporting requirements of the proposed rule. Accordingly, a regulatory flexibility analysis is not required.

Paperwork Reduction Act

NCUA has determined that several requirements of the proposed rule constitute collections of information under the Paperwork Reduction Act. The requirements are: (1) To establish a written investment policy; (2) to perform an annual review of the written investment policy; (3) to provide notification to the federal credit union's board of directors of investments that do not fall within the guidelines of the established policy; (4) to prepare a written report of investments monthly; (5) to obtain price quotes on securities prior to purchase or sale; (6) to complete and document a monthly review of the fair value of each security; (7) to obtain a semiannual independent assessment of the fair value of securities held; (8) to complete a credit analysis of the issuing entity prior to purchasing an investment if the principal and interest is not fully guaranteed by the U.S. government, its agencies, or enterprises or is not fully insured by NCUA or the FDIC; (9) to obtain individual confirmation statements for each investment purchased or sold; (10) to obtain and reconcile a monthly statement of investments held in safekeeping; (11) to prepare a monthly written report of the fair value and/or total return at the trade date of all trading securities and purchase and sale transactions and the resulting gain or loss on an individual basis; (12) to complete and document the retesting of CMOs on a quarterly basis; (13) to provide written notice to the Regional Director of CMOs that fail the High Risk Security Test; and (14) to prepare and provide to the Regional Director a written divestiture plan if the federal credit union does not immediately sell the failed CMO.

It is NCUA's view that the time a federal credit union spends developing a responsible and reasonable policy, notifying the federal credit union's board of directors of investments that do not fall within the guidelines of the established policy, obtaining individual confirmation statements for each investment purchased or sold, and obtaining and reconciling a monthly statement of investments held in safekeeping are not burdens created by this regulation, but rather are usual and customary practices in the normal

operations of a federal credit union. The paperwork burdens created by this rule are the remaining requirements outlined above.

NCUA estimates that it should take an average of 2.5 hours to review the investment policy annually and 2 hours per month to prepare the written report of investments. Since this requirement applies to all 7,400 federal credit unions, 196,100 burden hours would be required to comply with these two requirements. NCUA estimates that 370 federal credit unions would have to comply with the requirement to report investments that fall outside board policy after purchase. It is expected that this would take 15 minutes per year, resulting in a total of 92.5 burden hours. NCUA estimates that 5,624 federal credit unions would be required to obtain price quotes prior to the purchase or sale of securities, projected to take 2 hours per year, to review the fair value of each security monthly, projected to take 12 hours per year, and to independently assess the fair value of its securities semiannually, projected to take 2 hours per year. The burden for these requirements totals 89,984 hours. NCUA estimates that 705 federal credit unions would be required to complete a credit analysis. It is estimated that this analysis would take 25 hours, resulting in a total of 17,625 burden hours. NCUA estimates that 74 federal credit unions would be required to prepare a written report of the trading account activity, an activity that is expected to take 12 hours per year, imposing a total burden of 888 hours. NCUA estimates that 1,850 federal credit unions would have to comply with the quarterly retesting of CMOs. It is projected that this requirement would take a credit union 2 hours per year to perform, making to total burden 3,700 hours. NCUA estimates that 370 federal credit unions would be required to prepare written notices and divestiture plans regarding downgraded or failed investments. It is expected that a notice and plan would take 3 hours, making a total burden of 1,110 hours. In total, the burden created by the proposed rule is 309,499.5 hours. A significant portion of the paperwork required by the proposed rule is already being completed by credit unions. It is NCUA's view that the additional requirements are necessary in order for a credit union to understand the risks presented by a substantial portion of its balance sheet.

The Paperwork Reduction Act of 1995 and regulations of the Office of Management and Budget (OMB) require that the public be provided an opportunity to comment on information collection requirements, including an

agency's estimate of the burden of the collection of information.

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 the collection of information; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) ways to minimize the burden of collection of information. Send comments to Attn: Milo Sunderhauf, OMB Reports Management Branch, New Executive Office Building, Rm. 10202, Washington, DC 20530. Comments should be postmarked by January 29, 1996.

Executive Order 12612

Executive Order 12612 requires NCUA to consider the effect of its actions on state interests. Since the proposed rule applies only to federal credit unions, it has no effect on state interests.

List of Subjects in 12 CFR Part 703

Credit unions, Investments.

By the National Credit Union Administration Board on November 16, 1995.
Becky Baker,
Secretary of the Board.

For the reasons set forth in the preamble, NCUA proposes to revise 12 CFR Part 703 to read as follows:

PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

Sec.

- 703.1 Scope.
- 703.2 Definitions.
- 703.3 Investment policies and practices.
- 703.4 Authorized activities.
- 703.5 Prohibitions.
- 703.6 Pledging securities.
- 703.7 Divestiture requirements.
- 703.8 Prohibited fees.
- 703.9 Grandfather provisions.

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

§ 703.1 Scope.

Sections 107(7), 107(8) and 107(15) of the Federal Credit Union Act ("Act"), 12 U.S.C. 1757(7), 1757(8), 1757(15), set forth those securities, deposits, and other obligations in which federal credit unions may invest. This part interprets several of the provisions of Sections 107(7), 107(8), and 107(15)(B) and (C). This part does not apply to: investments in loans to members and related activities, which are governed by §§ 701.21, 701.22, and 701.23 of this chapter; 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; investment in credit union service organizations, which is governed by § 701.27 of this chapter; investment in fixed assets, which is governed by § 701.36 of this chapter; or investments by corporate credit unions, which is governed by part 704 of this chapter.

§ 703.2 Definitions.

Adjusted trading means any method or transaction used to defer a loss whereby a federal credit union sells a security to a counterparty at a price above its current fair value and simultaneously purchases or commits to purchase from the counterparty another security at a price above its current fair value.

Amortizing security means a security where the principal is reduced by contractual payments.

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

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

Business day means a day other than a Saturday, Sunday, or federal holiday.

Capital means the total of all undivided earnings, regular reserves, other reserves (excluding the allowance for loan losses), net income, and accumulated unrealized gains (losses) on available-for-sale securities.

Collateralized mortgage obligation (CMO) means a multi-class bond issue collateralized by whole loan mortgages or mortgage-backed securities.

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

Corporate credit union means a credit union that meets the definition of "corporate credit union" contained in part 704 of this chapter.

Custodial agreement means a contract whereby a third party, for a fee, agrees to exercise ordinary care in protecting the securities held in safekeeping for its customers.

Delivery versus payment, in the context of the purchase and sale of securities, means that payment for a security occurs simultaneously with its delivery.

Embedded option means a characteristic of an investment which gives the issuer or the holder of the investment the right to change features such as rate and principal payment schedule. Embedded options include,

but are not limited to, caps, floors, calls, and prepayment provisions. These options can result in the principal and/or interest cash flows of an investment varying in response to changes in interest rates.

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

Facility means the home office of a federal credit union or any suboffice thereof, including, but not necessarily limited to, credit union service center, wire service, telephonic station, or mechanical teller station.

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.

Federal funds transaction means a transaction among depository institutions involving the transfer of immediately available funds resulting from credits to deposit balances at Federal Reserve banks or from credits to new or existing deposit balances due from a correspondent depository institution.

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

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

Index means an interest rate which is regularly reported in a publication or electronic service of national circulation.

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

Interest rate swap means a contract to exchange streams of interest payments based upon a specified dollar amount at specified dates in the future.

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.

Investment characteristic means a feature of an investment such as its maturity, index, cap, floor, coupon rate, coupon formula, index, call provision, or average life.

Maturity means the date the last principal amount of a security is scheduled to come due and shall 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 and Exchange Act of 1934, *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.

Municipal security means a security as defined in Section 107(7)(K) of the Act.

Official means any member of the board of directors, credit committee, or supervisory committee.

Option means a contract which provides the right, but not the obligation, to buy or sell a security at a fixed price on or before a specified date in the future.

Pair-off transaction means a security purchase transaction that is closed or sold at, or prior to, the settlement date.

Parallel shift means an equal basis point change at every point along a given yield curve.

Prepayment model means a reasonable and supportable forecast of mortgage prepayments in alternative interest rate scenarios. Models are available from securities broker-dealers and industry-recognized information providers. These models 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.

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

Regular-way settlement means delivery of a security from a seller to a buyer within the specified number of days established for that type of security. For example, regular-way settlement for transactions in U.S. government securities is one business day after the trade date and in agency securities is three business days after the trade date.

Repurchase transaction means a transaction in which a federal credit union agrees to purchase a security from a counterparty and to resell the same or any identical security to that counterparty at a specified future date and at a specified price.

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.

Reverse repurchase transaction means a transaction in which a federal credit union agrees to sell a security to a counterparty and to repurchase the same or any identical security from that counterparty at a specified future date and at a specified price.

Section 107(8) institution means an institution in which a federal credit union is authorized to make deposits pursuant to Section 107(8) of the Act, i.e., an institution that is insured by the Federal Deposit Insurance Corporation or is a state bank, trust company or mutual savings bank operating in accordance with the laws of a state in which the federal credit union maintains a facility.

Securities loan means a transaction in which a federal credit union agrees to lend a security to a counterparty.

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.

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

Settlement date means the date originally agreed to by a federal credit union and a vendor for settlement of the purchase or sale of a security.

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

Small business related security means a security as defined in Section 3(a)(53) of the Securities and Exchange Act of 1934, i.e., a security, rated in one of the four highest rating categories by a nationally recognized statistical rating organization, 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.

Standby commitment means a commitment to either buy or sell a security, on or before a future date, at a predetermined price. The seller of the commitment is required to either accept delivery of a security (in the case of a commitment to buy) or make delivery of a security (in the case of a commitment to sell), in either case, at the option of the buyer of the commitment.

Street name, for a security, means registered in the name of a broker-dealer. Customer-owned securities held by a safekeeper normally are registered in street name to facilitate transfer when the security is sold. The customer remains the beneficial owner of the security.

Stripped mortgage-backed security means a security that represents either the principal- or interest-only portion of the cash flows of an underlying pool of mortgages or mortgage-backed securities.

Total return means, for a specific holding period, the sum of interest and principal payments, the income earned on the reinvestment of these cash flows, and the change in fair value.

Trade date means the date a federal credit union originally agrees, orally or in writing, to purchase or sell a security.

U.S. government agency means an instrumentality of the U.S. government, including the Commodity Credit Corporation, the Export-Import Bank, the Federal Farm Credit Bank, the Farm Credit System Financial Assistance Corporation, the Federal Financing Bank, the Federal Housing Administration, the Financing Corporation, the Government National Mortgage Association, the Maritime Investment Corporation, the Resolution Funding Corporation, the Small Business Administration, the Tennessee Valley Authority, and the Veterans Administration.

U.S. government-sponsored enterprise means an entity originally established or chartered by the federal government to serve public purposes specified by the U.S. Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the U.S. government. Such enterprises include the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, and the Student Loan Marketing Association.

When issued trading 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.

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

§ 703.3 Investment policies and practices.

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

- (1) Purposes and objectives of the credit union's investment activities;
- (2) Authorized investments, by issuer and characteristics;
- (3) Interest rate risk management, if not addressed in the credit union's asset-liability management policies;
- (4) Concentration limits;
- (5) Approved CMO/REMIC prepayment models, subject to the requirements of § 703.4(e)(3);
- (6) Liquidity risk management, if not addressed in the credit union's asset-liability management policies;
- (7) Credit risk management, if applicable, including approved issuers, or criteria for issuers, and limits on the amounts that may be invested with each issuer;
- (8) Persons to whom investment authority has been delegated, the knowledge and experience required of such persons, and the extent of their authority. This requirement may be met by the board's approval of position descriptions which address the same criteria;
- (9) Approved securities broker-dealers and limits on the amounts and types of transactions to be executed with each broker-dealer. Limits to be considered should include safekeeping arrangements, repurchase transactions, securities lending and borrowing, other transactions with credit risk, and total credit risk with an individual broker-dealer;
- (10) Approved safekeeping entities and limits on the amounts and types of investments that may be safekept with each entity; and
- (11) Trading policies, if the credit union engages in trading, including persons who have purchase and sale

authority, trading account size limitations, allocation of cash flow to trading accounts, stop loss or sale provisions, dollar size limitations of specific types, quantity and maturity to be purchased, limits on the length of time an investment may be inventoried in the trading account, appropriate segregation of duties, and other internal controls.

(b) Federal credit unions must comply with the following investment practices:

(1) *Reporting.* A federal credit union must classify a security as held-to-maturity, available-for-sale, or trading, in accordance with generally accepted accounting principles (GAAP) and consistent with the federal credit union's documented intent and ability regarding the security.

(2) *Investment authority.* (i) Any official or employee of a federal credit union who has discretionary investment authority must be able to demonstrate an understanding of the risk characteristics of investments and investment transactions under that authority. Only officials, employees, and members of a federal credit union may be voting members of the credit union's investment and/or asset-liability management committees. The ultimate responsibility for supervising a federal credit union's investment activities rests with the board of directors.

(ii) Except as provided in paragraphs (b)(2)(iii) through (v) of this section, a federal credit union must retain discretionary control over the purchase and sale of investments and may not delegate such control to a person other than an official or employee of the credit union. Control is not considered delegated when a federal credit union is required to authorize a recommended purchase or sale transaction prior to its execution and the federal credit union, in practice, reviews such recommendations and authorizes such transactions.

(iii) A federal credit union may delegate discretionary control of its investment portfolio, within established parameters, to a person other than an official or employee of the credit union, 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). A federal credit union is prohibited from compensating an investment adviser on a per transaction basis or based on capital gains, capital appreciation, net income, performance relative to an index, or any other incentive basis.

(iv) The aggregate of a federal credit union's delegation of investment control, under paragraph (b)(2)(iii) of

this section, and investment in investment companies, under § 703.4(d), is limited to 100 percent of capital at time of delegation and/or purchase.

(v) When a credit union has delegated discretionary investment control, it no longer has the ability to control its own securities, and all holdings for which such control has been delegated must be reported as available-for-sale.

(3) *Investments outside board policy.* The board of directors of a federal credit union must be notified as soon as possible, but no later than the next regularly scheduled board meeting, of any investment which falls outside of board policy after purchase. Board action regarding the investment must be documented in the minutes of the board meeting.

(4) *Interest rate risk.* (i) In the management of interest rate risk, a federal credit union must use a process that is commensurate with the scope, size, and complexity of the risk assumed. Market factors and characteristics of an investment which affect risk exposures must be evaluated prior to purchase and adequately measured, monitored, and controlled while the investment is held in the portfolio.

(ii) At least monthly, a federal credit union must prepare a written report setting forth:

(A) As applicable, the characteristics of each investment in the portfolio;

(B) The net increase or decrease in the fair value or total return of each security since the date of purchase and for the last month, with summary information on the whole portfolio for the last month;

(C) The sum of the fair values of all fixed and variable rate securities that have one or more of the following characteristics:

(1) Amortizing features;

(2) Embedded options;

(3) Maturities greater than 3 years; or

(4) Contract rates that are related to more than one index or are inversely related to, or multiples of, an index.

(iii) Where the amount calculated in paragraph (b)(4)(ii)(C) of this section is greater than the federal credit union's capital, the report described in paragraph (b)(4)(ii) of this section must provide a reasonable and supportable estimate of:

(A) The potential impact on the fair value and/or total return of each security in the portfolio and the portfolio as a whole, in percentage and dollar terms, of an immediate and sustained parallel shift in market interest rates of plus and minus 300 basis points; and

(B) The potential impact on capital, in percentage and dollar terms, of the dollar value calculated in paragraph (b)(4)(iii)(A) of this section.

(iv) Where a federal credit union does not have an asset-liability management or investment committee, each member of the board of directors must receive a copy of the report described in paragraphs (b)(4)(ii) and (iii) of this section. Where a federal credit union has such a committee, each member of the committee must receive a copy of the report, and each member of the board of directors must receive a summary of the information contained therein.

(5) *Valuation of securities.* (i) Prior to purchasing or selling a security, a federal credit union must obtain and document, on the trade date, either:

(A) Price quotes for the security, or a security with substantially similar characteristics, from at least two securities broker-dealers; or

(B) A price quote on the security from an industry-recognized information provider.

(ii) At least monthly, a federal credit union must review and document the fair value of each security held in portfolio.

(iii) At least semiannually, a federal credit union must obtain and document an independent assessment of the fair value of each security held in portfolio. This may be accomplished by obtaining either:

(A) At least one timely price quote on the security, or a security with substantially similar characteristics, from a securities broker-dealer other than the one from which it was purchased; or

(B) A price quote on the security from an industry-recognized information provider.

(6) *Credit risk.* (i) A federal credit union must conduct and document a credit analysis of the issuing entity prior to purchasing an investment and must update such analysis at least semiannually as long as the investment is held in portfolio. At a minimum, this analysis should consist of a review of the investment's prospectus and, if rated, its credit rating.

(ii) If an issuer is a financial institution which is rated by a nationally recognized statistical rating organization, it must have an issuer rating of B/C (or equivalent) or higher.

(iii) The requirements of paragraphs (b)(6)(i) and (ii) of this section do not apply in the case of investments that are:

(A) Issued or fully guaranteed as to principal and interest by the U.S. government, U.S. government agencies,

or U.S. government-sponsored enterprises; or

(B) Fully insured (including accumulated interest) by the National Credit Union Administration or the Federal Deposit Insurance Corporation.

(7) *Securities broker-dealers.* (i) A federal credit union may transact business with a securities broker-dealer provided that such 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 bank whose broker-dealer activities are regulated by a federal financial institution regulatory agency.

(ii) In determining whether to transact business with a securities broker-dealer, a federal credit union must consider the following factors:

(A) The ability of the broker-dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength, liquidity, and operating results. This evidence should be gathered from current financial data, annual reports, credit reports, and other sources of financial information.

(B) The broker-dealer's general reputation for financial stability and fair and honest dealings with customers. Other depository institutions that are past or current customers of the broker-dealer should be contacted.

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

(D) The background of any broker-dealer's sales representative upon whose advice the credit union may rely to determine his or her experience or expertise.

(iii) A federal credit union must review the audited financial condition of approved broker-dealers at least annually.

(8) *Control of investments.* (i) A federal credit union's purchased investments and repurchase collateral must be in the credit union's possession, recorded as owned by the credit union through the Federal Reserve Book-Entry System, or held by a board-approved safekeeper under a written custodial agreement.

(ii) A federal credit union must obtain an individual confirmation statement for each investment purchased or sold.

(iii) A federal credit union may not leave purchased investments and repurchase collateral in safekeeping with the selling broker-dealer, except that where the broker-dealer is a bank or

corporate credit union, the investments or collateral may be safekept in a separately identifiable department or division of the bank or corporate credit union.

(iv) A credit union must receive a safekeeping receipt for each investment held in safekeeping. An investment may be held in street name, provided that the credit union and/or the safekeeper maintain documentation establishing that the credit union is the beneficial owner of the investment.

(v) A federal credit union must obtain and reconcile monthly a statement of purchased investments and repurchase collateral held in safekeeping and must review the financial condition of approved safekeepers at least annually.

(vi) All purchases and sales of investments must be delivery versus payment.

(9) *Trading.* (i) Any federal credit union engaging in trading must be able to demonstrate that it has sufficient resources, knowledge, systems, and procedures to handle the risks of such activity.

(ii) At least monthly, the board of directors or board-appointed investment committee must be provided a written report setting forth the fair value and/or total return at the trade date of all trading securities and purchase and sale transactions and the resulting gain or loss on an individual basis.

(iii) Any security purchased for trading purposes must be recorded at fair value on the trade date.

(10) *Documentation.* Documentation regarding an investment transaction must be maintained as long as the investment is held and until the documentation has been both audited and examined. At a minimum, documentation should include, where appropriate, credit ratings, bids and prices for periodic updates, a prospectus or description of the security from an industry-recognized information provider, and all the tests and reports required by the federal credit union's investment policy and this part. Documentation used in approving a broker-dealer or safekeeper must be maintained as long as the broker-dealer or safekeeper is on a federal credit union's approved list and until it has been both audited and examined.

§ 703.4 Authorized activities.

(a) *Contracting for securities.* A federal credit union may contract for the purchase or sale of a security provided that the delivery of the security is by regular-way settlement.

(b) *Repurchase transactions.* A federal credit union may enter into a repurchase transaction provided the

collateral securing the transaction is a permissible investment for federal credit unions and the transaction is priced to reflect accrued interest, the risk of the securities, and the term of the transaction.

(c) *Federal funds transactions.* A federal credit union may sell federal funds to Section 107(8) institutions and credit unions, provided that the interest or other consideration received from the financial institution is at the market rate for federal funds transactions.

(d) *Investment companies.* (1) A federal credit union may invest in an investment company, such as a mutual fund or unit investment trust, which is registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a), provided that the portfolio of such management company is restricted by its investment policy, changeable only if authorized by shareholder vote, solely to investments and investment transactions that are permissible for federal credit unions.

(2) An investment company's investment policy is established by its prospectus and any statement of additional information incorporated therein.

(3) For the purposes of this part, an investment company's portfolio is deemed to be restricted solely to investments and investment transactions that are permissible for federal credit unions when its investment policy states that the investments and investment transactions of the company are limited to those authorized for federal credit unions under the Federal Credit Union Act and National Credit Union Administration Rules, Regulations, and Interpretive Ruling and Policy Statements.

(4) The federal credit union must, periodically, obtain a summary of the portfolio of the investment company to ensure consistency with the Federal Credit Union Act and this part.

(5) The aggregate of a federal credit union's investment in investment companies, under this paragraph (d), and delegation of investment control, under § 703.3(b)(2), is limited to 100 percent of capital at time of purchase and/or delegation.

(e) *CMOs/REMICs.* (1) A federal credit union may invest in or hold a fixed or variable rate CMO/REMIC only if it meets all of the following tests:

(i) *Average life test.* The CMO/REMIC has an estimated average life of 10 years or less.

(ii) *Average life sensitivity test.* The estimated average life of the CMO/REMIC 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 estimated change in the price of the CMO/REMIC 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) The three tests contained in paragraph (e)(1) of this section shall apply at the time of purchase and on any subsequent date, based on market prices, interest rates, and estimated prepayments at the time of testing. CMOs/REMICs must be retested at least quarterly, more frequently if market or business conditions dictate.

(3) Before a federal credit union may invest in a CMO/REMIC, the board of directors must set forth, in its investment policy, the method by which the credit union will obtain the prepayment estimates necessary to conduct the tests contained in paragraph (e)(1) of this section. In its policy, the board must state whether the credit union will use either a median prepayment estimate or individual prepayment models, one of which may be the median estimate. Only one method may be selected; once selected, it is the only method that may be used when testing a CMO/REMIC. If the board elects to use individual prepayment models, it must identify specific models, with a minimum of two. If a median prepayment estimate is used, it must be obtained from an industry-recognized information provider. At purchase, the median estimate must be based on at least 5 prepayment models. At retesting, the median estimate must be based on at least 2 prepayment models. If individual prepayment models are used, estimates must be obtained from all of the prepayment models identified in the federal credit union's investment policy. One of the individual prepayment models may be the median prepayment estimate from an industry-recognized information provider. At purchase, a CMO/REMIC must pass the tests for each prepayment model used. At retesting, the CMO/REMIC must pass the tests for a majority of the prepayment models used at the time of purchase.

(f) *Corporate credit unions.* A federal credit union may purchase shares or deposits in a corporate credit union, except where the NCUA Board has provided notice that the corporate credit

union is not operating in compliance with part 704 of this chapter. A federal credit union's purchase of corporate credit union capital shares, as defined in part 704 of this chapter, is limited to one percent of the investing credit union's assets.

(g) *Municipal securities.* A federal credit union may purchase and hold a municipal security only if it has been rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization.

(h) *Variable rate investments.* The index of any variable rate investment must be tied to domestic interest rates and not, for example, to foreign currencies, foreign interest rates, or domestic or foreign commodity or equity prices. For purposes of this part, the U.S. dollar-denominated London Interbank Offered Rate (LIBOR) is considered a domestic interest rate.

(i) *Yankee dollars, eurodollars, and bankers' acceptances.* A federal credit union may invest in yankee dollar deposits in a Section 107(8) institution, in eurodollar deposits in a branch of a Section 107(8) institution, and in bankers' acceptances issued by a Section 107(8) institution.

§ 703.5 Prohibitions

A federal credit union is prohibited from:

(a) Purchasing or selling a standby commitment or an option contract, except as permitted under § 701.21(i) of this chapter;

(b) Purchasing or selling futures or interest rate swap contracts;

(c) Engaging in pair-off transactions, adjusted trading, when issued trading, or short sales;

(d) Purchasing stripped mortgage backed securities, residual interests in CMOs/REMICs, mortgage servicing rights, commercial mortgage related securities, or small business related securities; and

(e) Purchasing a zero coupon investment with a maturity date that is more than 10 years from the settlement date.

§ 703.6 Pledging securities.

(a) *Permissible activities.* A federal credit union may pledge securities through reverse repurchase transactions, securities loans, and collateralized borrowing, and receive in exchange cash, other securities, and/or a fee.

(b) *Limitations.* (1) A federal credit union may enter into a transaction described in paragraph (a) of this section provided that the transaction is priced to reflect accrued interest, the risk of the securities, and the terms of the transaction.

(2) Cash obtained in a transaction described in paragraph (a) of this section is subject to the borrowing limit specified in Section 107(9) of the Act.

(3) Any investment purchased with cash obtained in a transaction described in paragraph (a) of this section must be a permissible investment for federal credit unions and must mature no later than the maturity of the transaction.

(4) Any security received in a transaction described in paragraph (a) of this section must be a permissible investment for federal credit unions.

§ 703.7 Divestiture requirements.

(a) Any federal credit union in possession of an investment that fails a requirement of this part, either because it has been downgraded below a minimum rating by the same rating agency used when it was purchased or because it is a CMO/REMIC that does not meet one of the tests set forth at § 703.4(e) upon retesting, must, within 30 days of the date of the failure, provide written notice of the failure to the board of directors and the appropriate regional director, except that notification to the regional director is not required if the investment matures within 90 days.

(b) If the federal credit union does not sell the failed investment within 30 days of the date of the failure, it must provide to the regional director, within 60 days of the written notice, a written plan to hold the investment. The regional director, however, has the authority to require the written plan within a shorter timer period or require immediate divestiture if serious safety and soundness concerns are present. The plan must address:

(1) The investment's characteristics and risks;

(2) The process to obtain and adequately evaluate the investment's market pricing, cash flows, and risk;

(3) How the investment fits into the credit union's asset liability management strategy;

(4) The impact that either holding or selling the investment will have on the federal credit union's earnings, liquidity and capital in different interest rate environments; and

(5) The likelihood that the investment may again pass the requirements of this part.

(c) Except where serious safety and soundness concerns are present, the federal credit union is not required to sell the investment until it receives a written response to the plan described in paragraph (b) of this section from the regional director.

§ 703.8 Prohibited fees.

(a) A federal credit union's officials, senior management employees, and immediate family members of such individuals, may not receive pecuniary consideration in connection with the making of an investment by the federal credit union. The prohibition contained in this subsection also applies to any employee not otherwise covered if the employee is directly involved in investments or deposits unless the board of directors determines that the employee's involvement does not present a conflict of interest.

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

§ 703.9 Grandfather provisions.

(a) Subject to safety and soundness considerations, a federal credit union's authority to hold an investment is governed by the regulations in effect at the time of purchase. Past regulations governing certain investments are described in paragraphs (b) through (d) of this section.

(b) Subject to safety and soundness considerations, a federal credit union may hold a fixed-rate 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; or

(3) On or after December 2, 1991, but before the effective date of the final regulation, if for the purpose of reducing interest rate risk.

(c) Subject to safety and soundness considerations, a federal credit union may hold a variable-rate CMO/REMIC purchased:

(1) Before December 2, 1991;

(2) 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

(3) On or after July 30, 1993, but before the effective date of this regulation, 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; and

(iv) The estimated change in its 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, a federal credit union may hold a CMO/REMIC residual, SMBS, or zero coupon security with a maturity greater than 10 years, if the investment was purchased:

(1) Before December 2, 1991; or

(2) On or after December 2, 1991, but before the effective date of the final regulation, if for the purpose of reducing interest rate risk.

(e) All grandfathered investments are subject to the reporting and risk management requirements of § 703.3.

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DEPARTMENT OF HEALTH AND HUMAN SERVICES

Food And Drug Administration

21 CFR Part 872

[Docket No. 95N-0298]

Dental Devices; Effective Date of Requirement for Premarket Approval of Partially Fabricated Denture Kits

AGENCY: Food and Drug Administration, HHS.

ACTION: Proposed rule; opportunity to request a change in classification.

SUMMARY: The Food and Drug Administration (FDA) is proposing to require the filing of a premarket approval application (PMA) or a notice of completion of a product development protocol (PDP) for partially fabricated denture kits. The agency is also summarizing its proposed findings regarding the benefits to the public from use of the device as well as the degree of risk of illness or injury intended to be eliminated or reduced by requiring that the device have an approved PMA or a completed PDP. In addition, FDA is announcing an opportunity for interested persons to request the agency to change the classification of the device based on new information.

DATES: Written comments by February 27, 1996; requests for a change in classification by December 14, 1995. FDA intends that if a final rule based on this proposal is issued, PMA's or notices of completion of PDP's will be required to be submitted within 90 days of the effective date of the final rule.

ADDRESSES: Submit written comments or requests for a change in classification to the Dockets Management Branch (HFA-305), Food and Drug Administration, rm. 1-23, 12420 Parklawn Dr., Rockville, MD 20857.

FOR FURTHER INFORMATION CONTACT: Louis Hlavinka, Center for Devices and Radiological Health (HFZ-410), Food and Drug Administration, 9200 Corporate Blvd., Rockville, MD 20850, 301-443-8879.

SUPPLEMENTARY INFORMATION:

I. Background

Section 513 of the Federal Food, Drug, and Cosmetic Act (the act) (21 U.S.C. 360c) requires the classification of medical devices into one of three regulatory classes: Class I (general controls), class II (special controls), and class III (premarket approval). Generally, devices that were on the market before May 28, 1976, the date of enactment of the Medical Device Amendments of 1976 (the amendments) (Pub. L. 94-295), and devices marketed on or after that date that are substantially equivalent to such devices, have been classified by FDA. For the sake of convenience, this preamble refers to the devices that were on the market on or after that date as "preamendments devices."

Section 515(b)(1) of the act (21 U.S.C. 360e(b)(1)) establishes the requirement that a preamendments device that FDA has classified into class III is subject to premarket approval. A preamendments class III device may be commercially distributed without an approved PMA or notice of completion of a PDP until 90 days after FDA promulgates a final rule requiring premarket approval for the device, or 30 months after final classification of the device under section 513 of the act, whichever is later. Also, such a device is exempt from the investigational device exemption (IDE) requirements (part 812 (21 CFR part 812)) until the date stipulated by FDA in the final rule requiring the submission of a PMA application or a notice of completion of a PDP for that device. At that time, an IDE must be submitted only if a PMA has not been submitted or a PDP not completed.

Section 515(b)(2)(A) of the act provides that a proceeding to issue a final rule to require premarket approval