

# **INVESTMENT GUIDANCE PAPER FOR THE IMPLEMENTATION OF PART 703**

**MARCH 2000**

This is a working paper being made available to examiners and credit unions to assist with credit union compliance with Part 703. If you have any comments or suggestions please call the Investment hotline 1-800-755-5999.

**TO USE THIS DOCUMENT:** Part 703 language appears boxed with **section headings in BOLD.**

## §703.10

### **§703.10 What does Part 703 cover?**

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

### **§703.20 What does Part 703 not cover?**

This part 703 does not apply to:

- (a) Investment in loans to members and related activities, which is governed by §§ 701.21, 701.22, and 701.23 of this chapter;
- (b) The purchase of real estate-secured loans, pursuant to Section 107(15)(A) of the Act, which is governed by §701.23 of this chapter;
- (c) Investment in credit union service organizations, which is governed by § 701.27of this chapter;
- (d) Investment in fixed assets, which is governed by § 701.36 of this chapter;
- (e) Investment by corporate credit unions, which is governed by Part 704 of this chapter; or
- (f) Investment activity by state-chartered credit unions, except as provided in §741.3(a)(3) of this chapter.

A state-chartered credit union still must establish an Investment Valuation Reserve for non-conforming investments (e.g., some CMOs/REMICs and municipal bonds, corporate bonds and equities).

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

The board of directors must establish a written investment policy that is consistent with the Act, and other applicable laws and regulations. The investment policy must address the following:

- (a) The purpose and objectives of your investment activities.

The policy should provide a clear description of the credit union’s investment goals. It can broadly state investment objectives for levels of risk, liquidity (funding needs), and return (yield), but it must be compatible with the credit union’s needs and constraints.

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

The policy need not specify every parameter of each approved investment. However, the board should provide enough detail in its policy to limit investments to those instruments where credit union personnel understand the risk and can evaluate and manage this risk. The board of directors should determine which investments are appropriate for the credit union, not just list those which are permissible under the FCU Act.

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Below are examples of the degree of specificity of the characteristics of investments that should be contained in credit union policies. These examples represent conservative policy revisions.

- fixed rate investments issued by the US Treasury, the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal National Mortgage Association (FNMA);
- fixed rate federally insured deposits of 1 year or less;
- securities with fixed rate coupons and maturities of 3 years or less;
- variable rate securities with maturities less than 7 years indexed to Constant Maturity Treasury (CMT) yields of 1 year or less, adjusting at least annually, that have a coupon that is not a multiple of the index, and a lifetime cap at the time of purchase that is at least 300 basis points above the current coupon on the investment;
- mortgage-backed securities issued or guaranteed by GNMA, FNMA or FHLMC having a weighted average life of 3 years or less.

Instead of using statements that address the maturity or weighted average life limits, the relation of a coupon to a cap or floor or other characteristics addressing interest rate risk, a credit union could choose instead to specify directly its risk limits by including statements such as the following:

- investments must have a duration of less than 3 years and a convexity of no less than minus 0.5;
- investments must be estimated to have a price change of no more than 10 percent for a 300 basis point instantaneous, parallel shift in the yield curve.

Management can assess the potential price changes of purchased investments using a number of industry-recognized information providers (“IRIPs”). Bloomberg is the most common, but others are also acceptable.

IRIP models handle option risk differently, resulting in varying estimates of the sensitivity of an investment’s price to changes in interest rates. More sophisticated models, for example, reflect the price impact of a cap or floor before the coupon on a variable rate security reaches its cap or floor. In less sophisticated models the impact of the cap or floor only occurs when the coupon reaches the cap or floor. The Bloomberg Total Return Analysis (TRA) OAS Shock Analysis screen provides an example of the results of a sophisticated model. More sophisticated models will also estimate mortgage prepayments which reflect the impact of changes in the slope of the yield curve. The more sophisticated the measurement of risk, the wider the credit union

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can set its policy limits, since it becomes less likely that actual price behavior will exceed the values predicted by the interest rate risk model.

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

Since this rule is limited to investment activity, it only addresses interest rate risk in the investment portfolio. A credit union with an Asset-Liability Management (ALM) policy that addresses interest rate risk across the balance sheet (e.g., for shares and loans as well as investments) need not establish a separate policy that only addresses interest rate risk in the investment portfolio. However, a section of the ALM policy must still include the investment policy requirements which limit the amount of risk the credit union can take in its investment portfolio.

One example of how a credit union might set its risk limits is provided below.

Yield Curve Changes		Maximum Allowable Investment Portfolio Market Loss to Net Capital	Maximum Allowable Reduction in Net Income From The Investment Portfolio
+/- 100 bps		a%	x%
+/- 200 bps		b%	y%
+/- 300 bps		c%	z%

Once the policy limits for net capital and earnings are set, management can evaluate the price risk of its investments and provide the necessary reports to the board, comparing the results to policy constraints.

To be consistent with both Section 703.30(b) and Section 703.30(c) a board must set criteria for individual investments in addition to overall portfolio limits. Otherwise, the credit union's policy would provide the opportunity for credit union personnel to purchase securities they do not understand.

The more sophisticated credit unions with complex portfolios may set more complex policy limits e.g., not only for parallel interest rate shifts, but also for non-parallel shifts in the yield curve, changes in volatility or changes in prepayment rates (if they permit the purchase of mortgage-backed securities).

(d) How you will manage your liquidity risk.

Liquidity risk is the risk that a credit union will not have sufficient liquid assets (assets that can be quickly converted into cash with minimal loss) to meet immediate cash needs. In assessing the potential for immediate cash needs, the policy should address factors in its cash flow and/or cash budget statements such as:

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- historical and seasonal experience for member loan needs and share withdrawals;
- concentrated share relationships (e.g., large depositors);
- unfunded loan commitments;
- internal demand for funds (e.g., expenses, buildings);
- investment maturities and convertibility to cash;
- planned use of borrowings (reverse repurchase and outside lines of credit);
- planned share promotions; and
- planned loan promotions.

Credit union management often uses a laddered portfolio as a tool to manage liquidity and interest rate risk. Under this approach, investment maturities, as well as overnight funds, are laddered to provide the necessary cash flow. This approach is appropriate if the credit union can demonstrate the cash flows from a laddered portfolio will meet its liquidity needs.

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

One option is for the policy to list the specific issuers and the amount the credit union board allows to be invested with each. See Section 703.40(d) for a discussion of credit analysis. The investment officer and the investment-related committee must ensure that all investments stay within the prescribed limits.

Instead of approving specific issuers, the policy can establish the criteria for approving issuers by identifying the minimum credit standards. A credit union may choose to use one or more of the following approaches:

- financial measures of the issuer's risk and performance using call reports or other financial information;
- rating agency minimum ratings, e.g., AAA and AA only. (Ratings are most common with municipals and private issue mortgage backed pools. US government agency ratings are typically AAA.);
- ratio and peer institution analysis (e.g., Sheshunoff, Uniform Bank Performance Reports for banks, etc.).

A credit union should recognize that there can be a significant time lag between a credit deterioration and the credit downgrade.

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The policy may also include limits on the types of investments which have credit risk. In establishing limits on investments such as CDs over insured limits, fed funds, private label mortgage-backed securities, municipal securities and uninsured investments in corporate credit unions, the board should consider management's ability to adequately conduct internal credit analysis. If management is not able to conduct internal credit analysis, the board should limit such investments to an acceptable level of risk considering the amount of reserves available for losses after providing for other balance sheet reserve needs. See comments below and in Section 703.40(d) relating to deposits in corporate credit unions.

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

Examples of potential concentration risk in the investment portfolio include large dollar amounts of investments in:

- certificates of deposit (CDs) over the insured limit from one issuer (credit risk);
- fed funds lent to one bank (credit risk);
- private label mortgage-backed securities from a single issuer. Lack of geographical distribution may occur in mortgage-backed securities (credit risk);
- variable rate instruments linked to one index such as the 1-year CMT, 3-month LIBOR, or COFI (basis risk);
- mortgage-backed investments (i.e., the total of mortgage-backed pools and CMOs/REMICs), (prepayment risk);
- callable securities (option risk).

Concentrations can increase a credit union's vulnerability to credit, interest rate, and liquidity risks. The credit union's concentration limits need to be evaluated relative to its financial condition and ability to assess and adequately monitor the risks of an approved investment. A small credit union may invest all of its surplus funds in a corporate credit union as an appropriate risk management alternative to investing in securities. However, as the credit union grows it should become aware of the risk and begin to understand and monitor the factors of credit evaluation and measure the acceptable level of risk it is willing to take against available reserves.

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In situations where the board permits high concentration of credit risk, relative to net capital, the credit union must demonstrate its qualifications to evaluate these risks through well documented, in-depth, internal credit reviews. See further discussion in Section 703.40(d).

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

The policy should clearly indicate who has been granted delegated investment authority and the extent of that authority. The authority could be broad for some instruments and not for others. For example, the investment officer may be given the authority to purchase securities up to a specific dollar amount (individually or in the aggregate), if the securities have one of the following characteristics:

- a fixed rate with a maturity that does not exceed three years and pays all of the principal at maturity or;
- a variable rate linked to 3 or 6-month US LIBOR with a maturity up to 5 years with a cap at least 300 basis points above the current coupon; or
- an expected price change for a 300 basis point, instantaneous, parallel shock that does not exceed 7 percent.

Instruments with complex characteristics (defined specifically by the board -- e.g., CMOs/REMICs, securities with call provisions or step-up rates), those with greater price sensitivity, or those with amounts above authorized limits may require approval from the Chief Financial Officer (CFO), the investment committee, ALCO, or the board.

The board is responsible for ensuring that individuals with delegated investment authority are qualified to exercise that authority. This means individuals with the investment authority should be able to explain the impact of interest rate changes on the cash flows and the values of the investments where they have delegated authority. The person with the investment authority must be able to explain portfolio risks (e.g., interest rate, credit, etc.) and how the investments fit into the credit union's strategy.

There is a safety and soundness risk when an individual with investment authority fails to understand the material risks of an investment under that authority. The credit union should either reduce the individual's authority or exclude the investments from its policy.

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The credit union's investment officer should have adequate experience and skills to assess and monitor interest (market), credit, liquidity, and other risks associated with the credit union's investments. For example, if the scope of investment activities is limited to low risk investments (e.g., short-term, fixed rate, fully insured deposits in corporate credit unions, non-brokered short term fixed rate CDs that pay principal at maturity, short-term Treasury securities, or agency securities without a cap and linked to a short-term market index), the investment officer would not be expected to have extensive investment experience and skills. More would be expected if investments included, for example: (1) a large credit risk concentration; (2) complex interest rate risks involving options (e.g., caps and floors) in structured notes, mortgage-backed securities, and CMOs/REMICs; or (3) trading activities.

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

The policy should specifically list board approved broker-dealers, along with limits, if appropriate. This provision only applies if the credit union uses broker-dealers to purchase or sell investments, including CDs. Credit unions using information providers, such as rate services, do not need board approval for the information provider. See Section 703.50 for a further discussion on selecting broker-dealers.

The SEC establishes, monitors, and enforces certain minimum requirements for broker-dealers. In selecting broker-dealers the credit union may review the firm's financial statements, paying particular attention to such factors as net capital, capital in excess of minimum required capital, operating income, and level of liquid assets. These items are generally disclosed directly in the financial statements or in footnotes.

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

Using one safekeeper simplifies purchases, sales, and deliveries, and also eases monthly reconciliations.

Brokered, participation CDs present a unique safekeeping problem because the ownership record of the depositor may reside with the broker subdividing the certificate or with the broker's custodian. One way the credit union can protect its interests is to receive a copy of the public audit opinion from the safekeeper on an annual basis and appropriate information that the safekeeper is regulated and supervised by either the SEC or a federal or state depository institution regulatory agency.

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Current practices have established a multi-level system of safekeeping that facilitates delivery and settlement. For example, a regional broker would have the list of securities owned by the credit union and be considered the safekeeper by the credit union. This is permissible under the regulation, since the custodian/safekeeper is examined by the SEC. The regional broker may, in turn, safekeep the securities in nominee name (i.e., the name of the regional broker) at a national broker such as Merrill Lynch. The national broker may, in turn, hold the securities in nominee name at a bank such as Chase. In turn, Chase would hold the securities in nominee name in the book entry system of the Federal Reserve or Depository Trust Company. Section 703.60(c) indicates that a permissible safekeeper includes a separate identifiable department or division of a bank, a corporate credit union, or a broker-dealer registered with the SEC.

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

The board must establish its own policies for investments that:

- fail the board's internal investment policy (after purchase);
- fail any provision of this regulation.

At a minimum, the policy should address each of the requirements explained in Section 703.40(e) for these failed investments, including:

- notification procedures to the investment-related committee and the board;
- preparation of risk evaluation analysis to be reviewed by the investment-related committee and the board;
- recommendation whether to sell or hold the investment(s);
- subsequent monitoring procedures and reporting to be followed if the decision is made to continue to hold the investment; and
- specific intervals when a new evaluation will be made to continue to hold or sell the investment.

(k) If you engage in trading activities, how you will conduct those activities. The policy should address The persons who have purchase and sale authority;

- (1) Trading account size limitations;
- (2) Allocation of cash flow to trading accounts;
- (3) Stop loss or sale provisions;
- (4) Dollar size limitations of specific types, quantity, and maturity to be purchased;
- (5) Limits on the length of time an investment may be inventoried in the trading account; and
- (6) Internal controls, including appropriate segregation of duties.

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Policy guidelines are required when securities trading has been authorized by the credit union's board. Securities trading occurs when securities are purchased with the intent to resell, based on short-term price movements. This activity is typically characterized by a high volume of purchase and sale activity. Trading can also involve pair-off transactions and "when-issued" securities trading.

A pair-off transaction is a security purchase transaction that is closed or sold at, or prior to, the settlement date. In a pair-off, an investor commits to purchase a security but then offsets this obligation by the sale of the same security prior to or on the settlement date.

"When-issued" securities trading is the buying and selling of securities in the interim between the announcement of an offering, and the issuance and payment date of the securities. A purchaser of a "when-issued" security acquires all the risks and rewards of owning a security, and may sell the security at a profit or loss before taking initial delivery and paying for it. This trading activity most often involves upcoming US Treasury auctions. "When issued" trading must be accounted for on trade date.

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

(a) You (a federal credit union) must classify a security as hold-to-maturity, available-for-sale, or trading, in accordance with generally accepted accounting principles and consistent with your documented intent and ability regarding the security.

- Hold-to-Maturity: Securities that the credit union has the positive intent and ability to hold to maturity;
- Trading: Securities that are bought and held principally for the purpose of selling them in the short term;
- Available-for-Sale: Securities that are not hold-to-maturity or for trading.

The credit union's approach to investments in relation to the Statement of Financial Accounting Standards (SFAS) 115 should be contained in its investment policy, procedures, and reporting. For more discussion see SFAS 115.

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

Control is not delegated if the credit union is required to authorize each transaction and the credit union actually reviews and authorizes each transaction. There should be some documentation of the review, demonstrating that the individual authorizing the transaction had knowledge and understood its risk.

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Authorization occurs if the credit union approves each transaction. There should be direct communication (usually occurring via telephone or fax) between the credit union and the broker and some contemporaneous record that the authorization occurred. Documentation of the authorization may be written and/or through a recorded telephone line.

Authorization does not occur if the broker offers an investment to the credit union and is given the authority to purchase the security if the credit union does not respond within a specified time frame.

Assessment of the credit union's authorization and review procedures is an important part of the internal control review for these investment transactions. The following evidence should be available:

- a description, terms sheet, offering circular, or prospectus that adequately describes the investment and its features;
- at least two prices for the investment -- a handwritten note of the prices, the date, time, source, and the individual obtaining this information is sufficient;
- handwritten notes evaluating how the purchase fits into the portfolio, balance sheet, and/or investment policy; and
- analysis of the risk/return parameters.

For example, the credit union may compare the risk and return of a federal agency security or Treasury by evaluating their price sensitivities, durations, or convexities. This could be documented by a Bloomberg Total Return Analysis (TRA) screen, an evaluation of risk from a third party vendor, or the result of a mathematical or spreadsheet computation. Alternatively, an experienced investment officer may have made a sufficient number of transactions to know the risk of simple securities (e.g., 1-year Treasuries) without calculations. A security's duration gives a reasonable approximation of price risk for securities without options. Generally, it is more accurate for shorter term securities.

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

The board of directors and management must understand the investments purchased and sold by the advisor as well as the associated risks.

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

- Ensure the advisor is registered with the SEC under the Investment Advisors Act of 1940.

Documentation from the advisor, or preferably documents obtained independently by the credit union, should be in the file.

- Analyze the background of the advisor.

A resume can be obtained from the advisor listing experience, education, and references. Another source could be other credit unions. There should be documentation of contacts with the references to ensure the credit union is doing its homework. (See Part 703.50(b)(2) for additional information on investigating brokers.)

- Analyze data from state or federal securities regulators, including enforcement actions against the advisor or associated personnel.

Associated personnel can be any partner, officer, or director of the investment advisor; or any person performing similar functions; or any person directly or indirectly controlling or controlled by the investment advisor (including any employee of the investment advisor).

Persons associated with an investment advisor whose functions are clerical are not included in the meaning of the term. Although the regulation requires investment advisors to be registered with the SEC, not all persons offering financial advice are SEC-registered investment advisors. Further, the SEC does not require the completion of any course of study or an examination. Investment advisors that are not registered with the SEC are subject to state regulation. The credit union should conduct its own independent research before retaining an advisor. The SEC tracks disciplinary actions on registered advisors.

It may not be practicable to perform background and enforcement action checks on all associated personnel in a large firm. To require a complete and comprehensive investigation of all associated personnel in large firms would likely result in prohibitive costs and may deprive credit unions of this valuable investment resource. Investigating the background and enforcement actions on the local office, on the managing partner at that office, and on the broker or advisor with whom the credit union is conducting business should be sufficient in most cases.

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

Examples of permissible compensation include payments based on the amount of dollars being managed by the advisor or a flat fee or retainer paid to the advisor. There should be a written agreement with the advisor that includes the terms and conditions of compensation.

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

The monthly report sent by the advisor should be reviewed to assess if trading is occurring. The frequency of trades and the time securities remain in the portfolio can be used to assess if the account should be categorized as a trading account.

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

Many written agreements include benchmarks for the investments. For example, the agreement may be that the return from the delegated funds must be at least equal to the return on the 3-month Treasury security.

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

The date of the agreement should be documented and the net capital at that time should be calculated to ensure the agreement complies with this section.

The net capital limitation on delegation does not apply to the traditional broker-dealer relationship where the broker-dealer recommends a purchase and does not act until the credit union has approved the transaction. Net capital is defined as total capital less the Allowance for Loan Losses account. [Note: the preamble uses "capital" when discussing this section but "net capital" is the limitation.] If there is a material change (decline) in net capital, the credit union should reassess its delegation limits.

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A written contract is not mandated in the regulation, but the absence of a written agreement would raise safety and soundness concerns. This contract should include a termination clause (usually permitting the credit union to terminate the agreement with no more than a 30-day notice) to protect the interests of the credit union. The contract should be reviewed at least annually. It is important to note that if the credit union's net capital declines at the end of the current contract, management may be required to reduce the amount of investments managed by the advisor(s) at the renewal date (or new delegation date). In addition, the contract should include the following items, at a minimum:

- the time frame the agreement will remain in effect with any rollover provisions;
- the compensation and how the compensation will be calculated;
- the limitation on investments and transactions to those permissible under the Federal Credit Union Act and Part 703, within the policies established by the credit union and any additional restrictions that are placed on the investment advisor;
- a clause promising to provide detailed monthly reports; and
- a clause that describes how either party can terminate the agreement.

There is no restriction on the amount a credit union can invest in a mutual fund. However, the credit union should review the mutual fund's prospectus before allowing an investment advisor(s) to purchase a particular fund. This type of internal control heightens the credit union's awareness of the potential risk being taken. A mutual fund investing in long-term securities or mortgage-backed securities would have greater risk than one investing in short-term Treasuries. A mutual fund purchasing large CDs will be exposed to more credit risk than one limited to Treasuries.

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

Credit unions may use credit ratings to assess creditworthiness and manage credit risk. The date of the rating should be used to determine when it must be updated. For example, on 12/31/97, the credit union may obtain a credit rating that is dated 6/30/97. Since the data is already six months old, the credit union must update the data on 6/30/98, not 12/31/98, to comply with the annual update requirement.

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There is a difference between a credit rating for an “issue” and for the “issuer” that is important to understand. The credit rating for the issue evaluates the investment and any support that may be related to that particular investment. Whereas, the credit rating for the issuer takes the entire issuer into consideration.

The use of outside rating agencies is permissible, but a credit union should not rely solely on external sources if exposure from uninsured funds is material in relation to net capital. If a credit union does not have the ability to evaluate credit risk, it may choose to limit investments to those that are fully guaranteed or insured.

Examples of uninsured investments include federal funds, bank notes, municipal securities, repurchase transactions, mutual funds, and deposits more than \$100,000 in banks, thrifts, and corporate or other credit unions. Credit analysis is not required for mutual funds, accounts at a Federal Reserve Bank, or accounts at a Federal Home Loan Bank.

The only minimum rating restriction occurs in Section 703.100(f). It indicates a municipal security must be rated in the top four categories (e.g., investment grade) by a nationally recognized statistical rating organization. (See the table in Section 703.100(f) for the top four rating categories.)

As an example, a credit union may state in its policy that credit exposure will be limited to those investments or institutions rated in the top two categories by one or more nationally recognized statistical rating organizations, rather than listing institutions by name. Although it is not mandatory, the policy should list which nationally recognized statistical rating organizations the credit union will use. There is no guarantee that institutions or investments will be rated by any outside rating agency. If ratings are not available and the credit union makes the investment, there should be adequate internal credit analysis to support the decision to buy uninsured investments.

NCUA recognizes that a small credit union may be unable to perform a detailed credit analysis. For a small credit union, investing funds in corporate credit unions may be an appropriate risk management alternative to investing in securities. However, NCUA expects a larger credit union to perform a credit analysis whenever there is credit risk. The uninsured portion of an investment in any insured institution presents such risk. NCUA supervision of corporate credit unions does not serve as a guarantee of the investment products offered by corporates, and does not ensure against potential loss.

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A credit union should review an institution's income, capital, and financial trends. In addition, for corporate credit unions, a credit union should review the corporate's operating level according to Section 704.8 and be aware of its exposure to a 300 basis point shift in interest rates. Credit unions should receive and review this information no less frequently than annually. The extent of this review should be documented. The credit analysis of other institutions where the credit union holds uninsured funds should include a review of capital, ratings (if available), financial trends, earnings, and loan losses.

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

The policy should list the steps the credit union will follow if an investment falls outside policy or regulation (a requirement of Section 703.30(j)). For example, board notification may extend to notification of the investment-related committee, e.g., ALCO. This committee may have to generate reports to assess the impact on earnings and capital from the investment. The analysis used to determine what action will be taken must be consistently applied and address safety and soundness concerns.

Many policies are more restrictive than the regulation. The regional director does not have to be notified if an investment falls outside a credit union's policy unless it also fails a requirement of the regulation.

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

- Bids and prices at purchase and sale and for periodic updates.

The pricing must be reasonable and supportable. The bid or ask price on the day of the transaction is available from another broker-dealer. The documentation will likely be a handwritten note only, with the credit union staff indicating the price, time, broker and the individual obtaining the information on the note. This is acceptable, since broker-dealers who do not make the transaction usually do not provide hard copy documentation. An indicative bid or ask price may also be available from Bloomberg or other pricing services. If a credit union utilizes an advisor the advisor must obtain two prices and document them for the credit union. For example, an "ALLQ" Bloomberg screen is also acceptable documentation.

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The price from the previous day may be obtained from the Wall Street Journal, USA Today, New York Times, a local newspaper, etc. Prices from these sources are acceptable as indicative of the price for the purchase or sale. A price for a specific date in the past may be obtained from an industry-recognized source such as Bloomberg, the safekeeper, or some other independent source.

- Relevant disclosure documents or a description of the security from an industry-recognized information provider.

Typical sources include:

1. a Bloomberg description page (DES);
2. an offering circular with terms and conditions announcing a new issue; and
3. a prospectus.

- Financial data, tests, and reports required by policy and this regulation.

Examples include: credit ratings, Bloomberg TRA Shock Analysis, CMO high risk security tests, investment-related committee reports, and quarterly shock tests as required by this regulation.

If an investment is purchased and sold between examinations, or if it is purchased and then matures between examinations, documentation must be retained so that the transaction can be audited and examined.

**§703.50 What rules govern credit union dealings with entities used to purchase and sell investments (“broker-dealers”)?**

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

Documentation of SEC registration should be part of the information the credit union reviews when deciding to place the broker-dealer on its approved list. This information should be in the file for the broker-dealer.

Some credit unions purchase CDs through entities called deposit brokers. Use of deposit brokers that are not SEC registered is prohibited if the transaction involves the credit union sending funds to the deposit broker. However, if a credit union only uses a non-SEC-registered deposit broker as a “finder,” and deals directly with the issuing institution in conducting the transaction, there is no violation of the regulation. A credit

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union would be deemed to deal directly with the issuing institution if it sends the funds directly to the issuing institution and maintains a deposit, in the credit union's name, at the issuing institution. A finder does not handle the credit union's money and is not part of the transaction. Finders merely locate investments and recommend purchases to a credit union. They do not act as agent or principal in the transaction.

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

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

Background includes:

- education (college, training);
- experience (work history); and
- references (list of clients).

Background information is usually provided in the form of a resume and a list of references. The credit union should contact references to determine if the reference uses the sales representative the way the credit union will use the sales representative. The credit union should also inquire about the reference's level of satisfaction with the representative and the broker-dealer.

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

- The North American Securities Administrators Association (NASAA)

The credit union can call 202-737-0900 for the name and telephone number of its state securities regulator. This information is also posted on NASD's website: <http://www.nasdr.com> The credit union should call the state securities regulator for the history of state disciplinary actions against the registered broker-dealer firm and individual representative.

- The National Association of Securities Dealers (NASD)

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The NASD's toll free number is 1-800-289-9999. Their website is <http://www.nasdr.com>. To access the disciplinary history select "About Your Broker", then "On-line Request Form." The Central Registration Depository is maintained by state regulators.

The information may take the form of a list of all disclosable information about the broker-dealer and/or the representative. The lists should be maintained in the file for each broker-dealer. This requirement may be fulfilled by the investment manager, the ALCO, the supervisory committee, or other personnel.

The following is a summary of NASD disclosable and non-disclosable information available to those requesting broker-dealer background data:

NASD Disclosable Information:

censures	criminal conviction	bars
fines	criminal indictment	expulsions
C&D orders	dismissed complaints	injunctions
registration denial	pending NASD or NYSE actions	other self-office decisions

NASD Non-disclosable Information:

customer complaints	SIPC liquidations	termination for cause
personal bankruptcy	in-house disciplinary actions	liens cause
letters of admonishment by public customers	pending arbitration	discrimination complaints and decisions

The review conducted by the board for each approved broker-dealer must be maintained for as long as the broker-dealer is approved, and until it has been examined by NCUA. This includes the initial review that is conducted as well as the annual updates. The review must include each of the factors explained above.

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

An affiliate could be a company that owns a broker-dealer firm, is owned by the broker-dealer firm, or is under common ownership with the broker-dealer firm. A counterparty does not mean a broker-dealer when the broker-dealer is acting as agent (i.e., arranging for the purchase or sale of the security) for the credit union.

**§703.50(b)(3)**

**§703.50(b)(3)**

In addition to financial analysis, the retained documentation should include anything used to investigate the broker if it is acting as a counterparty. The SEC establishes, monitors, and enforces certain minimum requirements for broker-dealers. In selecting broker-dealers and advisors the credit union should review the firm's financial statements, paying particular attention to such factors as net capital, net capital in excess of minimum capital requirements, operating income, and level of liquid assets. These items are generally disclosed directly in the firm's financial statements or in footnotes.

The review conducted by the board for each approved broker-dealer must be maintained for as long as the broker-dealer is approved. Once the approved broker-dealer has been removed from the approved list, the review must be maintained until after the next NCUA examination. If a review is comprehensive, prior annual updates need not be retained. The review must include each of the factors explained above.

**§703.60 What rules govern the safekeeping of investments?**

(a) Your (a federal credit union's) purchased investments and repurchase collateral must be in your possession,

Investments that may be in the credit union's possession are limited since most securities are in book-entry form. A credit union may have a physical GNMA certificate or, more likely, a CD, in physical form. If a credit union buys a piece of a master CD, it will not have the physical CD in its possession. It would likely be safekept by the broker, or its designated safekeeper/custodian, who must then be a board approved custodian.

recorded as owned by you through the Federal Reserve Book-Entry System; or

The investments and repurchase collateral may also be recorded through the Treasury Direct Program. The credit union must have an account statement for securities held in the Federal Reserve Book-Entry (or Treasury Direct) System showing the securities are in the credit union's name.

held by a board-approved safekeeper under a written custodial agreement. A custodial agreement is a contract in which a third party agrees to exercise ordinary care in protecting the securities held in safekeeping for its customers.

The credit union must have a custodian agreement with its safekeeper which is usually its broker, corporate credit union, or commercial bank. When brokers are involved, the custodian agreement is typically part of the account agreement. The credit union should have this custodial agreement in the file. It may be a separate document or it can be a part of the account agreement. The agreement should include the terms "ordinary, due, or reasonable" care. Typically, these terms are used interchangeably.

**§703.60(a)**

#### §703.60(a)

- In contrast, the agreement may state that the safekeeper can only be held liable for ‘gross negligence or willful misconduct.’ This level of care is less than ordinary care and does not comply with this regulation. If the agreement requires ordinary care, but then limits liability to gross negligence, the agreement does not comply with this requirement.
- Investments may be held in street or nominee name (endorsed in blank or in favor of a broker-dealer) as long as the credit union and the safekeeper maintains documentation showing the credit union as the true owner of the investment. If this is the arrangement it is consistent with the regulation. A monthly account statement from the safekeeper and a purchase confirmation are adequate documentation of ownership.

Current practices have established a multi-level system of safekeeping that facilitates delivery and settlement. An example may help to clarify. A regional broker would have the list of securities owned by the credit union and be considered the safekeeper by the credit union. This is permissible under the regulation since the custodian/safekeeper dealer is examined by the SEC. The regional broker may, in turn, safekeep the securities in nominee name (i.e., the name of the regional broker) at a national broker such as Merrill Lynch. The national broker may, in turn, hold the securities in nominee name at a bank such as Chase. In turn, Chase would hold the securities in nominee name through the Book Entry System of the Federal Reserve. This example represents a typical safekeeping arrangement and is permissible under the regulation.

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

Every investment file should contain the purchase or sale confirmation. The confirmation should list the credit union as the owner and show the:

- type of investment (e.g., issuer, guarantor);
- trade and settlement dates;
- amount of the security bought/sold;
- price paid;
- accrued interest purchased, if applicable; and
- coupon rate or formula.

(c) Any safekeeper you use must be regulated and supervised by either the Securities and Exchange Commission or a federal or state depository institution regulatory agency.

#### §703.60(c)

### §703.60(c)

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

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

The credit union should verify that the securities on the safekeeping statement agree with its general ledger and subsidiary records.

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

For example, a credit union's funds would not be released (i.e., debited from its account) until the security purchased is properly delivered by the seller on the other side of a delivery versus payment (DVP) transaction. DVP typically occurs and examiners can assume a transaction was settled DVP unless there is evidence to the contrary.

In the Federal Reserve's payment system funds are not released until both the purchaser and seller of the securities have confirmed the transaction. Then, the securities and funds transfer occurs simultaneously. For example, the selling broker's computer (e.g., Merrill Lynch) would inform the Fed's computer that it has purchased a security from another broker (e.g., Goldman). The Fed, after receiving the information from Merrill Lynch's computer, transfers funds to Merrill Lynch and simultaneously informs the Goldman computer and transfers the securities to Goldman. If Goldman's computer was not expecting the transaction, the entire transaction is reversed. All of this occurs in a millisecond. Merrill Lynch and Goldman will ensure the accounts of their customers are properly adjusted. If a broker is selling from its inventory, the securities owned by the credit union are segregated from the firm's assets. For the purposes of the regulation this too represents DVP. The SEC, in its examination of broker-dealers, ensures that the systems are in place for this transaction to occur properly.

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

The regulation makes an important distinction between a "security" and an "investment." The word "investment" is the broader term. NCUA uses the GAAP definition of a security (e.g., marketable instruments such as Treasuries, agencies, mortgage-back securities, and some jumbo CDs). An investment includes securities plus deposits and

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shares in depository institutions that are not subject to SFAS 115. Examples of non-security investments include ordinary CDs, fed funds, bank and corporate credit union shares and deposits, and certain jumbo CDs.

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

The reports are typically found in the board, ALCO, or investment committee minutes. The report should include the book value of these individual investments as well as the total book value of all these investments.

(1) Embedded options.

Characteristics of an investment that give the issuer or holder the right to alter the level and timing of cash flows of the investment. Embedded options include call and put provisions as well as interest rate caps and floors. The Amortizing Certificate Program offered by corporate credit unions and similar CDs offered by commercial banks are examples of such investments.

(2) Remaining maturities greater than 3 years; or

For purposes of this section of the regulation the governing maturity is the final maturity date regardless of its possible repricing features, weighted average life or duration.

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

Some formula examples of complex coupon formulas would be:

- 10-Year Constant Maturity Treasury (CMT) minus 3-Month US LIBOR plus 4 percent
- 3 times the 6-Month US LIBOR minus 12 percent;
- 0.5 times 3-Month US LIBOR plus 3 percent.

However, a single index (e.g., LIBOR, 1-year CMT, COFI) plus or minus a margin is not a complex coupon formula. For example, an instrument that pays “US LIBOR plus 50 basis points” is not considered a complex coupon formula investment. In addition, one times an index would not be considered a multiple.

**§703.70(a)(3)**

**§703.70(a)(3)**

It is difficult to model complex formula investments. If the credit union's policies permit these instruments, management must be able to explain the nature of the instrument and its risks. Management must also be able to provide the rationale for the use of these instruments.

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

Whether a share or deposit is a security must be determined by the credit union.

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

The full report should include:

- the issuer of each investment;
- individual and total dollar values; and
- a brief description of each investment's characteristics.

The summary should, at a minimum, provide the total dollar value of the investments listed in the report.

**§703.80 What must the credit union do to value its securities?**

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

- (1) Price quotations on the security from at least two broker-dealers; or
- (2) A price quotation on the security from an industry-recognized information provider (IRIP).

If the credit union uses an advisor, the advisor is required to obtain two prices and make them available to the credit union. The credit union is not required to obtain another price from a third party. The Wall Street Journal is an acceptable IRIP, as are other newspapers.

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

It is important for the investment-related committee and board to know what has happened to the value of all securities regardless of whether the securities are classified as held-to-maturity or available-for-sale, and to relate this to its policy limits. A credit union should ensure the values received from a safekeeper are market prices and not some other default price such as 100 (par value) for those instruments that are difficult to price. Rarely will the market price of a security be exactly par.

**§703.80(b)**



**§703.80(c)**

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

The Supervisory Committee or its auditor must verify the prices received from broker-dealers or safekeepers whether the securities are classified as assets held-to-maturity, available for sale, or for trading. Assessing the reliability of the monthly price quotations can be done using sampling techniques.

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

Documentation should indicate what was used to determine a substantially similar security. These may include: the security's rating, issuer, remaining maturity, cash flow frequency, embedded options, and coupon (fixed versus variable). For example, prices are not available for all GNMA pools, but many pools have substantially similar characteristics. The price for the similar GNMA pool may be substituted. Seeking broker-dealer assistance in identifying a similar security is one way credit union staff can comply with this requirement.

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

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

This report should be included in the board, ALCO, or investment committee minutes. The dollar change in fair value for each security must be disclosed. To address amortizing securities (securities that experience periodic principal paydowns) and amortization's of premiums and discounts, the credit union should report the difference in value from one month to the next and, if material, footnote how much of the difference was due to the change in amortized cost.

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

(1) Embedded options (see Section 703.150 Definitions).

**§703.90(b)**

## §703.90(b)

Characteristics of an investment that give the issuer or holder the right to alter the level and timing of cash flows of the investment. Embedded options include call and put provisions as well as interest rate caps and floors. They also include investments where the principal cash flow will change based upon interest rates: Mortgage-backed securities and CMOs/REMICs have embedded options. Embedded options will be disclosed on the security description screens from IRIPs and in the prospectus.

(2) Remaining maturities greater than 3 years; or

For this test the instrument's final maturity date is used regardless of repricing features, call dates, weighted average life or duration. If the final maturity date is longer than 3 years from the reporting date, the security meets this category.

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

Some formula examples would be:

- 10-Year Constant Maturity Treasury (CMT) minus 3-Month US LIBOR plus 4 percent;
- 3 times the 6-Month US LIBOR minus 12 percent; or
- 0.5 times 3-Month US LIBOR plus 3 percent.

However, a single index without any embedded options (e.g., US LIBOR, 1-year CMT, COFI) plus or minus a margin is not a complex coupon formula. For example, an instrument that pays "US LIBOR plus 50 basis points" is not considered a complex coupon formula investment. In addition, one times an index would not be considered a multiple.

It is difficult to model complex coupon formula securities. If the credit union's policies permit such instruments, management must be able to explain the nature of the instrument and its risks, and how the risk will be measured and limited. If the credit union triggers the testing requirements of Section 703.90(c) the credit union must determine the impact on fair value of a change in interest rates. Management must also be able to provide the rationale for the use of these instruments.

(c) Where the amount calculated in paragraph (b) of this section is greater than net capital (See Definitions Section 703.150) the report described in that paragraph must provide a reasonable and supportable estimate of the potential impact, in percentage and dollar terms, of an immediate and sustained parallel shift in market interest rates of plus and minus 300 basis points on:

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- |   |
|---|
| <ol style="list-style-type: none"><li>1. The fair value of each security in the entire portfolio;</li><li>2. The fair value of the portfolio as a whole; and</li><li>3. Your net capital.</li></ol> |
|---|

Several options are available for obtaining this information.

1. The Bloomberg TRA screen in the “O” (OAS) mode makes this calculation for many securities, including mortgage-backed bonds. The term “Shock Analysis” will appear on the top of the screen and the settlement date and the horizon date will be the same. For CMOs/REMICs with fixed coupons, the Bloomberg HRST screen can be used to determine the price change. For variable rate CMOs/REMICs, the Bloomberg FSPM provides a better estimate of the potential price change. The results of price shocks from other third parties (e.g., CMS Bond Edge, Barra (GAT), etc.) are also acceptable.

To obtain reasonable estimates, the model must have some method to value the embedded options, if the securities have embedded options. The model is inferior if the cap or floor only has an effect on the price of the security if the interest rate reaches its cap or floor. These options should have a price impact considerably before the cap or floor is reached. For mortgage-backed securities, the model must make a reasonable and supportable estimate of the change in prepayment speeds for a change in interest rates.

2. For securities without embedded options and maturities in excess of 3 years, calculations of risk can be made using a standard spreadsheet program or a calculator, or using a more sophisticated system. A reasonable and supportable estimate for a fixed coupon, fixed maturity Treasury could be a present value calculation from a spreadsheet program using the appropriate interest rate shocks. The discount rate used should be consistent with market rates of return for Treasuries with the same remaining maturity. Multiplying the effective duration of the instrument by the appropriate interest rate shock, although not as accurate, is also acceptable unless these securities represent a substantial part of the portfolio. If they are a substantial part, more accuracy should be required.

Many vendors offer shock test analysis to meet the requirements of the regulation. If the credit union has a potential vulnerability to interest rate changes, its tests of the rate sensitivity of the investment portfolio must be more sophisticated. Vulnerability can be evaluated by the amount of rate sensitive assets and liabilities in relation to capital. Factors which would indicate potential vulnerability include the amount of holdings in:

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- mortgage loans and/or mortgage securities, including CMOs/REMICs, or amortizing securities that have cash flow patterns that mimic the pattern of mortgage cash flows (e.g., index amortizing notes);
- variable rate securities linked to only one short-term index (e.g., 3-month US LIBOR, 3-month or 6-month CMT) where the cap is less than 300 basis points above the current level of the index, or where a call would occur less than 300 basis points below the current level of the index;
- securities linked to longer indexes (e.g., CMTs of 3 years or more);
- securities linked to administered non-money market rates (e.g., Prime, COFI); and
- securities with unusual coupons (e.g., dual indexes, inverse floaters, range floaters, and variable rate securities linked to the multiple of an index).

The credit union should ensure that the risk management process is commensurate with the size, scope, and complexity of the institution's holdings.

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

**§703.100 What investments and investment activities are permissible for the credit union?**

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

In the secondary market, the typical regular-way delivery for a Treasury security is next business day; for agency securities and secondary market mortgage-backed securities and CMOs, it is 3 business days. Regular-way settlement for new issues of mortgages will be longer

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

(c) You may purchase shares or deposits in a corporate credit union, except where the NCUA Board has notified you that the corporate credit union is not operating in compliance with Part 704 of this chapter.

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If a corporate is not operating in compliance with Part 704, NCUA will inform both the credit union community and examiner staff.

The aggregate purchase of member paid-in capital and membership capital in one corporate credit union is limited to one percent of the investor's assets.

The limit does not apply to regular shares or deposits in corporate credit unions; it applies only to capital shares, which can come in two forms: membership capital and member paid-in capital. A credit union is limited to investing a total of 1 percent of its assets, all in membership capital, all in member paid-in capital, or divided between them, in each corporate credit union in which it invests.

A credit union must fully understand the risks associated with paid-in and membership capital before making such investments. An investing credit union must be aware that its funds are at risk and that it may not have access to them for 20 years, in the case of paid-in capital, and 3 years, in the case of membership capital.

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

Mutual funds (including NIFCU\$ and GSP) and certain sweep accounts are investments in collective investment funds. The Statement of Additional Information may contain the fund's restrictions. It is legally part of the prospectus, so it is sufficient if the restrictions are described in this document. In the absence of this statement, the prospectus should be reviewed to determine that the fund is a permissible investment. If the credit union does not have the prospectus, it must obtain one.

### §703.100(d) cont'd

For the purposes of this part, the following definitions apply:

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

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

Common trust funds such as NIFCU\$ and the Government Securities Program (GSP) would be examples of collective investment funds.

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**§703.100(e)**

(e) You may invest in fixed or variable rate CMOs/REMICs.

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

NRSROs: Moody's, Thomson's BankWatch, IBCA, S&P, Fitch, and Duff & Phelps

Rating Category	S&P	Moody's	Fitch	Duff & Phelps	Thomson's BankWatch	IBCA
First	AAA	Aaa	AAA	AAA	AAA	AAA
Second	AA	Aa	AA	AA	AA	AA
Third	A	A	A	A	A	A
Fourth	BBB	Baa	BBB	BBB	BBB	BBB

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

Information is available from IRIPs. Other possible sources for the money market rates are the Wall Street Journal, the New York Times, or other daily newspapers.

(h) You may invest in the following instruments issued by a Section 107(8) institution or branch: (See definitions for all the following in §703.150.)

- Yankee dollar deposits;
- Eurodollar deposits;
- Banker's acceptances;
- Deposit notes; and
- Bank notes with original weighted average maturities of less than five years.

Deposit notes are insured up to \$100,000. Bank notes are not insured. Therefore, management should look at the offering circular to determine the degree of credit risk. Bank notes issued by a bank holding company are impermissible for federal credit unions. As an example: Advanta National Bank is owned by Advanta Corporation (a holding company). Bank notes issued by Advanta Corporation are impermissible investments for federal credit unions.

**§703.100(h)**

**§703.100(i)**

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

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

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

There should be a daily market value report indicating the value of the collateral held for the repurchase transaction. The value should be tested on a sample basis by the credit union to ensure accuracy. The value of the collateral should exceed the amount of the "loan." For Treasury securities, the typical amount is 102 percent of the "loan." For other collateral, the percentage should be more than 102 percent. The amount will depend upon the potential price risk in the securities.

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

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

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

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

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

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

(1) You receive written confirmation of the loan;

**§703.100(j)(3)**

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

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

The borrowing limit cited is not to exceed 50 percent of the credit union's paid-in and unimpaired capital and surplus.

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

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

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

Trade date recording will require the credit union to recognize gains and losses prior to settlement.

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

Securities trading should be undertaken only by credit unions with strong capital and earnings coupled with management that can demonstrate the appropriate expertise. Furthermore, this activity should only take place in a closely supervised trading account with adequate management expertise to administer the program. Adequate internal controls limiting potential trading losses, and possibly triggering divestiture (or at least a review for possible divestiture) need to be in place.

It is possible that the loss limits established by the credit union for potential trading losses will be exceeded if credit union management has underestimated the potential price changes for the trading securities. This is usually due to greater than expected interest rate movements, inadequate analytics, or other related factors. Inadequate internal controls can also allow the loss limits to be exceeded. Lack of appropriate segregation of duties (e.g., lack of separation of risk reporting from risk taking) could allow loss limits to be exceeded through deliberate or inadvertent erroneous reporting.

**§703.100(l)(3)**



**§703.110**

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

- (a) You (a federal credit union) may not purchase or sell financial derivatives, such as futures, options, interest rate swaps, or forward rate agreements, except as permitted under 701.21(i) of this chapter.
- (b) You may not engage in adjusted trading or short sales.
- (c) You may not purchase stripped mortgage backed securities, residual interests in CMOs/REMICs, mortgage servicing rights, commercial mortgage related securities, or small business related securities.

See Section 703.150 for definitions.

Small business related securities are those that were authorized under the Reigle Community Development and Regulatory Improvement Act of 1994. This should not be confused with Small Business Administration (SBA) securities that are issued by a federal agency and are permissible investments.

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

Zero coupon investments includes securities and CDs. For example, a zero coupon investment (CD or security) with a 15 year original maturity and an 8 year remaining maturity at purchase is permissible.

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

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

"Anything of value" indicates zero tolerance in this area. This means that gifts, meals, entertainment tickets, golf balls, etc. (even if unsolicited) are not permitted.

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

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

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

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

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

(1) Before December 2, 1991; or

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

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

The credit union should not hold these securities unless it can provide reasonable and supportable evidence that this action will not affect the credit union's safety and soundness. The credit union should look for the results of stress tests and the credit union's calculation of the impact on capital if there were a 300 basis point change in interest rates to justify continued holding of these securities. In addition, the credit union should understand the risk associated with these securities by explaining the impact of cash flows and changes in the yield curve on their value.

(ii) a monitoring and reporting system is used to conduct and document an analysis that shows, before purchase, that the proposed investment will reduce a credit union's interest rate risk;

In order to accomplish this, the credit union should have evidence of the correlation between the asset that was purchased and the instrument that is being hedged. This should include the potential interest rate exposure both before and after the hedge, for at least a 300 basis point instantaneous change in rates.

(iii) after purchase, an evaluation is made at least quarterly to determine whether or not it has actually reduced the credit union's interest rate risk; and

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**§703.130(a)(2)**

There should be appropriate documentation in the investment file and in the ALCO or board minutes demonstrating that the correlation, which existed at the time of purchase, remains. The monitoring system should be able to demonstrate how well the hedge is working and how it has changed over time to reduce interest rate exposure.

(iv) the investment is classified as either trading or available-for-sale.

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

Safety and soundness issues may require divestiture of otherwise permissible investments.

**§703.140 What is the investment pilot program and how can the credit union participate in it?**

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

Applying for a pilot program is not an alternative way to obtain a waiver of a credit union's individual investment practices or holdings. To be considered for a pilot program, the activity must have broad applicability to other credit unions. The petitioning credit union must be able to demonstrate how other credit unions could benefit from the proposed activity, and what procedures and controls would be in place. For further information on pilot programs, federal credit unions should contact their appropriate regional office.

(b) Except as provided in paragraph (c) of this section, before you (a federal credit union) may engage in additional activities, you must obtain written approval from NCUA. To begin the approval process, you must submit a request to your regional director that addresses the following items:

- (1) Board policies approving the activities and establishing limits on them.
- (2) A complete description of the activities, with specific examples of how you will conduct them and how they will benefit you.
- (3) A demonstration of how the activities will effect your financial performance, risk profile, and asset-liability management strategies.
- (4) Examples of reports you will generate to monitor the activities.
- (5) A projection of the associated costs of the activities, including personnel, computer, audit, etc.
- (6) A description of the internal systems to measure, monitor, and report the activities, and the qualifications of the staff and/or official(s) responsible for implementing and overseeing the activities.
- (7) The internal control procedures you will implement, including audit requirements.

**§703.140**

**§703.140(b)(7)**

A credit union participating in a pilot program should have:

- evidence that the pilot program has received approval from the NCUA Board, and the credit union has met the conditions to participate in the pilot program;
- approval of participation in the program by the board of directors;
- procedures and controls are established to monitor, control, and report the results of the pilot program to the credit union's board;
- reporting to demonstrate the credit union is meeting the requirements of the pilot program;
- evidence of how the activities have affected the credit union's financial performance, risk profile, and asset-liability management (ALM) strategies;
- analysis of the costs of the pilot program; and
- internal control procedures that the credit union implemented.

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

- (1) A complete description of the activities, with specific examples of how a credit union will conduct them and how they will benefit a credit union.
- (2) A description of any risks to a credit union from participating in the program.

**703.140(c)**