

# 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)<sup>1</sup> 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

<sup>1</sup> Hereafter, in this supplementary information section, "CMO" means "CMOs and REMICs."