

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

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

Section 703.5 Prohibitions.

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

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

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

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

The proposed rule also clarifies that credit unions may not purchase mortgage servicing rights directly, as there is no express or incidental authority for such purchase. This prohibition does not affect the right of a credit union to retain servicing rights of loans that are sold, whether the loans have been made by the credit union or purchased to complete a pool for sale or pledge on the secondary market.

Section 703.6 Pledging Securities

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

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

Section 703.7 Divestiture Requirements

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

Section 703.8 Prohibited Fees

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

Section 703.9 Grandfather Provisions

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

Regulatory Procedures

Regulatory Flexibility Act

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