7535-01-U

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 703

RIN: 3133-AE06

Investment and Deposit Activities

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed rule with request for comments.

SUMMARY: The NCUA Board (Board) proposes to amend its investment regulation to allow federal credit unions (FCUs) to purchase Treasury Inflation Protected Securities (TIPS). This proposed amendment adds TIPS to the list of permissible investments for FCUs in part 703. The Board believes TIPS will provide FCUs with an additional investment portfolio risk management tool that can be useful in an inflationary economic environment.

DATES: Comments must be received on or before [Insert date 60 days from date of publication in the FEDERAL REGISTER].

ADDRESSES: You may submit comments by any of the following methods (**Please send comments by one method only**):

- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- NCUA Web Site: http://www.ncua.gov/Legal/Regs/Pages/PropRegs.aspx. Follow the instructions for submitting comments.
- E-mail: Address to regcomments@ncua.gov. Include "[Your name] Comments on Proposed Rule 703, Investment and Deposit Activities" in the e-mail subject line.
- Fax: (703) 518-6319. Use the subject line described above for e-mail.
- Mail: Address to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.
- Hand Delivery/Courier: Same as mail address.

PUBLIC INSPECTION: You may view all public comments on NCUA's website at http://www.ncua.gov/Legal/Regs/Pages/PropRegs.aspx as submitted, except for those we cannot post for technical reasons. NCUA will not edit or remove any identifying or contact information from the public comments submitted. You may inspect paper copies of comments in NCUA's law library at 1775 Duke Street, Alexandria, Virginia 22314, by appointment weekdays between 9:00 a.m. and 3:00 p.m. To make an appointment, call (703) 518-6546 or send an e-mail to OGCMail@ncua.gov.

FOR FURTHER INFORMATION CONTACT: Frank Kressman, Associate General Counsel, Office of General Counsel, at the above address or telephone (703) 518-6540, or J. Owen Cole, Jr., Director, Division of Capital Markets, Office of Examination and Insurance, at the above address or telephone (703) 518-6360.

SUPPLEMENTARY INFORMATION:

I. Background

II. Regulatory Procedures

I. Background

A. Why is the NCUA Board Proposing This Rule?

The Board is proposing this rule because, after extensive research and analysis as discussed more fully below, it believes TIPS can be a valuable risk management tool for FCUs. The Board also believes FCUs have the ability to manage the risks associated with TIPS and can benefit from including them in their overall investment portfolio. In addition to analyzing the nature and performance of TIPS in the marketplace, NCUA has monitored FCU usage of TIPS through a long-term investment pilot program. The results of the pilot program are consistent with the Board's opinion that TIPS are an appropriate investment for FCUs and can be a valuable portfolio management tool when there are inflationary risks in the economy.

Accordingly, for the reasons discussed above, NCUA proposes to make TIPS permissible under part 703.

B. What is a TIPS?

TIPS[1] is a security issued by the U.S. Department of the Treasury, Bureau of Public Debt, which is readily available to investors. TIPS differ from other securities by providing protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Bureau of Labor Statistic's Consumer Price Index (CPI).[2] When a TIPS matures, the holder is paid the adjusted principal or original principal, whichever is greater. TIPS pay interest twice a year at a fixed rate. The rate is applied to the adjusted principal, so, like the principal, interest payments rise with inflation and fall with deflation. In a deflationary period, it is possible to experience a contractual decline in the principal balance, which is not an event of default.

C. Analysis of TIPS and Part 703.

<u>Overview</u>

TIPS are currently a prohibited investment under part 703 because they reprice their value in response to changes in the CPI, and the CPI is a prohibited index for variable rate instruments. Under §703.14(a), an FCU is permitted to invest in a variable rate

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[1] To learn more about TIPS, see the U.S. Department of the Treasury, Bureau of Public Debt website at: http://www.treasurydirect.gov/indiv/research/indepth/tips/res_tips.htm.

[2] The CPI program produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services. To learn more about how the CPI is produced, see the Bureau of Labor Statistics "Frequently Asked Questions" on CPI, found at: http://www.bls.gov/cpi/cpifaq.htm.

instrument as long as the rate is tied to a domestic interest rate.[3] 12 CFR §703.14(a). The purpose of this provision is to reduce the basis risk between the interest earned on assets and the dividends paid on shares.[4] Generally, deposit/share rates for financial institutions, including credit unions, are responsive to market interest rates. As market rates change, so do the deposit/share rates. Thus, if an FCU invests in a variable rate instrument with an index tied to market rates, the spread between the asset's income stream and the share dividends paid should remain relatively constant. This protects the FCU's earnings in times of rate volatility, especially in periods of rising rates.

However, there is not always a perfect correlation between market interest rates and deposit/share rates. This can result in greater volatility for an FCU if it does not take action to manage this basis risk.

Why TIPS Should be Permissible

As noted, FCUs are permitted to invest in variable rate instruments where the index is tied to a domestic interest rate. Common domestic interest rates include the Fed Funds rate, Treasury rates, and LIBOR. Despite the common label "domestic interest rate,"

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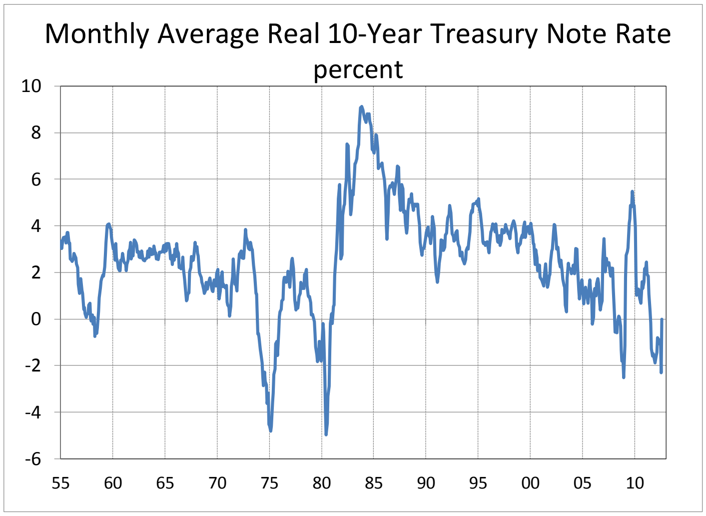
[3] (a) *Variable rate investment.* A Federal credit union may invest in a variable rate investment, as long as the index is tied to domestic interest rates and not, for example, to foreign currencies, foreign interest rates, or domestic or foreign commodity prices, equity prices, or inflation rates.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

[4] Basis risk is a common form of risk incurred by financial institutions, including credit unions. Basis risk is the variability between two or more indices (e.g., equity barometers such as the S&P 500, and interest rate indices such as the 1 year Treasury rate) that serve as benchmarks for valuing financial institution assets and liabilities.

each of these rates is not perfectly correlated with the others. There is certainly some measure of correlation, but an FCU can be exposed to earnings variability if it invests in variable rate assets tied to one rate, LIBOR rates for example, and prices its shares on another, Treasury rates for example.

Historically, the Board has prohibited variable rate instruments tied to non-domestic rate indices because of the basis risk for FCUs. While the Board remains concerned about basis risk, it recognizes that FCUs now have greater access to advanced asset-liability management tools that can identify and measure basis risk, and are therefore better equipped to manage such risk associated with adding CPI as a permissible index.

- The adjacent graph shows that the "ex-post" real interest rate – the nominal 10-year Treasury rate less the 1-year inflation rate – turned sharply negative in the mid-1970s and the late 1970s/early 1980s.



- These periods coincide with an unexpected acceleration of inflation.

- The negative real interest signals that someone holding a 10-year Treasury during that period was losing real purchasing power, as a result of not being able to forecast inflation accurately.

Allowing FCUs to hold TIPs in their investment portfolios adds no credit risk and allows them the option of minimizing the need for accurate inflation forecasting as a way to maintain the real value of their investment portfolios.

D. Caution in Investing in TIPS.

The Board believes the authority to invest in TIPS for the purpose of protecting against inflation risk can be a valuable part of an effective risk management program for FCUs that understand the risks. TIPS may not be appropriate for all FCUs. As with any investment, the decision to purchase TIPS should be based upon sound due diligence and a demonstrated effectiveness in managing risk. This proposal authorizes FCUs to purchase TIPS only. Other similar securities based on inflation indices currently available or available in the future that are not issued by the United States Treasury Department are not authorized by this rule. The current TIPS pilot program will expire in the event this proposal is eventually finalized by the Board.

II. Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact a proposed rule may have on a substantial number of small entities (primarily those under ten million dollars in assets). This proposed rule reduces compliance burden and extends regulatory relief while maintaining existing safety and soundness standards. NCUA has determined this proposed rule will not have a significant economic impact on a substantial number of small credit unions.

Paperwork Reduction Act

NCUA has determined that the requirements of this rule do not increase the paperwork requirements under the Paperwork Reduction Act of 1995 and regulations of the Office of Management and Budget.

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order to adhere to fundamental federalism principles. This proposed rule would not have a substantial direct effect on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. NCUA has determined that this proposed rule does not constitute a policy that has federalism implications for purposes of the executive order.

List of Subjects

12 CFR part 703

Credit unions, Investments.

By the National Credit Union Administration Board on   , 2012.

Mary Rupp

Secretary of the Board

For the reasons discussed above, NCUA proposes to amend 12 CFR §703.14 as follows:

PART 703—INVESTMENT AND DEPOSIT ACTIVITES

1. The authority citation for part 703 continues to read as follows:

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

2. Revise §703.14(a) to read as follows:

§ 703.14 – Permissible investments.

(a) Variable rate investment. A federal credit union 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 with the exception of Treasury Inflation Protected Securities. For purposes of this part, the U.S. dollar-denominated London Interbank Offered Rate (LIBOR) is a domestic interest rate.