



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: Final rule.

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

DATES: The final rule is effective on [Insert date 30 days from date of publication in the FEDERAL REGISTER].

FOR FURTHER INFORMATION CONTACT: John H. Brolin, Staff Attorney, or Frank Kressman, Associate General Counsel, Office of General Counsel, at 1775 Duke Street, Alexandria, VA 22314 or telephone: (703) 518-6438; 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. September 2012 Proposal
- III. Final Rule
- IV. Regulatory Procedures

I. Background

TIPS are securities issued by the U.S. Department of the Treasury, Bureau of Public Debt, and are readily available to investors. TIPS differ from other securities by providing protection against inflation. The principal amount of TIPS increases with inflation and decreases with deflation, as measured by the Bureau of Labor Statistic's Consumer Price Index (CPI). When TIPS mature, holders are 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.¹

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 instrument as long as the rate is tied to a domestic interest rate.² The purpose of this provision is to reduce the basis risk between the interest earned on assets and the dividends paid on shares.³ 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.

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 12 CFR 703.14(a) states that an FCU 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 part 703, the U.S. dollar-denominated London Interbank Offered Rate (LIBOR) is a domestic interest rate.

³ 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.

II. September 2012 Proposal

A. Summary of the September 2012 proposal.

The Board issued a proposed rule in September 2012 to amend §703.14(a) to add TIPS to the list of permissible investments for FCUs in part 703.⁴ The Board issued the proposal after research and analysis demonstrated that TIPS would be a valuable risk management tool for FCUs. In addition to analyzing the nature and performance of TIPS in the marketplace, NCUA also monitored FCU usage of TIPS through a long-term investment pilot program. The results of the pilot program are consistent with the Board's research demonstrating that TIPS are an appropriate investment for FCUs and can be a valuable portfolio management tool when there are inflationary risks in the economy.

B. Summary of comments on the September 2012 proposal.

The NCUA received eight comment letters on the September 2012 proposal: two from FCU trade associations and six from state credit union leagues. The Board has considered these comments in adopting this final rule.

⁴ 77 FR 59144 (Sept. 26, 2012).

All of the commenters agreed that the authority to invest in TIPS will help FCUs manage inflation risk. Several commenters noted that TIPS are guaranteed by the U.S.

Government, and the benefits to TIPS investors are widely recognized. One state credit union league noted that certain state-chartered institutions already have the authority to invest in TIPS, which they argued demonstrates that such securities can be utilized safely. Moreover, several commenters noted that FCUs now have greater access to advanced asset-liability management tools that can help identify and measure basis risk.

In addition to supporting the proposal, several commenters also made other recommendations that were outside the scope of the proposal. In general, the commenters asked the Board to take additional steps in the future to provide increased flexibility and additional investment powers to FCUs. Several commenters also urged NCUA to work closely with state regulators to facilitate the ability of well-managed state credit unions to invest in TIPS, where permissible under state law.

III. Final Rule

A. Why is the Board adopting this rule?

As discussed, the Board is adopting this final rule to provide FCUs with an additional investment portfolio risk management tool that can be useful in an inflationary economic environment.

Historically, the Board has prohibited FCUs from investing in variable rate instruments tied to non-domestic rate indices, such as TIPS, because of the basis risk for FCUs. The Board remains concerned about basis risk. However, the Board generally agrees with commenters who noted 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 the risks associated with investing in TIPS. Moreover, the Board agrees with commenters that 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. Accordingly, the Board is adopting the September 2012 proposal without substantive change. However, the Board has amended the language of the section slightly to better incorporate the amendment into the existing language of the rule.

B. Does this rule impose any new regulatory burdens on FCUs?

While the Board believes the authority to invest in TIPS can be a valuable part of an effective risk management program for those 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 on sound due diligence and a demonstrated effectiveness in managing risk. However, other than the due diligence and risk management requirements already required by NCUA for investments under §703.14(a), this final rule does not impose any new TIPS-specific due diligence or risk management requirements on FCUs.

This final rule 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. While several commenters requested the Board provide increased flexibility and additional investment powers to qualified FCUs, such requests are outside the scope of this rulemaking and will be considered separately by the Board.

C. What happens to the TIPS pilot program?

The TIPS pilot program will be terminated as of the effective date of this final rule.

IV. Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact a rule may have on a substantial number of small entities (primarily those under \$50 million in assets). This final rule extends regulatory relief while maintaining existing safety and soundness standards. NCUA has determined this final rule will not have a significant economic impact on a substantial number of small credit unions.

Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (PRA) applies to rulemakings in which an agency by rule creates a new paperwork burden on regulated entities or modifies an existing burden.⁵ For purposes of the PRA, a paperwork burden may take the form of either a reporting or a recordkeeping requirement, both referred to as information collections. As noted above, this final rule extends regulatory relief while maintaining existing safety and soundness standards. 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 final rule will 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. The rule only adds to the list of permissible investments for FCUs. NCUA

⁵ 44 U.S.C. 3507(d); 5 CFR part 1320.

has determined that this final rule does not constitute a policy that has federalism implications for purposes of the executive order.

Assessment of Federal Regulations and Policies on Families

NCUA has determined that this final rule will not affect family well-being within the meaning of Section 654 of the Treasury and General Government Appropriations Act, 1999.⁶

Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Fairness Act of 1996⁷ (SBREFA) provides generally for congressional review of agency rules. A reporting requirement is triggered in instances where NCUA issues a final rule as defined by Section 551 of the Administrative Procedure Act.⁸ The Office of Management and Budget has determined that the final rule is not a “major rule” for purposes of SBREFA.

List of Subjects in 12 CFR part 703

Credit unions, Investments.

⁶ Pub. L. 105–277, 112 Stat. 2681 (1998).

⁷ Pub. L. 104–121, 110 Stat. 857 (1996).

⁸ 5 U.S.C. 551.

By the National Credit Union Administration Board on February 21, 2013.

Mary Rupp

Secretary of the Board

For the reasons discussed above, the Board amends 12 CFR part 703 as follows:

PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

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. Except in the case of Treasury Inflation Protected Securities, the variable rate investment cannot, for example, be tied to foreign currencies, foreign interest rates, 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.

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