

requiring natural person credit unions to make up the difference. Since corporate credit unions benefit natural person credit unions, it may be appropriate to ask the latter to pay for the whole system. The Board requests comment on these options.

B. Section-by-Section Analysis

Section 704.1—Scope

Part 704 applies directly to all federally insured corporate credit unions. It applies to non federally insured corporate credit unions, via Part 703 of the Rules and Regulations, if such credit unions accept shares from federally chartered credit unions. To clarify the application of Part 704, the Board is proposing to amend the Scope section so that it states both that the regulation applies to all federally insured corporate credit unions, and that non federally insured corporate credit unions must agree, by written contract, to adhere to the regulation and submit to NCUA examination as a condition of receiving funds from federally insured credit unions.

The Board considered deleting from the proposed rule Section 704.1(b), which sets forth its authority to waive a requirement of Part 704. In the few years that the provision has been in effect, NCUA has been deluged with requests for waivers. The Board is concerned that corporate credit unions may have received the impression that compliance with the rule is optional and that waivers are granted as a matter of course. The Board wishes to emphasize that corporate credit unions are expected to comply with the rule. The Board has determined to retain Section 704.1(b) in the proposed rule, however, to make clear its authority, in extraordinary circumstances, to waive provisions of the regulation.

The Board proposes to add a sentence to Section 704.1(b) regarding state-chartered credit unions. Where a state law provision is also contained in Part 704, and a state-chartered corporate wishes to request a waiver of that provision, the corporate must obtain state approval of the waiver before requesting a waiver from NCUA.

Section 704.2—Definitions

Capital

The Board is proposing to revise the definition of capital. The revised definition encompasses primary capital and secondary capital share accounts upon which notice has not been given. These terms are defined later in this Section. The current definition includes each of the balance sheet accounts that comprise primary capital. As these

accounts are also listed in the definition of primary capital, it is not necessary to list them under capital.

Commitment

The Board is proposing to delete the phrase "or lease financing receivables" from the definition of "commitments," as corporate credit unions generally do not enter into lease financing arrangements.

Corporate Service Organization (CSO)

Currently, corporate credit unions can invest in and loan to credit union service organizations (CUSOs) as defined in Section 701.27 of the NCUA Rules and Regulations. Section 701.27 was written with natural person credit unions in mind and contains a broad list of permissible activities, many of which the Board believes are inappropriate for corporate CUSOs. Accordingly, the Board is proposing to create a new term and establish new rules for such organizations. They would be called "corporate service organizations (CSOs)" and would be limited to serving only the corporate credit unions that have invested in or loaned to the CSO and/or the members of such corporate credit unions. Thus, a CSO wholly owned by ABC Corporate Credit Union could serve only ABC and its member credit unions. If the CSO received a loan from DEF Corporate Credit Union, it could serve ABC and its member credit unions and DEF and its member credit unions. The Board believes that this restriction would preserve the integrity of field of membership requirements.

The Board is also proposing that a CSO's services be limited to data and item processing, wire transfers, record retention and storage, securities brokerage services, investment advisory services, and trust services. The Board is concerned that some corporate CUSOs currently are performing services that have nothing to do with the daily activities of corporate credit unions, such as shared branching services and home banking.

The Board is also proposing to require that a CSO be chartered as a corporation under state law.

Embedded Options

Embedded options are a common feature in many investment securities. Mortgage backed securities, federal agency structured notes, and many other corporate obligations have features such as maturity calls, principal prepayments, periodic and lifetime interest rate caps, and conversion factors, over which the investor has no control. The fact that these options can be exercised by the issuer (or mortgage

holder) and not the investor raises concerns for the Board.

These features entail substantial risks for investors that do not properly understand and evaluate how these options impact the performance of the investment. The function of a matched book strategy is to immunize the effects that changing interest rates will have on the economic value of assets and liabilities. If the characteristics of an asset are not replicated in the corresponding source of funds, the integrity of the match is compromised. This is especially true for assets which have conditional cash flows that are linked to the level of interest rates and other market factors.

One example of an investment with conditional cash flows is mortgage backed securities. Mortgage backed securities are impacted by the behavior of the underlying mortgage holders whose loans make up the securities. If they elect to pay off or refinance their mortgages, the securities will likewise pay down. The investor has no control over this action. Prepayment risk has a substantial impact on the market value and liquidity of an instrument and the uncertainty of the cash flow behavior makes these securities especially difficult to match.

Many investors were caught by surprise during the rate upswing in 1994 because the market values of their securities were adversely impacted far more than they had anticipated. The embedded options such as prepayment extension and caps on floating rate instruments caused a serious threat to the liquidity and solvency of many credit unions. The risk associated with such securities cannot be ignored and it must be factored into the matching strategies of corporate credit unions. This is imperative because corporate credit unions must ensure that the viability of the income, liquidity and net market value of the matched book balance sheet is not jeopardized.

Identically Matched

The Board recognizes that it is not possible for corporate credit unions to perfectly match all shares and certificates to identical assets because there sometimes exists an immaterial difference in dollar amount, the accrual methods, or the precise maturity date. To be substantiated as immaterial, such minute differences cannot have the effect of causing any significant exposure to changing spread performance or the net market value of the match. The integrity of the matched book depends upon how substantially close the match is with regard to such factors as the dollar amounts, rate reset