

Adjusted Trading; Bailment for Hire Contract; Cash Forward Agreement; Collateralized Mortgage Obligation; Facility; Federal Funds Transaction; Forward Rate Agreement; Futures Contract; Immediate Family Member; Market Price; Maturity Date; Official; Option Contract; Primary Dealer; Real Estate Mortgage Investment Conduit; Repurchase Transaction; Residual Interest; Reverse Repurchase Transaction; Section 107(8) Institution; Senior Management Employee; Settlement Date; Short Sale; Standby Commitment; Stripped Mortgage Backed Security; Swap Agreement; Trade Date; Zero Coupon Bond

Currently, Part 704 incorporates by reference Part 703, which governs federal credit union investments, except where inconsistent with Part 704. To eliminate the confusion that has arisen over the applicability of certain provisions of Part 703, and because Part 703 may be amended in the future, the Board is proposing to move the relevant portions of Part 703 into Part 704. Most of these definitions are from Part 703; some have been altered slightly. A few other investment-related definitions have been added.

Capital of a Broker/Dealer; Claims; Corporate Reserves; Credit Union Service Organization; Membership Capital Share Deposit; Non Credit Union Member; Original Maturity; Other Reserves; Risk-Based Capital; Secondary Capital; Speculative Activities; Term Subordinated Debt

The Board is proposing to eliminate all of these definitions, primarily because the terms are not used in the proposed regulation. The term "claims" is used in the appendices, but the definition, "loans or other debt obligations," is deemed to be self-evident.

Section 704.3—Planning: Strategic and Business Plans

The Board is proposing to revise § 704.3 to specify that the board of directors of a corporate credit union must adopt *written* strategic and business plans. The Board is concerned that the directors of corporate credit unions might develop concepts for such plans through discussion and brainstorming sessions, but not place them in formal written format. The lack of written documentation would result in the inability of the directors to monitor their success in achieving their goals. Additionally, wording was added to require that the annual review of the plans be documented and provided to

the corporate credit union's auditor and supervisory committee and to NCUA.

Section 704.4—Asset/Liability Management

Matched book requirement. The evolution of "managed" book strategies in the corporate credit union network has become a huge concern to the Board. The assumption of interest rate risk by some corporates has been demonstrably short-sighted as evidenced by the wide-spread exposure to rising interest rates taken by many corporates in recent years.

In some dramatic instances, portfolios were merely matched by repricing characteristics, and not always effectively at that, which subjected some corporate credit unions to potentially extreme depletions of capital. The mismatches that result when short duration liabilities are matched against longer duration investment assets cannot be managed if the ability to sell troubled assets is forfeited by a "hold-to-maturity" philosophy. Thus, the managed book approach has, in many cases, resulted in an unmanaged wager against changing interest rates.

The fact that most securities in corporate portfolios that can be adversely impacted by rising rates are classified as "hold-to-maturity" largely contradicts the notion that the risks associated with these managed portfolios can be managed when and if the wrong combination of circumstances prevails.

The Board is concerned about the potential problems that result when corporate credit unions that "manage" sources and uses of funds assume unreasonable levels of risk exposure with the overnight portion of member funds. The growth and complexity of the floating rate securities market has inspired many corporate credit unions to employ a "managed" risk approach in which maturity and average life are disregarded in favor of matching sources and uses of funds by interest rate reset characteristics.

This has led some corporate credit unions to assume substantial duration mismatches when they "match" their overnight funds against corresponding floating rate assets which have embedded options, long weighted average lives, or coupons linked to inappropriate indices. When such assets have interest rate dependent features that affect their market values, the liquidity and solvency of the credit union can be adversely affected. The Board believes that such risk exposures should be identified, measured, and limited to a reasonable level of primary capital. When such risks cannot be

immunized in the matching process, they are unacceptable.

The Board is aware that a floating rate security can have a very short duration if it is tied to a sensitive market index, reprices frequently, has little or no embedded option risk, and has a relatively short final maturity. The Board also recognizes that a portion of overnight shares at a corporate credit union represents a core amount of funds that is essentially permanent in nature. Such core funds are required to cover clearings and other daily activities. It is not inappropriate for a corporate credit union to mismatch a conservative portion of overnight funds into longer maturity assets provided that the assets are convertible to cash without suffering a material loss.

The Board is proposing that a corporate credit union be permitted to mismatch 25 percent of funds in the overnight book. The parameters set forth on the assets permitted in this 25 percent portion are established to prevent any material adverse market value effect upon the liquidation potential of these assets if and when the need arises. The ability to mismatch a conservative portion of the overnight account allows corporate credit unions to augment their earnings potential in addition to the investment of capital.

The Board does not believe that any interest rate risk should be taken with term certificates. Any source of funds, with the exception of capital, that has a maturity of greater than one business day must be identically matched to an asset that has the same maturity and repricing characteristics. The danger of entertaining duration mismatches with member certificates is regarded to be completely inconsistent with the charge of a liquidity facility. This activity is not regarded to be a legitimate means of generating retained earnings because of the risk and complexity associated with managing a mismatched portfolio.

Portfolio pricing. It is essential for corporate credit unions to evaluate the risk inherent in their balance sheets on a regular basis. A frequent pricing of the investment portfolio is an important component of risk assessment since it provides critical information about changes in the liquidation value of the balance sheet.

Whether assets are classified as available-for-sale or hold-to-maturity, they need to be reviewed in the context of fair market value. The management of a corporate credit union should know at all times where the relative market value of its balance sheet stands in order to ensure that the core solvency of the institution is not remotely threatened by any adverse change in market rates.