Maximum unrealized loss on available-for-sale assets. The Board is proposing that the aggregate loss in the accumulated unrealized gains/losses on available-for-sale assets, net of any unrealized gains or losses on the corresponding source of funds, be limited to a conservative percentage of the corporate's primary capital. Consistent with the provision that all investment securities be priced to market on a monthly basis, the need to closely monitor the impact of changing market rates on the available-for-sale portfolio is imperative.

The Board is also proposing that sufficient early withdrawal penalties be in place to guarantee protection from replacement risk. This would allow corporates to capture the economic benefit of the liabilities that are matched against available-for-sale assets; accordingly, it is appropriate to factor in the corresponding liabilities when setting a maximum limit upon the aggregate loss in the accumulated unrealized gain/loss on "available-forsale" assets.

*Rate shock analysis.* The use of scenario analysis to measure potential risk is not a new concept to many corporate credit unions. This discipline is already resident in a number of corporates. The purpose of using a rate shock calculation is to view interest rate risk from a severe but plausible perspective. The senior management and board of directors of a corporate should always be cognizant of potential interest rate risk exposures before they arise.

It is clear that a perfectly matched book does not have the same volatility that a "managed" mismatched book has. Depending upon how the overnight and capital accounts are structured, they could potentially create some exposure to changing rates. Such exposures need to be identified, measured, related to primary capital, and reported to all oversight authorities on a regular basis.

Rate shock analysis is a standard form of risk assessment that is used in many industry applications. The FFIEC High Risk Stress Test for CMOs, total return analysis, and income simulation models all feature this approach. It is a useful and conservative practice that enhances the risk management process.

*Risk analysis, supervision and compliance.* The Board is particularly concerned that corporate credit unions have a comprehensive risk management process in place to identify all applicable risk exposures before and after an investment is made. The process should ensure that such risk exposures are measured on a regular

basis and in relation to all limitations that are in place to govern such risks.

The risk management process is a discipline that requires a large measure of vigilance on the part of management. The impact of changing market and credit conditions may be swift and severe. The risk management process must be a proactive and defensive mechanism for preserving the earnings and capital of the credit union. The more in-depth the risk analysis and the greater the frequency of review, the more accountable the board of directors can be in policing the risks that are undertaken.

The board of directors of a corporate credit union is responsible for the actions and risk exposures that the institution undertakes. In order to effectively understand and ultimately supervise risk, the board must receive a complete distillation of risk activities on a timely basis. That information must summarize the actions taken and the consequences, as stated in terms of capital at risk, that will result when applicable risk factors change.

The board of directors cannot supervise and direct the actions of the credit union at the line level. However, the board is obligated to demand that management provide all of the information necessary for board members to make fully informed decisions. Thus the reporting element of the risk management process is no less important in the scheme of managing risk. The board must have clear, concise summaries of risk activities and exposures in order to carry out its oversight responsibilities.

The Board regards risk analysis, supervision, and compliance as an essential process for all credit unions. Risk management procedures vary considerably among corporate credit unions and are a major concern. The need to standardize the discipline of the risk management process is obvious. The incorporation of a consistent framework will bolster the integrity and viability of the corporate credit union system.

*Contingency funding.* The role of all corporate credit unions as liquidity custodians has drawn attention to a major deficiency in the system. The disregard for contingent funding plans has been a particularly troublesome issue. Contingency funding plans guarantee the role of a corporate as an inviolable provider of liquidity, regardless of the circumstances. The fact that liquidity is most scarce when it is most required underscores the danger of not planning for unexpected needs.

The borrowing capacity of corporate credit unions is not an unlimited

resource. Many corporate credit unions have suggested that liquidity will be easily obtainable through repurchase agreements and lines of credit. The reality is that many factors can impinge upon the ability of a corporate to borrow the amount of funds for the amount of time that is required.

Corporate credit unions must evaluate all viable resources of liquidity on a regular basis and understand how changes in market factors will impact those resources over time. For example, it may be unreasonable to assume that borrowing capacity is not hindered by severe economic circumstances. The corporate must know that it can provide liquidity in normal or catastrophic situations. The board of directors needs to be assured that the plan to meet liquidity needs is realistic and up-todate.

Modeling. The Board wishes to quantify more precisely how the proposed changes to Part 704 will affect corporate credit union earnings and capital accumulation. To this end, NCUA will conduct analytical assessments of these changes through simulation modeling techniques using a sampling of corporate credit union balance sheets. Interested parties who believe the proposed changes, if implemented, would adversely affect corporate credit unions' ability to serve their members are requested to submit the results of similar assessments to support their positions.

## Section 704.5—Investments

The Board is proposing to modify and move the policies section of current §704.6 to proposed §704.4. The remaining sections of current § 704.6 would be revised and recodified at proposed §704.5. The Board is also proposing to include the relevant provisions of Part 703, governing federal credit union investments, in proposed Part 704, rather than simply incorporating them by reference, as is done currently. Sections 703.4 and 703.5, with some modifications, would be included in § 704.5, and § 703.2, which provides definitions, would be included in proposed § 704.2.

Proposed § 704.5(a) would replace current § 704.6(b)(2)(i), except that the reference to investments authorized by Part 703 would be deleted. This paragraph would also explain the operation of the divestiture provisions set forth in the remainder of the section. Finally, this paragraph would address investments that must be classified as available-for-sale and the limit on investments in any one issuer. While the current rule bases all investment limitations on a percentage of assets, the