unions, except where those laws and rules are inconsistent with Part 704 of the NCUA regulations, 12 CFR Part 704, which specifically governs corporate credit unions. Although Part 704 contains a detailed investment section, it does not cover all aspects of corporate credit union investment activities. Accordingly, corporate credit unions are subject to certain provisions of Part 703. This occasionally has caused confusion, however, as it is not always clear when a general law or rule is ''inconsistent'' with Part 704. Part 704 is currently being revised, and plans are for it to incorporate all of the applicable NCUA rules governing investment activities, even if this means duplicating portions of Part 703. Therefore, proposed Section 703.1 clarifies that Part 703 is not applicable to corporate credit unions.

Section 703.2 Definitions

NCUA is proposing to add a number of new definitions, to redefine certain already-defined terms, and to delete several definitions.

The proposed rule treats amortizing securities and securities with embedded options as investments that have the potential to present significant interest rate risk. The proposed rule does not prohibit credit unions from purchasing such investments, but it does subject a credit union holding these and other potentially risky investments in an amount greater than capital to additional measures of interest rate risk. To ensure consistency, the proposed rule provides definitions of ''amortizing security'' and ''embedded option.''

The proposed rule substitutes the term ''custodial agreement'' for the current regulation's ''bailment for hire contract,'' using an almost identical definition. Based on questions that have been received, it appears that the current term may no longer widely be used.

The dollar amount of capital is used as a threshold in a number of places in the proposed rule. Therefore, a definition of capital has been provided. The allowance for loan losses is excluded from capital for the purposes of Part 703 since the balance in this account has already been allocated to specific loan losses and is not available to absorb investment losses. Capital for the purpose of determining CAMEL ratios includes the allowance for loan losses.

The proposed rule discusses securities in terms of fair value rather than market price to conform to guidance in recent statements of the Financial Accounting Standards Board (FASB). Market price is the best evidence of fair value; if a market price is not available, fair value may be estimated based on the market price of a security with similar characteristics or on valuation techniques, including calculating the present value of estimated future cash flows using an appropriate discount rate, option pricing, or matrix pricing.

''Industry-recognized information provider'' refers to an entity which provides information regarding investments, but which is not, for instance, a broker or dealer. An example of such an entity is Bloomberg, L.P., an electronic service which provides market information to subscribers, who must lease a specialized terminal to access the information. Other examples are the Wall Street Journal and other bona fide newspapers, news magazines, or business or financial publications or electronic services of general and regular circulation.

The proposed rule provides separate definitions for ''investment'' and ''security,'' as the terms are not used interchangeably. ''Investment'' is a broad category that includes securities, deposits, and shares in credit unions.

The proposed rule simplifies the definition of ''repurchase transaction,'' because the current definition has proved confusing. The safekeeping element of the current definition has been moved to proposed section 703.3(b)(8).

The term ''counterparty'' in the proposed definition of ''reverse repurchase transaction'' has been substituted for ''purchaser'' in the current definition. This reflects current market terminology.

The proposed rule deletes some sentences in the definitions of ''standby commitment'' and ''stripped mortgage-backed security,'' as being unnecessarily detailed.

Definitions are provided for the following new terms used in the proposed rule: ''business day,'' ''commercial mortgage related security,'' ''delivery versus payment,'' ''interest rate swap,'' ''investment characteristic,'' ''maturity,'' ''mortgage related security,'' ''mortgage servicing,'' ''municipal security,'' ''official,'' ''option,'' ''pair-off transaction,'' ''parallel shift,'' ''prepayment model,'' ''regular-way settlement,'' ''securities loan,'' ''small business related security,'' ''street name,'' ''total return,'' ''U.S. government agency,'' ''U.S. government-sponsored enterprise,'' and ''when issued trading.''

The proposed rule deletes the following definitions, as the terms are no longer used: ''cash forward agreement'' and ''maturity date.''

Section 703.3 Investment Policies and Practices

Policies

Section 703.3(a) of the proposed rule requires that the board of a federal credit union establish written investment policies consistent with the Federal Credit Union Act, the NCUA Rules and Regulations governing investments, and other applicable laws and regulations. The policy must address the purposes and objectives of the credit union's investment activities. The policy must provide a clear statement of the credit union's investment goals. A credit union's primary goals may be to minimize risk, provide liquidity, and generate a reasonable rate of return. The emphasis placed on each goal will vary based on individual credit union constraints or needs.

The policy must also list authorized investments for the credit union, by issuer and characteristics. Characteristics of an investment include its maturity, index, cap, floor, coupon rate, coupon formula, index, call provision, and average life. For example, a policy statement may authorize investments issued or guaranteed by the U.S. Treasury, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association. The policy statement could also stipulate that no investment may have a maturity of more than 5 years, or that only investments with a fixed coupon, or those indexed, without caps, to 3-month LIBOR or the 3-month Treasury rate, will be permitted. The complexity of amortizing securities may cause the board to exclude any securities or deposits with amortizing cash flows.

The policy is also required to address interest rate risk management. A credit union's interest rate risk management policy should be related to its existing and potential cost of funds. In addition, for credit unions holding securities with potential interest rate risk, the policy may state that total return or average price cannot vary by more than a certain percentage of capital for a specific parallel shift in interest rates. The policy may state that capital should not be permitted to decline below a specific minimum level when the portfolio is subjected to a particular interest rate shock. Consistent with NCUA's intent to place more responsibility with credit union boards, the proposed rule does not specify particular limits. The policy should be tailored to a credit union's activity level and portfolio sophistication. Less complex