institutions will have a less complicated policy statement.

The board must also develop prudent concentration limits for all investments, including deposits in Section 107(8) institutions and shares and deposits in corporate credit unions. Concentrations can result from single or related issuers, lack of geographical distribution, holdings of obligations with similar characteristics, such as mortgage-backed bonds, zero coupon bonds, and bonds linked to the same index, holdings of bonds having the same trustee, and holdings of securitized loans having the same originator, packager, or guarantor. Concentrations can increase a credit union's vulnerability to unforeseen market, credit, and liquidity risks. Each credit union must evaluate concentration risk in relation to its financial condition and its ability to analyze the risks of all investments.

Of all securities available in recent years, credit unions have purchased more inappropriate CMOs than they have any other type of instrument. For this reason, NCUA has decided to retain specific testing requirements for CMOs. These are set forth at proposed section 703.4(e). To control the "cherry picking'' that has accompanied such testing (selecting the prepayment model that will allow a particular CMO to pass the tests), the proposed rule requires potential purchasers of CMOs to identify in their investment policies the specific prepayment models that will be used in the tests. Each credit union has the flexibility to choose the prepayment models it believes are the best measures of potential risk, as long as the models are reasonable and supportable.

Liquidity risk is the risk that a credit union will have insufficient liquid assets to meet immediate cash demands. The board must assess the potential for such demands, document how it arrived at this assessment, and establish a liquidity policy that will enable it to meet the demands. A credit union may use either a simple estimate, based upon the history of prior cash flows, or a more sophisticated approach.

Credit risk is the risk of default. The board must establish a policy to manage this risk, if the credit union entertains any. While it is not impermissible to rely on credit ratings, boards should be aware that ratings may fail to timely reflect a creditor's deteriorating ability to repay its obligations. A credit union without the ability to fully evaluate credit risk may choose to limit its investments to those that are fully guaranteed or insured by the U.S. government and its agencies.

The board has the fiduciary responsibility to ensure that any person

authorized to make investment decisions has the knowledge and experience necessary to carry out this function. The proposed rule requires that the board establish criteria for such persons, either in the investment policy or by approving appropriate position descriptions.

The proposed rule requires that the policy statement indicate approved broker-dealers and limits on the amounts and types of transactions for each broker. Although the rule does not require that the credit union approve more than one broker-dealer, reliance on a single individual or firm could be disadvantageous to the credit union. A credit union might choose to approve one broker-dealer for the full range of its investment activities and another for only certain of the investments authorized by policy. For example, the credit union may permit one broker, with more limited knowledge, to sell to the credit union only Treasury securities with less than 1 year maturity, while permitting another, with more knowledge and ability, to sell longer term securities or securities with embedded options issued by U.S. government agencies, as well as Treasury securities. The details for these authorizations should be established by policy.

The proposed rule expands the requirements for credit union policies regarding the safekeeping of investments. The policy statement should include the amount and type of investments that can be safekept. The proposed rule does not require more than one safekeeping agent. Thus, all of a credit union's investments may be held by one safekeeper if this authorization is set forth in the policy statement.

Most credit unions do not engage in trading, because it requires a great deal of sophistication, market knowledge, and strong controls. Credit unions that choose to enhance their income through this method may do so, provided they have established appropriate policies and controls.

Practices

In addition to expanding the requirements for the establishment of investment policies, the proposed rule requires that credit unions follow certain practices designed to ensure that officials and employees involved with investment activities have adequate information regarding investments to make appropriate decisions to manage and control risk.

Section 703.3(b)(1) of the proposed regulation requires that a federal credit union classify its securities as held-to-

maturity, available-for-sale, or trading, in accordance with generally accepted accounting principles (GAAP) and consistent with the federal credit union's documented intent and ability regarding the security. Deposits and shares in Section 107(8) institutions and corporate credit unions are not securities and therefore are not subject to these classifications.

It is NCUA's view that a credit union should not hold an investment unless its board of directors, chief financial officer, investment committee, and investment manager understand the risks reflected in the policy statement. Proposed Section 703.3(b)(2)(a) requires that any official or employee of a federal credit union who has discretionary investment authority be able to demonstrate an understanding of the risk characteristics of investments and investment transactions under that authority. The board must recognize its responsibilities in this area. Directors must be able to fully understand the risks associated with investment products that are authorized by policy. While not a specific requirement, NCUA recommends that in credit unions with more sophisticated portfolios, one or more board members serve on the assetliability management and/or investment committees.

The NCUA examiner may request that individuals with investment authority demonstrate their understanding of that authority. If they are not able to do so, the credit union may be required to alter its policy statement or take other appropriate action. To ensure the board maintains control

over the credit union's investment activities, proposed Section 703.3(b)(2)(B) establishes a general prohibition against delegating discretionary control of investment authority to an outside party. However, proposed Section 703.3(b)(2)(C) allows a credit union to delegate such control to an investment advisor who is registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. Registration imposes a number of requirements designed to ensure that an adviser acts in the client's best interest. Nevertheless, to ensure that the transactions being made by the adviser are consistent with the credit union's policies and objectives, a credit union must establish specific, detailed parameters and reporting procedures when delegating investment authority.

Proposed Section 703.3(b)(2)(D) limits the total of a credit union's delegation of investment authority and investment in mutual funds and other investment companies to 100 percent of capital.