Proposed Section 703.3(b)(3) requires that the board be notified when an investment has fallen outside board-approved policy parameters. For instance, if the credit union has established a minimum issuer credit rating of B, and during the course of holding an investment, the issuer's rating falls to B/C, the board must be notified and some decision regarding the investment or policy made and documented in the minutes.

Proposed Section 703.3(b)(4) addresses the reporting of interest rate risk. It requires a federal credit union to prepare a monthly report showing the characteristics of each investment in the portfolio and the net increase or decrease in the fair value or total return of each security, and the portfolio, in sufficient detail to ensure that all of the securities, and the portfolio as a whole, remain within board policy. The change in fair value of held-to-maturity securities must be included because losses from such securities reflect future losses of income. Where the credit union has an active asset-liability management or investment committee, the report may be provided to such committee, with a summary to the board. Where the credit union does not have such a committee, the full report must be provided to the board.

A credit union that chooses to keep all of its investments in CDs and corporate credit union shares and deposits would not be required to price these investments and therefore would not be subject to this reporting requirement. Only those credit unions that have marketable securities would be required to report this information. Credit unions that purchase securities with greater potential risk may have additional reporting requirements.

Section 703.3(b)(4)(ii)(C) sets forth the securities that NCUA has determined represent greater potential risk. They are: (1) Securities that amortize; (2) securities with embedded options; (3) securities with maturities greater than 3 years; and (4) securities where contract rates are related to more than one index or are inversely related to, or multiples of, an index. If the total of securities that have any one of these characteristics is greater than capital, proposed Section 703.3(b)(4)(iii) requires that the credit union calculate the potential impact, on the fair value and/or total return of each security in the portfolio and the portfolio as a whole, of parallel shifts of plus and minus 300 basis points. The purpose of this analysis is to determine the impact of potential shifts in interest rates on the credit union's future capital position. Current investment decisions must be made in the context of this analysis. Credit unions that do not want to conduct this analysis can restrict the total of these potentially risky investments to less than capital. For purposes of this rule, adjustable rate securities with a final maturity of 3 years or more are considered securities which represent greater potential risk.

This interest rate shock test reflects a trade-off between ensuring a credit union board's full awareness of the risks of its portfolio and reducing the burden on small and medium-sized credit unions. The rule could have included long-term CDs and term investments in corporate credit unions in the list of investments that trigger the test, since such investments can present a high degree of interest rate risk. The rule also could have required a credit union holding even one of the triggering securities to subject its portfolio to a 300 basis point shock, because of the potential for greater interest rate risk. The rule also could have required more complex interest rate tests. Since financial markets do not change in parallel shifts, a 300 basis point parallel shift is inadequate to truly evaluate potential risk. More accurate tests would consider factors such as twists in the yield curve, lags, changes in volatility, the reinvestment rate of cash flows, and institutional factors affecting prepayment patterns. Finally, NCUA could have required credit unions to subject their entire balance sheets, including loans and shares, to an interest rate shock test, since testing only the investment portfolio yields an incomplete picture of the interest rate risk on a credit union's balance sheet. The NCUA Board determined, however, that more complex or additional tests would be too burdensome for small and medium-sized credit unions. However, it is NCUA's judgment that holders of large portfolios of more complex securities cannot manage interest rate risk adequately without conducting additional testing, and examiners will anticipate that additional evaluations be done.

NCUA is proposing to permit credit unions the choice of using either changes in the fair value or total return to establish risk parameters and assess return. Changes in fair value can provide an approximation of risk exposure and return. However, credit unions may prefer to calculate and report total return since it is a more comprehensive measure. Managers with more sophisticated portfolios will likely calculate total return. The method used for calculating total return should be documented for review purposes.

A credit union should always compare prices among broker-dealers for similar securities. In some instances, the price a credit union has paid or received for a security has been significantly different from the market price because the credit union conducted transactions with only one broker, who knew that the credit union was not verifying the price with another source. Proposed Section 703.3(b)(5)(i) requires that prior to purchase or sale a credit union obtain a price quote from a second broker or from an industry-recognized information provider. The information provider can be a pricing service or simply a newspaper with a financial section. These latter sources provide only indicative prices, however, and generally are not sufficient to ensure the credit union has received the best price quote. Where a credit union wishes to purchase a security that cannot be competitively priced, it should obtain a price on a comparable security. It is understood that the prices received from broker-dealers will generally not be in writing; however, the credit union should maintain documentation of who was called, the date and time of the call, and the quoted price or spread to the relevant Treasury security.

Proposed Section 703.3(b)(5)(ii) requires a monthly review of the fair value of each security in a credit union's portfolio. This information is generally provided by broker-dealers or safekeepers. Although such information may not be as accurate as a real bid, the NCUA Board recognizes that obtaining real bids on a monthly basis is impractical and burdensome. To ensure some independent verification of these prices, however, Section 703.3(b)(5)(iii) requires that at least semiannually the credit union obtain a price on each security from another broker or an industry-recognized information provider. A credit union may eliminate the burden of valuing securities by restricting its portfolio to CDs and shares and deposits in corporate credit unions. In addition, a credit union can lessen its burden of valuing securities by restricting its portfolio to securities whose market prices are readily available.

Proposed Section 703.3(b)(6) provides that credit unions must perform credit analyses of issuing entities unless the investment is issued or fully guaranteed by the U.S. government or its agencies or enterprises or is insured by the Federal Deposit Insurance Corporation or NCUA. The NCUA Board recognizes that it is often difficult for credit unions to perform a detailed credit analysis. Therefore, the proposed rule establishes a minimum issuer rating for financial institutions of B/C (or equivalent) or