NATIONAL CREDIT UNION ADMINISTRATION
NATIONAL CREDIT UNION SHARE INSURANCE FUND

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DEAR BOARD OF DIRECTORS:

Over the past several years, many financial institutions have experienced a declining yield on assets as a result of lower interest rates and a significant decline in loan demand. A greater proportion of earnings is derived from a larger investment portfolio yielding an overall lower return.

Some credit unions have attempted to offset the effect on profitability by seeking higher yields through purchases of new types of financial instruments. Along with the higher yield, there may be additional risks (for example, unexpected price declines) or potentially uncertain cash flows associated with these investments. A number of newer investments are on the market today:

- Treasury securities and mortgage pools have been transformed into new instruments where both the cash flows and yields are very different from the underlying collateral.
- Treasury coupon bonds have been converted into zero coupon bonds by stripping the coupon and separately selling each cash flow (i.e., cash flows from interest payments and principal payments known as IOs and POs).
- Mortgage pools have been recast as Real Estate Mortgage Investment Conduits (REMICs) and Collateralized Mortgage Obligations (CMOs) by splitting the pool's cash flows.
- Some CMOs and REMICs have been designed to conform with NCUA Rules and Regulations at the time of purchase, but not at a later date (Extend-o-matics).
- Some banks offer certificates of deposit where the yield is related to the Standard and Poor's 500 Index.
- The return on some Federal National Mortgage Association debt is linked to the difference between the Italian Lira and the Swiss Franc and other currency spreads.
- Current proposals call for slicing municipal bonds into various trenches.

Under the Federal Credit Union Act and NCUA Rules and Regulations, many of the investment instruments noted above are **permissible**. However, it is the responsibility of credit union officials to determine if the investments are **appropriate** for their institutions. An investment is appropriate only if it is consistent with the credit union's overall asset/liability management requirements, is fully addressed in the investment policy, and its risks are fully understood by management.

The investment marketplace is constantly changing. Officials should be aware of any potential risks before an investment product is purchased. Officials should also understand and document what can happen to the value and cash flow of an investment in different interest rate environments. No security should be purchased unless it is authorized in the credit union's investment policy; the risk, yield and cash flow characteristics of the investment are understood; and the instrument, is consistent with the needs of the credit union.

In summary, whenever management is uncertain of an investment's appropriateness, or if the investment is not fully understood, the best decision is not to purchase it. As always, the best investments remain-loans to members.

For the National Credit Union
Administration Board,

Roger W. Jepsen
Chairman