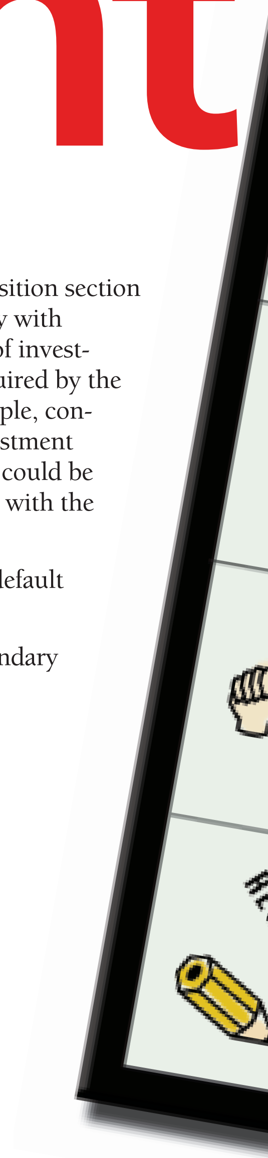
Making A Statement

A practical guide to the board's role in establishing investment policy.

By Michael J. Philbin



While the investment portfolio may not take center stage in strategic and tactical decision making, for many credit unions it still represents a significant earning asset and therefore requires attention from the board and senior management. And the board's attention should be focused on establishing policy, for the responsibility for the formulation and implementation of a credit union's investment policy rests with the board of directors.

This is a responsibility that cannot—and should not—be taken lightly. With an effective and well thought-out investment policy statement, volunteers can deliver good governance to their credit unions.

While their business model has evolved throughout the years, credit unions' core mission still centers on offering loan and deposit products to their members. Since these services determine so much of the overall operational performance of a credit union, it is understandable that the investment portfolio generally serves in a complementary role, usually as a liquidity vehicle to complement the asset and liability mix.

Through the investment policy statement, the board can set forth policies and procedures to guide the day-to-day administration of the credit union's investment activities. While there is no one "gold" standard regarding an investment policy statement, there are some practical areas the statement should address in order to meet its objective as governing document.

Investment objective

For many credit unions, the objective of the investment portfolio is to provide liquidity and facilitate lending operations. So, the investment objective in the policy statement could be stated as just that: To convert excess cash resulting from deposit inflows and to provide liquidity for deposit outflows or loan demands (or other contingencies). Incremental language might broadly state the expectations regarding yield, credit quality and interest rate risk. In addition, the methodology used to ensure liquidity, such as a tier (ladder) approach, can be stated as part of the objective.

The portfolio composition section of your plan can specify with greater detail the type of investments that may be acquired by the credit union. For example, considering the stated investment objective, the portfolio could be comprised of securities with the following attributes:

- minimal credit or default risk,
- highly liquid (secondary market), and
- low-market price volatility due to changes in interest rates.


INVESTMENTOPOLY
COMMUNITY CHEST
CHANCE
MODIFICATIONS
PORTFOLIO
SECURITIES
LIABILITY COMMITTEE
REQUIREMENTS
REVIEWS
LIQUIDITY VEHICLE
SAFETY OF PRINCIPAL
YIELD
DIVERSITY
GOOD GOVERNANCE
LENDING OPERATIONS
BOARD MEETING
9:00 AM
RULES AND REGULATIONS
CORE MISSION
%
MATURITY
INVESTMENT ACTIVITIES
GO

Clearly, in this example, the emphasis is on liquidity and safety of principal. Yield is a secondary consideration. In addition to the emphasis on liquidity and safety and a board's own policies, federal regulations further constrain investment activity. It's important for board members to know which investments are authorized and which ones are unauthorized. They should also be familiar with maturity constraints and diversification requirements.

Part 703 of the NCUA Rules and Regulations specifies the types of permissible investments federal credit unions are authorized to purchase. The credit union board can further restrict these options if they feel it is necessary to do so.

A cardinal rule for fixed-income investing has to do with an instrument's maturity. All things equal, the longer an investment has in terms of its time to mature, the greater the price sensitivity and default exposure. To control the risk resulting from these two factors, you can specify the maturity distribution of the portfolio. For example, your policy could restrict investments that mature beyond four or five years.

To enhance the liquidity management of your portfolio, your policy can call for targeted levels for the portfolio as opposed to hard and fast limits. For example, your policy could state that:

- up to 100 percent of the portfolio can be for a term less than two years,
- a maximum of 75 percent of the portfolio can be for terms of more than two years and less than five years, and
- a maximum of 20 percent of the portfolio can be for terms of more than five years but not more than 10 years.

Diversification

A credit union's financial exposure to any single entity can be managed by placing diversification requirements into the policy statement. For example, the policy may state that the amount of funds on deposit with an institution will not exceed $3 million, or that total combined investments shall not exceed $4 million.

Although the overall interest rate risk for a credit union is generally managed by the asset/liability committee, there can be specific language in the policy regarding the stand-alone interest rate risk in the investment portfolio.

As referenced in the authorized investments section, Part 703 of the NCUA Rules and Regulations, there are certain types of investment transactions that are restricted. Your board of directors could, if it so desired, further amend these transactions.

Your policy can also list the broker dealers the credit union is allowed to transact with and the type of due diligence required by management in their dealings with brokers. The policy can also designate the procedures for securities owned by the credit union but not in its physical possession.

An investment policy, once implemented, is not static. Modifications to the investment policy may be necessary for a number of reasons, such as a change to an industry regulation or an accounting procedure. Such changes can be initiated by the board or recommended by management. In order to perceive and adjust for any external factors, management should review the policy at least annually, and they should present their findings to the board.

Online Resources

There are a number of groups, especially corporate credit unions, offering investment solutions to the credit union community. Here are some to check out.

Corporate One FCU
www.corporateone.coop

Eastern Corporate FCU
www.eascorp.org

Members United Corporate FCU
www.membersunited.org

Mid-Atlantic Corporate FCU
www.midatlanticcorp.org

NIFCU$
www.nifcus.com

Southeast Corporate FCU
www.secorp.org

Southwest Corporate FCU
www.swcorp.org

WesCorp
www.wescorp.org

"An investment policy, once implemented, is not static."

In addition to regulatory and accounting factors, investment policies are often modified because of:

- impractical time horizons for return objectives;
- operational problems that surface as a result of the investment process;
- issues that arise and are important but are not covered in the current policy; and
- substantial changes in long-term market trends, macroeconomic conditions or investment opportunities that are markedly different than the policy.

When considering modifications to the investment policy, most credit union boards take a long-term view of market conditions and investment options and guard against reacting to short-term situations. Any modifications made are usually reviewed and discussed with the investment officers of the credit union prior to implementation.

Practical applications

From a practical standpoint, the credit union board should view the investment policy statement in two ways: One as the basic tool for the execution of the credit union's investing program and as a dynamic document that can react to the changing requirements of the institution. Working within this framework, below are some practical examples that demonstrate the policy application often used by boards to fulfill their role in governance:

- **A post-purchase investment falls outside of the policies:** This can be a common occurrence with amortizing investments, such as CMOs, and would require interpretation of the policy—if one existed—on maturity limits. The decision would come down to whether or not the credit union should divest of the investment or continue to hold. The board can provide good counsel in this area, and the discussion, as recorded in the minutes, reinforces good governance.

- **Policy is unclear on a particular type of investment:** Oftentimes the policy statement does not explicitly allow—or disallow—a particular type of investment activity. This is often the case with recently approved investments (e.g., securities lending). When this situation arises, the board must interpret the existing policy and apply or amend the language to clarify for management the position on the activity.

- **Changes to the approved broker list:** Many investment policy statements assign criteria (such as capitalization targets or levels) for brokers. When circumstances change for an approved broker—he or she may no longer meet the capitalization requirements or if a formal complaint has been made against that broker—the board can decide how diligent it wants to be in enforcing the requirements of the statement.

As a working document, the investment policy statement establishes the overall investment strategies and discipline for the credit union. From a practical standpoint, the policy should be designed to allow sufficient flexibility to capture investment opportunities, yet ensure that parameters are put in place to maintain care and execution in the investment program. By their involvement with this part of the credit union's operations, board members can impact—in a positive way—the safety and soundness of their institutions.

Michael J. Philbin is vice president of NIFCU$, the National Investment Fund for Credit Unions (www.nifcus.com). He can be reached at michael.philbin@uboc.com or 800-336-4644, ext. 298.