CORPORATE CREDIT UNION GUIDANCE LETTER

No. 2007-02 DATE: April 18, 2007

SUBJ: Credit and Market Value Risks of Mortgage-Backed Securities (MBS)

TO: The Corporate Credit Union Addressed

The purpose of this letter is to note credit quality and market value concerns with MBS having underlying sub-prime or nontraditional mortgages and/or structured with an available funds cap (AFC). Policy requirements for credit concentrations and credit monitoring were addressed in Corporate Credit Union Guidance Letter No. 2003-01.

Credit Risks of Nontraditional Mortgages

As of December 31, 2006, system-wide corporate credit union exposure to securities collateralized by real estate totaled 75.34 percent of all marketable securities. OCCU expects management to identify and closely monitor the risks when a corporate has a significant position in these securities.

Problems recently reported with underwriting and servicing of many sub-prime and non-traditional loans intensify the need for adequate monitoring of MBS by management, since such loans may have been securitized.

The federal financial regulatory agencies issued *Nontraditional Mortgage Product Risks* addressing the risks posed by residential mortgage products that allow borrowers to defer repayment of principal and sometimes interest. These products, referred to as nontraditional, alternative, or exotic mortgage loans, include interest only mortgages and payment option adjustable-rate mortgages. The loans allow borrowers to exchange lower payments during an initial period for higher payments later. The concern is that some borrowers may not fully understand the risks associated with these products.

The following guidance offers advice on managing the potential risks created by these loans. See, NCUA Letter to Credit Unions No. 06-CU-16, available online at http://www.ncua.gov/letters/2006/CU/06-CU-16.pdf.

Available Funds Caps

The value of a MBS with an AFC may be negatively impacted by credit losses or interest shortfalls. By way of example, a transaction may use excess spread for credit support and pass through a floating rate subject to a cap equal to the weighted average interest rates on underlying loans. If a shortfall occurs because of a credit loss, the amount of interest currently distributed will be reduced to the amount payable based on available funds. A transaction may provide for the shortfall to be carried forward and paid at a later date if there is excess cash. Note a transaction might provide for payment of any carry forward amount only if there is excess cash after building over collateralization to a target level. Further, a transaction may not cover a carry forward amount after specified dates or events.

When an AFC security incurs an interest shortfall it will impact liquidity, reinvestment, and market risks. Some AFC classes have experienced interest shortfalls recently. Corporate credit unions owning AFC classes should monitor their performance to determine if they are in accrual (interest shortfall) status and the resulting impact on the security and net income.

Identify and Monitor Risk

To ensure prompt identification of risks, at a minimum, corporate procedures should require appropriate prepurchase analysis and ongoing monitoring of MBS to control material exposures to:

1. Credit risk (including risks of sub-prime and nontraditional loans);

2. Market value risk arising from AFC; and

3. Concentration risk to a single originator or servicer.

Corporate credit unions are strongly encouraged to closely monitor their MBS on an ongoing basis. If you have any questions, please contact this office, your examiner, or if applicable, your state supervisor.

Sincerely,

/S/

Kent Buckham
Director
Office of Corporate Credit Unions

cc: State Supervisory Authorities
NASCUS
NAFCU
ACCU