

NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456
LETTER TO CREDIT UNIONS

NCUA LETTER NO. 96

DATE: MARCH. 1988

TO THE BOARD OF DIRECTORS OF THE FEDERAL CREDIT UNION ADDRESSED:

The National Credit Union Administration (NCUA) Board has acted to permit Federal credit unions to invest in privately-issued mortgage-related securities under Section 107 (15) (FB) of the Federal Credit Union Act. The NCUA Board has also acted to authorize certain investments in mortgage notes pursuant to Section 107 (15) (A) of the Act.

Investments made under Section 107 (15) (A) may only be made if a Federal credit union has an ongoing program of making real estate-secured loans and needs comparable loans to complete the packaging of a pool of loans for sale or pledge on the secondary market. Section 701 23 of NCUA's regulations contains the requirements for this activity.

This letter is to provide information and guidance concerning Section 107(15)(B) investments, as well as discuss the mortgage-related security market in general. Before making investments authorized under Section 107(15)(B), the credit union's board of directors should determine that the investment is permissible. This determination should be supported by a legal opinion from an independent source, and not by relying on the advice of the broker or other party marketing the investment.

Privately -issued securities require the same sound investment policies and practices as other investments. In brief, the board of directors should:

- a. Diversify investments by type, maturity and degree of risk.
- b. Follow investment strategy that includes an asset-liability and a rate sensitivity analysis.
- c. Deal with established, financially sound and reputable broker/dealers.
- d. Determine that proper safekeeping of securities is maintained.
- e. Monitor investments continually, review management performance, and determine compliance with policy. In Letter No. 89, the NCUA Board gave specific guidance to credit unions who choose to actively trade in the securities market. There are many mortgage-backed securities such as FNMA Strips, Splits, Pos and Ios that are extremely volatile as interest rates change. While these investments may be legal, their volatility makes them inappropriate for most credit union investment strategies. Extreme caution is urged. If the market characteristics of the instrument, whether privately- or government-issued, make it extremely volatile, then it will be considered a trading

account and is subject to the requirements and restrictions of NCUA Letter No. 89 to Federally-Insured Credit Unions, dated April 3, 1987.

Enclosed is an Appendix which provides general information about mortgage-related securities. The key to successful investing remains common sense and sound investment policies.

Sincerely,

ROGER W. JEPSEN
CHAIRMAN, NCUA BOARD

APPENDIX

Federal Credit Unions (FCUs) have long been authorized to invest in mortgage-related securities issued by Federal instrumentalities - the Federal National Mortgage Association (FNMA), the Government National mortgage Association (GNMA), and the Federal Home Loan Mortgage Corporation (FHLMC) (see Section 107 (7) (E) of the FCU Act) - but they did not have the statutory authority prior to enactment of Section 107(15) of the FCU Act to invest in privately-issued mortgage-related securities. The purpose of this Appendix is to provide information about the new authority to invest in privately-issued mortgage-related securities and to discuss various safety and soundness guidelines applicable to all mortgage-related securities.

Mortgage-related securities contain varying elements of risk. Among these are credit risk, interest rate risk, and liquidity risk:

(1) Credit Risk.

By definition, privately-issued mortgage-related securities are those that are rated in one of the two highest rating categories by at least one nationally-recognized statistical rating organization. As an example, Standard & Poors (S&P) and Moody's would satisfy the national rating organization requirement. Their two highest rating categories are:

S&P AAA or AA+, AA, and AA-
Moody's Aaa or Aa1, Aa2, and Aa3

In light of the rating criteria that must be satisfied to receive a rating in one of the two highest categories (one of the requirements in the definition of a privately-issued mortgage-related security under Section 107(15)(B), NCUA does not consider credit risk to be a major concern. However, if the rating for a particular security declines below the two highest rating categories after purchase, the security falls outside the Section 107 (15) (B) authority, and must be marked to the lower of cost or market and divested as soon as possible.

(2) Interest Rate Risk.

All mortgage-related securities are subject, in varying degrees, to decline in market value when interest rates rise, though this decline may be offset by other factors. Some form of securities may be less volatile than others, e.g., CMOs or REMIC securities in the fastest-paying tranche with an average maturity of 1 to 3 years are generally less volatile than IOs (interest only securities).

Another aspect of mortgage-related securities that is influenced by interest rates is the prepayment rate of the underlying mortgages. Prepayment rates on the underlying mortgage collateral will also impact on the overall yield and market value of the investment.

This is particularly significant in such securities as FNMA Strips, IOs and POs (principal only securities).

Because of the potential for either a loss of market value or holding a low-yielding investment, a prudent approach to investing in interest-sensitive securities is to analyze the interest rate sensitivity of the balance sheet. For example, what is the impact on the market value of the investment and earnings position of the credit union if interest rates were to shift 100, 200, or 300 basis points. This rate sensitivity analysis will vary from credit union to credit union depending upon the rate and maturity structure of both assets and liabilities. However, this approach should assist an FCU in determining what would be a reasonable and prudent level of investment in such securities. Depending on the results of the analysis, an FCU may decide to limit its investment in mortgage-related securities to a specified percentage of its total assets, total investments and/or a multiple of total reserves, or place dollar size limitations on specific types of securities to be purchased.

Duration is another consideration in analyzing interest rate risk. Duration is a measure of the sensitivity of the price of a particular security to changes in interest rates. The duration factor, however, is measured as a function of time. If interest rates rise, anticipated prepayments will diminish thereby lengthening the anticipated "duration" (i.e., life) of the securities involved. Similarly, if interest rates fall, such prepayments may be expected to rise due both to the refinancing involved and the multiple payments made against the higher interest loans outstanding.

It must be noted that the price sensitivity is not linear in nature. That is, a 5 percent change in the anticipated duration will not necessarily result in a 5 percent change in the anticipated price. Such a change may be greater or less than the actual change in interest rates.

Stop loss provisions may also be used to limit losses on a given security. Such provisions are intended to sell a particular security at a predetermined stop-loss price. In the event that the market value of the security declines to the stop-loss price, the credit union would sell the security in order to prevent further price erosion. Stop loss provisions may be particularly appropriate during periods of rising interest rates or extraordinary market volatility.

(3) Liquidity.

Interest rate volatility can cause mortgage-related securities to decline in market value. If an FCU's liquidity needs require the sale of the securities during periods of increased interest rates, they may have to be sold at a significant loss .

Since many of the mortgage-related securities and derivative securities, such as CMOs and REMICS, are relatively new to the marketplace, there is limited information available relative to prepayment histories on the underlying mortgages of these securities.

There is no formalized existing secondary market for the sale or purchase of these securities. Therefore, disposal of this type of security may be difficult to achieve on a timely basis.

In light of the potential for liquidity problems, a credit union should carefully review its current and anticipated liquidity needs prior to investing in mortgage-related securities. The review necessarily requires a thorough knowledge of the nature and makeup of the credit union's assets and liabilities; the economic and competitive environment in which the credit union operates; and, most importantly, the needs of the membership. A credit union should not make a commitment to mortgage-related securities if it determines that the investment may impair its future earnings position or its ability to service the membership.

Section 107 (15) (B) of the FCU Act gives FCUs the power to invest, subject to NCUA guidance, in mortgage-related securities defined in Section (3)(a)(41) of the Securities Exchange Act of 1934. The Securities and Exchange Commission therefore has primary responsibility and authority to interpret what is a mortgage-related security under Section 107(15)(B) of the FCU Act. Accordingly, credit unions entering this investment area should obtain SEC or legal counsel review of a particular security prior to investing. The following discussion is provided to credit unions for general guidance only and reflects this Agency's understanding and experience with the more common types of mortgage-related investments now being offered.

Definition of "Mortgage - Related Security"

- a. The security is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization; and
- b. The security must either represent ownership of one or more promissory notes or certificates of interest or participation in such notes; or be secured by one or more promissory notes or certificates of interest or participation in such notes and, by its terms, provide for payments of principal in relation to payments or reasonable projections of payments, on notes, or certificates of interest or participations, in promissory notes; and
- c. The underlying notes or certificates must be directly secured by a first lien on a single parcel of real estate; stock allocated to a dwelling unit in a residential cooperative housing corporation, upon which is located a dwelling or mixed residential and commercial structure; or on a residential manufactured home; and
- d. The underlying notes or certificates must have been originated by a savings and loan association, savings bank, commercial bank, credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority; or by a mortgagee approved by the Secretary of Housing and Urban Development.

The types of investments covered by this definition have been expanding in the marketplace. These investments include securities such as mortgage pass-through securities, and mortgage

pay-through securities such as Collateralized Mortgage obligations (CMOs) and Real Estate Mortgage Investment Conduits (REMICs).

Description of the General Types of Mortgage-Related Securities Available.

a. Mortgage Pass-Through Securities.

Investors own undivided interests in a pool of underlying mortgages and receive pro rata shares of cash flows. Each pool has, for example, a coupon or pass-through rate, an issue date, a maturity date, and a payment date. In addition, each pool may have some unique features. Many FCUs are familiar with and have invested in pass-through securities issued by GNMA, FNMA and FHLMC under the express authority in Section 107(7)(E) of the FCU Act. The types of mortgage pass-through securities that are authorized under the SMMEA amendment would include those securities issued by private institutions that qualify as mortgage-related securities.

b. Mortgage-Backed Securities (Bonds).

It is our understanding that so-called mortgage-backed bonds are usually in fact general obligations of the issuer. If that is so, it is our further understanding that they are not considered mortgage-related securities by the Securities and Exchange Commission and, therefore, are impermissible as investments by Federal credit unions.

c. Mortgage Pay-Through Securities.

(1) Mortgage pay-through bonds

These are also known as cash flow bonds. They combine aspects of pass-through securities with features of mortgage-backed bonds. As with mortgage-backed bonds, the investor owns the bond while the issuer retains ownership of the mortgage collateral. However, unlike a mortgage-backed bond, pay-through bonds link the cash flow from the collateral to the cash flow on the bonds. Due to the linking of the cash flows, principal payments on the bonds will fluctuate depending on the timing of unscheduled principal payments from the collateral.

(2) Collateralized Mortgage obligations (CMOs)

CMOs are multiclass pay-through bonds. CMOs can be general obligations of the issuer backed by mortgage collateral or they can be limited obligations where the bondholders can only look to the pledged collateral for payment. The cash flows generated by the collateral are linked to the cash flows of the bonds. Principal payments are made to one class at a time based upon an order of priority determined at the bond issue date.

Each bond class, or tranche, has a stated maturity date and a fixed coupon rate. After interest payments have been made, all available cash goes to repay principal on the

"fastest-pay" tranche. Following retirement of the first class, the next tranche in the sequence becomes the exclusive recipient of principal payments until this class is retired. Due to principal prepayments on the collateral, the bonds may be retired substantially earlier than their final maturity date.

Many CMO issues include one or more tranches that are "accrual bonds (or "Z-bonds")." An accrual bond does not receive any cash payments of principal or interest until all tranches preceding it are retired. In effect, an accrual bond is a deferred interest obligation, resembling a zero coupon bond prior to the time when the preceding tranches are retired. FCU -investment in an unrated residual interest of a CMO is not authorized under Section 107(15)(B) of the FCU Act.

(3) Real Estate Mortgage Investment Conduits (REMICs)

The Tax Reform Act of 1986 establishes and creates rules relating to REMICS. REMICs were authorized as a way of avoiding problems of double taxation. In general, a REMIC is a fixed pool of mortgages with multiple classes of interests held by investors. In order to qualify as a REMIC, all of the interests in the REMIC must consist of one or more classes of "regular" interests and a single class of "residual" interest. Regular interests are like the class(es) of a CMO issue. The residual interest consists of the excess interest and reinvestment earnings that exist as a result of the differential between the income flow from the underlying mortgages and the income outflow to the regular interestholders. FCU investment in an unrated residual interest of an REMIC is not authorized under Section 107(15)(B) of the FCO Act.

Other Mortgage-Derived Securities

Stripped Mortgage-Backed Securities (SMBS) allocate principal and interest from a pool of mortgages and produces two classes of security, an Interest only (IO) portion and a Principal only (PO) portion. The rate of return of an SMBS depends on the specific percentage allocation of the principal or interest and on mortgage pay-off speed. Mortgage pay-off speed is usually directly related to the rise and fall in interest rates. Accordingly, the IO and PO portion of an SMBS is extremely sensitive to interest rate movements and highly price volatile.

When purchasing an IO or PO, the purchaser is speculating on the movements of future interest rates as these movements affect pay-off speed of the underlying mortgages. The IO portion performs well when interest rates rise and the PO portion performs well when interest rates fall. IOs may serve as a useful hedge to mortgages and similar instruments in a depository institution's portfolio because they gain in value as interest rates rise. Any investment in either an IO or PO without a complete and continuing hedge analysis will generally be considered a trading account security.