NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION

NATIONAL CREDIT UNION SHARE INSURANCE FUND

LETTER NO. 155

LETTER TO CREDIT UNIONS DATE: April 1994

DEAR BOARD OF DIRECTORS:

The proliferation of mutual funds, the increasing complexity of mutual fund investments, and the active management of a mutual fund, which can involve rapid changes in its portfolio has made it more difficult for credit unions to determine if an individual mutual fund is permissible. This letter will clarify the National Credit Union Administration's (NCUA) position and assist federal credit unions (FCUs) in reviewing the permissibility of investments in a given mutual fund.

Section 703.4(j) of the NCUA Rules and Regulations, 12 C.F.R. Section 703.4(j), provides that a federal credit union may invest in a mutual fund if the investments and investment transactions of the fund are legally permissible for FCUs under the Federal Credit Union Act and NCUA Rules and Regulations. Conversely, an FCU may not invest in a mutual fund if the prospectus or official statement of additional information explicitly authorizes the fund to make investments or engage in investment transactions that are impermissible for FCUs. NCUA has taken the position that an FCU is not permitted to invest in such a fund even if the FCU has evidence that the fund is not making such investments or engaging in such transactions.

In 1991, Part 703 of the NCUA Rules and Regulations was amended to prohibit FCUs from investing in:

* Stripped mortgage-backed securities (SMBSs).

* Collateralized Mortgage Obligation (CMO) and Real Estate Mortgage Investment Conduit (REMIC) securities that do not pass a high risk securities test.

* CMO and REMIC residuals.

* Zero coupon securities with maturities greater than 10 years.

FCUs are permitted to hold the first three if the investment is made solely to reduce interest-rate risk and the requirements of Section 703.5(i) are met.

Since the regulation was amended, FCUs have been presented with situations in which, for example, a mutual fund prospectus states that the fund is authorized to invest in "CMOs and REMICs," without specifying that any securities purchased will either pass the high risk securities test or be held to reduce interest-rate risk. Where a fund prospectus fails to narrow a broad category of securities sufficiently, such as with CMOs and REMICs, FCUs have been encouraged to ask the fund manager to "sticker" the prospectus with a formal statement containing the necessary restriction so that fund would be permissible for FCUs. The sticker must state that any CMOs or REMICs purchased by the fund would either pass the high risk securities test or be held solely to reduce interest-rate risk. If the prospectus were amended with such a sticker, the fund would be a permissible investment.

When an FCU has been unable to get a prospectus stickered, the matter has been left to the examiner's discretion. Some examiners have recommended divestiture because the potential exists for the mutual fund to make investments or engage in investment transactions that are impermissible for FCUs. Other examiners have recommended that the FCU obtain written assurance that it will be informed prior to the fund making an impermissible investment or engaging in an impermissible transaction. Still others have recommended that the FCU monitor the fund's transactions to ensure that the fund does not make such investments or engage in such transactions.

It has become increasingly difficult for FCUs to monitor funds' investments and investment transactions, however, and FCUs cannot be certain that they will be informed when funds plan to engage in prohibited activities. For these reasons, and to eliminate examiner inconsistency, NCUA is taking the position that an FCU may invest in a mutual fund only when the prospectus indicates that the fund's authority is strictly limited to investments and investment transactions that are legal for FCUs. Therefore, a fund authorized to purchase CMOs and REMICs without restriction is an impermissible investment for FCUs, even though the FCU has evidence that the fund purchases only securities passing the high risk securities test. To minimize hardship to FCUs and give funds time to revise their prospectuses, this policy change will not be effective until January 1, 1995.

For the National Credit Union Administration Board,

Norman E. D'Amours
Chairman