NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION

NATIONAL CREDIT UNION SHARE INSURANCE FUND

LETTER TO CREDIT UNIONS

LETTER NO. 139

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DEAR BOARD OF DIRECTORS:

We have noticed a growing interest in credit unions to invest in a derivative of mortgage-backed securities known as Collateralized Mortgage Obligations (CMOs). Last year, the National Credit Union Administration (NCUA) revised Part 703 of the regulations to address these investments.

We are concerned that some credit unions, once assured the CMO conforms to NCUA's regulations (Part 703.5 (g)), purchase these instruments because of their attractive yields without fully evaluating the characteristics of these investments.

CMOs can be a suitable investment for credit unions, but they are complex instruments, and you need to be convinced they are appropriate for your credit union. At the very least, before you purchase a CMO, you need to be sure you understand how a CMO works and have a firm idea of the potential impact of a change in interest rates on the price of the CMO, its yield and its cash flows.

This is not as straight forward as with a bank certificate of deposit or government security. Although many CMOs that are legal credit union investments have more predictable cash flows than ordinary mortgage-backed securities, both of these instruments receive their interest and principal payments from mortgages. More homeowners prepay their mortgages as interest rates fall and fewer prepay as interest rates rise. That means that typically:

- CMOs mature more rapidly when rates fall. This can force your credit union to reinvest larger cash flows at lower market yields when interest rates decline.

- CMOs mature more slowly as rates rise. This can force your credit union to hold more of its assets at interest rates below current market yields when interest rates increase.

Major security dealers forecast prepayment rates for different interest rate scenarios. You should obtain prepayment forecasts from at least three different dealers when considering a specific CMO. A conservative approach would be to rely on the prepayment forecasts that show the greatest degree of price or yield volatility if interest rates change.

You may also want to consider two additional sources of information. They include:

- Total Return Table. This projects the expected yield on your investment if you have to reinvest the CMO cash flows at different market yields than are currently available.

- Cash Flow Table. This projects your cash flows from the CMO, based on your forecast of future interest rates.

All the information you need on CMOs should be readily available from your securities dealer. If your securities dealer does not have access to this information, you should be extremely careful about buying the investment and consider going to a source that can provide this data.

Re-evaluation

You cannot buy CMOs, determine they are suitable for your credit union and be done with them. These investments must be reviewed periodically. NCUA's regulations require a credit union to evaluate these investments at least annually, but this may not be frequently enough for your credit union.

In any case, you should always take another look if there are significant shifts in either the economy or in interest rates. CMOs that were suitable for your credit union at one time may no longer be appropriate.

Above all, remember the first rule of investing, if you don't understand it, don't buy it. Educate yourself before you invest in CMOs or any other instrument. Otherwise, it could be a very expensive lesson.

For the National Credit Union Administration Board,

Roger W. Jepsen
Chairman
FICU