NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION

NATIONAL CREDIT UNION SHARE INSURANCE FUND

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DEAR BOARD OF DIRECTORS: In today's changing interest rate environment, credit union officials are faced with increasingly complex investment decisions and asset-liability management (ALM) planning. This letter is intended to clarify the National Credit Union Administration's (NCUA's) position on divestiture of Collateralized Mortgage Obligations (CMOs) and Real Estate Mortgage Investment Conduits (REMICs) that fail one or more parts of the high-risk securities test (HRST). The guidelines set forth in this letter may also assist in your analysis of future investment purchases and decisions.

The most significant investment fluctuations that credit unions have experienced involve CMOs and REMICs. We conducted a special review last fall of credit unions that reported large investments in CMOs and REMICs. We found that:

* 57 percent of these credit unions were holding at least one security that failed one or more parts of the HRST;

* 29 percent of these credit unions ran the HRST semiannually or less often (normally at the request of an examiner or auditor); and,

* 39 percent of the managers of these credit unions did not have an adequate understanding of the risks involved in these investments.

As a result of the findings of this review, I have placed a high priority on examining credit unions that hold high concentrations of investments that may pose a significant risk to safety and soundness. Our examiners will be working with the management of these credit unions to ensure that sound investment policies and adequate asset-liability management (ALM) planning are in place.

It is apparent that credit unions who hold CMOs and REMICs often do not have a clear understanding of the requirements for testing and periodic retesting. Furthermore, many credit unions fail to understand what NCUA expects them to do when the investments fail one or more parts of the high-risk securities test (HRST).

Part 703.5(g)(1) of the NCUA Rules and Regulations prohibits federal credit unions from purchasing fixed-rate CMOs or REMICs that fail any one of the three parts of the HRST, which are:

* Average Life Test, * Average Life Sensitivity Test, and * Price Sensitivity Test.

These tests must be applied not only at the time of purchase, but also periodically after purchase. If a security fails any one of the three parts of the HRST, divestiture may be required. These cases will be reviewed by our examiners on an individual basis.

In addition, Part 703.5(j) requires that the Price Sensitivity Test be applied to floating or adjustable rate

CMOs or REMICs.

For Federally Insured State Credit Unions, CMOs/REMICs that fail one or more parts of the high-risk securities test (HRST) are non-conforming investments that require the establishment of a special reserve as required by Section 741.9(a)(3).

If your credit union finds that it is holding securities that fail one or more parts of the HRST, you should immediately dispose of them or, within five business days of discovery, develop and submit to NCUA a written action plan that at a minimum includes:

* an ALM modeling analysis that demonstrates the impact that both holding and selling the failed instruments will have on earnings, liquidity and capital;

* evidence of the credit union's ability to hold the failed instrument(s) and manage the risks under +(-) 300 basis points interest rate shocks;

* an individual dollar loss figure for each failed security that will trigger their sale;

* a monthly log of market bids offered for the failed securities; and

* a monthly monitoring process to evaluate the stress test results for all CMOs and REMICs.

In failed CMO and REMIC cases, NCUA examiners will assess the credit union's action plans. This assessment will consider the reasonableness of the plan and the credit union's ability to manage the balance sheet risk. Specific factors that examiners will focus on will be the ability of the credit union officials to:

* satisfactorily explain the securities characteristics and risks to the examiner;

* obtain and adequately evaluate the security's market pricing, cash flows and test modeling;

* define, explain and document how the failed securities fit into the credit union's ALM strategy;

* analyze the impact that either holding or selling the failed securities will have on earnings, liquidity and capital in different interest rate scenarios; and

* demonstrate the likelihood that the failed securities may again pass the high risk security tests at a future date.

After a careful review of the above factors, the examiner and the credit union management should be able to agree on whether divestiture is appropriate and necessary. If the examiner does not feel that a suitable action plan has been developed, the credit union will be required to sell the failed CMOs or REMICs in accordance with a written directive which will be given to the credit union by NCUA.

NCUA will also propose revisions later this year to Part 703 of the NCUA Rules and Regulations (Investment and Deposit Activities) to update the regulation for the changing environment that exists today in complex investment areas. You will, as always, be given ample opportunity to comment on these proposed changes, and your comments will be carefully considered.

Credit unions need to carefully look at all investments, regardless of what they are or who offers them. We also believe that credit unions investing or depositing large amounts in any financial institution should obtain sufficient information about the operational and financial condition of these institutions in order to make informed investment decisions. This includes analyzing the safety of the institution standing behind the investment. Credit union investment policies should include the requirement and the criteria for an evaluation of the risk involved with every type of investment and deposit that the credit union makes.

NCUA examiners have been instructed to review each investment a credit union makes to determine its appropriateness in relation to the credit union's overall funds management goals.

For the National Credit Union Administration Board,

Karl Hoyle
Executive Director