NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

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August 7, 1987

Office of General Counsel

Mr. Rick Ruffin
UMIC, Inc.
850 Ridge Lake Boulevard
Memphis, TN 38119

Dear Mr. Ruffin:

This is in response to your correspondence regarding the status of Collateralized Mortgage Obligations (CMO's) eligibility as Federal credit union investments.

At present, Federal credit unions are not authorized to invest in privately-issued CMO's. Section 107(15) of the FCU Act, 12 U.S.C. §1757(15), states in part that:

> "[A Federal credit union shall have power] to invest in securities that -
>
> * * *
>
> (B) are mortgage related securities. . . subject to such regulations as the Board may prescribe, including regulations prescribing minimum size of the issue. . .or minimum aggregate sales prices, or both";

Privately-issued CMO's come within the purview of Section 107(15)(B) of the FCU Act. The authority provided in Section 107(15)(B) is not effective until NCUA implements it through regulation, an interpretive ruling, or other Agency action. You

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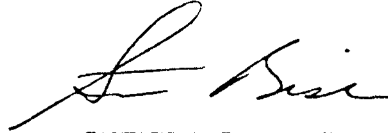
will be interested to know that a Request for Comments has been issued by the NCUA Board at its July 15, 1987 Board meeting. I have enclosed a copy for your review.

Sincerely,



STEVEN R. BISKER
Assistant General Counsel

SRB:wm

Enclosure

Proposed Rules

Federal Register
Vol. 52, No. 143
Monday, July 27, 1987

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Ch. VII

Federal Credit Union Investment In Mortgage Securities

AGENCY: National Credit Union Administration (NCUA).

ACTION: Request for comments.

SUMMARY: The Secondary Mortgage Market Enhancement Act of 1984 amended the Federal Credit Union Act to permit Federal credit unions to invest in certain mortgages and in mortgage securities. The NCUA Board is seeking comment on several safety and soundness issues relating to this new authority. The Board also requests comments on the manner in which NCUA should implement this new FCU authority. FCU's are not currently empowered to make these investments.

DATE: Comments must be received on or before September 18, 1987.

ADDRESS: Send comments to Becky Baker, Secretary, NCUA Board, National Credit Union Administration, 1776 G. Street, NW., Washington, DC 20456.

FOR FURTHER INFORMATION CONTACT: D. Michael Riley, Director, Office of Examination and Insurance, or Steven R. Bisker, Assistant General Counsel, Office of General Counsel, at the above address, or telephone: (202) 357-1065 (Mr. Riley); (202) 357-1030 (Mr. Bisker).

SUPPLEMENTARY INFORMATION: Section 105(b) of the Secondary Mortgage Market Enhancement Act of 1984 ("SMMEA") (Pub. L. 98-440) amended section 107 of the Federal Credit Union Act by inserting new sections 107(15) (A) and (B). *See* 12 U.S.C. 1757(15). As is discussed in greater detail below, these sections authorize Federal credit unions to invest in certain mortgages and privately-issued mortgage-related securities, respectively. The purpose of this document is to request comment on what actions the National Credit Union Administration should take to implement this authority.

It is noted that the NCUA has taken the position that section 107(15) is *not* self-implementing and requires regulation or other official action by the NCUA Board.

Section 107(15)(A)

Section 107(15)(A) authorizes Federal credit unions to invest in "securities that . . . are offered and sold pursuant to section 4(5) of the Securities Act of 1933 (15 U.S.C. 77d(5)). Essentially, this authorizes FCU's to invest in notes, and participation interests in notes, where the note is secured by a first lien on a dwelling or commercial structure and certain other conditions are met.

FCU's have had similar authorities for several years. Section 107(5) authorizes FCU's to make loans, including mortgage loans, to members and to participate with other lenders in making loans to the credit union's members (*See* 12 U.S.C. 1757(5)). Section 107(13) allows FCU's to purchase "eligible obligations" of their members. (*See* 12 U.S.C. 1757(13)). Sections 701.21, 701.22 and 701.33 of NCUA's Rules and Regulations implement these authorities.

In all cases, the lending authority and the loan relationships of FCU's have been limited to *members* of the credit unions. While the new section 107(15) authority to invest in notes secured by first liens is not specifically limited to notes of members, any different interpretation would substantially and materially alter the nature of Federal credit union asset powers and, in effect, would authorize loans to nonmembers. The NCUA Board does not believe Congress intended this result. Accordingly, the new section 107(15)(A) authority is interpreted to be limited to notes of members of the purchasing FCU.

The NCUA Board invites public comment on this interpretation. The Board also requests comment on whether § 701.22 of NCUA's Rules and Regulations (Loan Participation) and § 701.23 (Purchase of Eligible Obligations) should be revised to clarify their applicability to loans and participations acquired under the authority of section 107(15)(A) of the Act.

Section 107(15)(B)

Section 107(15)(B) authorizes FCU's to invest in *privately*-issued "mortgage related securities" (as defined in section 3(a)(41) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(41)) "subject to such regulations as the Board may prescribe, including regulations prescribing minimum size of the issue (at the time of initial distribution) or minimum aggregate sales prices, or both." Although FCU's have been authorized to invest in mortgage-backed securities issued by 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 Act, 12 U.S.C. 1757(7)(E)), they previously did not have the statutory authority to invest in *privately*-issued mortgage-related securities until the enactment of SMMEA.

NCUA has reviewed the investment activity in mortgage-related securities since the enactment of SMMEA. As a result, NCUA has determined to seek comment from FCU's and the public on whether a regulation is necessary, or whether some other form of Agency action, such as an Interpretive Ruling and Policy Statement ("IRPS"), might be more appropriate. Additionally, the Board requests comment on various safety and soundness issues, addressed below, concerning mortgage-related securities.

The following discussion addresses the definition of "mortgage-related securities," the types of investments falling within the definition, and the issues and concerns of NCUA with respect to the safety and soundness of FCU investment in these securities.

Definition of "Mortgage-Related Security"

The term "mortgage-related security" is defined in section 101 of the SMMEA (15 U.S.C. 78c(a)(41)). Items (1)-(4) below summarize the requirements contained in the definition. The definition generally includes any security that satisfies *all* of these requirements:

(1) The security is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization; and

(2) The security must either represent ownership of one or more promissory notes or certificates of interest or participations 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

(3) 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

(4) 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, mortgage-backed securities (bonds), and mortgage pay-through securities such as Collateralized Mortgage Obligations ("CMO's") and Real Estate Mortgage Investment Conduits ("REMIC's").

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 delay. In addition, each pool may have some unique features. Many FCU's 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 would be authorized under the SMMEA amendment would include those securities issued by private institutions that qualify as mortgage-related securities.

(b) Mortgage-Backed Securities (Bonds)

Investors own the security (bond) which is secured by collateral consisting, at least in part, of mortgages or mortgage related securities. Mortgage-backed bonds are more similar to traditional corporate bonds than to pass-through securities. The main distinction between mortgage-backed bonds and corporate bonds is the use of mortgage-related collateral. A mortgage-backed security may be a general obligation of the issuer, which is additionally secured by mortgages, or it may be backed solely by the mortgage collateral. The bonds have a known maturity date and a predetermined cash flow. Unlike a pass-through security, where principal and interest are passed on directly to the investors on a pro rata basis, mortgage-backed bond cash flows are redirected on a priority basis to various classes of bondholders. The bond issuer owns the collateral and distributes that portion of the cash flows generated by the mortgage collateral that is dedicated to the investors.

(c) Mortgage Pay-Through Securities

(i) 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.

(ii) CMO's

CMO's are multiclass pay-through bonds. CMO's 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.

Pursuant to the authority in section 107(7)(E) of the Act, FCU's have been authorized to invest in CMO's issued by the FHLMC (the first issuer of CMO's). The authority provided by the SMMEA amendment would broaden FCU's investment authority to generally include CMO's of private issuers.

(iii) REMIC's

The Tax Reform Act of 1986 establishes and creates rules relating to REMIC's. REMIC's 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 residual interests is *not* authorized under the SMMEA Amendment.

Safety and Soundness Issues

Mortgage-backed securities can sustain significant changes in market value and prepayment rates as interest rates change. The credit union industry incurred substantial losses in the late 1970's and early 1980's from holding long-yielding fixed-rate mortgage-backed securities during an economic environment of high double-digit investment yields. The NCUA Board had to utilize resources of the National Credit Union Administration to assist in stabilizing the earnings position of some credit unions while the asset/liability maturity mix was restructured. More recently, rising interest rates have resulted in market losses at credit unions that have invested in mutual funds composed of long-term securities, many of which are mortgage related. The lack of market awareness and the potential risk exposure assumed by credit unions in the investment area

continue to concern the NCUA Board. Specifically, the safety and soundness issues include credit risk, interest rate risk, and liquidity risk resulting from improper asset-liability management techniques utilized by the credit unions. These various risks are described and discussed below.

Commenters are requested to focus on these issues and provide their thoughts on what steps NCUA should take to ensure that FCU's operate in a safe and sound manner. Should NCUA consider *all* mortgage-backed securities, e.g., GNMA's, FNMA's, FHLMC's, in conjunction with the action it takes to implement the SMMEA amendment? Should NCUA consider taking some form of action with respect to FNMA Strips (both principal only and interest only), in light of the extreme volatility and potential for significant losses, as evidenced by the recent $250 million loss of a well-known national securities brokerage firm?

(a) Credit Risk

By definition, 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—Aaa or Aa1, Aa2, and Aa3.

The rating companies do extensive, in-depth analysis of the transactions involved in a pool of mortgages backing a securities issue. Pool quality and ratings are dependent on collateral characteristics, including: lien status, type of property, occupancy status, amortization type, mortgage term, amount of seasoning or age of the mortgage, location and geographic dispersion of mortgages, size of mortgage, loan-to-value ratios, size of pool, and other factors such as mortgage default insurance, pool insurance, and degree of over-collateralization.

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 mortgage-related security), the Board does not consider credit risk to be a major concern.

(b) Interest Rate Risk

The NCUA Board has repeatedly addressed the issue of volatility of mortgage-backed securities to changes in the prevailing interest rates. Essentially all mortgage-related securities are subject, in varying degrees, to loss in market value when interest rates rise. Some form of securities may be less volatile than others, e.g., CMO's or REMIC securities in the fastest-paying tranche with an average maturity of 1–3 years are generally less volatile than mortgage-backed bonds.

Another aspect of mortgage-related or -backed 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 value of the investment. This is particularly significant in such securities as FNMA Strips.

It has been suggested that a prudent approach to investing in interest-sensitive investments is to analyze the interest rate sensitivity with respect to its impact on the value of the investment and earnings position of the credit unions based upon various basis point shifts (e.g., a 300 basis point shift in interest rates either up or down). The NCUA Board specifically requests comments on the advisability and usefulness of such an analysis and, if advisable, whether it should be required of FCU's before making such investments.

(c) Evaluation of the Investment in Light of the FCU's Assets and Liabilities

Although mortgage-related securities and other mortgage-derivative securities, such as FNMA Strips, are extremely volatile and therefore risky, the risk to an FCU investing in these securities may be lessened somewhat depending on the makeup of the FCU's asset portfolio and its liabilities. Most of the mortgage-type securities that are currently available have been developed with savings and loan associations in mind. They have been useful in converting mortgage loans into securities (referred to as "securitizing" loans) and in providing investments for savings and loans to help manage their inherent mismatch between assets and liabilities (i.e., major portion of many S&L's assets are in long-term, fixed-rate mortgages while their deposit liabilities are short term). In general, Federal credit unions, unlike savings and loan associations, do not have such an inherent mismatch. FCU loan portfolios are typically comprised of short-term consumer loans, making a mismatch less likely. Therefore, the need of FCU's to invest in mortgage-related and mortgage-derivative securities is not the same as that of savings and loan associations.

The Board is concerned about the reasons why FCU's invest in mortgage securities. While the use of such securities to hedge against other assets and liabilities can be a legitimate use, investing in them simply because of their higher yields and their potential for capital gains can be viewed as an unsafe and unsound practice. Even though NCUA has sent out several letters to all federally-insured credit unions in the past two years warning of the pitfalls of reaching for high-yield, long-term investments, particularly in GNMA mutual funds, many FCU's had ignored the warnings and plunged head first into these investments. With the rise in interest rates over the last few months, these credit unions have sustained significant markdowns in their investments which have impacted on their ability to pay dividends and, in other instances, have rendered the credit union insolvent.

The legislative history of SMMEA provides insight as to Congress' view of such investments. In discussing the final version of the SMMEA amendment to the FCU Act, the House Committee stated:

> A proposed requirement that mortgage related securities have a $250,000 aggregate purchase price was deleted by the Committee from the definition of mortgage related securities. The Committee was persuaded that the protection provided by registration and disclosure made it unnecessary. On the other hand, the Committee was of the view that small banks, thrifts and credit unions lacking in financial expertise should be provided additional protection against risky purchases. *Accordingly, section 105 of the bill requires the appropriate regulators to consider this question and provide regulations where necessary governing the size and denomination of the purchases that are authorized. In this way, the bill endeavors to protect the liquidity of less financially sophisticated institutions on whom many of our citizens rely for the protection of their savings.* (Emphasis added.)

H.R. Rep. No. 994, 98th Cong., 2d Sess. at 13 (1984).

In S. Rep. No. 293, 98th Cong., 1st Sess. at 6 (1983), the Senate Committee, in commenting on Section 102 of the Secondary Mortgage Market Enhancement Act of 1983, the precursor to SMMEA section 105, noted that:

> Section 102 liberalizes existing statutory restrictions imposed on federally chartered financial institutions affecting their ability to invest in mortgage-backed securities. *Such restrictions would be lifted save for limitations imposed by their respective federal regulators.*
>
> . . . Likewise, the Federal Credit Union Act is amended to allow federal credit unions to invest in mortgage-backed securities for the first time, *again as regulated by the National Credit Union Administration.*
>
> * * * * *

... Mortgage-backed securities are not inherently risky investments. They are backed by a pool of many mortgages with relatively low default risk as well as mortgage insurance on both the individual mortgages and the pool. Moreover, as is the case under existing law, *institutions are subject to continuous scrutiny of their regulators who require prudence and good business judgment in the management of investment accounts* .... (Emphasis added.)

The Board solicits public comments on the extent of regulation, if any, that should be promulgated governing the size and denomination of the securities purchased pursuant to section 107(15)(B) of the FCU Act.

(d) Liquidity

As seen from the above legislative history of SMMEA, Congress was concerned about the effect of investment in mortgage-related securities on the liquidity of financial institutions such as credit unions. Interest rate volatility can cause these securities to decline in value and become "underwater securities." If liquidity needs require the sale of these securities during periods of increased interest rates, they would have to be sold at the loss.

Since many of the mortgage-related securities and derivative securities such as CMO's, REMIC's, and FNMA Strips 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. It is our understanding that information concerning price-to-yield calculations based on prepayment histories is becoming available, for example by the Public Securities Association ("PSA") to subscribers of their service. PSA has established a CMO data base of securities that are part of initial offerings over $25 million. However, overall, there is limited availability to information and no formalized secondary market.

In light of the potential for liquidity problems, comment is sought on what actions (e.g., regulation, IRPS, letter to credit unions) NCUA should take to address this issue.

By the National Credit Union Administration Board on July 15, 1987.

Becky Baker,

Secretary of the Board.

[FR Doc. 87-16938 Filed 7-24-87; 8:45 am]

BILLING CODE 7535-01-M

RAILROAD RETIREMENT BOARD

20 CFR Part 200

Assessment or Waiver of Interest, Penalties, and Administrative Costs With Respect to the Collection of Certain Debts

AGENCY: Railroad Retirement Board.

ACTION: Proposed rule.

SUMMARY: The Railroad Retirement Board (Board) proposes to revise section 200.7 of its regulations to provide for the assessment of interest, penalties, and administrative costs with respect to the collection of certain debts, as authorized by the Debt Collection Act of 1982, in connection with the collection of certain debts arising from erroneous benefit payments under the several Acts administered by the Board. The Debt Collection Act of 1982 requires the Board to charge interest on claims for money owed the Board, to assess penalties on delinquent debts, and to assess charges to cover the costs of processing claims for delinquent debts. This revision sets forth the circumstances under which the Board may assess interest, penalties, and charges which arise from benefit or annuity overpayments made under any of the Acts which the Board administers.

DATE: Comments must be submitted on or before September 25, 1987.

ADDRESS: Secretary to the Board, Railroad Retirement Board, 844 Rush Street, Chicago, Illinois 60611.

FOR FURTHER INFORMATION CONTACT: Stanley Jay Shuman, General Attorney, Railroad Retirement Board, 844 Rush Street, Chicago, Illinois 60611, (312) 751-4568 (FTS 386-4568).

SUPPLEMENTARY INFORMATION: Section 11 of the Debt Collection Act of 1982 (Pub. L. 97-365) amended section 3(e) of the Federal Claims Collection Act of 1966, which was revised and recodified at 31 U.S.C. 3717 (Pub. L. 97-452, § 1(16)(A), Jan. 12, 1983, 96 Stat. 2472), to provide that the head of an agency shall charge interest on claims owed the agency, assess penalties on delinquent debts, and assess charges to cover the costs of processing claims for delinquent debts. The revised § 200.7 implements the provisions of 31 U.S.C. 3717 relating to assessment of interest, penalties, and administrative costs by establishing criteria therefor in conformity with the standards adopted by the Attorney General and the Comptroller General as set forth in 4 CFR 102.13.

The Board has determined that this is not a major rule for purposes of Executive Order 12291. Therefore, no Regulatory Impact Analysis is required. In addition, this rule does not impose any information collections within the meaning of the Paperwork Reduction Act.

List of Subjects in 20 CFR Part 200

Claims, Debt collection, Employee benefit plans, Railroad employees, Railroad retirement, Railroad unemployment insurance.

Title 20 CFR, Chapter II, is proposed to be amended as follows:

1. The table of contents for Title 20, Chapter II, Subchapter A, Part 200, is proposed to be amended by removing "200. Waiver of interest, penalties, and collection costs with respect to certain debts." and inserting in lieu thereof "200. Assessment or waiver of interest, penalties, and administrative costs with respect to collection of certain debts."

2. The authority citation for 20 CFR Part 200 is revised to read as follows and the authority stations following the sections are removed:

Authority: 45 U.S.C. 231f(b)(5) and 45 U.S.C. 362. § 200 also issued under 31 U.S.C. 3717.

§ 200.4 also issued under 5 U.S.C. 552.

§ 200.5 also issued under 5 U.S.C. 552a.

§ 200.6 also issued under 5 U.S.C. 552b.

3. Title 20 CFR 200 is proposed to be revised to read as follows:

§ 200.7 Assessment or waiver of interest, penalties, and administrative costs with respect to collection of certain debts.

(a) *Purpose.* The Debt Collection Act of 1982 requires the Board to charge interest on claims for money owed the Board, to assess penalties on delinquent debts, and to assess charges to cover the costs of processing claims for delinquent debts. The Act permits, and in certain cases requires, an agency to waive the collection of interest, penalties and charges under circumstances which comply with standards enunciated jointly by the Comptroller General and the Attorney General. Those standards are contained in 4 CFR 102.13. This section contains the circumstances under which the Board may either assess or waive interest, penalties, and administrative costs which arise from benefit or annuity overpayments made under any of the Acts which the Board administers.

(b) (1) Simple interest shall be assessed once a month on the unpaid principal of a debt.

(2) Interest shall accrue from the date on which notice of the debt and demand for repayment with interest is first mailed or hand-delivered to the debtor, or in the case of a debt which is subject to section 10(c) of the Railroad Retirement Act or section 2(d) of the