



NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

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3500

May 2, 1988

Office of General Counsel

Mr. Gerald J. Novak
President
Credit Union Mortgage Services, Inc.
2925 Briar Park Drive, Suite 1250
Houston, Texas 77042

Re: Federal Credit Union Purchase of a Participation
Interest in a Pool of Mortgage Loans (Your February 25,
1988, Letter)

Dear Mr. Novak:

You have asked whether a Federal credit union ("FCU") may purchase a participation interest in a pool of mortgage loans originated by other credit unions. An FCU's authority to purchase a participation interest in a loan, and to originate a loan in which participation interests will be sold, is subject to Section 701.22 of NCUA's Rules and Regulations [12 C.F.R. §701.22]. This section applies only to the purchase of a participation interest in a loan; it does not authorize the purchase of a security collateralized by loans. However, an FCU may, pursuant to Section 107(15)(B) of the FCU Act [12 U.S.C. §1757(15)(B)], purchase a participation interest in a pool of loans if the interest qualifies as a mortgage-related security as that term is defined in Section 3(a)(41) of the Securities Exchange Act of 1934 [15 U.S.C §78c(a)(41)].

Background

Credit Union Mortgage Services, Inc. (CUMSI) provides instruction and assistance to credit unions and credit union service organizations in the origination, sale, and servicing of first mortgage loans. CUMSI will purchase first mortgage loans from an FCU originating first mortgage loans. This FCU will have the option of retaining a 10% interest in the loans it originates, or of selling the entire loan to CUMSI. CUMSI will pool the loans purchased and then sell participation interests in the pool of loans.

It is unclear from your letter whether an FCU would be purchasing an interest in a mortgage loan or in a security that is

FOIA Vol. I.C, 15 Participation Loans

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collateralized by a pool of mortgage loans. If an FCU is purchasing an interest in a loan, Section 701.22 of NCUA's Rules and Regulations [12 C.F.R. §701.22] governs¹ the transaction. If the FCU is purchasing a security collateralized by mortgage loans, Section 107(15)(B) of the FCU Act [12 U.S.C. §1757(15)(B)] governs.

Section 701.22 of NCUA's Rules and Regulations

NCUA's Loan Participation Rule [12 C.F.R. §701.22] applies to an FCU's purchase of a participation interest in a loan and origination of a loan in which participation interests will be sold. Most of the requirements of Section 701.22 are self-explanatory. Section 701.22(b)(2), however, states:

prior to final disbursement, a written participation agreement shall be properly executed, acted upon by the Federal credit union's board of directors or the investment committee and retained in the Federal credit union's office. The agreement shall include provisions which identify the participation loan or loans.

Also, Section 701.22(d)(1) [12 C.F.R. §701.22(d)(1)] states that an FCU may "participate only in loans it is empowered to grant." Section 107(5) of the FCU Act [12 U.S.C. §1757(5)] and Section 701.21 of NCUA's Rules and Regulations [12 C.F.R. §701.21] set forth FCU lending authority.

Finally, Section 701.22(c)(2) requires an FCU originating a loan in which participation interests will be sold to retain at least 10% of the face amount of the loan. Since your letter states that credit unions originating participation loans will have the option of retaining a 10% interest in loans they originate, this portion of the arrangement would have to be modified to come within the Loan Participation Rule. Of course, an FCU may, pursuant to Section 701.23(c) of NCUA's Rule and Regulations, sell to any source a loan it originates and not retain an interest in the loan.

¹You had inquired whether Section 701.23 of NCUA's Rules and Regulations [12 C.F.R. §701.23] would authorize an FCU to purchase a participation interest in a loan. This section authorizes an FCU to purchase and sell certain loans. It does not apply to the purchase of a participation interest in a loan.

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Section 107(15)(B) of the FCU Act

Section 107(15)(B) of the FCU Act [12 U.S.C. 81757(15)(B)]
authorizes an FCU:

to invest in securities that -

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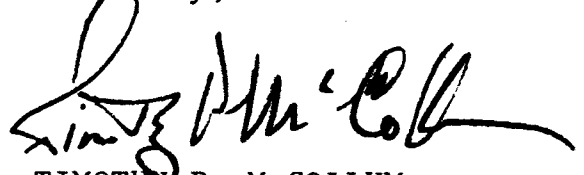
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(B) are mortgage related securities (as that term is defined in section 3(a)(41) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(41)), subject to such regulations as the Board may prescribe, including regulations prescribing minimum size of the issue (at the time of initial distribution) or minimum aggregate sales prices, or both.

This authority to invest in privately-issued, mortgage-related securities was implemented by an amendment to Part 703 of NCUA's Rules and Regulations [12 C.F.R. Part 703], effective February 18, 1988. (See 53 Fed. Reg. 4843, February 18, 1988.) The authority is limited by NCUA regulation only to the same extent as other investments and deposits, as set forth in Part 703. NCUA has issued Letter to Federal Credit Unions No. 96 to assist FCU's in making Section 107(15)(B) investments. Copies of the regulatory change and of Letter to Credit Unions No. 96 are enclosed.

Sincerely,



TIMOTHY P. MCCOLLUM
Assistant General Counsel

JT:bms

**NATIONAL CREDIT UNION
ADMINISTRATION**

12 CFR Parts 701 and 703

**Organization and Operations of
Federal Credit Unions; Investment and
Deposit Activities**

AGENCY: National Credit Union
Administration (NCUA).

ACTION: Final amendments.

SUMMARY: 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). These final amendments implement these sections of the Act. Section 107(15)(B), which authorizes FCU's to invest in certain privately-issued, mortgage-related securities, is implemented by amendment to NCUA's investment rule (Part 703 of NCUA's regulations.) As a result, these investments are subject to the same rules governing other similar FCU investments. Section 107(15)(A), which authorizes FCU's to purchase certain mortgage notes, is implemented by amendment to NCUA's rule concerning purchase of eligible obligations (section 701.23). As a result, this authority may be used to purchase real estate-secured loans to complete a pool of loans for packaging and sale or pledge on the secondary market.

EFFECTIVE DATE: February 18, 1988.

ADDRESS: National Credit Union Administration, 1776 G Street NW., Washington, DC 20456.

FOR FURTHER INFORMATION CONTACT: Timothy P. McCollum, Assistant General Counsel, or Julie Tamuleviz, Staff Attorney, at the above address, or telephone: (202) 357-1030.

SUPPLEMENTARY INFORMATION:

Background

Section 105(b) of SMMEA amended section 107 of the Federal Credit Union Act by inserting sections 107(15) (A) and (B), authorizing FCU's to invest in securities that:

(A) are offered and sold pursuant to section 4(5) of the Securities Act of 1933 (15 U.S.C. 77d(5)); or

(B) are mortgage related securities (as that term is 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 price, or both.

On July 22, 1987, the NCUA Board requested comment on several safety and soundness issues relating to the power granted to FCU's by SMMEA.

The Board also sought comments on the manner in which NCUA should regulate that power. See 52 F.R. 27994 (July 27, 1987). NCUA there stated its preliminary views: (a) That section 107(15) is not self-implementing; (b) that the section 107(15)(A) investment authority is limited to notes of the purchasing FCU's members.

Approximately 39 comments were received in response to the "Request for Comments." Comment letters were received from: 21 FCU's, 3 state-chartered credit unions, 4 state credit union leagues, 2 credit union trade associations and one other trade association, the credit union division of one state, 2 investment management companies, 3 broker/dealers, one federally-chartered corporation involved in the secondary market for home mortgages, and one individual.

Some commenters criticized both of NCUA's preliminary views. Since the NCUA Board is now providing implementing authority, the question whether section 107(15) is self-implementing is moot.

As to section 107(15)(A), the NCUA Board has been persuaded by the comments received that the power is not limited to notes of a purchasing FCU's members. As further explained below, however, the authority is limited to purchasing notes for the purpose of selling or pledging a pool of loans on the secondary market.

Section 107(15) (B) Authority

The majority of the commenters focused on the section 107(15) (B) authority. This section authorizes FCU's to invest in "privately-issued mortgage related securities" as that term is defined in section 3(a) (41) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a) (41)). While the Securities Exchange Act sets forth limitations on this authority, perhaps the most significant is that these investments are limited to securities rated in one of the two highest rating categories by at least one nationally-recognized statistical rating organization. Responsibility for clarifying the instruments included within the authority is primarily entrusted to the Securities and Exchange Commission.

Comments received on the section 107(15) (B) power were diverse; some commenters recommended NCUA significantly restrict such investments; other urged the Agency merely to issue guidelines explaining the types of permissible investments and the safety and soundness issues associated with them.

The Board believes these investments have sufficient safeguards against excessive risk—primarily in the

requirement that the security be "rated in one of the two highest rating categories by at least one nationally-recognized statistical rating organization"—not to require significant restrictions at this time. Imposition of a separate regulatory limitation on these investments would not be consistent with the Agency's policy to permit each FCU maximum flexibility in designing a safe and sound investment strategy suitable to its needs. Such investments do present safety and soundness issues, however—e.g., risks related to credit, interest rate, asset/liability management, and liquidity. The NCUA Board is therefore issuing guidelines (Letter to Credit Unions No. 56) to all Federal credit unions to assist them in making their investment decisions.

Section 107(15) (A) Authority

Section 107(15) (A) authorizes FCU's to invest in mortgage notes offered and sold pursuant to section 4(5) of the Securities Act of 1933 (15 U.S.C. 77d(5)). This section of the Securities Act establishes certain limitations on the authority, including that the notes be "secured by a first lien on a single parcel of real estate upon which is located a dwelling or other residential or commercial structure." There is, however, no limitation as to the borrower on the notes.

Thus, section 107(15) (A) might appear to authorize FCU's to purchase real estate-secured notes made by other lenders, even though the loan was made to a nonmember of the FCU and on other terms and conditions (loan amount, maturity, rate, prepayment penalties, etc.) that are not authorized for loans made by FCU's. Due to concern that this authority was difficult to reconcile with basic provisions of the FCU Act and NCUA's Rules and Regulations concerning membership and lending limitations, NCUA had stated, in its request for comments, that the authority would be limited to the purchase of notes of the purchasing FCU's members.

After review of the comments, the Board has determined that the authority is not limited to notes of a purchasing FCU's members, and that the authority can be reconciled with other statutory and regulatory provisions by limiting its exercise to circumstances where the FCU makes real estate-secured loans on an ongoing basis and the purchase is for the purpose of completing a pool of loans for sale or pledge on the secondary market.

Accordingly, section 107(15)(A) is being implemented by amendment to § 701.23 of NCUA's regulations, "Purchase, Sale, and Pledge of Eligible Obligations." Specifically,

Preamble to Parts 701 and 703 in NCUA Rules and Regulations - Reprint from the Federal Register
Vol. 53, No. 32, February 18, 1988, 12 C.F.R. 701 and 703

§ 701.23(b)(1)(iv), which authorized FCU's to purchase real estate loans for the purpose of packaging a pool of loans, is being amended to delete the reference to loans made pursuant to NCUA's long-term first mortgage loan regulation (section 701.21(g)). Thus, an FCU with an ongoing program of making real estate-secured loans may purchase comparable loans (long-term first mortgages or otherwise) from other lenders for the purpose of packaging a pool of loans for sale or pledge on the secondary market.

Conclusion

In summary, the section 107(15) authority is implemented as follows. The authority to invest in privately-issued mortgage-related securities (section 107(15)(B)) is implemented by amendment of NCUA's investment regulation (Part 703). No new regulations are being imposed. The authority is limited by NCUA regulation only to the same extent as other investments and deposits. Letter Number 95, which is

being mailed to all FCU's concurrently with the rule, explains the limitations of the Securities Exchange Act and provides safety and soundness of guidelines. The authority to invest in mortgage notes (section 107(15) (A)) is implemented by amendment of NCUA's regulation on purchase of eligible obligations (section 701.23). The authority is thus limited to purchasing notes to complete the packaging of a pool of loans to be sold or pledged on the secondary market.

Regulatory Procedures

Regulatory Flexibility Act

The NCUA Board has determined and certifies that these amendments will not have a significant economic impact on a substantial number of small credit unions. The Board does not anticipate investment by small credit unions pursuant to section 107(15)(A) or (B) of the FCU Act. Therefore, a regulatory flexibility analysis is not required.

Paperwork Reduction Act

These amendments do not impose any additional paperwork requirements.

List of Subjects in 12 CFR Part 703

Credit unions, Investments, Mortgage related-securities, Mortgages, Notes.

By the National Credit Union Administration Board on February 10, 1988.

Becky Baker,

Secretary of the Board.

SUMMARY: The NCUA Board is repealing its regulation concerning establishment of a cash fund (12 CFR 701.10) and amending its regulation concerning security programs (12 CFR 748.0). Section 701.10 is being deleted because it duplicates other provisions in the Federal Credit Union ("FCU") Act and FCU Bylaws. Section 748.0, which addresses implementation of security programs to protect FCU's from criminal actions, is being amended to include requiring security against embezzlement, a crime commonly associated with loss to a cash fund.

EFFECTIVE DATE: February 10, 1988.

ADDRESS: National Credit Union Administration, 1776 G Street, NW., Washington, DC 20456.

FOR FURTHER INFORMATION CONTACT: James J. Engel, Deputy General Counsel, at the above address, or telephone: (202) 357-1030.

SUPPLEMENTARY INFORMATION: Section 107(12) of the FCU Act 12 U.S.C. 1757(12), authorizes FCU's:

in accordance with rules and regulations prescribed by the Board, to sell to members negotiable checks (including travelers checks) money orders and other similar money transfer instruments; and to cash checks and money orders for members, for a fee.

Article XV, Section 3, of the Standard FCU Bylaws states:

A cash fund may be authorized by the [FCU] board by resolution for the purpose of making change, and for such other purposes as prescribed in the *Accounting Manual for Federal Credit Unions*.

The board may authorize by resolution the establishment of a petty cash fund for

postage, and for defraying other expense items in amounts of less than \$10.

Section 701.10 of NCUA's Rules and Regulations ("Establishment of a Cash Fund") 12 CFR 701.10 provides:

The board of directors of a Federal credit union may authorize the establishment of or changes in a cash fund for making change, cashing checks, or other purposes. Before such authorization is given, the directors will consider whether a need for the fund exists and will insure that adequate safeguards and accountability will exist to protect the fund.

Section 701.10 has been in existence unchanged since January 29, 1969. (34 FR 1398).

Section 748.0 ("Security Program") states:

(a) Each federally-insured credit union will develop a written security program within 90 days of the effective date of insurance.

(b) The security program will be designed to protect each credit union office from robberies, burglaries, and larcenies; to prevent destruction of vital records as defined in the *Accounting Manual for Federal Credit Unions*; and to assist in the identification of persons who commit or attempt such crimes.

On November 12, 1987, the NCUA Board, as part of its continuing review of NCUA regulations, proposed to eliminate § 701.10 and to add "embezzlement" to the list of crimes against which an FCU would have to secure. The Board explained: (a) The first sentence of § 701.10 was unnecessary in light of the language of section 107(12) of the FCU Act (12 U.S.C. 1757(12)) and of Article XV, Section 3, of the Standard FCU Bylaws; (b) the provisions of the second sentence more

properly belonged in § 748.0, relating to security precautions; and (c) with the addition of "embezzlement" to the list of crimes an FCU must secure against, § 748.0 would provide adequate guidance to FCU's.

Three comments were received. All supported the proposal, although one suggested more extensive changes to § 748.0. The Board will consider these when undertaking its regulatory review of that provision.

Regulatory Procedures

Regulatory Flexibility Act

The NCUA Board has determined and certifies that the amendment and repeal of these regulations will not have a significant economic impact on a substantial number of small credit unions (primarily those under \$1 million in assets). The action eliminates and clarifies NCUA Regulations. Accordingly, the Board has determined that a Regulatory Flexibility Analysis is not required.

Paperwork Reduction Act

The changes do not impose any additional paperwork requirements.

List of Subjects in 12 CFR Parts 701 and 748

Credit unions, Cash fund, Embezzlement, Security programs.

By the National Credit Union Administration Board on February 10, 1988.

Becky Baker,
Secretary of the Board.

NCUA 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)(B) 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

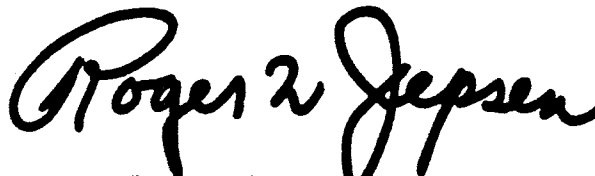
broker/dealers.

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. JENSEN
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 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

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 a REMIC is not authorized under Section 107(15)(B) of the FCU 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.