

unit investment trusts. The regulatory language has been changed to clarify that these other types are permissible investments for credit unions.

The proposed rule retains the requirement that the investments and investment transactions of the investment company must be permissible for credit unions and clarifies that this limitation must be set out in the company's prospectus and/or statement of additional information. For several years, NCUA has struggled with how much detail a prospectus/statement must contain in order for a credit union to determine that the investments and transactions are permissible for credit unions. Last year, NCUA issued Letter to Credit Unions No. 155, which attempted to provide guidance in this area for investments in mutual funds.

The Letter stated that NCUA was taking the position that a credit union could 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 federal credit unions." The Letter provided the example of a fund authorized to purchase CMOs, without restriction; it stated that the fund would be an impermissible investment for credit unions because the prospectus/statement would have to declare that only CMOs passing the HRST could be purchased. The Letter was intended to set forth the position that statements about a fund being "a legal investment for federal credit unions" or "legal under the Federal Credit Union Act and NCUA Rules and Regulations" were insufficient. A prospectus/statement of additional information was to set forth the specific investments and investment transactions authorized for the fund, in sufficient detail that credit unions and examiners could see that fund management clearly understood the limits of credit union investment authority and that the activities of the fund were within that authority.

The Letter has led to more questions concerning the level of detail required in a prospectus, such as, for example, whether a prospectus must address the actions a fund will take if a CMO fails the stress tests upon retesting. Since it is not NCUA's intent that a mutual fund prospectus recite all of Part 703, and it is difficult to draw a line about what must be specifically included, the proposed rule provides that one method of establishing that a fund is a permissible investment for federal credit unions is for the prospectus simply to assert that the fund is "a legal investment for federal credit unions" or "legal under the Federal Credit Union

Act and NCUA Rules and Regulations." A credit union that has invested in a mutual fund should monitor the activities of the fund to determine that they do not exceed the limits of credit union authority. The NCUA Board specifically requests comments on this issue. To the extent that a provision of Letter 155 is inconsistent with this rule, that provision would be superseded by this rule.

Section 704.4(e) of the proposed rule addresses the high risk securities test (HRST) for CMOs. The most significant change is the application of the entire test to variable as well as fixed rate CMOs. A number of credit unions have been unaware of the risks associated with variable rate CMOs. They owned securities linked to lagging market indexes, frequently the 11th District Cost of Funds (COFI). The weighted average lives of these securities extended 20 years or more following the last interest rate increase, and the securities suffered substantial price deterioration. Under the proposed regulation, both variable rate and fixed rate CMOs would be subject to all three tests. However, credit unions should still be aware of the limitations of the HRST, particularly as applied to variable rate securities based on lagging indexes. When testing a variable rate CMO, the credit union must be aware that a "thumbs up" on the HRST may not mean it passes the tests imposed by this rule. The credit union must review the results of each part of the test (average life, average life sensitivity, and price sensitivity) to ensure compliance.

There has been some confusion regarding the applicability of the current regulation when a CMO has passed the HRST for one prepayment model, but failed for another. NCUA does not want to specify which of the prepayment models a credit union must use to evaluate the risks associated with the CMO. However, as discussed earlier, the proposed rule requires that the credit union board specify, in its policy statement, an approved list of prepayment models that will be used when purchasing or retesting a CMO. At the time of purchase, a CMO will be required to pass the HRST for all the prepayment models listed in the policy statement. At any subsequent retesting date, the CMO must pass the HRST for the majority of the prepayment models specified in the policy statement and used in the purchase decision.

This provides a credit union's board of directors with several options: (1) Where the policy specified the use of the median prepayment estimate alone, the subsequent failure of the HRST upon retest, using the same median,

would make the security impermissible. (2) Where the policy specified three specific prepayment models, for example, the CMO could fail the HRST for one prepayment model and still be held by the credit union. Where five prepayment models were specified, the CMO could fail two and still be held. (3) Where the policy specified the use of a median prepayment model in addition to proprietary models, the CMO would not be subject to divestiture unless it failed a majority of the prepayment models used rather than the median alone.

A majority cannot be interpreted as half of the prepayment models. If the credit union specifies only two prepayment models in its policy statement, then the CMO must pass the HRST for both prepayment models if the security is to remain in the portfolio and not be subject to the divestiture requirement of proposed Section 703.7.

Proposed Section 703.4(f) addresses federal credit union investments in corporate credit union capital shares and deposits. In a slight rewording of the current rule, it provides that such investments are permissible except where the NCUA Board has provided notice that the corporate credit union is not operating in compliance with the NCUA regulations governing corporate credit unions. This should address concerns regarding investing credit unions' knowledge of corporate compliance. The proposed rule also limits credit union investment in the capital shares of a corporate credit union to a total of one percent of the investing credit union's assets, due to the potential risk associated with such investments. Membership capital share deposits, as defined in Section 704.2 of the NCUA Rules and Regulations, 12 CFR 704.2, are currently the only type of capital shares corporate credit unions are authorized to offer. The NCUA Board specifically requests comment regarding the appropriateness of this one percent limit.

Proposed section 703.4(g) establishes minimum credit ratings for municipal bonds. Credit unions would be limited to purchasing bonds rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization. In the existing rule there is no limitation on credit quality, exposing credit unions to potentially unacceptable risk.

The prior rule was silent as to the types of indexes to which variable rate instruments could be tied. The proposed rule limits permissible indexes to those tied to domestic interest rates only. There is no correlation between a credit