DIFS DEPARTMENT OF INSURANCE AND FINANCIAL SERVICES

I. PURPOSE

Collateralized Mortgage Obligations are reviewed to determine compliance with state and federal regulations, and the adequacy of investment policies, procedures, and controls. Management's ability to manage the risks in the investment portfolio and understand how an investment's market value and unrealized gains or losses could impact the credit union's financial position must also be evaluated.

II. DEFINITION

1. Collateralized mortgage obligations (CMOs) are multi-class pass through bonds which are either general obligations of the issuer backed by mortgage collateral or limited obligations where bondholders rely on the pledged collateral for payment. Each bond class, or tranche, has a stated maturity date and a fixed coupon or variable rate. The cash flows generated by the collateral relate to the cash flows of the bonds.

2. Typical issuers of this type of security are FNMA, FHLMC, GNMA and other private issuers.

3. CMOs can contain significant liquidity and interest rate risk, including the following:
   a. Unanticipated prepayments could result in the issuer retiring the bonds substantially sooner than the final maturity date;
   b. In a low or declining interest rate environment, investments may experience reduced yields;
   c. If an instrument is purchased at a premium, the effective rate of return decreases as prepayments increase;
   d. As interest rates increase, cash flow could decrease significantly and reduce the amount of funds available to reprice at higher rates.

III. PRIMARY REFERENCES / RELATED REGULATIONS

1. Michigan Credit Union Act:
   a. Section 342: Board Responsibility to Establish Policy
   b. Section 431: Permissible Investments and Activities
2. NCUA Rules and Regulations Part 741.219: Investment Requirements
3. NCUA Rules and Regulations Part 741.3(3): Investment Policies
4. Accounting Standards Codification (ASC) 320: Accounting for Investments

IV. MINIMUM PROCEDURES

1. Review the documentation for collateralized mortgage obligation securities (e.g. broker statements, trade tickets, confirmation receipts, etc.). Verify ownership and investment characteristics including:
    - **a.** The description of the security;
    - **b.** The coupon interest rate and maturity date;
    - **c.** The date of purchase, purchase price, par value;
    - **d.** The book value, and market value, including reported unrealized gains/losses.

2. Review the pre-purchase analysis for the investment (this should include a risk analysis, competitive price quotes, etc.)
    - **a.** Review Bloomberg screen shots for individual investments, including the Security Description, Total Risk Analysis (TRA), the details of the mortgages that make up the pool, and other applicable screens.
    - **b.** Ensure Bloomberg screens have not been manipulated to change shock test inputs to achieve desired results.

3. Review the aggregate and individual exposure to each issuer, and the risks present in the portfolio(s).
    - **a.** Evaluate the identified risk relative to the credit union's net worth.
    - **b.** Evaluate management's understanding of the security and all associated risks.

    - **c.** Review the interest rate risk and liquidity exposures with the investment.
        - **i.** Review the prepayment speeds (PSA) of the investment: If an examiner has access to Bloomberg, an examiner can enter a PSA range of 0 and 2000 to view the true interest rate sensitivity of the investment.
        - **ii.** Review the 300 basis point instantaneous shock of the investment.