November 12 1992

Philip Eitman
President
High Yield Management Securities, Inc.
4 Brighton Rd.
Clifton, NJ 07012

Re: Inverse Floating CMOs (Your October 27, 1992, Letter)

Dear Mr. Eitman:

You have asked whether, under 12 C.F.R Part 703, inverse floating collateralized mortgage obligations (CMOs) are permissible investments for federal credit unions if, at the time of purchase: 1) the cap is 300 basis points over the current coupon; and 2) the tranche average life would not extend or shorten by more than six years under modeling scenarios where mortgage commitment rates immediately rise or fall 300 basis points. The answer is no.

Section 703.5(j) of the Regulations, 12 C.F.R. ~703.5(j), provides that the average life test does not apply to a floating rate CMO if: 1) the interest rate is reset at least annually; 2) the maximum allowable interest rate on the instrument is at least 300 basis points above the interest rate at the time of purchase; and 3) the interest rate of the instrument varies directly (not inversely) with the index upon which it is based and is not reset as a multiple of the change in the related index. Since the investment about which you are inquiring varies inversely with the index upon which it is based, it is not entitled to the exemption from the average life test. Therefore, to be a permissible investment for federal credit unions, the investment must either be purchased to reduce interest rate risk, pursuant to Section 703.5(i), or must meet the average life test. The investment need not have a 300 basis point cap.

Sincerely,

Hattie M. Ulan
Associate General Counsel

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