February 6, 2003

Brian L. McDonnell, President
Navy Federal Credit Union
P.O. Box 3000
Merrifield, VA 22119-3000

Re: Credit Enhancements as a Permissible Activity
For Credit Union Service Organizations (CUSOs).

Dear Mr. McDonnell:

You have asked if Navy Federal Credit Union (Navy) may continue to invest in Navy Federal Financial Group (NFFG), a CUSO solely owned by Navy, if NFFG begins offering credit enhancements on certain mortgage loans. Yes, we believe the credit enhancement program discussed below is a preapproved activity and service that falls within the “Loan support services” category in the CUSO rule. Although we believe this is legally permissible, we recommend you consult with NCUA’s Region II to determine if it has any safety and soundness concerns.

You believe the credit enhancement program will benefit credit unions and their members. You have stated that as a result of the program credit unions will receive higher secondary market pricing for their loans and will find it easier to sell their loans with better terms. You believe this will enable credit unions to offer their members more flexible mortgage products at lower rates with better terms. You have described the credit enhancement program as follows:

> NFFG would enter into credit enhancement agreements with a number of credit unions and CUSOs that originate mortgage loans and sell them in the secondary market. Under such agreements, NFFG would agree to accept a portion of the risk of default associated with certain mortgage loans that are originated or serviced by one of the participating credit unions or CUSOs and sold to selected secondary market investors. In return for accepting part of the risk of default, NFFG will receive a portion of the interest generated by the mortgage on a monthly basis either from the secondary market investor or the participating credit union. The investor, in return for the credit enhancement, will pay a higher price for the loans to the selling credit union or CUSO.

You have represented that NFFG would only offer credit enhancements on loans originated, purchased or serviced by Navy’s subsidiaries or by credit unions or CUSOs approved for the program.

You have indicated that, in the event of a loss under these agreements, the investor would not have a right to any fees collected by NFFG prior to the recognition of the loss or a right to look to NFFG’s internal reserves for payment. You have explained that NFFG’s risk of loss is limited to the revenue stream that occurs after a loss is recognized and that those losses could absorb all of the revenue stream. In any event, you have also represented that Navy will not guarantee NFFG’s obligations or provide any further credit enhancements. Navy’s total exposure to the credit enhancement program is limited to the amount of its capital investment in NFFG.

NCUA’s CUSO rule states that an FCU may invest in, loan to or contract with a CUSO that is sufficiently bonded or insured and engaged in the preapproved activities and services related to the routine daily operations of credit unions. 12 C.F.R. §712.5. The activities specified within each preapproved category are illustrative, not an exhaustive list. Id. The preapproved category of “Loan support services” includes, among other things, “loan processing, servicing, and sales.” 12 C.F.R. §712.5(i)(2). We believe NFFG’s credit enhancement program is a logical extension of this preapproved activity. Although we believe Navy may legally continue to invest in, loan to, or contract with NFFG after NFFG implements the program, we recommend again that you consult with NCUA’s Region II to determine if it has any safety and soundness concerns.

Sincerely,

Sheila A. Albin
Associate General Counsel

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