

June 8, 1992

Robert A. Rylander
Executive Vice President
Alaska USA Federal Credit Union
P.O. Box 196613
Anchorage, Alaska 99519-6613

Re: Securitization of Real Estate Loans (Your March 2, 1992, Letter)

Dear Mr. Rylander:

You have asked a number of questions concerning the creation of GNMA securities through mortgage loan pooling. The proposed transaction outlined in your letter is impermissible due to the prohibition on short sales. Your specific questions and our answers are set out below.

BACKGROUND

Federal credit unions are authorized to issue and sell GNMA securities pursuant to Section 107(7)(E) of the Federal Credit Union Act (12 U.S.C. 1757(7)(E)). Alaska USA Federal Credit Union (FCU) wants to engage in pooling FHA and VA guaranteed mortgage loans into GNMA securities. The FCU will be setting prices (note rates) for the mortgage loans that will be pooled on or before closing of the mortgage loans. To minimize interest rate risk, the security being created with the mortgage pool will be sold on the to-be-announced (TBA) market 30 to 60 days in advance of the security's creation. The FCU anticipates committing to the sale of such securities, with receipt and settlement occurring on the same day. If the FCU can not complete the securitization in time to fulfill the commitment, the FCU will purchase a security on the open market to satisfy the obligation.

QUESTIONS & ANSWERS

1. Does the forward sale of a TBA security as described above constitute a "short sale" and as such is it prohibited; or is it an acceptable hedge against interest rate risk associated with real estate loan originations activity?

Section 703.2 of NCUA's Regulations (12 C.F.R 703.2) defines a short sale as "the sale of a security not owned by the seller." Section 703.5(d) prohibits an FCU from engaging in a short sale. Under the proposed transaction the FCU will be the anticipated owner/seller of the security being sold, but the security will not be in existence at the time of the sale. The proposed transaction meets the definition of a short sale as defined in Part 703 of the NCUA's Regulations and therefore is prohibited.

2. Do the provisions of Section 701.21(i) apply to the type of activity described above?

No, Section 701.21(i) specifically allows for an FCU to enter into put options in order "to manage risk of loss through a decrease in value of its commitments to originate real estate loans at specified interest rates" (~701.21(i)(2)). Section 701.21(i) does not authorize an FCU to commit to sell a security that does not yet exist. The Supplementary Information Section to Section 701.21(i) as published in the Federal Register distinguishes between the prohibited transaction (to sell securities not owned) and the authorized transaction (the option, not an obligation, to sell a security not owned). (See Supplementary Information, Section IV, A & B, 53 FR 19748, 5/31/88, enclosed.)

Although your proposed transaction is impermissible due to the prohibition on short sales and is not a put option under Section 701.21(i), the following discussion on put options may prove helpful to you in engaging in other transactions or in revising your proposed program.

Section 701.21(i)(1)(vii) defines a put as "a financial options contract which entitles the holder to sell entirely at the holder's option a specified quantity of a security at specified interest rates." Section 701.21(i)(2) permits the use of put options under certain conditions. Section 701.21(i)(2)(iii)(A) requires that the FCU's written policies include:

the Federal credit union's strategy in using financial options contracts and its analysis of how the strategy will reduce sensitivity to changes in price or interest rates in its commitments to originate real estate loans at specified interest rates. . .

Section 701.21(i)(2)(iii)(A) should not be read to prohibit the use of put options to manage interest rate risk on real estate loans acquired in the course of completing a pool. Instead this section prohibits an FCU from purchasing put options to limit risk on loans produced or held in its loan portfolio for investment. (See Section V. c. of the Supplementary Information to Section 701.21(i), enclosed.) Therefore, an FCU has the authority to use put options for both loans that are originated and acquired for pooling. This is consistent with an FCU's authority to purchase real estate loans on the open market if the purchase will facilitate the packaging of a pool of loans to be sold on the secondary market. Of course, the remaining requirements set forth in Section 701.21(i) must be met when using put options.

3. If the provisions of Section 701.21(i) do apply to this activity, then can such hedges be used for both originated and purchased real estate loans being placed in the same pool?

As noted, your program is not permitted due to the prohibited short sale, however, hedges can be used for both originated and purchased loans as discussed in the answer to #2 above.

4. Are there any special approvals required prior to engaging in the above described activity?

Your program is prohibited because of the short sale. According to Section 701.21(i)(2)(iv), an FCU may enter into put positions on GNMA, FNMA, and FHLMC securities, to manage risk of loss "if the Federal credit union has received written permission from the appropriate NCUA Regional Director to engage in financial options contracts in accordance with this ~701.21(i) and its policies and procedures as written." However, the Regional Director does not have to be notified before an FCU pools loans for sale on the secondary market.

If you have any questions or further information for us to consider, please let us know.

Sincerely,

Hattie M. Ulan
Associate General Counsel

Enclosure

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SSIC 3501
92-0313