NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

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.

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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. (<u>See</u> 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

Hattie M. Ulan
Associate General Counsel

Enclosure

GC/MM:sg
SSIC 3501
92-0313

PART 701—ORGANIZATION AND OPERATION OF FEDERAL CREDIT UNIONS

1. The authority for Part 701 is revised to read as follows:

Authority: 12 U.S.C. 1755, 1756, 1757, 1759, 1761a, 1761b, 1766, 1787, 1782, 1784, 1787, 1789, 1798.

In addition § 701.31 is also authorized by 15 U.S.C. 1601 *et seq.*, 42 U.S.C. 1781 and 42 U.S.C. 3601–3610.

2. Section 701.6(a) is revised to read as follows:

§ 701.6 Fees Paid by Federal Credit Unions.

(a) *Basis for assessment.* Not later than January 31 of each calendar year or as otherwise directed by the Board, each Federal credit union shall pay to the Administration for the current National Credit Union Administration fiscal year (October 1 to September 30) an operating fee in accordance with a schedule as fixed from time to time by the National Credit Union Administration Board based on the total assets of each Federal credit union as of June 30 of the preceding year or as otherwise determined pursuant to paragraph (b) this section.

* * * * *

3. Section 701.35(c) is revised to read as follows:

§ 701.35 Share, share draft, and share certificate accounts.

* * * * *

(c) A Federal credit union may, consistent with this Section, other Federal law, and its contractual obligations, determine the type of disclosures, fees or charges, time for crediting of deposited funds, and all other matters affecting the opening, maintaining or closing of a share, share draft or share certificate account. State laws regulating such activities are not applicable to Federal credit unions.

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12 CFR Parts 701 and 703

Loans to Members and Lines of Credit to Members

AGENCY: National Credit Union Administration ("NCUA").

ACTION: Interim final amendment.

SUMMARY: This amendment gives Federal credit unions ("FCU's") an additional tool for use solely to reduce risk of loss from interest rate increases between the time the interest rate commitment is made to a member on a real estate loan and the time the loan is sold on the secondary market. This additional tool must be used in accordance with written policies and procedures prepared by the FCU.

Because the seasonal peak in FCU real estate lending is at hand, the amendment has been made effective immediately, without prior public comment, but temporarily requires NCUA Regional Office permission prior to an individual FCU's engaging in the activity, and monthly reporting to NCUA. These temporary requirements are planned to be deleted after public comments have been received and further study has been completed.

EFFECTIVE DATE: This amendment is effective on an interim basis May 31, 1988. Comments must be received on or before August 29, 1988.

ADDRESS: National Credit Union Administration, 1776 G Street NW., Washington, DC 204546.

FOR FURTHER INFORMATION CONTACT: D. Michael Riley or Edward P. Dupcak, Office of Examination and Insurance, at the above address, or telephone: (202) 357–1065; Timothy P. McCollum or Julie Tamuleviz, Office of General Counsel, at the above address, or telephone: (202) 357–1030.

SUPPLEMENTARY INFORMATION:

I. Loan Production Risks

There are two kinds of risks an FCU must manage from the time a member applies for a loan to the time the loan is sold on the secondary market or included in its loan portfolio as an FCU investment:

a. "Fallout risk," the possibility that a party making a commitment to the FCU on the loan will fail to perform, either because there is no legal obligation to do so or because that obligation is breached. There are two kinds of fallout risk:

1. "Borrower fallout," where the member fails to close on a loan commitment. This may occur, for example, if interest rates decrease after the commitment is made and the member finds a better rate elsewhere; if the member is unable to perform; or, in real estate loans particularly, the seller of the property fails to perform.

2. "Investor fallout," where the party committed to taking the loan as an investment, either the FCU or a purchaser on the secondary market, fails to close. This can occur, for example, if the investor finds a higher-rate loan elsewhere; or if the investor or the FCU itself is without sufficient capital to perform.

b. "Price risk," the possibility that the value of the commitment the FCU makes to the borrower will decrease relative to the value of the FCU commitment to the investor or to the anticipated value to the FCU as an investment. There are three kinds of price risk:

1. Increased interest-rate price risk, where an FCU commits at application to a specified interest rate and rates increase.

2. Decreased interest-rate price risk, where an FCU commits to sell an uncommitted loan at a specified interest rate and rates decrease.

3. Product risk, where unusual characteristics in a loan arrangement—e.g., interest-only payment for an extended term—depress its fair market value.

II. Tools Available to an FCU for Managing Loan Production Risks

A. General

There are, in general, three ways to reduce loan production risks: (1) Asset/liability management; (2) forward sale of loans, on a mandatory or optional basis; and (3) sale or purchase of substitute assets with characteristics similar to a loan in production, on a mandatory or optional basis. As the NCUA Board has previously pointed out (49 FR 12,671 (March 30, 1984)), an FCU presently has authority to use the first two:

> [The] range of business strategies available to FCU's [includes]: (a) not investing or lending at long-term fixed rates; (b) using variable rate lending and floating rate investments; (c) using secondary markets to sell long-term loans to limit or manage the level of exposure; (d) using improved funds management strategies under deregulation to create a "basket" of share maturities which would complement the duration of longer-term assets; and (e) using reserves (established for this purpose) to temporarily cover losses should rising interest rates lead to short-term mismatches.

B. Sale and Purchase of Substitute Assets

Congress recently granted FCU's the power to invert in mortgage-related securities [12 U.S.C. 1757(16)(b)]. Through interest-only ("IO"), principal only ("PO"), and "residual" variations on these investments are sometimes marketed as risk management tools, as explained in Letter to Credit Unions No. 96 and IRPS 88–1, such instruments are so complex, varied, and volatile, there use to manage risk is almost always unwise.

The other kinds of transactions in substitute assets widely available involve futures and options (or standby commitments) on interest-sensitive securities. In 1979, NCUA prohibited both. At that time, it concluded (44 FR 42674 (July 20, 1979):

> Some commenters suggested that Federal credit unions should be permitted to engage in buying and selling standby commitments for authorized securities as a means of hedging against potential losses incurred in the making of real estate loans. The Administration believes that the informal and unorganized nature of the market in standby commitments argues against its use as a hedging device by Federal credit unions.
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> Since the Administration does not believe that hedging by means of buying and selling standby commitments for authorized securities is necessary to make real estate loans, the final rule contains [a] * * * general ban on standby commitments. However, it does not prohibit a Federal credit union from selling its real estate loans by use of a standby commitment in order to facilitate the making of such loans. This has been accomplished by defining the term "security" as not to include loans to members or residential real estate loans authorized under subsections 701.21-6 and 701.21-8 of Part 701 of the National Credit Union Administration rules and regulations. Such activity would be incidental to the exercise of a Federal credit union's real estate lending authority.

As to futures, the Board stated (44 FR 42676 (July 20, 1979):

> The proposed regulation limited Federal credit union participation in a futures market to the purchase or sale of a futures contract as a hedging device incident to the assembly of a pool of mortgages for sale in the secondary market. The Administration will issue a proposed regulation on that subject. Until that regulation is published in final form, Federal credit unions may not participate in any futures trading.

In 1984, the NCUA Board again considered allowing an FCU to use options and futures as a risk management tool; and again decided to prohibit their use in all circumstances (49 FR 12671 (March 30, 1984)):

> The Board does not consider standby commitments an essential tool to reduce the potential risks that Federal credit unions may have because of maturity mismatches between their assets and liabilities. Because of their complexity and their inherently speculative nature, reliance on standby commitments to offset mismatching can only lead to confusion, uncertainty, and ultimately to safety and soundness problems * * *.
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> * * * * *
>
> The Board has [also] determined not to authorize investment in futures contracts at this time. To the extent that futures contracts are seen as tools to reduce the interest rate risk that results from a mismatch between asset and liability maturities, the Board believes that there are already a range of other business strategies available to FCU's * * *. Further, it is the opinion of the Board that as long as Federal credit unions take in short-term funds and elect to invest or lend in long-term instruments, there is a risk. No option, including futures or standby commitments, eliminate the risk; they may, at best, just reduce some of the potential costs.

III. Need for Additional Risk Management Tools in Real Estate Loan Production

The tools now available to an FCU for managing interest rate risks have generally worked well. This has been made somewhat easier because traditionally the vast majority of loans originated and held by FCU's have been relatively short-term. Though in 1977, Congress allowed an FCU to make long-term real-estate loans (Pub. L. 95-22, Section 302(a)), FCU's generally maintained their character as consumer lenders.

Particularly in the last two years, however, FCU's have significantly increased real estate lending. In 1987, while total FCU lending grew 16 percent, FCU real estate lending grew 48 percent. By December 31, 1987, real estate loans constituted 27 percent of FCU loan investments; many more such loans were sold in the secondary market.

Real estate loans pose different risk management problems for an FCU. Because of their size and term, to plan properly members need to have the interest-rate set on the day they apply for the loan. The time between application and closing on real estate loans, however, is generally significant—60 days or more. Interest rates on fixed-rate, long-term real estate loans can change dramatically virtually overnight. And many real estate loan applications, for a variety of reasons, do not lead to closing. An FCU is therefore likely to have significantly greater price and fallout risks with its real estate lending than with its consumer lending.

The risk management tools generally applicable to loans and other interest-sensitive assets and liabilities are equally useful to real-estate loan production, particularly if the FCU intends to hold the loans for investment. Mandatory forward commitments to sell loans—a risk management tool presently available—should be the primary means for managing risk for an FCU selling its real estate loan originations in the secondary market; they are relativity inexpensive and offer the most complete risk coverage.

But for an FCU wishing to offer a specific interest rate on the date a member applies for a real estate loan which will be sold on the secondary market, these tools may not be adequate to manage the FCU's increased interest-rate price risk.

Mandatory forward commitments will eliminate price risk for the loan volume certain to close. But their use for the portion of the loans in production which may or may not close, while decreasing price risk, increases the borrower fallout risk, since the FCU will remain liable to deliver the loan committed to the secondary market regardless of whether the member closes. A possible alternative, optional forward commitments, are available from FNMA and FHLMC, but the expensive. Moreover, they are not normally available from reliable parties for VA and FHA loans, which constitute a substantial portion of FCU real estate lending.

IV. Substitute Asset Transactions as a Tool To Manage Increased Interest-Rate Price Risk

A. Cash Market and Futures Transactions in Financial Instruments

One way for an FCU to manage interest rate risk on the portion of an FCU's real estate loan commitments where closing is uncertain is through purchase or sale of readily marketable substitute assets—those which can be expected to respond to changes in interest rates similar to the FCU's loan commitments. Generally, the substitute assets with the closest correlation to FCU real estate loans are GNMA, FNMA, and FHLMC securities, and Treasury notes, and bonds. Properly structured, transactions in these securities, matched to loan commitments which may not close, can provide effective insurance against price and investor fallout risk without increasing borrower fallout risk.

Use of the cash market in these securities, however, would likely require an unrealistic capital commitment. Moreover, as with establishing a short position in the futures market for these securities, an FCU could find it impossible to determine upfront the costs of managing risk. The normal way in which cash and futures markets in substitute assets are used to manage risk of interest rate changes in a loan portfolio is to establish a short position (i.e., to sell securities not owned) and to take an off-setting long position (to purchase securities) later. The difference in the sale and purchase prices, which can only be determined at the end, is the cost of the risk management insurance.

B. Options on Financial Instruments

A more attractive substitute asset transaction for managing increased interest-rate price risk in the real estate loans an FCU is not certain will close are long positions on put options for financial instruments.

An option is a right, but not an obligation, to buy or sell an item at a prearranged price within an agreed-upon period. A "put" option is the right to sell; a "call" option is the right to buy. There are two parties to an option:

1. The "holder" (who is said to enter into a "long position"). This person, in exchange for paying an upfront fee, holds the power to purchase (with a call option) or sell (with a put option), in accordance with the terms of the option contract.

2. The "writer" (who is said to enter into a "short position"). This person, in exchange for receiving an upfront fee, must stand ready to sell (with a call option) or purchase (with a put option) on demand by the holder, in accordance with the terms of the option contract.

A long position on a call option or a short position on a put option for a financial instrument like a GNMA security or a Treasury bond helps manage risk of an interest rate decrease. These are therefore not appropriate tools when used alone for the limited problem faced by FCU's in real estate loan production.

A short position on a call option for one of these financial instruments, used alone, helps manage risk of a interest rate increase, but, like a short position in the cash market or in a future, it exposes the writer to unknown costs if interest rates decrease.

A long position on a put option for one of these financial instruments seems the best substitute asset protection generally available against increased interest-rate price risk: it increases in value as interest rates increase; and the maximum potential cost, the upfront fee, is known at the outset.

C. Risks in Long Put Option Positions

An FCU's establishing long positions in put options can be useful in managing risk only if properly structured. No substitute asset transaction will perfectly match the interest rate sensitivity of an FCU's loans in production. Expectations on real estate loan prepayments can cause the value of an FCU's loans in production to fluctuate differently from Treasuries—these expectations can even cause loans to differ from mortgage-related securities, depending on differences in stated interest-rate and maturity. Prepayment expectations can also cause 30-year real estate loans to perform more like Treasury notes than Treasury bonds. Supply and demand factors for Treasuries may cause them to move out of step with an FCU's loans in production. A one basis point change in yield on a Treasury note does not equal a one basis point yield change in a 30-year loan in production.

Construction of a proper basket of substitute asset transactions to match the loans in production for which interest rate protection is needed requires sophistication and continual monitoring.

V. Section 701.21(i)

Particularly since this expansion of FCU power is being done as an interim final rule without prior public comment, § 701.21(i) is a conservative extension of FCU authority:

a. An FCU is limited to long positions on put options for GNMA, FNMA, and FHLMC securities. As mortgage-related securities, they offer the greatest potential for adequate price risk coverage of an FCU's real estate loans while providing upfront an exact awareness of the maximum insurance cost.

b. An FCU may purchase put options only on an exchange designated by the Commodity Futures Trading Commission or from a primary dealer in Government securities. This limits investor fallout risk. Though no CFTC-designated exchange currently offers options on GNMA, FNMA, or FHLMC securities (or on futures of those securities), plans for one are being developed. The over-the-counter market established by primary dealers is a competitive market.

c. An FCU may purchase put options only to reduce risk of loss from interest rate increases on loans being produced for sale on the secondary market. This rule does not, at this time, permit an FCU to purchase put options to limit risk on loans produced or held in its loan portfolio for investment. An FCU producing loans for sale in the secondary market is likely to be more in need of interest-rate protection since its volume of loans can be significant relative to the FCU's assets. An FCU producing loans for its own long-term investment is limited to available capital. The asset/liability management tools now available to manage risk for loans produced for investment—as well as similar risks for Treasury bonds, GNMA securities and other long-term investments—seem to be adequate.

d. An FCU may engage in put purchases only pursuant to policies approved and supervised by its board of directors.

This amendment empowers an FCU to purchase options in securities permissible for FCU investment, for the sole purpose of reducing risk in loan production; it is therefore authorized by sections 107(5), 107(7), 107(16), and 120(a) of the FCU Act (12 U.S.C. 1757(5), 1757(7), 1757(16), 1766(a)).

VI. Interim Final Rule

FCU real estate lending for all intents and purposes means home mortgage lending. Since the spring and summer are the peak home buying seasons, FCU's need this authority now for use in 1988. By requiring prior NCUA Regional Office permission to engage in this activity and monthly reporting to that Regional Office, risk of loss to the Insurance Fund for this expansion of FCU authority as an interim final rule has been minimized. It is anticipated that these requirements will be deleted when a final rule is issued.

VII. Accounting for Put Option Purchases

Options accounting has not been officially addressed by the Financial Accounting Standards Board ("FASB"). In the absence of specific authoritative accounting advice, guidelines provided in an American Institute of Certified Public Accountants (AICPA) Accounting Standards Division issues paper, "Accounting for Options," issued March 6, 1986, are helpful. Pending further NCUA study, an FCU engaged in purchasing puts as a risk management tool must follow these guidelines. In summary form, these are the relative conclusions of the AICPA as discussed in the issues paper:

(a) For purchased options, the premium is reflected as an asset.

(b) The "time value" part of the premium paid should be charged to income (amortized) over the period the option is open. "Time value" is the difference between the total premium for an option and the option's intrinsic value. "Intrinsic value" is equal to the difference between the exercise price and the market price of the underlying security or commodity.

(c) To quality for hedge accounting, a loan commitment must expose the credit union to unwanted price or interest rate risk and the option reduces that exposure because:

(i) At the time the option is designated as a hedge, it is probable that changes in the market value of the item underlying the option will correlate highly with changes in the market value of the item being hedged, and

(ii) A clear economic relationship exists between the price of the item underlying the option and the price of the item being hedged, and

(iii) The option is designated as a hedge.

(d) If the option qualifies as a hedge of a firm commitment or an anticipated transaction involving an item stated at other than market. the change in the market price of the option should be deferred and included in the measurement of the hedged transaction; however. the recognition of losses should not be deferred if it is estimated that deferral would lead to recognized losses in later periods.

Note.—Under FASB rules for the mortgage banking industry, mortgage loans held for sale should be valued at the lower of cost or market at the balance sheet date.

VII. Request for Comments

The NCUA Board has perceived a need for this expansion of FCU authority, but is not wedded to any particular approach. The Board welcomes comments on all aspects of this interim final rule.

Regulatory Procedures

Regulatory Flexibility Act

The NCUA Board hereby certifies that this interim final amendment will not have a significant impact on a substantial number of small credit unions. Accordingly, the Board has determined that a Regulatory Flexibility Analysis is not required.

Paperwork Reduction Act

This interim final amendment has two recordkeeping requirements: (1) An FCU must prepare written plans and policies for engaging in put purchases for risk management; and (2) an FCU must maintain monthly summaries of its options transactions, and submit a copy to NCUA. At this point, it seems likely that these requirements will affect fewer than ten FCU's; therefore, the requirements of the Paperwork Reduction Act of 1980 do not apply.

Executive Order 12612

This amendment does not affect state regulation of credit unions. It implements provisions of the Federal Credit Union Act applying only to Federal credit unions.

List of Subjects

12 CFR Part 701

Credit unions. Financial options contracts.

12 CFR Part 703

Credit unions, Investments.

By the National Credit Union Administration Board on May 20, 1988.

Becky Baker,

Secretary of the Board.

Accordingly, NCUA has amended its regulations as follows:

PART 701—[AMENDED]

1. The authority citation for Part 701 continues to read as follows:

Authority: 12 U.S.C. 1755, 1756, 1757, 1759, 1761a, 1761b, 1766, 1767, 1782, 1784, 1787, 1789, and 1798.

Section 701.31 is also authorized by 15 U.S.C. 1601 *et seq.*, 42 U.S.C. 1981 and 42 U.S.C. 3601–3610.

2. Section 701.21 is amended by adding paragraph (i):

§ 701.21 Loans to members and lines of credit to members.

* * * * *

(i) *Put Option Purchases in Managing Increased Interest-Rate Risk for Real Estate Loans Produced for Sale on the Secondary Market*—(1) *Definitions.* For purposes of this § 701.21(i):

(i) "Financial options contract" means an agreement to make or take delivery of a standardized financial instrument upon demand by the holder of the contract at any time prior to the expiration date specified in the agreement, under terms and conditions established either by—

(A) A contract market designated for trading such contracts by the Commodity Futures Trading Commission, or

(B) By a Federal credit union and a primary dealer in Government securities that are counterparties in an over-the-counter transaction.

(ii) "FHLMC security" means obligations or other securities which are or ever have been sold by the Federal Home Loan Mortgage Corporation pursuant to section 305 or 306 of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1454 and 1455).

(iii) "FNMA security" means an obligation, participation, or any instrument of or issued by, or fully guaranteed as to principal and interest by, the Federal National Mortgage Association.

(iv) "GNMA security" means an obligation, participation, or any instrument of or issued by, or fully guaranteed as to principal and interest by, the Government National Mortgage Association.

(v) "Long position" means the holding of a financial options contract with the option to make or take delivery of a financial instrument.

(vi) "Primary dealer in Government securities" means:

(A) A member of the Association of Primary Dealers in United States Government Securities; or

(B) Any parent, subsidiary, or affiliated entity of such primary dealer where the member guarantees (to the satisfaction of the FCU's board of directors) over-the-counter sales of financial options contracts by the parent, subsidiary, or affiliated entity to a Federal credit union.

(vii) "Put" means a financial options contract which entitles the holder to sell, entirely at the holder's option, a specified quantity of a security at a specified price at any time until the stated expiration date of the contract.

(2) *Permitted Options Transactions.* A Federal credit union may, to manage risk of loss through a decrease in value of its commitments to originate real estate loans at specified interest rates, enter into long put positions on GNMA, FNMA, and FHLMC securities:

(i) If the real estate loans are to be sold on the secondary market within ninety (90) days of closing;

(ii) If the positions are entered into:

(A) Through a contract market designated by the Commodity Futures Trading Commission for trading such contracts, or

(B) With a primary dealer in Government securities;

(iii) If the positions are entered into pursuant to written policies and procedures which are approved by the Federal credit union's board of directors, and include, at a minimum:

(A) 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;

(B) A list of brokers or other intermediaries through which positions may be entered into;

(C) Quantitative limits (e.g., position and stop loss limits) on the use of financial options contracts;

(D) Identification of the persons involved in financial options contracts transactions, including a description of these persons' qualifications, duties, and limits of authority; and description of the procedures for segregating these persons' duties;

(E) A requirement for written reports for review by the Federal credit union's board of directors at its monthly meetings, or by a committee appointed by the board on a monthly basis, of:

(1) The type, amount, expiration date, correlation, cost of, and current or projected income or loss from each position closed since the last board review, each position currently open and current gains or losses from such positions, and each position planned to be entered into prior to the next board review;

(2) Compliance with limits established in the policies and procedures; and

(3) The extent to which the positions described contributed to reduction of sensitivity to changes in prices or interest rates in the Federal credit union's commitments to originate real estate loans at a specified interest rate; and

(iv) If the Federal credit union has received written permission from the appropriate NCUA Regional Director to engage in financial options contracts transactions in accordance with this § 701.21(i) and its policies and procedures as written.

(3) *Recordkeeping and reporting.* (i) The reports described in § 701.21(i)(2)(iii)(E) for each month must be submitted to the appropriate NCUA Regional Office by the end of the following month.

(ii) The records described in § 701.21(i)(2)(iii)(E) must be retained for two years from the date the financial options contracts are closed.

(4) *Accounting.* A Federal credit union must account for financial options contracts transactions:

(i) In accordance with standards established by the NCUA Board in the *Accounting Manual for Federal Credit Unions*, available from NCUA Administrative Office, 1776 G St. NW., Washington, DC 20456, or such other instruction as may be deemed appropriate; or

(ii) To the extent not inconsistent with NCUA Board instruction, in accordance with generally accepted accounting standards or principles.

PART 703—[AMENDED]

3. The authority citation for Part 703 is revised to read as follows:

Authority: 12 U.S.C. 1757(7), 1757(8), 1757(15), 1766(a), and 1789(a)(11).

4. Section 703.1 is revised to read as follows:

§ 703.1 Scope.

Sections 107(7), 107(8) and 107(15) of the Federal Credit Union Act (12 U.S.C. 1757(7), 1757(8), 1757(15)), set forth those securities, deposits, and other obligations in which Federal credit unions may invest. Included are securities issued or fully guaranteed by the United States Government or any of its agencies, shares of central credit unions and any federally-insured credit union, accounts in other federally-insured financial institutions, certain mortgages and mortgage-related securities, and other specified investments. This part interprets several of the provisions of sections 107(7), 107(8) and 107(15)(B). It also places limits on the types of transactions that Federal credit unions may enter into in connection with the purchase and sale of authorized securities, deposits, and obligations under sections 107(7), 107(8) and 107(15)(B). This part does not apply: to investments in loans to members and related activities, which are governed by §§ 701.21, 701.22 and 701.23 (12 CFR 701.21, 701.22 and 701.23); to the purchase of real estate-secured loans pursuant to section 107(15)(A), which is governed by § 701.23; to investment in credit union service organizations, which is governed by § 701.27 (12 CFR 701.27); or to investment in fixed assets, which is governed by § 701.36 (12 CFR 701.36).

5. Section 703.4(a) is revised to read as follows:

§ 703.4 Prohibited activities.

(a) Except as provided in § 701.21(i), a Federal credit union may not purchase or sell a standby commitment.

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SMALL BUSINESS ADMINISTRATION

13 CFR Part 136

Enforcement of Nondiscrimination on the Basis of Handicap in Small Business Administration Programs

AGENCY: Small Business Administration.

ACTION: Final rule.

SUMMARY: This regulation requires that the Small Business Administration operate all of its programs and activities to ensure nondiscrimination against qualified individuals with handicaps. It sets forth standards for what constitutes discrimination on the basis of mental or physical handicap, provides a definition for individual with handicaps and qualified individual with handicaps, and establishes a detailed complaint mechanism for resolving allegations of discrimination against the Small Business Administration. This regulation is issued under the authority of section 504 of the Rehabilitation Act of 1973, as amended, which prohibits discrimination on the basis of handicap in programs or activities conducted by the Small Business Administration.

EFFECTIVE DATE: July 15, 1988.

FOR FURTHER INFORMATION CONTACT: J. Arnold Feldman, Chief, Office of Civil Rights Compliance, Small Business Administration, 1441 L Street NW.—Rm. 501, Washington, DC 20416, (202) 653-6054 (Voice) or (202) 653-6579 (TDD). These are not toll free numbers.

SUPPLEMENTARY INFORMATION: On July 2, 1984, the Small Business Administration (SBA) published a Notice of Proposed Rulemaking (NPRM) for the enforcement of section 504 of the Rehabilitation Act of 1973, as amended, which prohibits discrimination on the basis of handicap as it applies to programs and activities conducted by the SBA. 48 FR 27184. Comments were received from seven organizations representing individuals with handicaps. Most were the same as those submitted to the Department of Justice on its proposed regulation for its federally conducted programs, concerning the deletion of the regulation's "undue financial and administrative burdens" language, asserting that the Agency was imposing a lesser requirement on itself than on recipients of Federal financial assistance. Commenters also requested that "all agency resources" be considered instead of specific program or activity funding, by the Agency head when deciding whether a contemplated action would result in undue financial and administrative burdens. SBA's responses to the comments will be discussed under the appropriate sections.

Section 504 requires that regulations that apply to programs and activities of Federal Executive agencies shall be submitted to the appropriate authorizing committees of Congress and that such regulations may take effect no earlier than the thirtieth day after they have been so submitted. The Agency has today submitted this regulation to the House Education and Labor Committee, the Senate Labor and Human Resources Committee, and the House and Senate Small Business Committees. The regulation will become effective on July 15, 1988.

This rule applies to all programs and activities conducted by the Small Business Administration. Copies of this rule are available on tape for those with impaired vision. Copies may be obtained from the Office of Civil Rights Compliance at the address listed above.

Background

The purpose of this rule is to provide for the enforcement of section 504 of the Rehabilitation Act of 1973, as amended, 29 U.S.C. 794, as it applies to programs and activities conducted by the SBA. As amended by the Rehabilitation, Comprehensive Services, and Developmental Disabilities Amendments of 1978, section 119 (Pub. L. 95-602, 92 Stat. 2982), and the Rehabilitation Act Amendments of 1986 (Pub. L. 99-506, 100 Stat. 1810), section