



June 28, 2002

NCUA Reforms Corporate Credit Union Rules

EXECUTIVE SUMMARY

The NCUA Board (Board) voted unanimously to issue a proposal that reforms the corporate credit union rules. This proposal has been revised from an earlier proposal issued in September 2002. The revised proposal contains major revisions in the areas of capital, credit concentrations, and credit risk. Comments on these changes are due on August 30th. The highlights of the revised proposal include:

- The Board has revised the definition of Paid-in Capital (PIC) so it is a perpetual, non-cumulative dividend account.
- The Board has eliminated the minimum RUDE ratio and replaced it with an earnings retention requirement. The earnings requirement has a mechanism for increasing retained earnings to 2 percent on an ongoing basis.
- To provide flexibility, the Board permits corporate credit unions to meet the earnings retention requirements on a rolling 3-month average. The regulation also allows a corporate credit union to pay dividends without prior approval if its retained earnings ratio falls below 2 percent under two conditions: 1) if the retained earnings ratio was already below 2 percent but the corporate credit union has an increase in retained earnings for the current measurement period, or 2) if the corporate credit union experiences a loss on the sale of investments. In addition, the regulation gives the OCCU Director the authority to approve a lower earnings retention amount to avoid a significant adverse impact on the corporate credit union.
- The revised proposal includes a new definition of a limited liquidity investment (i.e., a private placement or a funding agreement). The revised proposal deletes the requirement for a perfected first priority security interest for repurchase transactions. The revised proposal, like the current rule, also permits trading securities but requires transactions be accounted for on a trade date basis.
- The revised proposal deletes the definitions of “long-term investment” and “short-term investment.” Regarding concentration limits, the Board is increasing the concentration limit in repurchase transactions to 250% of capital for corporate credit unions that meet the infrastructure requirements within its section on expanded authorities. The Board has withdrawn the proposed amendments that would have required a corporate to impose a market-based penalty for early withdrawal.

- Comments on this proposal are due to NCUA by August 30, 2002. Please submit your comments to CUNA by August 19, 2002. Please feel free to fax your responses to CUNA at 202-638-7052; e-mail them to Associate General Counsel Mary Dunn at mdunn@cuna.com or to Assistant General Counsel Michelle Profit at mprofit@cuna.com; or mail them to Mary Dunn or Michelle Profit in c/o CUNA's Regulatory Advocacy Department, 601 Pennsylvania Avenue, N.W., South Building - Suite 600, Washington, DC 20004. You may also contact us if you would like a copy of the proposal or you may access it on the Internet at the following address: http://www.ncua.gov/news/proposed_regs/12CFRParts703and704-proposed.htm

BACKGROUND ON THE PROPOSAL

Before issuing this revised proposal, NCUA had issued two advance notices of proposed rulemaking (ANPRs) on its corporate credit union regulation. Based on the comments received in response to the ANPRs, the Board issued a proposed rule. In response to comments received on that rule, the Board drafted the current revised proposal.

Below are a list of proposed changes to the rule that differ from the initial proposed rule issued in September 2001. These changes are addressed by section.

Section 704.2 – Definitions:

The proposal would remove the definitions of commercial related security, correspondent services, market price, member paid-in capital, mortgage servicing, net interest income, non-member paid-in capital, non secured obligation, prepayment model, real estate mortgage investment conduit, reserve ratio, and trade association.

The proposal revises the definitions of collateralized mortgage obligation (CMO), fair value, forward settlement, membership capital, mortgage related security, obligor, paid-in capital, regular-way settlements, repurchase transaction and residual interest. The proposal amends the definition of asset-backed security by revising the last sentence and net economic value by revising everything but the first and last sentence. The proposal also adds new definitions of quoted market price and core capital ratio. Some of the key amended or revised definitions are outlined below.

Core capital - means the corporate credit union's retained earnings and paid-in capital.

Core capital ratio - means the corporate credit union's core capital divided by its moving daily average net assets.

Daily Average Net Assets: NCUA does not agree with commenters that accounting for future-dated ACH items should be as of the advice date. Rather, NCUA believes there is a divergence of opinion within the accounting community on whether such transactions should be accounted for as of the advice date or as of the settlement date. The proposal does not exclude future-dated ACH items from the definition of DANA. Each corporate should continue to prepare its other internal and external financial statements based on the advice of its CPA.

Paid-in capital –means accounts or other interests of a corporate credit union that: are perpetual, non-cumulative dividend accounts; are available to cover

losses that exceed retained earnings; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings.

Retained earnings - means the total of the corporate credit union's undivided earnings, reserves, and any other appropriations designated by management or regulatory authorities. For purposes of this regulation, retained earnings does not include the allowance for loan and lease losses account, accumulated unrealized gains and losses on available for sale securities, accumulated FASB adjustments, or other comprehensive income items.

Retained earnings ratio - means the corporate credit union's retained earnings divided by its moving daily average net assets.

Section 704.3 – Corporate credit union capital: Below is a summary of the changes to the capital section of the regulation.

- The minimum 2% RUDE ratio requirement has been eliminated from the revised proposal.
- The revised proposal provides a mechanism for increasing retained earnings to 2% on an ongoing basis. The earnings retention requirement in §704.3(i) [*see below*] includes features of the existing reserve transfer requirement, in addition to a core capital measurement.
- **Earnings retention requirement** - A corporate credit union must increase retained earnings if the prior month-end retained earnings ratio is less than 2 percent. Its retained earnings must increase:
 - (i) During the current month, by an amount equal to or greater than the monthly earnings retention amount; or
 - (ii) During the current and prior two months, by an amount equal to or greater than the quarterly earnings retention amount.

Earnings retention amounts are calculated as follows:

- (i) The monthly earnings retention amount is determined by multiplying the earnings retention factor by the prior month-end moving daily average net assets; and
- (ii) The quarterly earnings retention amount is determined by multiplying the earnings retention factor by moving daily average net assets for each of the prior three month-ends.

The earnings retention factor is determined as follows:

- (i) If the prior month-end retained earnings ratio is less than 2 percent and the core capital ratio is less than 3 percent, the earnings retention factor is .15 percent per annum; or
- (ii) If the prior month-end retained earnings ratio is less than 2 percent and the core capital ratio is equal to or greater than 3 percent, the earnings retention factor is .10 percent per annum.

The OCCU Director may approve a decrease to the earnings retention amount if it is determined a lesser amount is necessary to avoid a significant adverse impact upon a

corporate credit union. A corporate credit union may authorize the payment of dividends provided:

- (i) the payment will not cause the retained earnings ratio to fall below 2 percent;
- (ii) the payment will not cause the amount of retained earnings to decrease from the prior month-end, unless the decrease results from losses on the sale of investments; or
- (iii) the OCCU Director and, if applicable, state regulator have given prior written approval for the payment.

Section 704.5 – Investments: Below is a summary of the investments section of the regulation:

- The proposal combines the policy requirements in Section 704.5(a) and deletes “if any” from Section 704.5(a)(1) to clarify that a corporate must have “appropriate tests and criteria” to evaluate the investments it makes on an ongoing basis, as well as new types of investments.
- **Section 704.5(a)(2):** The proposed rule deleted the requirement that the investment policy address the marketing of liabilities to its members. The proposed rule added a requirement for a corporate to establish appropriate aggregate limits on limited liquidity investments, including private placements and funding agreements. A number of commenters observed many privately placed securities have active quoted markets or readily obtainable market quotes, with liquidity comparable to publicly registered securities. In response to those comments, the NCUA notes other private placements do not have readily obtainable market quotes. A corporate would have difficulty selling such investments with reasonable promptness at a price that corresponds reasonably to fair value. NCUA also is concerned if there is only one active market purchaser for a private placement or a funding agreement.

The revised proposed rule omits the examples of limited liquidity investments, defines a limited liquidity investment to mean a private placement or a funding agreement, requires a corporate to specify concentration limits in relation to capital and requires the investment policy to address reasonable and supportable concentration limits for limited liquidity investments. By reasonable, the Board means concentration limits should be economically reasonable. By supportable, the Board means the investment policy should address the prepurchase analysis a corporate should undertake before making a limited liquidity investment. For example, the investment policy may require a prepurchase analysis to include estimates of bid-asked spreads and, also, an estimate of the time necessary to sell a limited liquidity investment.

- **Section 704.5(d) – Repurchase agreements:** The revised proposal deletes the requirement for a perfected first priority security interest for repurchase transactions.
- **Section 704.5(e) – Securities lending:** Ten commenters to the proposed rule viewed the existing requirement for a perfected first priority security interest as inconsistent with standard market practice for securities lending agreements. NCUA has removed the word “perfected” but will continue to require a first priority security interest through possession or control of the collateral. Often, under state law, possession or control constitutes a “perfected” security interest. In addition, the Board has clarified

in the revised proposal that ownership is an appropriate substitute for possession and control.

- **Section 704.5(h) – Prohibitions:** The proposed rule prohibited trading securities. The revised proposal, like the current rule, permits trading securities but requires transactions to be accounted for on a trade date basis and, in addition, no longer prohibits engaging in pair-off transactions and when-issued trading. NCUA agreed with the commenters that concerns with these investments should be handled as a supervisory matter. The revised proposed rule retains the prohibitions on engaging in adjusted trading and short sales.

Section 704.6 - Credit Risk Management: Below is a summary of the changes to this section of the regulation:

- **Section 704.6(c) – Concentration limits:** The revised proposal retains a general concentration limit of 50% of capital or a *de minimus* limit of \$5 million form the aggregate of all investments in any single obligor, whichever is greater. In the revised proposal, NCUA notes “that this limit is the most credit exposure a corporate should prudently take in investment-grade quality investments. While NCUA recognizes the corporate network has increased its due diligence capabilities, if the corporate network is to maintain and enhance its ability to withstand financial crises, it must exercise caution in placing membership capital at risk. Placing all capital at risk would substantially increase the likelihood of a crisis and decrease membership confidence if losses occurred.”
- **Section 704.6(c)(3) -** Proposed §704.6(c)(3) applied the requirements for an investment action plan in §704.10 when a reduction in capital after the purchase of an investment resulted in a credit concentration that was higher than permitted by regulation. One commenter believed that noncompliance caused by a reduction in capital should not trigger the 30-day notification period in §704.10. Rather, the commenter suggests calling the investment “nonconforming” rather than “failed” and allowing a 90-day period to permit a corporate to bring the investment into compliance before triggering the requirements of §704.10. NCUA agrees with the commenter’s suggestion, and the revised proposed rule deems an investment as “nonconforming” if it fails a requirement because of a reduction in capital. A corporate credit union is required to exercise reasonable efforts to bring nonconforming investments into conformity within 90 days. Investments that remain nonconforming for 90 days are deemed to “fail” a requirement and will require compliance with the requirements in §704.10.
- **Section 704.6(d) – Credit ratings:** Most of the commenters noted the regulation’s definitions of “short-term investment” and “long-term investment” can be inconsistent with the market. For consistency, they suggested the rule reference investments with short-term or long-term ratings. NCUA agrees and adopts the suggestion in the revised proposed rule.
To avoid confusion regarding the investment watch list requirements of §704.6(e)(1), the revised proposed rule clarifies in §704.6(d)(4) that it is applicable only when the corporate relied upon more than one rating to meet the minimum credit rating requirements at the time of purchase. If there is a subsequent downgrade below the minimum requirement, then the investment must be placed on the investment watch

list. The revised proposed rule permits a board to decide under §704.6(e)(1) to what extent it will require management to report to the board its review of a downgrade that does not result in a rating lower than the minimum requirements of part 704. The Board notes it remains a sound business practice for a corporate to monitor the credit quality of all investments, including reviewing any downgrades of credit ratings.

Section 704.8 – Asset and Liability Management

- **704.8(a)(6) - This** section added a requirement for the asset and liability management policy to address the tests used to evaluate the impact of investments on the percentage decline in NEV, compared to the base case NEV. Many commenters opposed this requirement. The revised proposal clarifies NCUA does not expect a corporate to run a complete NEV analysis to establish a base case at the time of each investment transaction. The revised proposed rule is intended to require each corporate to establish an ongoing process to identify, estimate, monitor and control interest rate risk between the periodic complete NEV analysis.
- **Section 704.8(c) – Penalty for early withdrawal:** The proposed rule required a corporate to impose a market-based penalty for early withdrawal, if early withdrawal is permitted. The proposed rule also required the penalty to equal the estimated replacement cost of the certificate or share redeemed. This change would have prohibited a corporate from imposing a penalty in excess of the replacement cost and would have required a penalty to be reasonably related to current offering rates of that corporate. Many commenters objected to the proposed provision. NCUA was persuaded that no substantive change was needed to this section and has withdrawn the proposed amendments.
- **Section 704.8(d) – Interest rate sensitivity analysis:** The proposal decreased the NEV decline limit for a base corporate from 18% to 10% Based on the comments, NCUA re-evaluated the NEV decline limit for a base corporate. The revised proposed rule establishes a limit of 15%. This increases the amount of interest rate risk most base corporates may undertake compared to the existing regulation.

Section 704.11 – Corporate CUSOs:

- **Section 704.11(b) – Investment and loan limitations:** Six commenters requested that the current 15% aggregate limit for investments in and loans to corporate CUSOs be increased to 30% and the additional 15% for loans that are fully secured be retained. NCUA agrees that with respect to loans to corporate CUSOs. Because of the mandatory due diligence requirements, a corporate' lending limits should be increased to 30%. The revised proposed rule maintains a limit of 15% of capital for investments in corporate CUSOs, increases the aggregate limit for loans and investments to 30% of capital, and retains the additional 15% for loans that are fully secured.

In addition, six commenters supported revising §704.11(b) so that it mirrors §712.6 of the natural person CUSO rule. Section 704.11(b) prohibits a corporate from acquiring control directly or indirectly of another “financial institution” and §712.6 prohibits a natural person credit union from acquiring control directly or indirectly of

another “depository financial institution.” NCUA agrees and has placed the modifier “depository” before “financial institution.”

Section 704.12 – Services: To eliminate confusion, the revised proposal lists the permissible services in categories in the same manner they are listed in parts 712 and 721. NCUA is retaining the six broad categories in the proposed, adding the category of trustee or custodial services, and including examples under each category. NCUA is adding a provision similar to the provisions in parts 712 and 721 concerning adding new permissible services. The new section permits corporates to petition the Board to add a new service to §704.12 and encourages them to seek an advisory opinion from the Office of General Counsel (OGC) on whether a proposed service is already covered by one of the authorized categories before filing a petition. The rule does not require a corporate to come to OGC for an opinion every time it wants to provide a service not specifically listed as an example under a broad category. An opinion from OGC is recommended if there is doubt as to whether a specific service falls within one of the broad categories. In those situations, a corporate that does not consult with OGC runs the risk of engaging in an impermissible activity and being subject to supervisory action.

Section 704.14 - Representation:

- **Section 704.14(b):** The revised proposal retains the definition of “credit union trade association” in the initial proposal. NCUA continues “to believe that the chairman of the board of a corporate should not serve simultaneously as an officer, director or chair of a national credit union trade association or its affiliates. As the Board stated when this provision was originally drafted, “the chair should be an individual whose loyalty is **in no way divided** between the corporate credit union and a trade association.” 59 FR 59357, 59358, November 17, 1994. (Emphasis added). If the Board were to exclude affiliates from the definition, the chair’s loyalty could be divided between the corporate and the credit union trade association affiliate.

Section 704.19 – Wholesale Corporates:

- **Section 704.19(b) – Capital:** The revised proposal imposes an earnings retention requirement on wholesale corporates. A wholesale corporate credit union must increase retained earnings if the prior month-end retained earnings ratio is less than 1 percent. A wholesale corporate must increase its retained earnings:
 - (i) During the current month, by an amount equal to or greater than the monthly earnings retention amount; or
 - (ii) During the current and prior two months, by an amount equal to or greater than the quarterly earnings retention amount.

Earnings retention amounts are calculated as follows:

- (i) The monthly earnings retention amount is determined by multiplying the earnings retention factor by the prior month-end moving daily average net assets; and

(ii) The quarterly earnings retention amount is determined by multiplying the earnings retention factor by moving daily average net assets for each of the prior three month-ends.

The earnings retention factor is determined as follows:

- (i) If the prior month-end retained earnings ratio is less than 1 percent and the core capital ratio is less than 3 percent, the earnings retention factor is .15 percent per annum; or
- (ii) If the prior month-end retained earnings ratio is less than 1 percent and the core capital ratio is equal to or greater than 3 percent, the earnings retention factor is .075 percent per annum.

The OCCU Director may approve a decrease in the earnings retention amount set forth in this section if it is determined a lesser amount is necessary to avoid a significant adverse impact upon a wholesale corporate credit union.

A corporate credit union may authorize the payment of dividends provided either:

- (i) the payment will not cause the retained earnings ratio to fall below 1 percent;
- (ii) the payment will not cause the amount of retained earnings to decrease from the prior month-end, unless the decrease results from losses on the sale of investments; or
- (iii) the OCCU Director and, if applicable, state regulator have given prior written approval for the payment.

Appendix B – Expanded Authorities:

- **Volatility limits:** The revised proposal increases the proposed volatility levels as noted in the table below. The revised proposal adopts the menu-driven approach proposed for only Part II expanded authority for corporates requesting both Part I and Part II expanded authorities.

Level of expanded authorities	Minimum capital requirement	Proposed rule NEV decline limit	Revised proposed rule NEV decline limit
Base plus	4%	15%	20%
Part I	4%	15%	20%
	5%	20%	28%
	6%	Not proposed	35%
Part II	4%	15%	20%
	5%	20%	28%
	6%	30%	35%

- **Part II:** For Part II corporates, NCUA proposed lowering the minimum rating requirement for a short-term investment (including asset-backed securities) to A-2 (or equivalent), provided the issuer has a long-term rating no lower than BBB (flat). Given the additional credit risk analysis infrastructure

requirements of a Part II corporate, NCUA believes the proposed rating is appropriate and has adopted it in the revised proposed rule.

However, in her comments at the meeting, Board member Debbie Matz noted that she is not comfortable with a corporate having the ability to place 50% of its capital in instruments with BBB (flat) ratings. She urged commenters to address this issue.

- **Part V: NCUA** agreed with the commenters on the issue of establishing aggregate participation loan limits on a case-by-case basis. The revised proposed rule permits this; however, the Board only intends to permit aggregate participation loan limits above 100 percent of capital after a corporate demonstrates its ability to manage this activity soundly. Once a corporate has demonstrated its ability to soundly manage this activity, the OCCU Director may authorize greater aggregate participation loan limits.

QUESTIONS REGARDING THE PROPOSAL

1. In its last comment letter, CUNA strongly opposed NCUA's imposition of a minimum 2% RUDE ratio. The revised proposal replaces the minimum RUDE ratio with a retained earnings ratio in addition to features of a core capital measurement. CUNA staff views this as very positive because it could lend support for natural person credit unions to be able to utilize secondary capital to restore net worth below 6 percent.

Please explain why you support or oppose this provision.

2. The revised proposal changes the definition of PIC so it is a perpetual, non-cumulative dividend account. According to NCUA, this brings PIC in accordance with GAAP definition of equity accounts. Existing PIC is grandfathered from this requirement but is subject to the amortization schedule proposed in September 2001 (i.e., full amortization one year before the date of maturity). Because new PIC must be perpetual, the amortization requirement only applies to grandfathered PIC. Should CUNA support this change? If not, why not?

3. In its last comment letter, CUNA urged NCUA to revise the definition of Daily Average Net Assets to exclude future-dated ACH transactions. The proposal does not exclude future-dated ACH items from the definition of DANA. Are there other arguments that CUNA can assert to NCUA to support the proposition that such items should be accounted as of the settlement date rather than the advice date?

Yes _____ No _____

Please explain

4. Should CUNA support the changes to the Investments section of the proposal? Do you agree with the new definition and requirements for a limited liquidity investment? If not, why not?

5. Should CUNA continue to oppose the 50% of capital concentration limit proposed by NCUA? Should CUNA support the criteria regarding when an investment is “nonconforming?” If not, why not? Are there any other issues regarding credit risk management that CUNA should address in its comment letter?

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6. The proposal decreased the NEV decline limit for a base corporate from 18% to 10%. Based on the comments, NCUA re-evaluated the NEV decline limit for a base corporate. The revised proposed rule establishes a limit of 15%. This increases the amount of interest rate risk most base corporates may undertake compared to the existing regulation. Should CUNA support these changes? Please explain your position.

7. Should CUNA support the proposed earning retention requirements for wholesale corporate credit unions? Are there other issues that CUNA should address in its comment letter regarding wholesale corporate credit unions?

8. Do you have any other comments on the changes in the proposed corporate credit union regulation? Please explain

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