



December 22, 2011

## NCUA Proposal Rule: RegFlex Program Changes

### EXECUTIVE SUMMARY

- The National Credit Union Administration (NCUA) Board issued a proposed rule that would remove Part 742 and eliminate the RegFlex program.
- However, the proposal would also amend rules affected by the current RegFlex program that are designed to provide some regulatory relief for federal credit unions (FCUs).
- CUNA is reviewing this proposal but has concerns that it may not be that useful. CUNA will be developing a survey on this proposal as well as activating Operation Comments very shortly.
- The proposal would do the following:
- Place most of the six flexibilities of the current RegFlex rule into the subject-specific rules that apply to all FCUs. These areas include (1) charitable contributions, (2) nonmember deposits, (3) fixed assets, (4) zero-coupon investments, (5) borrowing repurchase transactions, and (6) commercial mortgage related securities (CMRS).
- Extend the time period in the fixed assets rule until which an FCU must partially occupy premises acquired for future expansion from three years to six years for FCUs that acquire unimproved land.
- Eliminate the entire charitable contributions rule (§ 701.25) so that any FCU can make donations based on sound judgment and business practices without prior approval of its board of directors and without regulatory restrictions as to fund recipients.
- Allow FCUs to accept more nonmember deposits by raising the dollar limit in § 701.32(b) from \$1.5 million to \$3 million. This would allow FCUs with less than \$7.5 million in total shares to accept up to \$3 million in nonmember deposits.
- Permit extended maturities for zero-coupon investments up to 30 years for an FCU that meets a “well capitalized standard,” which would be satisfied by an FCU that has received a CAMEL rating of 1 or 2 during its last two exams and (1) has maintained a “well capitalized” net worth classification for the preceding six quarters, or (2) has remained “well capitalized” for the preceding six quarters after applying the applicable risk-based net worth requirement. The proposal would grandfather zero-coupon investments purchased under RegFlex authority before the final rule becomes effective.
- Permit borrowing repurchase transactions for FCUs meeting the “well capitalized standard.” In addition, the proposal would extend relief to FCUs that do not meet the “well capitalized standard” from the maturity requirement for borrowing repurchase transactions.
- Allow FCUs to purchase private label Commercial Mortgage Related Securities’ (CMRS) under similar conditions as provided in the current RegFlex rule.
- NCUA is accepting public comments until February 27. **Please send your comments to CUNA by February 1.**

Please send comments to Senior Vice President and Deputy General Counsel [Mary Dunn](#) and Assistant General Counsel [Luke Martone](#), or contact us at (800) 356-9655 ext. 6733 with any questions. [Click here](#) for the proposed rule.

## **BRIEF DESCRIPTION OF THE PROPOSAL**

The proposed rule would eliminate NCUA's RegFlex program (Part 742) as well as the charitable contributions rule, and amend the rules that apply to eligible obligations, nonmember deposits, fixed assets, and investments. The proposal is intended to enable FCUs to take advantage of some flexibility regulatory treatment under the existing RegFlex rule. As of June 30, 2011, there are 4,534 FCUs, 2,764 of which are RegFlex FCUs. The proposed changes would extend regulatory relief to the remaining 1,770 FCUs that are not currently designated as RegFlex FCUs.

### Charitable Contributions

The proposed rule would eliminate the entire charitable contributions rule (§ 701.25) so that any FCU can make donations without the prior approval of its board of directors and without regulatory restrictions as to recipients. Currently, RegFlex FCUs are exempt from the entire charitable contributions rule.

The current charitable contributions rule allows an FCU to make charitable contributions or donations only to nonprofits located in or conducting activities in a community where the FCU is located, or § 501(c)(3) tax exempt organizations that operate primarily to promote and develop credit unions. In addition, the current rule requires an FCU's board of directors to approve charitable contributions that are in the best interests of the FCU and are reasonable given the FCU's size and financial condition.

### Nonmember Deposits

The proposed rule would increase the dollar threshold on the nonmember deposit limit in § 701.32(b) from \$1.5 million to \$3 million.

Currently, § 701.32 limits the amount of nonmember shares that an FCU may hold to the greater of (1) 20% of the FCU's total shares or (2) \$1.5 million. This means that an FCU holding less than \$7.5 million in total shares cannot accept nonmember deposits in excess of \$1.5 million, since \$1.5 million is 20% of \$7.5 million. RegFlex FCUs are currently exempt from the cap on nonmember deposits.

NCUA acknowledges that, by eliminating RegFlex, RegFlex FCUs would lose their blanket exemption from the nonmember deposit cap. "From its review of the nonmember deposits presently held by RegFlex FCUs, however, the [NCUA] Board believes the proposal provides all of the necessary flexibility and regulatory relief to all FCUs without adversely affecting any of the RegFlex FCUs that have accepted nonmember deposits in excess of the cap."

## Fixed Assets

Currently, the fixed asset rule provides limits on fixed asset investments, establishes occupancy and other requirements for acquired and abandoned premises, and prohibits certain transactions. Section 701.36(e) defines “fixed assets” to include “premises,” which means any office, branch office, suboffice, service center, parking lot, facility, or real estate where a credit union transacts business.

When an FCU acquires premises for future expansion and does not fully occupy the space within one year, the rule requires the FCU’s board of directors to have a resolution in place by the end of that year with plans for full occupation. Additionally, the FCU must partially occupy the premises within three years, unless the FCU obtains a waiver within 30 months of acquiring the premises. The existing fixed assets rule and the RegFlex rule extend the three-year time period to six years for RegFlex FCUs, but only with respect to the acquisition of unimproved land.

## Zero-coupon Investments

The proposed rule would continue the general prohibition that FCUs may not purchase zero-coupon investments with maturities that exceed 10 years but would permit FCUs that are “well-capitalized” to purchase zero-coupon investments with a maturity of up to 30 years.

Currently, § 703.16(b) of NCUA’s rules prohibits an FCU from purchasing a zero-coupon investment with a maturity that exceeds 10 years. RegFlex FCUs are exempt from the 10-year limitation in the investment rule.

Since the RegFlex rule was adopted, however, NCUA has reviewed the strategic and risk management considerations of FCU participation in long-term zero-coupon investments and concluded that such investments generally are not appropriate. “Zero-coupon investments with maturities exceeding 10 years have higher price sensitivity than other securities, including shorter-term zero-coupon investments. This increased price sensitivity, together with the lack of interim cash flows, makes long-term zero-coupon investments inconsistent with the primary portfolio objectives of safety and liquidity,” according to NCUA.

To balance the risk management concerns inherent in zero-coupon investments with the flexibility previously granted to RegFlex FCUs, the proposal would establish the maximum maturity date of zero-coupon investments to 30 years for any FCU that meets a “well-capitalized standard” (for purposes of this rulemaking). To meet the “well-capitalized standard,” an FCU must have received a composite CAMEL rating of 1 or 2 during its last two exam and (1) maintained a “well-capitalized” net worth classification for the immediately preceding six quarters, or (2) remained “well-capitalized” for the immediately preceding six quarters after applying the applicable risk-based net worth requirement.

As proposed, the rule would “grandfather” zero-coupon investments purchased in accordance with § 742.4(a)(4) prior to the effective date of the final rule. Under the proposal, an FCU that does not meet the “well-capitalized standard” must comply with the current § 703.16(b) requirement. Such an FCU would be prohibited from purchasing a zero-coupon investment with a maturity that exceeds 10 years, absent approval by the FCU’s regional director.

## Borrowing Repurchase Transactions

A borrowing repurchase transaction is a transaction in which an FCU agrees to sell a security to a counterparty and to repurchase the same (or an identical security) from that counterparty at a specified future date and at a specified price. Generally, an FCU may enter into a borrowing repurchase transaction so long as any investments the FCU purchases with borrowed funds mature no later than when the borrowing repurchase transaction matures — this concept is referred to as “mismatched maturities.” 12 CFR 703.13(d). NCUA adopted this restriction because of its concern that FCUs could incur significant interest rate risk by borrowing funds at short-term interest rates and investing in long-term fixed rate instruments. Interest rate risk results if an FCU invests the proceeds of the transaction significantly shorter or longer than the borrowing transaction.

NCUA, however, adopted a limited exemption for RegFlex FCUs from the maturity restriction. In so doing, the Board recognized that NCUA does not impose a similar prohibition for other borrowing arrangements. The RegFlex rule permits RegFlex FCUs to purchase securities with mismatched maturities, so long as the amount of securities does not exceed the credit union’s net worth under § 742.4(a)(5).

The proposal would continue this flexibility of mismatched maturities for borrowing repurchase transactions for FCUs meeting the “well capitalized standard.” In addition, the proposal amends § 703.13 to permit FCUs to enter into borrowing repurchase transactions and use the proceeds to purchase securities (1) with maturities no more than 30 days later than the transaction’s term and (2) the value of the purchased assets does not exceed the FCU’s net worth. As proposed, FCUs that do not meet the “well capitalized standard” may also request additional authority from their regional director to enter transactions with maturity mismatches of greater than 30 days. The proposed rule would grandfather borrowing repurchase transactions that an FCU entered under its RegFlex authority prior to the effective date of the final rule.

Proposed § 703.13(d)(3) sets out the following possible scenarios for borrowing repurchase transactions:

- (1) The borrowing and corresponding investment transactions must have matched maturities.
- (2) However, the matched maturity requirement would not apply if an FCU buys investments that mature no more than 30 days later than the borrowing repurchase transaction and the value of those investments does not exceed 100% of the FCU’s net worth.
- (3) An FCU that meets the “well capitalized standard” may enter borrowing repurchase transactions with mismatched maturities greater than 30 days if the value of the investments does not exceed 100% of the FCU’s net worth.

## Commercial Mortgage Related Securities

The proposed rule would permit all FCUs to purchase private label CMRS if certain criteria are met.

Section 703.16(d) of NCUA's investment rule generally prohibits an FCU from purchasing non-GSE issued CMRS. However, FCUs are permitted under § 107(15)(B) of the FCU Act to purchase mortgage related securities (as defined in § 3(a)(41) of the Securities Exchange Act of 1934), which include mortgage related securities backed solely by residential mortgages, solely by CMRS, and by mixed residential and commercial mortgages. Under the existing RegFlex rule, § 742.4(a)(6) permits RegFlex FCUs to purchase CMRS that are not otherwise permitted by § 107(7)(E) of the FCU Act if certain conditions are present.

The proposed rule removes the § 703.16 prohibition against the purchase of private label CMRS and adds the authority as a permissible investment in proposed § 703.14(j), with limits based on whether the FCU meets the "well capitalized standard." An FCU that meets the "well capitalized standard" may purchase private label CMRS under the same parameters currently found in § 742.4(a)(6), which are:

- The security is rated in one of the two highest rating categories by an NSRO (as amended in accordance with § 939A of the Dodd-Frank Act);
- The security meets the definition of mortgage related security and the definition of CMRS;
- The pool of loans underlying the CMRS contains more than 50 loans with no one loan representing more than 10% of the pool; and
- The FCU does not purchase an aggregate amount of CMRS in excess of 50% of its net worth.

The proposal would apply these same parameters to FCUs that do not meet the "well capitalized standard" except that the 50% of net worth limitation would be reduced to 25%, which could be increased by the FCU's regional director. As proposed, § 703.18 would include a grandfather provision for private label CMRS purchased by an FCU under its RegFlex authority prior to the effective date of the final rule.

### Eligible Obligations

The proposed rule would permit FCUs meeting the "well capitalized standard" to buy loans from other federally insured credit unions without regard to whether the loans are eligible obligations of the purchasing FCU's members or the members of a liquidating credit union.

The eligible obligations rule permits an FCU to purchase loans from any source, provided that: (1) the borrower is a member of that FCU; and (2) the loan is either of a type the FCU is empowered to grant or the FCU refinances the loan within 60 days of its purchase to meet that standard. 12 CFR 701.23. The rule also permits an FCU to purchase student loans and real estate-secured loans if the purchasing FCU grants these loans on an ongoing basis and is purchasing either type of loan to facilitate the packaging of a pool of such loans for sale or pledge on the secondary market. An FCU may also purchase the obligations of a liquidating credit union's individual members from the liquidating credit union. The eligible obligations rule imposes restrictions, including a limit on the aggregate amount of loans that an FCU may purchase of 5% of the purchasing FCU's unimpaired capital and surplus. It excludes certain types of loans from this limit, including loans purchased to facilitate a sale or pledge on the secondary market.

Currently, RegFlex FCUs may buy loans from other federally insured credit unions without regard to whether the loans are eligible obligations of the purchasing FCU's members or the members of a liquidating credit union. Loans purchased from a liquidating credit union, however, are subject to the eligible obligations cap of 5% unimpaired capital and surplus. RegFlex FCUs may also purchase student loans and real-estate secured loans without the need to purchase them in order to facilitate a secondary market pool package under current § 742.4(b).

The proposed rule retains the flexibility provided currently in the RegFlex rule for FCUs meeting the "well capitalized standard." In addition, the proposal would grandfather all obligations purchased by RegFlex FCUs under existing § 742.4(b) as well as nonmember business loans purchased under RegFlex authority or proposed § 701.23(b)(2).

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### Questions to Consider Regarding the Proposal

1) The proposed rule would eliminate the entire charitable contributions rule (§ 701.25) so that any FCU can make donations without the prior approval of its board of directors and without regulatory restrictions as to recipients. Currently, RegFlex FCUs are exempt from the entire charitable contributions rule. Do you support this proposed change? Is there any reason to limit which FCUs may make donations without prior approval and other regulatory restrictions?

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2) Do you support the proposed increase in the nonmember deposit limit (§ 701.32(b)) from \$1.5 million to \$3 million? Why or why not? Would a higher amount be more appropriate?

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3) NCUA acknowledges that, by eliminating RegFlex, RegFlex FCUs would lose their blanket exemption from the nonmember deposit cap. "From its review of the nonmember deposits presently held by RegFlex FCUs, however, the [NCUA] Board believes the proposal provides all of the necessary flexibility and regulatory relief to all FCUs without adversely affecting any of the RegFlex FCUs that have accepted nonmember deposits in excess of the cap." Do you agree with NCUA's position?

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4) The proposed rule would amend the fixed assets rule to extend the three-year time period to six years for any FCU that is acquiring unimproved land; the extension would not apply to any other kind of premises. NCUA cites the challenges associated with occupying unimproved land in its decision to limit the proposed extension to unimproved land. Do you agree?

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5) The proposed rule would generally prohibit FCUs from purchasing zero-coupon investments with maturities that exceed 10 years, except for FCUs that meet the “well capitalized standard,” which would be permitted to purchase zero-coupon investments with a maturity of up to 30 years. Do you support this proposed provision?

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6) The proposed rule would permit borrowing repurchase transactions in the following possible scenarios: (1) the borrowing and corresponding investment transactions must have matched maturities; (2) the matched maturity requirement would not apply if an FCU buys investments that mature no more than 30 days later than the borrowing repurchase transaction and the value of those investments does not exceed 100% of the FCU’s net worth; and (3) an FCU that meets the “well capitalized standard” may enter borrowing repurchase transactions with mismatched maturities greater than 30 days if the value of the investments does not exceed 100% of the FCU’s net worth. Do you agree? Are there other possible scenarios in which borrowing repurchase transactions should be permitted?

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7) NCUA seeks comment on whether the regulation should specify minimum experience requirements for staff involved in the analysis and ongoing risk management of a repurchase-agreement book, especially in cases where maturities of sources and uses are mismatched.

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8) The proposed rule would permit all FCUs to purchase private lable CMRS if certain criteria are met. NCUA seeks comment on whether the conditions for purchasing CMRS in the proposal should be enhanced to encourage diversity and mitigate risk. NCUA is concerned from its recent experience that the current rule may contain inadequate limitations.

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9) The proposed rule would permit FCUs meeting the “well capitalized standard” to buy loans from other federally insured credit unions without regard to whether the loans are eligible obligations of the purchasing FCU’s members or the members of a liquidating credit union. Do you support this proposed provision?

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10) Should the flexibility from the eligible obligations rule be extended to all FCUs? Are there safety and soundness concerns that prevent NCUA from extending this authority to all FCUs? Alternatively, should the final rule permit FCUs that do not meet the “well capitalized standard” to request approval from regional directors, similar to the proposed process for expanded investment authority?

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11) Any other questions or comments.

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