7535-01-U

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 702, 703, 704, 709, and 747

RIN 3133-AD58

Corporate Credit Unions

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed rule.

SUMMARY: NCUA is issuing proposed amendments to its rule governing corporate credit unions contained in part 704. The major revisions involve corporate credit union capital, investments, asset-liability management, governance, and credit union service organization (CUSO) activities. The amendments would establish a new capital scheme, including risk-based capital requirements; impose new prompt corrective action requirements; place various new limits on corporate investments; impose new asset-liability management controls; amend some corporate governance provisions; and limit a corporate CUSO to categories of services preapproved by NCUA. In addition, this proposal contains conforming amendments to part 702, Prompt Corrective Action (for natural person credit unions); part 703, Investments and Deposit Activities (for federal credit unions); part 747, Administrative Actions, Adjudicative Hearings, Rules of Practice and Procedure, and Investigations; and part 709, Involuntary Liquidation of Federal Credit Unions and Adjudication of Creditor Claims Involving Federally Insured Credit Unions. These amendments will strengthen individual corporates and the corporate credit union system as a whole.

DATES: Comments must be received on or before March 9, 2010.

ADDRESSES: You may submit comments by any of the following methods (Please send comments by one method only):

- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- NCUA website: http://www.ncua.gov/RegulationsOpinionsLaws/proposed_regs/proposed_regs.html. Follow the instructions for submitting comments.
- E-mail: Address to regcomments@ncua.gov. Include "[Your name] Comments on Part 704 Corporate Credit Unions" in the e-mail subject line.

- Fax: (703) 518-6319. Use the subject line described above for e-mail.
- Mail: Address to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.
- Hand Delivery/Courier: Same as mail address.

Public inspection: All public comments are available on the agency's website at http://www.ncua.gov/RegulationsOpinionsLaws/comments as submitted, except as may not be possible for technical reasons. Public comments will not be edited to remove any identifying or contact information. Paper copies of comments may be inspected in NCUA's law library at 1775 Duke Street, Alexandria, Virginia 22314, by appointment, weekdays between 9:00 a.m. and 3:00 p.m. To make an appointment, call (703) 518-6540 or send an e-mail to OGCMail@ncua.gov.

FOR FURTHER INFORMATION CONTACT: Richard Mayfield, Capital Markets Specialist, Office of Corporate Credit Unions, at the address above or telephone: (703) 518-6642; Ross Kendall, Staff Attorney, Office of General Counsel (OGC), at the at the address above or telephone (703) 518-6540; Paul Peterson, Director, Applications Section, OGC, at the address above or telephone (703) 518-6540; or Todd Miller, Regional Capital Market Specialist, Region V, at telephone (703) 409-4317.

SUPPLEMENTARY INFORMATION:

The NCUA's primary mission is to ensure the safety and soundness of federally-insured credit unions. NCUA performs this important public function by examining all federal credit unions, participating in the examination and supervision of federally-insured state chartered credit unions in coordination with state regulators, and insuring federally-insured credit union members' accounts. In its statutory role as the administrator of the National Credit Union Share Insurance Fund (NCUSIF), the NCUA insures and supervises approximately 7,740 federally-insured credit unions, representing 98 percent of all credit unions and approximately 89 million members.[1]

Over 95 percent of natural person credit unions (NPCUs) belong to, and receive services from, corporate credit unions (corporates). There are 27 *retail* corporates that provide services directly to NPCUs, and there is one *wholesale* corporate, U.S. Central Federal Credit Union (U.S. Central), that provides services to many of the 27 retail corporates.

[1] Within the fifty states, approximately 155 state-chartered credit unions are privately insured and are not subject to NCUA regulation or oversight.

The corporate system offers a broad range of support to NPCUs. The products and services provided by U.S. Central to retail corporates, and by retail corporates to NPCUs, include: investment/deposit services, wire transfers, share draft processing and imaging, automated clearinghouse transactions (ACH) processing, automatic teller machine (ATM) processing, bill payment services and security safekeeping. The volume of payment systems-related transactions throughout the system annually runs into the millions and the dollar amounts associated with those transactions are in the billions each month. Corporates also serve as liquidity providers for NPCUs. Natural person credit unions invest excess liquidity in a corporate when the NPCU has lower loan demand and draw down the invested liquidity when loan demand increases. In sum, corporates provide NPCUs with convenient and quality services and expertise, all at a fair price. For many NPCUs, this is a combination that makes the corporate system a valuable resource and, for some smaller NPCUs, an essential resource.

Federally-chartered corporates are governed by federal law and state chartered corporates by state law. In addition, all corporates that are federally-insured, or that accept share deposits from NPCU members that are federally insured, must comply with NCUA's part 704 corporate credit union rule. 12 CFR part 704; §704.1, and 12 U.S.C. 1766(a). This proposal contains significant changes to part 704 and conforming changes to other parts of NCUA's rules. The changes include new investment limitations, asset-liability management requirements, capital standards, prompt corrective action requirements, corporate governance requirements, and CUSO requirements.

Prior to drafting this proposal, the Board considered all of the existing part 704, but ultimately concluded that the rule provisions addressed in this proposal, and discussed below, were the provisions that needed modification. These modifications are intended not only to avert a repeat of the recent problems encountered in the corporate system but also to anticipate new problems that might occur. For example, while the recent corporate problems were caused in part by spread widening associated with perceptions of credit risk, the proposal requires a corporate conduct a new spread widening test that should demonstrate sensitivity to both credit risk and other potential market risks. Likewise, increased capital requirements and well-defined concentration limits protect not only against the types of risk that materialized in the past but also different risks that might materialize suddenly in the future.

This preamble is organized in four sections as follows. Section I discusses the historical background leading up to the need for this rulemaking. Section II summarizes affected portions of the current corporate rule and the proposed changes to those portions. Section III contains a more complete analysis of the proposed changes with references to particular sections and paragraph numbers

within part 704. Section IV discusses various statutory requirements applicable to the rulemaking process.

Section III, with its analysis of each proposed change to part 704, is particularly important. Included in subsection III.E are illustrations of how the various provisions of this proposal, if they had been applied to the corporate system in the past, would have drastically reduced the recent corporate losses. Section III looks not only to the past, but also the future. Specifically, subsection III.D. includes a discussion of how a hypothetical corporate might structure its balance sheet so as to achieve the proposed new capital requirements while at the same time complying with the various proposed investment and asset-liability limitations. The Board encourages commenters to take a very close look at the discussion in III.D. This discussion will help commenters to understand how the Board envisions the various elements of the proposal, working together, can permit the corporate system to return to a position of providing necessary services to natural person credit unions while ensuring the system operates within appropriate safety and soundness constraints. The Board invites comment on all aspects of Section III, including the viability of the assumptions employed by NCUA.

I. History of Current Issues in the Corporate System.

I.A. Corporate system: prior to 2000.

Up until the late 1990s, federally chartered corporates had a defined field of membership (FOM) serving a specific state or geographic region. Most state chartered corporates had national FOMs but primarily serviced the state in which they were incorporated. In 1998, the NCUA Board began to approve national FOMs for federal corporates, in part to provide requested parity with state charters. Within a few years most corporates had a national FOM.

NCUA's intention in allowing national FOMs was to provide NPCUs with the ability to select membership in a corporate that best met the needs of each NPCU in serving its members. The anticipated level of competition was expected to spur consolidation within the industry to build scale and improve efficiencies. In turn, this would build capital through increased earnings. While a few mergers occurred, one of the primary consequences of competition was to reduce margins on services and put pressure on the corporates to seek greater yields on their investments.

I.B. Corporate system: 2000 through mid-2007.

The investment provisions of NCUA's corporate regulation, located at 12 CFR part 704, have for many years permitted corporates to purchase private label mortgage-backed and mortgage-related securities (collectively referred to as *MBS*). Part 704, however, restricts most corporates (those without expanded investment authority) to investing in only the highest credit quality rated securities by at least one Nationally Recognized Statistical Rating Organization (NRSRO).[2] Historically, highly rated securities have experienced minimal defaults and have been very liquid. Under NCUA rules, some corporates were permitted to exercise expanded investment authority and to purchase investment grade securities rated down to BBB because they had higher capital ratios, more highly trained personnel, and more capacity in their systems to monitor and model their portfolios. Even those corporates that had expanded credit risk authority, however, used it sparingly. In addition to being limited to securities with very high NRSRO ratings, corporates were required to perform a comprehensive credit analysis of the underlying collateral supporting the marketable security.

Either through direct purchase, or indirectly through investments at U.S. Central, the corporate system became heavily invested in privately issued MBS. Between 2003 and mid-2007, the percentage of investments in MBS grew from 24 percent to 37 percent. At purchase, these securities provided the corporates with a modest increase in yield over traditional investments in other asset-backed securities (e.g., securitized credit card and auto receivables). The vast majority of MBS had high credit ratings (AA equivalent or above) and interest rates that reset on a monthly or quarterly basis, which closely matched the corporates' need to fund dividends on member shares.[3] These features made MBS highly marketable and thus provided adequate liquidity to the corporates so they, in turn, could provide liquidity to their NPCU members.

U.S. Central and Western Corporate Federal Credit Union (WesCorp) had the highest concentrations of MBS in the entire corporate system.[4] The advent of national FOMs produced the competition that may, in turn, have helped generate these MBS concentrations. WesCorp was able to attract new NPCU members in part by offering dividend rates higher than other corporates. Consequently, it

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[2] The term nationally recognized statistical rating organization (NRSRO) is used in federal and state statutes and regulations to confer regulatory benefits or prescribe requirements based on credit ratings issued by credit rating agencies identified by the Securities and Exchange Commission (SEC) as NRSROs. The Credit Rating Agency Reform Act of 2006 requires a credit rating agency seeking to be treated as an NRSRO to apply for, and be granted, registration with the SEC. See final SEC Rule, *Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations*, at 72 Fed. Reg. 33564 (June 18, 2007).

[3] Overnight share dividends repriced daily. Fixed rate share certificates were funded by investing in interest rate swaps. The swaps converted the variable rates paid by the MBS to fixed rates that could be used to pay the certificate dividends.

[4] NCUA placed both USC and WesCorp into conservatorship in March 2009, as discussed further below.

maintained an aggressive earnings strategy achieved by acquiring higher yielding (i.e., riskier, though still highly rated) MBS with greater amounts of credit risk. In direct response to WesCorp's market share success, other corporates likely pressured U.S. Central, their wholesale corporate, to pay higher, more competitive dividends which those corporates could pass along to their NPCU members. As a result, U.S. Central changed its portfolio strategy and also invested heavily in higher yielding MBS.

NCUA communicated to corporates the need to establish reasonable concentration limits in their board policies. In January 2003, NCUA issued *Corporate Credit Union Guidance Letter 2003-01*, which expressly highlighted the risks associated with credit concentrations and specifically addressed the need for corporates to establish appropriate limitations within their credit risk management policies.

During this timeframe, NCUA was also beginning to focus efforts on identifying and educating NPCUs on emerging risks associated with proper credit risk management of lending, including real estate lending, because of a nation-wide increase in alternative lending arrangements. Over the next few years, NCUA and the federal banking agencies worked cooperatively to provide numerous pieces of industry guidance on non-traditional mortgage products. NCUA warned of the potential adverse impact these types of loans could have on consumers and credit union balance sheets. Natural person credit unions have responded favorably to the supervision oversight of NCUA; to date, these types of mortgage loans represent less than 4 percent of all first mortgage loans outstanding in the credit union industry.

In April 2007, several months before the distress in the mortgage market surfaced, NCUA issued *Corporate Credit Union Guidance Letter No. 2007-02*, focusing on the various risks associated with MBS. This letter addressed MBS credit risk, liquidity risk, market value risk, and concentration risk, and by mid-2007 corporates had, by-and-large, ceased the purchase of private label MBS. Still, by the summer of 2007 the MBS at the heart of the corporate problem were already on the books of U.S. Central and WesCorp. At that time, all their investments, including MBS, were still rated investment grade, and 98 percent were rated AA or higher. It was not until a year later (June 2008) that these corporates' MBS credit ratings began migrating downward, and even then 96 percent were still investment grade and 92 percent were still rated AA or better.

I.C. Corporate system: mid-2007 through mid-2008*.*

Beginning mid-year 2007, real estate values declined across many markets in the U.S. and greater numbers of mortgages became delinquent leading to a greater number of foreclosures. The higher number of foreclosures further

eroded housing prices, resulting in lower recovery of principal and even higher losses when the foreclosed properties were liquidated. This resulted in sharp price declines for MBS and a corresponding shallowing of the market as a flight to quality arose.

Initially, market participants believed the market disturbance was limited to the subprime market and would be short-lived, and the performance of the senior credit positions in MBS, such as those primarily held by corporates, would not be at risk; however, that has proven not to be the case. By the end of 2007 and early into 2008, what started out as problems with sub-prime mortgages spread to Alt-A loans, option ARM loans, and finally to prime mortgage loans.[5]

Some MBS were backed by underlying loans that had imprudent underwriting. These alternative mortgage loans were aggressively made to buyers in high-price home markets as a means to address home affordability. [6] The weak credit fundamentals of the underlying mortgages, the inherent risk of the MBS structures, and the declining home market combined to severely affect the performance of MBS holdings of some corporates.

MBS prices and marketability declined significantly. Even bonds that held AA ratings or higher were unable to be sold at prices close to par, discouraging investors, including corporates, from selling them. Corporates increasingly looked to borrowings to meet liquidity demands. By pledging their MBS assets as security, corporates were able to obtain financing from external lenders.

In hindsight, it would have been preferable for the corporates to have sold their problem MBS in 2007. However, any sale following the MBS market dislocation in the summer of 2007 would have forced unrealized losses to become realized losses at a time when actual credit impairment of the underlying assets was viewed by many as unlikely. Absent a market of willing buyers, private label MBS increasingly could only be sold at a very severe discount (distressed prices) – causing losses even more significant than the accumulated unrealized losses on available-for-sale securities reflected on the financial statements. The conventional market wisdom at the time was that the problems in the MBS markets were temporary and it did not make economic sense to sell securities until market liquidity and counterparty trust improved.

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[5] Alt-A loans are between subprime and prime. Generally, the borrowers have good credit histories, but pay higher interest because of some other risk factor, such as low documentation or high loan-to-value ratio. Option ARM loans (option adjustable rate mortgages) allow the borrower to choose between different payment options period to period. Prime mortgage loans are considered high quality, with highly rated borrowers and other criteria indicating relatively low risk.

[6] Very few, if any, of these problems loan that found their way into MBS pools were originated by credit unions.

Conditions did not improve and as the MBS markets became more distressed and illiquid, the margin requirements set by lenders for MBS collateral pledged by their corporate credit union borrowers increased. The cost of primary borrowing sources available to corporates became prohibitively expensive as a result. Due to the continued price devaluation of MBS, the ability to borrow by pledging corporate investment portfolios diminished significantly, thereby increasing liquidity pressures. In turn, this reduced leverage diminished the yields paid by the corporates and made them less attractive. NPCUs began to invest part of their excess liquidity elsewhere, further increasing corporate liquidity concerns.

In response to these concerns, NCUA directed corporates to consider a number of steps to ensure adequate sources of liquidity, including: encouraging the establishment of commercial paper and medium-term note programs; encouraging additional liquidity sources (both advised and committed); encouraging an increase in the number of repo transaction counterparties; encouraging membership in a Federal Home Loan Bank (FHLB); requiring independent third party stress test modeling of mortgage-related securities to determine if the securities would continue to cash flow; assisting U.S. Central to gain access to the Federal Reserve Board's discount window; and encouraging education and communication with their members about what was occurring in the financial market and how it was affecting their balance sheets. Corporates have done a good job of communicating these issues with their members and this did assist in preventing significant outflows of funds from the corporate system.

On August 11, 2008, the Wall Street Journal published an article on the unrealized losses on available-for-sale securities in the corporate system. The article generated additional questions and concerns throughout the credit union industry and increased the possibility of a run on corporate shares. A run would have forced some corporates to sell their MBS at severely depressed prices, leading to loss of not only all the member capital in the affected corporates but also most member shares.[7] The loss of these shares would have likely caused the failure of many member NPCUs and required numerous recapitalizations of the NCUSIF, with catastrophic effects on the credit union system as a whole.

Also in that August 2008 timeframe the media publicized problems with Fannie Mae, Freddie Mac, Bear Stearns, Countrywide, and numerous other financial entities. Liquidity in the global markets froze: liquidity had become not only expensive, but almost impossible to obtain. Unfortunately, these events coincided with seasonal liquidity demands placed by NPCUs on their corporates. Traditionally, NPCUs withdraw funds during August and September, and funds

[7] The vast majority of shares in corporates are uninsured because the account balances are well above the $250,000 federal insurance limit.

begin to flow back into the corporates in October. The tightening liquidity environment was of significant concern to NCUA and the corporate system, because corporates must maintain adequate liquidity to ensure the uninterrupted functioning of the payment systems.

The potential loss of member confidence in their corporates, ever-increasing concerns about the credit quality of MBS, and the seasonal liquidity outflows all created the "perfect storm" for the corporate system. NCUA was concerned that some corporates would be unable to meet the liquidity demands of their members in the short-term or be unable to fund payment systems activity. In addition, NCUA had indications of an exodus of NPCU funds from the corporate system due to a lack of confidence. Accordingly, in the fall of 2008 it became critical for NCUA to initiate dramatic action to bolster confidence in the corporates and ensure the continuing flow of liquidity in the credit union system. The NCUA's initial public actions involved liquidity support, while the Board intensified its contingency planning on related issues, including corporate capital and corporate restructuring.

During the last half of calendar year 2008 NCUA took several actions, in tandem with the Central Liquidity Facility (CLF), to increase liquidity throughout the entire credit union system, especially within the corporates. These pro-liquidity actions included:

- Encouraging corporates with large unrealized losses on holdings of MBS to make application to the Federal Reserve Discount Window.
- Converting loans made by corporates to NPCUs to CLF-funded loans using funds borrowed by the CLF from the U.S. Treasury.
- Announcing and implementing the *Temporary Corporate Credit Union Liquidity Guarantee Program* (TCCULGP) on October 16, 2008. The TCCULGP is similar to the FDIC's Temporary Liquidity Guarantee Program announced by the FDIC on October 14, 2008. The TCCULGP provides a 100 percent guarantee on certain new unsecured debt obligations issued by eligible corporates.
- Announcing and implementing the Credit Union System Investment Program (CU SIP) and the Credit Union Homeowners Affordability Relief Program (CU HARP). Both programs allow participating NPCUs to borrow funds from the CLF and invest those funds in CU SIP notes issued by corporates, injecting additional liquidity into the corporates and the entire credit union system. With the launch of CU HARP and CU SIP, NCUA

provided about $8 billion of additional funding to corporates to pay down external borrowings.[8]

The unrealized losses in the corporate system grew to nearly $18 billion by year-end 2008. The severity of the MBS price declines and credit downgrades, along with the erosion of subordinated classes within the MBS structures held by corporates, required reconsideration by some corporate credit unions that all such fair value declines were temporary.[9] In January, 2009, several corporates reported major realized losses and significant capital depletion, and it became apparent that the NCUA's liquidity assistance efforts by themselves would not be sufficient to stabilize the corporates. The NCUA Board continued its consideration of issues including corporate capital and corporate restructuring and, at its January 28, 2009, meeting, the NCUA Board took the following actions in furtherance of corporate stabilization:

- Approved issuance of a $1 billion NCUSIF capital note to U.S. Central as a result of pending realized losses on MBS and other asset-backed securities. This action was necessary to preserve confidence in U.S. Central, given its pivotal role in the corporate system, and maintain external sources of funding.
- Approved the *Temporary Corporate Credit Union Share Guarantee Program* (TCCUSGP), which guarantees uninsured shares at participating corporates through September 30, 2011. This program was vital in maintaining NPCU confidence in the corporate system.
- Authorized the engagement of Pacific Investment Management Company, L.L.C. (PIMCO), an independent third party, to conduct a comprehensive analysis of expected non-recoverable credit losses for distressed securities held by corporates. This information served to augment NCUA's previous analysis of potential losses to the NCUSIF and provided an independent assessment of the reliability of information provided by the corporates. The focus on non recoverable credit losses rather than the higher and more volatile losses due to other market factors was consistent with the need to determine the actual loss exposure of the NCUSIF.
- Announced that losses to the NCUSIF associated with corporates would be several billion dollars, exceeding the NCUSIF's entire retained earnings and impairing each credit union's one percent capitalization deposit.

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[8] The SIP and HARP programs were key in providing liquidity to the corporates and the credit union system at this critical juncture. These two programs, and other CLF lending, would not have been possible without NCUA's advocacy the previous September for lifting the CLF cap.

[9] The term "subordinated" means that the security will absorb credit losses in the underlying pool of loans before other, more senior, securities absorb credit losses. In general, the principal of the subordinated security will be exhausted before the more senior securities absorb any loss.

- Issued an Advance Notice of Public Rulemaking (ANPR) on restructuring the corporate rule. The sixty-day comment period expired in April 2009. NCUA received almost five hundred comment letters, providing suggestions on possible regulatory reforms for corporates and the corporate system.

In March 2009, due to huge operating losses at U.S. Central and WesCorp, lack of sufficient capital, and for other reasons, the NCUA Board was forced to place these two corporates into conservatorship. The action protected retail credit union share deposits and the interests of the NCUSIF and helped clear the way for NCUA to take additional mitigating actions as they might become necessary.

As of May 2009, NCUA estimated that losses to the NCUSIF associated with the troubles in the corporate system exceeded the entire equity in the Fund and impaired approximately 69 percent of the capitalization deposit that all federally insured credit unions maintain with the NCUSIF. These losses necessitated premium and deposit replenishment assessments that would, in total, cost insured credit unions an amount equal to almost one percent of their insured shares. Though the credit union system as a whole had the net worth to absorb these costs and remain well capitalized, the legal structure of the NCUSIF would have required that credit unions take all these insurance expense charges at once, which would result in a contraction of credit union lending and other services. This would come at a particularly difficult time, when it was vital that credit unions be a source of consumer confidence and continue to make credit available to support an economic recovery. In fact, the NCUA Board realized that such a large, sudden impact on credit unions' financial statements could further destabilize consumer confidence.

The Board was committed to seeking the lowest cost option for stabilizing the corporate system, while also minimizing the adverse impact on natural person credit unions and their members so that credit unions could remain a vibrant and healthy sector of the U.S. financial system. In pursuit of these ends, the Board drafted legislation to create a Temporary Corporate Credit Union Stabilization Fund (CCUSF). The proposed CCUSF would borrow money from the Treasury for up to seven years and use the money to pay expenses associated with the ongoing problems in the corporate credit union system, such as the capital injection into U.S. Central. The primary purpose of this new CCUSF would be to spread over multiple years the costs to insured credit unions associated with the corporate credit union stabilization effort, and to ensure that the payment by insured credit unions of those costs was anti-cyclical, and not pro-cyclical.

The Board sought Congressional support and passage of the CCUSF. On May 20, 2009, Congress enacted and the President signed into law the *Helping Families Save Their Homes Act of 2009* (*Helping Families Act*), Pub. L. No. 111-

22. Section 204 of the Helping Families Act created the sought-after CCUSF and provided NCUA with other helpful tools, such as increasing the authority of the NCUSIF and CCUSF to borrow from the Treasury and permitting the NCUSIF to assess premiums over as much as 8 years to rebuild the equity ratio should the ratio fall below 1.20 percent.

Immediately following passage of this legislation, the NCUA Board took a series of actions establishing and implementing the CCUSF. On June 18, 2009, the Board obligated the CCUSF to accept assignment from the NCUSIF of the $1 billion capital note extended to U.S. Central executed on January 28, 2009. The Board also determined to legally obligate the CCUSF for any liability arising from the TCCUSGP (share guarantee) and TCCULGP (liquidity guarantee) programs. These steps effectively spread the cost of the corporate stabilization program for insured credit unions over multiple years.

For more than a year, then, going back to the summer of 2008, the NCUA Board has worked a number of avenues to stabilize the corporate system, involving liquidity improvement and protection, capital injections, and spreading the costs to NPCUs of the stabilization program out over multiple years. These actions were critical to the near- and mid-term survival of the corporate system and to minimizing the potential costs to the NCUSIF and to the insured NPCUs obligated to the fund the NCUSIF. For the longer term, however, the Board believes it needs to address the structure of corporates and the corporate system and the investment, capital, and governance standards by which corporates operate. Accordingly, the Board has turned its attention to part 704, NCUA's corporate rule, and to the public comments that the Board solicited in response to its ANPR.

I.D. The Advance Notice of Proposed Rulemaking (ANPR).

In January 2009, NCUA solicited public comment on whether comprehensive changes to the structure of the corporate system were warranted. 74 FR 6004 (Feb. 4, 2009). This corporate credit union ANPR sought comment on how best to define and structure the role of corporates in the credit union system, whether to modify the level of required capital for corporates, whether to modify or limit the range of permissible investments for corporates, whether to impose new standards and limits on asset-liability management and credit risk, and whether to make modifications in the area of corporate governance.

NCUA received some 445 comments in response to the ANPR. More than 370 of these comments came from natural person credit unions (NPCUs). Eighteen corporates, 27 state credit union leagues, four national trade associations, and the National Association of State Credit Union Supervisors also commented.

NCUA reviewed these public comments closely and considered them carefully in drafting this proposed rule. Certain specific comments received in response to the ANPR are discussed in Section C below as they relate to particular proposed amendments.

II. Summary of Current Rule and Proposed Changes.

This proposal contains numerous changes to the current corporate rule. Some of these changes are short and straightforward, while others are more lengthy and complex. This Section II briefly summarizes the current part 704 provisions, and the proposed changes. Section III describes each proposed change in more detail.

II.A. Current part 704 capital rules.

Currently, corporates have only one mandatory minimum capital requirement: they must maintain total capital -- retained earnings, paid-in capital (PIC), and membership capital accounts (MCAs) --in an amount equal to or greater than 4 percent of their moving daily average net assets.[10] Failure by a corporate to meet this minimum capital ratio triggers the requirement to file a capital restoration plan with NCUA and may cause NCUA to issue a capital restoration directive and take other administrative action. Although Prompt Corrective Action (PCA) applies to NPCUs and to banking entities, PCA does not currently apply to corporates.[11] The current rule also provides that retail corporates with a retained earnings ratio of less than two percent must increase their retained earnings by a certain amount each quarter, but this reserving requirement only applies to a wholesale corporate credit union if its retained earnings ratio falls below one percent.

II.B. Proposed amendments to part 704 capital rules.

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[10] 12 CFR 704.3(d). Corporates have other capital-related requirements, such as a core capital ratio and a retained earnings ratio, but failure to meet these requirements only triggers future earnings retention requirements and does not trigger a capital restoration plan requirement.

[11] Section 216 of the Federal Credit Union Act establishes a PCA scheme for natural person credit unions. 12 U.S.C. 1790d. Paragraph (m) of §216 states specifically that the provisions of §216 are not applicable to corporate credit unions. Since corporate credit unions are different in form, function, and mission than natural person credit unions, the PCA scheme set forth in this proposal differs from that contained in §216 and its implementing regulation, 12 CFR Part 702. The legal authority for this proposed corporate PCA scheme is found in two different places. Section 120(a) of the Act, states, in pertinent part, that "[A]ny central credit union chartered by the Board shall be subject to such rules, regulations, and orders as the Board deems appropriate . . . . " 12 U.S.C. 1766(a). Section 201(b)(9) of the Act also requires that federally insured credit unions "comply with the requirements of this [share insurance] title and of regulations prescribed by the Board thereto." 12 U.S.C. 1781(b)(9).

NCUA intends to change the corporate capital requirements to make them stronger and more consistent with the requirements of the banking regulators. For example, the other regulators employ three different minimum capital ratios, not one ratio like NCUA. The current corporate minimum capital ratio is also calculated differently from any of the three ratios employed by the other regulators.

The proposal replaces the current four percent total capital ratio with a four percent *leverage ratio*, and limits the capital that can be used to calculate the leverage ratio to *core*, or *Tier 1*, capital, which would include only the more permanent forms of corporate capital. The proposal also includes new minimum risk-based capital ratios that are calculated based on risk-weighted assets. Failure to meet these minimum ratios will trigger a capital restoration plan requirement, potential capital restoration directives, and other, new prompt corrective action (PCA) provisions. The new PCA provisions are similar to those currently applicable to banks. The due process associated with the new PCA provisions is set out in a new subpart to part 747 of NCUA's rules.

The proposal also refines the acceptable elements of corporate capital. For example, after an appropriate phase-in period a certain percentage of core capital must be in the form of retained earnings. The timing and amount of this retained earnings requirement is discussed in detail in Section III below.

The proposal will also toughen the requirements for *Tier 2* capital accounts (i.e., MCAs) that can be used in part to satisfy the new total risk based capital ratio. Specifically, the current minimum three year requirement for MCAs will be lengthened to five years, and the adjustable balance type of MCA accounts will be eliminated.

The proposal also renames the two types of contributed capital accounts (PIC and MCA) to render the names more descriptive of what they actually are. PIC is renamed as perpetual contributed capital (PCC), and MCAs are renamed as nonperpetual capital accounts (NCAs). The proposal further permits corporates to issue PCC and NCAs to both members and nonmembers.

The proposal will eliminate the current prohibition on corporates requiring credit unions to contribute capital to obtain membership or receive services. It will also permit members to transfer corporate capital instruments they hold to third parties and will require corporates to facilitate such transfers.

The proposal also eliminates the special treatment that wholesale corporates receive with regard to retained earnings reserving requirements. All corporates will be subject to the same requirements with regard to retained earnings.

Finally, the proposal permits a corporate, at its option, to give new contributed capital priority over existing contributed capital.

II.C. Current part 704 investment limitations.

Among other investment provisions, the current part 704:

- Requires that a corporate maintain an internal investment policy that includes reasonable and supportable concentration limits, including limits by investor type and sector, but does not prescribe standards for determining the reasonableness of those limits.
- Requires that the aggregate of all investments in any single obligor is limited to the greater of 50 percent of capital or $5 million.
- Specifies, for permissible investment types, that the investment must be rated no lower than AA- by at least one Nationally Recognized Statistical Rating Organization (NRSRO) at time of purchase. The required rating may be lower for certain investment types if the corporate has expanded authorities. Additional requirements apply if the rating is subsequently lowered. Certain investment types, such as U.S. government securities and CUSO investments, are exempt from the NRSRO requirement.
- Specifically prohibits certain types of investments, including most derivatives, most stripped MBS (e.g., interest only strips and principal only strips), mortgage servicing rights, and residual interests in asset-backed securities (ABS).
- Does not address investments that are structured to be subordinate, in terms of potential credit losses, to other securities.

II.D. Proposed amendments to part 704 investment limitations.

The proposal will impose specific concentration limits by investment sector. Sectors include residential mortgage-backed securities, commercial mortgage-backed securities, student loan asset-backed securities, automobile loan/lease asset-backed securities, credit card asset-backed securities, other asset-backed securities, corporate debt obligations, municipal securities, registered investment companies, and an *all others* category to account for the development of new investments types. The proposal further restricts the purchase of high-risk structured instruments that concentrate, and thus multiply, market risk exposures, such as investments that return a multiple of a particular market interest rate. These limits would be in addition to current limits on derivatives. The proposal would also limit subordinated positions in all sectors. This limit will reduce a corporate's credit risk by restricting its ability to purchase *mezzanine* residential mortgage-backed securities, as some corporates did, or other

subordinated structured securities that are not the most senior security in terms of credit risk.

The proposed changes would prohibit additional investment types that have proven problematic, such as collateralized debt obligations (CDOs) and Net Interest Margin (NIM) securities.

The proposed changes would require that a corporate get multiple ratings from different NRSROs, and only use the lowest of the ratings, and require that ratings be used only to exclude an investment, not as authorization to include one. Credit ratings will not be a substitute for pre-purchase due diligence and ongoing risk monitoring. Downgrades below the minimum rating threshold will continue to trigger investment action plans. These provisions, along with the asset-liability management (ALM) provisions described below, will reduce reliance on NRSRO ratings.

The proposal will eliminate the current Part II expanded investment authority, modify the current Part IV expanded authority on derivatives, and impose increased capital requirements to qualify for Part I and II expanded investment authorities.

II.E. Current part 704 ALM provisions.

The current part 704 requires that corporates maintain an internal ALM policy. The rule requires that as part of that policy the corporate do Net Economic Value (NEV) modeling to measure interest rate risk, but the rule does not have any other specific requirements relating to the risks of mismatches between asset and liability cash flows. The current part 704 requires that any corporate permitting early withdrawals on share certificates "assess a market-based penalty sufficient to cover the estimated replacement cost of the certificate redeemed." The current rule does not establish any minimum amount of cash, or cash equivalents, that a corporate must, for liquidity purposes, maintain on hand at all times. The current rule limits a corporate's borrowing to the greater of 10 times capital or 50 percent of shares and capital, but does not place any additional limits on secured borrowings.

II.F. Proposed amendments to part 704 ALM provisions.

The proposal would:

- Establish a maximum limit on the weighted average life of a corporate's aggregate assets.

- Establish limits on cash flow mismatches so as not to exceed an acceptable gap between the average life of assets and liabilities.
- Require additional testing for spread widening and net interest income (NII) modeling; including testing standards.
- Further limit a corporate's ability to pay a market-based redemption price to no more than par, thus eliminating the ability to pay a premium on early withdrawals.
- Require a corporate maintain a minimum amount of cash or cash equivalents to ensure sufficient liquidity protection for payment system operations.
- Restrict the use of secured borrowings for purposes other than liquidity needs.

The effects of these new, proposed ALM provisions, as well as the investment provisions discussed in paragraph E. above, are illustrated in more detail in subsection III.D. below.

II.G. Current part 704 corporate governance provisions.

The current part 704 places limitations on board representation, including limits on the number of trade organization representatives. The current rule does not, however, place any experience or knowledge requirements on individual corporate directors. The current rule does not require any disclosure of executive compensation to the members of a corporate, nor does it place any limits on *golden parachute* severance packages for senior executives.[12] The current part 704 does not limit the representation of corporate executives and officials on the boards of other corporates.

II.H. Proposed amendments to part 704 corporate governance provisions.

The proposed changes, after appropriate phase-in periods, would:[13]

- Require that corporate directors currently hold a Chief Executive Officer (CEO), Chief Financial Officer (CFO), or Chief Operating Officer (COO) position, at their credit union or member entity.
- Require that all compensation agreements between a corporate and its senior executives and directors be disclosed to the members of the corporate upon request and at least once annually to the entire membership.

[12] The Internal Revenue Code, and state law, may require some disclosure for state chartered corporates, but not for federal charters.
[13] Some of these proposals are phased-in over time.

- Provide for disclosure of material increases in compensation related to corporate mergers.
- Prohibit certain golden parachute payments and related indemnification provisions.
- Require that a majority of all corporate boards (including USC) consist of representatives from natural person credit unions.
- Establish term limits on both corporate members and individuals serving as representatives of corporate members.
- Prohibit an individual from serving on the boards of more than one corporate at a time and prohibit an organizational entity from having two or more individual representatives on the board of a single corporate.

II.I. Miscellaneous proposed amendments to part 704.

The proposal:

- Removes §704.19, which provided wholesale corporates with a lower retained earnings requirement than retail corporates.
- Restricts the total amount of investments and loans a corporate may accept from any single member.
- Requires that corporate CUSOs restrict their services to brokerage services, investment advisory services, and other categories of services as preapproved by NCUA.
- Expands the current requirement that corporate CUSOs agree to give NCUA access to books and records to include access to the CUSO's personnel and facilities.

III. Discussion and Analysis of Particular Proposed Amendments.

This proposed rule contains amendments to different sections and appendices in part 704. The following table summarizes the current organization of part 704, and where, when, and how the Board intends to amend that organization and substance.

Current Part 704 Rule Provision		Amended?
704.1	Scope	No.
704.2	Definitions	Yes. First amendment effective upon publication of final rule. Second amendment effective one year after publication of final rule.
704.3	Corporate credit union capital	Yes. Removed and replaced effective one year after

		publication of final rule.
704.4	Board responsibilities	Yes. Effective one year after publication of final rule, current *Board responsibilities* moved to 704.13. Effective one year after publication of final rule, new 704.4 (*Prompt corrective action*) added.
704.5	Investments	Yes.
704.6	Credit risk management	Yes.
704.7	Lending	No.
704.8	Asset and liability management	Yes.
704.9	Liquidity management	Yes.
704.10	Investment action plan	No.
704.11	Corporate CUSOs	Yes.
704.12	Permissible services	No.
704.13	[Reserved]	Effective one year after publication of final rule, current 704.4, *Board responsibilities*, moved to 704.13. No change to substance.
704.14	Representation	Yes.
704.15	Audit requirements	No.
704.16	Contract/written agreements	No.
704.17	State-chartered corporate credit unions	No.
704.18	Fidelity bond coverage	No.
704.19	Wholesale corporate credit unions	Yes. Current 704.19 removed. New 704.19, *Disclosure of executive and director compensation*, added.
704.20	None.	Yes. New 704.20, *Golden parachute and indemnification payments*, added.
Appendix A	Model Forms	Yes. Renamed *Capital Prioritization and Model Forms*.
Appendix B	Expanded Authorities and Requirements	Yes.
Appendix C	None.	Yes. Effective one year after publication of final rule, new Appendix C, *Risk-Based Capital Credit Risk-Weight Categories*,

	added.

This section of the preamble discusses each of these proposed amendments in detail. This section generally follows the organization of part 704, that is, starting with the proposed capital (§704.3) and PCA (§704.4) amendments, then investments (§704.5) and credit risk (§704.6), then asset and liability management (§704.8), then corporate board representation §(704.14), and then the new sections relating to disclosure of executive and director compensation (§704.19) and golden parachutes and indemnification (§704.20).

Many of the proposed amendments require new definitions that appear in §704.2, and the discussion of these definitions appears with the discussion of the associated substantive change to the corporate rule. The proposal includes amendments to the Appendices A and B, and adds a new Appendix C. Since Appendix B relates to investment authority, the proposed amendments to that appendix are discussed as part of the discussion of §704.5. Since Appendices A and C (on model forms and the risk-weighting of assets, respectively) relate to corporate capital, the changes to these appendices are discussed as part of the discussion of the proposed §704.3. The proposed addition of subpart L to part 747 provides the due process associated with the new PCA provision, and so is discussed as part of the §704.4 discussion.

The proposed changes to capital terminology in part 704 also necessitate conforming amendments to parts 702, 703, and 709, as discussed below.

III.A. Amendments to part 704 relating to Capital.

Current part 704 capital requirements.

Adequate capital is essential to the safe and sound operation of a corporate. It ensures that the corporate has a buffer against the losses associated with all the various risks associated with the investments and activities of a corporate.

Currently, part 704 contains only one mandatory, minimum capital requirement: that corporates achieve and maintain a ratio of capital to moving daily average net assets of at least four percent. Part 704 defines capital, generally, to include retained earnings, paid-in capital (PIC), and membership capital accounts (MCAs). The current capital requirements in part 704 differ in certain respects from the capital requirements that banking regulators impose on banks. For example, part 704 does not include any capital calculations based on risk-weighted assets. Part 704 also permits certain membership capital accounts to qualify as corporate capital where those same accounts would not satisfy the bank regulators' definition of capital. Part 704 permits membership capital

accounts with terms as short as three years, while banking regulators require such capital to have terms of at least five years. In addition, part 704 permits adjustable balance membership capital accounts; while banking regulators do not recognize any sort of adjustable balance accounts as capital.

Public comment on the ANPR.

The ANPR discussed various approaches that NCUA is considering with respect to capital requirements for corporates and solicited comment on several aspects of this issue. For example, the agency asked whether it should establish a new *leverage ratio* consisting only of more permanent (core) capital and excluding MCAs; increase the required capital ratio to more than four percent; and implement changes that would result in redefining MCAs in line with accepted banking notions of capital. The agency asked whether it should establish new minimum capital ratios based on risk-weighted asset classifications, which could include the use of some form of membership capital. Another question presented for comment and discussion in the ANPR was whether natural person credit unions should maintain contributed capital as a prerequisite to obtaining services from a corporate.

Comments about capital and capital requirements were wide ranging, reflecting the importance and difficulty of this issue. Many commenters believe there is a need for greater capital within the corporate system and for more sensitive measures of the necessary capital.

Ninety-seven commenters addressed the question of whether the agency should establish a new required capital ratio consisting of core capital only and excluding membership capital accounts. Sixty-four favored such a new capital ratio while 33 opposed it. One hundred sixteen commenters discussed whether a corporate should be permitted to provide services only to members who contributed tier 1 capital; 82 favored this restriction while 34 opposed it. Regarding the question of whether the required capital ratio should be increased, the vast majority of commenters – 80 of 93 – favored increasing the required capital ratio to more than four percent.

Of the 58 commenters who addressed the topic of whether the agency should change the rules regarding the manner in which membership capital can be adjusted, 44 favored and 14 opposed rule changes in this area. On the question of whether the corporates should be subject to risk-based capital standards, the commenters were nearly unanimous, with 173 of 185 comments favoring risk-based capital standards for corporates.

Commenters advocating greater capital requirements generally supported a phase-in period before any new requirements become effective. The corporate

trade association and many corporates suggested that all corporates should attain a minimum Tier 1 core capital ratio of four percent using 12 month daily average net assets (DANA) by the end of 2010 and higher minimum core capital levels in the future based on Basel.[14] These commenters also said the use of DANA is necessary to account for fluctuations in assets due to the cash flow seasonality of credit unions, although there were different views among the commenters about the appropriate length of DANA, ranging from three months to three years.

Some commenters took the opposing view, suggesting that current capital requirements are adequate with proper oversight and risk management. One commenter noted that an increased capital contribution requirement would limit the flexibility of credit unions in dealing with the corporate system. Another commenter indicated that, with an appropriate limitation on the investment authority and range of permissible services offered by a corporate in a consolidated corporate network, current capital rules should be adequate.

Others commenters advocated that NCUA require mandatory capital contributions by natural person credit unions as a condition of receiving services from a corporate. One corporate that supported mandatory capital for services stated that such a requirement would likely drive the regionalization of corporates as natural person credit unions would limit their corporate relationships to one nearby corporate. Some commenters, however, took the opposite view, believing mandatory capital contributions to be too limiting on the ability of credit unions to choose the corporate they want to do business with; these commenters suggested that the corporate simply charge higher service fees for members not contributing capital.

Many of those commenters who discussed the issue of membership capital accounts (MCAs) supported the idea of making MCA conform to the accepted banking standard of *Tier 2* capital, e.g., to require that it be a minimum of five year term or, if of indefinite term, subject to at least five years notice of withdrawal. Many commenters suggested that MCA contributions be tied to asset size and also that NCUA mandate that corporates implement MCA with uniform characteristics, so that there would be less competition among the corporates for capital from NPCUs. Some commenters also stated that MCA withdrawals should only be permitted if the corporate would be in compliance with applicable capital standards after withdrawal. Some commenters expressed the opposite view, with one suggesting that withdrawal within six months of notice should be sufficient.

[14] The definitions of DANA, and moving DANA, are laid out and discussed further on in this preamble.

Commenters who supported the idea of a risk-based approach to capital indicated that they believed that appropriately designed risk-based capital requirements would encourage corporates to monitor and control their more risky investments and activities. Some of these commenters, however, stated that if NCUA restricts investment or other authorities of corporates through regulatory changes, then capital requirements should be less than that required of other institutions under Basel standards. Another commenter expressed doubt about the effectiveness of a risk-based system, noting that it did not alleviate or prevent the current difficulties being experienced in the banking sector.

Discussion of proposed capital regulations.

A corporate's capital levels must be consistent with the risks associated with the activities in which a corporate engages. Linking the amount of a credit union's capital requirement to the overall riskiness of its assets is a more accurate method of ensuring that the credit union can afford to cover losses that may arise from such activities without becoming insolvent. The other federal banking regulators have adopted this risk-based approach to capital in a manner consistent with the international framework for capital standards established by the Basel Committee on Banking Supervision (commonly referred to as the *Basel Supervisors Committee*) in July, 1988 (*Basel I*), and as subsequently expanded upon in 2006 (*Basel II*).

Activities that potentially have higher returns generally have such potential because of their higher risk of loss. Because higher risk/return activities can exhaust a corporate's capital faster than lower risk/return activities, the Board believes corporates engaging in higher risk activities should hold more capital to protect the National Credit Union Share Insurance Fund and to provide appropriate incentives for prudent management. Likewise, institutions that engage in lower risk activities do not need as large a capital cushion and should be permitted to operate with a lower minimum capital requirement, consistent with protection of the insurance fund and the long-term safety of the credit union industry and the individual corporate.

Unfortunately, it is not easy to develop a capital scheme that accounts for all possible risks and that requires only as much capital as is necessary to cover the potential losses associated with such risks. The Board has closely examined the efforts of the other regulators to develop a risk-based capital scheme. Those efforts are based, in large part, on the Basel Accords. A short discussion of those Accords and the related efforts of the banking regulators follows.

Summary of the Basel Accords.

A group of eleven industrialized nations, including the U.S., formed the Basel Committee to harmonize banking standards and regulations among the member nations. One of the Committee's tasks was to design standards that would provide a bank with sufficient capital in relation to the risks undertaken by the bank. In July of 1988, the Committee issued the *International Convergence of Capital Measurements and Capital Standards*, known informally as *Basel I*.

Basel I created a risk-based capital scheme based on four *pillars*. The first pillar, *constituents of capital*, defined the elements of Tier 1 and Tier 2 capital. The second pillar, *asset risk weighting*, provided for risk-weighting of asset classes into four categories: zero percent, 20 percent, 50 percent, and 100 percent. The third pillar, *target standard ratio*, imposed an eight percent minimum risk-weighted capital ratio, at least half of which (four percent) must be Tier 1. Pillar 4, or *transitional and implementing agreements*, urged banking regulators to support these capital requirements with strong surveillance and enforcement. All of the major U.S. banking regulators subsequently adopted capital requirements based on Basel I.[15]

Basel I, however, was subject to significant domestic and international criticism. One criticism was that the risk-weightings only accounted for credit risk. In other words, Basel I did not provide a capital buffer for potential loss from other risks, such as operational risk, market risk, interest rate risk, legal risk, currency risk, and reputational risk.[16] The U.S. banking regulators compensated for the capital requirements associated with these additional risks by imposing a separate capital ratio, the leverage ratio, which was not based on the credit risk-weighted assets but was based on *total* assets. Another criticism of Basel I was that the risk-weightings were too broad and general, and that within a particular asset class individual assets should not all be risk-weighted at, say, 50 percent, but should be classified with more specificity. For example, loans to corporations are of varying credit quality and should not all carry the same risk-weighting. Again, the leverage ratio helps compensate for this lack of granularity in credit-risk weighting. Also, Basel I did not account for new asset classes, such as the securitizations that were first making an appearance during the 1980s.

Due in part to the criticisms of Basel I, the Basel Committee set to work on another agreement, the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, which was finalized in 2006. This *New Accord*, also known as *Basel II*, greatly expands the scope, technicality, and

[15] References to banking regulators here mean the Federal Reserve (Fed), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation (FDIC).

[16] "Operational risk" includes risks such as loss due to fraud and legal/compliance risk. "Market risk" includes losses due to general economic downturns and market fluctuations, but also sometimes includes the other enumerated risks (e.g., reputational and interest rate risk).

depth of Basel I. Basel II provides for new approaches to credit risk; adapts to the securitization of bank assets; covers market, operational, and interest rate risk; and incorporates market based surveillance (market discipline) and regulation.

Basel II has three pillars. Pillar one, *minimum capital requirements,* created a formula for risk-based capital that translates roughly into Reserves (capital) = (.08)(Risk-Weighted Assets) + (Operational Risk Reserves) + (Market Risk Reserves). Basel II provided alternative ways to calculate credit-risk weights and operational reserves.[17] Pillar two, *the supervisory review process*, required that banking regulators provide significant oversight and enforcement of capital standards. Pillar three, *market discipline*, required that banks make significant public disclosure of their investments and activities to help control risk through market discipline.

The primary criticism of Basel II is the complexity associated with its more comprehensive, and more complex, risk and risk-weighting scheme.

Status of the capital schemes of the banking regulators.

As noted above, the primary banking regulators have adopted capital schemes based on Basel I, referred to here as the "general risk-based capital rules." Since the completion of Basel II these regulators have published three important rulemakings related to capital.

- In September 2006, the banking regulators issued a proposed rule with *Advanced* Basel II risk standards and measurements. Generally, the proposal would have permitted banks to adopt their own methodology for calculating credit and operation risks, so long as the methodology complied with the three pillars of Basel II and the banks could justify the methodology to the regulators. In December 2007, the regulators finalized this Advanced Basel II rulemaking.[18] Compliance with this Advanced methodology is mandatory for large banks (i.e., above $250 billion), and optional for all other banks.
- In December 2006, the banking regulators published proposed improvements to the general risk-based capital rules, which they labeled

[17] The other banking agencies, in their July 2008 proposed rulemaking, listed six different Basel II methods for calculating the reserve requirements associated with credit and operational risk:

Credit-Risk Weighting Methods:	**Operation Risk Reserve Methods:**
Standardized	Standardized
Foundation Internal ratings based	Basic Indicator Approach (BIA)
Advanced internal ratings based	Advanced Measurement (AMA)

[18] 72 FR 69288 (Dec. 7, 2007).

as the *Basel IA NPR*.[19] This Basel IA NPR stated: "A banking organization would be able to elect to adopt these proposed revisions or remain subject to the Agencies' existing risk-based capital rules, unless it uses the Advanced Capital Adequacy Framework proposed in the notice of proposed rulemaking published in September 2006." The banking regulators, however, never adopted these proposed improvements.

- In July 2008, the banking agencies published a proposed Basel II rulemaking called the *Standardized Framework*.[20] The preamble to this NPR noted that the "[a]gencies have decided not to finalize the Basel IA NPR and to propose instead a new risk-based capital framework that would implement the Standardized Framework for credit risk, the Basic Indicator Approach for operational risk, and related disclosure requirements," and "[m]any commenters felt the Basel II Standardized Framework is more risk sensitive than the Basel IA NPR and would more appropriately address the industry's economic concerns regarding domestic and international competitiveness." Under this proposed Basel II Standardized Framework banks that are not required to use the Basel II Advanced approach have the option of either continuing with existing (pre-Basel IA) general risk-based capital rules or opting into the new Basel II Standardized Framework. Also, regardless of whether a bank opts to continue under the Basel I rules or the Basel II Standardized Framework rules, the banking regulators indicated that they will continue to require a minimum leverage ratio as well as risk-based capital ratios. As of October 2009, the banking regulators, however, had *not* adopted a final Basel II Standardized rulemaking.

In determining how to amend the existing capital requirements of part 704 to meet the needs of corporates, NPCUs, and the NCUSIF, the Board concluded that the ideal would be a corporate capital scheme that provides sufficient capital protection against risk without undue complexity. The scheme needs to take into account the capital schemes of the banking regulators, so as to give external entities some comfort with the scheme, while including capital elements that account for the unique nature of corporate as member-owned cooperatives serving other member-owned cooperatives. The capital scheme must also account for the fact that corporates have limited means to raise capital because, for example, they cannot issue stock.

The Advanced Basel II approach appears inappropriate for corporates at this time. The Advanced approach is more complex than necessary, and the other regulators do not require it for banks with less than $250 billion in assets. The Standardized Basel II approach also appears inappropriate for corporates

[19] 71 FR 77446 (Dec. 26, 2006).
[20] 73 FR 43983 (July 29, 2008).

because the other regulators have not yet finalized their Standardized methodology and could make significant changes to that methodology. In addition, even when the other regulators do finalize their Basel II Standardized Framework, they will permit banks smaller than $250 billion in size to elect to continue under the Basel I rules. If NCUA adopted a Basel II Standardized Framework, NCUA would need to have both a Basel II and a Basel I rule for corporates to be consistent with the rules of the other regulators – which would add an additional level of complexity to the pending NCUA rulemaking. The Board has determined that, given this fact and the relative size of corporates and their activity base, the NCUA should adopt a corporate capital rule based on the existing general risk-based capital rules of the other regulators, that is, the Basel I rules. The Basel I standards, when combined with investment and ALM requirements that limit noncredit risk and a robust leverage ratio requirement, should ensure corporates have the capital they need to cover noncredit risks and to reserve for weaknesses in the Basel I credit risk methodology. The Board believes use of the existing Basel I format provides the best synthesis of capital requirements and ease of application.[21]

In crafting the proposed capital rule, NCUA closely examined the capital rules of the federal banking regulators. In particular, NCUA looked to the capital rules of the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS), the primary regulators of federally-chartered banks.[22] The NCUA also looked to the capital rules of the Federal Deposit Insurance Corporation (FDIC) for state chartered nonmember banks, since both the NCUA and the FDIC function as federal account insurers.[23] The Board adapted these rules, as much as possible, to the capital needs of corporates, in consonance with the differences between credit unions and banks and with a view toward simplification wherever possible.

The NCUA also looked to the OTS' PCA regulations, and Section 38 of the Federal Deposit Insurance Act (FDIA), in drafting proposed regulations for corporates on the consequences of having inadequate capital.[24] The proposed PCA regulations are discussed later in this preamble.

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[21] To understand the length and complexity of the Basel I capital rules *alone*, the OTS Basel I capital provisions fill up 35 full pages in the Code of Federal Regulations (CFR), and the OTS Prompt Corrective Action provisions fill up another 10 full CFR pages, for a total of 45 pages. These two OTS rulemakings together are twice as long as NCUA's entire corporate rule, Part 704, which fills up about 23 CFR pages. The proposed Basel II Standardized and the final Basel II Advanced rules are even longer.

[22] See 12 CFR part 567 (OTS Capital Rules) and 12 CFR part 3 (OCC Capital Rules). The OTS rules were of particular interest the mutual savings banks regulated by the OTS, like credit unions, are structured as mutual organizations.

[23] See 12 CFR part 325 (FDIC capital rules).

[24] 12 CFR 565 (OTS' Prompt Corrective Action rules); and 18 U.S.C. 1831o (FDIA Prompt Corrective Action).

The NCUA believes that corporates operating with adequate capital have more incentive and are better positioned to evaluate the potential risks and rewards inherent in various activities. Thus, a corporate operating with more than minimum amounts of capital may be permitted a wider range of activities without as much direct regulatory restriction, subject only to supervisory review.

Structure of proposed capital regulations.

The proposed changes to the capital requirements of part 704 affect three different sections.

Proposed §704.3 establishes new risk-based and leveraged capital ratios and standards. The credit risk categories that are used in determining a corporate's risk-weighted assets appear in a proposed new Appendix C to part 704.

Proposed amendments to §704.2 contain revised definitions of terms used in the capital standards. The permissible components of a corporate's capital base, including which items qualify as core capital, which items qualify as supplementary capital, and which items must be deducted in determining the corporate's capital base for purposes of the risk-based and leverage ratio standards are set forth in proposed §704.2.

Proposed §704.4, prompt corrective action, outlines the potential consequences of a corporate's failure to meet any of its regulatory capital requirements.

Proposed §704.3 Corporate credit union capital.

Overview.

The proposed rule establishes three standards that a corporate must satisfy in order to meet its capital requirement: a leverage ratio of adjusted core capital to moving daily average net assets (DANA), a tier 1 risk-based capital ratio of that same adjusted core capital over moving daily average net risk-based assets (DANRA), and a total risk-based capital standard expressed as a percentage of total capital to moving DANRA.

The two risk-based capital standards address the credit risk inherent in the assets in a corporate's investment portfolio and activities. Of course, there are other risks that are inherent in corporates and their portfolios and activities, such as market risk, interest rate risk, liquidity risk, and the risk of fraud. The leverage ratio requirement is intended to ensure that no matter how free from credit risk a corporate may be, it must maintain a minimum amount of capital measured in terms of its total assets as protection against risks other than credit risk. While

there are other, important provisions of the existing corporate rule and the proposal that place limits around these noncredit risks, these risks still exist and are significant.[25] Accordingly, a minimum leverage ratio requirement is essential.

These proposed capital measurements and associated minimums are similar to those described in Basel I and adopted by the federal banking regulators. There are some minor differences, reflecting the mutual organization of corporates and the unique role they play in the credit union system. For example, this proposal employs average asset calculations in the capital ratio denominators, and not the period-end assets employed by the banking regulators. This reflects the corporate's unique role as a liquidity provider, as discussed further below. The proposal also does not include a tangible capital or tangible equity requirement.[26] On the other hand, the proposal does require that corporates build and maintain a certain amount of retained earnings to satisfy their minimum leverage ratio requirement.

Elements of capital.

As discussed above, the current part 704 sets forth three different categories of capital: retained earnings, PIC, and MCAs. These elements of capital are divided by moving DANA to obtain the capital ratio. A corporate must maintain a minimum four percent capital ratio.

MCAs are currently defined in part 704 as:

> [F]unds contributed by members that: are adjustable balance with a minimum withdrawal notice of 3 years or are term certificates with a minimum term of 3 years; are available to cover losses that exceed retained earnings and paid-in capital; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings.

12 CFR 704.2. The proposed rule changes the nomenclature for MCAs, renaming them with a more descriptive title: *nonperpetual contributed capital accounts* (NCAs). This proposed retitling summarizes the substantive difference between MCAs and PIC and reflects that fact that the proposal will permit corporates to issue NCAs to both members and nonmembers.[27] The proposal specifically defines NCAs as follows:

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[25] For example, the interest rate sensitivity analysis required by §704.8(d) of the current corporate rule controls for, but does not eliminate, interest rate risk. Likewise, the provisions in this proposed rule that would control the mismatch in the duration of a corporate's assets and liabilities would limit, but not eliminate, the risk of spread widening.

[26] *See*, *e.g.,* 12 CFR 567.2(a)(3).

[27] PIC will also be retitled as *perpetual contributed capital*, as discussed further below.

> *Nonperpetual capital* means funds contributed by members or nonmembers that: are term certificates with a minimum term of five years or that have an indefinite term (i.e., no maturity) with a minimum withdrawal notice of five years; are available to cover losses that exceed retained earnings and perpetual contributed capital; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings. In the event the corporate is liquidated, the holders of nonperpetual capital accounts (NCAs) will claim equally. These claims will be subordinate to all other claims (including NCUSIF claims), except that any claims by the holders of perpetual contributed capital (PCC) will be subordinate to the claims of holders of NCAs.

The currently permissible three-year term MCAs, and MCAs that are adjustable balance over a short period of time, are insufficiently permanent to meet the definition of capital as described in the Basel accords and as adopted by the federal banking regulators.[28] To qualify as capital, the proposal requires that hybrid debt instruments such as nonperpetual contributed capital accounts (NCAs) be term instruments of an initial maturity of at least five years or, if structured as indefinite notice (or "no maturity") accounts, must have a notice period of at least five years.

Accounts that can adjust automatically as permitted under the current rule on a periodic basis are also of insufficient permanency. A member can rapidly manipulate its share balances in a corporate, so NCA adjustments based on share balances have little permanency -- and a member can even manipulate its asset size to some extent and so that measure also does not ensure the necessary capital permanency. The proposed redefinition of NCAs to eliminate adjustable balance accounts helps ensure permanency and so ensure that NCAs reflect the basic requirements of true capital. Although the proposal eliminates adjustable balance capital accounts, a corporate may enter into an agreement with a member where the member commits to providing additional capital if the member uses certain services or increases its shares at the corporate above a certain level.

The current part 704 permits a corporate to issue paid-in capital to both members and nonmembers, but the membership capital account, as suggested by its name, is currently available only to members of the corporate. Corporates may, of course, borrow funds from various entities under various terms, and the Board believe that if a corporate issues long-term subordinate debt to nonmembers under terms and conditions identical to the current membership capital, the

[28] *See*, *e.g.*, 12 CFR 3.100(f)(OCC requires minimum five year term).

corporate should be able to treat such nonmember subordinated debt as capital in the same manner it treats membership capital accounts. Accordingly, the proposal permits both members and nonmembers to invest in nonperpetual contributed capital accounts (NCAs).

Currently, part 704 defines *paid-in capital* (PIC) as follows:

> Paid-in capital means accounts or other interests of a corporate 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.

12 CFR 704.2. The proposal does not make any change to the definition of PIC except to rename PIC as *perpetual contributed capital* (PCC). To ensure that a corporate can function as a viable entity, it must be clear to creditors, both current and future, that capital in the form of PCC and NCAs protect the creditors against any losses borne by the corporates. Capital instruments, to perform their function as capital, must be depleted when needed to cover corporate losses. Accordingly, the proposal also adds the following definition of *available to cover losses* in §704.2 to clarify the meaning of that phrase:

> *Available to cover losses that exceed retained earnings* means that the funds are available to cover operating losses realized, in accordance with generally accepted accounting principles (GAAP), by the corporate credit union that exceed retained earnings. Likewise, *available to cover losses that exceed retained earnings and perpetual contributed capital* means that the funds are available to cover operating losses realized, in accordance with GAAP, by the corporate credit union that exceed retained earnings and perpetual contributed capital. Any such losses must be distributed *pro rata* at the time the loss is realized first among the holders of perpetual contributed capital accounts (PCC), and when all PCC is exhausted, then *pro rata* among all nonperpetual contributed capital accounts (NCAs), all subject to the optional prioritization in Appendix A of this Part. To the extent that any contributed capital funds are used to cover losses, the corporate credit union must not restore or replenish the affected capital accounts under any circumstances. In addition, contributed capital that is used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate.

This language is similar to that used to define the phrase *available to cover losses* as it relates to secondary capital in NCUA's low income credit union rule. 12 CFR 701.34(b)(7).

The proposal defines *core capital* as Generally Accepted Accounting Principles (GAAP) retained earnings, PCC, the retained earnings of any acquired credit union if the acquisition was a mutual combination, and certain minority interests in the equity accounts of CUSOs that are fully consolidated. This definition is the same as the current §704.2 definition, with the addition of any minority interests in the equity accounts of CUSOs that are fully consolidated with the corporate. So, for example, if a corporate owned 90 percent of the equity in a CUSO, with 10 percent equity owned by third parties, and the corporate consolidated its financials with the CUSO, the corporate could include the remaining 10 percent minority interest in its Tier 1 capital. This treatment is consistent with the treatment afforded such minority interests by the other regulators.[29]

Also, the terms *core capital* and *Tier 1 capital* are used synonymously in this proposal.

The proposal further defines *supplementary capital* as including certain portions of its NCAs, GAAP allowance for loan and lease losses, and net unrealized gains on available-for-sale equity securities with readily determinable fair values. During the last five years of an nonperpetual contributed capital account, the amount that may be considered supplementary capital is reduced, on a monthly basis, until the amount reaches zero when the account has only one year of life remaining, all as described in paragraph 704.3(b)(3). This reduction is consistent with the current corporate rule and the capital regulations of the other regulators. A corporate may also include its allowance for loan and lease losses in supplementary capital, up to a maximum of 1.25 percent of risk-weighted assets. This is also consistent with the capital regulations of the other regulators. As noted by the OCC:

> The allowance for loan and lease losses is intended to absorb future losses. Although future losses may not be identified specifically at the time a provision is made, a presumption exists that losses are inherent in the loan and lease portfolio. The obvious link between the allowance and inherent losses in the loan and lease portfolio precludes it from qualifying as Tier 1 capital, which

[29] *See, e.g.*, 12 CFR 567.5(a)(1)(iii)(OTS definition of Tier 1 capital); 12 CFR part 3, Appendix A, §2(a)(3)(OCC definition of Tier 1 capital). "[M]inority interests in the equity accounts of consolidated subsidiaries . . . [are] accorded Tier 1 treatment because, as a general rule, [they] represent equity that is freely available to absorb losses in operating subsidiaries.'" Todd Eveson, "Financial and Bank Holding Company Issuance of Trust Preferred Securities," 6 N.C. Banking Inst. 315, 321 (2002).

> encompasses only the purest and most stable forms of capital. Furthermore, it is intended that the loan loss reserves which qualify for inclusion as Tier 2 capital will be general in nature. That is, any portion of the allowance for loan and lease losses which is ascribed to particular assets that have been identified as possessing a reasonable probability of some loss is not to be included as Tier 2 capital . . . . Beyond the clearly identified specific loan loss reserves, it is difficult to distinguish between the portion of the loan loss reserve that is freely available to absorb future losses within the portfolio and the portion that reflects likely losses on existing problem or troubled loans. However, a bank that maintains a relatively large allowance for loan and lease losses usually has a relatively greater incidence of identified asset quality problems in its loan and lease portfolio, and in this situation the entire allowance for loan and lease losses cannot be considered to be a true general reserve for the purposes of risk-based capital. Therefore, a standard percentage limitation, based on total risk-weighted assets, is the most reasonable method of eliminating the bulk of the non-qualifying loan loss reserves from banks' capital calculations. The figure of 1.25 percent of risk-weighted assets was determined on the basis of historical data . . . .

54 FR 4168 (Jan. 27, 1989).

The proposal also provides that a corporate may include 45 percent of its unrealized gains on available-for-sale equity securities in supplementary capital. Unrealized gains are unrealized holding gains, net of unrealized holding losses, calculated as the amount, if any, by which fair value exceeds historical cost. The proposal further provides that NCUA may disallow such inclusion in the calculation of supplementary capital if the NCUA determines that the securities are not prudently valued. Again, this is similar to how the other regulators define supplementary capital.[30] Although it is unlikely that corporates will hold much in the way of equity securities, they might have some equity securities in CUSOs. Because the 45 percent limitation used by the banking regulators includes the effects of possible taxation upon sale, and corporates are not subject to income taxation, the Board invites comment on the proposed 45 percent limitation.[31]

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[30] *See*, *e.g.*, 12 CFR 567.5(a)(OTS capital rule).

[31] "The Basel Accord also permits institutions to include up to 45 percent of the pretax net unrealized gains on equity securities in supplementary capital. As explained in the Basel Accord, the 55 percent discount is applied to the unrealized gains to reflect the potential volatility of this form of unrealized capital, as well as the tax liability charges that generally would be incurred if the unrealized gain were realized or otherwise taxed currently." 63 FR 46518 (Sept. 1, 1998)(Discussion of joint FDIC, OTS, and OCC capital rulemaking).

The terms *supplementary capital* and *Tier 2 capital* are used synonymously in this preamble and the proposal. *Nonperpetual contributed capital* is a form of Tier 2 capital.

The use of core capital and supplementary capital, and their incorporation into the proposed minimum capital ratios, is discussed further in the following paragraph-by-paragraph summary of the proposed §704.3.

Paragraph-by-paragraph analysis of §704.3.

Paragraph 704.3(a) Capital requirements.

This proposed paragraph (a) requires a corporate to maintain, at all times, three minimum capital ratios. Paragraph (a)(1) requires all corporates maintain a leverage ratio of 4.0 percent or greater, a Tier 1 risk-based capital ratio of 4.0 percent or greater, and a total risk-based capital ratio of 8.0 percent or greater. Each of these ratios are further defined in §704.2 as discussed below. Paragraph 704.3(a)(2) continues the existing requirement that a corporate have a capital plan in place to achieve and maintain the necessary capital. Paragraph (a)(3) requires that the corporate prepare and submit a retained earnings accumulation plan if, under certain circumstances described below, the corporate is not making sufficient progress in building the necessary retained earnings to satisfy its future minimum leverage ratio requirements.

Leverage ratio.

The proposed leverage ratio is defined in the proposal as the adjusted core capital divided by moving DANA. As discussed above, the leverage ratio ensures that the corporate has adequate capital to provide for losses other than credit losses. Paragraph 704.3(a) requires a minimum leverage ratio of 4.0 percent. The capital numerator, and the asset denominator, of the leverage ratio are discussed below.

Leverage ratio denominator: moving DANA.

The proposal employs moving DANA as the leverage ratio denominator.

Moving DANA means the average of DANA for the month being measured and the previous eleven (11) months. DANA means the average of net assets calculated for each day during the period (which would be the previous month).

Net assets means total assets less loans guaranteed by the NCUSIF and member reverse repurchase transactions. For its own account, a corporate's payables under reverse repurchase agreements and receivables under

repurchase agreements may be netted out if the GAAP conditions for offsetting are met. Also, any amounts deducted from core capital in calculating adjusted core capital are also deducted from net assets.

This is virtually the same denominator employed in the current part 704 for the total capital ratio. The proposal includes a slight modification to make clear that any asset deducted from core capital to obtain adjusted core capital (i.e., the leverage ratio numerator) should likewise be deducted from the denominator.

The proposed leverage ratio differs from that of the banking regulators in that the proposal uses a moving 12-month average of assets where the other regulators use period-end assets. The Board believes that the corporates, in their role as liquidity providers and liquidity managers for natural person credit unions, need some flexibility to handle seasonal variations in total assets – and moving DANA provides that flexibility. Proposed paragraph 704.3(e), however, empowers the NCUA, in appropriate cases, to direct that a particular corporate use period-end assets in its capital ratio calculations rather than moving DANA.

Leverage ratio numerator: adjusted core capital.

As discussed above, core capital generally means the sum of a corporate's retained earnings, as calculated under GAAP, and perpetual contributed capital.[32] To obtain adjusted core capital, the proposal requires the corporate to make several modifications to core capital.

First, the corporate must deduct an amount equal to the amount of the corporate's intangible assets that exceed one half percent of the corporate's moving DANA. Generally, intangible assets are difficult to value and highly volatile. In addition, many forms of intangible assets, such as goodwill, decline in value if an entity suffers losses, which is the point in time that the permanency of capital is most important. The other regulators have recognized these problems with intangible assets and so generally require banks to deduct problematic intangibles from both assets and capital when calculating core capital ratios. Corporates, however, do not generally maintain intangibles on their books. The Board, therefore, is proposing that intangibles of a *de minimus* amount (one half of one percent of total assets) may be treated just like other assets in the capital calculation. However, intangibles above this *de minimus* amount must be deducted from both core capital (the numerator of the capital ratios) and assets

[32] For a corporate that acquires another credit union in a mutual combination, core capital also includes the retained earnings of the acquired credit union, or of an integrated set of activities and assets, at the point of acquisition.

(the denominator). This treatment of intangibles is similar to the treatment given intangibles by the other regulators.[33]

The proposal, however, provides some flexibility on the treatment of intangibles. The NCUA, on its own initiative or upon application from a corporate, may direct that a particular corporate add some or all of these excess intangibles back into the corporate's adjusted core capital and associated assets. In making this determination, the NCUA will consider the volatility and permanency of the particular intangible and the overall financial condition of the particular corporate.

Second, the corporate must deduct investments, both equity and debt, from consolidated CUSOs. To include these investments would overstate the amount of capital available to absorb losses in the consolidated entity. This treatment of these investments is similar to the treatment given these investments by the other regulators.[34]

Third, If the corporate credit union, on or after twelve months following the publication of the final rule, contributes new capital or renews existing capital to another corporate credit union, the corporate must deduct an amount equal to the aggregate of such new or renewed capital. Because the corporate universe is so small, and may get even smaller in the future, the Board is concerned that capital investment between two or more corporates can endanger the stability of the entire corporate system and, ultimately, the stability of the entire credit union system. Accordingly, this proposed deduction from corporate capital discourages capital investment between corporates. For example, without the deduction corporate A might place significant capital in corporate B, which then, in turn, might place significant capital in corporate C. Losses in corporate C might then cause corresponding losses in corporates A and B which, in turn, may have to pass some of those losses to their natural person credit union members. The Board invites comment on this proposed deduction from capital, including whether there should be an exception for *de minimus* member capital contributions between corporates and, if so, how that exception should be defined. The Board notes that corporates will have some time to adapt to this deduction, since it will not be effective for 12 months and, even then, will not apply to preexisting capital accounts unless the account is renewed in some fashion (e.g., renewal of an NCA instrument upon maturity).

The current part 704 encourages corporates to achieve and maintain retained earnings at 2 percent of assets, but does not actually require them to do so. The Board believes that some regulatory mechanism to force corporates to build retained earnings is necessary. In the long run, contributed capital like PCC is a

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[33] *See*, *e.g.*, 12 CFR 567.5(a)(2)(OTS capital rule).
[34] *See*, *e.g.*, 12 CFR 567.5(a)(2)(iv)(OTS capital rule).

supplement to retained earnings, but PCC is not an entirely adequate replacement for retained earnings. As demonstrated in the recent corporate crisis, the depletion of the contributed capital at corporates put severe, procyclical stress on their member natural person credit unions. While this situation cannot be entirely avoided in the future, it can be mitigated through retained earnings growth. Accordingly, the proposal requires that, after an appropriate phase-in period, a certain percentage of core capital consist of retained earnings.

The initial adjustment to core capital, effective six years after the date of publication of the final rule, will require that a corporate deduct from core capital any amount of PCC that causes PCC minus retained earnings, all divided by moving daily average net assets (DANA), to exceed two percent. The effect of this provision is to require that, for a corporate to achieve the minimum four percent leverage ratio necessary for adequate capitalization, it must have at least 100 bp of retained earnings at the six year mark. The remaining 300 bp in the ratio numerator may consist of either PCC or retained earnings. Similarly, to have a five percent leverage ratio at the six year mark and thus be well capitalized, a corporate must have 150 bp of retained earnings, and the remaining 350 bp in the ratio numerator may consist of PCC. This adjustment to core capital will, then, force corporates to work toward building their retained earnings.

The Board, however, believes that, ideally, a corporate should continue to increase its retained earnings and reduce its reliance on contributed capital. The second adjustment to core capital, effective ten years after the date of publication of the final rule, will require that a corporate deduct from core capital any amount of PCC that causes PCC to exceed retained earnings. The effect of this provision is to require that, for a corporate to have a four percent leverage ratio at the ten year mark and thus be adequately capitalized, the corporate must have at least 200 bp of retained earnings. The remaining 200 bp in the ratio numerator may consist of PCC. Similarly, to have a five percent leverage ratio at the ten year mark and thus be adequately capitalized, a corporate must have 250 bp of retained earnings, and the remaining 250 bp in the ratio numerator may consist of PCC.

Although the first explicit retained earnings requirement will not become effective for six years, the Board recognizes that corporates must work hard during the entire six year period to build retained earnings. Accordingly, paragraph 704.3(a)(3) provides that, beginning with the first call report submitted by the corporate three years after the date of the final rule:

> [A] corporate credit union must calculate and report the ratio of its retained earnings to its moving daily average net assets. If this

> ratio is less than 0.45 percent, the corporate credit union must, within 30 days, submit a retained earnings accumulation plan to the NCUA for NCUA's approval. The plan must contain a detailed explanation of how the corporate credit union will accumulate earnings sufficient to meet all its future minimum leverage ratio requirements, including specific semiannual milestones for accumulating retained earnings. If the corporate credit union fails to submit a plan acceptable to NCUA, or fails to comply with any element of a plan approved by NCUA, the corporate will immediately be classified as significantly undercapitalized or, if already significantly undercapitalized, as critically undercapitalized. The corporate credit union will be subject to all the associated prompt corrective actions under §704.4 of this part.

The intent of this retained earnings accumulation plan (REAP) provision is to ensure that corporates strive for, and attain, retained earnings growth rates that are adequate to achieve 100 bp of retained earnings by the end of year six and 200 bp of retained earnings by the end of year ten.

Adequate retained earnings are critical to the health of the corporate system going forward. It is the Board's intent that, if a corporate is subject to a REAP and fails to meet any of the established retained earnings milestones, NCUA will take decisive action under the prompt corrective action authorities of 704.4. Included among those authorities are replacement of the board and senior management, and liquidation, conservatorship or consolidation of the corporate. These actions are discretionary on NCUA's part under 704.4, however, and the NCUA Board requests comment on whether any such actions should be mandatory for a corporate that fails to meet its REAP requirements.

In addition to the REAP provision in paragraph 704.8(a)(3) above, the proposal contains other tools to deal with corporates that are either unable, or unwilling, to build retained earnings at an adequate pace during the phase-in period. For example, proposed §704.3(d), discussed further below, permits the Board to establish different minimum capital requirements for individual corporates "upon a determination that the corporate credit union's capital is *or may become* inadequate in view of the credit union's circumstances." Proposed §704.3(d)(2) (emphasis added). This provision also provides that "higher capital levels may be appropriate when NCUA determines that . . . the credit union has failed to properly plan for, or execute, necessary retained earnings growth." Proposed §704.3(d)(2)(ix). NCUA could use this particular tool, and other PCA tools, to address capital inadequacies, if any -- even *before* the third anniversary of the final rule and the associated requirement to prepare a REAP.

Tier 1 risk-based capital ratio.

The proposal defines the Tier 1 risk-based capital ratio (T1RBCR) to mean the ratio of adjusted core capital to the moving daily average net risk-weighted assets. NCUA intends this ratio, along with the total risked-based capital ratio (TRBCR), to ensure that the corporate has sufficient capital to handle the credit risk associated with its investments and activities. The combination of the T1RBCR, and the TRBCR ratio discussed below, ensures that at least half of the capital used for purposes of protecting against losses associated with credit risk is the more permanent capital (i.e., core capital). The other portion of capital used to protect against credit risk may be *Tier 2 capital*, also called *supplementary capital*, as discussed below in connection with the TRBCR.

T1RBCR numerator: adjusted core capital.

The capital numerator for the T1RBCR is adjusted core capital, the same as the numerator for the leverage ratio discussed above.

T1RBCR denominator: moving daily average net risk-weighted assets (DANRA).

The moving DANRA means the average of daily average net risk-weighted assets for the month being measured and the previous eleven (11) months. DANRA means the average of net risk-weighted assets calculated for each day during the period (which would be the previous month).

Net risk-weighted assets means risk-weighted assets less CLF stock subscriptions, CLF loans guaranteed by the NCUSIF, U.S. Central CLF certificates, and member reverse repurchase transactions. For its own account, a corporate's payables under reverse repurchase agreements and receivables under repurchase agreements may be netted out if the GAAP conditions for offsetting are met. Also, any amounts deducted from core capital in calculating adjusted core capital are also deducted from net risk-weighted assets. To this point, this is similar to the moving DANA calculation in the denominator of the leverage ratio. However, the moving DANRA calculation required the use of *risk-weighted* assets, which are calculated as provided for in the proposed Appendix C of part 704. This risk-weighting process is described in detail in the section of the preamble devoted to Appendix C.

Total risked-based capital ratio.

The total risk-based capital ratio means the ratio of total capital to moving DANRA.

The denominator, moving DANRA, is the same as the denominator for the T1RBCR, as discussed above. The numerator, “Total capital” means the sum of

a corporate's adjusted core capital and its supplementary capital less the corporate's equity investments not otherwise deducted when calculating adjusted core capital.

Supplementary capital, or Tier 2 capital, generally means the sum of all the corporate's NCAs, except that at the beginning of each of the last five years of the life of an NCA instrument the amount that is eligible to be included as supplementary capital is reduced by 20 percent of the original amount of that instrument (net of redemptions). While, as discussed above, the proposal adjusts the definition of NCAs to make these accounts more permanent and bring them in line with the Basel requirements for supplementary capital, the value of these NCAs as a buffer against losses as the NCAs approach their maturity or withdrawal date. The proposed amortization schedule tracks the amortization used by the banking regulators for supplementary capital that takes this hybrid debt instrument form.

Paragraph 704.3(b) Requirements for nonperpetual contributed capital.

This proposed paragraph describes the NCA account terms and the various disclosure, transfer, and release requirements. This paragraph is similar to the existing 704.3(b), taking into account the change in NCA terms described above. The proposal also protects against the premature release of NCAs with the addition of the following new paragraph (b)(5):

> A corporate credit union may redeem nonperpetual contributed capital prior to maturity or the end of the notice period only with the prior approval of the NCUA.

Paragraph 704.3(c) Requirements for perpetual contributed capital.

This paragraph describes the PCC account terms and the various disclosure, transfer, and release requirements. Again, this paragraph is similar to the existing 704.3(c). As with NCA, the proposal protects against the premature release of PCC by permitting a corporate to call PCC only with NCUA's prior approval.

Paragraph 704.3(d) Individual minimum capital requirements.

Paragraph 704.3(d) provides that the NCUA may establish increased individual minimum capital requirements for a particular corporate upon a determination that the corporate's capital is or may become inadequate in view of the credit union's circumstances.

The proposal provides several examples where a greater minimum capital requirement may be appropriate, such as where a corporate:

- Is receiving special supervisory attention;
- Has or is expected to have losses resulting in capital inadequacy;
- Has a high degree of exposure to interest rate risk, prepayment risk, credit risk, concentration risk, certain risks arising from nontraditional activities or similar risks, or a high proportion of off-balance sheet risk;
- Has poor liquidity or cash flow;
- Is growing, either internally or through acquisitions, at such a rate that supervisory problems are presented that are not dealt with adequately by other NCUA regulations or other guidance;
- May be adversely affected by the activities or condition of its CUSOs or other persons or credit unions with which it has significant business relationships, including concentrations of credit;
- Has a portfolio reflecting weak credit quality or a significant likelihood of financial loss, or that has loans or securities in nonperforming status or on which borrowers fail to comply with repayment terms;
- Has inadequate underwriting policies, standards, or procedures for its loans and investments;
- Has failed to properly plan for, or execute, necessary retained earnings growth; or
- Has a record of operational losses that exceeds the average of other, similarly situated corporates; has management deficiencies, including failure to adequately monitor and control financial and operating risks, particularly the risks presented by concentrations of credit and nontraditional activities; or has a poor record of supervisory compliance.

When the NCUA determines that a different minimum capital requirement is necessary or appropriate for a particular corporate, including minimum capital relating to classification as significant or critically undercapitalization, the NCUA will notify the corporate in writing of its proposed minimum capital requirements; the schedule for compliance with the new requirement; and the specific causes for determining that the higher individual minimum capital requirement is necessary or appropriate for the corporate. The NCUA will forward the notifying letter to the appropriate state supervisor if a state-chartered corporate would be subject to an individual minimum capital requirement.

The responses of the corporate and appropriate state supervisor must be in writing and must be delivered to the NCUA within 30 days after the date on which the notification was received. The NCUA may extend or shorten the time period for good cause.

The corporate's response must include any information that the credit union wants the NCUA to consider in deciding whether to establish or to amend an individual minimum capital requirement for the corporate, what the individual capital requirement should be, and, if applicable, what compliance schedule is appropriate for achieving the required capital level.

After expiration of the response period, the NCUA will decide whether or not the proposed individual minimum capital requirement should be established for the corporate, or whether that proposed requirement should be adopted in modified form, based on a review of the corporate's response and other relevant information. Failure to provide an adequate response will constitute a legal basis for prompt corrective action under §704.4.

Paragraph 704.3(e) Reservation of authority.

Financial organizations are constantly developing innovative transactions that may not fit well into the various risk-weight categories in Appendix C to part 704. New investment activities may nominally fit into a particular risk-weight category or credit conversion factor, but impose risks on the holder at levels that are not commensurate with the nominal risk-weight or credit conversion factor for the asset, exposure or instrument. Accordingly, the proposal clarifies NCUA's authority over corporates, on a case-by-case basis, to determine the appropriate risk-weight for assets and credit equivalent amounts and the appropriate credit conversion factor for off-balance sheet items in these circumstances. Specifically, the NCUA may:

- Disregard any transaction entered into by a corporate primarily for the purpose of reducing the minimum required amount of regulatory capital or otherwise evading the requirements of this section;
- Require a corporate to compute its capital ratios on the basis of period-end, rather than average, assets when it is appropriate to carry out the purposes of part 704;
- Notwithstanding the definitions of core and supplementary capital in the corporate rule, find that a particular asset or core or supplementary capital component has characteristics or terms that diminish its contribution to a corporate's ability to absorb losses and require the discounting or deduction of such asset or component from the computation of core, supplementary, or total capital;
- Notwithstanding Appendix C of this section, look to the substance of a transaction, find that the assigned risk-weight for any asset, or credit equivalent amount or credit conversion factor for any off-balance sheet item does not appropriately reflect the risks imposed on the corporate, and

may require the corporate to apply another risk-weight, credit equivalent amount, or credit conversion factor that the NCUA deems appropriate; and

- If Appendix C does not specifically assign a risk-weight, credit equivalent amount, or credit conversion factor to a particular asset or activity of the corporate, assign any risk-weight, credit equivalent amount, or credit conversion factor that it deems appropriate.

Exercise of this authority by NCUA may result in a higher or lower risk-weight for an asset or credit equivalent amount or a higher or lower credit conversion factor for an off-balance sheet item. This reservation of authority explicitly recognizes NCUA's retention of sufficient discretion to ensure that corporates, as they become involved with new types of financial assets and activities, will be treated appropriately under the regulatory capital standards.

Applicable state regulator.

Several paragraphs of t his proposed §704.3 on capital, and the proposed §704.4 on prompt corrective action, refer to the *applicable state regulator* in connection with potential actions involving state chartered corporates. The proposal amends §704.2 to define *applicable state regulator* as the prudential state regulator of a state chartered corporate.

Appendix A to part 704 – Capital Prioritization and Model Forms

The current Appendix A to part 704, entitled *Model Forms*, contains forms that members provide the corporate on an annual basis acknowledging the terms and conditions of the members' PIC and MCA accounts. The proposal renames Appendix A as *Capital Prioritization and Model Forms*. The new Appendix A has two parts. Part II contains amended model disclosure forms. Part I is new, and reads as follows:

> Part I – Optional Capital Prioritization
>
> Notwithstanding any other provision in this chapter, a corporate credit union, at its option, may determine that capital contributed to the corporate on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] will have priority, for purposes of availability to absorb losses and payout in liquidation, over capital contributed to the corporate before that date. The board of directors at a corporate credit union that desires to make this determination must:
>
> a) On or before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER], adopt a resolution implementing its determination.

b) Inform the credit union's members and NCUA, in writing and as soon as practicable after adoption of the resolution, of the contents of the board resolution.
c) Ensure the credit union uses the appropriate initial and periodic Model Form disclosures in Part II below.

This option, if implemented by a corporate's board of directors, will give those entities that contribute new capital to the corporate starting 60 days after the publication of the final rule priority – in terms of availability to absorb losses and payout in liquidation - over those capital contributions made before that date. The purpose of this provision is to provide a tool for facilitating capital growth.

The proposal amends the forms so that they are consistent with the proposed definitions of PCC and NCAs. These form changes include changing the notice and term of NCAs from three-year to five-year, eliminating references to adjustable balance NCAs, and describing in more detail the meanings of the phrase "available to cover losses." Because this new option will be available to corporates before the other new capital provisions go into effect, including the nomenclature changes (that is, from PIC to PCC, and from MCAs to NCCs), the proposal expands the number of model forms in Part II from the two current forms to eight forms.

The current paragraph (6) in the model forms reads as follows:

> Where the corporate credit union is liquidated, membership capital accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF.

It is possible, for example, that a solvent corporate could be voluntarily liquidated and that there could be some funds remaining after payment to creditors, uninsured shareholders, and the NCUSIF. It is also possible (although unlikely) that the value of the assets of an insolvent, involuntarily liquidated corporate credit union could increase between the date of liquidation and the date the assets are sold, and there could then be some funds in the liquidation estate remaining after payment to the creditors, uninsured shareholders, and the NCUSIF. In both of these cases, the NCA holders, and possibly the PCC holders, would receive a distribution[35] – but this is only true to the extent that the NCAs and PCCs were not used in a previous fiscal year to cover losses. Once used to cover losses, the NCAs and PCC are gone to the extent so used, and all possible claims related to those accounts, including liquidation-based

[35] This possibility is recognized in NCUA's involuntary liquidation rule. 12 CFR 709.5(b)(7) and (9).

claims, are extinguished. Accordingly, the proposal adds the following clarifying language to the end of each paragraph (6):

> However, [NCAs or PCCs] that are used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate.

The proposal also adds a conforming amendment to NCUA's involuntary liquidation rule, 12 CFR 709.10, to reflect the option to give new contributed capital payout priority.

Appendix C to part 704 -- Risk-based capital ratios and asset risk-weightings.

A corporate's risk-based capital requirement is calculated based on the credit risk presented by both its on-balance sheet assets and off-balance sheet commitments and obligations. With certain limited exceptions, the asset base of a corporate is determined on a consolidated basis, *i.e.,* including its consolidated CUSOs. Assets are assigned a credit-risk weighting based upon their relative risk. Risk-weights are generally tied to the nature of the underlying obligor.

The risk-weightings range from zero percent for assets backed by the full faith and credit of the United States or that pose no credit risk to the corporate to 100 percent as the standard risk-weighting.

Off-balance sheet commitments are converted to a "credit equivalent" amount by using a conversion factor intended to estimate the likelihood that the contingent obligation will result in an actual obligation of the corporate and the potential size of loss such items may result in. That amount is then risk-weighted according to the risk associated with the underlying obligor, just as an on-balance sheet asset would be. The amount of risk-weighted assets will then be multiplied by a credit risk capital requirement to determine the minimum amount of capital required for that corporate.

The rule also sets forth the items that count as capital and that may be used to satisfy the risk-based capital requirement. "Core capital," or "tier 1 capital," includes items of a more permanent nature, such as PCC and GAAP retained earnings. Certain other items provide a somewhat lesser degree of protection, often because of their nonpermanent nature or their imposition of fixed obligations. These items are considered "supplementary capital," or "tier 2 capital," and include NCAs. Together, the sum of core and supplementary capital equal a corporate's "total capital."

Although both core and supplementary capital may be used in meeting the risk-based capital requirement, the amount of supplementary capital that may be

counted toward that requirement is limited to the amount of the credit union's core capital through the use of the T1RBC ratio. Additional limits are placed upon certain types of supplementary capital. These limits may restrict the extent to which these forms of supplementary capital may be used to satisfy the corporate's capital requirement. Items that are deducted from a corporate's asset base in determining its assets are also deducted from its capital.

On-balance sheet assets.

The proposed amendments sets forth a system of risk-weighted assets similar to that used by the other federal banking regulators. Assets, in general, will be assigned to risk categories based on the degree of credit risk associated with the obligor or nature of the obligation. The categories include risk-weights of 0, 20, 50, and 100 percent.

The 100 percent category is the standard risk category. Assets not specifically included in another category fall within this category. Items that are less risky than a "standard risk asset" because of the traditional financial strength of the obligor, the default history of the asset type, or the guarantee or security backing the asset are assigned to a lower risk category. This reflects the Board's determination, mirroring in many ways the implicit determinations made by the market, that such assets present lower risks.

Risk-weighted assets are determined by taking the book value of each asset and multiplying it by the risk-weight assigned to it. Ownership interests in investment companies such as mutual funds are assigned risk-weights based upon the composition of the investment company's underlying portfolio of assets. The resulting values are added together to arrive at total risk assets. The amount of total risk assets is the amount against which the minimum capital requirement is applied.

Summary of risk-weights for on-balance sheet assets.

Zero percent weighting (Category 1). This category, presenting, in the Board's estimation, a nearly non-existent level of credit risk, includes:

- Cash;
- Securities issued by and other direct claims on the U.S. Government or its agencies or the central government of an Organization for Economic Cooperation and Development (OECD) country;
- Notes and obligations issued by or guaranteed by the Federal Deposit Insurance Corporation or the National Credit Union Share Insurance Fund and backed by the full faith and credit of the United States Government;

- Deposit reserves at, claims on, and balances due from Federal Reserve Banks; the book value of paid-in Federal Reserve Bank stock;
- Assets directly and unconditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country; and
- Certain claims on a qualifying securities firm that are collateralized by cash on deposit in the corporate or by securities issued or guaranteed by the United States Government or its agencies, or the central government of an OECD country.

Twenty percent weighting (Category 2). This category contains items viewed as presenting a significantly lower level of risk than standard risk assets. It includes:

- Cash items in the process of collection;
- Assets conditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country, or collateralized by securities issued or guaranteed by the United States government or its agencies, or the central government of an OECD country;
- Certain securities issued by the U.S. Government or its agencies which are not backed by the full faith and credit of the United States Government;
- Certain securities issued by United States Government-sponsored agencies;
- Assets guaranteed by United States Government-sponsored agencies;
- Assets collateralized by the current market value of securities issued or guaranteed by United States Government-sponsored agencies;
- Claims guaranteed by a qualifying securities firm, subject to certain conditions;
- Claims representing general obligations of any public-sector entity in an OECD country, and that portion of any claims guaranteed by any such public-sector entity;
- Balances due from and all claims on domestic depository institutions.
- The book value of paid-in Federal Home Loan Bank stock;
- Deposit reserves at, claims on, and balances due from the Federal Home Loan Banks;
- Assets collateralized by cash held in a segregated deposit account by the reporting corporate;
- Claims on, or guaranteed by, official multilateral lending institutions or regional development institutions in which the United States Government is a shareholder or contributing member;[36]

[36] These institutions include, but are not limited to, the International Bank for Reconstruction and Development (World Bank), the Inter-American Development Bank, the Asian Development

- Assets collateralized by the current market value of securities issued by official multilateral lending institutions or regional development institutions in which the United States Government is a shareholder or contributing member;
- All claims on depository institutions incorporated in an OECD country, and all assets backed by the full faith and credit of depository institutions incorporated in an OECD country;
- Claims on, or guaranteed by depository institutions other than the central bank, incorporated in a non-OECD country, with a remaining maturity of one year or less; and
- Local currency claims conditionally guaranteed by central governments of non-OECD countries, to the extent the corporate has local currency liabilities in that country.

Fifty percent risk-weighting (Category 3). This category contains assets considered to present a moderate level of credit risk as compared to standard risk assets. It includes:

- Revenue bonds issued by any public-sector entity in an OECD country for which the underlying obligor is a public-sector entity, but which are repayable solely from the revenues generated from the project financed through the issuance of the obligations;
- Qualifying mortgage loans and qualifying multifamily mortgage loans;
- Certain privately-issued mortgage-backed securities; and
- Qualifying residential construction loans.

One hundred percent risk-weighting (Category 4). All assets not classified elsewhere or deducted from calculations of capital pursuant to §§704.2 and 704.3 are assigned to this category, which comprises standard risk assets. This category includes:

- Consumer loans;
- Commercial loans;
- Home equity loans;
- Non-qualifying mortgage loans;
- Non-qualifying multifamily mortgage loans;
- Residential construction loans;
- Land loans;
- Nonresidential construction loans;

Bank, the African Development Bank, the European Investments Bank, the International Monetary Fund and the Bank for International Settlements.

- Obligations issued by any state or any political subdivision thereof for the benefit of a private party or enterprise where that party or enterprise, rather than the issuing state or political subdivision, is responsible for the timely payment of principal and interest on the obligations;
- Debt securities not specifically risk-weighted in another category;
- Investments in fixed assets and premises;
- Servicing assets;
- Interest-only strips receivable, other than credit-enhancing interest-only strips;
- Equity investments;
- The prorated assets of subsidiaries (except for the assets of consolidated CUSOs) to the extent such assets are included in adjusted total assets;
- All repossessed assets or assets that are more than 90 days past due; and
- Intangible assets not specifically weighted in some other category.

The term "prorated assets" means the total assets (as determined in the most recently available GAAP report) of a consolidated CUSO multiplied by the corporate credit union's percentage of ownership of that consolidated CUSO.

Corporates may take indirect ownership of assets, such as through a mutual fund. The proposal provides that investments representing an indirect holding of a pool of assets are assigned to risk-weight categories based upon the risk-weight that would be assigned to each category of assets in the pool, and described various methods for achieving that result. In no case, however, will any such investment be assigned a total risk-weight of less than 20 percent.

The proposal also recognizes that certain transactions or activities, such as derivatives transactions, may appear on corporate's balance sheet but are not specifically described in the Section II(a) on-balance sheet risk-weight categories. These items will be assigned risk-weights as described in Section II(b) or II(c) below, generally relating to off-balance sheet items.

Off-balance sheet items.

The Board is also proposing to incorporate off-balance sheet items in its calculation of risk-weighted assets, using a method similar to that used by the federal banking regulators.

Under the proposal, off-balance sheet items are incorporated into risk-weighted assets by first determining the on-balance sheet credit equivalent amounts for the items and then assigning the credit equivalent amounts to the appropriate

risk category according to the obligor, or if relevant, the guarantor or the nature of the collateral.

For many types of off-balance sheet transactions, the risk-weight is determined by a two-step process. First, the notional principal, or face value, amount of the off-balance sheet item is multiplied by a credit conversion factor to arrive at a balance sheet "credit-equivalent amount." The conversion factor is based upon the relative likelihood that a credit obligation will result from the commitment. The credit-equivalent amount is then assigned to the appropriate risk category depending upon the obligor (e.g., to the 20 percent risk category if guaranteeing an obligation of a depository institution). For certain off-balance sheet contracts, however, including interest and exchange rate contracts, credit equivalent amounts are determined by summing two amounts: the current exposure and the estimated potential future exposure.

Summary of conversion factors for off-balance sheet items.

Conversion factors -- Group A -- 100 Percent. Direct credit substitutes are assigned to Group A. Direct credit substitutes are any irrevocable obligations in which a corporate has essentially the same credit risk as if it had made a direct loan to the obligor or account party. Direct credit substitutes include guarantees (or guarantee-type instruments) backing financial claims, such as outstanding securities, loans, and other financial obligations including those on behalf of CUSOs. Direct credit substitutes also include standby letters of credit, equivalent obligations, and forward agreements that are legally binding agreements (contractual obligations) to purchase assets with certain drawdowns at specified future dates.

Asset sales with recourse, if not already included on the balance sheet, are treated in the same way as direct credit substitutes. Such sales will be treated as if they did not occur. Capital will be required against the full amount sold for assets sold with recourse. Retention of the subordinated portion of a senior/subordinated loan participation or package of loans will be treated in the same manner as an asset sale with recourse. The minimum amount of capital required against loans sold to an institution with full recourse is determined by the type of obligor.

Group B -- 50 percent. This group includes transaction-related contingencies and unused commitments not falling within Group E. Transaction-related contingencies include performance bonds, performance standby letters of credit, warranties, and standby letters of credit related to particular transactions. These instruments are different from financial guarantee-type standby letters of credit in that they concern performance of nonfinancial or commercial contracts or undertakings. These instruments generally involve guaranteeing the account

party's obligation to deliver a service or product in the conduct of its day-to-day business.

A commitment is defined as any arrangement between an institution and its customer that legally obligates the institution to extend credit to the customer in the form of loans or leases. It also includes such undertakings as overdraft transactions. Normally, a commitment involves a written contract or agreement, a commitment fee, or some other form of consideration.

Commitments are included in risk-weighted assets regardless of whether they contain "material adverse change" clauses or other similar provisions. Commitments with material adverse change clauses are included in this category (rather than in a category carrying a smaller conversion factor) because they represent obligations that may involve risk if an institution funds the commitment before the customer's condition deteriorates, or before the deterioration is recognized. Moreover, while the Board does not wish to discourage the use of material adverse change clauses, some court decisions suggest that the presence of a material adverse change clause cannot necessarily be relied on to relieve an institution of its obligations pursuant to a commitment.

Only the unused portion of a commitment is treated as an off-balance sheet item. Amounts that are already drawn and outstanding under a commitment appear on the balance sheet; such amounts, therefore, will not be included as commitments for purposes of computing the risk-asset ratio.

Group C -- 20 percent. Group C includes short-term, self-liquidating, trade-related contingencies that arise from the movement of goods, including commercial letters of credit and other documentary letters of credit collateralized by the underlying shipments.

Group D -- 10 percent. Group D includes unused portions of eligible Asset-backed Commercial Paper (ABCP) liquidity facilities with an original maturity of one year or less. The ABCP risk-weighting treatment is similar to the risk-weighting employed by the other regulators. The proposal adds key terms related to the ABCP risk-weighting to the definitions section. 12 CFR 704.2.

Group E -- Zero Percent. Group E includes unused commitments that are less than one year in maturity or that the corporate can, at its option, unconditionally (without cause) cancel. Facilities that, at the institution's option, are unconditionally cancelable at any time are not considered to be commitments, provided that the institution makes a separate credit decision before each drawdown under the facility. Unused retail credit card lines are deemed to fall under this group if the corporate has the unconditional option to cancel the card at any time.

Group F – Off balance sheet contracts; interest rate and foreign exchange contracts. Credit equivalent amounts for these contracts, including interest-rate swaps, futures, over-the-counter options, interest-rate options purchased (caps, floors and collars), foreign exchange rate contracts, and forward rate agreements are determined by summing two amounts: the current exposure and the estimated potential future exposure.

The current exposure (sometimes referred to as replacement cost) of a contract is derived from its market value. In most instances the initial market value of a contract is zero.[37] A corporate should mark all of its rate contracts to market to reflect the current value of the transaction in light of changes in the market price of the contracts or in the underlying interest or exchange rates. Unless the market value of a contract is zero, one party will always have a positive mark-to-market value for the contract, while the other party (counterparty) will have a negative mark-to-market value.

An institution holding a contract with a positive mark-to-market value is "in-the-money," that is, it would have the right to receive payment from the counterparty if the contract were terminated. Thus, an institution that is in-the-money on a contract is exposed to counterparty credit risk, since the counterparty could fail to make the expected payment. The potential loss is equal to the cost of replacing the terminated contract with a new contract that would generate the same expected cash flows under the existing market conditions. Therefore, the in-the-money institution's current exposure on the contract is equal to the market value of the contract.

An institution holding a contract with a negative mark-to-market value, on the other hand, is "out-of-the-money" on that contract, that is, if the contract were terminated, the institution would have an obligation to pay the counterparty. The institution with the negative mark-to-market value has no counterparty credit exposure because it is not entitled to any payment from the counterparty in the case of counterparty default. Consequently, a contract with a negative market value is assigned a current exposure of zero. A current exposure of zero is also assigned to a contract with a market value of zero, since neither party would suffer a loss in the event of contract termination. In summary, the current exposure of a rate contract equals either the positive market value of the contract or zero.

[37] An options contract has a positive value at inception, which reflects the premium paid by the purchaser. The value of the option may be reduced due to market movements but it cannot become negative. Therefore, unless an option has zero value, the purchaser of the option contract will always have some credit exposure, which may be greater than or less than the original purchase price, and the seller of the option contract will never have credit exposure.

The second part of the credit equivalent amount for rate contracts, the estimated potential future exposure (often referred to as the add-on), is an amount that represents the potential future credit exposure of a contract over its remaining life. This exposure is calculated by multiplying the notional principal amount of the underlying contract by a credit conversion factor that is determined by the remaining maturity of the contract and the type of contract.

The potential future credit exposure is calculated for all contracts, regardless of whether the mark-to-market value is zero, positive, or negative. For interest rate contracts with a remaining maturity of one year or less, the credit conversion factor is 0 percent and for those over one year, the factor is .5 percent. For exchange rate contracts with a maturity of one year of less, the factor is 1 percent and for those over one year the factor is 5 percent. Because exchange rate contracts involve an exchange of principal upon maturity and are generally more volatile, they carry a higher conversion factor. No potential future credit exposure is calculated for single-currency interest-rate swaps in which payments are made based on two floating indices (basis swaps).

The potential future exposure is then added to the current exposure to arrive at a credit equivalent amount.[38] Each credit equivalent amount is then assigned to the appropriate risk category, according to the counterparty or, if relevant, the guarantor or the nature of the collateral. The maximum risk-weight applied to such rate contracts is 50 percent.

Netting and risk-based capital treatment of off-balance sheet contracts.

Netting arrangements are a means of improving efficiency and reducing counterparty credit exposure. Often referred to as master netting contracts, these arrangements typically provide for both payment and close-out netting.

Payment netting provisions permit an institution to make payments to a counterparty on a net basis by offsetting payments it is obligated to make with payments it is entitled to receive and, thus, to reduce its costs arising out of payment settlements. Close-out netting provisions permit the netting of credit exposures if a counterparty defaults or upon the occurrence of another event such as insolvency or bankruptcy. If such an event occurs, all outstanding contracts subject to the close-out provisions are terminated and accelerated, and their market values are determined. The positive and negative market values are then netted, or set off, against each other to arrive at a single net exposure to be paid by one party to the other upon final resolution of the default or other event.

[38] This method of determining credit equivalent amounts for rate contracts is known as the *current exposure method*, which is used by most banks under $250 billion in assets.

The potential for close-out netting provisions to reduce counterparty credit risk, by limiting an institution's obligation to the net credit exposure, depends upon the legal enforceability of the netting contract, particularly in insolvency or bankruptcy.

Accordingly, the proposal permits a corporate, in determining its current credit exposure for multiple off-balance sheet rate contracts executed with a single counterparty, to net off-balance sheet rate contracts subject to a bilateral netting contract by offsetting positive and negative mark-to-market values, provided that the netting contract meets certain requirements, including that the bilateral netting contract creates a single, enforceable legal obligation for all individual off-balance sheet rate contracts covered by the contract.[39] A bilateral netting contract that contains a walkaway clause is not eligible for netting for purposes of calculating the current credit exposure amount. A walkaway clause is a provision in a netting contract that permits the non-defaulting counterparty to make only limited payments, or no payments at all, to the estate of the defaulter even if the defaulter is a net creditor under the contract.

Certain off-balance sheet rate contracts are not subject to the above calculation, and therefore, are not part of the denominator of a corporate's risk-based capital ratio. These include a foreign exchange rate contract with an original maturity of 14 calendar days or less; any interest rate or foreign exchange rate contract that is traded on an exchange requiring the daily payment of any variations in the market value of the contract; and certain asset-backed commercial paper programs.

Recourse obligations, direct credit substitutes, and certain other positions.

The proposed rule provides additional risk-weighting provisions for recourse obligations, direct credit substitutes, and certain other positions. These terms generally relate to asset securitization and associated securities. A discussion of asset securitization follows.

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[39] The Basel Supervisors' Committee issued a consultative paper on April 30, 1993, proposing an expanded recognition of netting arrangements in the regulations based on Basel I. The paper is entitled "The Prudential Supervision of Netting, Market Risks and Interest Rate Risk." The section applicable to netting is subtitled "The Supervisory Recognition of Netting for Capital Adequacy Purposes." Specifically, the Basel proposal states that netting for risk-based capital purposes is permissible if (1) In the event of a counterparty's failure to perform due to default, bankruptcy or liquidation, the corporate's claim (or obligation) would be to receive (or pay) only the net value of the sum of unrealized gains and losses on included transactions; (2) the banking entity has obtained written and reasoned legal opinions stating that in the event of legal challenge, the netting would be upheld in all relevant jurisdictions; and (3) the entity has documentation and procedures in place to ensure that the netting arrangements are kept under review in light of changes in relevant law. These criteria are contained in the proposed rule.

Asset securitization is the process by which loans or other credit exposures are pooled and reconstituted into securities, with one or more classes or positions, that may then be sold. Securitization provides an efficient mechanism for depository institutions to buy and sell loan assets or credit exposures and thereby to increase the organization's liquidity.[40]

Securitizations typically carve up the risk of credit losses from the underlying assets and distribute it to different parties. The "first dollar," or most subordinate, loss position is first to absorb credit losses; the most "senior" investor position is last to absorb losses; and there may be one or more loss positions in between ("second dollar" loss positions). Each loss position functions as a credit enhancement for the more senior positions in the structure.

For residential mortgages sold through certain Federally-sponsored mortgage programs, a Federal government agency or Federal government-sponsored enterprise (GSE) guarantees the securities sold to investors and may assume the credit risk on the underlying mortgages. However, many of today's asset securitization programs involve assets that are not Federally supported in any way. Sellers of these privately securitized assets therefore often provide other forms of credit enhancement-that is, they take first or second dollar loss positions-to reduce investors' credit risk.

A seller may provide this credit enhancement itself through recourse arrangements. The proposed rule uses the term "recourse" to refer to the credit risk that a banking organization or credit union retains in connection with the transfer of its assets. Banks and credit unions have long provided recourse in connection with sales of whole loans or loan participations; today, recourse arrangements frequently are also associated with asset securitization programs. Depending on the type of securitization transaction, the sponsor of a securitization may provide a portion of the total credit enhancement internally, as part of the securitization structure, through the use of excess spread accounts, overcollateralization, retained subordinated interests, or other similar on-balance sheet assets. When these or other on-balance sheet internal enhancements are provided, the enhancements are "residual interests" for regulatory capital purposes. Such residual interests are a form of recourse.

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[40] For purposes of this discussion, references to "securitization" also include structured finance transactions or programs and synthetic transactions that generally create stratified credit risk positions, which may or may not be in the form of a security, whose performance is dependent upon a pool of loans or other credit exposures. Synthetic transactions bundle credit risks associated with on-balance sheet assets and off-balance sheet items and resell them into the market. For examples of synthetic securitization structures, *see* Banking Bulletin 99-43, November 15, 1999 (OCC).

A seller may also arrange for a third party to provide credit enhancement in an asset securitization.[41] If the third-party enhancement is provided by another banking organization, that organization assumes some portion of the assets' credit risk. In this final rule, all forms of third-party enhancements, i.e., all arrangements in which a banking organization assumes credit risk from third-party assets or other claims that it has not transferred, are referred to as "direct credit substitutes."[42] The economic substance of the credit risk from providing a direct credit substitute can be identical to its credit risk from retaining recourse on assets transferred.

Many asset securitizations use a combination of recourse and third-party enhancements to protect investors from credit risk. When third-party enhancements are not provided, the transferring entity often retains credit risk on the assets transferred.

Risk management of exposures arising from securitization activities.

While asset securitization can enhance both credit availability and profitability, managing the risks associated with this activity can pose significant challenges. The risks involved, while not new to banking organizations and credit unions, may be less obvious and more complex than the risks of traditional lending. Specifically, securitization can involve credit, liquidity, operational, legal, and reputational risks in concentrations and forms that may not be fully recognized by management or adequately incorporated into a credit union's risk management systems.

Risk-weighting of direct credit substitutes and recourse obligations (including residual interests and credit enhancing IO strips).

The proposal defines four key terms: direct credit substitute, recourse obligations, residual interests, and credit enhancing interest only (IO) strips. The proposal defines a direct credit substitute as any arrangement in which a corporate assumes, in form or in substance, credit risk associated with an on-balance sheet or off-balance sheet asset or exposure that was not previously owned by the corporate (third-party asset) and the risk assumed by the corporate exceeds the *pro rata* share of the corporate's interest in the third-party asset.[43]

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[41] As used in this proposed rule, the terms "credit enhancement" and "enhancement" refer to both recourse arrangements, including residual interests, and direct credit substitutes.

[42] For purposes of this rule, purchased credit-enhancing interest-only strips are also "residual interests."

[43] If a corporate has no claim on the third-party asset, then the corporate's assumption of any credit risk is a direct credit substitute. As stated in the definition, direct credit

The proposal generally defines *recourse obligations* as a corporate's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold (in accordance with Generally Accepted Accounting Principles) that exceeds a *pro rata* share of that corporate's claim on the asset. A recourse obligation typically arises when a corporate transfers assets in a sale and retains an explicit obligation to repurchase assets or to absorb losses due to a default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly if a corporate provides credit enhancement beyond any contractual obligation to support assets it has sold.[44]

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substitutes include:
(1) Financial standby letters of credit that support financial claims on a third party that exceed a corporate's *pro rata* share in the financial claim;
(2) Guarantees, surety arrangements, credit derivatives, and similar instruments backing financial claims that exceed a corporate's *pro rata* share in the financial claim;
(3) Purchased subordinated interests that absorb more than their *pro rata* share of losses from the underlying assets, including any tranche of asset backed securities that is not the most senior tranche;
(4) Credit derivative contracts under which the corporate assumes more than its *pro rata* share of credit risk on a third-party asset or exposure;
(5) Loans or lines of credit that provide credit enhancement for the financial obligations of a third party;
(6) Purchased loan servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced. Servicer cash advances as defined in this section are not direct credit substitutes;
(7) Clean-up calls on third party assets. However, clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the corporate are not direct credit substitutes; and
(8) Liquidity facilities that provide support to asset-backed commercial paper (other than eligible ABCP liquidity facilities).

[44] As stated in the definition, recourse obligations include:
(1) Credit-enhancing representations and warranties made on transferred assets;
(2) Loan servicing assets retained pursuant to an agreement under which the corporate will be responsible for losses associated with the loans serviced. Servicer cash advances as defined in this section are not recourse obligations;
(3) Retained subordinated interests that absorb more than their *pro rata* share of losses from the underlying assets;
(4) Assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet;
(5) Loan strips sold without contractual recourse where the maturity of the transferred portion of the loan is shorter than the maturity of the commitment under which the loan is drawn;
(6) Credit derivatives that absorb more than the corporate's *pro rata* share of losses from the transferred assets;
(7) Clean-up calls on assets the corporate has sold. However, clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the corporate are not recourse arrangements; and

As stated above, the primary difference between direct credit substitutes and recourse obligations is that recourse obligations involve the assumption of credit risk associated with assets that the corporate once owned but transferred, while direct credit substitutes involve the assumption of credit risk related to assets that the corporate does not own. Both direct credit substitutes and recourse obligations, however, can involve similar, and significant, credit risk. Accordingly the proposal outlines the same general process (with some exceptions) for risk-weighting both direct credit substitutes and recourse obligations.

The proposal requires that the corporate multiply the full amount of the credit-enhanced assets for which the corporate directly or indirectly retains or assumes credit risk by a 100 percent conversion factor. The corporate will then assign this credit equivalent amount to the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral, in accordance with the risk-weight categories in Section II(a) of the Appendix. The proposal states that, for a direct credit substitute that is an on-balance sheet asset (e.g., a purchased subordinated security), a corporate must use the amount of the direct credit substitute and the full amount of the asset its supports, i.e., all the more senior positions in the structure). This means, for example, that if a corporate invests in a senior mezzanine security that supports a more senior tranche, the corporate must use the full amount of the supported tranche, without regard for the existence or not of tranches subordinate to the mezzanine tranche. This can result in a risk-weighting several times greater than the risk-weighting for the most senior tranche.

There are two subsets of recourse obligations that receive special treatment for risk-weighting purposes: residual interests and credit enhancing interest only strips. In addition, in some asset transfers the transferring entity might retain two or more different recourse obligations on the same transferred assets, and the rule provides for a special risk-weighting calculation in this case. These situations are discussed further below.

The proposal defines *residual interests*, a form of recourse obligation, as any on-balance sheet asset that:

(1) Represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with Generally Accepted Accounting Principles) of financial assets, whether through a securitization or otherwise; and

(2) Exposes a corporate to credit risk directly or indirectly associated with the

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(8) Liquidity facilities that provide support to asset-backed commercial paper (other than eligible ABCP liquidity facilities).

transferred asset that exceeds a *pro rata* share of that corporate's claim on the asset, whether through subordination provisions or other credit enhancement techniques.

Residual interests generally include credit-enhancing interest-only strips, spread accounts, cash collateral accounts, retained subordinated interests (and other forms of overcollateralization), and similar assets that function as a credit enhancement. Residual interests further include those exposures that, in substance, cause the corporate to retain the credit risk of an asset or exposure that had qualified as a residual interest before it was sold. While residual interests generally do not include assets purchased from a third party, the definition does include a credit-enhancing interest-only strip that is acquired in any asset transfer as a residual interest.

The proposal provides that a corporate must maintain risk-based capital for a residual interest equal to the face amount of the residual interest, even if the amount of risk-based capital that must be maintained exceeds the full risk-based capital requirement for the assets transferred. For residual interests in the form of credit enhancing interest only strips, the rule further provides that a corporate must maintain risk-based capital equal to the remaining amount of the **strip** (emphasis added) even if the amount of risk-based capital that must be maintained exceeds the full risk-based capital requirement for the assets transferred.

Where a corporate transfers assets, and holds both a residual interest (including a credit-enhancing interest-only strip) and another recourse obligation in connection with that transfer, the corporate must maintain risk-based capital equal to the greater of the risk-based capital requirement for the residual interest or the full risk-based capital requirement for the assets transferred.

Ratings-based approach to risk-weighting.

In lieu of the general risk-weighting approach described above, the proposal would allow a corporate to employ a ratings based approach to certain asset-backed securities, direct credit substitutes, or residual interests.

To apply a ratings based approach to one of these particular assets, the asset must generally be a *traded position*, and if a long term position, must be rated by an NRSRO as one grade below investment grade or better or, if a short-term position, must be rated be publicly rated by an NRSRO as investment grade or better.[45] To obtain the risk-weighted asset amount, the corporate will multiply

[45] The proposal defines a *traded position* as a position retained, assumed, or issued in connection with a securitization that is rated by a NRSRO, where there is a reasonable

the face amount of the asset by the appropriate risk-weight determined in accordance with Table A or B below:

Table A

Long-term rating category	Risk-weight (In percent)
Highest or second highest investment grade	20
Third highest investment grade	50
Lowest investment grade	100
One category below investment grade	200

Table B

Short-term rating category	Risk-weight (In percent)
Highest investment grade	20
Second highest investment grade	50
Lowest investment grade	100

The proposal also permits certain asset-backed securities (ABS), direct credit substitutes, and recourse obligations that do not meet the definition of "traded position" to be risk-weighted based on NRSRO ratings category under certain circumstances.[46]

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expectation that, in the near future, the rating will be relied upon by:
(1) Unaffiliated investors to purchase the security; or
(2) An unaffiliated third party to enter into a transaction involving the position, such as a purchase, loan, or repurchase agreement.

Also, if two or more NRSROs assign ratings to a traded position, the corporate must use the lowest rating to determine the appropriate risk-weight category.

[46] A position that is not traded is eligible for the ratings based risk-weighting if:
(1) The position is a recourse obligation, direct credit substitute, residual interest, or asset- or mortgage-backed security extended in connection with a securitization and is not a credit-enhancing interest-only strip;
(2) More than one NRSRO rate the position;
(3) All of the NRSROs that provide a rating rate a long term position as one grade below investment grade or better or a short term position as investment grade. If the NRSROs assign different ratings to the position, the corporate must use the lowest rating to determine the appropriate risk-weight category;
(4) The NRSROs base their ratings on the same criteria that they use to rate securities that are

Use of ratings based approach to assets that are not specifically rated by an NRSRO.

The proposal provides that, in certain circumstances, a corporate may use the ratings based approach for asset-backed securities, direct credit substitutes, or residual interests that are not specifically rated by an NRSRO.

If the asset is senior or preferred in all features to a particular traded position, including collateralization and maturity, the corporate may risk-weight the face amount of the senior position under the ratings based approach using Tables A and B above based on the NRSRO rating of the traded position, subject to supervisory guidance. The corporate must satisfy NCUA that this treatment is appropriate.

An asset created in connection with a securitization is eligible for a ratings-based risk-weighting treatment in accordance with Table C below if the asset is not rated by an NRSRO, is not a residual interest, and meets the one of three different, alternative standards for internal ratings described below.

Table C

Rating category	Risk-weight (In percent)
Investment grade	100
One category below investment grade	200

A direct credit substitute, but not a purchased credit-enhancing interest-only strip, is eligible for the a ratings based risk-weighting under Table C if the asset is created in connection with an asset-backed commercial paper program sponsored by the corporate and the rating is generated by an appropriate internal credit risk rating system.[47]

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traded positions; and
(5) The ratings are publicly available.

[47] The proposed rule provides that such internal credit risk rating systems typically:
(1) Are an integral part of the corporate's risk management system that explicitly incorporates the full range of risks arising from the corporate's participation in securitization activities;
(2) Link internal credit ratings to measurable outcomes, such as the probability that the position will experience any loss, the expected loss on the position in the event of default, and the degree of variance in losses in the event of default on that position;
(3) Separately consider the risk associated with the underlying loans or borrowers, and the risk associated with the structure of the particular securitization transaction;
(4) Identify gradations of risk among "pass" assets and other risk positions;

A recourse obligation or direct credit substitute, but not a residual interest, is eligible for a ratings based risk-weighting under Table C if the asset is created in connection with a structured finance program and an NRSRO has reviewed the terms of the program and stated a rating for positions associated with the program.[48] If the program has options for different combinations of assets, standards, internal or external credit enhancements and other relevant factors, and the NRSRO specifies ranges of rating categories to them, the corporate may apply the rating category applicable to the option that corresponds to the corporate's position. To rely on this sort of program rating, the corporate must demonstrate to NCUA's satisfaction that that the credit risk rating assigned to the program meets the same standards generally used by NRSROs for rating traded positions. The corporate must also demonstrate to NCUA's satisfaction that the criteria underlying the assignments for the program are satisfied by the particular

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(5) Use clear, explicit criteria to classify assets into each internal rating grade, including subjective factors;
(6) Employ independent credit risk management or loan review personnel to assign or review the credit risk ratings;
(7) Include an internal audit procedure to periodically verify that internal risk ratings are assigned in accordance with the corporate's established criteria;
(8) Monitor the performance of the assigned internal credit risk ratings over time to determine the appropriateness of the initial credit risk rating assignment, and adjust individual credit risk ratings or the overall internal credit risk rating system, as needed; and
(9) Make credit risk rating assumptions that are consistent with, or more conservative than, the credit risk rating assumptions and methodologies of NRSROs.

[48] Under the proposal, a corporate may use a rating obtained from a rating agency for unrated direct credit substitutes or recourse obligations (but not residual interests) in structured finance programs that satisfy specifications set by the rating agency. The corporate would need to demonstrate that the rating meets the same rating standards generally used by the rating agency for rating traded positions. In addition, the corporate must also demonstrate to the NCUA's satisfaction that the criteria underlying the rating agency's assignment of ratings for the program are satisfied for the particular direct credit substitute or recourse exposure.

To use this approach, a corporate must demonstrate to the NCUA that it is reasonable and consistent with the standards of this final rule to rely on the rating of positions in a securitization structure under a program in which the corporate participates if the sponsor of that program has obtained a rating. This aspect of the final rule is most likely to be useful to corporates with limited involvement in securitization activities. In addition, some banking entities extensively involved in securitization activities already rely on ratings of the credit risk positions under their securitization programs as part of their risk management practices. Such corporates also could rely on such ratings under this final rule if the ratings are part of a sound overall risk management process and the ratings reflect the risk of non-traded positions to the corporates.

This approach can be used to qualify a direct credit substitute or recourse obligation (but not a residual interest) for a risk-weight of 100 percent or 200 percent of the face value of the position under the ratings-based approach, but not for a risk-weight of less than 100 percent.

position.

A recourse obligation or direct credit substitute, but not a residual interest, is eligible for a ratings based risk-weighting under Table C if the asset is created in connection with a structured financing program and the corporate uses an acceptable credit assessment computer program to determine the rating of the position. An NRSRO must have developed the computer program and the corporate must demonstrate to NCUA's satisfaction that the ratings under the program correspond credibly and reliably with the rating of traded positions.[49]

Other limitations on risk-based capital requirements.

The proposal contains some miscellaneous limitations on the risk-based capital requirements. There is a low-level exposure provision that limits the maximum risk-based capital requirement to the maximum contractual loss exposure, even where risk-based capital requirement as calculated under Appendix C might exceed that amount. There is a provision that limits the amount of risk-based capital to support mortgage-related securities or participation certificates retained in a mortgage loan swap. There is a provision that eliminates double counting of assets for purposes of risk-weighting. Finally, there is a provision that requires the corporate to risk-weight recourse obligations and direct credit substitutes retained or assumed by a corporate on the obligations of CUSOs in which the corporate has an equity investment in accordance with this Section II(c), unless the corporate's equity investment is deducted from credit union's capital and assets under §704.2 and §704.3.

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[49] The NCUA will also allow corporates, particularly those with limited involvement in securitization activities, to rely on qualifying credit assessment computer programs that the rating agencies have developed to rate otherwise unrated direct credit substitutes and recourse obligations (but not residual interests) in asset securitizations.

To qualify for use by a corporate for risk-based capital purposes, a computer program's credit assessments must correspond credibly and reliably to the rating standards of the rating agencies for traded positions in securitizations. A corporate must demonstrate the credibility of the computer program in the financial markets, which would generally be shown by the significant use of the computer program by investors and other market participants for risk assessment purposes. A corporate must also demonstrate the reliability of the program in assessing credit risk.

A corporate may use a computer program for purposes of applying the ratings-based approach under this final rule only if the corporate satisfies NCUA that the program results in credit assessments that credibly and reliably correspond with the ratings of traded positions by the rating agencies. The corporate should also demonstrate to the NCUA's satisfaction that the program was designed to apply to its particular direct credit substitute or recourse exposure and that it has properly implemented the computer program.

III.B. Amendments to part 704 relating to Prompt Corrective Action.

Proposed §704.4. Prompt corrective action.

Section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o) (Section 38) contains a framework that applies to every insured banking institution a system of supervisory actions indexed to the capital level of the individual institution. The purpose of this "prompt corrective action" (PCA) statutory provision is to "resolve the problems of insured depository institutions at the least possible long-term loss to the [Federal Deposit Insurance Corporation's] deposit insurance fund." Section 216 of the Federal Credit Union Act (12 U.S.C. 1790d) (Section 216) contains a similar PCA provision, and NCUA has implemented Section 216 through regulations in part 702. 12 CFR part 702. Section 216 of the FCUA, however, is not applicable to corporates, and neither is part 702. 12 U.S.C. 1790d(m); 12 CFR 702.1(c). The Board has determined, however, that some sort of regulatory PCA regime is appropriate for corporates, and this proposal sets forth such a regime.

Corporates have a wider variety of powers than natural person credit unions, including some powers that are more like bank powers. Accordingly, this proposed PCA rule, to be located at §704.4 of NCUA's corporate rule, contains elements from both Section 38 of the FDIA and Section 216 of the FCUA, and their various implementing regulations. Part 747 of NCUA's rules describes the rules and procedures for various hearings and recommendations, and subpart L sets forth the procedures for the issuance, review, and enforcement of orders imposing PCA on natural person credit unions. The proposal contains a new subpart M in part 747 that contains similar procedures for corporate PCA.

The proposal establishes five categories of corporate capital classification: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The proposal deems a corporate, generally, to be "well capitalized" if the institution significantly exceeds the required minimum level for each relevant capital measure; "adequately capitalized" if the institution meets the required minimum level for each relevant capital measure; "undercapitalized" if the institution fails to meet the required minimum level for any relevant capital measure; "significantly undercapitalized" if the institution is significantly below the required minimum level for any relevant capital measure; or "critically undercapitalized" if the institution is critically below the required minimum level for any relevant capital measure.

Capital ratios alone, of course, are not fully indicative of the capital strength of an institution. In particular, in proposing these minimum capital levels, the NCUA is aware that a corporate can have capital ratios above the specified minimums for the well capitalized and adequately capitalized categories while still exhibiting

unsafe and unsound characteristics. One reason for this dichotomy is that capital is a lagging indicator of problems of insured depository institutions, and use of moving DANA and DANRA exacerbates this lag.

Accordingly, a corporate might be subject to a written order or directive that establishes higher capital levels for that institution. NCUA is proposing that for a corporate to be well capitalized, it must not be subject to any written capital order or directive.[50] This proposal reflects the view that a corporate that is subject to a written capital directive does not have capital that significantly exceeds the required minimum level for the relevant capital measures.

The proposal also gives the NCUA discretion to downgrade, where appropriate, a "well capitalized" corporate by one category and require an "adequately capitalized" or "undercapitalized" corporate to comply with supervisory actions as if it were in the next lower category. Additionally, the NCUA may, for good cause, modify the minimum capital ratio percentages for purposes of determining the appropriate PCA capital category for a particular corporate credit union. The proposal further clarifies that NCUA continues to have available all other non-PCA supervisory tools traditionally used to supervise corporates, and the agency intends to use these tools as appropriate in supervising corporates. These tools include appropriate enforcement actions and supervisory follow-up measures based upon the corporate's overall condition and the existence of any financial, operational, or other supervisory weaknesses, irrespective of the corporate's capital category for purposes of the prompt corrective action provisions of the proposal.

Finally, the proposal prohibits a corporate from disseminating to third-parties its capital category, except where permitted by NCUA or otherwise provided by statute or regulation. This also prohibits corporates from advertising their capital category.

A paragraph-by-paragraph summary of the PCA proposal follows.

Paragraph 704.4(a) Purpose.

This proposed paragraph establishes that the principal purpose of PCA is to define, for corporates that are not adequately capitalized, the capital measures and capital levels that are used for determining appropriate supervisory actions. The proposal also establishes procedures for submission and review of capital restoration plans and for issuance and review of capital directives, orders, and other supervisory directives. In the case of a state-chartered corporate credit

[50] This would include capital orders, capital directives, and cease and desist orders related to capital.

union, the proposal provides that NCUA will consult with, and seek to work cooperatively with, the appropriate State official before taking any discretionary PCA actions.

Paragraph 704.4(b) Scope.

This paragraph establishes that the PCA section applies to corporates, including officers, directors, and employees. The paragraph clarifies that the section does not limit the authority of the NCUA in any way to take supervisory actions to address unsafe or unsound practices, deficient capital levels, violations of law, unsafe or unsound conditions, or other practices. It generally prohibits a corporate from stating in any advertisement or promotional material its capital category or that the NCUA has assigned the corporate to a particular category. The proposal also requires newly chartered corporates to submit to NCUA a draft plan that sets forth how the corporate will solicit contributed capital and build retained earnings.

Paragraph 704.4(c) Notice of capital category.

This paragraph describes the effective date of change in capital category, which is important in terms of triggering various time-sensitive actions. The paragraph provides that that the effective date will be the most recent date that a 5310 Financial Report is required to be filed with the NCUA; a final NCUA report of examination is delivered to the corporate; or written notice is provided by the NCUA to the corporate that its capital category has changed.

The rule also provides that a corporate must provide the NCUA with written notice that an adjustment to the corporate's capital category may have occurred no later than 15 calendar days following the date that any material event has occurred that would cause the corporate to be placed in a lower capital category from the category assigned to the corporate on the basis of the corporate's most recent call report or report of examination. After receiving this notice, or on its own initiative, the NCUA will determine whether to change the capital category of the corporate and will notify the corporate of the NCUA's determination.

Paragraph 704.4(d) Capital measures and capital category definitions.

This paragraph restates the relevant capital measures from proposed §704.3, that is the total risk-based capital ratio, the tier 1 risk-based capital ratio, and the leverage ratio. The paragraph then defines the five PCA capital categories in terms of these ratios.

The proposal provides that a corporate is “well capitalized” if it has a total risk-based capital ratio of 10.0 percent or greater, a Tier 1 risk-based capital ratio of

6.0 percent or greater, a leverage ratio of 5.0 percent or greater, and is not subject to any written agreement, order, capital directive, or prompt corrective action directive issued by NCUA to meet and maintain a specific capital level for any capital measure. A corporate must satisfy all four of these criteria to be considered well capitalized.

The proposal provides that a corporate is "adequately capitalized" if the corporate has a total risk-based capital ratio of 8.0 percent or greater, a Tier 1 risk-based capital ratio of 4.0 percent or greater, a leverage ratio of 4.0 percent or greater, and does not meet the definition of a well capitalized corporate. A corporate must satisfy all four of these criteria to be considered adequately capitalized.

The proposal provides that a corporate is "undercapitalized" if the corporate has a total risk-based capital ratio that is less than 8.0 percent, or has a Tier 1 risk-based capital ratio that is less than 4.0 percent, or has a leverage ratio that is less than 4.0 percent. Failure to achieve any one of these three minimum percentages will cause the corporate to be undercapitalized.

The proposal provides that a corporate is "significantly undercapitalized" if the corporate has a total risk-based capital ratio that is less than 6.0 percent, or a Tier 1 risk-based capital ratio that is less than 3.0 percent, or a leverage ratio that is less than 3.0 percent. Again, failure to achieve any one percentage will cause the corporate to be significantly undercapitalized.

The proposal provides that a corporate is "critically undercapitalized" if the corporate has a total risk-based capital ratio that is less than 4.0 percent, or a Tier 1 risk-based capital ratio that is less than 2.0 percent, or a leverage ratio that is less than 2.0 percent. Again, failure to achieve any one of percentages will cause the corporate to be critically undercapitalized.

The proposal provides NCUA with authority to reclassify a corporate's capital category based on supervisory criteria other than capital. One such criteria is a determination by NCUA that the corporate received a less-than-satisfactory rating (i.e., three or lower) for any rating category (other than in a rating category specifically addressing capital adequacy) under the Corporate Risk Information System (CRIS) rating system and has not corrected the conditions that served as the basis for the less than satisfactory rating. In this case, the NCUA may reclassify a well capitalized corporate as adequately capitalized, and may require an adequately capitalized or undercapitalized corporate to comply with certain mandatory or discretionary supervisory actions as if the corporate were in the next lower capital category. NCUA may also downgrade the capital category of a well capitalized, adequately capitalized, or undercapitalized corporate by one category if the NCUA determines that the corporate is otherwise in an unsafe or unsound condition.

In both situations, however, the NCUA must offer the corporate notice and opportunity to be heard before carrying out such a supervisory downgrade. The procedures, which include the opportunity for a hearing, are described in paragraph 704.4(h) and the proposed subpart M of part 747.

Paragraph 704.4(e) Capital restoration plans.

The proposal requires that any corporate that is downgraded to undercapitalized, or a lower capital category, must file a capital restoration plan with the NCUA.

The capital restoration plan must include all of the information required to be filed under paragraph (k)(2)(ii). This information includes the steps the corporate will take to become adequately capitalized; the levels of capital to be attained during each year in which the plan will be in effect; how the corporate will comply with the other PCA restrictions or requirements then in effect under this section; the types and levels of activities in which the corporate will engage; and other information as the NCUA may require. All financial data in the plan must be prepared in accordance with the instructions provided on the call report. A corporate required to submit a capital restoration plan as the result of a reclassification of the corporate for supervisory reasons must also include a description of the steps the corporate will take to correct the unsafe or unsound condition or practice.

The capital restoration plan must be filed with the NCUA within 45 days of the date that the corporate receives notice or is deemed to have notice that the corporate is undercapitalized, significantly undercapitalized, or critically undercapitalized, unless the NCUA notifies the corporate of a different filing period. An adequately capitalized corporate that has been reclassified for supervisory reasons is not, however, required to submit a capital restoration plan solely by virtue of the reclassification. Also, a corporate that has already submitted and is operating under a capital restoration plan is not required to submit an additional capital restoration plan based on a revised calculation of its capital measures or a reclassification unless the NCUA requests one.

A corporate that is undercapitalized and that fails to submit a timely, written capital restoration plan will be subject to all of the provisions of this section applicable to significantly undercapitalized corporates.

Within 60 days after receiving a capital restoration plan under this section, the NCUA will provide written notice to the corporate of whether it has approved the plan. The NCUA may extend this time period.

If NCUA does not approve a capital restoration plan, the corporate must submit a

revised capital restoration plan, when directed to do so and within the time specified by the NCUA. An undercapitalized corporate is subject to the provisions of §704.4 applicable to significantly undercapitalized credit unions until it has submitted, and NCUA has approved, a capital restoration plan. If NCUA directs that the corporate submit a revised plan, it must do so in time frame specified by NCUA.

Any undercapitalized corporate that fails in any material respect to implement a capital restoration plan will be subject to all of the provisions of §704.4 applicable to significantly undercapitalized corporates. A corporate that has filed an approved capital restoration plan may, after prior written notice to and approval by the NCUA, amend the plan to reflect a change in circumstance. Until such time as NCUA has approved a proposed amendment, the corporate must implement the capital restoration plan as approved prior to the proposed amendment.

Paragraph 704.4(f) Mandatory and discretionary supervisory actions.

The proposal provides for certain mandatory supervision actions depending on a corporate's capital category. Many of these provisions are incorporated by cross reference to paragraph 704.4(k).

Provisions applicable to all corporates.

Paragraph (k)(1) provides that a corporate is prohibited, unless it obtains NCUA's prior written approval, from making any capital distribution, including payment of dividends on perpetual contributed capital or nonperpetual contributed capital accounts if, after making the distribution, the institution would be undercapitalized.

Provisions applicable to undercapitalized, significantly undercapitalized, and critically undercapitalized corporates.

Upon being categorized as undercapitalized, significantly undercapitalized, or critically undercapitalized, a corporate will be subject to the following conditions and restrictions.

The corporate must submit an acceptable capital restoration plan to the NCUA. The corporate must not permit its DANA during any calendar month to exceed its moving DANA unless the NCUA has accepted the corporate's capital restoration plan and any increase in total assets is consistent with the plan. The corporate also must not, directly or indirectly, acquire any interest in any entity, establish or acquire any additional branch office, or engage in any new line of business

unless the NCUA determines that the proposed action is consistent with and will further the achievement of the plan.

The NCUA will also closely monitor the corporate for compliance with capital standards, capital restoration plans and activities.

Additional provisions applicable to significantly undercapitalized corporates and undercapitalized corporates that fail to submit and implement acceptable capital restoration plans.

If a corporate is significantly undercapitalized, or is undercapitalized and has failed to submit and implement a capital restoration plans acceptable to the NCUA, the corporate is prohibited from doing any of the following without the prior written approval of the NCUA:

- Paying any bonus or profit-sharing to any senior executive officer.
- Providing compensation to any senior executive officer at a rate exceeding that officer's average rate of compensation (excluding bonuses and profit-sharing) during the 12 calendar months preceding the calendar month in which the corporate became undercapitalized.

The NCUA will not grant approval with respect to a corporate that has failed to submit an acceptable capital restoration plan.

If a corporate is significantly undercapitalized, or is undercapitalized and has failed to submit and implement a capital restoration plans acceptable to the NCUA, the NCUA may also take one or more of the following actions:

- Requiring recapitalization, through requiring the corporate to seek and obtain additional contributed capital, requiring the corporate to increase its rate of earnings retention, or requiring the corporate to combine with another insured depository institution, if one or more grounds exist for appointing a conservator or liquidating agent for the institution.
- Further restricting the corporate’s transactions with affiliates.
- Restricting the interest rates that the corporate pays on shares and deposits to the prevailing rates of interest on deposits of comparable amounts and maturities in the region where the institution is located, as determined by the NCUA.
- Restricting the corporate’s asset growth more stringently than required under paragraph (k)(2)(iii), or requiring the corporate to reduce its total assets.

- Requiring the corporate or any of its CUSOs to alter, reduce, or terminate any activity that the NCUA determines poses excessive risk to the corporate.
- Ordering a new election for the corporate's board of directors.
- Requiring the corporate to dismiss from office any director or senior executive officer who had held office for more than 180 days immediately before the corporate became undercapitalized.
- Requiring the corporate to employ qualified senior executive officers (who, if the NCUA so specifies, will be subject to approval by the NCUA).
- Requiring the corporate to divest itself of or liquidate any interest in any CUSO or other entity if the NCUA determines that the entity is in danger of becoming insolvent or otherwise poses a significant risk to the corporate.
- Conserve or liquidate the corporate if NCUA determines the corporate has no reasonable prospect of becoming adequately capitalized.
- Requiring the corporate to take any other action that the NCUA determines will better carry out the purpose of this section than any of the actions described in this paragraph.

The NCUA may also impose one or more of the restrictions applicable to critically undercapitalized corporates, discussed below, if the NCUA determines that those restrictions are necessary to carry out the purpose of this section.

Additional provisions applicable to critically undercapitalized corporates.

In addition to the provisions described above for undercapitalized and significantly undercapitalized corporates, the proposal provides that corporates that are critically undercapitalized are subject to additional requirements and restrictions.

A critically undercapitalized corporate must not, beginning 60 days after becoming critically undercapitalized, make any payment of dividends on contributed capital or any payment of principal or interest on the corporate's subordinated debt unless the NCUA determines that the exception would further the purpose of this section. Interest, although not payable, may continue to accrue under the terms of any subordinated debt to the extent otherwise permitted by law. Dividends on contributed capital do not, however, continue to accrue.

The NCUA will, by order, restrict the activities of any critically undercapitalized corporate and prohibit any such corporate from doing any of the following without the NCUA's prior written approval:

- Entering into any material transaction other than in the usual course of business, including any investment, expansion, acquisition, sale of assets, or other similar action.
- Extending credit for any highly leveraged transaction.
- Amending the corporate's charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order.
- Making any material change in accounting methods.
- Paying excessive compensation or bonuses.
- Paying interest on new or renewed liabilities at a rate that would increase the corporate's weighted average cost of funds to a level significantly exceeding the prevailing rates of interest on insured deposits in the corporate's normal market areas.

With regard to the phrase "significantly exceeding the prevailing rates," the prevailing effective yields of interest are the effective yields on insured deposits (or shares) of comparable maturities offered by other insured depository institutions in the market area in which the corporate is soliciting shares. A market area is any readily defined geographic area in which the rates offered by any one insured depository institution operating in the area may affect the rates offered by other institutions operating in the same area. For a corporate, the market could be a national market.

The NCUA may also, at any time, conserve or liquidate a critically undercapitalized corporate or require such a corporate to combine, in whole or part, with another institution. NCUA will consider, not later than 90 days after a corporate becomes critically undercapitalized, whether NCUA should liquidate or conserve the institution.

Paragraph 704.4(g) Directives to take prompt corrective action.

The proposed rule states that the NCUA will provide an undercapitalized, significantly undercapitalized, or critically undercapitalized corporate prior written notice of the NCUA's intention to issue a directive requiring such corporate to take actions or to follow restrictions described in this part. Proposed §747.3002 of this chapter, discussed below, prescribes the notice content and associated process.

Paragraph 704.4(h) Procedures for reclassifying a corporate based on criteria other than capital.

This provides that when the NCUA intends to reclassify a corporate or subject it to the supervisory actions applicable to the next lower capitalization category

based on an unsafe or unsound condition or practice the NCUA will provide the credit union with prior written notice of such intent. Proposed §747.3003 of this chapter, discussed below, prescribes the notice content and associated process.

Paragraph 704.4(i) Order to dismiss a director or senior executive officer.

This provides that when the NCUA issues and serves a directive on a corporate requiring it to dismiss from office any director or senior executive officer, the NCUA will also serve upon the person the corporate is directed to dismiss (Respondent) a copy of the directive (or the relevant portions, where appropriate) and notice of the Respondent's right to seek reinstatement. Proposed §747.3004 of this chapter, discussed below, prescribes the content of the notice of right to seek reinstatement and the associated process.

Paragraph 704.4(j) Enforcement of directives.

This proposed paragraph cross references proposed §747.3005, discussed below, on the process for enforcement of directives.

Paragraph 704.4(k) Remedial actions towards undercapitalized, significantly undercapitalized, and critically undercapitalized corporates.

This proposed paragraph describes the various PCA remedial actions, discussed in detail in the section of paragraph 704.4(f) above.

Proposed subpart M of part 747-- Issuance, Review and Enforcement of Orders Imposing Prompt Corrective Action on Corporates.

Proposed subpart M of part 747 provides an affected corporate, and its officials and employees, with due process related to certain NCUA actions taken under proposed §704.4 establishing PCA for corporates. Proposed subpart M is similar to the current subpart L, which sets forth the applicable due process for natural person credit union PCA under part 702 of NCUA's rules. 12 CFR 702. A section-by-section analysis of subpart M follows.

Section 747.3001 Scope.

Section 747.3001 establishes an independent process for appealing certain NCUA decisions to impose PCA under part 704.4. In the case of state charted corporates seeking independent review under subpart M, this section provides that the parties (*i.e.,* NCUA and corporate and/or a dismissed director or officer) will serve upon the appropriate State official the documents filed or issued in connection with a proceeding under subpart M.

Section 747.3002 Discretionary supervisory actions (DSAs).

Section 747.3002 provides for prior notice and an opportunity to be heard before a DSA is imposed. The NCUA Board must give advance notice of its intention to impose a DSA, 12 CFR 747.3002(a)(1), except when necessary to further the purpose of PCA. 12 CFR 747.3002(a)(2). The corporate may then challenge the proposed action in writing and request that the DSA not be imposed or be modified. 12 CFR 747.3002(c). The corporate, however, is not entitled to a hearing. The NCUA, or an independent person designated by the NCUA, may then decide not to issue the directive or to issue it as proposed or as modified, 12 CFR 747.3002(d); and that decision is final. A corporate which already is subject to a DSA may request reconsideration and rescission due to changed circumstances. 12 CFR 747.3002(f).

In general, this system avoids involving panels or councils in the appeal process, and expanding it beyond an opportunity to be heard in writing, because this would undermine the overall objective of PCA, that is, to take prompt action. On the other hand, a time limit, as contained in the proposal, for the NCUA to decide on requests to modify, to not issue, or to rescind DSAs is appropriate. Accordingly, the rule includes in §747.3002(f) the safeguard that if NCUA fails to decide a request to modify or rescind an existing DSA within 60 days, that DSA will be deemed modified or rescinded.

Section 747.3003 Reclassification to lower capitalization category.

The NCUA is authorized to reclassify a corporate to the next lower capital category on grounds of an unsafe or unsound practice or condition, provided the corporate is first given notice and an opportunity for a hearing. 12 CFR 704.4(d)(3). In such cases, therefore, §747.3003 requires the NCUA to give notice of the NCUA's intention to reclassify a corporate, 12 CFR 747.3003(a), and describe the practice(s) and/or condition(s) justifying reclassification. 12 CFR 747.3003(b). The corporate may then challenge the reclassification, provide evidence supporting its position, and request an informal hearing and the opportunity to present witnesses. 12 CFR 747.3003(c).

If the corporate requests a hearing, an informal hearing will be conducted by a presiding officer designated by the NCUA. 12 CFR 747.3003(d). At the hearing, the corporate or its counsel may introduce relevant documents, present oral argument, and, if authorized, present witnesses. 12 CFR 747.3003(e). The presiding officer then makes a recommended decision to the NCUA, 12 CFR 747.3003(e)(4), who then issues a final decision whether to reclassify the corporate. 12 CFR 747.3003(f).

Section 747.3004 Dismissal of director or senior executive officer.

The NCUA is authorized to issue a DSA directing a corporate to dismiss a director or senior executive officer. 12 CFR 704.4(k)(3)(ii)(F). In such cases, §747.3004 requires the NCUA Board to serve the dismissed person with a copy of the directive issued to the corporate, accompanied by a notice of the right to seek reinstatement by the NCUA Board. 12 CFR 747.3004(a)-(b). That person may then challenge the dismissal and request for reinstatement, and may request an informal hearing and the opportunity to present witness testimony.[51] 12 CFR 747.3004(c). The dismissal remains in effect while the request for reinstatement is pending. 12 CFR 747.3004(g).

If a hearing is requested, an NCUA-designated presiding officer conducts the hearing under procedures identical to those which §747.3003 prescribes in cases of reclassification, with two exceptions. First, the dismissed person bears the burden of proving that his or her continued employment would materially strengthen the corporate's ability to become "adequately capitalized" or to correct an unsafe or unsound condition, as the case may be. 12 CFR 747.3004(e)(4). Second, if the NCUA's final decision is to deny reinstatement, it must provide reasons for its decision. 12 CFR 747.3004(f).

Section 747.3005 Enforcement of orders imposing prompt corrective action.

When a corporate fails to comply with a mandatory supervisory action (MSA) or DSA, the NCUA Board may apply to the appropriate U.S. District Court to enforce that action. 12 CFR 747.3005(a). Alternatively, the NCUA Board may assess a civil money penalty against a corporate (and any institution-affiliated party acting in concert with it) which violates or fails to comply with an MSA or DSA, or fails to implement an approved capital restoration plan. 12 CFR 747.3005(b). Finally, subpart M allows the NCUA Board to enforce an MSA or DSA under §704.4 "through any other judicial or administrative proceeding authorized by law." 12 CFR 747.3005(c).

Phase-in of proposed capital and PCA requirements.

The Board intends to phase-in the proposed capital and PCA requirements over time. Details about the proposed phase-in are contained in subsection III.D. below.

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[51] The corporate directed to dismiss a director or officer may not seek reinstatement of the dismissed director or officer under §747.3004, but that corporate may challenge the directive under §747.3002.

III.C. Amendments to part 704 relating to corporate investments and asset-liability management.

The proposal contains amendments to the part 704 investment authorities. These proposed amendments work in conjunction with the asset-liability management provisions of the regulation to prevent excessive concentrations of risk. By limiting investment types and concentrations in combination with more comprehensive risk assessment requirements, the proposal establishes a more rigorous framework for identifying, measuring, monitoring, and controlling a corporate's balance sheet risks – and does so in a manner consistent with the avowed conservative principles of corporate credit union mission.

In formulating the proposed changes to investment authorities and asset-liability management, NCUA incorporated lessons learned from both its recent experience with corporate investment portfolios and their associated losses, as well as comments received from the ANPR. NCUA determined that three major risk conditions were the primary contributors to the current losses in the corporate system: (1) excessive investment sector concentrations; (2) excessive average-life mismatches between assets and liabilities; and (3) excessive concentrations in subordinated securities, including mezzanine securities.

The proposed revisions to the investment and asset-liability provisions of the corporate rule restrict these risk conditions in the aggregate through the use of limits tied to a corporate credit union's capital. The intent of the proposed revisions is to provide a framework that allows for a level of risk-taking necessary to support the profitability of a corporate but which will be continuously and adequately supported by the corporate's capital. Sufficient capital prevents losses from adversely affecting corporate members and the entire credit union industry. As illustrated in more detail in subsection III.E. below, the proposed revisions, had they been in place prior to 2007, would have significantly reduced the current losses in the corporate system.

NCUA believes that placing restrictions on investment authorities without concomitant limits on asset-liability management could still result in corporate credit unions assuming excessive risk positions. Accordingly, members of the public are encouraged to consider the combined effects of the revised investment and asset-liability management authorities and restrictions when submitting comments to NCUA.

In addition to the amendments to part 704 investment authorities, NCUA also intends to revise corporate credit union reporting requirements on the 5310. The goal of the additional reporting requirements will be for readers to have a clear and comprehensive view of the financial condition of corporate credit unions. Likely additions and modifications to the current 5310 will include: (1) credit

ratings and sector concentrations by book and market value; (2) average lives and durations, spread and effective, of a corporate credit unions assets and liabilities; and (3) additional disclosure on pricing sources and pricing level.

Section 704.5 Investments.

The current §704.5 describes permissible corporate investments and the limits on those investments. Corporate investment authority is somewhat different than the investment authority for natural person federal credit unions.

One hundred thirty eight commenters responded to the ANPR question on whether corporate investments should be limited to those permissible for natural person credit unions. Thirty-four commenters were in favor of the proposal, but 104 were opposed. The NCUA Board agrees with the commenters opposed to limiting corporate credit union investment authorities to those provided to natural person credit unions. Corporate credit unions and natural person credit unions have different balance sheet dynamics and business models and serve different types of members. As such, an alignment of investment authorities for the sake of parity may not be prudent. Ninety-four commenters discussed the question of prohibiting specific investment authorities. Sixty-three supported some prohibitions, while 31 did not. The NCUA Board concurs with the commenters that some investment types that are permissible under the current regulation are not appropriate for corporate credit unions.

Accordingly, the proposal amends paragraph 704.5(h) to prohibit corporate credit unions from making investments in collateralized debt obligations and net interest margin securities.

Collateralized debt obligations (CDOs) are defined in §704.2 as a debt security collateralized by mortgage- and asset-backed securities or corporate obligations in the form of loans or debt. *Net interest margin securities* (NIMs) are defined in §704.2 as securities collateralized by residual interests in (1) collateralized mortgage obligations, (2) real estate mortgage investment conduits, or (3) asset-backed securities. *Residual interests* are further defined in §704.2 as the ownership interest in remainder cash flows from a CMO or ABS transaction after payments due bondholders and trust administrative expenses have been satisfied.

Both CDOs and NIMs have concentrated risk attributes (i.e., they are highly leveraged by design) and complex cash flow rule structures that make them susceptible to excessive losses. These high-risk investments are also inherently less liquid and more price volatile than other investments backed by similar collateral, making them inappropriate investments for corporate credit unions.

Although Re-REMICs are technically collaterized debt obligations, the proposal excludes senior tranches of Re-REMICs consisting of senior mortgage- and asset-backed securities from the CDO definition. Accordingly, these Re-REMICs, which do not have the excessive risk characteristics of other CDOs, are permissible investments provided they fall within the other investment and asset-liability restrictions of the rule.

Mortgage-related securities.

The proposal eliminates the phrase *mortgage-related security* (MRS) from part 704 because it is unnecessary and potentially confusing. The current part 704 permits corporates to invest in domestic *asset backed securities*, a term which includes *mortgage-backed securities* (MBS), that is, a type of security backed by first or second mortgages on real estate upon which is located a dwelling, mixed residential and commercial structure, a residential manufactured home, or a commercial structure. 12 CFR 704.5(c)(5), 704.2 (definition of ABS and MBS). MRS are a limited subset of MBS, and so references to MBS, and not MRS, are appropriate in the corporate rule.[52] Of course, a corporate may not invest in any MBS, or any other ABS, unless the security satisfies the other requirements of part 704, including the minimum NRSRO rating requirements and the prohibitions on certain investments, such as strips, residuals, CDOs, and NIMs. 12 CFR 704.5(h).

Expanded investment authorities.

The current part 704 provides that corporates that meet certain requirements may qualify for expanded investment authorities. Those expanded authorities, currently labeled as *Base-plus*, *Part I*, *Part II*, *Part III*, *Part IV*, and *Part V*, are described in Appendix B of part 704. Base-plus expanded authority permits slightly greater declines in NEV when subjected to interest rate shocks. Part I expanded authority allows for the purchase of certain investments with lower NRSRO ratings, provides for additional categories of permissible investments, and permits greater declines in NEV when subject to interest rate shocks. Part II expanded authority is similar to Part I, but provides even more leeway. Parts III, IV, and V relate to foreign investments, derivative transactions, and loan participation authority, respectively.

The ANPR sought comments on the continued need for expanded authorities for corporate credit unions. Of the 164 commenters who discussed the topic of expanded authorities, 110 deemed expanded authorities appropriate and

[52] Natural person federal credit unions may invest in MRS, as permitted by 12 U.S.C. 1757(15), but are generally not permitted to invest in ABS or MBS that are not also MRS.

necessary for corporate credit unions, while 54 commenters thought the expanded authorities should be reduced or eliminated. Seventy-five of these commenters discussed whether NCUA should change the eligibility requirements and/or require periodic requalification for expanded authorities, with 68 commenters favoring changes and seven opposed.

Many commenters opposed to expanded authorities suggested that reliance on the authorities is a large contributor to the current problems facing corporate credit unions. Many of these commenters believe the authorities are no longer beneficial or necessary. Other commenters argued that the current economic problems confronting the corporate system were not, in fact, caused by reliance on expanded authorities.

Supporters of expanded authorities noted that corporates must be allowed to earn a return on their investments above their cost of funds and the use of expanded authorities, when properly done, facilitates this level of return and benefits the entire credit union system. Some of these commenters suggested that NCUA should consider even broader investment authorities for corporate credit unions. These commenters argue that the current limits on corporate credit union investment authority require a corporate to overexpose itself to securities backed by mortgages, auto loans, and credit card receivables, which forces concentration into the same products that natural person credit unions are exposed to and increases risk throughout the credit union industry.

Many of those supporting the continuation of expanded authorities stated that NCUA should adopt stronger capital requirements and more conservative concentration limits to help manage the associated risks. Additional suggestions included enhanced safety and soundness oversight, establishment of education and experience standards for corporate staff who oversee investments, and ongoing requalification of corporates that have been approved for expanded authority. Commenters strongly supported risk-based capital levels commensurate with any additional investment risk associated with the use of expanded authorities.

The NCUA Board agrees that expanded authorities for corporate credit unions do offer benefits to the entire credit union system. The Board does, however, believe stronger controls in this area are appropriate. Accordingly, the proposed rule revises the qualification criteria, and elements of, Base-plus and Part I authority, and eliminates the current Part II authority.

To qualify for Part I authority, the proposal adds a requirement that a corporate achieve and maintain a leverage ratio of at least six percent, meaning that its tier 1 capital, divided by its moving DANA, must equal or exceed six percent.

Part I currently permits investments with lower NRSRO ratings, and, to control for credit risk, proposed paragraph (e) limits the aggregate investments purchased under the authority of Part I to the lower of 500 percent of capital or 25 percent of assets. Paragraph (b) of Part I also currently permits qualifying corporates to engage in repurchase and securities lending agreements in an amount up to 300 percent of capital with any one counterparty, but the proposal removes this provision, thus limiting all such transactions to 200 percent of capital. 12 CFR 704.6(c)(2)(i).

The current rule further also provides that, as part of the interest rate shock test, a Part I corporate's NEV may decline as much as 28 percent if the corporate has a minimum capital ratio of at least five percent and as much as 35 percent if the corporate has a minimum capital ratio of at least six percent. The proposal, after a 12 month phase-in, replaces the capital ratio with the new leverage ratio, and replaces 5 and 6 percent with 7 and 8 percent, respectively. The proposal makes similar changes to Part I authority with regard to the new Asset-Liability NEV test, discussed further in connection with the amendments to §704.8 below.

The proposal also eliminates Part II authority (which permits investments down to the lowest investment grade) in its entirety. In the past, corporates did not use much of the Part II authority they had, and those corporates that did use the authority generally used it only to continue to hold downgraded investments and avoid divestiture. Prices of securities also tend to drop precipitously once an investment's credit rating falls to non-investment grade, so it is prudent to avoid the threat that a further single credit category downgrade might lead to additional impairment of asset values.

The proposal also modifies the current Part IV authority on derivatives to ensure that corporates do not use derivatives to take on additional risk, but only use derivatives to mitigate interest rate and credit risk or to create structured products equivalent to what a corporate could purchase directly.

Due to the elimination of Part II, the proposal renumbers the current Parts III, IV, and V authorities as Parts II, III, and IV, respectively. Also, a corporate that currently qualifies for a particular expanded authority may continue to use that authority without seeking requalification if the corporate meets the new requirements in the final rule. For Parts I and II, those new requirements include a six percent minimum total capital ratio, and, one year after publication of the final rule in the Federal Register, a six percent minimum leverage ratio.

Investments in investment companies.

Paragraph (f) currently permits a corporate credit union to invest in an investment company registered with the Securities and Exchange Commission under the

Investment Company Act of 1940 where the prospectus restricts the investment portfolio to investments and investment transactions that are permissible for that corporate credit union to engage in directly. The proposal amends the paragraph to permit investment in collective investment funds maintained by a national bank or a mutual savings bank subject to the same requirement that the fund limit its investment and investment transactions to those that are permissible direct investments for corporates.

Miscellaneous revisions to investment definitions.

The proposal contains several miscellaneous revisions, and additions, to the investment definitions.

The proposal adds a definition of *Nationally Recognized Statistical Rating Organization* (NRSRO) that recognizes that NRSROs are designations made by the United States Securities and Exchange Commission. The proposal amends the definitions of *derivatives contract*, *equity investment*, and *equity security* so that they stand alone without external cross-references. The proposal eliminates references to *regular way settlement*, and the definition of that term, in favor of a simpler reference to *investment settlement*. The proposal amends the definition of *residual interest* to clarify that it represents the ownership interest in certain cash flows.

Section 704.6 Credit risk management.

The current §704.6 includes a single obligor concentration limit. The rule also requires that a corporate have a credit risk management policy that addresses certain concentrations of risk, but does not dictate sector concentrations. Additionally, the current rule requires that all corporate investments, other than in another corporate or a CUSO, have a credit rating from at least one NRSRO of no lower than AA- for long term ratings and A-1 for short term ratings.

There was strong support among the ANPR commenters for additional regulation of concentration limits. Seventy-nine of 89 commenters favored adoption of stronger concentration limits. Some commenters, however, expressed concern about the possibility that sector limits could actually force corporates to over-diversify into the more risky sectors and thus increase risk.

The current rule generally limits investments in any single obligor to 50 percent of capital or $5 million, whichever is greater. 12 CFR 704.6(c). The proposed rule reduces this 50 percent single obligor limit to 25 percent.

The Board believes the current, general limit of 50 percent of capital is too high and presents excessive potential risk to corporate credit unions. The 25 percent

limit encourages risk diversification, alleviates excessive concentration of risk exposure with any one obligor, and protects corporate credit unions' ongoing ability to serve as liquidity providers.

The Board also believes that the current rule has not resulted in effective corporate policies on sector investment concentrations. Accordingly, the proposed rule adds a new paragraph 704.6(d) establishing explicit regulatory concentration limits by discreet investment sector.

The proposed sector concentration limits are divided into ten asset classes: (1) residential mortgage-backed securities; (2) commercial mortgage-backed securities; (3) Federal Family Education Loan Program (FFELP) student loan asset-backed securities; (4) private student loan asset-backed securities; (5) auto loan/lease asset-backed securities; (6) credit card asset-backed securities; (7) other asset-backed securities; (8) corporate debt obligations; (9) municipal securities; and (10) registered investment companies. The proposal also adds several related definitions to §704.2. *Mortgage-backed security* (MBS) means a security backed by first or second mortgages secured by real estate upon which is located a dwelling, mixed residential and commercial structure, residential manufactured home, or commercial structure. *Commercial MBS* means an MBS collateralized primarily by multi-family and commercial property loans. *Residential MBS* means an MBS collateralized primarily by residential mortgage loans. The proposal also modifies the existing definition of asset-backed security (ABS) to clarify that, generally, MBS are a type of ABS.

The maximum amount of a corporate's investment in each of these ten sectors is limited to a certain multiple of capital: either the lower of 500 percent of capital or 25 percent of assets, or the lower of 1000 percent of capital or 50 percent of assets. In formulating the proposed sector concentration limits, the Board considered various factors. For example, the Board wanted to ensure adequate diversification of investments across a range of asset types considered appropriate for the stable liquidity, NEV and capital levels expected to be maintained by corporates. The Board also wanted to ensure, however, that the sectors and sector limits did not force a corporate to "overdiversify." In other words, the Board wanted to permit a corporate to concentrate in two or three less risky sectors, or to avoid investing in certain sectors altogether, if that was the corporate's desired course of action.

Accordingly, the rule places a lower of 1000 percent of capital limitation or 50 percent of assets on each of these three sectors: corporate debt obligations, municipal securities, FFELP student loan asset-backed securities, and registered investment companies, and places a more restrictive limit of the lower of 500 percent of capital or 25 percent of assets on the other sectors. The higher limits for corporate debt obligations and municipal securities allow a corporate the

flexibility and option to invest away from securitized bonds, if they choose to do so. The higher limit for FFELP student loan asset-backed securities is appropriate since the U.S. Department of Education reinsures a vast majority of the underlying student loan balances. The lower of 500 percent of capital limits or 25 percent of assets for the remaining sectors ensure that a corporate has prudent diversification when investing in non-government securities. Both USC and WesCorp, the two conserved corporates, would have had substantially less losses if non-government residential mortgage-backed securities had been limited to the lower of 500 percent of capital or 25 percent of assets**,** working in conjunction with the proposed subordinated security limitations prior to 2007. The hypothetical effect of this concentration limit, and other aspects of the proposed rule, on U.S. Central's and WesCorp's historical balance sheets is discussed in more detail in subsection III.E. below.

Sector concentration limits ensure that the composition of the investment portfolio is consistently more diversified across various asset types. The asset classes and concentration limits are necessarily broad to allow for various portfolio mixtures and changing market factors. While the limits allow for significant portions of the investment portfolio to be placed in a specific asset type, they are restrictive enough to force any particular corporate to hold multiple asset types at all times. These sector concentration limits -- when combined with the tighter single obligor, short weighted average life, and limited subordinated securities restrictions -- substantially reduce the threat of excessive credit risk to corporate earnings and capital.

The Board invites comment on whether there should be additional concentration sublimits in any of these sectors. For example, the Board is interested in whether it should impose further limits on corporate debt obligations by industry of the obligor.

In addition to the 1000 percent of capital or 50 percent of assets for registered investment companies (i.e., mutual funds), the corporate must identify the underlying assets in each fund. The corporate must then categorize each asset into one of the other nine sectors and include those assets when calculating compliance with those sector limits. If current data on the underlying assets is not readily available, the corporate can use the most recent available data. Also, a corporate may only invest in a registered investment if the fund's prospectus limits the fund to investments otherwise permissible for direct corporate investment.

The proposal also includes a catchall sector in paragraph 704.6(d)(2). A corporate credit union must limit its aggregate holdings in any investments that do not fall within one of the ten sectors above to the lower of 100 percent of

capital or five percent of assets. To provide flexibility for the development and use by corporates of new investment types, the NCUA may approve a higher limit in appropriate cases.

The proposal excludes certain assets entirely from both the proposed sector concentration limits and the single obligor concentration limit, including fixed assets, loans, investments in CUSOs, investments issued by the United States or its agencies or its government sponsored enterprises, and investments fully guaranteed or insured as to principal and interest by the United States or its agencies. Investments in other federally-insured credit unions, deposits in other depository institutions, and investment repurchase agreements are also excluded from the sector concentration limits but not the single obligor concentration limit.

The proposal amends paragraph 704.6(d)(4), renumbered to 704.6(f)(5), to clarify that if any investment group or asset class fails the single obligor, or sector, concentration limit, at the time of purchase or after the time of purchase, then all the investments of that obligor, or in that asset class, are subject to the investment rule's investment action plan requirements. 12 CFR 704.10. Although the new sector concentration limits and changes to the single obligor concentration limit are effective immediately, they will not require automatic divestiture of any existing asset held by a corporate credit union on the effective date of the rule. Accordingly, the Board does not believe that corporate credit unions need a transition period before the sector concentration limits become effective.

In addition to the new obligor and sector concentration limits, the proposal adds a new paragraph 704.6(e) that further limits a corporate's investments in subordinated securities. Holders of subordinated debt are accorded a low priority in the event of insolvency and liquidation. Subordinated securities present greater credit risk, liquidity risk, price volatility, and ratings volatility than more senior securities. All these factors combine to make any significant concentration in subordinated securities inappropriate for a corporate's portfolio. Accordingly, the proposal limits a corporate's aggregate investment in subordinated securities to the lower of 400 percent of capital or 20 percent of assets and the amount of subordinated securities in any single asset sector to the lower of 100 percent of capital or 5 percent of assets.

The proposal includes the following definition of subordinated security to §704.2:

> *Subordinated security* means a security that has a junior claim on the underlying collateral or assets to other securities in the same issuance. If a security is junior to only to money market fund eligible securities in the same issuance, the former security is not subordinated for purposes of this definition.

This definition covers all support tranches, including senior mezzanine tranches. The definition also includes securities with performance “triggers” that could cause the security to assume a junior claim position.

The proposed limitations on subordinated securities, working in conjunction with the proposed sector limitations on non-government residential MBS, would have – assuming both limits had been in effect prior to 2007 -- prevented a substantial amount of the current MBS losses experiences by U.S. Central and WesCorp. This is explained in greater detail in subsection III.E.below.

The current paragraph 704.6(d) provides that all corporate investments, other than in a corporate credit union or CUSO, must have an applicable credit rating from at least one nationally recognized statistical rating organization (NRSRO). Many ANPR commenters expressed support for decreased reliance on NRSRO ratings, with 89 of 122 commenters in favor of tighter regulation in this area. Some of these commenters suggested requiring a consensus of three NRSROs, and some suggested requiring that ratings only be used for the purpose of excluding investments, not including them, in an investment portfolio.

The Board believes that credit ratings constitute potentially useful information about credit risk, but expects corporates to avoid reliance on individual ratings or NRSROs as a primary criterion of purchase suitability. Several provisions of this proposal act to reduce the effect of NRSRO reliance, including the new sector concentration limits and the limits on subordinated securities, discussed above, and the restrictions on average-life mismatches discussed later in this section.

The proposal also amends the current paragraph 704.5(d), and renumbers it as 704.5(f), to place two new, specific limits on the use of NRSROs. First, the proposal requires a corporate use the lowest available NRSRO rating for compliance purposes. NRSRO rating changes may lag changes in the financial condition of the entity or instrument being rated, particularly in the case of downgrades, and so the corporate should be required to respond to the first such NRSRO downgrade. Second, the proposal requires that a minimum of 90 percent of a corporate’s investment holdings, by book value, must be rated by at least two NRSROs. This will ensure ratings diversification, will further reduce reliance on individual NRSROs, and will result in a more timely identification of credit problems with particular investments. The proposal also requires that a corporate monitor any new post-purchase NRSRO ratings on investments it holds.

Finally, the proposal requires that a corporate address, in its policies, the treatment of concentration risk related to servicers of receivables, collateral type, and tranche priority.

§ 704.8 Asset and liability management.

The current §704.8 contains several asset-liability management (ALM) provisions. The rule requires a corporate establish an asset and liability management committee, charge a market-based penalty on early withdrawals sufficient to cover replacement cost of a redeemed certificate, adopt a written ALM policy that includes modeling for interest rate risk (IRR) sensitivity and affect on net economic value (NEV), and assess on an annual basis whether the corporate should do additional NEV modeling. 12 CFR 704.8.

The ANPR proposed a number of possible actions to further reduce the level of risk in corporate credit union balance sheets, including the implementation of cash flow duration requirements and additional, mandatory stress testing. Of the 104 comments directed to this issue, 94 supported some action in this area. The NCUA Board generally agrees with these commenters and is proposing several new ALM requirements in an effort to better identify, measure, monitor and control future risk.

Maximum redemption value for share certificates.

While not specifically addressed in the ANPR, the Board recognizes the need for more stability within the liabilities on a corporate credit union's balance sheet. While the current rule requires market-based early withdrawal penalties, the liquidity problems faced by corporates can be exacerbated by permitting members to redeem certificates a premium, that is, a price higher than book value. Accordingly, the proposal amends paragraph 704.8(b) to permit redemption at the lesser of book value plus accrued dividends or the value based on a market-based penalty sufficient to cover the estimated replacement cost of the certificate redeemed.

Limiting the average-life mismatches between assets and liabilities.

To the extent that a corporate maintains a mismatch between the average life of its assets and liabilities, it becomes exposed to several forms of market risk. A corporate credit union that buys floating rate securities may have minimal exposure to changes in the level of the Treasury yield curve but may have significant risk exposure to changes in credit spreads (a change in yields on non-Treasury instruments relative to market Treasury yields). For example, when a depository invests its assets in a long-term, floating rate security rather than in a short-term security, and the depository is funded with overnight deposits, it is exposed to additional credit spread risk whenever the market spread relationship on that instrument changes vis-a-vis Treasury securities. Short of default, the

price decline of a long-term security is likely to be greater than that of a short-term security, given a deteriorating credit outlook for the issuer.

The Board intends to restrict any mismatch between the principal cash flows of assets and liabilities so as to limit the degree of credit spread duration to which a corporate credit union is exposed**.** In lieu of capturing the repricing risk, the Board decided to limit the base case average-life mismatch between assets and liabilities as well as the change in base case mismatch for given changes in market spreads.

Net economic value (NEV) has traditionally been used by the NCUA to measure interest rate risk (IRR) on a corporate credit union's balance sheet. NCUA adopted the IRR NEV measurement requirement in response to excessive interest rate risks taken in the early to mid 1990's by corporate credit unions. IRR NEV proved to be an effective tool of measuring interest rate risk during periods of relative asset price stability, prior to mid-2007, while providing a less effective measurement of credit spread risk when market values of assets suffered from the systemic shock that began in mid-2007. Accordingly, the Board is now proposing a new paragraph 704.8(e) to require average life (AL) mismatch NEV modeling in addition to the existing IRR NEV modeling. The new AL NEV modeling will help ensure appropriate matching of asset and liability cash-flow durations.

Proposed paragraph 704.8(e) requires an AL NEV stress test to measure the economic impact on capital resulting from a credit spread widening of 300 bp. These spread increases would be applied to both assets and liabilities. The corporate will examine the effect on its absolute NEV and the volatility of its NEV (how much NEV changes for a given stress) in a manner similar to the current §704.8(d) IRR NEV modeling. Specifically, a corporate must limit its risk so that, when the spread widening shock is applied, its NEV ratio does not decline below 2 percent and the NEV itself does not decline more than 15 percent. The proposal specifies that all investments must be tested, excluding derivatives and equity investments, and that all borrowings and shares must be tested, but not contributed capital.

The proposed rule will also add a new paragraph 704.8(f) with a separate spread widening test that assumes a 50 percent slowdown in prepayment speeds. This additional test will force a corporate to structure its assets and liabilities so that, when the spread widening shock is applied, its NEV ratio does not decline below 1 percent and the NEV itself does not decline more than 25 percent. This additional test will help determine if a potential extension of a corporate's average life mismatch is within an acceptable limit.

For example, consider a corporate with a five percent base case NEV. Applying the §704.8(e) base AL NEV test, the proposed regulatory limits -- that is, that the NEV ratio not decline below two percent and the NEV itself not decline more than 15 percent -- will permit this corporate to operate with an approximate average-life mismatch of up to 0.25 years. Applying the §704.8(f) AL NEV test with its 50 percent slowdown in prepayment speeds, the proposed regulatory limits – that is, that the NEV ratio not decline below 1 percent and the NEV itself not decline more than 25 percent – will permit this corporate an additional mismatch extension of up to 0.2 years. These proposed AL NEV tests, of course, are designed to permit greater average-life mismatches as a corporate's base case NEV level moves higher, just as with the current IRR NEV modeling.

The proposed rule employs a conservative approach when NEV testing for dealing with assets and liabilities with embedded options. The rule imposes conservative treatment of non-mandatory issuer options, i.e., issuer call options, by assuming they are not exercised. Additionally, the proposed rule balances this conservative approach against the lack of a requirement for a corporate to shorten liabilities based on anticipated or potential early redemption of share certificates. The NCUA, however, will be monitoring the issuance of liabilities with long maturities and short calls to determine if they are issued to manipulate NEV measures and may, among other things, mandate a greater capital requirement. See the proposed §704.3(e).

New paragraphs (e)(2) and (f)(2) also require corporates to measure the effect that failed triggers, e.g., delinquency triggers and cumulative loss triggers, have on average-life NEVs. Many non-government mortgage-backed securities, and other securitized securities, redirect cash-flows if delinquencies or losses increase to a predetermined level because of a failed trigger. The effects of the redirected cash-flows should be measured and understood by corporate credit unions.

Below are two examples that illustrate both the current IRR NEV calculation and the proposed, new average life (AL) NEV calculation using a simplified corporate balance sheet. These examples are intended to provide the reader with a better understanding the current and proposed rules.

Sample Corporate Credit Union "A" Balance Sheet. [53]

Assets	Weighted Average	Modified Duration	Par Value	Market Value

[53] This is a simplified balance sheet and simplified examples. Each corporate credit union will likely, depending on its particular balance sheet, need to employ more granular information and sophisticated modeling.

	Life (years)			
Private Label MBS (2)	2	0.083	$1,000,000	$1,000,000
ABS (3)	1.5	0.8	$2,000,000	$2,000,000
Corporate Bonds & Member Loans (3)	1.5	0.90	$3,000,000	$3,000,000
Cash and Cash Equivalent Investments (1)	0.1	0.1	$3,850,000	$3,850,000
Capital Instruments (PCC or NCA) (2)	3	0.083	$50,000	$50,000
Property	N/A	N/A	$50,000	$50,000
CUSO Equity	N/A	N/A	$50,000	$50,000
Total (Capital Notes and Property not included in WAL and duration)	1.01	0.48	$10,000,000	$10,000,000
Liabilities	**Weighted Average Life (years)**	**Modified Duration**	**Par Value**	**Market Value**
Overnight and Short-Term Deposits (1)	0.1	0.1	$7,500,000	$7,500,000
Long-Term Certificates (1)	1.0	0.95	$1,500,000	$1,500,000
Borrowings (2)	2.0	0.24	$450,000	$450,000
Total	0.34	0.24	$9,500,000	$9,500,000
Base Case NEV				$500,000
Capital Instruments (PCC or NCA) (2)	3	0.083	$50,000	$50,000
Retained Earnings	N/A	N/A	$450,000	$450,000

1-Fixed rate, 2- Floating Rate, and 3- both Fixed and Floating Rate

The sample balance sheet is for a corporate credit union with NEV ratio (base case NEV/Fair market value of assets) of 5 percent. The current IRR NEV requires the corporate credit union to evaluate the impact of an instantaneous, permanent, and parallel shock of the yield curve of plus and minus 100, 200, and 300 bp on its IRR NEV ratio and IRR NEV volatility. Corporate credit unions must consider the effects on prepayment speeds when performing the rate shocks. Results of the rate shocks must not result in NEV ratio declining below 2 percent or a decline of NEV (NEV volatility) of more than 15 percent (expanded

authorities allow for greater NEV volatility). A corporate credit union must also include the effects of interest rate derivative exposure when performing the rate shocks.

Corporate Credit Union A: 300 bp Increase in Interest Rates.

Assets	**Weighted Average Life (years)**	**Modified Duration**	**Par Value**	**Market Value**
Private Label MBS (2)	3.00	0.083	$1,000,000	$997,510
ABS (3)	1.70	0.900	$2,000,000	$1,946,000
Corporate Bonds & Member Loans (3)	1.50	0.900	$3,000,000	$2,919,000
Cash and Cash Equivalent Investments (1)	0.10	0.100	$3,850,000	$3,838,450
Capital Instruments (PCC or NCA) (2)	3.00	0.083	$50,000	$49,876
Property	N/A	N/A	$50,000	$50,000
CUSO Equity	N/A	N/A	$50,000	$50,000
Total (Capital Notes and Property not included in WAL and duration)	1.16	0.500	$10,000,000	$9,850,836
Liabilities	**Weighted Average Life (years)**	**Modified Duration**	**Par Value**	**Market Value**
Overnight and Short-Term Deposits (1)	0.10	0.10	$7,500,000	$7,477,500
Long-Term Certificates (1)	1.00	0.95	$1,500,000	$1,457,250
Borrowings (2)	2.00	0.24	$500,000	$496,400
Total	0.34	0.24	$9,500,000	$9,431,150
+300 Basis Point NEV				$419,686
Capital Instruments (PCC or NCA) (2)	3,00	0.083	$50,000	$50,000
Retained Earnings	N/A	N/A	$450,000	$450,000

1-Fixed rate, 2- Floating Rate, and 3- both Fixed and Floating Rate

In the example above, Corporate A is shocked with a 300 basis point (bp) increase in interest rates. Its IRR NEV ratio falls to 4.26 percent ($419, 686/$9,850,836) and the plus 300 basis point IRR NEV volatility is 14.80 percent ([5.00%-4.26%]/5.00%]. Corporate A would have been within regulatory compliance since its IRR NEV ratio still exceeds 2 percent and its NEV volatility was lower than 15 percent.

The plus 300 bp shock above assumed that prepayment speeds for amortizing securities would slow in an up rate scenario. The slowdown in prepayment speeds would account for the extended average lives and durations in the MBS and ABS holdings.

The proposed AL NEV measure uses the framework of the IRR NEV, but modifies it to measure and limit the mismatch of average lives of the assets and liabilities related to a corporate's shares, certificates, and borrowings. A 300 basis point credit spread widening, as opposed to changes in interest rates, is used to shock the portfolio and determine if the average life mismatch between assets and liabilities is excessive for the corporate credit union's base net economic value. The proposal requires that the spread widening not result in NEV ratio declining below 2 percent or the NEV volatility of more than 15 percent (expanded authorities allow for greater IRR NEV volatility). The proposal also requires a secondary AL NEV test with a 50 percent slowdown in prepayment speeds to determine if a corporate has excessive average life extension risk.

Corporate Credit Union A: 300 bp Spread Widening.

Assets	Weighted Average Life (years)	Modified Duration	Par Value	Market Value
Private Label MBS (2)	2.00	0.083	$1,000,000	$943,600
ABS (3)	1.50	0.80	$2,000,000	$1,915,200
Corporate Bonds & Member Loans (3)	1.50	0.90	$3,000,000	$2,872,700
Cash and Cash Equivalent Investments (1)	0.10	0.10	$3,850,000	$3,838,450
Capital Instruments (PCC or NCA) (2)	N/A	N/A	$50,000	$50,000
Property	N/A	N/A	$50,000	$50,000
CUSO Equity	N/A	N/A	$50,000	$50,000
Total (Capital Notes and Property not included in WAL	1.01	0.48	$10,000,000	$9,719,950

and duration)				
Liabilities	**Weighted Average Life (years)**	**Modified Duration**	**Par Value**	**Market Value**
Overnight and Short-Term Deposits (1)	0.10	0.10	$7,500,000	$7,477,500
Long-Term Certificates (1)	1.00	0.95	$1,500,000	$1,457,250
Borrowings (2)	2.00	0.24	$450,000	$425,000
Total	0.34	0.24	$9,500,000	$9,359,750
+300 Basis Point NEV				$360,200
Capital Instruments (PCC or NCA) (2)	3.00	0.083	$50,000	$50,000
Retained Earnings	N/A	N/A	$450,000	$450,000

1-Fixed rate, 2- Floating Rate, and 3- both Fixed and Floating Rate

In the example above, we see that, after a 300 bp spread widening, Corporate A's AL NEV ratio is 3.71 percent ($360,200/$9,719,950) and its AL NEV volatility is 25.80 percent ([5.00%-3.71%]/5.00%]. So Corporate A would have been within regulatory compliance with regard to its AL NEV ratio, but the corporate would have failed the AL NEV volatility portion of the proposed requirement.

This secondary AL NEV measurement that assumes a 50 percent slowdown in prepayment speeds helps model the effect of extension risk on the average life mismatches between assets and liabilities. Slower prepayment speeds will extend securities that amortize based on the payments of the underlying collateral. Securities with more sensitivity to changes in prepayment speeds will suffer greater declines in value when applying the spread widening and prepayment speed slowdown, all else being equal. The proposal permits additional volatility in this particular AL NEV test, from 15 percent to 25 percent (expanded authorities allow for greater AL NEV volatility in the 50 percent slowdown in prepayment speed measure), and also allows for a lower minimum NEV ratio requirement of 1 percent.

These new AL NEV measurements, unlike the IRR NEV measurement, do not include the effect of interest rate derivatives and capital note assets. Interest rate derivatives are excluded because they do not have principal cash flows. Capital instruments are also excluded from AL NEV calculations unless the associated

cash inflows or outflows have a fixed date, i.e., they are without rolling or perpetual maturities.

The Board specifically invites comment on the proposed AL NEV limits as well as the assumptions used by NCUA in creating the hypothetical corporate portfolio used to model the effect of those limits.

Net interest income modeling.

The ANPR asked about additional testing by corporate credit unions to ensure adequate monitoring of the impact of changing market conditions on the overall balance sheet. For example, the ANPR asked about net interest income (NII), that is, the difference between a corporate's revenues on its assets and the cost of servicing its liabilities, and how NII is affected by changing interest rates. A large majority of commenters who addressed this issue supported incorporating NII modeling into the corporate rule.

The Board believes that NII modeling adds an additional, needed measurement of projected future earnings in multiple interest rate scenarios. Proper and realistic NII modeling will assist corporate management with its budgeting process and will provide an interest rate risk measurement tool if base case NEV declines sharply due to external market shocks. Accordingly, the proposal adds a new paragraph 704.8(g) requiring NII modeling. Corporates must model NII at least once each quarter, using multiple interest rate environments extended over a period of at least two years.

Two-year average life.

In addition to the proposed spread widening and NII modeling, the Board is proposing a new paragraph 704.8(h) that will limit the weighted average life (WAL) of a corporate's assets to two years. A corporate credit union must test its assets at least once a month for compliance with this WAL limitation and report noncompliance to the NCUA immediately. In calculating its average life, the proposal requires that a corporate assume that issuer options will not be exercised.

The Board believes that an excessive asset average life is inconsistent with a corporate's primary mission and subjects the corporate to unnecessary risks. The Board proposes to use a two year limit because that should give corporate adequate flexibility to manage their business while maintaining a risk profile consistent with the corporate mission.

Calculation of duration at the individual asset/liability level.

The proposal adds a new paragraph 704.8(i) that requires a corporate calculate the effective duration and spread duration for each of its assets and liabilities where the values of these are affected by changes in interest rates or credit spreads. While the NEV tests described above implicitly require such calculation at the individual asset or liability level, the Board believes it important to state this requirement explicitly. This information about individual assets and liabilities will enable the credit union's auditors, board of directors, and NCUA examiners to determine if the corporate is performing these granular calculations correctly, particularly for those assets and liabilities that have embedded optionality resulting in more complex calculations.

Violations of NEV and NII tests or limits on average life of assets.

Proposed paragraph 704.8(j) has specific requirements pertaining to violations of the NEV and NII testing and the requirement to maintain an average asset life of two years or less.

If a corporate's decline in NEV, base case NEV ratio, or any other NEV ratio resulting from the IRR and AL NEV tests in 704.6 violates the associated regulatory limits, and the corporate cannot adjust its balance sheet so as to satisfy those limits within ten calendar days after detecting the violation, then operating management of the corporate credit union must immediately report this information to its board of directors, supervisory committee, and the NCUA.

If the corporate's regulatory violation persists for 30 or more calendar days, the corporate must submit an action plan to NCUA and is also subject to PCA reclassification. Immediately following the 30th day the corporate must submit a detailed, written action plan to the NCUA that sets forth the time needed and means by which the corporate intends to correct the violation and, if the NCUA determines that the plan is unacceptable, the corporate must immediately restructure its balance sheet to bring the exposure back within compliance or adhere to an alternative course of action determined by the NCUA. If the corporate is currently categorized as adequately capitalized or well capitalized for purposes of §704.4 (prompt corrective action), the corporate will be immediately recategorized as undercapitalized until the violation is corrected. If the corporate is already in some undercapitalized category, the corporate will be reclassified as one category lower. The corporate must comply with all the PCA provisions relating to undercapitalization until such time as the corporate demonstrates to the satisfaction of the NCUA that the regulatory violation is corrected.

The proposal treats violation of the two-year average asset life requirement, and the NII testing requirement, in a similar fashion. Violations that persist for ten or more days must be reported as described above, and violations that persist for

30 or more days require the submission of an action plan to NCUA and a potential downgrade in PCA capital category.

Limitations on investments from single member or other entity.

The Board is concerned about risks to both individual corporates and individual natural person credit unions that arise from placing undue reliance on a single entity. For example, if a corporate relies too heavily on investments from one member, that member might decide to remove its funds which could cause severe liquidity problems at the corporate. Similarly, if a natural person credit union (NPCU) has too much money invested in a particular corporate, the NPCU is exposed to credit risk and, potentially, liquidity risk from that lack of diversification.

Accordingly, the proposal adds a new paragraph (k) to §704.8 that prohibits the corporate from accepting from a member or other entity any investment, including shares, loans, PCC, or NCAs, if, following that investment, the aggregate of all investments from that entity in the corporate would exceed ten percent of the corporate's moving daily average net assets. The purpose of this provision is to prevent a corporate from being too exposed to any particular member or other entity in the event that the entity should suddenly decide to reduce its investments in the corporate.

The concentration limit in proposed paragraph (j) will not become effective for 30 months so as to allow affected corporates a deliberate and orderly transition. At the conclusion of this 30-month phase-in, an affected entity may not make new investments or new loans, or renew existing loans, or reinvest shares or dividends in the corporate, if the aggregate of all the entity's investments in the corporate immediately following such a transaction would exceed the 10 percent limit.

§704.9 Liquidity management.

The corporate system provides essential payment systems support to many NPCUs, but the current corporate rule says nothing about maintaining adequate liquidity to support the corporate's payment systems obligations. The proposal amends paragraph 704.9(a) to require that corporates demonstrate accessibility to sources of internal and external liquidity and that they keep a sufficient amount of cash and cash equivalents on hand to support their payment systems obligations.

The current rule places the following aggregate limitation on corporate borrowing:

> A corporate credit union may borrow up to 10 times capital or 50 percent of shares (excluding shares created by the use of member reverse repurchase agreements) and capital, whichever is greater. CLF borrowings and borrowed funds created by the use of member reverse repurchase agreements are excluded from this limit . . . .

12 CFR 704.9(b). The proposal modifies this aggregate limit to restrict corporate borrowing to the lower of ten times capital or 50 percent of capital and shares.

The Board also believes that corporates should be limited in their ability borrow on a secured basis for other than liquidity purposes. As demonstrated by recent events, secured borrowing can create additional risks for the corporate and the NCUSIF. Secured lenders require collateral to be valued at market and they impose an additional haircut (margin) to ensure the borrowing is fully and continuously collateralized. Market shocks can create short-term market values that are below long-term intrinsic values and which can magnify potential losses if collateral were to be seized and sold as permitted by the lending agreements.

Accordingly, the proposal permits secured borrowing for nonliquidity purposes only if the corporate is well capitalized, that is, its core capital exceeds five percent of its moving DANA. The proposal further restricts such borrowing to an amount equal to the difference between the corporate's core capital and five percent of its moving DANA.

Beyond the aggregate borrowing limit, the proposal does not restrict the amount of secured borrowing a corporate may do for liquidity purposes. The proposal does, however, restrict the maturity of any secured borrowing for liquidity purposes to a maximum of 30 days. This maturity limit will not preclude a corporate from renewing liquidity- related borrowings on a rolling basis.

These limits on aggregate borrowing and secured borrowing should help mitigate the consequences of future adverse market events for the corporates and the NCUSIF.

III.D. Phase-in of part 704 capital and PCA requirements.

The Board understands that the proposed amendments to Part 704 capital regulations are complex and that many corporates would not meet the targets upon issuance of the final rule. Instead of an immediate implementation, the Board proposes to phase-in the new capital and PCA requirements over a ten-year period of time. Most of the new provisions will be effective after one year, the minimum leverage ratio requirement will become effective after three years, and the provisions related to minimum retained earnings will become effective in

the sixth through tenth years. This subsection III.D. discusses the phase-in and demonstrates how a hypothetical corporate might, while complying with the proposed investment and asset liability limitations described above, generate sufficient earnings to meet the capital requirements by the end of the phase-in periods.

None of the new provisions related to capital and PCA will be effective for a period of one year following the publication of the final rule in the Federal Register. During this time period, corporates must continue to comply with the existing §704.3 capital ratio requirement and its associated capital definitions, within the guidance provided by NCUA. Also, while the Board will delay the effective date of the proposed capital and PCA requirements, the Board expects each corporate to begin calculating and reporting its new capital ratios upon publication of the final rule.

Beginning with the first anniversary of the final rule publication corporates will be subject to, and must be in compliance with, all of the new risk-based capital provisions and PCA provisions and their associated definitions. Between the first and third anniversaries, the corporate will continue to comply with the existing minimum total capital ratio in addition to the new risk-based capital ratios. The proposal accomplishes this transition to the new leverage ratio by employing an interim definition of leverage ratio in §704.2, from the first to the third anniversaries, that tracks the current rule's minimum total capital ratio. Corporates will have several methods, or combination of methods, to achieve compliance with these new capital requirements prior to the third anniversary, including decreasing aggregate assets or portfolio risk or increasing NCAs, PCC, or retained earnings.

Beginning with the third anniversary, corporates will be subject to, and must be in compliance with, the new leverage ratio; however, corporates will not yet need to comply with the additional requirement that retained earnings constitute a specified minimum part of core capital for purposes of the capital ratios.[54] Corporates will have several methods, or combination of methods, to satisfy this new minimum leverage ratio prior to the seventh anniversary, including decreasing assets or increasing PCC or retained earnings.

Beginning with the sixth anniversary, corporates will be subject to, and must be in compliance with, the retained earnings part of the various capital ratios. Most importantly, the corporates must have at least 100bp of retained earnings to satisfy the adequately-capitalized four percent minimum leverage ratio, and

[54] Beginning on the third anniversary, corporates that are not making adequate progress in accumulating retained earnings will have to submit a retained earnings accumulation plan, as described in proposed §704.3(a)(3).

150bp of retained earnings to achieve a five percent leverage ratio and be considered well capitalized. Corporates can only achieve this retained earnings requirement by decreasing assets or increasing retained earnings.

In proposing this phase-in plan the Board analyzed 1) the current capital position of the various corporates, 2) the earning ability of the corporates, and 3) the impact and uncertainty associated with the existing, troubled MBS (discussed further below). The Board believes this phase-in period will encourage corporates to improve their capital base without encouraging overly aggressive strategies to accumulate retained earnings or solicit high cost capital. The Board invites comment on the reasonableness of the proposed phase-in plan and the following analysis.

Results – current capital positions.

NCUA analyzed each corporate's current capital under the proposed capital standards based upon 5310 data from August 2009. NCUA adjusted retail corporate credit union capital levels based on known losses at U.S. Central. After this adjustment, 18 retail corporates have zero retained earnings. Nine of the 18 face a complete elimination of PCC accounts and a partial elimination of existing NCA. Additional Other Than Temporary Impairment (OTTI) losses at U.S. Central may increase the number of corporates that fall into this category.

In certain cases, the data in the current 5310 reports do not contain the precision necessary to make an exact calculation. For example, the private label mortgage securities lack details to determine the precise risk-weight. NCUA used 50 percent, but a portion of these instruments will carry higher risk-weights in certain corporates. NCUA also made some assumptions with respect to the risk-weights of derivative portfolios. An accurate risk-weight in these cases requires the assignment of a risk-weight at the transaction level.

Under the proposed capital standards, only two of the 28 corporates would be considered well capitalized or adequately capitalized today, while 16 of 28 corporates would be considered critically undercapitalized. Only two corporates would currently meet the minimum four percent leverage ratio requirement.

The 18 retail corporates that have zero retained earnings will face a significant challenge in meeting the four percent leverage ratio requirement. At the end of year six they will need to have retained earnings equal to 1.0 percent of DANA. This will require earnings in the range of 0.15-0.2 percent of DANA, depending on asset growth. This will require adjustments to business plans and will limit the ability of these corporates to grow.

NCUA created a number of scenarios for recapitalization of the corporate system over this period. In all recapitalization scenarios, retained earnings growth is critical, particularly given the new investment and ALM limitations contained in the proposal. The ability to grow retained earnings is so critical that, before proceeding with the capital phase-in discussion, it is important to first discuss the ability of a corporate to grow its retained earnings under the proposal.

Ability to grow retained earnings under the proposed investment and ALM limitations.

As discussed above, to be adequately capitalized under the new capital rules will require a minimum leverage ratio of four percent (400 bp), consisting of a combination of PCC and retained earnings and measured in relation to 12 month DANA. One hundred of these 400 bp must, by the end of year six, consist of retained earnings. While NCUA believes it is essential to build retained earnings as a component of capital, it also considered whether this prescribed target was reasonable and attainable. Accordingly, NCUA staff analyzed the ability of a hypothetical corporate to obtain 100 bp of retained earnings within six years (measured in relation to 12 month DANA).

Assuming no retained earnings to start, and no asset growth, the corporate would have to earn about 17 bp of net income each year to reach this target. There are many variables that can impact actual earning, and there will be variability in specific corporate credit unions' abilities to meet this target. Nonetheless, NCUA determined that, within reasonable assumptions for future earnings and expenses, a corporate credit union could generate the minimum annual earnings necessary to reach the retained earnings target.

The table below presents a sample corporate portfolio with one possible investment mix. This particular portfolio of investments adheres to the proposed limits for investment concentrations and weighted average asset life (WAL).[55]

Investments			
Sector	**Portfolio Percentage**	**Total Weighted Average Life**	**LIBOR/EDSF Spread**

[55] The investment concentration limits appear in proposed §704.6(d). The two year limit on weighted average asset life appears in proposed §704.8(h). These limits are discussed in greater detail earlier in this preamble.

		(years)	
FFELP Student Loan ABS	20%	1.000	25
Private Student Loan ABS	10%	0.500	200
Auto ABS	20%	0.600	25
Credit Card ABS	10%	1.000	30
Other ABS	10%	0.300	10
Overnight Investments	30%	0.003	0
Total	**100%**	**0.501**	**34**

In structuring this table, NCUA estimated interest income from current investment market data. Additionally:

- Spreads were obtained from Wall Street research, dealer offerings and Wall Street contacts for mid-October 2009.
- All ABS spreads are for AAA senior bonds.
- Overnight Investments include excess Fed Reserves, Repo and Overnight Corporate Deposits.

In preparing this analysis, NCUA also assumed the following corporate liabilities. Funding costs were approximated using a sample of current corporate credit union offerings.

Liabilities			
Type	**Total Percentage**	**Total Weighted Average Life (years)**	**LIBOR/EDSF Spread**
Overnight Shares	30%	0.003	0
Term Certificates	70%	0.500	0
Total	100%	0.351	0

This liability mix, when combined with the assets above and assuming the corporate has 4 percent NEV and total capital, also satisfies the proposed asset liability cash flow mismatch sensitivity test.[56]

[56] The cash flow mismatch limit appears in proposed §704.8(e). In the example, the mismatch of about 0.16 years (0.501 minus 0.351) equates to about two months. At four percent NEV, this two month mismatch satisfies the requirement that the NEV ratio not decline below two percent, and the percentage decline in NEV not exceed fifteen percent, when spread widen 300 bp as specified in paragraphs 704.8(e)(1)(ii) and (iii). Again, this particular limit is discussed in more detail earlier in this preamble.

As demonstrated in the two tables above, this asset-liability mix is capable of generating a net interest income of 34 bp a year under the limitations of the proposed regulation. Using June 2009 corporate system averages for pro forma income and expenses would produces the following net income from operations:[57]

Pro Forma Income Using January - June 2009 System Averages	
Net Interest Income	0.34%
Other Income	0.17%
Total Operating Income	**0.51%**
Total Operating Expenses	**0.30%**
Net Income from Operations	**0.21%**

The pro forma income projections above indicate that a corporate can, in fact, grow retained earnings at or above 20 bp a year and so achieve income from operations sufficient to build 100 bp of retained earnings in five to six years (assuming no asset growth).

In addition to the considerations discussed above, there are other factors that can positively affect a corporate's ability to build retained earnings. For example, a modest assumption of interest rate risk usually generates a stable and positive return. A slight mismatch between the modified duration of assets and liabilities can generate a source of positive spread between sources and uses of funds without creating an excessive exposure of earnings or capital at risk or assuming too much interest rate risk. Investments purchased during periods of upward sloping yield curves (i.e., when longer maturities have a higher yield than shorter maturities) usually generate additional earnings consistent with a modest level of interest rate risk. To the extent that the yield curve maintains its slope over the life of the investment, net interest income improves as investment average lives shorten and the book yield is higher versus current market yields for comparable securities with the same remaining average life. This "roll down" effect can also occur due to lower benchmark yields and/or tighter credit spreads. Corporates also have some pricing power in service pricing or dividends paid that can positively affect the building of retained earnings.

[57] NCUA derived the non-interest income and expenses from recent aggregate corporate system 5310 data.

Conversely, there are factors that may negatively affect a corporate's ability to build retained earnings. Future net interest investment income may be diminished by tighter credit spreads if a corporate doesn't have the ability to lower the dividend rates it pays, and an inverted yield curve may also have negative implication on a corporates ability to build retained earnings.

Finally, NCUA realizes that some corporates may have difficulty at first in restructuring their existing portfolios to meet the requirements of the new regulation, particularly with regard to the new cash flow mismatch and WAL limitations. NCUA has the authority, in appropriate cases and within the context of a carefully crafted investment action plan, to permit individual corporates to operate outside these limitations while illiquid legacy investments amortize. Of course, to the extent that legacy investments have credit issues, and the corporate is forced to recognize OTTI, this OTTI will have a negative effect on the corporate's retained earnings growth.

Results: projected capital positions.

Having established that it is possible for a corporate to fashion a balance sheet that facilitates earnings growth under the proposed investment and ALM limitations, NCUA used a mix of earnings, growth, and capital contribution assumptions to build scenarios further analyzing the ability of corporates to reach adequate capitalization by year seven.

The different mix types lead NCUA to four scenarios, entitled A through D (for analysis cataloging only). In all scenarios, NCUA assumed that PCC and NCA would be used only to the extent that they qualify for inclusion in the proposed capital measures. In determining the pool of available PCC and NCA investments available, NCUA used an average asset size for natural person credit unions and applied that to the number of current members in each corporate. NCUA also assumed an equal amount of PCC and NCA accounts in all of the scenarios.

The scenario assumptions and results are summarized below.

1. "A" Case Assumptions - NCUA assumed that corporates would have zero growth beyond recapitalization deposits and annual earnings equal to 0.2 percent of DANA (20 bp). NCUA assumed that natural person credit unions would voluntarily recapitalize the corporate system at historical rates of 0.4 percent of assets.

2. "B" Case Assumptions - NCUA assumed that corporates would have zero growth beyond recapitalization deposits, and annual earnings equal to 0.1 percent of DANA (10 bp). NCUA also assumed that existing natural

person credit unions would voluntarily recapitalize the corporate system at historical rates of 0.4 percent of assets.

3. "C" Case Assumptions – NCUA assumed that natural person credit unions would not voluntarily recapitalize the corporate system at historical rates. This scenario assumes that natural person credit unions would limit capital investments in the corporate system to 0.2 percent of assets. In the case of U.S. Central, the assumption was that other corporates would invest in capital accounts at one-half of historical levels. In this scenario, DANA and risk-weighted assets were reduced by 4 percent of each year, and earnings are 0.2 percent of DANA.

4. "D" Case Assumptions – NCUA assumed that corporates would have zero growth beyond recapitalization deposits for the first 3 years. Annual earnings would equal 0.2 percent of DANA and natural person credit unions would voluntarily recapitalize the corporate system at historical rates of 0.4 percent of assets. In year 4, DANA was immediately reduced by one third.

The table below illustrates the number of corporates that would achieve adequate capitalization, by year, over the next 7 years, under the various case assumptions.

	Year One	**Year Two**	**Year Three**	**Year Four**	**Year Five**	**Year Six**	**Year Seven**
"A" Case	**5**	**6**	**7**	**8**	**24**	**25**	**25**
"B" Case	**5**	**5**	**5**	**7**	**7**	**7**	**8**
"C" Case	**4**	**5**	**6**	**6**	**18**	**21**	**24**
"D" Case	**5**	**6**	**7**	**23**	**24**	**24**	**26**

A discussion about the results of each scenario follows.

The A case scenario would result in 25 of the 28 corporates reaching an adequate level of capitalization within six years. With zero growth and .2 percent of earnings each year, a corporate's retained earnings reaches the minimum 100 bp requirement by year five. Three of the corporates fail to meet the aggregate capital requirements by year six because their current assets and numbers of members produce a pool of available PPC and NCA accounts that is inadequate for these three corporates. It is possible that one or more of these three

corporates would become adequately capitalized if they are able to obtain an appropriate level of PPC accounts.

Under the B case assumptions, 21 corporates (i.e., 28 minus seven) are unable to reach an adequate capitalization level within six years and 20 are unable to reach an adequate capitalization level within seven years. These institutions will need to further adjust assets, or adjust earnings to insure that return on DANA is significantly in excess 0.1 percent, or obtain member capital investments at amounts greater than historical industry averages.

The C case assumes a 0.2 percent earnings level but also assumes that natural person credit unions will not be willing to recapitalize the corporates at historical levels. In this scenario DANA shrinks by four percent each year, to correspond with the reduced availability of capital instruments. Seven of the 28 corporates are unable to reach adequate capital levels in the first six years. This scenario illustrates that at least a majority of corporates may still reach adequate capital levels even if natural person credit unions reduce the historic amount of capital invested in the corporate system. On the other hand, some corporates may find it difficult to achieve adequate capital levels if their natural person credit unions refuse to provide near historic levels of capital funding. The alternative for these corporates is to reduce assets.

The “D” case scenario represents another possible strategy. A corporate may attempt to maintain current assets, generate retained earnings on the current asset base for several years and then shrink the balance sheet before the final leverage ratio requirement becomes effective. All but four corporates would reach adequate capitalization under this scenario by the end of year six. Implementation of this scenario may be challenging as it is difficult to shrink assets by this magnitude on the basis of rates alone. The corporate’s members would need to actively assist the corporate for it to succeed in this strategy.

These particular scenarios do not reflect NCUA’s classification of any specific corporate or its expected capital position during the phase-in period. Each corporate will need to complete a similar analysis with assumptions more specific to its own business plans and based on its own members potential PCC and NCA contributions. Also, this analysis only goes out to seven years, and does not incorporate the final leverage requirement, effective at ten years, that PCC count only to the extent it is matched dollar for dollar by retained earnings. Corporates that meet the six year leverage requirement should be well-positioned to meet the ten year requirement, but numerical projections beyond six or seven years rely on too many assumptions to carry significant meaning.

These scenarios also make clear that many corporates will struggle to achieve the minimum capital ratios over the proposed phase in period. The minimum

leverage ratio will be the most difficult ratio for corporates to achieve because improvements in this ratio require the corporate credit union to both solicit permanent capital and build retained earnings. But if corporates were limited to earnings only, and not able to solicit capital, many would not be able to reach the adequately capitalized level for a significant number of years -- in some cases, twenty or more years.

Phase-in of capital provisions (conclusion).

The most likely capital outcome for each corporate will depend a number of factors unique to that corporate. These factors include the ability to raise capital from existing members and the level of earnings that the corporate is able to achieve. Achieving these new capital requirements may also require a corporate make significant changes in historic business plans and in the way it prices its services and deposit products.

Still, NCUA believes that well-managed corporates that have financial support from their members can in fact reach their capital targets within the proposed phase-in period. For a corporate that lacks good management or significant member support, however, these capital goals may not be achievable. Those corporates that struggle to grow their earnings or to convince members to invest capital will need to shrink their balance sheets, look for potential merger partners, or both.

In addition to general comments on the proposed capital phase-in, NCUA invites individual corporates to provide additional modeling information related to the effect of the proposed phase-in period on that corporate.

III.E. Proposed rule: hypothetical effect on recent losses at WesCorp and U.S. Central.

As discussed above, the primary purpose of these proposed changes to part 704 is to mitigate future risks to the corporate system so that the system can continue to provide valuable services to NPCUs in a safe and sound manner. Although the focus of the proposal is forward looking, NCUA realizes that it cannot avoid, to some extent, a look backwards. Accordingly, this subsection III.E. illustrates the hypothetical effects of the proposed rule on the balance sheets of WesCorp and U.S. Central as those entities existed in June 2007. NCUA chose WesCorp and U.S. Central for this illustration since their risk positions account for the vast majority of projected losses in the corporate system.

The following chart illustrates the effect of the proposed investment sector limits on the permissible amount of total non-agency residential mortgage backed securities (RMBS): [58]

Corporate	Non-Agency RMBS Percent of Capital (2007)	Proposed Rule Limit as Percent of Capital	Exposure Reduction Under Proposed Rule[59]
WesCorp	990%	500%	Approximately 50%
U.S. Central[60]	1,040%	500%	More than 50%

Non-agency RMBS produced almost 100 percent of projected losses and OTTI in the corporate credit union system. Had it been in effect, the proposed rule would have limited the exposure to this sector by approximately 50 percent for WesCorp and U.S. Central. Using projected losses and the assumption that security selection would have been comparable in quality to what they hold now, WesCorp and U.S. Central losses would have been cut in half.

The following chart illustrates the effect of the proposed limit on the permissible amount of subordinated non-agency residential mortgage backed securities:[61]

Corporate	Subordinated Non-Agency RMBS as Percent of Capital (2007)	Proposed Rule Limit as Percent of Capital	Exposure Reduction Under Proposed Rule
WesCorp	More than 600%	100%	More than 80%
U.S. Central	More than 150%	100%	More than 30%

Subordinated non-agency RMBS produced approximately 70 percent of the combined projected losses and OTTI in WesCorp and U.S. Central. [62] The proposed rule would have lowered the exposure to subordinated non-agency

[58] Proposed §704.6(d). NCUA used post-June June 2007 statistics where the June 2007 statistics were not available. The use of more recent statistics understates loss exposure and, therefore, understates the effects the proposed rule would have had on projected losses if it had been in effect.

[59] The proposed §704.5(h) also prohibits Net Interest Margin securities (NIMs) and collateralized debt obligations (CDOs), and these are included in the loss projections and exposure reductions. Additionally, contributed capital by corporate credit unions in U.S. Central is excluded from the projected loss number since the losses are directly related to OTTI taken on non-agency RMBS at U.S. Central.

[60] Sandlot Funding assets are included due to the subsequent reconsolidation on U.S. Central's balance sheet and recent accounting changes related to ABCP conduits.

[61] Proposed §704.6(e).

[62] Subordinated securities include senior mezzanine tranches.

RMBS by more than 80 percent in WesCorp and more than 30 percent in U.S. Central. Using projected losses and the assumption that security selection would have been comparable in quality, WesCorp's losses would have been reduced by more than 75 percent and U.S. Central's losses would have been reduced by more than 15 percent.

Combining the effects of the non-agency RMBS sector limitations, the subordinated non-agency RMBS, and the CDO and NIM prohibitions, aggregate WesCorp losses would have been reduced by approximately 80 percent and U.S. Central losses would had been reduced by approximately 45 percent. The following chart illustrates the effect of the proposed cash flow weighted average life (WAL) mismatch limit under the proposed rule:[63]

Corporate	**Investment Portfolio WAL (2007)**	**Liability WAL**	**Estimated Asset and Liability WAL Mismatch**	**Proposed Rule's Approximate Limit on WAL Mismatch**	**Minimum Estimated WAL Reduction of Investment WAL Under Proposed Rule**
WesCorp	2.88 years	0.97 years	1.91 years	0.40 years	1.51 years
U.S. Central	2.93 years	0.93 years	2.00 years	0.30 years	1.70 years

The proposal also limits the WAL of the aggregate investment portfolio to two years. Had they been in place, these proposed restrictions on the maximum average WAL mismatch and the absolute maximum investment WAL would have reduced the amount of liquidity risk and credit risk in the WesCorp and U.S. Central portfolios. The shorter average lives would have produced much quicker principal paydowns and shorter maturities than WesCorp and U.S. Central experienced since June 2007, strengthening system liquidity. Furthermore, the resulting shorter average lives, combined with the limits on WAL extension risk, would have lowered the risk in the allowable RMBS portfolio due to more stable cash flow characteristics.[64]

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[63] Proposed §704.8(e). As discussed above, the proposed rule also limits WAL mismatches based on three factors: (1) Current base net economic value (NEV); (2) Investment authorities, and; (3) Total capital. Furthermore, the proposed rule requires WALs be measured assuming: 1) issuer options are not exercised; and 2) further tests and limits for a slowdown in prepayment speeds are conducted.

[64] As discussed above, proposed §704.8(f) contains an mismatch test that requires the corporate to assume a 50% slowdown in payment speeds.

NCUA is comfortable that these provisions of the proposed rule, taken together, would have resulted in significantly lower corporate losses had they been in effect prior to the recent credit crisis. The reduced losses would have protected corporate credit unions with capital in U.S. Central from some, if not all, of the losses from depleted capital. Additionally, WesCorp's members would have seen lower write-downs of their capital in Wescorp, and WesCorp would have not caused any loss to the NCUSIF -- and thus no losses to credit unions that were not WesCorp members.

III.F. Amendments to part 704 related to the structure of the corporate system.

At present, the corporate system consists of twenty-seven corporates that provide retail service and support to natural person credit unions and one wholesale corporate that provides products and services only to the retail corporates. The ANPR discussed this configuration and solicited comment about whether this two-tier structure continues to make sense in the current marketplace. The ANPR asked what the role of the wholesale corporate should be and whether there should be any differentiation in powers and authorities between retail and wholesale corporates.

A slight majority of the commenters believe the two-tiered corporate system, with a network of retail corporates and a single wholesale corporate, U.S. Central, is outdated and unnecessary. Many commenters believe this two-tier structure has resulted in an aggregation of excessive risk at the top tier and that U.S. Central duplicates the investment and payment services that large retail corporates can provide at competitive cost and with greater diversification of risk. Some commenters stated the wholesale tier is redundant, inefficient, led to too much concentrated risk, and has resulted in the creation of an entity that has become "too big to fail." Others stated that elimination of the two-tiered system may lead to a necessary consolidation of the corporate credit union system, resulting in a system in which corporates are more economically viable.

Other commenters, predominantly smaller credit unions, believe that the wholesale tier is beneficial and necessary. Smaller credit unions believe that the level of services and support they receive from corporates, including investment expertise, is not readily available to them in the outside marketplace. Some of these commenters felt that the existence of U.S. Central created efficiencies in the system and that U.S. Central had the greatest level of investment expertise available to the system. Supporters of the status quo, however, typically felt greater regulatory oversight, risk mitigation, and higher capital standards for corporates were still necessary.

Existing §704.19 – Wholesale corporate credit unions.

The Board believes that having a third tier in the credit union system presents both an element of inefficiency and a systemic risk multiplier effect. The inefficiency arises from the added cost of having two layers of intermediation for the goods and services extended by the wholesale corporate through its retail corporate members to their natural person credit union members. The multiplier on risk results from the fact that each dollar of loss in excess of retained earnings at the wholesale level can result in as much two additional dollars of loss for the rest of the system: one dollar lost at the retail corporate level and one at the natural person credit union level.[65] Accordingly, the Board is moving towards eliminating regulatory and policy distinctions between wholesale and retail corporates.

The existing §704.19 provides that wholesale corporates must strive to obtain a one percent retained earnings ratio, as opposed to the existing §704.3(i), which requires that all other corporates strive to retain a two percent retained earnings ratio. The proposed capital revisions to §704.3 eliminate the need for any earnings retention requirement. To ensure that the new capital requirements apply equally to both wholesale and retail corporates, the proposal eliminates both the current paragraph 704.3(i) and current §704.19. The proposal also eliminate the unnecessary term "wholesale corporate credit union" from the definitions in §704.2.

To further facilitate the elimination of the third tier, the proposal also amends the existing part 704 provisions on board representation to require that the board of every corporate have a majority of its members comprised of representatives of natural person credit unions. As a result, no corporate in the system will ever again be captive to other corporates. This amendment, and the associated transition period, are discussed in more detail below in connection with the proposed corporate governance amendments applicable to all corporates.

The Board has also directed OCCU to eliminate any distinctions between corporates in field of membership (FOM) policy, and so retail corporates will be allowed to offer services to other corporates and U.S. Central will be allowed to provide services to natural person credit unions.

III.G. Amendments to part 704 related to corporate CUSOs.

Part 704 currently permits corporates to invest in and lend to credit union service organizations (corporate CUSOs). A corporate CUSO is defined as an entity that

[65] *See*, *e.g.*, *Retail Corporates Apply U.S. Central Capital Losses*, Credit Union Times, August 3, 2009, at www.cutimes.com.

is at least partly owned by a corporate credit union; primarily serves credit unions; restricts its services to those related to the normal course of business of credit unions; and is structured as a corporation, limited liability company, or limited partnership under state law. 12 CFR 704.11(a). Part 704 does not list the permissible activities for corporate CUSOs, unlike part 712, which does list the permissible activities for the CUSOs of natural person FCUs. 12 CFR 712.5(b).

The Board believes it is appropriate to tighten NCUA oversight over the activities of corporate CUSOs. A corporate CUSO may serve hundreds or even thousands of natural person credit unions, and so its activities can affect the entire credit union system. Additionally, as the corporate credit union system evolves in the coming years, some of the services that are currently accomplished in-house at a corporate may migrate to a corporate CUSO. The movement of these activities could increase the systemic risk associated with corporate CUSOs, and NCUA wants to ensure it has some oversight and control of these activities.

Accordingly, the proposal amends §704.11 to require that, generally, a corporate CUSO must agree that it will limit is services to brokerage services, investment advisory services, and other categories of services as preapproved by NCUA and published on NCUA's website. A CUSO that desires to engage in an activity not preapproved by NCUA can apply to NCUA for that approval

The current paragraph 704.11(e) prohibits a corporate CUSO from acquiring control, directly or indirectly, of another depository financial institution or to invest in shares, stocks, or obligations of an insurance company, trade association, liquidity facility, or similar organization. The proposal retains this prohibition, but moves it paragraph 704.11(g), which sets forth the contents of the mandatory written agreement between ever corporate and its CUSOs. The proposal also adds two other requirements to this mandatory agreement. First, the proposal requires the CUSO agree to expanded access for auditors, the corporate's directors, and NCUA. Currently, the CUSO must agree to permit access to the CUSO's "books, records, and other pertinent documentation," and the proposal expands this access to: "personnel, facilities, equipment, books, records, and any other documentation that the auditor, directors, or NCUA deem pertinent." Second, the proposal prescribes that the CUSO specifically agree to abide by all the requirements set forth in §704.11.

The current paragraph 704.11(b) places limits on the aggregate amount of a corporate's investments in, and loans to, a CUSO. The proposal does not contain any changes to these limits. Still, data available to NCUA indicates that the level of corporate investment in CUSOs is significantly less than these 704.11(b) limits would allow, based on November 2008 corporate capital levels.

The Board invites comment on whether, in the final rule, it should reduce the CUSO investment and loan limits in the current 704.11(b).

III.H. Amendments to part 704 related to corporate governance.

As noted in the ANPR, corporate management requires a high level of sophistication and expertise. Successful corporate management also requires performance and practices that instill and inspire confidence by the membership in the integrity of those in positions of leadership and responsibility. With this proposal, NCUA intends to improve corporate governance standards and elevate confidence in corporate leadership, thereby supporting and strengthening the corporate system. As more fully developed below, the proposed rule sets out new provisions in the following areas:

- Qualifications for corporate directorship, including term limits and NPCU representation;
- Transparency of senior executive and director compensation arrangements; and
- Restrictions on certain severance and indemnification payments for senior executive officers.

§704.14 Representation.

Qualifications of directors.

Corporate credit unions are complex entities that can, and do, have a significant impact on the functioning of the entire credit union system. The ANPR solicited comment on whether changes to the corporate rule are necessary to ensure a corporate credit union's governing board possesses the requisite degree of knowledge and expertise. One hundred fifty-seven commenters responded to NCUA's request for comment on this subject, and nearly three-quarters of these commenters – 112 – supported additional qualification standards for corporate directors.

Sophisticated corporate investment and operation strategies require directors with adequate levels of knowledge and experience to understand and provide oversight for these strategies. NCUA believes that the recent crisis in the corporate system was attributable, in part, to a failure on the part of the some corporate boards to understand the extent of the risk embedded in their balance sheets.

Those commenters who supported regulatory director qualifications thought such qualifications would ensure corporates are governed by knowledgeable

individuals who are up-to -date on the most recent developments in the credit union system. Some commenters said that board candidates should be limited to either chief executive officers (CEOs) or chief financial officers (CFOs) of member credit unions. There was also some support that directors be required to obtain periodic training or continuing education. Other commenters suggested that the issue of director qualification be left to the discretion of the individual corporate and not be mandated by regulation. Some commenters said that, with respect to state charters, this issue is a function of state law and regulation. Others said that nothing presently prevents a board of directors from retaining outside experts to assist its understanding on any issue that board may determine.

Some of those opposed to imposing minimum director qualifications stated that an emphasis on education may disqualify certain persons who have valuable experience, skills, or talents not attributable to formal education. Others opposed to regulatory qualifications noted that such qualifications are no assurance against the recurrence of the current corporate system problems, with one noting that all of the various proposed qualifications existed on a voluntary basis at one or more corporates, and those governance techniques had not protected those corporates from the effects of the current economic downturn.

Corporates have evolved into complicated entities with key roles in the credit union system. The Board believes, therefore, that individuals seeking a position on a corporate board should exhibit a minimum level of knowledge and expertise. Accordingly, the proposal adds a new paragraph 704.14(a)(2) to require, as qualification for directorship, that all candidates must currently hold the equivalent of a CEO, CFO, or chief operating officer (COO) position at the member institution (typically, though not always, a natural person credit union). The proposal phases this requirement in by applying it only to candidates at the time of election or reelection, and making the effective date of the proposal some four months after the effective date of the rule.

In lieu of such an experience requirement, the Board considered proposing that directors of corporates be required to obtain formal training on an annual or other periodic basis as a condition of service on a corporate board. The Board determined not to include that requirement in the proposal for a couple of reasons. First, as noted above, the Board believes limiting director eligibility to persons currently holding a CEO, CFO or COO position will help ensure qualified candidates are chosen for board positions. In addition, the Board does not believe it a good use of examiner resources to analyze training attendance records, the sufficiency of a particular corporate's training standards, or the effectiveness of the training.

Although the Board has determined not to impose by regulation a specific, and mandatory, training requirement, the Board believes director training is important and corporates should encourage such training. In 2005, NCUA stated:

> In today's environment directors must have considerable knowledge and devote sufficient time to have an adequate understanding of a corporate's operations. In many cases directors may need extensive training in the corporate's unique operations (i.e., sophisticated investments and asset liability management). The information provided by management is normally extensive and complex. Directors need to dedicate a significant amount of effort to becoming familiar with these concepts.

Corporate Credit Union Guidance Letter 2005-02 (April 5, 2005). These training principles are just as valid today as back in 2005. The standard FCU bylaws also state that FCUs will establish "a policy to address training for newly elected and incumbent directors and volunteer officials in areas such as ethics and fiduciary responsibility, regulatory compliance, and accounting . . . ." Standard FCU Bylaws, Art. VI, §6(d) (2006). Although corporates are not governed by these FCU bylaws, the Board could incorporate similar language into the standard corporate bylaws. The Board solicits comment as to whether such a change to the corporate bylaws would be appropriate.

Term limits and other board restrictions. The ANPR also solicited comment on whether NCUA should impose term limits for service on a corporate board. The majority of those who offered a comment, on this issue, 80 out of 145, supported the concept of corporate term limits. Those supporting term limits generally stated this would help to eliminate complacency on boards and ensure that corporates were run by the best qualified individuals. Others, in opposition to the idea, advocated that NCUA not impose mandatory term limits by regulation. One corporate opposed director term limits but supported term limits on officer positions within the board to ensure "adequate change in leadership while retaining experienced directors." Others who opposed term limits generally felt that this disrupted continuity and reduced efficiency by creating a continuous need to train new directors.

The Board has determined that some form of term limit will be beneficial. New directors are more likely, generally, than old directors to ask questions about existing policies and to generate suggestions for improvement. This, in turn, should help ensure that corporate policies are subject to continuous review and evaluation. Accordingly, the proposal adds a new paragraph 704.14(a)(3) to impose a six-year limit on continuous service as a corporate director.

Generally, corporate directors serve for staggered three-year terms, as provided in Art. VII, §2, Corporate Credit Union Bylaws (2003), and the Board intends, for sitting directors, to phase in this new term limit requirement without undue disruption. Accordingly, the proposal would not require any current director to step down before the current term ends, regardless of the length of time served before the rule became effective. Instead, the proposal provides that no individual may stand for election to the board if, at the end of the term for which the individual seeks election, he or she would have served for more than six consecutive years as a director. Corporates should ensure that directors who run for reelection following the effective date of this rule will, in fact, be able to complete their entire term without exceeding the six-year term limit.

The rule also clarifies that, for purposes of calculating term limits, service on the board is determined by reference to the corporate member on whose behalf the individual is serving, and not simply by the number of years the particular individual has served. Thus, for example, if the CEO of an NPCU has served on the board of a corporate for six years, the CFO or COO of that NPCU may not follow on to the board in the next succeeding term. For purposes of the rule, all individuals representing a single member are treated as a single individual.

Given the importance of the role corporate directors fulfill in establishing the overall policy and direction for corporate credit unions, the Board is concerned that those individuals who are chosen for this role be in a position to devote the degree of time and attention necessary to effectively discharge their responsibilities. Accordingly, the proposed rule would establish that no individual may be elected or appointed to the board of one corporate while serving at the same time as a member of any other corporate credit union board. This restriction will help ensure that directors are undivided in their loyalty to the corporate for which they are serving and are not distracted from attending to the needs of their institution because of competing demands arising from another corporate.

The proposal would also prohibit any member of a corporate from having more than one of its officers sitting on the board of the corporate at one time. This provision will prevent a corporate from being dominated by any single member.

Representation by natural person credit unions.

As discussed above, the Board intends to eliminate the distinction between wholesale and retail corporates. Accordingly, the proposal adds a new paragraph 704.14(a)(4) requiring that a majority of a corporate's directors, including the chair of the board, must serve on the board as representatives of natural person credit union members. Retail corporates should already satisfy this governance requirement. The proposal, however, delays the effective date

of this provision for three years to allow U.S. Central, the only wholesale corporate, time to meet this new governance requirement.

Because of the addition of the new subparagraphs 704.14(a)(2), (3), and (4), as discussed above, the proposal renumbers the remaining subparagraphs of paragraph 704.14(a).

§704.19 Disclosure of executive and director compensation.

As noted in the ANPR, part 704 does not currently require any disclosure by a corporate to its members of senior executive compensation arrangements. The response to the ANPR contained a few comments on compensation transparency. Some who commented noted that disclosure of corporate compensation should be subject to the same guidance as applies to natural person credit unions. One commenter said corporates should provide transparency through existing filing requirements, such as the Internal Revenue Service Form 990 – required for state charters, but not federal charters. Another commenter argued that executive compensation and disclosure of salary and benefit information have no bearing on the current crisis. This commenter stated that a number of publicly traded companies, each with their management compensation packages fully disclosed to the public, have gone bankrupt during this current crisis.

Debate over disclosure of credit union compensation has been ongoing for years. For example, in November 2005, Congress and the Government Accountability Office (GAO) raised questions about the lack of transparency regarding credit union senior executive compensation. In response, the NCUA undertook the Member Service Assessment Pilot Program to study, among other issues, the transparency of senior executive compensation. On November 3, 2006, NCUA completed its study and issued the *Member Service Assessment Pilot Program: A Study of Federal Credit Union Service* (MSAP), which recommended NCUA consider alternatives requiring FCUs to make periodic disclosure of executive compensation to their members.

Soon after the issuance of the MSAP, GAO also recommended "the Chairman of NCUA take action to ensure that information on federal credit union executive compensation is available to credit union members and the public for review and inspection." GAO, *Credit Unions: Transparency Needed on Who Credit Unions Serve and on Senior Executive Compensation Arrangements* (GAO-07-29) (2006). The Board created an outreach task force which, although not focused specifically on corporate issues, did consider and make some recommendations focused on compensation transparency and related issues. One OTF recommendation was that NCUA "promulgate a regulation requiring federal credit unions and federal corporate credit unions to annually disclose individual senior

executive officer compensation to their members." Report to the NCUA Board from the Outreach Task Force, p. 71, available at http://www.ncua.gov/ReportAndPlans/plans-and-reports/2008/OutreachTFReport-022608.pdf.

Addressing compensation disclosure requires a balancing of privacy interests against the ownership and financial interests of members. The basic question presented is whether an increased level of transparency would strengthen cooperative principles and accountability, and if so, whether those benefits outweigh the damage to individual privacy interests of the affected executives. In the corporate context particularly, the Board believes this balance can and should be struck in favor of increased transparency and disclosure to members. The member-owners of a corporate credit union have a strong financial interest in the corporate. The typical corporate member has large investments in the corporate and much of this investment is at risk, either in the form of perpetual contributed capital, nonperpetual contributed capital, or uninsured shares. The corporate member needs to have this investment properly managed and protected. Accordingly, the member wants the corporate to provide proper financial incentives to its managers and official to do a good job while ensuring that the corporate is also properly expending its funds -- and both these interests are affected by compensation paid to corporate executives and officials. Corporate managers and officials, of course, do have privacy interests in their compensation, but those interests diminish the more senior the manager and the more responsibility the manager or official has for the performance of the corporate and for the attendant protection of the financial interests of the corporate's owners. In sum, the Board believes the interests that corporate members have in this compensation information outweighs any privacy interests the senior managers may have in that information.[66]

Accordingly, the proposal contain a new §704.19 requiring corporates to provide to its members certain information about the compensation and benefits of senior executive officers and directors. Given the importance Congress and GAO placed on the disclosures required in IRS Form 990 (an annual informational filing required of many tax-exempt entities, including state chartered credit unions), much of §704.19 mirrors the Form 990 information and access process. For purposes of the rule, however, the Board has concluded that completion of the Form 990 is not sufficient. The IRS determines the form and content of the Form 990 disclosure and so that may change in the future. In addition, even though Form 990 data is publicly available, the affirmative disclosure required by this proposal provides for greater transparency to members.

[66] The financial interests of corporate members in their corporate are likely to be more significant than the financial interests of natural person members in their natural person credit union, because natural persons are less likely to have significant amounts of at-risk investments in their credit union than are members of corporates.

A paragraph-by-paragraph discussion of the new §704.19 follows.

Proposed paragraph 704.19(a) requires each corporate to prepare and maintain the annual disclosure of executive and director compensation. As currently proposed, the rule would allow a corporate to choose the disclosure format it considers most appropriate, for example, through the use of a narrative, table, or chart. NCUA solicits comment on the question of whether the rule should specify the form that the disclosure should take, including, for example, the identification of specific categories that must be used, such as direct salary, bonus, deferred compensation, etc. In any case, the disclosure must specifically identify senior executive personnel by name, job title, and compensation. To the extent that members of the board of directors also receive compensation in exchange for or as an incident to their service on the board, the rule specifies that the corporate must disclose that compensation as well.

As discussed more fully below, the definition of compensation encompasses all benefits provided by the corporate to its senior executives or directors. The Board believes that, to be accurate, the disclosure must ascribe a dollar value to each component of compensation, and the proposed rule specifically requires this. The proposal contemplates each corporate will prepare the disclosure at approximately the same time each year, much like an annual tax filing. If senior executive or director compensation changes during the course of a year, a corporate will not be required to prepare a new or amended disclosure. In some instances requiring only an annual disclosure may result in some lag in updated information, but such a disclosure requirement more closely resembles the reporting made in annual tax filings for state chartered credit unions and lessens the disclosure burden on the corporate.

Proposed paragraph 704.19(b) provides that any member may obtain a copy of the most current disclosure, and all disclosures for the previous three years, on request made to the corporate in person or in writing. The corporate must provide the disclosure(s), at no cost to the requesting member, within five business days of receiving the request. In addition, the corporate must distribute the most current disclosure to all its members at least once a year, either in the annual report or in some other manner of the corporate's choosing.

The Board considered whether to impose some type of non-disclosure requirement on members as a condition to receiving the information, but ultimately determined not to impose such a condition, given the difficulty in enforcing such a requirement. The compensation information, however, is likely to be of interest only to members, and the Board anticipates that members will not likely disseminate the information to nonmembers.

Proposed paragraph 704.19(c) clarifies that a corporate may supplement the required disclosure, at its option, with information may put the disclosures in appropriate context. For example, a corporate could provide members with salary surveys, a discussion of compensation in relation to other credit union expenses, or compensation information from similarly sized credit unions or financial institutions.

In the case of merger, the Board is concerned that prospective merger partners may seek to improperly influence the deliberations of management or the board at a corporate seeking to merge. One way to deal with the potential for improper activity is transparency. Accordingly, proposed paragraph 704.19(d) provides that, where a corporate is considering a merger with another corporate, any arrangement resulting in a material increase in compensation (i.e., an increase in current compensation of more than 15 percent or $10,000, whichever is greater) for any senior executive officer or director of the merging corporate must be included in the annual disclosure form. In addition, the proposal specifies that corporates must describe in the merger plan submitted to the NCUA any financial arrangements providing for a material increase in compensation for any senior executive officer or director. The Board intends that all arrangements, formal and informal, be covered by this disclosure requirement. The scope of disclosure includes both arrangements that are written and those not immediately reduced to writing, as well as arrangements involving the deferred receipt of compensation.

Where a merging credit union is federally chartered, the proposal would also require an affirmative disclosure of the existence of a material increase in compensation to its members before their vote on the merger. State law governs whether members of a state-chartered credit union are entitled to vote; therefore, NCUA is only proposing this latter requirement for federally chartered corporate credit unions.

Section 704.2 contains two proposed definitions relating to the scope of the §704.19 disclosures. First, the proposal eliminates the current definition of *senior management employee*, a term no longer used in part 704, and replaces that definition with a definition of *senior executive officer* as:

> [A] chief executive officer, any assistant chief executive officer (e.g., any assistant president, any vice president or any assistant treasurer/manager), and the chief financial officer (controller). This term also includes employees of any entity hired to perform the functions described above.

This definition is similar to that currently used in §701.14 of NCUA's rules. 12 CFR 701.14. Second, since the Board believes it is important for complete

accuracy to require disclosure of all forms of executive compensation, the proposal defines *compensation* as:

> [A]ll salaries, fees, wages, bonuses, severance payments paid, current year contributions to employee benefit plans (for example, medical, dental, life insurance, and disability), current year contributions to deferred compensation plans and future severance payments, including payments in connection with a merger or similar combination (whether or not funded; whether or not vested; and whether or not the deferred compensation plan is a qualified plan under Section 401(a) of the IRS Code). Compensation also includes expense accounts and other allowances (for example, the value of the personal use of housing, automobiles or other assets owned by the corporate credit union; expense allowances or reimbursements that recipients must report as income on their separate income tax return; payments made under indemnification arrangements; and payments made for the benefit of friends or relatives). In calculating required compensation disclosures, reasonable estimates may be used if precise cost figures are not readily available.

The Board is also concerned about the possibility of "reverse" mergers, where a larger credit union merges into a smaller credit union and the officers and directors of the merging entity assume control of the continuing entity. Accordingly, the Board invites comment about whether, and under what circumstances, the requirement to disclose merger-related compensation should be extended to the officers and directors of the continuing credit union as well as the merging credit union.

§ 704.20 Limitations on golden parachute and indemnification provisions.

Section 2523 of the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990[67] (Fraud Act) amended the Federal Credit Union Act (Act) by adding a new section 206(t). Pub. L. No. 101-647, §2523(b) (1990). Section 206(t) provides that "[t]he Board may prohibit or limit, by regulation or order, any golden parachute payment or indemnification payment." 12 U.S.C. 1786(t)(1).

Accordingly, the proposal adds a new §704.20 to NCUA's corporate rule that prohibits golden parachutes, that is, payments made to an institution affiliated

[67] The Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990 is title XXV of the Crime Control Act of 1990, S. 3266, which was passed by Congress on October 27, 1990 and signed into law on November 29, 1990.

party (IAP) that are contingent on the termination of that person's employment and received when the corporate making the payment is troubled, undercapitalized, or insolvent. The proposal also prohibits a corporate, regardless of its financial condition, from paying or reimbursing an IAP's legal and other professional expenses incurred in administrative or civil proceedings instituted by NCUA or the appropriate state regulatory authority.

The new §704.20 will be effective immediately upon the finalization of this rule. These limitations will apply to all new employment contracts entered into on or after that date, and well as existing contracts that are renewed or modified in any way after that date.

A paragraph-by-paragraph summary of the proposed §704.20 follows.

Paragraph 704.20(a) Definitions.

This proposal contains several definitions. The key definitions are discussed further below.

Paragraph 704.20(b) Golden parachute payments prohibited.

The proposal provides, generally, that no corporate credit union will make or agree to make any golden parachute payment, that is, a payment to an *institution-affiliated party* (IAP) that is contingent on the termination of that person's employment and received when the corporate making the payment is troubled, as defined in §701.14(b)(4) of NCUA's rules. 12 CFR 701.14(b)(4); *see also* 12 USC 1790a; 12 U.S.C. 1786(r)(definition of IAP). The proposal also prohibits golden parachute payments in the event a corporate has become insolvent or "undercapitalized" for prompt corrective action purposes. *See* proposed §704.4. This prohibition is intended to prevent IAPs who are substantially responsible for the troubled condition of a corporate from receiving an unwarranted benefit.

The proposed definition of golden parachute would also exclude certain payments pursuant to certain bona fide deferred compensation plans. Although the rule text is necessarily complex, the proposal provides that, in general, a plan funded by earned but deferred compensation is allowed. Also, certain types of elective plans are allowed if they are funded, were in effect more than one year prior to any of the events described in §701.14(b)(4) of NCUA rules, and the party is vested in the plan. For example, payments made pursuant to qualified retirement plans; nondiscriminatory severance pay plans; benefit plans required by state statute, and death benefit arrangements would not be prohibited. Payments made pursuant to these exclusions, however, are generally limited in amount to 12 months of base salary.

Paragraph 704.20(c) Prohibited indemnification payments.

Section 206(t) of the Act authorizes NCUA to prohibit or limit indemnification payments. 12 USC 1786(t)(5). The Act defines a *prohibited indemnification payment* as a payment by a corporate for the benefit of an IAP for any liability or legal expense sustained in connection with an administrative or civil enforcement action that results in a final order or settlement pursuant to which the IAP is assessed a civil money penalty, removed from office, prohibited from participating in the conduct of the affairs of an insured credit union, or required to cease and desist from or take any affirmative action described in §206 of the FCU Act. 12 U.S.C. 1786. Accordingly, the proposed paragraph 704.20(d) generally prohibits a corporate, regardless of its financial condition, from paying or reimbursing an IAP's legal and other professional expenses incurred in proceedings instituted by NCUA or the appropriate state regulatory authority. Paragraph 704.20(e), discussed below, describes when a corporate can proceed to indemnify an IAP.

Paragraph 704.20(d) Permissible golden parachute payments.

The Board has determined that in certain, limited circumstances payments that otherwise satisfy the definition of golden parachute payments should be permitted. The proposal includes three exceptions to the general prohibition on golden parachutes:

- One exception permits the insertion of a golden parachute payment provision into an employment contract when a corporate which is already in troubled condition needs to hire a senior manager with expertise to help put the corporate back on a sound financial footing (the “white knight” exception). Without this white knight exception, a troubled corporate may not be able to attract qualified senior management. Before employing the white knight exception to make a payment, a corporate must notify and obtain the written permission of the Board.
- Another exception permits reasonable severance arrangements in the context of a merger for the management of the merging corporate. The merger must be unassisted, that is, at no cost to the NCUA; and any severance payments made cannot exceed twelve months salary. In addition, the NCUA Board must review and approve the payment in advance.
- Finally, there is a general exception that permits severance arrangements on an exceptional basis where the NCUA Board determines the payment is appropriate.

In applying to NCUA for any of the three exceptions above, the corporate credit union must assert to NCUA its belief that the IAP does not bear any responsibility for the troubled condition of the corporate. Specifically, the corporate must demonstrate that it does not possess, and is not aware of, any information that provides a reasonable basis to believe that:

- The IAP has committed any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the corporate credit union that has had or is likely to have a material adverse effect on the corporate credit union;
- The IAP is substantially responsible for the insolvency of, the appointment of a conservator or liquidating agent for, or the troubled condition of the corporate credit union;
- The IAP has materially violated any applicable federal or state banking law or regulation that has had or is likely to have a material effect on the corporate credit union; or
- The IAP has violated or conspired to violate certain specified criminal provisions of the United States Code.

In determining whether to grant an application for any of these exceptions, the Board may also consider:

- Whether, and to what degree, the IAP was in a position of managerial or fiduciary responsibility;
- The length of time the IAP was affiliated with the corporate credit union, and the degree to which the proposed payment represents a reasonable payment for services rendered over the period of employment; and
- Any other factors or circumstances which would indicate that the proposed payment would be contrary to the intent of section 206(t) of the Act.

Paragraph 704.20(e) Permissible indemnification payments.

Broadly speaking, Congress intended through the Fraud Act to limit the ability of IAPs who are responsible for losses sustained by an insured depository institution to avoid the consequences of that responsibility. Where, however, that responsibility has not yet been finally established, the Board does not intend to categorically prohibit corporates from advancing funds to pay or reimburse IAP's for reasonable legal or other professional expenses incurred in defending against an administrative or civil action brought by NCUA. Accordingly, paragraph 704.20(e) prescribes certain circumstances under which indemnification payments may be made.

The proposed rule provides that indemnification payments may be made where the corporate's board of directors makes a good faith determination, after due investigation, that:

- the IAP acted in good faith and in a manner he/she believed to be in the best interests of the corporate credit union;
- the payment of such expenses will not materially adversely affect the corporate credit union's safety and soundness;
- the indemnification payments ultimately do not become prohibited indemnification payments as defined in 704.20(a) , that is, the administrative action does not result in a civil money penalty, removal order, or cease and desist order against the IAP; and
- The IAP agrees in writing to reimburse the corporate credit union, to the extent not covered by payments from insurance, for that portion of the advanced indemnification payments, if any, which subsequently becomes prohibited indemnification payments.

The proposed rule does permit a corporate to purchase commercial insurance policies or fidelity bonds, at a reasonable cost, to pay the future potential cost of defending an administrative proceeding or civil action. Such insurance cannot pay for any penalty or judgment against an IAP but may pay restitution to the corporate or its liquidating agent.

Paragraph 704.20(f) Filing instructions.

This paragraph provides procedures for corporate credit unions to request Board permission to make nondiscriminatory severance plan payments and golden parachute payments described in paragraph 704.20(d).

Paragraph 704.20(g) Applicability in the event of liquidation or conservatorship.

This paragraph clarifies how the restrictions in this section function in the event of conservatorship or liquidation. Any consent or approval of a golden parachute payment granted under the provisions of this part by the Board will not in any way bind any liquidating agent or conservator for a failed corporate credit union and will not in any way obligate the liquidating agent or conservator to pay any claim or obligation pursuant to any golden parachute, severance, indemnification or other agreement.

Compensation disclosure and prohibition of golden parachutes: application to natural person credit unions; consideration of TARP limitations.

At this time, the Board is primarily concerned with recent problems exposed by the corporate financial crisis, including corporate governance problems. Accordingly, the Board intends to apply the requirements of proposed §704.19 and 704.20 only to corporates, and not to natural person credit unions.[68]

The Board also notes that its proposals (i.e., on disclosure of compensation and prohibition of golden parachutes and indemnification arrangements) differ from the requirements in the Treasury's recent final rule applicable to entities receiving federal assistance under the Troubled Asset Relief Program (TARP) program. 74 FR 28394 (June 15, 2009). The Treasury rule imposes several substantive limits on senior executive compensation, including limits on bonuses and the use of compensation plans that would encourage earnings manipulation to enhance executive compensation. The Treasury rule also requires affected entities establish a compensation committee comprised of independent directors, prepare a written policy on luxury expenditures, disclose certain types of perquisites, and eliminate tax gross ups. The Board does not believe adoption of the Treasury approach for all corporate credit unions is necessary or desirable at this time, although the Board reserves the right to impose similar conditions in the future on any credit union that receives assistance from the NCUSIF.

IV. Regulatory Procedures.

IV.A. Regulatory Flexibility Act.

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact any proposed regulation may have on a substantial number of small entities (those under $10 million in assets). The proposal only applies to corporates, all but one of which has assets well in excess of $10 million. Accordingly, the proposed amendments will not have a significant economic impact on a substantial number of small credit unions and, therefore, a regulatory flexibility analysis is not required.

IV.B. Paperwork Reduction Act.

The Paperwork Reduction Act of 1995 (PRA) applies to rulemakings in which an agency by rule creates a new paperwork burden on regulated entities or modifies an existing burden. 44 U.S.C. 3507(d). For purposes of the PRA, a paperwork burden may take the form of a either a reporting or a recordkeeping requirement, both referred to as information collections. The Office of Management and

[68] Natural person federal credit unions may provide for indemnification of officers and directors as set forth at §701.33 of NCUA. To the extent that this proposed §704.20 conflicts with §701.33 or any other federal law or regulation, or state law or regulation (for state-chartered corporates), the corporate must comply with §704.20. *See* 12 CFR 704.1.

Budget (OMB) has approved the current information collection requirements in part 704 and assigned them control number 3133-0129.

The proposed changes to part 704 modify existing information collection requirements and impose new information collection requirements. As required by the PRA, NCUA is submitting a copy of this proposed regulation to the Office of Management and Budget (OMB) for its review and approval. Persons interested in submitting comments with respect to the information collection aspects of the proposed rule should submit them to the OMB at the address noted below.

Estimated PRA burden: capital and PCA requirements.

NCUA has determined that the following capital and PCA aspects of the proposed rule either modify or create new information collection requirements:

- The current rule imposes an obligation on a corporate to prepare and submit a capital restoration plan in the event the corporate's capital falls below certain specified measures. The proposed rule creates several new capital standards and requirements, and thereby increases the potential for additional circumstances under which a capital restoration plan, or revisions to a plan already submitted, may be required.
- Beginning with the first call report submitted by a corporate three years after the date of the final rule, if the ratio of the corporate's retained earnings to moving daily average net assets is less than .45 percent, the corporate must prepare and submit to NCUA a retained earnings accumulation plan. The plan must explain how the corporate intends to accumulate earnings sufficient to meet the minimum leverage ratio requirements established by the rule within the time frames set forth in the rule.
- The proposal generally requires a corporate to obtain the prior approval of NCUA before permitting the early redemption of any contributed capital.
- The proposal requires a corporate to notify NCUA within fifteen days after any material event has occurred that would cause the corporate to be placed in a lower capital category from the category assigned to it on the basis of the corporate's most recent call report or report of examination.

The NCUA estimates the burden associated with these capital and PCA information collections as follows.

The new capital standards will apply uniformly to all twenty-eight corporates. NCUA estimates that approximately twenty corporates will be required to prepare new or revised capital restoration plans in the coming year, and that the

effort to prepare or revise a plan will involve fifty hours: 20 corporates x 50 hours = 1000 total hours.

NCUA estimates that three corporates will be required to prepare retained earnings accumulation plans, and that the effort to prepare such a plan will involve fifty hours: 3 corporates x 50 hours = 150 total hours.

NCUA estimates ten corporates may have to notify NCUA about requests to redeem contributed capital, but that the burden of preparing and sending such a notice would be minimal: 10 corporates x 1 hour = 10 hours.

Similarly, NCUA anticipates that ten corporates may be required to notify NCUA about changes affecting their category under the prompt corrective action provisions of the rule; again, the burden of preparing the notice is minimal: 10 corporates x 1 hour = 10 hours.

Estimated PRA burden: investment requirements.

With respect to investments, the proposal requires that at least 90 percent of a corporate's investments have NRSRO ratings, increasing the associated PRA burden.

The change applies to all corporates, and NCUA estimates that all twenty-eight will be required to acquire additional ratings as part of their due investment due diligence. This effort should entail a minimal expenditure of time: 28 corporates x 2 hours = 56 hours.

Given the change in how NRSRO ratings are used, NCUA estimates that approximately ten corporates will encounter downgrades affecting their investments, which will trigger new investment action plans or amended investment action plans. Developing an investment action plan can take as much as twenty hours, with the following burden: 10 corporates x 20 hours = 200 hours.

Estimated PRA burden: ALM requirements.

With respect to asset and liability management, the proposal requires new spread widening and net interest income testing, which are information collections. The additional testing, which must be done at least quarterly, will be required of and affect all corporates. The proposal also requires a corporate to calculate and record the effective and spread durations for individual assets and liabilities to support the test results. NCUA estimates that burden hours associated with compliance with this requirement would be as follows:

28 corporates x 168 hours (total for the four new tests per year) = 4,704 hours.

Estimated PRA burden: new CUSO procedures.

The current rule does not set out categories of approved CUSO activity for corporate CUSOs, but instead simply indicates that CUSOs must primarily serve credit unions and may engage in activity that is related to the business of credit unions. Under the proposal, a corporate will be required to obtain the approval from the NCUA for proposed CUSO activities, except for brokerage services and investment advisory services, which are specifically pre-approved. Once an activity has been approved, NCUA will publish that fact on its website and the activity will thereafter be considered pre-approved for other CUSOs. NCUA estimates that two hours will be sufficient for corporates to prepare approval requests, and NCUA anticipates that twelve such requests will be made.

Estimated PRA burden: corporate governance requirements.

With respect to corporate governance, the proposal requires:

- Corporates prepare and disseminate to members a disclosure document outlining the compensation arrangements for senior level employees.
- Merging corporates include certain compensation information in their filings with the NCUA and their notices to their members.
- Corporates obtain NCUA approval before making certain golden parachute payments.

These are information collections would apply to all twenty-eight corporates. NCUA estimates that compliance with the annual compensation disclosure requirement will take approximately ten hours: 28 corporates x 10 hours = 280 hours.

NCUA estimates that four corporates will merge with other corporates each year, with another entity, and that preparing the required notice and disclosure forms will take 5 hours: 4 corporates x 5 hours = 20 hours.

NCUA also estimates that four corporates will need to solicit NCUA approval in advance of making a severance or golden parachute payment within the scope of the proposed rule, and that preparing the request for approval may take four hours: 4 corporates x 4 hours = 16 hours.

Summary of collection burden.

NCUA estimates the total information collection burden represented by the proposal, calculated on an annual basis, as follows:

Capital restoration plans:	20 corporates x 50 hours = 1,000 hours.
Retained earnings accumulation Plans:	3 corporates x 50 hours = 150 hours.
Notice of intent to redeem contributed capital:	10 corporates x 1 hour = 10 hours.
Notice of PCA category change:	10 corporates x 1 hour = 10 hours.
Ratings procurement:	28 corporates x 2 hours = 56 hours.
Investment action plans:	10 corporates x 20 hours = 200 hours.
ALM testing:	28 corporates x 168 hours = 4,704 hours.
CUSO approval requests:	12 corporates x 2 hours = 24 hours.
Compensation disclosures:	28 corporates x 10 hours = 280 hours.
Merger related disclosures:	4 corporates x 5 hours = 20 hours.
Requests to make golden parachute and severance payments:	4 corporates x 4 hours = 16 hours.
Total Burden Hours:	***6,470 hours.***

NCUA previously estimated the burden associated with the current rule, and approved by OMB under control number 3133-0129, at about 2,434 hours per corporate, and, for 31 corporates, a total burden of 75,454 hours. The number of corporates has since dropped from 31 to 28, reducing the estimated burden under the current rule to about 68,152 hours. As discussed above, the proposal would add about 6,470 hours to the current burden, bringing the total burden covered by OMB control number 3133-0129 to about 74,622 hours.

NCUA does not anticipate that compliance with any of the new information collection aspects of the proposed rule will require that corporates purchase any additional equipment or hire any additional staff. Accordingly, existing maintenance and service costs to corporates are likewise unaffected, and there should be no additional depreciation expense, since all corporates should be

able to implement the new requirements using existing systems, equipment, and personnel. The proposal may require some corporates to incur additional marginal costs associated with the enhanced ALM testing requirements, to the extent that they are not already conducting these tests, and a few corporates will incur additional expense associated with obtaining required credit ratings for certain investments. NCUA estimates the labor cost associated with this compliance at approximately $50 per hour. Multiplying this figure by the number of additional hours estimated for these burden categories yields an additional financial burden associated with the proposed rule of $8,500 per corporate.
The NCUA considers comments by the public on this proposed collection of information in:

- Evaluating whether the proposed collection of information is necessary for the proper performance of the functions of the NCUA**,** including whether the information will have a practical use;
- Evaluating the accuracy of the NCUA's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;
- Enhancing the quality, usefulness, and clarity of the information to be collected; and
- Minimizing the burden of collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology; *e.g.*, permitting electronic submission of responses.

The Paperwork Reduction Act requires OMB to make a decision concerning the collection of information contained in the proposed regulation between 30 and 60 days after publication of this document in the Federal Register. Therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. This does not affect the deadline for the public to comment to the NCUA on the proposed regulation.

Comments should be sent to: Office of Information and Regulatory Affairs, OMB, New Executive Office Building, Washington, DC 20503; Attention: NCUA Desk Officer, with a copy to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.

IV.C. Executive Order 13132.

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order. The

executive order states that: "National action limiting the policymaking discretion of the states shall be taken only where there is constitutional and statutory authority for the action and the national activity is appropriate in light of the presence of a problem of national significance." NCUA has plenary statutory authority to regulate corporate credit unions. 12 U.S.C. 1766(a). Further, the risk of loss to federally-insured credit unions and the NCUSIF due to corporate activities are concerns of national scope. The proposed rule, if adopted, would apply to all corporates that accept funds from federally-insured credit unions, including some state chartered credit unions. NCUA believes that the protection of corporate credit unions, federally-insured credit unions, and ultimately the NCUSIF, warrants application of the proposed rule to all corporates.

The proposed rule does not impose additional costs or burdens on the states or affect the states' ability to discharge traditional state government functions. NCUA has determined that this proposal may have an occasional effect on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. However, the potential risk to the NCUSIF without the proposed changes justifies any such effects.

IV.D. The Treasury and General Government Appropriations Act, 1999 - - Assessment of Federal Regulations and Policies on Families.

The NCUA has determined that this proposed rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Pub. L. 105-277, 112 Stat. 2681 (1998).

List of Subjects

12 CFR part 702
Credit unions, Reporting and recordkeeping requirements.
12 CFR part 703.
Credit unions, Investments.
12 CFR part 704.
Credit unions, Corporate credit unions, Reporting and record keeping requirements.
12 CFR part 709.
Credit unions, Liquidations.
12 CFR part 747.
Credit unions, Administrative practices and procedures.

By the National Credit Union Administration Board on November 19, 2009.

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Mary F. Rupp
Secretary of the Board

Accordingly, NCUA proposes to amend 12 CFR parts 702, 703, 704, 709, and 747 as follows:

PART 702 – PROMPT CORRECTIVE ACTION

1. The authority citation for part 702 continues to read as follows:

Authority: 12 U.S.C. 1766(a), 1790d.

2. Effective [DATE 12 MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], revise paragraph (d) of §702.105 to read as follows:

§702.105 Weighted – average life of investments.

* * * * *

(d) *Capital in mixed-ownership Government corporations and corporate credit unions.* For capital stock in mixed-ownership Government corporations, as defined in 31. U.S.C. 9101(2), and perpetual and nonperpetual contributed capital in corporate credit unions, as defined in 12 CFR 704.2, the weighted-average life is defined as greater than one (1) year, but less than or equal to three years;

* * * * *

PART 703 – INVESTMENTS AND DEPOSIT ACTIVITIES

3. The authority citation for part 703 continues to read as follows:

Authority: 12 U.S.C. 1757(7), 1757(8), 1757(15).

4. Effective [DATE 12 MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], revise paragraph (b) of §703.14 to read as follows:

§703.14 Permissible investments.

* * * * *

(b) *Corporate credit union shares or deposits*. A Federal credit union may purchase shares or deposits in a corporate credit union, except where the NCUA Board has notified it that the corporate credit union is not operating in compliance with part 704 of this chapter. A Federal credit union's aggregate amount of perpetual and nonperpetual contributed capital, as defined in part 704 of this chapter, in one corporate credit union is limited to two percent of the federal credit union's assets measured at the time of investment or adjustment. A Federal credit union's aggregate amount of contributed capital in all corporate credit unions is limited to four percent of assets measured at the time of investment or adjustment.

* * * * *

PART 704 – CORPORATE CREDIT UNIONS

5. The authority citation for part 704 continues to read as follows:

Authority: 12 U.S.C. 1762, 1766(a), 1781, and 1789.

6. Revise §704.2 to read as follows:

§ 704.2 Definitions.

Adjusted trading means any method or transaction whereby a corporate credit union sells a security to a vendor at a price above its current market price and simultaneously purchases or commits to purchase from the vendor another security at a price above its current market price.

Asset-backed security (ABS) means a security that is primarily serviced by the cashflows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders. Mortgage-backed securities are a type of asset-backed security.

Available to cover losses that exceed retained earnings means that the funds are available to cover operating losses realized, in accordance with

generally accepted accounting principles (GAAP), by the corporate credit union that exceed retained earnings. Likewise, *available to cover losses that exceed retained earnings and paid-in capital* means that the funds are available to cover operating losses realized, in accordance with GAAP, by the corporate credit union that exceed retained earnings and perpetual contributed capital. Any such losses must be distributed *pro rata* at the time the loss is realized first among the holders of paid-in capital accounts (PIC), and when all PIC is exhausted, then *pro rata* among all membership capital accounts (MCAs), all subject to the optional prioritization described in Appendix A of this Part. To the extent that any contributed capital funds are used to cover losses, the corporate credit union must not restore or replenish the affected capital accounts under any circumstances. In addition, contributed capital that is used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate.

Capital means the sum of a corporate credit union's retained earnings, paid-in capital, and membership capital. For a corporate credit union that acquires another credit union in a mutual combination, capital includes the retained earnings of the acquired credit union, or of an integrated set of activities and assets, at the point of acquisition.

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

Collateralized debt obligation (CDO) means a debt security collateralized by mortgage-backed securities, asset-backed securities, or corporate obligations in the form of loans or debt. Senior tranches of Re-REMIC's consisting of senior mortgage- and asset-backed securities are excluded from this definition.

Collateralized mortgage obligation (CMO) means a multi-class mortgage-backed security.

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

Commercial mortgage-backed security (CMBS) means a mortgage-backed security collateralized primarily by multi-family and commercial property loans.

Compensation means all salaries, fees, wages, bonuses, severance payments paid, current year contributions to employee benefit plans (for example, medical, dental, life insurance, and disability), current year contributions to deferred compensation plans and future severance payments,

including payments in connection with a merger or similar combination (whether or not funded; whether or not vested; and whether or not the deferred compensation plan is a qualified plan under Section 401(a) of the IRS Code). Compensation also includes expense accounts and other allowances (for example, the value of the personal use of housing, automobiles or other assets owned by the corporate credit union; expense allowances or reimbursements that recipients must report as income on their separate income tax return; payments made under indemnification arrangements; and payments made for the benefit of friends or relatives). In calculating required compensation disclosures, reasonable estimates may be used if precise cost figures are not readily available.

Contributed capital means either paid-in capital or membership capital accounts.

Core capital means the sum of:

(1) Retained earnings as calculated under GAAP;

(2) Paid-in capital; and

(3) The retained earnings of any acquired credit union, or of an integrated set of activities and assets, calculated at the point of acquisition, if the acquisition was a mutual combination.

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

Corporate credit union means an organization that:

(1) Is chartered under Federal or state law as a credit union;

(2) Receives shares from and provides loan services to credit unions;

(3) Is operated primarily for the purpose of serving other credit unions;

(4) Is designated by NCUA as a corporate credit union;

(5) Limits natural person members to the minimum required by state or federal law to charter and operate the credit union; and

(6) Does not condition the eligibility of any credit union to become a member on that credit union's membership in any other organization.

Daily average net assets means the average of net assets calculated for each day during the period.

Derivatives means a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. Derivative contracts include interest rate derivative contracts, exchange rate derivative contracts, equity derivative contracts, commodity derivative contracts, credit derivative contracts, and any other instrument that poses similar counterparty credit risks.

Dollar roll means the purchase or sale of a mortgage-backed security to a counterparty with an agreement to resell or repurchase a substantially identical security at a future date and at a specified price.

Embedded option means a characteristic of certain assets and liabilities which gives the issuer of the instrument the ability to change the features such as final maturity, rate, principal amount and average life. Options include, but are not limited to, calls, caps, and prepayment options.

Equity investments means investments in real property and equity securities.

Equity security means any security representing an ownership interest in an enterprise (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants and call options) or dispose of (for example, put options) an ownership interest in an enterprise at fixed or determinable prices. However, the term does not include convertible debt or preferred stock that by its terms either must be redeemed by the issuing enterprise or is redeemable at the option of the investor.

Exchangeable collateralized mortgage obligation means a class of a collateralized mortgage obligation (CMO) that, at the time of purchase, represents beneficial ownership interests in a combination of two or more underlying classes of the same CMO structure. The holder of an exchangeable CMO may pay a fee and take delivery of the underlying classes of the CMO.

Fair value means the amount at which an instrument could be exchanged in a current, arms-length transaction between willing parties, as opposed to a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value. If a quoted market price in an active market is not available, fair value may be estimated using a valuation technique that is reasonable and supportable, a quoted market price in an active market for a similar instrument, or a current appraised value. Examples of valuation techniques include the present value of estimated future cash flows, option-

pricing models, and option-adjusted spread models. Valuation techniques should incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility.

Federal funds transaction means a short-term or open-ended unsecured transfer of immediately available funds by one depository institution to another depository institution or entity.

Foreign bank means an institution which is organized under the laws of a country other than the United States, is engaged in the business of banking, and is recognized as a bank by the banking supervisory authority of the country in which it is organized.

Immediate family member means a spouse or other family member living in the same household.

Limited liquidity investment means a private placement or funding agreement.

Member reverse repurchase transaction means an integrated transaction in which a corporate credit union purchases a security from one of its member credit unions under agreement by that member credit union to repurchase the same security at a specified time in the future. The corporate credit union then sells that same security, on the same day, to a third party, under agreement to repurchase it on the same date on which the corporate credit union is obligated to return the security to its member credit union.

Membership capital means funds contributed by members that: are adjustable balance with a minimum withdrawal notice of 3 years or are term certificates with a minimum term of 3 years; are available to cover losses that exceed retained earnings and paid-in capital; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings.

Mortgage-backed security (MBS) means a security backed by first or second mortgages secured by real estate upon which is located a dwelling, mixed residential and commercial structure, residential manufactured home, or commercial structure.

Moving daily average net assets means the average of daily average net assets for the month being measured and the previous eleven (11) months.

Mutual combination means a transaction or event in which a corporate credit union acquires another credit union, or acquires an integrated set of

activities and assets that is capable of being conducted and managed as a credit union.

Nationally Recognized Statistical Rating Organization (NRSRO) means any entity that has applied for, and been granted permission, to be considered an NRSRO by the United States Securities and Exchange Commission.

NCUA means NCUA Board (Board), unless the particular action has been delegated by the Board.

Net assets means total assets less loans guaranteed by the NCUSIF and member reverse repurchase transactions. For its own account, a corporate credit union's payables under reverse repurchase agreements and receivables under repurchase agreements may be netted out if the GAAP conditions for offsetting are met.

Net economic value (NEV) means the fair value of assets minus the fair value of liabilities. All fair value calculations must include the value of forward settlements and embedded options. Paid-in capital, and the unamortized portion of membership capital, that is, the portion that qualifies as capital for purposes of any of the total capital ratio, is excluded from liabilities for purposes of this calculation. The NEV ratio is calculated by dividing NEV by the fair value of assets.

Net interest margin security means a security collateralized by residual interests in collateralized mortgage obligations, residual interests in real estate mortgage investment conduits, or residual interests in other asset-backed securities.

Obligor means the primary party obligated to repay an investment, e.g., the issuer of a security, the taker of a deposit, or the borrower of funds in a federal funds transaction. Obligor does not include an originator of receivables underlying an asset-backed security, the servicer of such receivables, or an insurer of an investment.

Official means any director or committee member.

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.

Pair-off transaction means a security purchase transaction that is closed out or sold at, or prior to, the settlement or expiration date.

Quoted market price means a recent sales price or a price based on current bid and asked quotations.

Repurchase transaction means a transaction in which a corporate credit union agrees to purchase a security from a counterparty and to resell the same or any identical security to that counterparty at a specified future date and at a specified price.

Residential properties means houses, condominiums, cooperative units, and manufactured homes. This definition does not include boats or motor homes, even if used as a primary residence, or timeshare properties.

Residential mortgage-backed security (RMBS) means a mortgage-backed security collateralized primarily by residential mortgage loans.

Residual interest means the ownership interest in remainder cash flows from a CMO or ABS transaction after payments due bondholders and trust administrative expenses have been satisfied.

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 part, retained earnings does not include the allowance for loan and lease losses account, accumulated unrealized gains and losses on available for sale securities, or other comprehensive income items.

Retained earnings ratio means the corporate credit union's retained earnings divided by its moving daily average net assets. For a corporate credit union that acquires another credit union in a mutual combination, the numerator of the retained earnings ratio also includes the retained earnings of the acquired credit union, or of an integrated set of activities and assets, at the point of acquisition.

Section 107(8) institution means an institution described in Section 107(8) of the Federal Credit Union Act (*12 U.S.C. 1757(8)*).

Securities lending means lending a security to a counterparty, either directly or through an agent, and accepting collateral in return.

Senior executive officer mean a chief executive officer, any assistant chief executive officer (e.g., any assistant president, any vice president or any assistant treasurer/manager), and the chief financial officer (controller). This

term also includes employees of any entity hired to perform the functions described above.

Settlement date means the date originally agreed to by a corporate credit union and a counterparty for settlement of the purchase or sale of a security.

Short sale means the sale of a security not owned by the seller.

Small business related security means a security as defined in section 3(a)(53) of the Securities Exchange Act of 1934 (*15 U.S.C. 78c(a)(53)*), e.g., a security that is rated in 1 of the 4 highest rating categories by at least one nationally recognized statistical rating organization, and represents an interest in one or more promissory notes or leases of personal property evidencing the obligation of a small business concern and originated by an insured depository institution, insured credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority, or a finance company or leasing company. This definition does not include Small Business Administration securities permissible under Sec. 107(7) of the Act.

State means any one of the several states of the United States of America, the District of Columbia, Puerto Rico, and the territories and possessions of the United States.

Stripped mortgage-backed security means a security that represents either the principal-only or interest-only portion of the cash flows of an underlying pool of mortgages.

Subordinated security means a security that has a junior claim on the underlying collateral or assets to other securities in the same issuance. If a security is junior only to money market fund eligible securities in the same issuance, the former security is not subordinated for purposes of this definition.

Total assets means the sum of all a corporate credit union's assets as calculated under GAAP.

Total capital means the sum of a corporate credit union's core capital and its membership capital accounts.

Trade date means the date a corporate credit union originally agrees, whether orally or in writing, to enter into the purchase or sale of a security.

Trigger means an event in a securitization that will redirect cash-flows if predefined thresholds are breached. Examples of triggers are delinquency and cumulative loss triggers.

Weighted average life means the weighted-average time to the return of a dollar of principal, calculated by multiplying each portion of principal received by the time at which it is expected to be received (based on a reasonable and supportable estimate of that time) and then summing and dividing by the total amount of principal.

When-issued trading means the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities.

7. Effective [DATE 12 MONTHS AFTER PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], revise §704.2 to read as follows:

§ 704.2 Definitions.

Adjusted core capital means core capital modified as follows:

(1) Deduct an amount equal to the amount of the corporate credit union's intangible assets that exceed one half percent of the corporate credit union's moving daily average net assets, but the NCUA, on its own initiative, upon petition by the applicable state regulator, or upon application from a corporate credit union, may direct that a particular corporate credit union add some or all of these excess intangibles back to the credit union's adjusted core capital;

(2) Deduct investments, both equity and debt, in consolidated credit union service organizations (CUSOs);

(3) If the corporate credit union, on or after [DATE 12 MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], contributes new capital or renews an existing capital contribution to another corporate credit union, deduct an amount equal to the aggregate of such new or renewed capital;

(4) Beginning on [DATE 72 MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], and ending on [DATE 120 MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], deduct any amount of perpetual contributed capital (PCC) that causes PCC minus retained earnings, all divided by moving daily net average assets, to exceed two percent; and

(5) Beginning after [DATE 120 MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], deduct any amount of PCC that causes PCC to exceed retained earnings.

Adjusted total capital means *total capital* modified as follows: to the extent that nonperpetual contributed capital accounts are included in total capital, and the sum of those NCAs exceeds the aggregate of the corporate's PCC and retained earnings, the corporate will exclude the excess from adjusted total capital.

Adjusted trading means any method or transaction whereby a corporate credit union sells a security to a vendor at a price above its current market price and simultaneously purchases or commits to purchase from the vendor another security at a price above its current market price.

Applicable state regulator means the prudential state regulator of a state chartered corporate credit union.

Asset-backed commercial paper program (ABCP program) means a program that primarily issues commercial paper that has received a credit rating from an NRSRO and that is backed by assets or other exposures held in a bankruptcy-remote special purpose entity. The term *sponsor of an ABCP program* means a corporate credit union that:

(1) Establishes an ABCP program;

(2) Approves the sellers permitted to participate in an ABCP program;

(3) Approves the asset pools to be purchased by an ABCP program; or

(4) Administers the ABCP program by monitoring the assets, arranging for debt placement, compiling monthly reports, or ensuring compliance with the program documents and with the program's credit and investment policy.

Asset-backed security (ABS) means a security that is primarily serviced by the cashflows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders. Mortgage-backed securities are a type of asset-backed security.

Available to cover losses that exceed retained earnings means that the funds are available to cover operating losses realized, in accordance with generally accepted accounting principles (GAAP), by the corporate credit union that exceed retained earnings. *Available to cover losses that exceed retained earnings and perpetual contributed capital* means that the funds are available to cover operating losses realized, in accordance with GAAP, by the corporate

credit union that exceed retained earnings and perpetual contributed capital. Any such losses must be distributed *pro rata* at the time the loss is realized first among the holders of perpetual contributed capital accounts (PCC), and when all PCC is exhausted, then *pro rata* among all nonperpetual contributed capital accounts (NCAs), all subject to the optional prioritization described in Appendix A of this Part. To the extent that any contributed capital funds are used to cover losses, the corporate credit union must not restore or replenish the affected capital accounts under any circumstances. In addition, contributed capital that is used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate.

Capital means the same as *total capital*, defined below.

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

Collateralized debt obligation (CDO) means a debt security collateralized by mortgage-backed securities, asset-backed securities, or corporate obligations in the form of loans or debt. Senior tranches of Re-REMIC's consisting of senior mortgage- and asset-backed securities are excluded from this definition.

Collateralized mortgage obligation (CMO) means a multi-class mortgage-backed security.

Commercial mortgage-backed security (CMBS) means a mortgage-backed security collateralized primarily by multi-family and commercial property loans.

Compensation means all salaries, fees, wages, bonuses, severance payments paid, current year contributions to employee benefit plans (for example, medical, dental, life insurance, and disability), current year contributions to deferred compensation plans and future severance payments, including payments in connection with a merger or similar combination (whether or not funded; whether or not vested; and whether or not the deferred compensation plan is a qualified plan under Section 401(a) of the IRS Code). Compensation also includes expense accounts and other allowances (for example, the value of the personal use of housing, automobiles or other assets owned by the corporate credit union; expense allowances or reimbursements that recipients must report as income on their separate income tax return; payments made under indemnification arrangements; and payments made for the benefit of friends or relatives). In calculating required compensation disclosures, reasonable estimates may be used if precise cost figures are not readily available.

Consolidated Credit Union Service Organization (Consolidated CUSO) means any corporation, partnership, business trust, joint venture, association or similar organization in which a corporate credit union directly or indirectly holds an ownership interest (as permitted by §704.11 of this Part) and the assets of which are consolidated with those of the corporate credit union for purposes of reporting under Generally Accepted Accounting Principles (GAAP). Generally, consolidated CUSOs are majority-owned CUSOs.

Contributed capital means either perpetual or nonperpetual contributed capital.

Core capital means the sum of:

(1) Retained earnings as calculated under GAAP;

(2) Perpetual contributed capital;

(3) The retained earnings of any acquired credit union, or of an integrated set of activities and assets, calculated at the point of acquisition, if the acquisition was a mutual combination; and

(4) Minority interests in the equity accounts of CUSOs that are fully consolidated. However, minority interests in consolidated ABCP programs sponsored by a corporate credit union are excluded from the credit unions' core capital or total capital base if the corporate credit union excludes the consolidated assets of such programs from risk-weighted assets pursuant to Appendix C of this Part.

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

Corporate credit union means an organization that:

(1) Is chartered under Federal or state law as a credit union;

(2) Receives shares from and provides loan services to credit unions;

(3) Is operated primarily for the purpose of serving other credit unions;

(4) Is designated by NCUA as a corporate credit union;

(5) Limits natural person members to the minimum required by state or federal law to charter and operate the credit union; and

(6) Does not condition the eligibility of any credit union to become a member on that credit union's membership in any other organization.

Credit-enhancing interest-only strip means an on-balance sheet asset that, in form or in substance:

(1) Represents the contractual right to receive some or all of the interest due on transferred assets; and

(2) Exposes the corporate credit union to credit risk directly or indirectly associated with the transferred assets that exceeds its *pro rata* share of the corporate credit union's claim on the assets whether through subordination provisions or other credit enhancement techniques.

NCUA reserves the right to identify other cash flows or related interests as a credit-enhancing interest-only strip. In determining whether a particular interest cash flow functions as a credit-enhancing interest-only strip, NCUA will consider the economic substance of the transaction.

Daily average net assets means the average of net assets calculated for each day during the period.

Daily average net risk-weighted assets means the average of net risk-weighted assets calculated for each day during the period.

Derivatives means a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. Derivative contracts include interest rate derivative contracts, exchange rate derivative contracts, equity derivative contracts, commodity derivative contracts, credit derivative contracts, and any other instrument that poses similar counterparty credit risks.

Dollar roll means the purchase or sale of a mortgage-backed security to a counterparty with an agreement to resell or repurchase a substantially identical security at a future date and at a specified price.

Eligible ABCP liquidity facility means a legally binding commitment to provide liquidity support to asset-backed commercial paper by lending to, or purchasing assets from any structure, program or conduit in the event that funds are required to repay maturing asset-backed commercial paper and that meets the following criteria:

(1)(i) At the time of the draw, the liquidity facility must be subject to an asset quality test that precludes funding against assets that are 90 days or more past

due or in default; and

(ii) If the assets that the liquidity facility is required to fund against are assets or exposures that have received a credit rating by a Nationally Recognized Statistical Rating Organization (NRSRO) at the time the inception of the facility, the facility can be used to fund only those assets or exposures that are rated investment grade by an NRSRO at the time of funding; or

(2) If the assets that are funded under the liquidity facility do not meet the criteria described in paragraph (1) of this definition, the assets must be guaranteed, conditionally or unconditionally, by the United States Government, its agencies, or the central government of an Organization for Economic Cooperation and Development OECD country.

Embedded option means a characteristic of certain assets and liabilities which gives the issuer of the instrument the ability to change the features such as final maturity, rate, principal amount and average life. Options include, but are not limited to, calls, caps, and prepayment options.

Equity investment means an investment in real property and equity securities.

Equity security means any security representing an ownership interest in an enterprise (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants and call options) or dispose of (for example, put options) an ownership interest in an enterprise at fixed or determinable prices. However, the term does not include convertible debt or preferred stock that by its terms either must be redeemed by the issuing enterprise or is redeemable at the option of the investor.

Exchangeable collateralized mortgage obligation means a class of a collateralized mortgage obligation (CMO) that, at the time of purchase, represents beneficial ownership interests in a combination of two or more underlying classes of the same CMO structure. The holder of an exchangeable CMO may pay a fee and take delivery of the underlying classes of the CMO.

Fair value means the amount at which an instrument could be exchanged in a current, arms-length transaction between willing parties, as opposed to a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value. If a quoted market price in an active market is not available, fair value may be estimated using a valuation technique that is reasonable and supportable, a quoted market price in an active market for a similar instrument, or a current appraised value. Examples of valuation techniques include the present value of estimated future cash flows, option-

pricing models, and option-adjusted spread models. Valuation techniques should incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility.

Federal funds transaction means a short-term or open-ended unsecured transfer of immediately available funds by one depository institution to another depository institution or entity.

Foreign bank means an institution which is organized under the laws of a country other than the United States, is engaged in the business of banking, and is recognized as a bank by the banking supervisory authority of the country in which it is organized.

Immediate family member means a spouse or other family member living in the same household.

Intangible assets means assets considered to be intangible assets under GAAP. These assets include, but are not limited to, core deposit premiums, purchased credit card relationships, favorable leaseholds, and servicing assets (mortgage and non-mortgage). Interest-only strips receivable are not intangible assets under this definition.

Leverage ratio means, before [DATE 36 MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], the ratio of adjusted total capital to moving daily average net assets.

Leverage ratio means, on or after [DATE 36 MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], the ratio of adjusted core capital to moving daily average net assets.

Limited liquidity investment means a private placement or funding agreement.

Member reverse repurchase transaction means an integrated transaction in which a corporate credit union purchases a security from one of its member credit unions under agreement by that member credit union to repurchase the same security at a specified time in the future. The corporate credit union then sells that same security, on the same day, to a third party, under agreement to repurchase it on the same date on which the corporate credit union is obligated to return the security to its member credit union.

Mortgage-backed security (MBS) means a security backed by first or second mortgages secured by real estate upon which is located a dwelling,

mixed residential and commercial structure, residential manufactured home, or commercial structure.

Moving daily average net assets means the average of daily average net assets for the month being measured and the previous eleven (11) months.

Moving daily average net risk-weighted assets means the average of daily average net assets risk-weighted assets for the month being measured and the previous eleven (11) months.

Mutual combination means a transaction or event in which a corporate credit union acquires another credit union, or acquires an integrated set of activities and assets that is capable of being conducted and managed as a credit union.

Nationally Recognized Statistical Rating Organization (NRSRO) means any entity that has applied for, and been granted permission, to be considered an NRSRO by the United States Securities and Exchange Commission.

NCUA means NCUA Board (Board), unless the particular action has been delegated by the Board.

Net assets means total assets less loans guaranteed by the NCUSIF and member reverse repurchase transactions. For its own account, a corporate credit union's payables under reverse repurchase agreements and receivables under repurchase agreements may be netted out if the GAAP conditions for offsetting are met. Also, any amounts deducted from core capital in calculating adjusted core capital are also deducted from net assets.

Net economic value (NEV) means the fair value of assets minus the fair value of liabilities. All fair value calculations must include the value of forward settlements and embedded options. Perpetual contributed capital, and the unamortized portion of nonperpetual contributed capital that is, the portion that qualifies as capital for purposes of any of the minimum capital ratios, is excluded from liabilities for purposes of this calculation. The NEV ratio is calculated by dividing NEV by the fair value of assets.

Net interest margin security means a security collateralized by residual interests in collateralized mortgage obligations, residual interests in real estate mortgage investment conduits, or residual interests in other asset-backed securities.

Net risk-weighted assets means risk-weighted assets less Central Liquidity Facility (CLF) stock subscriptions, CLF loans guaranteed by the

NCUSIF, U.S. Central CLF certificates, and member reverse repurchase transactions. For its own account, a corporate credit union's payables under reverse repurchase agreements and receivables under repurchase agreements may be netted out if the GAAP conditions for offsetting are met. Also, any amounts deducted from core capital in calculating adjusted core capital are also deducted from net risk-weighted assets.

Nonperpetual capital means funds contributed by members or nonmembers that: are term certificates with a minimum term of five years or that have an indefinite term (i.e., no maturity) with a minimum withdrawal notice of five years; are available to cover losses that exceed retained earnings and perpetual contributed capital; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings. In the event the corporate is liquidated, the holders of nonperpetual capital accounts (NCAs) will claim equally. These claims will be subordinate to all other claims (including NCUSIF claims), except that any claims by the holders of perpetual contributed capital (PCC) will be subordinate to the claims of holders of NCAs.

Obligor means the primary party obligated to repay an investment, e.g., the issuer of a security, the taker of a deposit, or the borrower of funds in a federal funds transaction. Obligor does not include an originator of receivables underlying an asset-backed security, the servicer of such receivables, or an insurer of an investment.

Official means any director or committee member.

Pair-off transaction means a security purchase transaction that is closed out or sold at, or prior to, the settlement or expiration date.

Perpetual contributed capital (PCC) 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. In the event the corporate is liquidated, any claims made by the holders of perpetual contributed capital will be subordinate to all other claims (including NCUSIF claims).

Quoted market price means a recent sales price or a price based on current bid and asked quotations.

Repurchase transaction means a transaction in which a corporate credit union agrees to purchase a security from a counterparty and to resell the same or any identical security to that counterparty at a specified future date and at a specified price.

Residential properties means houses, condominiums, cooperative units, and manufactured homes. This definition does not include boats or motor homes, even if used as a primary residence, or timeshare properties.

Residential mortgage-backed security (RMBS) means a mortgage-backed security collateralized primarily by residential mortgage loans.

Residual interest means the ownership interest in remainder cash flows from a CMO or ABS transaction after payments due bondholders and trust administrative expenses have been satisfied.

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 part, retained earnings does not include the allowance for loan and lease losses account, accumulated unrealized gains and losses on available for sale securities, or other comprehensive income items.

Risk-weighted assets means a corporate credit union’s risk-weighted assets as calculated in accordance with Appendix C of this part.

Section 107(8) institution means an institution described in Section 107(8) of the Federal Credit Union Act (*12 U.S.C. 1757(8)*).

Securities lending means lending a security to a counterparty, either directly or through an agent, and accepting collateral in return.

Securitization means the pooling and repackaging by a special purpose entity of assets or other credit exposures that can be sold to investors. Securitization includes transactions that create stratified credit risk positions whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

Senior executive officer mean a chief executive officer, any assistant chief executive officer (e.g., any assistant president, any vice president or any assistant treasurer/manager), and the chief financial officer (controller). This term also includes employees of any entity hired to perform the functions described above.

Settlement date means the date originally agreed to by a corporate credit union and a counterparty for settlement of the purchase or sale of a security.

Short sale means the sale of a security not owned by the seller.

Small business related security means a security as defined in section 3(a)(53) of the Securities Exchange Act of 1934 (*15 U.S.C. 78c(a)(53)*), e.g., a security that is rated in 1 of the 4 highest rating categories by at least one nationally recognized statistical rating organization, and represents an interest in one or more promissory notes or leases of personal property evidencing the obligation of a small business concern and originated by an insured depository institution, insured credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority, or a finance company or leasing company. This definition does not include Small Business Administration securities permissible under Sec. 107(7) of the Act.

State means any one of the several states of the United States of America, the District of Columbia, Puerto Rico, and the territories and possessions of the United States.

Stripped mortgage-backed security means a security that represents either the principal-only or interest-only portion of the cash flows of an underlying pool of mortgages.

Subordinated security means a security that has a junior claim on the underlying collateral or assets to other securities in the same issuance. If a security is junior only to money market fund eligible securities in the same issuance, the former security is not subordinated for purposes of this definition.

Supplementary Capital means the sum of the following items:

(1) Nonperpetual capital accounts, as amortized under §704.3(b)(3);

(2) Allowance for loan and lease losses calculated under GAAP to a maximum of 1.25 percent of risk-weighted assets; and

(3) Forty-five percent of unrealized gains on available-for-sale equity securities with readily determinable fair values. Unrealized gains are unrealized holding gains, net of unrealized holding losses, calculated as the amount, if any, by which fair value exceeds historical cost. The NCUA may disallow such inclusion in the calculation of supplementary capital if the NCUA determines that the securities are not prudently valued.

Tier 1 capital means adjusted core capital.

Tier 2 capital means supplementary capital.

Tier 1 risk-based capital ratio means the ratio of Tier 1 capital to the moving daily average net risk-weighted assets.

Total assets means the sum of all a corporate credit union's assets as calculated under GAAP.

Total capital means the sum of a corporate credit union's adjusted core capital and its supplementary capital, less the corporate credit union's equity investments not otherwise deducted when calculating adjusted core capital.

Total risk-based capital ratio means the ratio of total capital to moving daily net risk-weighted assets.

Trade date means the date a corporate credit union originally agrees, whether orally or in writing, to enter into the purchase or sale of a security.

Trigger means an event in a securitization that will redirect cash-flows if predefined thresholds are breached. Examples of triggers are delinquency and cumulative loss triggers.

Weighted average life means the weighted-average time to the return of a dollar of principal, calculated by multiplying each portion of principal received by the time at which it is expected to be received (based on a reasonable and supportable estimate of that time) and then summing and dividing by the total amount of principal.

When-issued trading means the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities.

8. Effective [DATE 12 MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], revise §704.3 to read as follows:

§704.3 Corporate credit union capital.

(a) *Capital requirements.* (1) A corporate credit union must maintain at all times:

(i) A leverage ratio of 4.0 percent or greater;

(ii) A Tier 1 risk-based capital ratio of 4.0 percent or greater; and

(iii) A total risk-based capital ratio of 8.0 percent or greater.

(2) To ensure it meets its capital requirements, a corporate credit union must develop and ensure implementation of written short- and long-term capital goals, objectives, and strategies which provide for the building of capital consistent with regulatory requirements, the maintenance of sufficient capital to support the risk exposures that may arise from current and projected activities, and the periodic review and reassessment of the capital position of the corporate credit union.

(3) Beginning with the first call report submitted on or after [DATE 36 MONTHS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER], a corporate credit union must calculate and report to NCUA the ratio of its retained earnings to its moving daily average net assets. If this ratio is less than 0.45 percent, the corporate credit union must, within 30 days, submit a retained earnings accumulation plan to the NCUA for NCUA's approval. The plan must contain a detailed explanation of how the corporate credit union will accumulate earnings sufficient to meet all its future minimum leverage ratio requirements, including specific semiannual milestones for accumulating retained earnings. If the corporate credit union fails to submit a plan acceptable to NCUA, or fails to comply with any element of a plan approved by NCUA, the corporate will immediately be classified as significantly undercapitalized or, if already significantly undercapitalized, as critically undercapitalized. The corporate credit union will be subject to all the associated prompt corrective actions under §704.4.

(b) *Requirements for nonperpetual contributed capital accounts (NCA)* -- (1) Form. NCA funds may be in the form of a term certificate or a no-maturity notice account.

(2) Disclosure. The terms and conditions of a nonperpetual contributed capital account must be disclosed to the recorded owner of the account at the time the account is opened and at least annually thereafter.

(i) The initial NCA disclosure must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board; and

(ii) The annual disclosure notice must be signed by the chair of the corporate credit union. The chair must sign a statement that certifies that the notice has been sent to all entities with NCAs. The certification must be maintained in the corporate credit union's files and be available for examiner review.

(3) Five-year remaining maturity. When a no-maturity NCA has been placed on notice, or a term account has a remaining maturity of less than five years, the

corporate will reduce the amount of the account that can be considered as nonperpetual contributed capital by a constant monthly amortization that ensures the capital is fully amortized one year before the date of maturity or one year before the end of the notice period. The full balance of an NCA being amortized, not just the remaining non-amortized portion, is available to absorb losses in excess of the sum of retained earnings and perpetual contributed capital until the funds are released by the corporate credit union at the time of maturity or the conclusion of the notice period.

(4) Release. Nonperpetual contributed capital may not be released due solely to the merger, charter conversion, or liquidation of the account holder. In the event of a merger, the capital account transfers to the continuing entity. In the event of a charter conversion, the capital account transfers to the new institution. In the event of liquidation, the corporate may release a member capital account to facilitate the payout of shares, but only with the prior written approval of the NCUA.

(5) Redemption. A corporate credit union may redeem NCAs prior to maturity or prior to the end of the notice period only with the prior approval of the NCUA and, for state chartered corporate credit unions, the approval of the appropriate state regulator.

(6) Sale. A member may transfer its interest in a nonperpetual contributed capital account to a third party member or nonmember.

(7) Merger. In the event of a merger of a corporate credit union, nonperpetual capital will transfer to the continuing corporate credit union. The minimum five-year notice period for withdrawal of no-maturity capital remains in effect.

(c) *Requirements for perpetual contributed capital (PCC)* -- (1) Disclosure. The terms and conditions of any perpetual contributed capital instrument must be disclosed to the recorded owner of the instrument at the time the instrument is created and must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board.

(2) Release. Perpetual contributed capital may not be released due solely to the merger, charter conversion or liquidation of a member credit union. In the event of a merger, the perpetual contributed capital transfers to the continuing credit union. In the event of a charter conversion, the perpetual contributed capital transfers to the new institution. In the event of liquidation, the perpetual contributed capital may be released to facilitate the payout of shares with NCUA's prior written approval.

(3) Callability. A corporate credit union may call perpetual contributed capital

instruments only with the prior approval of the NCUA and, for state chartered corporate credit unions, the applicable state regulator. Perpetual contributed capital accounts are callable on a pro-rata basis across an issuance class.

(4) Perpetual contributed capital. PA corporate credit union may issue perpetual contributed capital to both members and nonmembers.

(5) The holder of a PCC instrument may freely transfer its interests in the instrument to a third party member or nonmember.

(d) *Individual minimum capital requirements.*

(1) *General.* The rules and procedures specified in this paragraph apply to the establishment of an individual minimum capital requirement for a corporate credit union that varies from any of the risk-based capital requirement(s) or leverage ratio requirements that would otherwise apply to the corporate credit union under this part.

(2) *Appropriate considerations for establishing individual minimum capital requirements.* Minimum capital levels higher than the risk-based capital requirements or the leverage ratio requirement under this part may be appropriate for individual corporate credit unions. The NCUA may establish increased individual minimum capital requirements, including modification of the minimum capital requirements related to being either significantly and critically undercapitalized for purposes of §704.4 of this part, upon a determination that the corporate credit union's capital is or may become inadequate in view of the credit union’s circumstances. For example, higher capital levels may be appropriate when NCUA determines that:

(i) A corporate credit union is receiving special supervisory attention;

(ii) A corporate credit union has or is expected to have losses resulting in capital inadequacy;

(iii) A corporate credit union has a high degree of exposure to interest rate risk, prepayment risk, credit risk, concentration risk, certain risks arising from nontraditional activities or similar risks, or a high proportion of off-balance sheet risk including standby letters of credit;

(iv) A corporate credit union has poor liquidity or cash flow;

(v) A corporate credit union is growing, either internally or through acquisitions, at such a rate that supervisory problems are presented that are not dealt with

adequately by other NCUA regulations or other guidance;

(vi) A corporate credit union may be adversely affected by the activities or condition of its CUSOs or other persons or entities with which it has significant business relationships, including concentrations of credit;

(vii) A corporate credit union with a portfolio reflecting weak credit quality or a significant likelihood of financial loss, or has loans or securities in nonperforming status or on which borrowers fail to comply with repayment terms;

(viii) A corporate credit union has inadequate underwriting policies, standards, or procedures for its loans and investments;

(ix) A corporate credit union has failed to properly plan for, or execute, necessary retained earnings growth, or

(ix) A corporate credit union has a record of operational losses that exceeds the average of other, similarly situated corporate credit unions; has management deficiencies, including failure to adequately monitor and control financial and operating risks, particularly the risks presented by concentrations of credit and nontraditional activities; or has a poor record of supervisory compliance.

(3) *Standards for determination of appropriate individual minimum capital requirements.* The appropriate minimum capital levels for an individual corporate credit union cannot be determined solely through the application of a rigid mathematical formula or wholly objective criteria. The decision is necessarily based, in part, on subjective judgment grounded in agency expertise. The factors to be considered in NCUA's determination will vary in each case and may include, for example:

(i) The conditions or circumstances leading to the determination that a higher minimum capital requirement is appropriate or necessary for the corporate credit union;

(ii) The exigency of those circumstances or potential problems;

(iii) The overall condition, management strength, and future prospects of the corporate credit union and, if applicable, its subsidiaries, affiliates, and business partners;

(iv) The corporate credit union's liquidity, capital and other indicators of financial stability, particularly as compared with those of similarly situated corporate credit unions; and

(v) The policies and practices of the corporate credit union's directors, officers, and senior management as well as the internal control and internal audit systems for implementation of such adopted policies and practices.

(4) Procedures -- (i) In the case of a state chartered corporate credit union, NCUA will consult with the appropriate state regulator when considering imposing a new minimum capital requirement.

(ii) When the NCUA determines that a minimum capital requirement is necessary or appropriate for a particular corporate credit union, it will notify the corporate credit union in writing of its proposed individual minimum capital requirement; the schedule for compliance with the new requirement; and the specific causes for determining that the higher individual minimum capital requirement is necessary or appropriate for the corporate credit union. The NCUA shall forward the notifying letter to the appropriate state supervisor if a state-chartered corporate credit union would be subject to an individual minimum capital requirement.

(iii) The corporate credit union’s response must include any information that the credit union wants the NCUA to consider in deciding whether to establish or to amend an individual minimum capital requirement for the corporate credit union, what the individual capital requirement should be, and, if applicable, what compliance schedule is appropriate for achieving the required capital level. The responses of the corporate credit union and appropriate state supervisor must be in writing and must be delivered to the NCUA within 30 days after the date on which the notification was received. The NCUA may extend the time period for good cause. The time period for response by the insured corporate credit union may be shortened for good cause:

(A) When, in the opinion of the NCUA, the condition of the corporate credit union so requires, and the NCUA informs the corporate credit union of the shortened response period in the notice;

(B) With the consent of the corporate credit union; or

(C) When the corporate credit union already has advised the NCUA that it cannot or will not achieve its applicable minimum capital requirement.

(iv) Failure by the corporate credit union to respond within 30 days, or such other time period as may be specified by the NCUA, may constitute a waiver of any objections to the proposed individual minimum capital requirement or to the schedule for complying with it, unless the NCUA has provided an extension of the response period for good cause.

(v) After expiration of the response period, the NCUA will decide whether or not the proposed individual minimum capital requirement should be established for the corporate credit union, or whether that proposed requirement should be adopted in modified form, based on a review of the corporate credit union's response and other relevant information. The NCUA's decision will address comments received within the response period from the corporate credit union and the appropriate state supervisor (if a state-chartered corporate credit union is involved) and will state the level of capital required, the schedule for compliance with this requirement, and any specific remedial action the corporate credit union could take to eliminate the need for continued applicability of the individual minimum capital requirement. The NCUA will provide the corporate credit union and the appropriate state supervisor (if a state-chartered corporate credit union is involved) with a written decision on the individual minimum capital requirement, addressing the substantive comments made by the corporate credit union and setting forth the decision and the basis for that decision. Upon receipt of this decision by the corporate credit union, the individual minimum capital requirement becomes effective and binding upon the corporate credit union. This decision represents final agency action.

(4) *Failure to comply*. Failure to satisfy any individual minimum capital requirement, or to meet any required incremental additions to capital under a schedule for compliance with such an individual minimum capital requirement, will constitute a basis to take action as described in §704.4.

(5) *Change in circumstances.* If, after a decision is made under paragraph (b)(3)(iv) of this section, there is a change in the circumstances affecting the corporate credit union's capital adequacy or its ability to reach its required minimum capital level by the specified date, the NCUA may amend the individual minimum capital requirement or the corporate credit union's schedule for such compliance. The NCUA may decline to consider a corporate credit union's request for such changes that are not based on a significant change in circumstances or that are repetitive or frivolous. Pending the NCUA's reexamination of the original decision, that original decision and any compliance schedule established in that decision will continue in full force and effect.

(e) *Reservation of authority.*

(1) *Transactions for purposes of evasion.* The NCUA may disregard any transaction entered into primarily for the purpose of reducing the minimum required amount of regulatory capital or otherwise evading the requirements of this section.

(2) *Period-end versus average figures*. The NCUA reserves the right to require a corporate credit union to compute its capital ratios on the basis of period-end,

rather than average, assets when the NCUA determines appropriate to carry out the purposes of this part.

(3) *Reservation of authority*. (i) Notwithstanding the definitions of core and supplementary capital in paragraph (d) of this section, the NCUA may find that a particular asset or core or supplementary capital component has characteristics or terms that diminish its contribution to a corporate credit union's ability to absorb losses, and the NCUA may require the discounting or deduction of such asset or component from the computation of core, supplementary, or total capital.

(ii) Notwithstanding Appendix C of this Part, the NCUA will look to the substance of a transaction and may find that the assigned risk-weight for any asset, or credit equivalent amount or credit conversion factor for any off-balance sheet item does not appropriately reflect the risks imposed on the corporate credit union. The NCUA may require the corporate credit union to apply another risk-weight, credit equivalent amount, or credit conversion factor that NCUA deems appropriate.

(iii) If Appendix C does not specifically assign a risk-weight, credit equivalent amount, or credit conversion factor to a particular asset or activity of the corporate credit union, the NCUA may assign any risk-weight, credit equivalent amount, or credit conversion factor that it deems appropriate. In making this determination, NCUA will consider the risks associated with the asset or off-balance sheet item as well as other relevant factors.

(4) Where practicable, the NCUA will consult with the appropriate state regulator before taking any action under this paragraph (e) that involves a state chartered corporate credit union.

§704.4, [Redesignated as §704.13]

9. Redesignate §704.4, *Board responsibilities*, as §704.13.

10. Effective [DATE 12 MONTHS AFTER THE DATE OF PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER}, add a new §704.4 to read as follows:

§ 704.4. Prompt Corrective Action.

(a) *Purpose*. The principal purpose of this section is to define, for corporate credit unions that are not adequately capitalized, the capital measures and capital levels that are used for determining appropriate supervisory actions. This section establishes procedures for submission and review of capital restoration

plans and for issuance and review of capital directives, orders, and other supervisory directives. In the case of a state-chartered corporate credit union, NCUA will consult with, and seek to work cooperatively with, the appropriate state regulator before taking any discretionary actions under this section.

(b) *Scope.* This section applies to corporate credit unions, including officers, directors, and employees.

(1) This section does not limit the authority of NCUA in any way to take supervisory actions to address unsafe or unsound practices, deficient capital levels, violations of law, unsafe or unsound conditions, or other practices. The NCUA may take action under this section independently of, in conjunction with, or in addition to any other enforcement action available to the NCUA, including issuance of cease and desist orders, approval or denial of applications or notices, assessment of civil money penalties, or any other actions authorized by law.

(2) Unless permitted by the NCUA or otherwise required by law, no corporate credit union may state in any advertisement or promotional material its capital category under this part or that the NCUA has assigned the corporate credit union to a particular category.

(3) Any group of credit unions applying for a new corporate credit union charter will submit, as part of the charter application, a detailed draft plan for soliciting contributed capital and building retained earnings. The draft plan will include specific levels of contributed capital and retained earnings and the anticipated timeframes for achieving those levels. The Board will review the draft plan and modify it as necessary. If the Board approves the plan, the Board will include any necessary waivers of this section or part.

(c) *Notice of capital category.* (1) Effective date of determination of capital category. A corporate credit union will be deemed to be within a given capital category as of the most recent date:

(i) A 5310 Financial Report is required to be filed with the NCUA;

(ii) A final NCUA report of examination is delivered to the corporate credit union; or

(iii) Written notice is provided by the NCUA to the corporate credit union that its capital category has changed as provided in paragraphs (c)(2) or (d)(3) of this section.

(2) Adjustments to reported capital levels and category —

(i) Notice of adjustment by corporate credit union. A corporate credit union must provide the NCUA with written notice that an adjustment to the corporate credit union's capital category may have occurred no later than 15 calendar days following the date that any material event has occurred that would cause the corporate credit union to be placed in a lower capital category from the category assigned to the corporate credit union for purposes of this section on the basis of the corporate credit union's most recent call report or report of examination.

(ii) Determination by the NCUA to change capital category. After receiving notice pursuant to paragraph (c)(1) of this section, or on its own initiative, the NCUA will determine whether to change the capital category of the corporate credit union and will notify the corporate credit union of the NCUA's determination.

(d) *Capital measures and capital category definitions.* (1) Capital measures. For purposes of this section, the relevant capital measures are:

(i) The total risk-based capital ratio;

(ii) The Tier 1 risk-based capital ratio; and

(iii) The leverage ratio.

(2) Capital categories. For purposes of this section, a corporate credit union is:

(i) Well capitalized if the corporate credit union:

(A) Has a total risk-based capital ratio of 10.0 percent or greater; and

(B) Has a Tier 1 risk-based capital ratio of 6.0 percent or greater; and

(C) Has a leverage ratio of 5.0 percent or greater; and

(D) Is not subject to any written agreement, order, capital directive, or prompt corrective action directive issued by NCUA to meet and maintain a specific capital level for any capital measure.

(ii) Adequately capitalized if the corporate credit union:

(A) Has a total risk-based capital ratio of 8.0 percent or greater; and

(B) Has a Tier 1 risk-based capital ratio of 4.0 percent or greater; and

(C) Has:

(1) A leverage ratio of 4.0 percent or greater; and

(2) Does not meet the definition of a well capitalized corporate credit union.

(iii) Undercapitalized if the corporate credit union:

(A) Has a total risk-based capital ratio that is less than 8.0 percent; or

(B) Has a Tier 1 risk-based capital ratio that is less than 4.0 percent; or

(C) Has a leverage ratio that is less than 4.0 percent.

(iv) Significantly undercapitalized if the corporate credit union has:

(A) A total risk-based capital ratio that is less than 6.0 percent; or

(B) A Tier 1 risk-based capital ratio that is less than 3.0 percent; or

(C) A leverage ratio that is less than 3.0 percent.

(v) Critically undercapitalized if the corporate credit union has:

(A) A total risk-based capital ratio that is less than 4.0 percent; or

(B) A Tier 1 risk-based capital ratio that is less than 2.0 percent; or

(C) A leverage ratio that is less than 2.0 percent.

(3) Reclassification based on supervisory criteria other than capital. Notwithstanding the elements of paragraph (d)(2) of this section, the NCUA may reclassify a well capitalized corporate credit union as adequately capitalized, and may require an adequately capitalized or undercapitalized corporate credit union to comply with certain mandatory or discretionary supervisory actions as if the corporate credit union were in the next lower capital category, in the following circumstances:

(i) Unsafe or unsound condition. The NCUA has determined, after notice and opportunity for hearing pursuant to paragraph (h)(1) of this section, that the corporate credit union is in an unsafe or unsound condition; or

(ii) Unsafe or unsound practice. The NCUA has determined, after notice and an opportunity for hearing pursuant to paragraph (h)(1) of this section, that the corporate credit union received a less-than-satisfactory rating (i.e., three or

lower) for any rating category (other than in a rating category specifically addressing capital adequacy) under the Corporate Risk Information System (CRIS) rating system and has not corrected the conditions that served as the basis for the less than satisfactory rating. Ratings under this paragraph (d)(3)(ii) refer to the most recent ratings (as determined either on-site or off-site by the most recent examination) of which the corporate credit union has been notified in writing.

(4) The NCUA may, for good cause, modify any of the percentages in paragraph (d)(2) of this section as described in §704.3(d).

(e) *Capital restoration plans.* (1) Schedule for filing plan—

(i) In general. A corporate credit union must file a written capital restoration plan with the NCUA within 45 days of the date that the corporate credit union receives notice or is deemed to have notice that the corporate credit union is undercapitalized, significantly undercapitalized, or critically undercapitalized, unless the NCUA notifies the corporate credit union in writing that the plan is to be filed within a different period. An adequately capitalized corporate credit union that has been required pursuant to paragraph (d)(3) of this section to comply with supervisory actions as if the corporate credit union were undercapitalized is not required to submit a capital restoration plan solely by virtue of the reclassification.

(ii) Additional capital restoration plans. Notwithstanding paragraph (e)(1)(i) of this section, a corporate credit union that has already submitted and is operating under a capital restoration plan approved under this section is not required to submit an additional capital restoration plan based on a revised calculation of its capital measures or a reclassification of the institution under paragraph (d)(3) of this section unless the NCUA notifies the corporate credit union that it must submit a new or revised capital plan. A corporate credit union that is notified that it must submit a new or revised capital restoration plan must file the plan in writing with the NCUA within 45 days of receiving such notice, unless the NCUA notifies the corporate credit union in writing that the plan is to be filed within a different period.

(2) Contents of plan. All financial data submitted in connection with a capital restoration plan must be prepared in accordance with the instructions provided on the call report, unless the NCUA instructs otherwise. The capital restoration plan must include all of the information required to be filed under paragraph (k)(2)(ii) of this section. A corporate credit union required to submit a capital restoration plan as the result of a reclassification of the corporate credit union pursuant to paragraph (d)(3) of this section must include a description of the

steps the corporate credit union will take to correct the unsafe or unsound condition or practice.

(3) Failure to submit a capital restoration plan. A corporate credit union that is undercapitalized and that fails to submit a written capital restoration plan within the period provided in this section will, upon the expiration of that period, be subject to all of the provisions of this section applicable to significantly undercapitalized credit unions.

(4) Review of capital restoration plans. Within 60 days after receiving a capital restoration plan under this section, the NCUA will provide written notice to the corporate credit union of whether it has approved the plan. The NCUA may extend this time period.

(5) Disapproval of capital plan. If the NCUA does not approve a capital restoration plan, the corporate credit union must submit a revised capital restoration plan, when directed to do so, within the time specified by the NCUA. An undercapitalized corporate credit union is subject to the provisions applicable to significantly undercapitalized credit unions until it has submitted, and NCUA has approved, a capital restoration plan. If the NCUA directs that the corporate submit a revised plan, it must do so in time frame specified by the NCUA.

(6) Failure to implement a capital restoration plan. Any undercapitalized corporate credit union that fails in any material respect to implement a capital restoration plan will be subject to all of the provisions of this section applicable to significantly undercapitalized institutions.

(7) Amendment of capital plan. A corporate credit union that has filed an approved capital restoration plan may, after prior written notice to and approval by the NCUA, amend the plan to reflect a change in circumstance. Until such time as NCUA has approved a proposed amendment, the corporate credit union must implement the capital restoration plan as approved prior to the proposed amendment.

(f) *Mandatory and discretionary supervisory actions.* (1) Mandatory supervisory actions. —

(i) Provisions applicable to all corporate credit unions. All corporate credit unions are subject to the restrictions contained in paragraph (k)(1) of this section on capital distributions.

(ii) Provisions applicable to undercapitalized, significantly undercapitalized, and critically undercapitalized corporate credit unions. Immediately upon receiving notice or being deemed to have notice, as provided in paragraph (c) or (e) of this

section, that the corporate credit union is undercapitalized, significantly undercapitalized, or critically undercapitalized, the corporate credit union will be subject to the following provisions of paragraph (k) of this section:

(A) Restricting capital distributions (paragraph (k)(1));

(B) NCUA monitoring of the condition of the corporate credit union (paragraph (k)(2)(i));

(C) Requiring submission of a capital restoration plan (paragraph (k)(2)(ii));

(D) Restricting the growth of the corporate credit union's assets (paragraph (k)(2)(iii)); and

(E) Requiring prior approval of certain expansion proposals (paragraph (k)(2)(iv)).

(iii) Additional provisions applicable to significantly undercapitalized, and critically undercapitalized corporate credit unions. In addition to the requirement described in paragraph (f)(1) of this section, immediately upon receiving notice or being deemed to have notice that the corporate credit union is significantly undercapitalized, or critically undercapitalized, or that the corporate credit union is subject to the provisions applicable to corporate credit unions that are significantly undercapitalized because the credit union failed to submit or implement in any material respect an acceptable capital restoration plan, the corporate credit union will become subject to the provisions of paragraph (k)(3)(iii) of this section that restrict compensation paid to senior executive officers of the institution.

(iv) Additional provisions applicable to critically undercapitalized corporate credit unions. In addition to the provisions described in paragraphs (f)(1)(ii) and (f)(1)(iii) of this section, immediately upon receiving notice or being deemed to have notice that the corporate credit union is critically undercapitalized, the corporate credit union will become subject to these additional provisions of paragraph (k) of this section:

(A) Restricting the activities of the corporate credit union ((k)(5)(i)); and

(B) Restricting payments on subordinated debt of the corporate credit union ((k)(5)(ii)).

(2) Discretionary supervisory actions. In taking any action under paragraph (k) of this section that is within the NCUA's discretion to take in connection with a corporate credit union that is deemed to be undercapitalized, significantly

undercapitalized or critically undercapitalized, or has been reclassified as undercapitalized, or significantly undercapitalized; or an action in connection with an officer or director of such corporate credit union; the NCUA will follow the procedures for issuing directives under paragraphs (g) and (i) of this section.

(g) *Directives to take prompt corrective action.* The NCUA will provide an undercapitalized, significantly undercapitalized, or critically undercapitalized corporate credit union prior written notice of the NCUA's intention to issue a directive requiring such corporate credit union to take actions or to follow proscriptions described in this part. Section 747.3002 of this chapter prescribes the notice content and associated process.

(h) *Procedures for reclassifying a corporate credit union based on criteria other than capital.* When the NCUA intends to reclassify a corporate credit union or subject it to the supervisory actions applicable to the next lower capitalization category based on an unsafe or unsound condition or practice the NCUA will provide the credit union with prior written notice of such intent. Section 747.3003 of this chapter prescribes the notice content and associated process.

(i) *Order to dismiss a Director or senior executive officer.* When the NCUA issues and serves a directive on a corporate credit union requiring it to dismiss from office any director or senior executive officer under paragraphs (k)(3) of this section, the NCUA will also serve upon the person the corporate credit union is directed to dismiss (Respondent) a copy of the directive (or the relevant portions, where appropriate) and notice of the Respondent's right to seek reinstatement. Section 747.3004 of this chapter prescribes the content of the notice of right to seek reinstatement and the associated process.

(j) *Enforcement of directives.* Section 747.3005 of this chapter prescribes the process for enforcement of directives.

(k) *Remedial actions towards undercapitalized, significantly undercapitalized, and critically undercapitalized corporate credit unions.* (1) Provision applicable to all corporate credit unions. A corporate credit union is prohibited, unless it obtains NCUA's prior written approval, from making any capital distribution, including payment of dividends on perpetual and nonperpetual contributed capital accounts if, after making the distribution, the institution would be undercapitalized.

(2) Provisions applicable to undercapitalized corporate credit unions.

(i) Monitoring required. The NCUA will--

(A) Closely monitor the condition of any undercapitalized corporate credit union;

(B) Closely monitor compliance with capital restoration plans, restrictions, and requirements imposed under this section; and

(C) Periodically review the plan, restrictions, and requirements applicable to any undercapitalized corporate credit union to determine whether the plan, restrictions, and requirements are achieving the purpose of this section.

(ii) Capital restoration plan required.

(A) Any undercapitalized corporate credit union must submit an acceptable capital restoration plan to the NCUA.

(B) The capital restoration plan will--

(1) Specify--

(i) The steps the corporate credit union will take to become adequately capitalized;

(ii) The levels of capital to be attained during each year in which the plan will be in effect;

(iii) How the corporate credit union will comply with the restrictions or requirements then in effect under this section; and

(iv) The types and levels of activities in which the corporate credit union will engage; and

(2) Contain such other information as the NCUA may require.

(C) The NCUA will not accept a capital restoration plan unless the NCUA determines that the plan--

(1) Complies with paragraph (k)(2)(ii)(B) of this section;

(2) Is based on realistic assumptions, and is likely to succeed in restoring the corporate credit union's capital; and

(3) Would not appreciably increase the risk (including credit risk, interest-rate risk, and other types of risk) to which the corporate credit union is exposed; and

(iii) Asset growth restricted. An undercapitalized corporate credit union must not permit its daily average net assets during any calendar month to exceed its moving daily average net assets unless—

(A) The NCUA has accepted the corporate credit union's capital restoration plan; and

(B) Any increase in total assets is consistent with the plan.

(iv) Prior approval required for acquisitions, branching, and new lines of business. An undercapitalized corporate credit union must not, directly or indirectly, acquire any interest in any entity, establish or acquire any additional branch office, or engage in any new line of business unless the NCUA has accepted the corporate credit union's capital restoration plan, the corporate credit union is implementing the plan, and the NCUA determines that the proposed action is consistent with and will further the achievement of the plan.

(v) Discretionary safeguards. The NCUA may, with respect to any undercapitalized corporate credit union, take one or more of the actions described in paragraph (k)(3)(ii) of this section if the NCUA determines those actions are necessary to carry out the purpose of this section.

(3) Provisions applicable to significantly undercapitalized corporate credit unions and undercapitalized corporate credit unions that fail to submit and implement capital restoration plans.

(i) In general. This paragraph applies with respect to any corporate credit union that--

(A) Is significantly undercapitalized; or

(B) Is undercapitalized and--

(1) Fails to submit an acceptable capital restoration plan within the time allowed by the NCUA under paragraph (e)(1) of this section; or

(2) Fails in any material respect to implement a plan accepted by the NCUA.

(ii) Specific actions authorized. The NCUA may take one or more of the following actions:

(A) Requiring recapitalization.

(1) Requiring the corporate credit union to seek and obtain additional contributed capital.

(2) Requiring the corporate credit union to increase its rate of earnings retention.

(3) Requiring the corporate credit union to combine, in whole or part, with another insured depository institution, if one or more grounds exist under this section or the Federal Credit Union Act for appointing a conservator or liquidating agent .

(B) Restricting any ongoing or future transactions with affiliates.

(C) Restricting interest rates paid.

(1) In general. Restricting the rates of dividends and interest that the corporate credit union pays on shares and deposits to the prevailing rates on shares and deposits of comparable amounts and maturities in the region where the institution is located, as determined by the NCUA.

(2) Retroactive restrictions prohibited. Paragraph (k)(3)(ii)(c) of this section does not authorize the NCUA to restrict interest rates paid on time deposits or shares made before (and not renewed or renegotiated after) the date the NCUA announced this restriction.

(D) Restricting asset growth. Restricting the corporate credit union's asset growth more stringently than in paragraph (k)(2)(iii) of this section, or requiring the corporate credit union to reduce its total assets.

(E) Restricting activities. Requiring the corporate credit union or any of its CUSOs to alter, reduce, or terminate any activity that the NCUA determines poses excessive risk to the corporate credit union.

(F) Improving management. Doing one or more of the following:

(1) New election of Directors. Ordering a new election for the corporate credit union's board of Directors.

(2) Dismissing Directors or senior executive officers. Requiring the corporate credit union to dismiss from office any Director or senior executive officer who had held office for more than 180 days immediately before the corporate credit union became undercapitalized.

(3) Employing qualified senior executive officers. Requiring the corporate credit union to employ qualified senior executive officers (who, if the NCUA so specifies, will be subject to approval by the NCUA).

(G) Requiring divestiture. Requiring the corporate credit union to divest itself of or liquidate any interest in any entity if the NCUA determines that the entity is in danger of becoming insolvent or otherwise poses a significant risk to the corporate credit union;

(H) Conserve or liquidate the corporate credit union if NCUA determines the credit union has no reasonable prospect of becoming adequately capitalized; and

(I) Requiring other action. Requiring the corporate credit union to take any other action that the NCUA determines will better carry out the purpose of this section than any of the actions described in this paragraph.

(iii) Senior executive officers' compensation restricted.

(A) In general. The corporate credit union is prohibited from doing any of the following without the prior written approval of the NCUA:

(1) Pay any bonus or profit-sharing to any senior executive officer.

(2) Provide compensation to any senior executive officer at a rate exceeding that officer's average rate of compensation (excluding bonuses and profit-sharing) during the 12 calendar months preceding the calendar month in which the corporate credit union became undercapitalized.

(B) Failing to submit plan. The NCUA will not grant approval with respect to a corporate credit union that has failed to submit an acceptable capital restoration plan.

(iv) Discretion to impose certain additional restrictions. The NCUA may impose one or more of the restrictions prescribed by regulation under paragraph (k)(5) of this section if the NCUA determines that those restrictions are necessary to carry out the purpose of this section.

(4) More stringent treatment based on other supervisory criteria.

(i) In general. If the NCUA determines, after notice and an opportunity for hearing as described in subpart M of part 747 of this chapter, that a corporate credit union is in an unsafe or unsound condition or deems the corporate credit union to be engaging in an unsafe or unsound practice, the NCUA may--

(A) If the corporate credit union is well capitalized, reclassify the corporate credit union as adequately capitalized;

(B) If the corporate credit union is adequately capitalized (but not well capitalized), require the corporate credit union to comply with one or more provisions of paragraphs (k)(1) and (k)(2) of this section, as if the corporate credit union were undercapitalized; or

(C) If the corporate credit union is undercapitalized, take any one or more actions authorized under paragraph (k)(3)(ii) of this section as if the corporate credit union were significantly undercapitalized.

(ii) Contents of plan. Any plan required under paragraph (k)(4)(i) of this section will specify the steps that the corporate credit union will take to correct the unsafe or unsound condition or practice. Capital restoration plans, however, will not be required under paragraph (k)(4)(i)(B) of this section.

(5) Provisions applicable to critically undercapitalized corporate credit unions.

(i) Activities restricted. Any critically undercapitalized corporate credit union must comply with restrictions prescribed by the NCUA under paragraph (k)(6) of this section.

(ii) Payments on contributed capital and subordinated debt prohibited. A critically undercapitalized corporate credit union must not, beginning no later than 60 days after becoming critically undercapitalized, make any payment of dividends on contributed capital or any payment of principal or interest on the corporate credit union's subordinated debt unless the NCUA determines that an exception would further the purpose of this section. Interest, although not payable, may continue to accrue under the terms of any subordinated debt to the extent otherwise permitted by law. Dividends on contributed capital do not, however, continue to accrue.

(iii) Conservatorship, liquidation, or other action. The NCUA may, at any time, conserve or liquidate any critically undercapitalized corporate credit union or require the credit union to combine, in whole or part, with another institution. NCUA will consider, not later than 90 days after a corporate credit union becomes critically undercapitalized, whether NCUA should liquidate, conserve, or combine the institution.

(6) Restricting activities of critically undercapitalized corporate credit unions. To carry out the purpose of this section, the NCUA will, by order--

(i) Restrict the activities of any critically undercapitalized corporate credit union; and

(ii) At a minimum, prohibit any such corporate credit union from doing any of the following without the NCUA's prior written approval:

(A) Entering into any material transaction other than in the usual course of business, including any investment, expansion, acquisition, sale of assets, or other similar action.

(B) Extending credit for any transaction NCUA determines to be highly leveraged.

(C) Amending the corporate credit union's charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order.

(D) Making any material change in accounting methods.

(E) Paying compensation or bonuses NCUA determines to be excessive.

(F) Paying interest on new or renewed liabilities at a rate that would increase the corporate credit union's weighted average cost of funds to a level significantly exceeding the prevailing rates of interest on insured deposits in the corporate credit union's normal market areas.

11. Revise §704.5 to read as follows:

§ 704.5. Investments.

(a) *Policies*. A corporate credit union must operate according to an investment policy that is consistent with its other risk management policies, including, but not limited to, those related to credit risk management, asset and liability management, and liquidity management. The policy must address, at a minimum:

(1) Appropriate tests and criteria for evaluating investments and investment transactions before purchase; and

(2) Reasonable and supportable concentration limits for limited liquidity investments in relation to capital.

(b) *General*. All investments must be U.S. dollar-denominated and subject to the credit policy restrictions set forth in § 704.6.

(c) *Authorized activities*. A corporate credit union may invest in:

(1) Securities, deposits, and obligations set forth in Sections 107(7), 107(8), and 107(15) of the Federal Credit Union Act, 12 U.S.C. 1757(7), 1757(8), and 1757(15), except as provided in this section;

(2) Deposits in, the sale of federal funds to, and debt obligations of corporate credit unions, Section 107(8) institutions, and state banks, trust companies, and mutual savings banks not domiciled in the state in which the corporate credit union does business;

(3) Corporate CUSOs, as defined in and subject to the limitations of § 704.11;

(4) Marketable debt obligations of corporations chartered in the United States. This authority does not apply to debt obligations that are convertible into the stock of the corporation; and

(5) Domestically-issued asset-backed securities.

(d) *Repurchase agreements*. A corporate credit union may enter into a repurchase agreement provided that:

(1) The corporate credit union, directly or through its agent, receives written confirmation of the transaction, and either takes physical possession or control of the repurchase securities or is recorded as owner of the repurchase securities through the Federal Reserve Book-Entry Securities Transfer System;

(2) The repurchase securities are legal investments for that corporate credit union;

(3) The corporate credit union, directly or through its agent, receives daily assessment of the market value of the repurchase securities and maintains adequate margin that reflects a risk assessment of the repurchase securities and the term of the transaction; and

(4) The corporate credit union has entered into signed contracts with all approved counterparties and agents, and ensures compliance with the contracts. Such contracts must address any supplemental terms and conditions necessary to meet the specific requirements of this part. Third party arrangements must be supported by tri-party contracts in which the repurchase securities are priced and reported daily and the tri-party agent ensures compliance; and

(e) *Securities Lending*. A corporate credit union may enter into a securities lending transaction provided that:

(1) The corporate credit union, directly or through its agent, receives written confirmation of the loan, obtains a first priority security interest in the collateral by taking physical possession or control of the collateral, or is recorded as owner of the collateral through the Federal Reserve Book-Entry Securities Transfer System;

(2) The collateral is a legal investment for that corporate credit union;

(3) The corporate credit union, directly or through its agent, receives daily assessment of the market value of collateral and maintains adequate margin that reflects a risk assessment of the collateral and terms of the loan; and

(4) The corporate credit union has entered into signed contracts with all agents and, directly or through its agent, has executed a written loan and security agreement with the borrower. The corporate or its agent ensures compliance with the agreements.

(f) *Investment companies*. A corporate credit union may invest in an investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a), or a collective investment fund maintained by a national bank under 12 CFR 9.18 or a mutual savings bank under 12 CFR 550.260, provided that the company or fund prospectus restricts the investment portfolio to investments and investment transactions that are permissible for that corporate credit union.

(g) *Investment settlement*. A corporate credit union may only contract for the purchase or sale of an investment if the transaction is settled on a delivery versus payment basis within 60 days for mortgage-backed securities, within 30 days for new issues (other than mortgage-backed securities), and within three days for all other securities.

(h) *Prohibitions*. A corporate credit union is prohibited from:

(1) Purchasing or selling derivatives, except for embedded options not required under GAAP to be accounted for separately from the host contract or forward sales commitments on loans to be purchased by the corporate credit union;

(2) Engaging in trading securities unless accounted for on a trade date basis;

(3) Engaging in adjusted trading or short sales; and

(4) Purchasing mortgage servicing rights, small business related securities, residual interests in collateralized mortgage obligations, residual interests in real estate mortgage investment conduits, or residual interests in asset-backed securities; and

(5) Purchasing net interest margin securities;

(6) Purchasing collateralized debt obligations; and

(7) Purchasing stripped mortgage-backed securities (SMBS), or securities that represent interests in SMBS, except as described in subparagraphs (i) and (iii) below.

(i) A corporate credit union may invest in exchangeable collateralized mortgage obligations (exchangeable CMOs) representing beneficial ownership interests in one or more interest-only classes of a CMO (IO CMOs) or principal-only classes of a CMO (PO CMOs), but only if:

(A) At the time of purchase, the ratio of the market price to the remaining principal balance is between .8 and 1.2, meaning that the discount or premium of the market price to par must be less than 20 points;

(B) The offering circular or other official information available at the time of purchase indicates that the notional principal on each underlying IO CMO should decline at the same rate as the principal on one or more of the underlying non-IO CMOs, and that the principal on each underlying PO CMO should decline at the same rate as the principal, or notional principal, on one or more of the underlying non-PO CMOs; and

(C) The credit union investment staff has the expertise dealing with exchangeable CMOs to apply the conditions in paragraphs (h)(5)(i)(A) and (B) of this section.

(ii) A corporate credit union that invests in an exchangeable CMO may exercise the exchange option only if all of the underlying CMOs are permissible investments for that credit union.

(iii) A corporate credit union may accept an exchangeable CMO representing beneficial ownership interests in one or more IO CMOs or PO CMOs as an asset associated with an investment repurchase transaction or as collateral in a securities lending transaction. When the exchangeable CMO is associated with one of these two transactions, it need not conform to the conditions in paragraphs (h)(5)(i)(A) or (B) of this section.

(i) *Conflicts of interest*. A corporate credit union's officials, employees, and immediate family members of such individuals, may not receive pecuniary consideration in connection with the making of an investment or deposit by the corporate credit union. Employee compensation is exempt from this prohibition. All transactions not specifically prohibited by this paragraph must be conducted at arm's length and in the interest of the corporate credit union.

(j) *Grandfathering*. A corporate credit union's authority to hold an investment is governed by the regulation in effect at the time of purchase. However, all grandfathered investments are subject to the requirements of §§704.8 and 704.9.

12. Revise §704.6 to read as follows:

§ 704.6. Credit risk management.

(a) *Policies*. A corporate credit union must operate according to a credit risk management policy that is commensurate with the investment risks and activities it undertakes. The policy must address at a minimum:

(1) The approval process associated with credit limits;

(2) Due diligence analysis requirements;

(3) Maximum credit limits with each obligor and transaction counterparty, set as a percentage of capital. In addition to addressing deposits and securities, limits with transaction counterparties must address aggregate exposures of all transactions including, but not limited to, repurchase agreements, securities lending, and forward settlement of purchases or sales of investments; and

(4) Concentrations of credit risk (e.g., originator of receivables, servicer of receivables, insurer, industry type, sector type, geographic, collateral type, and tranche priority).

(b) *Exemption*. The limitations and requirements of this section do not apply to certain assets, whether or not considered investments under this part, including fixed assets, individual loans and loan participation interests, investments in CUSOs, investments that are issued or fully guaranteed as to principal and interest by the U.S. government or its agencies or its sponsored enterprises (excluding subordinated debt), and investments that are fully insured or guaranteed (including accumulated dividends and interest) by the NCUSIF or the Federal Deposit Insurance Corporation.

(c) *Issuer Concentration limits*— (1) General rule. The aggregate of all investments in any single obligor is limited to 25 percent of capital or $5 million, whichever is greater.

(2) Exceptions.
(i) Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 200 percent of capital;
(ii) Investments in non-money market registered investment companies are limited to of 50 percent of capital in any single obligor ;
(iii) Investments in money market registered investment companies are limited to 100 percent of capital in any single obligor; and
(iv) Investments in corporate CUSOs are subject to the limitations of § 704.11.

(3) For purposes of measurement, each new credit transaction must be evaluated in terms of the corporate credit union's capital at the time of the transaction. An investment that fails a requirement of this section because of a subsequent reduction in capital will be deemed non-conforming. A corporate credit union is required to exercise reasonable efforts to bring nonconforming investments into conformity within 90 calendar days. Investments that remain nonconforming for 90 calendar days will be deemed to fail a requirement of this section and the corporate credit union will have to comply with § 704.10.

(d) *Sector Concentration Limits*. (1) A corporate credit union must establish sector limits that do not exceed the following maximums:

(i) Residential mortgage-backed securities – the lower of 500 percent of capital or 25 percent of assets;

(ii) Commercial mortgage-backed securities – the lower of 500 percent of capital or 25 percent of assets;

(iii) FFELP student loan asset-backed securities – the lower of 1000 percent of capital or 50 percent of assets;

(iv) Private student loan asset-backed securities – the lower of 500 percent of capital or 25 percent of assets;

(v) Auto loan/lease asset-backed securities – the lower of 500 percent of capital or 25 percent of assets;

(vi) Credit card asset-backed securities – the lower of 500 percent of capital or 25 percent of assets;

(vii) Other asset-backed securities not listed in paragraphs (ii) through (vi) – the lower of 500 percent of capital or 25 percent of assets;

(viii) Corporate debt obligations – the lower of 1000 percent of capital or 50 percent of assets; and

(ix) Municipal securities – the lower of 1000 percent of capital or 50 percent of assets.

(2) Registered investment companies – A corporate credit union must limit its investment in registered investment companies to the lower of 1000 percent of capital or 50 percent of assets. In addition to applying the limit in this paragraph (d)(2), a corporate credit union must also include the underlying assets in each registered investment company in the relevant sectors described in paragraph (d)(1) of this section when calculating those sector limits.

(3) A corporate credit union will limit its aggregate holdings in any investments not described in paragraphs (d)(1) or (d)(2) to the lower of 100 percent of capital or 5 percent of assets. The NCUA may approve a higher percentage in appropriate cases.

(4) The following investments are also excluded from the concentration limits in paragraphs (d)(1), (d)(2), and (d)(3): Investments in other federally insured credit unions, deposits in other depository institutions, and investment repurchase agreements.

(e) *Subordinated securities*. A corporate credit union may not hold subordinated securities in excess of the lower of 100 percent of capital or 5 percent of assets in any single investment sector described in paragraphs (d)(1) and (d)(2) or in excess of the lower of 400 percent of capital or 20 percent of assets in all investment sectors described in paragraph (d).

(f) *Credit ratings*. — (1) All investments, other than in another depository institution, must have an applicable credit rating from at least one nationally recognized statistical rating organization (NRSRO). At a minimum, 90 percent of all such investments, by book value, must have a rating by at least two NRSROs. Corporate credit unions may use either public or nonpublic NRSRO ratings to satisfy this requirement.

(2) At the time of purchase, investments with long-term ratings must be rated no lower than AA– (or equivalent) by every NRSRO that provides a publicly available long-term rating on that investment, and investments with short-term ratings must be rated no lower than A–1 (or equivalent) by every NRSRO that provides a publicly available short-term rating on that investment. If the

corporate credit union obtains a nonpublic NRSRO rating, that rating must also be no lower than AA-, or A-1, for long-term and short-term ratings, respectively.

(3) All rating(s) relied upon to meet the requirements of this part must be identified at the time of purchase and must be monitored for as long as the corporate owns the investment. Corporate credit unions must identify and monitor any new post-purchase NRSRO ratings on investments they hold.

(4) Investments are subject to the requirements of §704.10 if:

(i) An NRSRO that rates the investment downgrades that rating, after purchase, below the minimum rating requirements of this part; or

(ii) The investment is part of an asset class or group of investments that exceeds the sector or obligor concentration limits of this section.

(g) *Reporting and documentation*. (1) At least annually, a written evaluation of each credit limit with each obligor or transaction counterparty must be prepared and formally approved by the board or an appropriate committee. At least monthly, the board or an appropriate committee must receive an investment watch list of existing and/or potential credit problems and summary credit exposure reports, which demonstrate compliance with the corporate credit union's risk management policies.

(2) At a minimum, the corporate credit union must maintain:

(i) A justification for each approved credit limit;

(ii) Disclosure documents, if any, for all instruments held in portfolio. Documents for an instrument that has been sold must be retained until completion of the next NCUA examination; and

(iii) The latest available financial reports, industry analyses, internal and external analyst evaluations, and rating agency information sufficient to support each approved credit limit.

13. Revise § 704.8 to read as follows:

§ 704.8. Asset and liability management.

(a) *Policies*. A corporate credit union must operate according to a written asset and liability management policy which addresses, at a minimum:

(1) The purpose and objectives of the corporate credit union's asset and liability activities;

(2) The maximum allowable percentage decline in net economic value (NEV), compared to base case NEV;

(3) The minimum allowable NEV ratio;

(4) Policy limits and specific test parameters for the NEV sensitivity analysis requirements set forth in paragraphs (d), (e), and (f) of this section;

(5) The modeling of indexes that serve as references in financial instrument coupon formulas; and

(6) The tests that will be used, prior to purchase, to estimate the impact of investments on the percentage decline in NEV compared to base case NEV. The most recent NEV analysis, as determined under paragraph (d)(1)(i), (e)(1)(i), and (f)(1)(i) of this section may be used as a basis of estimation.

(b) *Asset and liability management committee (ALCO)*. A corporate credit union's ALCO must have at least one member who is also a member of the board of directors. The ALCO must review asset and liability management reports on at least a monthly basis. These reports must address compliance with Federal Credit Union Act, NCUA Rules and Regulations (12 CFR chapter VII), and all related risk management policies.

(c) *Penalty for early withdrawals*. A corporate credit union that permits early share certificate withdrawals must redeem at the lesser of book value plus accrued dividends or the value based on a market-based penalty sufficient to cover the estimated replacement cost of the certificate redeemed. This means the minimum penalty must be reasonably related to the rate that the corporate credit union would be required to offer to attract funds for a similar term with similar characteristics.

(d) *Interest rate sensitivity analysis*. (1) A corporate credit union must:

(i) Evaluate the risk in its balance sheet by measuring, at least quarterly, the impact of an instantaneous, permanent, and parallel shock in the yield curve of plus and minus 100, 200, and 300 bp on its NEV and NEV ratio. If the base case NEV ratio falls below 3 percent at the last testing date, these tests must be calculated at least monthly until the base case NEV ratio again exceeds 3 percent;

(ii) Limit its risk exposure to levels that do not result in a base case NEV ratio or any NEV ratio resulting from the tests set forth in paragraph (d)(1)(i) of this section below 2 percent; and

(iii) Limit its risk exposures to levels that do not result in a decline in NEV of more than 15 percent.

(2) A corporate credit union must assess annually if it should conduct periodic additional tests to address market factors that may materially impact that corporate credit union's NEV. These factors should include, but are not limited to, the following:

(i) Changes in the shape of the Treasury yield curve;

(ii) Adjustments to prepayment projections used for amortizing securities to consider the impact of significantly faster/slower prepayment speeds; and

(iii) Adjustments to volatility assumptions to consider the impact that changing volatilities have on embedded option values.

(e) *Cash flow mismatch sensitivity analysis*.

(1) A corporate credit union must:

(i) Evaluate the risk in its balance sheet by measuring, at least quarterly, the impact of an instantaneous spread widening of both asset and liabilities by 300 basis points, assuming that issuer options will not be exercised, on its NEV and NEV ratio. If the base case NEV ratio falls below 3 percent at the last testing date, these tests must be calculated at least monthly until the base case NEV ratio again exceeds 3 percent;

(ii) Limit its risk exposure to levels that do not result in a base case NEV ratio or any NEV ratio resulting from the tests set forth in paragraph (e)(1)(i) of this section below 2 percent; and

(iii) Limit its risk exposures to levels that do not result in a decline in NEV of more than 15 percent.

(2) All investments must be tested, excluding derivatives and equity investments. All borrowings and shares must be tested, but not contributed capital.

(3) A corporate credit union must also test for the effects of failed triggers on its NEV and NEV ratios while testing the cash flow sensitivity analysis.

(f) *Cash flow mismatch sensitivity analysis with 50 percent slowdown in prepayment speeds*. (1) A corporate credit union must:

(i) Evaluate the risk in its balance sheet by measuring, at least quarterly, the impact of an instantaneous spread widening of both asset and liabilities by 300 basis points, assuming that issuer options will not be exercised and prepayment speeds will slow by 50 percent, on its NEV and NEV ratio. If the base case NEV ratio falls below 2 percent at the last testing date, these tests must be calculated at least monthly until the base case NEV ratio again exceeds 2 percent;

(ii) Limit its risk exposure to levels that do not result in a base case NEV ratio or any NEV ratio resulting from the tests set forth in paragraph (f)(1)(i) of this section below 1 percent; and

(iii) Limit its risk exposures to levels that do not result in a decline in NEV of more than 25 percent.

(2) All investments must be tested, excluding derivatives and equity investments. All borrowings and shares must be tested, but not contributed capital.

(3) A corporate credit union must also test for the effects of failed triggers on its NEV and NEV while testing the cash flow sensitivity analysis.

(g) *Net interest income modeling*. A corporate credit union must perform net interest income (NII) modeling to project earnings in multiple interest rate environments for a period of no less than 2 years. NII modeling must, at minimum, be performed quarterly.

(h) *Weighted average asset life*. The weighted average life (WAL) of a corporate credit union's investment portfolio, excluding derivative contracts and equity investments, may not exceed 2 years. A corporate credit union must test its investments at least quarterly for compliance with this WAL limitation. When calculating its WAL, a corporate credit union must assume that no issuer options will be exercised.

(i) Effective and spread durations. A corporate credit union must measure at least once a quarter the effective duration and spread durations of each of its assets and liabilities, where the values of these are affected by changes in interest rates or credit spreads.

(j) *Regulatory violations*. (1) (i) If a corporate credit union's decline in NEV, base case NEV ratio or any NEV ratio resulting from the tests set forth in paragraphs (d), (e), and (f) of this section violate the limits established in those

paragraphs, or the corporate credit union is unable to satisfy the tests in paragraphs (g) and (h) of this section; and

(ii) The corporate cannot adjust its balance sheet so as to satisfy the requirements of paragraph (d), (e), (f), (g), or (h) of this section within 10 calendar days after detecting the violation, then:

(iii) The operating management of the corporate credit union must immediately report this information to its board of directors, supervisory committee, and the NCUA.

(2) If any violation described in paragraph (j)(1)(i) persists for 30 or more calendar days, the corporate credit union:

(i) Must immediately submit a detailed, written action plan to the NCUA that sets forth the time needed and means by which it intends to correct the violation and, if the NCUA determines that the plan is unacceptable, the corporate credit union must immediately restructure its balance sheet to bring the exposure back within compliance or adhere to an alternative course of action determined by the NCUA; and

(ii) If presently categorized as adequately capitalized or well capitalized for PCA purposes, immediately be recategorized as:undercapitalized until the violation is corrected, and

(iii) If presently less than adequately capitalized, immediately be downgraded one additional capital category.

(k) *Overall limit on business generated from individual credit unions*. On or after [DATE 30 MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], a corporate credit union is prohibited from accepting from a member or other entity any investment, including shares, loans, PCC, or NCAs if, following that investment, the aggregate of all investments from that member or entity in the corporate would exceed 10 percent of the corporate credit union's moving daily average net assets.

14. Revise § 704.9 to read as follows:

§ 704.9. Liquidity management.

(a) *General*. In the management of liquidity, a corporate credit union must:

(1) Evaluate the potential liquidity needs of its membership in a variety of economic scenarios;

(2) Regularly monitor and demonstrate accessibility to sources of internal and external liquidity;

(3) Keep a sufficient amount of cash and cash equivalents on hand to support its payment system obligations;

(4) Demonstrate that the accounting classification of investment securities is consistent with its ability to meet potential liquidity demands; and

(5) Develop a contingency funding plan that addresses alternative funding strategies in successively deteriorating liquidity scenarios. The plan must:

(i) List all sources of liquidity, by category and amount, that are available to service an immediate outflow of funds in various liquidity scenarios;

(ii) Analyze the impact that potential changes in fair value will have on the disposition of assets in a variety of interest rate scenarios; and

(iii) Be reviewed by the board or an appropriate committee no less frequently than annually or as market or business conditions dictate.

(b) *Borrowing limits*. A corporate credit union may borrow up to the lower of 10 times capital or 50 percent of capital and shares (excluding shares created by the use of member reverse repurchase agreements).

(1) *Secured borrowings*. A corporate credit union may borrow on a secured basis for liquidity purposes, but the maturity of the borrowing may not exceed 30 days. Only a credit union with core capital in excess of five percent of its moving DANA may borrow on a secured basis for nonliquidity purposes, and the outstanding amount of secured borrowing for nonliquidity purposes may not exceed an amount equal to the difference between core capital and five percent of moving DANA.

(2) *Exclusions.* CLF borrowings and borrowed funds created by the use of member reverse repurchase agreements are excluded from this limit.

15. Revise §704.11 to read as follows:

§ 704.11 Corporate Credit Union Service Organizations (Corporate CUSOs).

(a) A corporate CUSO is an entity that:

(1) Is at least partly owned by a corporate credit union;
(2) Primarily serves credit unions;
(3) Restricts its services to those related to the normal course of business of credit unions as specified in paragraph (e) of this section; and
(4) Is structured as a corporation, limited liability company, or limited partnership under state law.

(b) *Investment and loan limitations*. (1) The aggregate of all investments in member and non-member corporate CUSOs must not exceed 15 percent of a corporate credit union's capital.
(2) The aggregate of all investments in and loans to member and nonmember corporate CUSOs must not exceed 30 percent of a corporate credit union's capital. A corporate credit union may lend to member and nonmember corporate CUSOs an additional 15 percent of capital if the loan is collateralized by assets in which the corporate has a perfected security interest under state law.
(3) If the limitations in paragraphs (b)(1) and (b)(2) of this section are reached or exceeded because of the profitability of the CUSO and the related GAAP valuation of the investment under the equity method without an additional cash outlay by the corporate, divestiture is not required. A corporate credit union may continue to invest up to the regulatory limit without regard to the increase in the GAAP valuation resulting from the corporate CUSO's profitability.

(c) *Due diligence*. A corporate credit union must comply with the due diligence requirements of §§ 723.5 and 723.6(f) through (j) of this chapter for all loans to corporate CUSOs. This requirement does not apply to loans excluded under § 723.1(b).

(d) *Separate entity*. (1) A corporate CUSO must be operated as an entity separate from a corporate credit union.
(2) A corporate credit union investing in or lending to a corporate CUSO must obtain a written legal opinion that concludes the corporate CUSO is organized and operated in a manner that the corporate credit union will not reasonably be held liable for the obligations of the corporate CUSO. This opinion must address factors that have led courts to ''pierce the corporate veil,'' such as inadequate capitalization, lack of corporate identity, common boards of directors and employees, control of one entity over another, and lack of separate books and records.

(e). *Permissible activities*. A corporate CUSO must agree to limit its activities to:
(1) Brokerage services,
(2) Investment advisory services, and
(3) Other categories of services as approved in writing by NCUA and published on NCUA's website.

(f) An official of a corporate credit union which has invested in or loaned to a corporate CUSO may not receive, either directly or indirectly, any salary, commission, investment income, or other income, compensation, or consideration from the corporate CUSO. This prohibition also extends to immediate family members of officials.

(g) Prior to making an investment in or loan to a corporate CUSO, a corporate credit union must obtain a written agreement that the CUSO:
(1) Will follow GAAP;
(2) Will provide financial statements to the corporate credit union at least quarterly;
(3) Will obtain an annual CPA opinion audit and provide a copy to the corporate credit union. A wholly owned or majority owned CUSO is not required to obtain a separate annual audit if it is included in the corporate credit union's annual consolidated audit;
(4) Will not acquire control, directly or indirectly, of another depository financial institution or to invest in shares, stocks, or obligations of an insurance company, trade association, liquidity facility, or similar organization;
(5) Will allow the auditor, board of directors, and NCUA complete access to its personnel, facilities, equipment, books, records, and any other documentation that the auditor, directors, or NCUA deem pertinent;
and
(6) Will comply with all the requirements of this section.

(h) Corporate credit union authority to invest in or loan to a CUSO is limited to that provided in this section. A corporate credit union is not authorized to invest in or loan to a CUSO under part 712 of this chapter.

16. Revise §704.14 to read as follows:

§ 704.14. Representation.

(a) *Board representation*. The board will be determined as stipulated in its bylaws governing election procedures, provided that:

(1) At least a majority of directors, including the chair of the board, must serve on the board as representatives of member credit unions;

(2) On or after [DATE 4 MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], only individuals who currently hold the

position of chief executive officer, chief financial officer, or chief operating officer at a member may seek election or re-election to the board;

(3) No individual may be elected to the board if, at the expiration of the term to which the individual is seeking election, the individual will have served as a director for more than six consecutive years. For purposes of calculating the six-year period, any consecutive prior service on the board by representatives of the same corporate member must be counted as though the individual seeking election had fulfilled that service. Accordingly, a corporate member may not circumvent the term limit provisions by putting forward a new candidate for directorship after one or more of its prior representatives has served on the board for six consecutive years;

(4) No individual may be elected or appointed to serve on the board if, after such election or appointment, the individual would be a director at more than one corporate credit union;

(5) No individual may be elected or appointed to serve on the board if, after such election or appointment, any member of the corporate credit union would have more than one representative on the board of the corporate;

(6) The chair of the board may not serve simultaneously as an officer, director, or employee of a credit union trade association;

(7) A majority of directors may not serve simultaneously as officers, directors, or employees of the same credit union trade association or its affiliates (not including chapters or other subunits of a state trade association);

(8) For purposes of meeting the requirements of paragraphs (a)(6) and (a)(7) of this section, an individual may not serve as a director or chair of the board if that individual holds a subordinate employment relationship to another employee who serves as an officer, director, or employee of a credit union trade association;

(9) In the case of a corporate credit union whose membership is composed of more than 25 percent non credit unions, the majority of directors serving as representatives of member credit unions, including the chair, must be elected only by member credit unions, and

(10) After [DATE 36 MONTHS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER], at least a majority of directors of every corporate credit union, including the chair of the board, must serve on the board as representatives of natural person credit union members.

17. Revise §704.19 to read as follows:

§704.19. Disclosure of executive and director compensation.

(a) Annual disclosure. Corporate credit unions must annually prepare and maintain a disclosure of the compensation, in dollar terms, of each senior executive officer and director.

(b) *Availability of disclosure.* Any member may obtain a copy of the most current disclosure, and all disclosures for the previous three years, on request made in person or in writing. The corporate credit union must provide the disclosure(s), at no cost to the member, within five business days of receiving the request. In addition, the corporate must distribute the most current disclosure to all its members at least once a year, either in the annual report or in some other manner of the corporate's choosing.

(c) *Supplemental information.* In providing the disclosure required by this section, a corporate credit union may also provide supplementary information to put the disclosure in context, for example, salary surveys, a discussion of compensation in relation to other credit union expenses, or compensation information from similarly sized credit unions or financial institutions.

(d) *Special rule for mergers.* With respect to any merger involving a corporate credit union that would result in a material increase in compensation, i.e., an increase of more than 15 percent or $10,000, whichever is greater, for any senior executive officer or director of the merging corporate, the corporate must: (i) describe the compensation arrangement in the merger plan documents submitted to NCUA for approval of the merger, pursuant to §708b of this part; and (ii) in the case of any federally chartered corporate credit union, describe the compensation arrangement in the materials provided to the membership of the merging credit union before the member vote on approving the merger.

18. Add a new §704.20 to read as follows:

§ 704.20. Limitations on golden parachute and indemnification payments.

(a) *Definitions.* The following definitions apply for this section:

(1) *Board* means the National Credit Union Administration Board.

(2) *Benefit plan* means any plan, contract, agreement or other arrangement which is an "employee welfare benefit plan" as that term is defined in section 3(1) of the Employee Retirement Income Security Act of 1974, as amended *(29 U.S.C. 1002*(1)), or other usual and customary plans such as dependent care, tuition reimbursement, group legal services or cafeteria plans; provided however, that such term does not include any plan intended to be subject to paragraphs (a)(4)(iv)(C) and (E) of this section.

(3) *Bona fide deferred compensation plan or arrangement* means any plan, contract, agreement or other arrangement whereby:

(i) An institution-affiliated party (IAP) voluntarily elects to defer all or a portion of the reasonable compensation, wages or fees paid for services rendered which otherwise would have been paid to the IAP at the time the services were rendered (including a plan that provides for the crediting of a reasonable investment return on such elective deferrals) and the corporate credit union either:

(A) Recognizes compensation expense and accrues a liability for the benefit payments according to Generally Accepted Accounting Principles (GAAP); or

(B) Segregates or otherwise sets aside assets in a trust which may only be used to pay plan and other benefits, except that the assets of such trust may be available to satisfy claims of the institution's or holding company's creditors in the case of insolvency; or

(ii) A corporate credit union establishes a nonqualified deferred compensation or supplemental retirement plan, other than an elective deferral plan described in paragraph (a)(3)(i) of this section:

(A) Primarily for the purpose of providing benefits for certain IAPs in excess of the limitations on contributions and benefits imposed by sections 415, 401(a)(17), 402(g) or any other applicable provision of the Internal Revenue Code of 1986 (26 USC 415, 401(a)(17), 402(g)); or

(B) Primarily for the purpose of providing supplemental retirement benefits or other deferred compensation for a select group of directors, management or highly compensated employees (excluding severance payments described in paragraph (4)(ii)(E) of this section and permissible golden parachute payments described in §704.20(d); and

(iii) In the case of any nonqualified deferred compensation or supplemental retirement plans as described in paragraphs (a)(3)(i) and (ii) of this section, the following requirements will apply:

(A) The plan was in effect at least one year prior to any of the events described in paragraph (a)(4)(ii) of this section;

(B) Any payment made pursuant to such plan is made in accordance with the terms of the plan as in effect no later than one year prior to any of the events described in paragraph (a)(4)(ii) of this section and in accordance with any amendments to such plan during such one year period that do not increase the benefits payable thereunder;

(C) The IAP has a vested right, as defined under the applicable plan document, at the time of termination of employment to payments under such plan;

(D) Benefits under such plan are accrued each period only for current or prior service rendered to the employer (except that an allowance may be made for service with a predecessor employer);

(E) Any payment made pursuant to such plan is not based on any discretionary acceleration of vesting or accrual of benefits which occurs at any time later than one year prior to any of the events described in paragraph (a)(4)(ii) of this section;

(F) The corporate credit union has previously recognized compensation expense and accrued a liability for the benefit payments according to GAAP or segregated or otherwise set aside assets in a trust which may only be used to pay plan benefits, except that the assets of such trust may be available to satisfy claims of the corporate credit union's creditors in the case of insolvency; and

(G) Payments pursuant to such plans must not be in excess of the accrued liability computed in accordance with GAAP.

(4) *Golden parachute payment* means any payment (or any agreement to make any payment) in the nature of compensation by any corporate credit union for the benefit of any current or former IAP pursuant to an obligation of such corporate credit union that:

(i) Is contingent on, or by its terms is payable on or after, the termination of such IAP's primary employment or affiliation with the corporate credit union; and

(ii) Is received on or after, or is made in contemplation of, any of the following events:

(A) The insolvency (or similar event) of the corporate that is making the payment; or

(B) The appointment of any conservator or liquidating agent for such corporate credit union; or

(C) A determination by the Board or the appropriate state supervisory authority (in the case of a corporate credit union chartered by a state) respectively, that the corporate credit union is in a troubled condition; or

(D) The corporate credit union is undercapitalized, as defined in §704.4; or

(E) The corporate credit union is subject to a proceeding to terminate or suspend its share account insurance; and

(iii) Is payable to an IAP whose employment by or affiliation with the corporate is terminated at a time when the corporate credit union by which the IAP is employed or with which the IAP is affiliated satisfies any of the conditions enumerated in paragraphs (a)(4)(ii)(A) through (E) of this section, or in contemplation of any of these conditions.

(iv) *Exceptions.* The term *golden parachute payment* does not include:

(A) Any payment made pursuant to a pension or retirement plan which is qualified (or is intended within a reasonable period of time to be qualified) under section 401 of the Internal Revenue Code of 1986 (26 USC §401); or

(B) Any payment made pursuant to a benefit plan as that term is defined in paragraph (a)(2) of this section; or

(C) Any payment made pursuant to a *bona fide* deferred compensation plan or arrangement as defined in paragraph (a)(3) of this section; or

(D) Any payment made by reason of death or by reason of termination caused by the disability of an IAP; or

(E) Any payment made pursuant to a nondiscriminatory severance pay plan or arrangement which provides for payment of severance benefits to all eligible employees upon involuntary termination other than for cause, voluntary resignation, or early retirement; *provided, however,* that no employee will receive any such payment which exceeds the base compensation paid to such employee during the twelve months (or such longer period or greater benefit as the Board will consent to) immediately preceding termination of employment, resignation or

early retirement, and such severance pay plan or arrangement must not have been adopted or modified to increase the amount or scope of severance benefits at a time when the corporate credit union was in a condition specified in paragraph (4)(ii) of this section or in contemplation of such a condition without the prior written consent of the Board; or

(F) Any severance or similar payment which is required to be made pursuant to a state statute which is applicable to all employers within the appropriate jurisdiction (with the exception of employers that may be exempt due to their small number of employees or other similar criteria); or

(G) Any other payment which the Board determines to be permissible in accordance with §704.20(d).

(5) *Institution-affiliated party (IAP)* means any individual meeting the criteria specified in §206(r) of the Act (12 USC §1786(r)).

(6) *Liability or legal expense* means:

(i) Any legal or other professional fees and expenses incurred in connection with any claim, proceeding, or action;

(ii) The amount of, and any cost incurred in connection with, any settlement of any claim, proceeding, or action; and

(iii) The amount of, and any cost incurred in connection with, any judgment or penalty imposed with respect to any claim, proceeding, or action.

(7) *Nondiscriminatory* means that the plan, contract or arrangement in question applies to all employees of a corporate credit union who meet reasonable and customary eligibility requirements applicable to all employees, such as minimum length of service requirements. A nondiscriminatory plan, contract or arrangement may provide different benefits based only on objective criteria such as salary, total compensation, length of service, job grade or classification, which are applied on a proportionate basis (with a variance in severance benefits relating to any criterion of plus or minus ten percent) to groups of employees consisting of not less than the lesser of 33 percent of employees or 1,000 employees.

(8) *Payment* means:

(i) Any direct or indirect transfer of any funds or any asset;

(ii) Any forgiveness of any debt or other obligation;

(iii) The conferring of any benefit, including but not limited to stock options and stock appreciation rights; or

(iv) Any segregation of any funds or assets, the establishment or funding of any trust or the purchase of or arrangement for any letter of credit or other instrument, for the purpose of making, or pursuant to any agreement to make, any payment on or after the date on which such funds or assets are segregated, or at the time of or after such trust is established or letter of credit or other instrument is made available, without regard to whether the obligation to make such payment is contingent on:

(A) The determination, after such date, of the liability for the payment of such amount; or

(B) The liquidation, after such date, of the amount of such payment.

(9) *Prohibited indemnification payment* means any payment (or any agreement or arrangement to make any payment) by any corporate credit union for the benefit of any person who is or was an IAP of such corporate credit union, to pay or reimburse such person for any civil money penalty, judgment or other liability or legal expense resulting from any administrative or civil action instituted by the Board or any appropriate state regulatory authority that results in a final order or settlement pursuant to which such person:

(i) Is assessed a civil money penalty;

(ii) Is removed from office or prohibited from participating in the conduct of the affairs of the corporate credit union; or

(iii) Is required to cease and desist from or take any affirmative action described in Section 206 of the Act with respect to such corporate credit union.

(iv) *Exceptions.* The term *prohibited indemnification payment* does not include any reasonable payment by a corporate credit union that:

(A) is used to purchase any commercial insurance policy or fidelity bond, provided that such insurance policy or bond must not be used to pay or reimburse an IAP for the cost of any judgment or civil money penalty assessed against such person in an administrative proceeding or civil action commenced by NCUA or the appropriate state supervisory authority (in the case of a state chartered corporate), but may pay any legal or professional expenses incurred in connection with such proceeding or action or the amount of any restitution to the corporate credit union or its liquidating agent; or

(B) represents partial indemnification for legal or professional expenses specifically attributable to particular charges for which there has been a formal and final adjudication or finding in connection with a settlement that the IAP has not violated certain laws or regulations or has not engaged in certain unsafe or unsound practices or breaches of fiduciary duty, unless the administrative action or civil proceeding has resulted in a final prohibition order against the IAP.

(10) *Troubled Condition* means that the corporate credit union:

(i) Has been assigned:

(A) a 4 or 5 Corporate Risk Information System (CRIS) rating by NCUA in either the Financial Risk or Risk Management composites, in the case of a federal corporate credit union, or

(B) an equivalent 4 or 5 CRIS rating in either the Financial Risk or Risk Management composites by the state supervisor in the case of a federally insured, state-chartered corporate credit union in a state that has adopted the CRIS system, or an equivalent 4 or 5 CAMEL composite rating by the state supervisor in the case of a federally insured, state-chartered corporate credit union in a state that uses the CAMEL system, or

(C) a 4 or 5 CRIS rating in either the Financial Risk or Risk Management composites by NCUA based on core work papers received from the state supervisor in the case of a federally insured, state-chartered credit union in a state that does not use either the CRIS or CAMEL system. In this case, the state supervisor will be notified in writing by the Director of the Office of Corporate Credit Unions that the corporate credit union has been designated by NCUA as a troubled institution; or

(ii) has been granted assistance as outlined under Sections 208 or 216 of the Federal Credit Union Act.

(b) *Golden parachute payments prohibited.*

No corporate credit union will make or agree to make any golden parachute payment, except as otherwise provided in this section.

(c) *Prohibited indemnification payments.* No corporate credit union will make or agree to make any prohibited indemnification payment, except as provided in this section.

(d) *Permissible golden parachute payments.* (1) A corporate credit union may agree to make or may make a golden parachute payment if and to the extent that:

(i) Such an agreement is made in order to hire a person to become an IAP either at a time when the corporate credit union satisfies or in an effort to prevent it from imminently satisfying any of the criteria set forth in §(a)(4)(ii), and the Board, consents in writing to the amount and terms of the golden parachute payment. Such consent by the Board must not improve the IAP's position in the event of the insolvency of the corporate credit union since such consent can neither bind a liquidating agent nor affect the provability of claims in liquidation. In the event that the institution is placed into conservatorship or liquidation, the conservator or the liquidating agent, as the case may be, will not be obligated to pay the promised golden parachute and the IAP will not be accorded preferential treatment on the basis of such prior approval; or

(ii) Such a payment is made pursuant to an agreement which provides for a reasonable severance payment, not to exceed twelve months salary, to an IAP in the event of a merger with another corporate credit union; *provided, however,* that a corporate credit union must obtain the consent of the Board, before making such a payment and this paragraph (d)(1)(iii) does not apply to any merger between corporates that results from an assisted transaction as described in section 208 of the Act (12 U.S.C. 1788) or the corporate credit union being placed into conservatorship or liquidation; or

(iii) The Board, with the written concurrence of the appropriate state supervisory authority (in the case of a state-chartered corporate), determines that such a payment or agreement is permissible.

(2) A corporate credit union making a request pursuant to paragraphs (d)(1)(i) through (iii) of this section must demonstrate that it does not possess and is not aware of any information, evidence, documents or other materials which would indicate that there is a reasonable basis to believe, at the time such payment is proposed to be made, that:

(i) The IAP has committed any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the corporate credit union that has had or is likely to have a material adverse effect on the corporate credit union;

(ii) The IAP is substantially responsible for the insolvency of, the appointment of a conservator or liquidating agent for, or the troubled condition, as defined by §701.14(b)(4), of the corporate credit union;

(iii) The IAP has materially violated any applicable federal or state banking law or regulation that has had or is likely to have a material effect on the corporate credit union; and

(iv) The IAP has violated or conspired to violate section 215, 656, 657, 1005, 1006, 1007, 1014, 1032, or 1344 of title 18 of the United States Code, or section 1341 or 1343 of such title affecting a federally insured financial institution as defined in title 18 of the United States Code.

(3) In making a determination under paragraphs (d)(1)(i) through (iii) of this section, the Board may consider:

(i) Whether, and to what degree, the IAP was in a position of managerial or fiduciary responsibility;

(ii) The length of time the IAP was affiliated with the corporate credit union, and the degree to which the proposed payment represents a reasonable payment for services rendered over the period of employment; and

(iii) Any other factors or circumstances which would indicate that the proposed payment would be contrary to the intent of section 206(t) of the Act or this part.

(e) *Permissible indemnification payments.* (1) A corporate credit union may make or agree to make reasonable indemnification payments to an IAP with respect to an administrative proceeding or civil action initiated by NCUA or a state regulatory authority if:

(i) The corporate credit union's board of directors, in good faith, determines in writing after due investigation and consideration that the institution-affiliated party acted in good faith and in a manner he/she believed to be in the best interests of the institution;

(ii) The corporate credit union's board of directors, in good faith, determines in writing after due investigation and consideration that the payment of such expenses will not materially adversely affect the institution's or holding company's safety and soundness;

(iii) The indemnification payments do not constitute prohibited indemnification payments as that term is defined in §704.20(c); and

(iv) The IAP agrees in writing to reimburse the corporate credit union, to the extent not covered by payments from insurance or bonds purchased pursuant to §704.20(a)(9)(iv)(A), for that portion of the advanced indemnification payments

which subsequently become prohibited indemnification payments, as defined in §704.20(a)(9).

(2) An IAP seeking indemnification payments must not participate in any way in the board's discussion and approval of such payments; *provided, however*, that such IAP may present his/her request to the board and respond to any inquiries from the board concerning his/her involvement in the circumstances giving rise to the administrative proceeding or civil action.

(3) In the event that a majority of the members of the board of directors are named as respondents in an administrative proceeding or civil action and request indemnification, the remaining members of the board may authorize independent legal counsel to review the indemnification request and provide the remaining members of the board with a written opinion of counsel as to whether the conditions delineated in paragraph (e)(1) of this section have been met. If independent legal counsel opines that said conditions have been met, the remaining members of the board of directors may rely on such opinion in authorizing the requested indemnification.

(4) In the event that all of the members of the board of directors are named as respondents in an administrative proceeding or civil action and request indemnification, the board will authorize independent legal counsel to review the indemnification request and provide the board with a written opinion of counsel as to whether the conditions delineated in paragraph (e)(1) of this section have been met. If independent legal counsel opines that said conditions have been met, the board of directors may rely on such opinion in authorizing the requested indemnification.

(f) *Filing instructions.* Requests to make excess nondiscriminatory severance plan payments pursuant to §704.20(a)(4)(iv)(E) and golden parachute payments permitted by §704.20(d) must be submitted in writing to the Board. The request must be in letter form and must contain all relevant factual information as well as the reasons why such approval should be granted.

(g) *Applicability in the event of liquidation or conservatorship.* The provisions of this part, or any consent or approval granted under the provisions of this part by the Board, will not in any way bind any liquidating agent or conservator for a failed corporate credit union and will not in any way obligate the liquidating agent or conservator to pay any claim or obligation pursuant to any golden parachute, severance, indemnification or other agreement. Claims for employee welfare benefits or other benefits that are contingent, even if otherwise vested, when a liquidating agent or conservator is appointed for any corporate credit union, including any contingency for termination of employment, are not provable claims or actual, direct compensatory damage claims against such liquidating agent or

conservator. Nothing in this part may be construed to permit the payment of salary or any liability or legal expense of any IAP contrary to 12 U.S.C. 1786(t)(3).

19. Revise Appendix A to part 704 to read as follows:

APPENDIX A TO PART 704 – Capital Prioritization and Model Forms

Part I – Optional Capital Prioritization

Notwithstanding any other provision in this chapter, a corporate credit union, at its option, may determine that capital contributed to the corporate on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] will have priority, for purposes of availability to absorb losses and payout in liquidation, over capital contributed to the corporate before that date. The board of directors at a corporate credit union that desires to make this determination must:

a) On or before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER], adopt a resolution implementing its determination.
b) Inform the credit union's members and NCUA, in writing and as soon as practicable after adoption of the resolution, of the contents of the board resolution.
c) Ensure the credit union uses the appropriate initial and periodic Model Form disclosures in Part II below.

Part II – Model Forms

Part II contains model forms intended for use by corporate credit unions to aid in compliance with the capital disclosure requirements of § 704.3 and Part I of this Appendix.

MODEL FORM A

Terms and Conditions of Membership Capital Account

[NOTE: This form is for use before [DATE 12 MONTHS AFTER PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER] in the circumstances where the credit union has determined NOT to give newly issued capital priority over older capital as described in Part I of this Appendix]

(1) A membership capital account is not subject to share insurance coverage by

the NCUSIF or other deposit insurer.

(2) A membership capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the membership capital account transfers to the continuing credit union. In the event of a charter conversion, the membership capital account transfers to the new institution. In the event of liquidation, the membership capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) A member credit union may withdraw membership capital with three years' notice.

(4) Membership capital cannot be used to pledge borrowings.

(5) Membership capital is available to cover losses that exceed retained earnings and paid-in capital.

(6) Where the corporate credit union is liquidated, membership capital accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF.

(7) Where the corporate credit union is merged into another corporate credit union, the membership capital account will transfer to the continuing corporate credit union. The three-year notice period for withdrawal of the membership capital account will remain in effect.

(8) If an adjusted balance account--: The membership capital balance will be adjusted--(1 or 2)--- time(s) annually in relation to the member credit union's---(assets or other measure)--- as of---(date(s))---. If a term certificate--: The membership capital account is a term certificate that will mature on---(date)---.

I have read the above terms and conditions and I understand them.

I further agree to maintain in the credit union's files the annual notice of terms and conditions of the membership capital account.

The notice form must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

The annual disclosure notice form must be signed by the chair of the corporate credit union. The chair must then sign a statement that certifies that the notice has been sent to member credit unions with membership capital accounts. The

certification must be maintained in the corporate credit union's files and be available for examiner review.

MODEL FORM B

Terms and Conditions of Membership Capital Account

[NOTE: This form is for use before [DATE 12 MONTHS AFTER PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER] in the circumstances where the credit union has determined THAT IT WILL give newly issued capital priority over older capital as described in Part I of this Appendix].

(1) A membership capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A membership capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the membership capital account transfers to the continuing credit union. In the event of a charter conversion, the membership capital account transfers to the new institution. In the event of liquidation, the membership capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) A member credit union may withdraw membership capital with three years' notice.

(4) Membership capital cannot be used to pledge borrowings.

(5) (a) Membership capital that is issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER], is available to cover losses that exceed retained earnings, contributed capital issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER], and perpetual capital issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. Any such losses will be distributed *pro rata,* at the time the loss is realized, among membership capital account holders with accounts issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. To the extent that NCA funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(b) Membership capital that is issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] is available to cover losses that exceed retained earnings and perpetual capital issued before [DATE

60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. Any such losses will be distributed *pro rata*, at the time the loss is realized, among membership capital account holders with accounts issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. To the extent that NCA funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(c) Attached to this disclosure is a statement that describes the amount of NCA the credit union has with the corporate credit union in each of the categories described in paragraphs (5)(a) and (5)(b) above.

(6) If the corporate credit union is liquidated:

(a) Membership capital accounts issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, but not including contributed capital accounts issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] and perpetual capital accounts issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. However, membership capital that is used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate.

(b) Membership capital accounts issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER], are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, but not including perpetual capital accounts issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. However, membership capital that is used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate.

(7) Where the corporate credit union is merged into another corporate credit union, the membership capital account will transfer to the continuing corporate credit union. The three-year notice period for withdrawal of the membership capital account will remain in effect.

(8) If an adjusted balance account--: The membership capital balance will be adjusted--(1 or 2)--- time(s) annually in relation to the member credit union's---(assets or other measure)--- as of---(date(s))---. If a term certificate--: The membership capital account is a term certificate that will mature on---(date)---.

I have read the above terms and conditions and I understand them.

I further agree to maintain in the credit union's files the annual notice of terms and conditions of the membership capital account.

The notice form must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

The annual disclosure notice form must be signed by the chair of the corporate credit union. The chair must then sign a statement that certifies that the notice has been sent to member credit unions with membership capital accounts. The certification must be maintained in the corporate credit union's files and be available for examiner review.

MODEL FORM C

Terms and Conditions of Nonperpetual Contributed Capital

[NOTE: This form is for use on and after [DATE 12 MONTHS AFTER PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER] in the circumstances where the credit union has determined NOT to give newly issued capital priority over older capital as described in Part I of this Appendix. Also, corporate credit unions should ensure that existing membership capital accounts that do not meet the qualifying conditions for nonperpetual contributed capital are modified so as to meet those conditions.]

Terms and Conditions of Nonperpetual Contributed Capital Account

(1) A nonperpetual contributed capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A nonperpetual contributed capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the nonperpetual contributed capital account transfers to the continuing credit union. In the event of a charter conversion, the nonperpetual contributed capital account transfers to the new institution. In the event of liquidation, the nonperpetual contributed capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) If the nonperpetual contributed capital account is a notice account, a member credit union may withdraw the nonperpetual contributed capital with a minimum

of five years' notice. If the nonperpetual contributed capital account is a term instrument it may be redeemed only at maturity. The corporate credit union may not redeem any account prior to the expiration of the notice period, or maturity, without the prior written approval of the NCUA.

(4) Nonperpetual contributed capital cannot be used to pledge borrowings.

(5) Nonperpetual contributed capital is available to cover losses that exceed retained earnings and perpetual contributed capital. Any such losses will be distributed *pro rata* among nonperpetual contributed capital account holders at the time the loss is realized. To the extent that NCA funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(6) Where the corporate credit union is liquidated, nonperpetual contributed capital accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF. However, nonperpetual contributed capital that is used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate.

(7) Where the corporate credit union is merged into another corporate credit union, the nonperpetual contributed capital account will transfer to the continuing corporate credit union. For notice accounts, the five-year notice period for withdrawal of the nonperpetual contributed capital account will remain in effect. For term accounts, the original term will remain in effect.

(8) If a term certificate--: The nonperpetual contributed capital account is a term certificate that will mature on---(date)--- (insert date with a minimum five-year original maturity).

I have read the above terms and conditions and I understand them.

I further agree to maintain in the credit union's files the annual notice of terms and conditions of the nonperpetual contributed capital account.

The notice form must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

The annual disclosure notice form must be signed by the chair of the corporate credit union. The chair must then sign a statement that certifies that the notice has been sent to member credit unions with nonperpetual contributed capital

accounts. The certification must be maintained in the corporate credit union's files and be available for examiner review.

MODEL FORM D

Terms and Conditions of Nonperpetual Contributed Capital

[NOTE: This form is for use before [DATE 12 MONTHS AFTER PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER] in the circumstances where the credit union has determined THAT IT WILL give newly issued capital priority over older capital as described in Part I of this Appendix. Also, corporate credit unions should ensure that existing membership capital accounts that do not meet the qualifying conditions for nonperpetual contributed capital are modified so as to meet those conditions.]

Terms and Conditions of Nonperpetual Contributed Capital Account

(1) A nonperpetual contributed capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A nonperpetual contributed capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the nonperpetual contributed capital account transfers to the continuing credit union. In the event of a charter conversion, the nonperpetual contributed capital account transfers to the new institution. In the event of liquidation, the nonperpetual contributed capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) If the nonperpetual contributed capital account is a notice account, a member credit union may withdraw the nonperpetual contributed capital with a minimum of five years' notice. If the nonperpetual contributed capital account is a term instrument it may be redeemed only at maturity. The corporate credit union may not redeem any account prior to the expiration of the notice period, or maturity, without the prior written approval of the NCUA.

(4) Nonperpetual contributed capital cannot be used to pledge borrowings.

(5)(a) Nonperpetual contributed capital that is issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] is available to cover losses that exceed retained earnings, all contributed capital issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER], and perpetual capital issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL

REGISTER]. Any such losses will be distributed *pro rata,* at the time the loss is realized, among nonperpetual contributed capital account holders with accounts issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. To the extent that NCA funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(b) Nonperpetual contributed capital that is before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER], is available to cover losses that exceed retained earnings and perpetual capital issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. Any such losses will be distributed *pro rata*, at the time the loss is realized, among nonperpetual contributed capital account holders with accounts issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. To the extent that NCA funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(c) Attached to this disclosure is a statement that describes the amount of NCA the credit union has with the corporate credit union in each of the categories described in paragraphs (5)(a) and (5)(b) above.

(6) If the corporate credit union is liquidated:

(a) Nonperpetual contributed capital accounts issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, but not including contributed capital accounts issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] or perpetual capital accounts issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. However, nonperpetual contributed capital that is used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate.

(b) Nonperpetual contributed capital accounts issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, but not including perpetual capital accounts issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. However, nonperpetual contributed capital that is used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate.

(7) Where the corporate credit union is merged into another corporate credit union, the nonperpetual contributed capital account will transfer to the continuing corporate credit union. For notice accounts, the five-year notice period for withdrawal of the nonperpetual contributed capital account will remain in effect. For term accounts, the original term will remain in effect.

(8) If a term certificate--: The nonperpetual contributed capital account is a term certificate that will mature on---(date)--- (insert date with a minimum five-year original maturity).

I have read the above terms and conditions and I understand them.

I further agree to maintain in the credit union's files the annual notice of terms and conditions of the nonperpetual contributed capital account.

The notice form must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

The annual disclosure notice form must be signed by the chair of the corporate credit union. The chair must then sign a statement that certifies that the notice has been sent to member credit unions with nonperpetual contributed capital accounts. The certification must be maintained in the corporate credit union's files and be available for examiner review.

MODEL FORM E

Terms and Conditions of Paid-in Capital

[NOTE: This form is for use before [DATE 12 MONTHS AFTER PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER] in the circumstances where the credit union has determined NOT to give newly issued capital priority over older capital as described in Part I of this Appendix]

Terms and Conditions of Paid-In Capital

(1) A paid-in capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A paid-in capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the paid-in capital account transfers to the continuing credit union. In the event of

a charter conversion, the paid-in capital account transfers to the new institution. In the event of liquidation, the paid-in capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) The funds are callable only at the option of the corporate credit union and only if the corporate credit union meets its minimum required capital and NEV ratios after the funds are called. The corporate must also obtain NCUA's approval before the corporate calls any paid-in capital.

(4) Paid-in capital cannot be used to pledge borrowings.

(5) Paid-in capital is available to cover losses that exceed retained earnings.

(6) Where the corporate credit union is liquidated, paid-in capital accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, and membership capital holders.

(7) Where the corporate credit union is merged into another corporate credit union, the paid-in capital account will transfer to the continuing corporate credit union.

(8) Paid-in capital is perpetual maturity and noncumulative dividend.

I have read the above terms and conditions and I understand them. I further agree to maintain in the credit union's files the annual notice of terms and conditions of the paid-in capital instrument.

The notice form must be signed by either all of the directors of the credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

MODEL FORM F

Terms and Conditions of Paid-in Capital

[NOTE: This form is for use before [DATE 12 MONTHS AFTER PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER] in the circumstances where the credit union has determined THAT IT WILL give newly issued capital priority over older capital as described in Part I of this Appendix].

Terms and Conditions of Paid-In Capital

(1) A paid-in capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A paid-in capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the paid-in capital account transfers to the continuing credit union. In the event of a charter conversion, the paid-in capital account transfers to the new institution. In the event of liquidation, the paid-in capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) The funds are callable only at the option of the corporate credit union and only if the corporate credit union meets its minimum required capital and NEV ratios after the funds are called. The corporate must also obtain NCUA's approval before the corporate calls any paid-in capital.

(4) Paid-in capital cannot be used to pledge borrowings.

(5) Availability to cover losses.

(a) Paid-in capital issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] is available to cover losses that exceed retained earnings. Any such losses must be distributed *pro rata*, at the time the loss is realized, among holders of paid-in capital issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. To the extent that paid-in capital funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(b) Paid-in capital issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] is available to cover losses that exceed retained earnings and any contributed capital issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. Any such losses must be distributed *pro rata*, at the time the loss is realized, among holders of paid-in capital issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. To the extent that paid-in capital funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(c) Attached to this disclosure is a statement that describes the amount of perpetual capital the credit union has with the corporate credit union in each of the categories described in paragraphs (5)(a) and (5)(b) above.

(6) Where the corporate credit union is liquidated:

(a) Paid-in capital accounts issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, but not including contributed capital accounts issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. However, paid-in capital that is used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate.

(b) Paid-in capital accounts issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, nonperpetual accounts issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] and contributed capital accounts issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. However, paid-in capital that is used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate.

(7) Where the corporate credit union is merged into another corporate credit union, the paid-in capital account will transfer to the continuing corporate credit union.

(8) Paid-in capital is perpetual maturity and noncumulative dividend.

I have read the above terms and conditions and I understand them. I further agree to maintain in the credit union's files the annual notice of terms and conditions of the paid-in capital instrument.

The notice form must be signed by either all of the directors of the credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

MODEL FORM G

Terms and Conditions of Perpetual Contributed Capital

[NOTE: This form is for use on and after [DATE 12 MONTHS AFTER PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER] in the

circumstances where the credit union has determined NOT to give newly issued capital priority over older capital as described in Part I of this Appendix. Also, capital previously issued under the nomenclature “paid-in capital” is considered perpetual contributed capital.]

(1) A perpetual contributed capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A perpetual contributed capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the perpetual contributed capital account transfers to the continuing credit union. In the event of a charter conversion, the perpetual contributed capital account transfers to the new institution. In the event of liquidation, the perpetual contributed capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) The funds are callable only at the option of the corporate credit union and only if the corporate credit union meets its minimum required capital and NEV ratios after the funds are called. The corporate must also obtain the prior, written approval of the NCUA before releasing any perpetual contributed capital funds.

(4) Perpetual contributed capital cannot be used to pledge borrowings.

(5) Perpetual contributed capital is perpetual maturity and noncumulative dividend.

(6) Perpetual contributed capital is available to cover losses that exceed retained earnings. Any such losses must be distributed *pro rata* among perpetual contributed capital holders at the time the loss is realized. To the extent that perpetual contributed capital funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(7) Where the corporate credit union is liquidated, perpetual contributed capital accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, and nonperpetual contributed capital holders. However, perpetual contributed capital that is used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate.

I have read the above terms and conditions and I understand them. I further agree to maintain in the credit union's files the annual notice of terms and conditions of the perpetual contributed capital instrument.

The notice form must be signed by either all of the directors of the credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

MODEL FORM H

Terms and Conditions of Perpetual Contributed Capital

[NOTE: This form is for use before [DATE 12 MONTHS AFTER PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER] in the circumstances where the credit union has determined THAT IT WILL give newly issued capital priority over older capital as described in Part I of this Appendix. Also, capital previously issued under the nomenclature "paid-in capital" is considered perpetual contributed capital].

(1) A perpetual contributed capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A perpetual contributed capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the perpetual contributed capital account transfers to the continuing credit union. In the event of a charter conversion, the perpetual contributed capital account transfers to the new institution. In the event of liquidation, the perpetual contributed capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) The funds are callable only at the option of the corporate credit union and only if the corporate credit union meets its minimum required capital and NEV ratios after the funds are called. The corporate must also obtain the prior, written approval of the NCUA before releasing any perpetual contributed capital funds.

(4) Perpetual contributed capital cannot be used to pledge borrowings.

(5) Perpetual contributed capital is perpetual maturity and noncumulative dividend.

(6) Availability to cover losses.
(a) Perpetual contributed capital issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] is available to cover losses that exceed retained earnings. Any such losses must be distributed *pro rata*, at the time the loss is realized, among holders of perpetual contributed capital issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. To the extent that perpetual contributed

capital funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(b) Perpetual contributed capital issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] is available to cover losses that exceed retained earnings and any contributed capital issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. Any such losses must be distributed *pro rata*, at the time the loss is realized, among holders of perpetual contributed capital issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. To the extent that perpetual contributed capital funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(c) Attached to this disclosure is a statement that describes the amount of perpetual capital the credit union has with the corporate credit union in each of the categories described in paragraphs (6)(a) and (6)(b) above.

(7) Where the corporate credit union is liquidated:

(a) Perpetual contributed capital accounts issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, but not including contributed capital accounts issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. However, perpetual contributed capital that is used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate.

(b) Perpetual contributed capital accounts issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER] are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, nonperpetual capital accounts issued before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER], and all contributed capital accounts issued on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER]. However, perpetual contributed capital that is used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate.

I have read the above terms and conditions and I understand them. I further agree to maintain in the credit union's files the annual notice of terms and conditions of the perpetual contributed capital instrument.

The notice form must be signed by either all of the directors of the credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

21. Revise Appendix B to Part 704 to read as follows:

Appendix B to Part 704 — Expanded Authorities and Requirements

A corporate credit union may obtain all or part of the expanded authorities contained in this Appendix if it meets the applicable requirements of Part 704 and Appendix B, fulfills additional management, infrastructure, and asset and liability requirements, and receives NCUA's written approval. Additional guidance is set forth in the NCUA publication Guidelines for Submission of Requests for Expanded Authority.

A corporate credit union seeking expanded authorities must submit to NCUA a self-assessment plan supporting its request. A corporate credit union may adopt expanded authorities when NCUA has provided final approval. If NCUA denies a request for expanded authorities, it will advise the corporate credit union of the reason(s) for the denial and what it must do to resubmit its request. NCUA may revoke these expanded authorities at any time if an analysis indicates a significant deficiency. NCUA will notify the corporate credit union in writing of the identified deficiency. A corporate credit union may request, in writing, reinstatement of the revoked authorities by providing a self-assessment plan detailing how it has corrected the deficiency.

Minimum Requirement

In order to participate in any of the authorities set forth in Base-Plus, Part I, Part II, Part III, or Part IV of this Appendix, a corporate credit union must evaluate monthly the changes in NEV, NEV ratio, and WAL for the tests set forth in paragraphs (d)(1)(i), (e)(1((i), (f)(1)(i), and (h) of §704.8.

BASE-PLUS

A corporate that has met the requirements for this Base-plus authority may, in performing the rate stress tests set forth in 704.8(d)(1)(i) and (e)(1)(i), allow its NEV to decline as much as 20 percent, and in performing the rate stress tests set forth in 704.8(f)(1)(i), allow its NEV to decline as much as 30 percent.

(a) A corporate credit union that has met all the requirements established by NCUA for this Part I, including a minimum capital ratio of at least six percent, may:

(1) Purchase investments with long-term ratings no lower than A– (or equivalent);

(2) Purchase investments with short-term ratings no lower than A–2 (or equivalent), provided that the issuer has a long-term rating no lower than A– (or equivalent) or the investment is a domestically-issued asset-backed security;

(3) Engage in short sales of permissible investments to reduce interest rate risk;

(4) Purchase principal only (PO) stripped mortgage-backed securities to reduce interest rate risk; and

(5) Enter into a dollar roll transaction.

(b) In performing the rate stress tests set forth in §704.8(d) and (e), the NEV of a corporate credit union that has met the requirements of this Part I may decline as much as:

(1) 20 percent;

(2) 28 percent if the corporate credit union has a seven percent minimum capital ratio and is specifically approved by NCUA; or

(3) 35 percent if the corporate credit union has an eight percent minimum capital ratio and is specifically approved by NCUA.

(c) In performing the rate stress tests set forth in §704.8(f), the NEV of a corporate credit union that has met the requirements of this Part I may decline as much as:

(1) 30 percent;

(2) 38 percent if the corporate credit union has a seven percent minimum capital ratio and is specifically approved by NCUA; or

(3) 45 percent if the corporate credit union has an eight percent minimum capital ratio and is specifically approved by NCUA.

(d) The maximum aggregate amount in unsecured loans and lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, must not exceed 100 percent of the corporate credit union's capital. The board of directors must establish the limit, as a percent of the corporate credit union's capital plus pledged shares, for secured loans and lines of credit.

(e) The aggregate total of investments purchased under the authority of Part I (a)(1) and Part I (a)(2) may not exceed the lower of 500 percent of the corporate credit union's capital or 25 percent of assets.

(f) On or after [DATE 12 MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE IN FEDERAL REGISTER], corporate credit unions will substitute "leverage ratio" for "capital ratio" wherever it appears in Part I.

PART II

(a) A corporate credit union that has met the requirements of Part I of this Appendix and the additional requirements established by NCUA for Part II may invest in:

(1) Debt obligations of a foreign country;

(2) Deposits and debt obligations of foreign banks or obligations guaranteed by these banks;

(3) Marketable debt obligations of foreign corporations. This authority does not apply to debt obligations that are convertible into the stock of the corporation; and

(4) Foreign issued asset-backed securities.

(b) All foreign investments are subject to the following requirements:

(1) Investments must be rated no lower than the minimum permissible domestic rating under the corporate credit union's Part I or Part II authority;

(2) A sovereign issuer, and/or the country in which an obligor is organized, must have a long-term foreign currency (non-local currency) debt rating no lower than AA– (or equivalent);

(3) For each approved foreign bank line, the corporate credit union must identify the specific banking centers and branches to which it will lend funds;

(4) Obligations of any single foreign obligor may not exceed 50 percent of capital; and

(5) Obligations in any single foreign country may not exceed 250 percent of capital.

PART III

(a) A corporate credit union that has met the requirements established by NCUA for this Part III may enter into derivative transactions specifically approved by NCUA to:

(1) Create structured products;

(2) Mitigate interest rate risk and credit risk on its own balance sheet; and

(3) Hedge the balance sheets of its members.

(b) Credit Ratings:

(1) All derivative transactions are subject to the following requirements:

(i) If the counterparty is domestic, the counterparty rating must be no lower than the minimum permissible rating for comparable term permissible investments; and

(ii) If the counterparty is foreign, the corporate must have Part II expanded authority and the counterparty rating must be no lower than the minimum permissible rating for a comparable term investment under Part II Authority.

(iii) Any rating(s) relied upon to meet the requirements of this part must be identified at the time the transaction is entered into and must be monitored for as long as the contract remains open.

(iv) Section 704.10 of this part if:

(A) One rating was relied upon to meet the requirements of this part and that rating is downgraded below the minimum rating requirements of this part; or

(B) Two or more ratings were relied upon to meet the requirements of this part and at least two of those ratings are downgraded below the minimum rating requirements of this part.

(2) Exceptions. Credit ratings are not required for derivative transactions with:

(i) Domestically chartered credit unions;

(ii) U.S. government sponsored enterprises; or

(iii) Counterparties if the transaction is fully guaranteed by an entity with a minimum permissible rating for comparable term investments.

PART IV

A corporate credit union that has met all the requirements established by NCUA for this Part IV may participate in loans with member natural person credit unions as approved by the NCUA and subject to the following:

(a) The maximum aggregate amount of participation loans with any one member credit union must not exceed 25 percent of capital; and

(b) The maximum aggregate amount of participation loans with all member credit unions will be determined on a case-by-case basis by the NCUA

22. Add a new Appendix C to Part 704 to read as follows:

Appendix C to Part 704 – Risk-Based Capital Credit Risk-Weight Categories.

Table of Contents

I. Introduction
(a) Scope
(b) Definitions

II. Risk-Weightings
(a) On-balance sheet assets
(b) Off-balance sheet activities
(c) Recourse obligations, direct credit substitutes, and certain other positions

Part I: Introduction

Section I.

(a) *Scope*.

(1) This Appendix explains how a corporate credit union must compute its risk-weighted assets for purposes of determining its capital ratios.

(2) Risk-weighted assets equal risk-weighted on-balance sheet assets (computed under Section II(a) of this Appendix), plus risk-weighted off-balance sheet activities (computed under Section II(b) of this Appendix), plus risk-weighted recourse obligations, direct credit substitutes, and certain other positions (computed under Section II(c) of this Appendix).

(3) Assets not included (i.e., deducted from capital) for purposes of calculating capital under part 704 are not included in calculating risk-weighted assets.

(4) Although this Appendix describes risk-weightings for various assets and activities, this Appendix does not provide authority for corporate credit unions to invest in or purchase any particular type of asset or to engage in any particular type of activity. A corporate credit union must have other identifiable authority for any investment it makes or activity it engages in.

(b) *Definitions.*

The following definitions apply to this Appendix. Additional definitions, applicable to this entire Part, are located in §704.2 of this Part.

Cash items in the process of collection *means* checks or drafts in the process of collection that are drawn on another depository institution, including a central bank, and that are payable immediately upon presentation; U.S. Government checks that are drawn on the United States Treasury or any other U.S. Government or Government-sponsored agency and that are payable immediately upon presentation; broker's security drafts and commodity or bill-of-lading drafts payable immediately upon presentation; and unposted debits.

Commitment means any arrangement that obligates a corporate credit union to:

(1) Purchase loans or securities;

(2) Extend credit in the form of loans or leases, participations in loans or leases, overdraft facilities, revolving credit facilities, home equity lines of credit, eligible ABCP liquidity facilities, or similar transactions.

Depository institution means a financial institution that engages in the business of providing financial services; that is recognized as a bank or a credit union by the supervisory or monetary authorities of the country of its incorporation and the country of its principal banking operations; that receives deposits to a substantial

extent in the regular course of business; and that has the power to accept demand deposits. In the United States, this definition encompasses all federally insured offices of commercial banks, mutual and stock savings banks, savings or building and loan associations (stock and mutual), cooperative banks, credit unions, and international banking facilities of domestic depository institutions. Bank holding companies and savings and loan holding companies are excluded from this definition. For the purposes of assigning risk-weights, the differentiation between OECD depository institutions and non-OECD depository institutions is based on the country of incorporation. Claims on branches and agencies of foreign banks located in the United States are to be categorized on the basis of the parent bank's country of incorporation.

Direct credit substitute means an arrangement in which a corporate credit union assumes, in form or in substance, credit risk associated with an on-balance sheet or off-balance sheet asset or exposure that was not previously owned by the corporate credit union (third-party asset) and the risk assumed by the corporate credit union exceeds the *pro rata* share of the corporate credit union's interest in the third-party asset. If a corporate credit union has no claim on the third-party asset, then the corporate credit union's assumption of any credit risk is a direct credit substitute. Direct credit substitutes include:

(1) Financial standby letters of credit that support financial claims on a third party that exceed a corporate credit union's *pro rata* share in the financial claim;

(2) Guarantees, surety arrangements, credit derivatives, and similar instruments backing financial claims that exceed a corporate credit union's *pro rata* share in the financial claim;

(3) Purchased subordinated interests that absorb more than their *pro rata* share of losses from the underlying assets, including any tranche of asset-backed securities that is not the most senior tranche;

(4) Credit derivative contracts under which the corporate credit union assumes more than its *pro rata* share of credit risk on a third-party asset or exposure;

(5) Loans or lines of credit that provide credit enhancement for the financial obligations of a third party;

(6) Purchased loan servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced. Servicer cash advances as defined in this section are not direct credit substitutes;

(7) Clean-up calls on third party assets. However, clean-up calls that are 10

percent or less of the original pool balance and that are exercisable at the option of the corporate credit union are not direct credit substitutes; and

(8) Liquidity facilities that provide support to asset-backed commercial paper (other than eligible ABCP liquidity facilities).

Exchange rate contracts means cross-currency interest rate swaps; forward foreign exchange rate contracts; currency options purchased; and any similar instrument that, in the opinion of the NCUA, may give rise to similar risks.

Face amount means the notational principal, or face value, amount of an off-balance sheet item or the amortized cost of an on-balance sheet asset.

Financial asset means cash or other monetary instrument, evidence of debt, evidence of an ownership interest in an entity, or a contract that conveys a right to receive or exchange cash or another financial instrument from another party.

Financial standby letter of credit means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary:

(1) To repay money borrowed by, or advanced to, or for the account of, a second party (the account party); or

(2) To make payment on behalf of the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

OECD-based country means a member of that grouping of countries that are full members of the Organization for Economic Cooperation and Development (OECD) plus countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF's General Arrangements to Borrow. This term excludes any country that has rescheduled its external sovereign debt within the previous five years. A rescheduling of external sovereign debt generally would include any renegotiation of terms arising from a country's inability or unwillingness to meet its external debt service obligations, but generally would not include renegotiations of debt in the normal course of business, such as a renegotiation to allow the borrower to take advantage of a decline in interest rates or other change in market conditions.

Original maturity means, with respect to a commitment, the earliest date after a commitment is made on which the commitment is scheduled to expire (i.e., it will reach its stated maturity and cease to be binding on either party), provided that either:

(1) The commitment is not subject to extension or renewal and will actually

expire on its stated expiration date; or

(2) If the commitment is subject to extension or renewal beyond its stated expiration date, the stated expiration date will be deemed the original maturity only if the extension or renewal must be based upon terms and conditions independently negotiated in good faith with the member at the time of the extension or renewal and upon a new, bona fide credit analysis utilizing current information on financial condition and trends.

Performance-based standby letter of credit means any letter of credit, or similar arrangement, however named or described, which represents an irrevocable obligation to the beneficiary on the part of the issuer to make payment on account of any default by a third party in the performance of a nonfinancial or commercial obligation. Such letters of credit include arrangements backing subcontractors' and suppliers' performance, labor and materials contracts, and construction bids.

Prorated assets means the total assets (as determined in the most recently available GAAP report but in no event more than one year old) of a consolidated CUSO multiplied by the corporate credit union's percentage of ownership of that consolidated CUSO.

Qualifying mortgage loan means a loan that:

(1) Is fully secured by a first lien on a one-to four-family residential property;

(2) Is underwritten in accordance with prudent underwriting standards, including standards relating the ratio of the loan amount to the value of the property (LTV ratio), as presented in the *Interagency Guidelines for Real Estate Lending Policies*, 57 Fed. Reg. 62890 (December 31, 1992). A nonqualifying mortgage loan that is paid down to an appropriate LTV ratio (calculated using value at origination, appraisal obtained within the prior six months, or updated value using an automated valuation model) may become a qualifying loan if it meets all other requirements of this definition;

(3) Maintains an appropriate LTV ratio based on the amortized principal balance of the loan; and

(4) Is performing and is not more than 90 days past due.

If a corporate credit union holds the first and junior lien(s) on a residential property and no other party holds an intervening lien, the transaction is treated as a single loan secured by a first lien for the purposes of determining the LTV ratio and the appropriate risk-weight under Appendix C. Also, a loan to an individual

borrower for the construction of the borrower's home may be included as a qualifying mortgage loan.

Qualifying multifamily mortgage loan means a loan secured by a first lien on multifamily residential properties consisting of 5 or more dwelling units, provided that:

(1) The amortization of principal and interest occurs over a period of not more than 30 years;

(2) The original minimum maturity for repayment of principal on the loan is not less than seven years;

(3) When considering the loan for placement in a lower risk-weight category, all principal and interest payments have been made on a timely basis in accordance with its terms for the preceding year;

(4) The loan is performing and not 90 days or more past due;

(5) The loan is made in accordance with prudent underwriting standards; and

(6) If the interest rate on the loan does not change over the term of the loan, the current loan balance amount does not exceed 80 percent of the value of the property securing the loan, and for the property's most recent fiscal year, the ratio of annual net operating income generated by the property (before payment of any debt service on the loan) to annual debt service on the loan is not less than 120 percent, or in the case of cooperative or other not-for-profit housing projects, the property generates sufficient cash flows to provide comparable protection to the institution; or

(7) If the interest rate on the loan changes over the term of the loan, the current loan balance amount does not exceed 75 percent of the value of the property securing the loan, and for the property's most recent fiscal year, the ratio of annual net operating income generated by the property (before payment of any debt service on the loan) to annual debt service on the loan is not less than 115 percent, or in the case of cooperative or other not-for-profit housing projects, the property generates sufficient cash flows to provide comparable protection to the institution.

For purposes of paragraphs (6) and (7) of this definition, the term value of the property means, at origination of a loan to purchase a multifamily property, the lower of the purchase price or the amount of the initial appraisal, or if appropriate, the initial evaluation. In cases not involving purchase of a multifamily loan, the value of the property is determined by the most current appraisal, or if

appropriate, the most current evaluation.

In cases where a borrower refinances a loan on an existing property, as an alternative to paragraphs (3), (6), and (7) of this definition:

(1) All principal and interest payments on the loan being refinanced have been made on a timely basis in accordance with the terms of that loan for the preceding year; and

(2) The net income on the property for the preceding year would support timely principal and interest payments on the new loan in accordance with the applicable debt service requirement.

Qualifying residential construction loan, also referred to as a residential bridge loan, means a loan made in accordance with sound lending principles satisfying the following criteria:

(1) The builder must have substantial project equity in the home construction project;

(2) The residence being constructed must be a 1-4 family residence sold to a home purchaser;

(3) The lending entity must obtain sufficient documentation from a permanent lender (which may be the construction lender) demonstrating that the home buyer intends to purchase the residence and has the ability to obtain a permanent qualifying mortgage loan sufficient to purchase the residence;

(4) The home purchaser must have made a substantial earnest money deposit;

(5) The construction loan must not exceed 80 percent of the sales price of the residence;

(6) The construction loan must be secured by a first lien on the lot, residence under construction, and other improvements;

(7) The lending credit union must retain sufficient undisbursed loan funds throughout the construction period to ensure project completion;

(8) The builder must incur a significant percentage of direct costs (i.e., the actual costs of land, labor, and material) before any drawdown on the loan;

(9) If at any time during the life of the construction loan any of the criteria of this rule are no longer satisfied, the corporate must immediately recategorize the loan

at a 100 percent risk-weight and must accurately report the loan in the corporate's next quarterly call report;

(10) The home purchaser must intend that the home will be owner-occupied;

(11) The home purchaser(s) must be an individual(s), not a partnership, joint venture, trust corporation, or any other entity (including an entity acting as a sole proprietorship) that is purchasing the home(s) for speculative purposes; and

(12) The loan must be performing and not more than 90 days past due.

The NCUA retains the discretion to determine that any loans not meeting sound lending principles must be placed in a higher risk-weight category. The NCUA also reserves the discretion to modify these criteria on a case-by-case basis provided that any such modifications are not inconsistent with the safety and soundness objectives of this definition.

Qualifying securities firm means:

(1) A securities firm incorporated in the United States that is a broker-dealer that is registered with the Securities and Exchange Commission (SEC) and that complies with the SEC's net capital regulations (17 CFR 240.15c3(1)); and

(2) A securities firm incorporated in any other OECD-based country, if the corporate credit union is able to demonstrate that the securities firm is subject to consolidated supervision and regulation (covering its subsidiaries, but not necessarily its parent organizations) comparable to that imposed on depository institutions in OECD countries. Such regulation must include risk-based capital requirements comparable to those imposed on depository institutions under the Accord on International Convergence of Capital Measurement and Capital Standards (1988, as amended in 1998).

Recourse means a corporate credit union's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold (in accordance with Generally Accepted Accounting Principles) that exceeds a *pro rata* share of that corporate credit union's claim on the asset. If a corporate credit union has no claim on a asset it has sold, then the retention of any credit risk is recourse. A recourse obligation typically arises when a corporate credit union transfers assets in a sale and retains an explicit obligation to repurchase assets or to absorb losses due to a default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly if a corporate credit union provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include:

(1) Credit-enhancing representations and warranties made on transferred assets;

(2) Loan servicing assets retained pursuant to an agreement under which the corporate credit union will be responsible for losses associated with the loans serviced. Servicer cash advances as defined in this section are not recourse obligations;

(3) Retained subordinated interests that absorb more than their *pro rata* share of losses from the underlying assets;

(4) Assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet;

(5) Loan strips sold without contractual recourse where the maturity of the transferred portion of the loan is shorter than the maturity of the commitment under which the loan is drawn;

(6) Credit derivatives that absorb more than the corporate credit union's *pro rata* share of losses from the transferred assets;

(7) Clean-up calls on assets the corporate credit union has sold. However, clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the corporate credit union are not recourse arrangements; and

(8) Liquidity facilities that provide support to asset-backed commercial paper (other than eligible ABCP liquidity facilities).

Replacement cost means, with respect to interest rate and exchange-rate contracts, the loss that would be incurred in the event of a counterparty default, as measured by the net cost of replacing the contract at the current market value. If default would result in a theoretical profit, the replacement value is considered to be zero. This mark-to-market process must incorporate changes in both interest rates and counterparty credit quality.

Residential properties means houses, condominiums, cooperative units, and manufactured homes. This definition does not include boats or motor homes, even if used as a primary residence, or timeshare properties.

Residual interest means any on-balance sheet asset that:

(1) Represents an interest (including a beneficial interest) created by a transfer

that qualifies as a sale (in accordance with Generally Accepted Accounting Principles) of financial assets, whether through a securitization or otherwise; and

(2) Exposes a corporate credit union to credit risk directly or indirectly associated with the transferred asset that exceeds a *pro rata* share of that corporate credit union's claim on the asset, whether through subordination provisions or other credit enhancement techniques.

Residual interests generally include credit-enhancing interest-only strips, spread accounts, cash collateral accounts, retained subordinated interests (and other forms of overcollateralization), and similar assets that function as a credit enhancement. Residual interests further include those exposures that, in substance, cause the corporate credit union to retain the credit risk of an asset or exposure that had qualified as a residual interest before it was sold. Residual interests generally do not include assets purchased from a third party, but a credit-enhancing interest-only strip that is acquired in any asset transfer is a residual interest.

Corporate credit unions will use this definition of the term “residual interests,” and not the definition in §704.2, for purposes of applying this Appendix.

Risk participation means a participation in which the originating party remains liable to the beneficiary for the full amount of an obligation (e.g., a direct credit substitute), notwithstanding that another party has acquired a participation in that obligation.

Risk-weighted assets means the sum total of risk-weighted on-balance sheet assets, as calculated under Section II(a) of this Appendix, and the total of risk-weighted off-balance sheet credit equivalent amounts. The total of risk-weighted off-balance sheet credit equivalent amounts equals the risk-weighted off-balance sheet activities as calculated under Section II(b) of this Appendix plus the risk-weighted recourse obligations, risk-weighted direct credit substitutes, and certain other risk-weighted positions as calculated under Section II(c) of this Appendix.

Servicer cash advance means funds that a residential mortgage servicer advances to ensure an uninterrupted flow of payments, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the loan. A servicer cash advance is not a recourse obligation or a direct credit substitute if:

(1) The servicer is entitled to full reimbursement and this right is not subordinated to other claims on the cash flows from the underlying asset pool; or

(2) For any one loan, the servicer's obligation to make nonreimbursable

advances is contractually limited to an insignificant amount of the outstanding principal amount on that loan.

Structured financing program means a program where receivable interests and asset-or mortgage-backed securities issued by multiple participants are purchased by a special purpose entity that repackages those exposures into securities that can be sold to investors. Structured financing programs allocate credit risk, generally, between the participants and credit enhancement provided to the program.

Traded position means a position retained, assumed, or issued in connection with a securitization that is rated by a NRSRO, where there is a reasonable expectation that, in the near future, the rating will be relied upon by:

(1) Unaffiliated investors to purchase the security; or

(2) An unaffiliated third party to enter into a transaction involving the position, such as a purchase, loan, or repurchase agreement.

Unconditionally cancelable means, with respect to a commitment-type lending arrangement, that the corporate credit union may, at any time, with or without cause, refuse to advance funds or extend credit under the facility.

United States Government or its agencies means an instrumentality of the U.S. Government whose debt obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the United States Government.

United States Government-sponsored agency or corporation means an agency or corporation originally established or chartered to serve public purposes specified by the United States Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the United States Government.

Part II: Risk-Weightings

Section II.

(a) *On-balance sheet assets*.

Except as provided in Section II(b) of this Appendix, risk-weighted on-balance sheet assets are computed by multiplying the on-balance sheet asset amounts times the appropriate risk-weight categories. The risk-weight categories are:

(1) Zero percent Risk-Weight (Category 1).

(i) Cash, including domestic and foreign currency owned and held in all offices of a corporate credit union or in transit. Any foreign currency held by a corporate credit union must be converted into U.S. dollar equivalents;

(ii) Securities issued by and other direct claims on the U.S. Government or its agencies (to the extent such securities or claims are unconditionally backed by the full faith and credit of the United States Government) or the central government of an OECD country;

(iii) Notes and obligations issued or guaranteed by the Federal Deposit Insurance Corporation or the National Credit Union Share Insurance Fund and backed by the full faith and credit of the United States Government;

(iv) Deposit reserves at, claims on, and balances due from Federal Reserve Banks;

(v) The book value of paid-in Federal Reserve Bank stock;

(vi) That portion of assets directly and unconditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country.

(viii) Claims on, and claims guaranteed by, a qualifying securities firm that are collateralized by cash on deposit in the corporate credit union or by securities issued or guaranteed by the United States Government or its agencies, or the central government of an OECD country. To be eligible for this risk-weight, the corporate credit union must maintain a positive margin of collateral on the claim on a daily basis, taking into account any change in a corporate credit union's exposure to the obligor or counterparty under the claim in relation to the market value of the collateral held in support of the claim.

(2) 20 percent Risk-Weight (Category 2).

(i) Cash items in the process of collection;

(ii) That portion of assets conditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country
(iii) That portion of assets collateralized by the current market value of securities issued or guaranteed by the United States government or its agencies, or the central government of an OECD country;;

(iv) Securities (not including equity securities) issued by and other claims on the U.S. Government or its agencies which are not backed by the full faith and credit

of the United States Government;

(v) Securities (not including equity securities) issued by, or other direct claims on, United States Government-sponsored agencies;

(vi) That portion of assets guaranteed by United States Government-sponsored agencies;

(vii) That portion of assets collateralized by the current market value of securities issued or guaranteed by United States Government-sponsored agencies;

(viii) Claims on, and claims guaranteed by, a qualifying securities firm, subject to the following conditions:

(A) A qualifying securities firm must have a long-term issuer credit rating, or a rating on at least one issue of long-term unsecured debt, from a NRSRO. The rating must be in one of the three highest investment grade categories used by the NRSRO. If two or more NRSROs assign ratings to the qualifying securities firm, the corporate credit union must use the lowest rating to determine whether the rating requirement of this paragraph is met. A qualifying securities firm may rely on the rating of its parent consolidated company, if the parent consolidated company guarantees the claim.

(B) A collateralized claim on a qualifying securities firm does not have to comply with the rating requirements under paragraph (a) if the claim arises under a contract that:

(1) Is a reverse repurchase/repurchase agreement or securities lending/borrowing transaction executed using standard industry documentation;

(2) Is collateralized by debt or equity securities that are liquid and readily marketable;

(3) Is marked-to-market daily;

(4) Is subject to a daily margin maintenance requirement under the standard industry documentation; and

(5) Can be liquidated, terminated or accelerated immediately in bankruptcy or similar proceeding, and the security or collateral agreement will not be stayed or avoided under applicable law of the relevant jurisdiction. For example, a claim is exempt from the automatic stay in bankruptcy in the United States if it arises under a securities contract or a repurchase agreement subject to section 555 or 559 of the Bankruptcy Code (11 U.S.C. 555 or 559), a qualified financial contract

under section 207(c)(8) of the Federal Credit Union Act (12 U.S.C. 1787(c)(8)) or section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or a netting contract between or among financial institutions under sections 401-407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401-4407), or Regulation EE (12 CFR part 231).

(C) If the securities firm uses the claim to satisfy its applicable capital requirements, the claim is not eligible for a risk-weight under this paragraph II(a)(2)(viii);

(ix) Claims representing general obligations of any public-sector entity in an OECD country, and that portion of any claims guaranteed by any such public-sector entity;

(x) Balances due from and all claims on domestic depository institutions. This includes demand deposits and other transaction accounts, savings deposits and time certificates of deposit, federal funds sold, loans to other depository institutions, including overdrafts and term federal funds, holdings of the corporate credit union's own discounted acceptances for which the account party is a depository institution, holdings of bankers acceptances of other institutions and securities issued by depository institutions, except those that qualify as capital;

(xi) The book value of paid-in Federal Home Loan Bank stock;

(xii) Deposit reserves at, claims on and balances due from the Federal Home Loan Banks;

(xiii) Assets collateralized by cash held in a segregated deposit account by the reporting corporate credit union;

(xiv) Claims on, or guaranteed by, official multilateral lending institutions or regional development institutions in which the United States Government is a shareholder or contributing member;[69]

(xv) That portion of assets collateralized by the current market value of securities issued by official multilateral lending institutions or regional development institutions in which the United States Government is a shareholder or contributing member.

[69] These institutions include, but are not limited to, the International Bank for Reconstruction and Development (World Bank), the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investments Bank, the International Monetary Fund and the Bank for International Settlements.

(xvi) All claims on depository institutions incorporated in an OECD country, and all assets backed by the full faith and credit of depository institutions incorporated in an OECD country. This includes the credit equivalent amount of participations in commitments and standby letters of credit sold to other depository institutions incorporated in an OECD country, but only if the originating bank remains liable to the member or beneficiary for the full amount of the commitment or standby letter of credit. Also included in this category are the credit equivalent amounts of risk participations in bankers' acceptances conveyed to other depository institutions incorporated in an OECD country. However, bank-issued securities that qualify as capital of the issuing bank are not included in this risk category;

(xvii) Claims on, or guaranteed by depository institutions other than the central bank, incorporated in a non-OECD country, with a remaining maturity of one year or less;

(xviii) That portion of local currency claims conditionally guaranteed by central governments of non-OECD countries, to the extent the corporate credit union has local currency liabilities in that country.

(3) 50 percent Risk-Weight (Category 3).

(i) Revenue bonds issued by any public-sector entity in an OECD country for which the underlying obligor is a public- sector entity, but which are repayable solely from the revenues generated from the project financed through the issuance of the obligations;

(ii) Qualifying mortgage loans and qualifying multifamily mortgage loans;

(iii) Privately-issued mortgage-backed securities (i.e., those that do not carry the guarantee of the U.S. government, U.S. government agency, or U.S. government sponsored enterprise) representing an interest in qualifying mortgage loans or qualifying multifamily mortgage loans. If the security is backed by qualifying multifamily mortgage loans, the corporate credit union must receive timely payments of principal and interest in accordance with the terms of the security. Payments will generally be considered timely if they are not 30 days past due; and

(iv) Qualifying residential construction loans.

(4) 100 percent Risk-Weight (Category 4).

All assets not specified above or deducted from calculations of capital pursuant to §704.2 and §704.3 of this part, including, but not limited to:

(i) Consumer loans;

(ii) Commercial loans;

(iii) Home equity loans;

(iv) Non-qualifying mortgage loans;

(v) Non-qualifying multifamily mortgage loans;

(vi) Residential construction loans;

(vii) Land loans;

(viii) Nonresidential construction loans;

(ix) Obligations issued by any state or any political subdivision thereof for the benefit of a private party or enterprise where that party or enterprise, rather than the issuing state or political subdivision, is responsible for the timely payment of principal and interest on the obligations, e.g., industrial development bonds;

(x) Debt securities not specifically risk-weighted in another category;

(xi) Investments in fixed assets and premises;

(xii) Servicing assets;

(xiii) Interest-only strips receivable, other than credit-enhancing interest-only strips;

(xiv) Equity investments;

(xv) The prorated assets of subsidiaries (except for the assets of consolidated CUSOs) to the extent such assets are included in adjusted total assets;

(xvi) All repossessed assets or assets that are more than 90 days past due; and

(xix) Intangible assets not specifically weighted in some other category.

(5) Indirect ownership interests in pools of assets. Assets representing an indirect holding of a pool of assets, e.g., mutual funds, are assigned to risk-weight categories under this section based upon the risk-weight that would be assigned to the assets in the portfolio of the pool. An investment in shares of a mutual fund whose portfolio consists primarily of various securities or money

market instruments that, if held separately, would be assigned to different risk-weight categories, generally is assigned to the risk-weight category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the investment objectives set forth in its prospectus. The corporate credit union may, at its option, assign the investment on a *pro rata* basis to different risk-weight categories according to the investment limits in its prospectus. In no case will an investment in shares in any such fund be assigned to a total risk-weight less than 20 percent. If the corporate credit union chooses to assign investments on a *pro rata* basis, and the sum of the investment limits of assets in the fund's prospectus exceeds 100 percent, the corporate credit union must assign the highest *pro rata* amounts of its total investment to the higher risk categories. If, in order to maintain a necessary degree of short-term liquidity, a fund is permitted to hold an insignificant amount of its assets in short-term, highly liquid securities of superior credit quality that do not qualify for a preferential risk-weight, such securities will generally be disregarded in determining the risk-weight category into which the corporate credit union's holding in the overall fund should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk-weighting of the mutual fund investment. For example, the use of hedging instruments by a mutual fund to reduce the interest rate risk of its government bond portfolio will not increase the risk-weight of that fund above the 20 percent category. Nonetheless, if the fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk-weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk-weight category.

(6) Derivatives. Certain transactions or activities, such as derivatives transactions, may appear on corporate’s balance sheet but are not specifically described in the Section II(a) on-balance sheet risk-weight categories. These items will be assigned risk-weights as described in Section II(b) or II(c) below.

(b) *Off-balance sheet items.*

Except as provided in Section II(c) of this Appendix, risk-weighted off-balance sheet items are determined by the following two-step process. First, the face amount of the off-balance sheet item must be multiplied by the appropriate credit conversion factor listed in this Section II(b). This calculation translates the face amount of an off-balance sheet exposure into an on- balance sheet credit-equivalent amount. Second, the credit-equivalent amount must be assigned to the appropriate risk-weight category using the criteria regarding obligors, guarantors, and collateral listed in Section II(a) of this Appendix. The following are the credit conversion factors and the off-balance sheet items to which they apply.

(1) 100 percent credit conversion factor (Group A).

(i) Risk participations purchased in bankers' acceptances;

(ii) Forward agreements and other contingent obligations with a certain draw down, e.g., legally binding agreements to purchase assets at a specified future date. On the date a corporate credit union enters into a forward agreement or similar obligation, it should convert the principal amount of the assets to be purchased at 100 percent as of that date and then assign this amount to the risk-weight category appropriate to the obligor or guarantor of the item, or the nature of the collateral;

(iii) Indemnification of members whose securities the corporate credit union has lent as agent. If the member is not indemnified against loss by the corporate credit union, the transaction is excluded from the risk-based capital calculation. When a corporate credit union lends its own securities, the transaction is treated as a loan. When a corporate credit union lends its own securities or is acting as agent, agrees to indemnify a member, the transaction is assigned to the risk-weight appropriate to the obligor or collateral that is delivered to the lending or indemnifying institution or to an independent custodian acting on their behalf; and

(iv) Unused portions of ABCP liquidity facilities that do not meet the definition of an eligible ABCP liquidity facility. The resulting credit equivalent amount is assigned to the risk category appropriate to the assets to be funded by the liquidity facility based on the assets or the obligor, after considering any collateral or guarantees, or external credit ratings under paragraph II(c)(3) of this Appendix, if applicable.

(2) 50 percent credit conversion factor (Group B).

(i) Transaction-related contingencies, including, among other things, performance bonds and performance-based standby letters of credit related to a particular transaction;

(ii) Unused portions of commitments (including home equity lines of credit and eligible ABCP liquidity facilities) with an original maturity exceeding one year except those listed in paragraph II(b)(5) of this Appendix. For eligible ABCP liquidity facilities, the resulting credit equivalent amount is assigned to the risk category appropriate to the assets to be funded by the liquidity facility based on the assets or the obligor, after considering any collateral or guarantees, or external credit ratings under paragraph II(c)(3) of this Appendix, if applicable; and

(iii) Revolving underwriting facilities, note issuance facilities, and similar arrangements pursuant to which the corporate credit union's CUSO or member

can issue short-term debt obligations in its own name, but for which the corporate credit union has a legally binding commitment to either:

(A) Purchase the obligations the member is unable to sell by a stated date; or

(B) Advance funds to its member, if the obligations cannot be sold.

(3) 20 percent credit conversion factor (Group C). Trade-related contingencies, i.e., short-term, self-liquidating instruments used to finance the movement of goods and collateralized by the underlying shipment. A commercial letter of credit is an example of such an instrument.

(4) 10 percent credit conversion factor (Group D). Unused portions of eligible ABCP liquidity facilities with an original maturity of one year or less. The resulting credit equivalent amount is assigned to the risk category appropriate to the assets to be funded by the liquidity facility based on the assets or the obligor, after considering any collateral or guarantees, or external credit ratings under paragraph II(c)(3) of this Appendix, if applicable;

(5) Zero percent credit conversion factor (Group E). (i) Unused portions of commitments with an original maturity of one year or less, except for eligible ABCP liquidity facilities;

(ii) Unused commitments with an original maturity greater than one year, if they are unconditionally cancelable at any time at the option of the corporate credit union and the corporate credit union has the contractual right to make, and in fact does make, either:

(A) A separate credit decision based upon the borrower's current financial condition before each drawing under the lending facility; or

(B) An annual (or more frequent) credit review based upon the borrower's current financial condition to determine whether or not the lending facility should be continued; and

(iii) The unused portion of retail credit card lines or other related plans that are unconditionally cancelable by the corporate credit union in accordance with applicable law.

(6) Off-balance sheet contracts; interest rate and foreign exchange rate contracts (Group F). –

(i) Calculation of credit equivalent amounts. The credit equivalent amount of an off-balance sheet interest rate or foreign exchange rate contract that is not

subject to a qualifying bilateral netting contract in accordance with paragraph II(b)(6)(ii) of this Appendix is equal to the sum of the current credit exposure, i.e., the replacement cost of the contract, and the potential future credit exposure of the off-balance sheet rate contract. The calculation of credit equivalent amounts is measured in U.S. dollars, regardless of the currency or currencies specified in the off-balance sheet rate contract.

(A) Current credit exposure. The current credit exposure of an off-balance sheet rate contract is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current credit exposure equals that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. In determining its current credit exposure for multiple off-balance sheet rate contracts executed with a single counterparty, a corporate credit union may net positive and negative mark-to-market values of off-balance sheet rate contracts if subject to a bilateral netting contract as provided in paragraph paragraph II(b)(6)(ii) of this Appendix.

(B) Potential future credit exposure. The potential future credit exposure of an off-balance sheet rate contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal by a credit conversion factor.[70] Corporate credit unions, subject to examiner review, should use the effective rather than the apparent or stated notional amount in this calculation. The conversion factors are:[71]

Remaining maturity	**Interest rate contracts (percents)**	**Foreign exchange rate contracts (percents)**
One year or less	0.0	1.0
Over one year	0.5	5.0

(ii) Off-balance sheet rate contracts subject to bilateral netting contracts. I n determining its current credit exposure for multiple off-balance sheet rate contracts executed with a single counterparty, a corporate credit union may net

[70] For purposes of calculating potential future credit exposure for foreign exchange contracts and other similar contracts, in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts to each party falling due on each value date in each currency.

[71] No potential future credit exposure is calculated for single currency interest rate swaps in which payments are made based upon two floating rate indices, so-called floating/floating or basis swaps; the credit equivalent amount is measured solely on the basis of the current credit exposure.

off-balance sheet rate contracts subject to a bilateral netting contract by offsetting positive and negative mark-to-market values, provided that:

(A) The bilateral netting contract is in writing;

(B) The bilateral netting contract creates a single legal obligation for all individual off-balance sheet rate contracts covered by the bilateral netting contract. In effect, the bilateral netting contract provides that the corporate credit union has a single claim or obligation either to receive or pay only the net amount of the sum of the positive and negative mark-to-market values on the individual off-balance sheet rate contracts covered by the bilateral netting contract. The single legal obligation for the net amount is operative in the event that a counterparty, or a counterparty to whom the bilateral netting contract has been validly assigned, fails to perform due to any of the following events: default, insolvency, bankruptcy, or other similar circumstances;

(C) The corporate credit union obtains a written and reasoned legal opinion(s) representing, with a high degree of certainty, that in the event of a legal challenge, including one resulting from default, insolvency, bankruptcy or similar circumstances, the relevant court and administrative authorities would find the corporate credit union's exposure to be the net amount under:

(1) The law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

(2) The law that governs the individual off-balance sheet rate contracts covered by the bilateral netting contract; and

(3) The law that governs the bilateral netting contract;

(D) The corporate credit union establishes and maintains procedures to monitor possible changes in relevant law and to ensure that the bilateral netting contract continues to satisfy the requirements of this section; and

(E) The corporate credit union maintains in its files documentation adequate to support the netting of an off-balance sheet rate contract.[72]

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[72] By netting individual off-balance sheet rate contracts for the purpose of calculating its credit equivalent amount, a corporate credit union represents that documentation adequate to support the netting of an off-balance sheet rate contract is in the corporate credit union's files and available for inspection by the NCUA. Upon determination by the NCUA that a corporate credit union's files are inadequate or that a bilateral netting contract may not be legally enforceable under any one of the bodies of law described in paragraphs II(b)(5)(ii) of this Appendix, the

(iii) Walkaway clause. A bilateral netting contract that contains a walkaway clause is not eligible for netting for purposes of calculating the current credit exposure amount. The term "walkaway clause" means a provision in a bilateral netting contract that permits a nondefaulting counterparty to make a lower payment than it would make otherwise under the bilateral netting contract, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the bilateral netting contract.

(iv) Risk-weighting. Once the corporate credit union determines the credit equivalent amount for an off-balance sheet rate contract, that amount is assigned to the risk-weight category appropriate to the counterparty, or, if relevant, to the nature of any collateral or guarantee. Collateral held against a netting contract is not recognized for capital purposes unless it is legally available for all contracts included in the netting contract. However, the maximum risk-weight for the credit equivalent amount of such off-balance sheet rate contracts is 50 percent.

(v) Exceptions. The following off-balance sheet rate contracts are not subject to the above calculation, and therefore, are not part of the denominator of a corporate credit union's risk-based capital ratio:

(A) A foreign exchange rate contract with an original maturity of 14 calendar days or less; and

(B) Any interest rate or foreign exchange rate contract that is traded on an exchange requiring the daily payment of any variations in the market value of the contract.

(C) Asset-backed commercial paper programs.

(1) A corporate credit union that qualifies as a primary beneficiary and must consolidate an ABCP program that is a variable interest entity under Generally Accepted Accounting Principles may exclude the consolidated ABCP program assets from risk-weighted assets if the corporate credit union is the sponsor of the ABCP program.

(2) If a corporate credit union excludes such consolidated ABCP program assets from risk-weighted assets, the corporate credit union must assess the appropriate risk-based capital requirement against any exposures of the corporate credit union arising in connection with such ABCP programs, including direct credit substitutes, recourse obligations, residual interests, liquidity facilities,

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underlying individual off-balance sheet rate contracts may not be netted for the purposes of this section.

and loans, in accordance with sections II(a), II(b), and II(c) of this Appendix.

(3) If a corporate credit union bank has multiple overlapping exposures (such as a program-wide credit enhancement and a liquidity facility) to an ABCP program that is not consolidated for risk-based capital purposes, the corporate credit union is not required to hold duplicative risk-based capital under this part against the overlapping position. Instead, the corporate credit union should apply to the overlapping position the applicable risk-based capital treatment that results in the highest capital charge.

(c) *Recourse obligations, direct credit substitutes, and certain other positions.*

(1) In general. Except as otherwise permitted in this Section II(c), to determine the risk-weighted asset amount for a recourse obligation or a direct credit substitute (but not a residual interest):

(i) Multiply the full amount of the credit-enhanced assets for which the corporate credit union directly or indirectly retains or assumes credit risk by a 100 percent conversion factor. (For a direct credit substitute that is an on-balance sheet asset (e.g., a purchased subordinated security), a corporate credit union must use the amount of the direct credit substitute and the full amount of the asset its supports, i.e., all the more senior positions in the structure); and

(ii) Assign this credit equivalent amount to the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral. Section II(a) lists the risk-weight categories.

(2) Residual interests. Except as otherwise permitted under this Section II(c), a corporate credit union must maintain risk-based capital for residual interests as follows:

(i) Credit-enhancing interest-only strips. A corporate credit union must maintain risk-based capital for a credit-enhancing interest-only strip equal to the remaining amount of the strip even if the amount of risk-based capital that must be maintained exceeds the full risk-based capital requirement for the assets transferred.

(ii) Other residual interests. A corporate credit union must maintain risk-based capital for a residual interest (excluding a credit-enhancing interest-only strip) equal to the face amount of the residual interest, even if the amount of risk-based capital that must be maintained exceeds the full risk-based capital requirement for the assets transferred.

(iii) Residual interests and other recourse obligations. Where a corporate credit

union holds a residual interest (including a credit-enhancing interest-only strip) and another recourse obligation in connection with the same transfer of assets, the corporate credit union must maintain risk-based capital equal to the greater of:

(A) The risk-based capital requirement for the residual interest as calculated under Section II(c)(2)(i) through (ii) of this Appendix; or

(B) The full risk-based capital requirement for the assets transferred, subject to the low-level recourse rules under Section II(c)(5) of this Appendix.

(3) Ratings-based approach -- (i) Calculation. A corporate credit union may calculate the risk-weighted asset amount for an eligible position described in Section II(c)(3)(ii) of this section by multiplying the face amount of the position by the appropriate risk-weight determined in accordance with Table A or B of this section.

Table A

Long term rating category	**Risk-weight (In percent)**
Highest or second highest investment grade	20
Third highest investment grade	50
Lowest investment grade	100
One category below investment grade	200

Table B

Short term rating category	**Risk-weight (In percent)**
Highest investment grade	20
Second highest investment grade	50
Lowest investment grade	100

(ii) Eligibility.

(A) Traded positions. A position is eligible for the treatment described in paragraph II(c)(3)(i) of this Appendix if:

(1) The position is a recourse obligation, direct credit substitute, residual interest,

or asset- or mortgage-backed security and is not a credit-enhancing interest-only strip;

(2) The position is a traded position; and

(3) The NRSRO has rated a long term position as one grade below investment grade or better or a short term position as investment grade. If two or more NRSROs assign ratings to a traded position, the corporate credit union must use the lowest rating to determine the appropriate risk-weight category under paragraph (3)(i).

(B) Non-traded positions. A position that is not traded is eligible for the treatment described in paragraph(3)(i) if:

(1) The position is a recourse obligation, direct credit substitute, residual interest, or asset- or mortgage-backed security extended in connection with a securitization and is not a credit-enhancing interest-only strip;

(2) More than one NRSRO rate the position;

(3) All of the NRSROs that rate the position rate it as no lower than one grade below investment grade (for long term position) or no lower than investment grade (for short term investments). If the NRSROs assign different ratings to the position, the corporate credit union must use the lowest rating to determine the appropriate risk-weight category under paragraph (3)(i) ;

(4) The NRSROs base their ratings on the same criteria that they use to rate securities that are traded positions; and

(5) The ratings are publicly available.

(C) Unrated senior positions. If a recourse obligation, direct credit substitute, residual interest, or asset- or mortgage-backed security is not rated by an NRSRO, but is senior or preferred in all features to a traded position (including collateralization and maturity), the corporate credit union may risk-weight the face amount of the senior position under paragraph (3)(i) of this section, based on the rating of the traded position, subject to supervisory guidance. The corporate credit union must satisfy NCUA that this treatment is appropriate. This paragraph (3)(i)(c) applies only if the traded position provides substantive credit support to the unrated position until the unrated position matures.

(4) Certain positions that are not rated by NRSROs. (i) Calculation. A corporate credit union may calculate the risk-weighted asset amount for eligible position described in paragraph II(c)(4)(ii) of this section based on the corporate credit

union's determination of the credit rating of the position. To risk-weight the asset, the corporate credit union must multiply the face amount of the position by the appropriate risk-weight determined in accordance with Table C of this section.

Table C

Rating category	Risk-weight (In percent)
Investment grade	100
One category below investment grade	200

(ii) Eligibility. A position extended in connection with a securitization is eligible for the treatment described in paragraph II(c)(4)(i) of this section if it is not rated by an NRSRO, is not a residual interest, and meets the one of the three alternative standards described in paragraphs (A), (B), or (C) below:

(A) Position rated internally. A direct credit substitute, but not a purchased credit-enhancing interest-only strip, is eligible for the treatment described under paragraph II(c)(4)(i) of this Appendix, if the position is assumed in connection with an asset-backed commercial paper program sponsored by the corporate credit union. Before it may rely on an internal credit risk rating system, the corporate must demonstrate to NCUA's satisfaction that the system is adequate. Acceptable internal credit risk rating systems typically:

(1) Are an integral part of the corporate credit union's risk management system that explicitly incorporates the full range of risks arising from the corporate credit union's participation in securitization activities;

(2) Link internal credit ratings to measurable outcomes, such as the probability that the position will experience any loss, the expected loss on the position in the event of default, and the degree of variance in losses in the event of default on that position;

(3) Separately consider the risk associated with the underlying loans or borrowers, and the risk associated with the structure of the particular securitization transaction;

(4) Identify gradations of risk among "pass" assets and other risk positions;

(5) Use clear, explicit criteria to classify assets into each internal rating grade, including subjective factors;

(6) Employ independent credit risk management or loan review personnel to assign or review the credit risk ratings;

(7) Include an internal audit procedure to periodically verify that internal risk ratings are assigned in accordance with the corporate credit union's established criteria;

(8) Monitor the performance of the assigned internal credit risk ratings over time to determine the appropriateness of the initial credit risk rating assignment, and adjust individual credit risk ratings or the overall internal credit risk rating system, as needed; and

(9) Make credit risk rating assumptions that are consistent with, or more conservative than, the credit risk rating assumptions and methodologies of NRSROs.

(B) Program ratings.

(1) A recourse obligation or direct credit substitute, but not a residual interest, is eligible for the treatment described in paragraph II(c)(4)(i) of this Appendix, if the position is retained or assumed in connection with a structured finance program and an NRSRO has reviewed the terms of the program and stated a rating for positions associated with the program. If the program has options for different combinations of assets, standards, internal or external credit enhancements and other relevant factors, and the NRSRO specifies ranges of rating categories to them, the corporate credit union may apply the rating category applicable to the option that corresponds to the corporate credit union's position.

(2) To rely on a program rating, the corporate credit union must demonstrate to NCUA's satisfaction that that the credit risk rating assigned to the program meets the same standards generally used by NRSROs for rating traded positions. The corporate credit union must also demonstrate to NCUA's satisfaction that the criteria underlying the assignments for the program are satisfied by the particular position.

(3) If a corporate credit union participates in a securitization sponsored by another party, NCUA may authorize the corporate credit union to use this approach based on a program rating obtained by the sponsor of the program.

(C) Computer program. A recourse obligation or direct credit substitute, but not a residual interest, is eligible for the treatment described in paragraph II(c)(4)(i) of this Appendix, if the position is extended in connection with a structured financing program and the corporate credit union uses an acceptable credit assessment computer program to determine the rating of the position. An NRSRO must have

developed the computer program and the corporate credit union must demonstrate to NCUA's satisfaction that the ratings under the program correspond credibly and reliably with the rating of traded positions.

(5) Limitations on risk-based capital requirements –

(i) Low-level exposure rule. If the maximum contractual exposure to loss retained or assumed by a corporate credit union is less than the effective risk-based capital requirement, as determined in accordance with this Section II(c), for the assets supported by the corporate credit union's position, the risk-based capital requirement is limited to the corporate credit union's contractual exposure less any recourse liability account established in accordance with Generally Accepted Accounting Principles. This limitation does not apply when a corporate credit union provides credit enhancement beyond any contractual obligation to support assets it has sold.

(ii) Mortgage-related securities or participation certificates retained in a mortgage loan swap. If a corporate credit union holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, it must hold risk-based capital to support the recourse obligation and that percentage of the mortgage-related security or participation certificate that is not covered by the recourse obligation. The total amount of risk-based capital required for the security (or certificate) and the recourse obligation is limited to the risk-based capital requirement for the underlying loans, calculated as if the corporate credit union continued to hold these loans as an on-balance sheet asset.

(iii) Related on-balance sheet assets. If an asset is included in the calculation of the risk-based capital requirement under this Section II(c) and also appears as an asset on the corporate credit union's balance sheet, the corporate credit union must risk-weight the asset only under this Section II(c), except in the case of loan servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In that case, the corporate credit union must separately risk-weight the on-balance sheet servicing asset and the related recourse obligations and direct credit substitutes under this section, and incorporate these amounts into the risk-based capital calculation.

(6) Obligations of CUSOs. All recourse obligations and direct credit substitutes retained or assumed by a corporate credit union on the obligations of CUSOs in which the corporate credit union has an equity investment are risk-weighted in accordance with this Section II(c), unless the corporate credit union’s equity investment is deducted from credit union’s capital and assets under §704.2 and §704.3.

PART 709 – INVOLUNTARY LIQUIDATION OF FEDERAL CREDIT UNIONS AND ADJUDICATION OF CREDITOR CLAIMS INVOLVING FEDERALLY INSURED CREDIT UNIONS IN LIQUIDATION.

23. The authority citation for part 709 continues to read as follows:

Authority: 12 U.S.C. 1757, 1766, 1767, 1786(h), 1787, 1788, 1789, 1789a.

24. Revise paragraphs (b)(7) and (b)(9) of §709.5 to read as follows:

§709.5 Payout priorities in involuntary liquidation.

* * * * *

(b) * * *

(7) in a case involving liquidation of a corporate credit union, holders of nonperpetual contributed capital accounts or instruments, subject to the capital priority option described in Appendix A of Part 704 of this chapter;

* * * * *

(9) in a case involving liquidation of a corporate credit union, holders of perpetual contributed capital instruments, subject to the capital priority option described in Appendix A of this chapter;

* * * * *

PART 747 -- ADMINISTRATIVE ACTIONS, ADJUDICATIVE HEARINGS, RULES OF PRACTICE AND PROCEDURE, AND INVESTIGATIONS.

25. The authority citation for part 747 continues to read as follows:

Authority: 12 U.S.C. 1766, 1782, 1784, 1786, 1787; 42 U.S.C. 4012a; Pub. L. 101-410; Pub. L. 104-134.

26. Add a new subpart M to part 747 to read as follows:

Subpart M – Issuance, Review and Enforcement of Orders Imposing Prompt Corrective Action on Corporate Credit Unions

Sec

747.3001. Scope.
747.3002. Review of orders imposing discretionary supervisory action.
747.3003. Review of order reclassifying a corporate credit union on safety and soundness criteria.
747.3004. Review of order to dismiss a director or senior executive officer.
747.3005. Enforcement of directives.
747.3006. Conservatorship or liquidation of critically undercapitalized corporate credit union.

Subpart M – Issuance, Review and Enforcement of Orders Imposing Prompt Corrective Action on Corporate Credit Unions

§ 747.3001. Scope.

(a) *Independent review process*. The rules and procedures set forth in this subpart apply to corporate credit unions, which are subject to discretionary supervisory actions under section 704.4 of this chapter and to reclassification under § 704.4(d)(3) of this chapter, to facilitate prompt corrective action, and to senior executive officers and directors of such corporate credit unions who are dismissed pursuant to a discretionary supervisory action imposed under section 704.4 of this chapter. Section 747.3002 of this subpart provides an independent appellate process to challenge such decisions.

(b) *Notice to State officials*. With respect to a State-chartered corporate credit union under §§ 747.3002, 747.3003 and 747.3004 of this subpart, any notices, directives and decisions on appeal served upon a corporate credit union, or a dismissed director or officer thereof, by the NCUA will also be served upon the appropriate State official. Responses, requests for a hearing and to present witnesses, requests to modify or rescind a discretionary supervisory action and requests for reinstatement served upon the NCUA by a corporate credit union, or any dismissed director or officer of a corporate credit union, will also be served upon the appropriate State official.

§ 747.3002. Review of orders imposing discretionary supervisory action.

(a) *Notice of intent to issue directive*. --

(1) *Generally*. Whenever the NCUA intends to issue a directive imposing a discretionary supervisory action under §§ 704.4(k)(2)(v) and 704.4(k)(3) of this chapter on a corporate credit union classified "undercapitalized" or lower, the NCUA will give the corporate credit union prior notice of the proposed action and an opportunity to respond.

(2) *Immediate issuance of directive without notice*. The NCUA may issue a directive to take effect immediately under paragraph (a)(1) of this section without notice to the corporate credit union if the NCUA finds it necessary in order to carry out the purposes of §704.4 of this chapter. A corporate credit union that is subject to a directive which takes effect immediately may appeal the directive in writing to the NCUA Board (Board). Such an appeal must be received by the Board within 14 calendar days after the directive was issued, unless the Board permits a longer period. Unless ordered by the NCUA, the directive will remain in effect pending a decision on the appeal. The Board will consider any such appeal, if timely filed, within 60 calendar days of receiving it.

(b) *Contents of notice*. The NCUA's notice to a corporate credit union of its intention to issue a directive imposing a discretionary supervisory action will state:

(1) The corporate credit union's capital measures and capital category classification;

(2) The specific restrictions or requirements that the Board intends to impose, and the reasons therefore;

(3) The proposed date when the discretionary supervisory action would take effect and the proposed date for completing the required action or terminating the action; and

(4) That a corporate credit union must file a written response to a notice within 14 calendar days from the date of the notice, or within such shorter period as the Board determines is appropriate in light of the financial condition of the corporate credit union or other relevant circumstances.

(c) *Contents of response to notice*. A corporate credit union's response to a notice under paragraph (b) of this section must:

(1) Explain why it contends that the proposed discretionary supervisory action is not an appropriate exercise of discretion under this section;

(2) Request the Board to modify or to not issue the proposed directive; and

(3) Include other relevant information, mitigating circumstances, documentation, or other evidence in support of the corporate credit union's position regarding the proposed directive.

(d) *NCUA Board consideration of response*. The Board, or an independent person designated by the Board to act on the Board's behalf, after considering a response under paragraph (c) of this section, may:

(1) Issue the directive as originally proposed or as modified;

(2) Determine not to issue the directive and to so notify the corporate credit union; or

(3) Seek additional information or clarification from the corporate credit union or any other relevant source.

(e) *Failure to file response*. A corporate credit union which fails to file a written response to a notice of the Board's intention to issue a directive imposing a discretionary supervisory action, within the specified time period, will be deemed to have waived the opportunity to respond, and to have consented to the issuance of the directive.

(f) *Request to modify or rescind directive*. A corporate credit union that is subject to an existing directive imposing a discretionary supervisory action may request in writing that the Board reconsider the terms of the directive, or rescind or modify it, due to changed circumstances. Unless otherwise ordered by the Board, the directive will remain in effect while such request is pending. A request under this paragraph which remains pending 60 days following receipt by the Board is deemed granted.

§ 747.3003. Review of order reclassifying a corporate credit union on safety and soundness criteria.

(a) *Notice of proposed reclassification based on unsafe or unsound condition or practice*. When the Board proposes to reclassify a corporate credit union or subject it to the supervisory actions applicable to the next lower capitalization category pursuant to § 704.4(d)(3) of this chapter (such action hereinafter referred to as "reclassification"), the Board will issue and serve on the corporate credit union reasonable prior notice of the proposed reclassification.

(b) *Contents of notice*. A notice of intention to reclassify a corporate credit union based on unsafe or unsound condition or practice will state:

(1) The corporate credit union's current capital ratios and the capital category to which the corporate credit union would be reclassified;

(2) The unsafe or unsound practice(s) and/or condition(s) justifying reasons for reclassification of the corporate credit union;

(3) The date by which the corporate credit union must file a written response to the notice (including a request for a hearing), which date will be no less than 14 calendar days from the date of service of the notice unless the Board determines that a shorter period is appropriate in light of the financial condition of the corporate credit union or other relevant circumstances; and

(4) That a corporate credit union which fails to --

(i) File a written response to the notice of reclassification, within the specified time period, will be deemed to have waived the opportunity to respond, and to have consented to reclassification;

(ii) Request a hearing will be deemed to have waived any right to a hearing; and

(iii) Request the opportunity to present witness testimony will be deemed have waived any right to present such testimony.

(c) *Contents of response to notice*. A corporate credit union's response to a notice under paragraph (b) of this section must:

(1) Explain why it contends that the corporate credit union should not be reclassified;

(2) Include any relevant information, mitigating circumstances, documentation, or other evidence in support of the corporate credit union's position;

(3) If desired, request an informal hearing before the Board under this section; and

(4) If a hearing is requested, identify any witness whose testimony the corporate credit union wishes to present and the general nature of each witness's expected testimony.

(d) *Order to hold informal hearing*. Upon timely receipt of a written response that includes a request for a hearing, the Board will issue an order commencing an informal hearing no later than 30 days after receipt of the request, unless the corporate credit union requests a later date. The hearing will be held in

Alexandria, Virginia, or at such other place as may be designated by the Board, before a presiding officer designated by the Board to conduct the hearing and to recommend a decision.

(e) *Procedures for informal hearing*. -- (1) The corporate credit union may appear at the hearing through a representative or through counsel. The corporate credit union will have the right to introduce relevant documents and to present oral argument at the hearing. The corporate credit union may introduce witness testimony only if expressly authorized by the Board or the presiding officer. Neither the provisions of the Administrative Procedure Act *(5 U.S.C. 554*-557) governing adjudications required by statute to be determined on the record nor the Uniform Rules of Practice and Procedure (12 CFR part 747) will apply to an informal hearing under this section unless the Board orders otherwise.

(2) The informal hearing will be recorded, and a transcript will be furnished to the corporate credit union upon request and payment of the cost thereof. Witnesses need not be sworn, unless specifically requested by a party or by the presiding officer. The presiding officer may ask questions of any witness.

(3) The presiding officer may order that the hearing be continued for a reasonable period following completion of witness testimony or oral argument to allow additional written submissions to the hearing record.

(4) Within 20 calendar days following the closing of the hearing and the record, the presiding officer will make a recommendation to the Board on the proposed reclassification.

(f) *Time for final decision*. Not later than 60 calendar days after the date the record is closed, or the date of receipt of the corporate credit union's response in a case where no hearing was requested, the Board will decide whether to reclassify the corporate credit union, and will notify the corporate credit union of its decision. The decision of the Board will be final.

(g) *Request to rescind reclassification*. Any corporate credit union that has been reclassified under this section may file a written request to the Board to reconsider or rescind the reclassification, or to modify, rescind or remove any directives issued as a result of the reclassification. Unless otherwise ordered by the Board, the corporate credit union will remain reclassified, and subject to any directives issued as a result, while such request is pending.

§ 747.3004. Review of order to dismiss a director or senior executive officer.

(a) *Service of directive to dismiss and notice*. When the Board issues and serves a directive on a corporate credit union requiring it to dismiss from office any director or senior executive officer under §§ 704.4(g) and 704.4(k)(3) of this chapter, the Board will also serve upon the person the corporate credit union is directed to dismiss (Respondent) a copy of the directive (or the relevant portions, where appropriate) and notice of the Respondent's right to seek reinstatement.

(b) *Contents of notice of right to seek reinstatement*. A notice of a Respondent's right to seek reinstatement will state:

(1) That a request for reinstatement (including a request for a hearing) must be filed with the Board within 14 calendar days after the Respondent receives the directive and notice under paragraph (a) of this section, unless the Board grants the Respondent's request for further time;

(2) The reasons for dismissal of the Respondent; and

(3) That the Respondent's failure to --

(i) Request reinstatement will be deemed a waiver of any right to seek reinstatement;

(ii) Request a hearing will be deemed a waiver of any right to a hearing; and

(iii) Request the opportunity to present witness testimony will be deemed a waiver of the right to present such testimony.

(c) *Contents of request for reinstatement*. A request for reinstatement in response to a notice under paragraph (b) of this section must:

(1) Explain why the Respondent should be reinstated;

(2) Include any relevant information, mitigating circumstances, documentation, or other evidence in support of the Respondent's position;

(3) If desired, request an informal hearing before the Board under this section; and

(4) If a hearing is requested, identify any witness whose testimony the Respondent wishes to present and the general nature of each witness's expected testimony.

(d) *Order to hold informal hearing*. Upon receipt of a timely written request from a Respondent for an informal hearing on the portion of a directive requiring a

corporate credit union to dismiss from office any director or senior executive officer, the Board will issue an order directing an informal hearing to commence no later than 30 days after receipt of the request, unless the Respondent requests a later date. The hearing will be held in Alexandria, Virginia, or at such other place as may be designated by the Board, before a presiding officer designated by the Board to conduct the hearing and recommend a decision.

(e) *Procedures for informal hearing*. -- (1) A Respondent may appear at the hearing personally or through counsel. A Respondent will have the right to introduce relevant documents and to present oral argument at the hearing. A Respondent may introduce witness testimony only if expressly authorized by the Board or by the presiding officer. Neither the provisions of the Administrative Procedure Act *(5 U.S.C. 554*-557) governing adjudications required by statute to be determined on the record nor the Uniform Rules of Practice and Procedure (12 CFR part 747) apply to an informal hearing under this section unless the Board orders otherwise.

(2) The informal hearing will be recorded, and a transcript will be furnished to the Respondent upon request and payment of the cost thereof. Witnesses need not be sworn, unless specifically requested by a party or the presiding officer. The presiding officer may ask questions of any witness.

(3) The presiding officer may order that the hearing be continued for a reasonable period following completion of witness testimony or oral argument to allow additional written submissions to the hearing record.

(4) A Respondent will bear the burden of demonstrating that his or her continued employment by or service with the corporate credit union would materially strengthen the corporate credit union's ability to --

(i) Become "adequately capitalized," to the extent that the directive was issued as a result of the corporate credit union's capital classification category or its failure to submit or implement a capital restoration plan; and

(ii) Correct the unsafe or unsound condition or unsafe or unsound practice, to the extent that the directive was issued as a result of reclassification of the corporate credit union pursuant to § 704.4(d)(3) of this chapter.

(5) Within 20 calendar days following the date of closing of the hearing and the record, the presiding officer will make a recommendation to the Board concerning the Respondent's request for reinstatement with the corporate credit union.

(f) *Time for final decision*. Not later than 60 calendar days after the date the record is closed, or the date of the response in a case where no hearing was

requested, the Board will grant or deny the request for reinstatement and will notify the Respondent of its decision. If the Board denies the request for reinstatement, it will set forth in the notification the reasons for its decision. The decision of the Board will be final.

(g) *Effective date*. Unless otherwise ordered by the Board, the Respondent's dismissal will take and remain in effect pending a final decision on the request for reinstatement.

§ 747.3005. Enforcement of directives.

(a) *Judicial remedies*. Whenever a corporate credit union fails to comply with a directive imposing a discretionary supervisory action, or enforcing a mandatory supervisory action under section 704.4 of this chapter, the Board may seek enforcement of the directive in the appropriate United States District Court pursuant to *12 U.S.C. 1786*(k)(1).

(b) *Administrative remedies* -- (1) *Failure to comply with directive*. Pursuant to *12 U.S.C. 1786*(k)(2)(A), the Board may assess a civil money penalty against any corporate credit union that violates or otherwise fails to comply with any final directive issued under section 704.4 of this chapter, or against any institution-affiliated party of a corporate credit union (per *12 U.S.C. 1786*(r)) who participates in such violation or noncompliance.

(2) *Failure to implement plan*. Pursuant to *12 U.S.C. 1786*(k)(2)(A), the Board may assess a civil money penalty against a corporate credit union which fails to implement a capital restoration plan under § 704.4(e) of this chapter, regardless whether the plan was published.
(c) *Other enforcement action*. In addition to the actions described in paragraphs (a) and (b) of this section, the Board may seek enforcement of the directives issued under section 704.4 of this chapter through any other judicial or administrative proceeding authorized by law.

§ 747.3006. Conservatorship or liquidation of critically undercapitalized corporate credit union.

Notwithstanding any other provision of this title, the NCUA may, without any administrative due process, immediately place into conservatorship or liquidation any corporate credit union that has been categorized as critically undercapitalized.