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NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 701, 723 and 742

RIN 3133-AD68

Fixed Assets, Member Business Loans, and Regulatory Flexibility Program

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed rule with request for comments.

SUMMARY: NCUA proposes to revise certain provisions of its Regulatory Flexibility Program (RegFlex) to enhance safety and soundness for credit unions. Those provisions pertain to fixed assets, member business loans (MBL), stress testing of investments, and discretionary control of investments. Some of these revisions will require conforming amendments to NCUA's fixed assets and MBL rules.

DATES: Comments must be received on or before [Insert date 60 days from date of publication in the FEDERAL REGISTER].

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 Web Site:
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 Proposed Rule 742, Regulatory Flexibility Program” 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) 518-6546 or send an e-mail to OGCMail@ncua.gov.

FOR FURTHER INFORMATION CONTACT: Frank Kressman, Staff Attorney, Office of General Counsel, at the above address or telephone (703) 518-6540.

SUPPLEMENTARY INFORMATION:

A. Background - Regulatory Flexibility Program

The RegFlex Program exempts from certain regulatory restrictions and grants additional powers to those federal credit unions (FCUs) that have demonstrated sustained superior performance as measured by CAMEL ratings and net worth classifications. 12 CFR 742.1. An FCU may qualify for RegFlex treatment automatically or by application to the appropriate regional director. 12 CFR 742.2. Specifically, an FCU automatically qualifies when it has received a composite CAMEL rating of “1” or “2” for the two preceding examinations and has maintained a net worth classification of “well capitalized” under Part 702 of NCUA’s rules for six consecutive preceding quarters or, if subject to a risk-based net worth (RBNW) requirement under Part 702, has remained “well capitalized” for six consecutive preceding quarters after applying the applicable RBNW requirement. An FCU that does not automatically qualify may apply for a RegFlex designation with the appropriate regional director. 12 CFR 742.2(a) and (b). An FCU’s RegFlex authority can be lost or revoked. 12 CFR 742.3.

The NCUA Board established RegFlex in 2002. 66 FR 58656 (November 23, 2001). Since then, NCUA has amended RegFlex a number of times to increase available relief for FCUs from a variety of regulatory restrictions or lessen the criteria required for obtaining RegFlex status. 71 FR 4039 (January 25, 2006); 72 FR 30247 (May 31, 2007); 74 FR 13083 (March 26, 2009).

B. Discussion

1. Overview

The current RegFlex rule provides RegFlex credit unions with regulatory relief in the following ten areas: 1) charitable contributions; 2) nonmember deposits; 3) fixed assets; 4) MBLs; 5) discretionary control of investments; 6) stress testing of investments; 7) zero-coupon securities; 8) borrowing repurchase transactions; 9) commercial mortgage related securities; and 10) purchase of obligations from a federally insured credit union. NCUA proposes amendments to the fixed assets, MBL, stress testing of investments, and discretionary control of investments provisions of the RegFlex rule. NCUA requests comment on those amendments.

2. Fixed Assets

The Federal Credit Union Act authorizes FCUs to purchase, hold, and dispose of property necessary or incidental to its operations. [12 U.S.C. 1757\(4\)](#). Generally, the fixed asset rule provides limits on fixed asset investments, establishes occupancy and other requirements for acquired and abandoned premises, and prohibits certain

transactions. [12 CFR 701.36](#). Fixed assets are defined in 701.36(e) as premises, furniture, fixtures, and equipment and includes any office, branch office, suboffice, service center, parking lot, facility, real estate where a credit union transacts or will transact business, office furnishings, office machines, computer hardware and software, automated terminals, and heating and cooling equipment. Section 701.36 prohibits an FCU with \$1 million or more in assets from investing in fixed assets, the aggregate of which exceeds five percent of the FCU's shares and retained earnings, although upon an FCU's application, a regional director may set a higher limit. 12 CFR 701.36(a)(1) and (2).

The RegFlex rule exempts RegFlex credit unions from the referenced five percent limit. 12 CFR 701.36(a)(1). NCUA believes that investing in higher levels of non-earning assets can materially affect a credit union's earnings ability and, therefore, its viability. Call report data collected by NCUA shows a higher percentage of earnings problems among credit unions with more than five percent of shares and retained earnings invested in fixed assets; the percentage of earnings problems increases as the level of fixed assets increases.

The following examples illustrate the kinds of fixed asset related financial problems some credit unions are experiencing and are a source of concern for NCUA. They demonstrate how credit unions are experiencing earnings and net worth problems as a result of excessive investment in fixed assets.

Example 1. Between 2005 and 2006, an FCU substantially increased its investment in fixed assets to 14.77% of total assets by relocating their main office, opening a new branch, and converting the old main office into a branch. This caused its operating expenses to increase to 99.85% of gross income, which left insufficient earnings to cover loan losses, pay dividends, and maintain net worth. The FCU expanded its operations without conducting a sufficient analysis of the impact of the expansion and developing a sound financial plan. The FCU has performed poorly since 2006 and its net worth ratio has dropped from approximately 10.76% in 2005 to 6.10% in 2010. The credit union is currently supervised by NCUA's Division of Special Actions.

Example 2. In December 2006, a credit union was interested in expanding and, at the time, its fixed assets were 1.46% of total assets. It built a new main office in 2007 in an effort to promote growth. The credit union projected it could grow into its new main office but due to the economic down-turn, cost overruns in the building construction, and other poor management decisions, it did not realize its projections. Since 2007, net income has been negative. By late 2008, fixed assets had risen to 17.50% of total assets, largely due to the cost of the building. The credit union is seeking a merger partner but has been unsuccessful to date, mainly due to the cost and devaluation of the new building.

Example 3. In 2004, a credit union decided to build a branch office to help promote growth. At the time, its net worth was 15.19% and fixed assets were 2.36% percent of total assets. When construction was completed in 2006, fixed assets had risen to

13.76% of total assets. Since then, income has been negative and net worth has declined to 9.15%. The credit union has closed the branch and put it up for sale but has not received any offers.

Example 4. An FCU began an aggressive fixed asset expansion project. The project caused its fixed assets to mushroom to approximately 16% of total assets. The FCU is unable to support this level of capital expenditures and has created a safety and soundness problem. NCUA issued a temporary cease and desist order to require the FCU to discontinue the project. The FCU is now cooperating with NCUA to address this problem. The above examples are a sampling of a larger and common problem. Accordingly, for the reasons discussed above, NCUA does not believe it is prudent to continue to exempt RegFlex credit unions from the five percent limit on fixed assets and proposes to rescind that exemption.

3. MBLs

The MBL rule requires a credit union making a business loan to obtain the personal liability and guarantee of the borrower's principals as part of the rule's collateral and security requirements. 12 CFR 723.7(b). Under the current rules, RegFlex credit unions are exempt from that requirement but may choose to require the principals' guarantee as part of their own underwriting standards and best practices. Id.

NCUA proposes to rescind this exemption for RegFlex credit unions. NCUA believes obtaining the principals' personal guarantee is a prudent underwriting practice that

greatly enhances the likelihood of loan repayment and should be required of all credit unions. A credit union that fails to do so subjects itself to increased risk, particularly in these economic times when MBL delinquencies and MBL charge-offs have increased. The below table illustrates the magnitude of MBL-related losses in credit unions.

September 30, 2009 Consolidated Financial Performance Report					
	2005	2006	2007	2008	9/2009
Delinquent MBLs	0.42%	0.53%	1.87%	2.26%	3.33%
Charged Off MBLs	0.07%	0.11%	0.15%	0.46%	0.47%

The below table illustrates an example of one credit union with a high concentration of MBLs with increasing net charge-offs.

December 31, 2009 Financial Performance Report					
	2005	2006	2007	2008	9/2009
Net Worth Ratio	9.81%	10.76%	9.61%	7.71%	7.18%
Percent of MBLs Compared to Assets	59.51%	52.07%	55.19%	50.77%	55.66%
Delinquent MBLs	0.15%	0.25%	1.05%	3.62%	7.21%
Charged Off MBLs	0.15%	1.18%	1.05%	0.81%	1.70%

This trend in losses and delinquencies is becoming increasingly common, even among credit unions whose MBLs portfolios represent a smaller portion of their assets.

Accordingly, for the reasons discussed above, the Board believes it is in the interest of safety and soundness to rescind the exemption. Credit unions will continue to have the option of seeking a waiver of the guarantee requirement under 723.10(e) on a case-by-case basis.

4. Stress Testing of Investments

NCUA's investment rule requires an FCU to monitor the securities it holds. 12 CFR 703.12. Specifically, at least monthly, an FCU must prepare a written report setting out the fair value and dollar change since the prior month-end for each security held with summary information for its entire portfolio. 12 CFR 703.12(a). Similarly, at least quarterly, an FCU must prepare a written report setting out the sum of the fair values of all fixed and variable rate securities whose features include: 1) embedded options; 2) remaining maturities greater than three years; or 3) coupon formulas that are related to more than one index or are inversely related to, or multiples of, an index. 12 CFR 703.12(b). If the sum in the quarterly report is greater than the FCU's net worth, then the report must estimate the potential impact, in percentage and dollar terms, of an immediate and sustained parallel shift in market interest rates of plus and minus 300 basis points on: 1) the fair value of each security in the FCU's portfolio; 2) the fair value of the FCU's portfolio as a whole; and 3) the FCU's net worth. 12 CFR 703.12(c). This calculation is known as "stress testing" the securities. Under the current rules, RegFlex credit unions are exempt from the requirement to stress test their securities.

Because of low investment yields due to the current economic environment, many credit unions are incurring additional risk by investing in long-term instruments to increase yield and improve earnings. NCUA believes many credit unions are purchasing investment products they do not fully understand and are incurring significant interest rate and liquidity risk.

The below chart illustrates the degree to which credit unions are investing in products with longer maturities further out on the yield curve. Although this may help achieve greater yield in the short term, an increase in market rates could result in a significant decrease in product value and cause liquidity problems. Credit unions need to stress test their investments so they have a clearer understanding of their risk profile and can better manage risk.

December 31, 2009 Consolidated Financial Performance Report					
	12/2008	3/2009	6/2009	9/2009	12/2009
Total Investment >3 Years Maturities	\$38.2B	\$39.7B	\$43.4B	\$45.6B	\$50.7B

The trends in the net long-term asset ratio reveal that credit unions are extending maturities in all types of assets, including loans and investments. NCUA has stressed the need for improved asset-liability management, and this includes stress testing investments.

For the reasons discussed above, the Board believes all FCUs must stress test their securities as a matter of safety and soundness and responsible business practices. Accordingly, the Board proposes to rescind the RegFlex exemption in this context.

5. Discretionary Control of Investments

NCUA's investment rule requires an FCU to retain discretionary control over its purchase and sale of investments although, under the rule, an FCU will not be deemed to have delegated discretionary control to an investment adviser if the FCU reviews all recommendations from the investment adviser and authorizes a recommended purchase or sale transaction before its execution. 12 CFR 703.5(a). An exception to this general rule is that an FCU may delegate discretionary control over the purchase and sale of its investments to a person outside the FCU if the person is an investment advisor registered with the Securities and Exchange Commission and if the amount delegated is limited to up to 100 percent of the FCU's net worth at the time of delegation. 12 CFR 703.5(b). If an FCU exercises this limited authority, it must adjust the amount of funds held under discretionary control to comply with the 100 percent of net worth cap at least annually. Id.

Under the current rule, a RegFlex credit union is exempt from the discretionary control requirements in 703.5 that pertain to the 100 percent of net worth limitation. In light of the current investment climate and reports of fraudulent practices in the investment banking industry, the Board is becoming increasingly concerned about the safety and

soundness of credit unions and their investments. Accordingly, the Board proposes to rescind the RegFlex exemption pertaining to discretionary control of investments.

C. Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact a proposed rule may have on a substantial number of small entities (primarily those under ten million dollars in assets). This rule enhances safety and soundness without additional regulatory burden. Accordingly, this proposed rule will not have a significant economic impact on a substantial number of small credit unions, and therefore, no regulatory flexibility analysis is required.

Paperwork Reduction Act

NCUA has determined that this rule will not increase paperwork requirements under the Paperwork Reduction Act of 1995 and regulations of the Office of Management and Budget.

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. This proposed rule would not have a substantial direct 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. NCUA has determined that this proposed rule does not constitute a policy that has federalism implications for purposes of the executive order.

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

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).

Agency Regulatory Goal

NCUA's goal is to promulgate clear and understandable regulations that impose minimal regulatory burden. We request your comments on whether this proposed rule is understandable and minimally intrusive if implemented as proposed.

List of Subjects

12 CFR part 701

Credit unions.

12 CFR part 723

Credit, Credit unions, Reporting and recordkeeping requirements.

12 CFR part 742

Credit unions, reporting and recordkeeping requirements.

By the National Credit Union Administration Board on March 18, 2010

Mary Rupp

Secretary of the Board

For the reasons discussed above, NCUA proposes to amend 12 CFR parts 701, 723, and 742 as follows:

PART 701 – ORGANIZATION AND OPERATIONS OF FEDERAL CREDIT UNIONS

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

Authority: 12 U.S.C. 1752(5), 1755, 1756, 1757, 1759, 1761a, 1761b, 1766, 1767, 1782, 1784, 1787, and 1789. Section 701.6 is also authorized by 31 U.S.C. 3717.

Section 701.31 is also authorized by 15 U.S.C. 1601 et seq., 42 U.S.C. 1861 and 42 U.S.C. 3601-3610. Section 701.35 is also authorized by 42 U.S.C. 4311-4312.

2. Revise section 701.36 by amending paragraph (d) to read as follows:

§ 701.36 FCU ownership of fixed assets.

* * * * *

(d) *Regulatory Flexibility Program.* Federal credit unions that meet Regulatory Flexibility Program standards, as determined pursuant to Part 742 of this chapter, are exempt from the three-year partial occupancy requirement described in paragraph (b) of this section when acquiring unimproved land for future expansion pursuant to the terms of section 742.4(a)(3) of this chapter. For a Federal credit union eligible for the Regulatory Flexibility Program that subsequently loses eligibility:

(1) Section 742.3 of this chapter provides that NCUA may require the credit union to divest any existing fixed assets for substantive safety and soundness reasons; and

(2) * * *

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PART 723 — MEMBER BUSINESS LOANS

3. The authority citation for part 723 continues to read as follows:

Authority: 12 U.S.C. 1756, 1757, 1757A, 1766, 1785, 1789.

4. Revise section 723.7 by deleting the last sentence of paragraph (b).

PART 742 – REGULATORY FLEXIBILITY PROGRAM

5. The authority citation for part 742 continues to read as follows:

Authority: 12 U.S.C. 1756, 1766.

6. Revise section 742.4 by deleting the first sentence of paragraph (a)(3) and deleting paragraphs (a)(4), (a)(5), and (a)(6) and redesignating all other paragraphs in this section as appropriate.