

BOARD ACTION MEMORANDUM

TO: NCUA Board

DATE: October 20, 2010

FROM: Director, Office of
Examination and Insurance

SUBJ: Amended Definition of
PCA "Low-risk assets"

General Counsel

ACTION ITEM: That the NCUA Board adopt an Interim Final Rule expanding the definition of "Low-risk assets" for Prompt Corrective Action purposes in order to extend a zero percent risk weighting to debt instruments unconditionally guaranteed by NCUA, which carry no credit risk because they are backed by the full faith and credit of the United States.

ACTION DATE: October 21, 2010

OTHER OFFICES CONSULTED: Office of General Counsel

VIEWS OF OTHER OFFICES CONSULTED: Concur

SUBMITTED TO THE INSPECTOR GENERAL FOR REVIEW: Yes

BUDGET IMPACT, IF ANY: None

RESPONSIBLE STAFF MEMBERS: John Kutchev, Deputy Director Office of Examination and Insurance; Steven Widerman, Trial Attorney, Office of General Counsel.

SUMMARY: To monetize the substantially devalued mortgage-backed and asset-backed securities ("the distressed assets") held in the investment portfolios of liquidated corporate credit unions, the NCUA Board has decided to sell those distressed assets to a trust it has established, which will then resecuritize the distressed assets in the form of senior debt instruments called "NCUA Guaranteed Notes" ("NGNs"). The NGNs will be offered to public investors, including credit unions. NCUA has fully and unconditionally guaranteed to investors the timely payment of principal and interest ("the NCUA Guaranty"). The NGNs are free of credit risk because the NCUA Guaranty is backed by the full faith and credit of the United States.

As a result of the NCUA Guaranty, the NGNs are legally permissible credit union investments. Under Prompt Corrective Action ("PCA") as it exists today, the NGNs held by a natural person credit union would be considered "investments" and thus would receive a minimum risk-weighting of 3 percent. 12 C.F.R. 702.104(c), 702.106(c)(1). In contrast, assets that meet the PCA definition of "Low-risk" *do* receive a risk-weighting of

zero, but the NGNs presently do not meet that definition. *Id.* §702.106(d). Only “Cash on hand . . . and the NCUSIF deposit” do. *Id.* §702.104(d).

To reflect that an obligation supported by the full faith and credit of the United States carries no credit risk, the Interim Final Rule expands the PCA definition of “Low-risk assets” to extend the zero percent risk weighting to “debt instruments unconditionally guaranteed by the National Credit Union Administration,” such as the NGNs. Were the definition not expanded accordingly, potential credit union investors in the NGNs would face a disincentive to invest: a minimum 3 percent risk-weighting—and the adverse effect on PCA net worth—even though the NGNs are free of credit risk.

On October 13, 2010, the other federal financial institution regulators confirmed that their respective institutions may apply a zero percent risk-weighting to the NGNs the institutions purchase because the NGNs are directly and unconditionally guaranteed by NCUA. The purpose of the Interim Final Rule is to accord the same zero percent risk-weighting to the NGNs purchased by natural person credit unions.

Good cause exists for NCUA to expand the “Low-risk assets” definition via an Interim Final Rule effective immediately and without advance public comment. NCUA already has begun offering the NGNs to investors, and credit unions have been among the purchasers. A series of similar NGN offerings is expected. To maximize credit union participation in these offerings, the first of which is set to close next week, it is imperative to implement a rule immediately eliminating the risk-weighting disincentive explained above. Nonetheless, the Interim Final Rule invites public comments that will be considered before the NCUA Board is asked to adopt a permanent Final Rule.

Finally, a line item for reporting the amount of a credit union’s investment in the NGNs has been added to the 5300 Call Report starting with the December 31, 2010 report, to ensure consistent reporting and tracking of total investment in the NGNs both by individual credit unions and industry-wide.

RECOMMENDED ACTION

That the NCUA Board adopt an Interim Final Rule revising section 702.104(d) of NCUA’s regulations to expand the definition of “Low-risk assets” to include debt instruments unconditionally guaranteed by NCUA, thus according them a zero percent risk weighting for PCA purposes.

ATTACHMENT

Interim Final Rule