June 21, 2017

RE: Authority to Issue and Sell Securities

NCUA has been asked whether a federal credit union (FCU) currently has the authority to issue and sell securities under the Federal Credit Union Act1 (FCUA) and NCUA’s regulations, or whether statutory or regulatory changes would need to be made before an FCU could engage in such activities.

Consistent with the FCUA and NCUA’s regulations, it is the opinion of NCUA’s Office of General Counsel that an FCU does have the authority to issue and sell securities as a power incidental to its operation,2 and, in the case of Government National Mortgage Association (Ginnie Mae) securities, as a power expressly authorized under the FCUA.3

Ginnie Mae Securities

The Housing and Urban Development Act of 1968, among other things, amended the National Bank Act to expressly authorize banks “to issue and sell securities which are guaranteed pursuant to section 306(g) of the National Housing Act.”4 Fourteen years later, Congress passed the Garn-St Germain Depository Institutions Act of 1982 that, among other things, amended the FCUA to provide the same express authority to FCUs “to issue and sell securities which are guaranteed pursuant to section 306(g) of the National Housing Act.”5 The addition of this new language to the FCUA clearly indicates that Congress, at a minimum, considers FCUs to be institutions capable and qualified to securitize assets, and intended for them to be able to sell qualifying mortgage loans through the issuance and sale of Ginnie Mae securities pursuant to section 306(g) of the National Housing Act.6

Other Securities

The FCUA expressly grants FCUs the power to, among other activities, purchase, hold and dispose of property; make loans to members; make certain investments; accept share, share draft and share certificate accounts; and sell and cash negotiable instruments.7 Section 107(17) of the

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2 See § 1757(17) (An FCU “shall have the power . . . to exercise such incidental powers as shall be necessary or requisite to enable it to carry on effectively the business for which it is incorporated.”); and 12 C.F.R. §§ 721.2 & 721.4.
3 § 1757(7)(E) (Providing in relevant part: “a federal credit union may issue and sell securities which are guaranteed pursuant to section 1721(g) of [title 12 of the United States Code].”).
6 12 U.S.C. § 1721(g).
7 12 U.S.C. 1757(4)–(7), (12), (15).
FCUA provides further that an FCU may “exercise such incidental powers as shall be necessary or requisite to enable it to carry on effectively the business for which it is incorporated.”

To determine whether an activity is authorized under the incidental powers provision of § 107(17) of the FCUA, NCUA initially looked to whether the activity was convenient or useful in connection with the performance of an FCU's established activities pursuant to its express powers granted by the FCUA. This standard was established in *Arnold Tours, Inc. v. Camp*, for determining the incidental powers of national banks. The convenient or useful standard adopted in *Arnold Tours* was acknowledged by courts as proper for analyzing the incidental powers provision of the FCU Act. For many years, NCUA followed the reasoning of *Arnold Tours* in recognizing various activities as incidental to an FCU's exercise of its express powers.

Relaxing the *Arnold Tours* standard in 1988, a subsequent court pronounced it “narrow and artificially rigid,” preferring instead to focus on the “essence” of the service being provided and its functional equivalency to a permitted activity. Then, in 1995, the U.S. Supreme Court broadened the standard for considering an expansion of the incidental powers of national banks. In *Nations Bank of North Carolina v. Variable Annuity Life Insurance Co.* (*VALIC*), the Court stated that the authorization of “incidental powers [. . .] necessary to carry on the business of banking” is an independent grant of authority, separate from the five activities specifically enumerated in the National Banking Act, 12 U.S.C § 24 (Seventh). The Court rejected the argument that the powers of national banks are limited to the five specifically enumerated activities, regarding those activities as “exemplary, not exclusive.” The Court held that “the ‘business of banking’ is not limited to the enumerated powers in § 24 (Seventh), and that the Comptroller therefore has discretion to authorize activities beyond those specifically enumerated,” provided that discretion is “kept within reasonable bounds.”

Applying the reasoning of *VALIC* to § 107(17) of the FCUA, “the business for which [a credit union] is incorporated” is not limited to the express powers in that section. Rather than linking incidental powers to express powers, *VALIC* provided the framework for NCUA to adopt a broader and more flexible analysis, giving it discretion to authorize FCUs to engage in activities

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8 § 1757(17).
9 472 F.2d 427 (1st Cir. 1972); accord Independent Insurance Agents of America, Inc. v. Hawke, 211 F. 3d 638, 640 (D.C. Cir. 2000) (“Whether a particular banking device's nomenclature harkens to traditional banking activities is not dispositive”); First National Bank of Eastern Arkansas v. Taylor, 907 F.2d 775, 778 (8th Cir.), cert. denied, 498 U.S. 972 (1990) (“Incidental powers are not confined to activities considered essential to the exercise of express powers”); M&M Leasing Corp. v. Seattle First National Bank, 563 F.2d 1377, 1382 (9th Cir. 1977), cert. denied, 436 U.S. 956 (1978) (“powers of national banks must be construed so as to permit the use of new ways of conducting the very old business of banking”).
13 *Id. *at 258; accord Independent Insurance Agents, 211 F. 3d at 640 (“enumeration of powers is only illustrative and Comptroller may authorize additional activities if encompassed by a reasonable interpretation”); Norwest Bank Minnesota, N.A. v. Sween Corp., 118 F.3d 1255, 1259 (8th Cir. 1997) (analyzing whether activity is closely related to an express power and useful in carrying out business of banks).
14 513 U.S. at 258.
15 *Id.* at 259 n.2.
beyond those specifically enumerated in § 107(17). Thus, activities may fall within an FCU’s incidental powers if they qualify as either “convenient or useful” in connection with an express power or otherwise fall within the scope of “the business for which [a credit union] is incorporated.”

As Congress reiterated in 1998, the FCU Act defines the business for which credit unions are incorporated—to promote thrift among members and to create sources of credit for provident or productive purposes.16 “Thrift” refers to “wise economy in the management of money and other resources.”17 A purpose is “provident” if it anticipates “providing for future needs or events,”18 it is “productive” if it involves “the creation of goods or services to produce wealth or value.”19 NCUA has consistently construed the authority of FCUs broadly to afford them maximum flexibility in providing services to their members.20 Congress's record of steadily expanding the range of expressly granted powers, combined with the legislative history encouraging NCUA to meet the needs of FCUs and their members, justify, if not require, a broad and ambulatory view of the business for which FCUs are incorporated.

In the course of expanding the powers of FCUs, Congress has repeatedly taken the opportunity to encourage NCUA to be flexible, innovative, and responsive in meeting the needs of FCUs and their members. When Congress created NCUA in 1970, the same year that share insurance was introduced, it recognized that “credit unions have become such a significant component of our society that they need and deserve a more responsive and independent regulatory agency.”21 Further, Congress envisioned that NCUA would have “a great responsibility and an opportunity to make real and substantial contributions to our society,” and “would be able to be more responsive to the needs of credit unions and to provide more flexible and innovative regulation.”22

When Congress amended the FCU Act in 1977 to add an extensive array of savings, lending and investment powers, it intended to “allow credit unions to continue to attract and retain the savings of their members by providing essential and contemporary services,” and acknowledged that credit unions are entitled to “updated and more flexible authority granting them the opportunity to better serve their members in a highly-competitive and ever-changing financial environment.”23 Congress acknowledged the difficulty in “regulating contemporary financial institutions within the framework of an Act that has on a continuing basis required major updating by means of regulation.”24

Following the example and encouragement of Congress to be flexible, innovative, and responsive, NCUA recognizes that the business of promoting thrift and providing access to credit for provident and productive purposes has witnessed a dramatic shift from the Depression-era

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18 Id. at 1411.
19 Id. at 1399.
20 50 FR 16462, 16463 (April 26, 1985).
22 Id. at 2481.
24 Id.
economy of 1934, to a post-War, industrial boom economy, to the present information age economy. During this evolution, financial services and products have emerged and matured. Advances in technology and communications have improved, and will continue to improve, the delivery of financial services. The marketplace for financial services has expanded and diversified, and competition has intensified.

Responding to Congress’s calls for flexibility and the needs of the credit union industry, the NCUA Board issued a final rule in 2001 that authorizes certain activities as incidental powers under § 107(17) of the FCUA that, even if not linked to an expressly granted power, nonetheless are convenient or useful in carrying out “the business for which [credit unions] are incorporated,” as that business has evolved since 1934; are a functional equivalent or logical outgrowth of activities within that business; and that involve risks similar in nature to those already assumed as part of that business.25 Part 721 of NCUA’s regulations, sets forth a three-part test used to determine whether an activity can be classified as an “incidental power.” Specifically, § 721.2 provides that an activity is an “incidental power,” even if not expressly authorized under the FCUA or NCUA’s regulations, if it:

(a) Is convenient or useful in carrying out the mission or business of credit unions consistent with the [FCUA];
(b) Is the functional equivalent or logical outgrowth of activities that are part of the mission or business of credit unions; and
(c) Involves risks similar in nature to those already assumed as part of the business of credit unions.26

While issuing and selling securities is not a preapproved incidental powers activity listed under part 721 of NCUA’s regulations, any activity that is found to meet all three of the criteria listed above is an incidental power of FCUs. For the reasons explained in more detail below, we find that issuing and selling securities meets all three criteria.

First, issuing and selling securities is consistent with the FCUA, and is convenient and useful in carrying out the mission or business of FCUs. Nothing in the FCUA expressly or impliedly prohibits an FCU from issuing and selling securities. Like national banks, which have long benefited from being able to securitize assets as a power incidental to the business of banking,27 the ability of FCUs to sell conventional credit union assets through the issuance and sale of certificates evidencing interests in pools of the assets will provide flexibility to FCUs. Securitizing assets can also provide an FCU with an important source of liquidity to further facilitate its lending activities by allowing the FCU to convert relatively illiquid assets into cash through the creation of instruments with maturities and other features that investors want to purchase. In addition, an FCU that securitizes its assets is less dependent on share deposits to fund its member loan demand, providing the credit union more flexibility when encountering high loan demand or increased market competition for deposits. Accordingly, we find that the

26 12 C.F.R. § 721.2.
27 See, e.g., 61 FR 63972, 63977 (Dec. 2, 1996) (Amending 12 C.F.R. § 1.3(g) to incorporate the Office of the Comptroller of the Currency’s long-standing position that a national bank may securitize and sell loan assets that it holds.).
process of pooling FCU assets and selling certificates representing interests therein can be
convenient and useful to an FCU’s ability to sell its assets.

Second, issuing and selling securities is a logical outgrowth of credit union’s core business
activities. Providing credit for provident or productive purposes is a central tenant of the mission
and business of credit unions. 28 Securitization can increase the amount of credit available to
consumers and businesses, due to the fact that an FCU can make more loans to its members with
a given level of capital (when assets are removed from the FCU’s balance sheet). Securitization
also creates a vehicle for mitigating a material amount of credit risk through transference of that
risk to investors. Accordingly, we find that the process of pooling FCU assets and selling
certificates representing interests therein to increase the amount credit available to consumers
and businesses is a logical outgrowth of providing credit for provident or productive purposes.

Third, issuing and selling securities involves risks that are similar in nature to those already
assumed as part of the business of credit unions. The primary risks associated with securitization
activities are credit, liquidity, reputation, operational (including transactional, compliance, and
legal risk), and strategic risk. For the reasons discussed in more detail below, the issuing and
selling of securities involves risks that are similar to those already assumed by many FCUs.

Credit risk arises from borrowers’ failures to repay their debts or otherwise perform as agreed.
FCUs routinely face this type of risk with loans they make and sell to third party securitizers or
that they retain on their own balance sheets. Moreover, securitization structures are generally
designed to reduce the credit exposure of the assets sold. For this reason, we find that the credit
risk associated with issuing and selling securities is similar in nature to the credit risk already
assumed by FCUs.

Liquidity risk arises from an FCU’s inability to manage unexpected changes in funding sources,
which if significant could threaten its viability, or in meeting its obligations at a reasonable cost
or without incurring significant losses. Securitization can also provide liquidity for balance sheet
assets as well as funding for leveraging origination capacity, but it can also increase liquidity
risk. The possibility that the FCU may not be able to sell subsequent charges on the accounts
and may need to fund these on balance-sheet liquidity concerns. Liquidity risk also arises from
an FCU’s failure to recognize or address changes in market conditions that may impact its ability
to liquidate assets quickly and with minimal loss. FCUs already face similar liquidity risk
associated with the sale of loans to third party securitizers, and in making and holding long-term
loans on balance sheet. For this reason, we find that the liquidity risk associated with issuing and
selling securities is similar in nature to the credit risk already assumed by FCUs.

Reputation risk is the risk to liquidity, earnings, and capital arising from a negative public
perception. Reputation risk can expose an FCU to difficulty accessing the markets for funding
(including securitizations), acquiring and retaining members, and increasing legal and regulatory
scrutiny that could result in fines, reimbursements, and possibly stricter rules. FCUs already face
similar reputation risk associated with activities such accessing markets to sell loans to third
party securitizers, making and servicing loans to members, acquiring and retaining members, and

28 See 12 U.S.C. § 1752(1) (“[T]he term ‘Federal credit union’ means a cooperative association organized . . . for the
purpose of creating a source of credit for provident or productive purposes.”)
complying with NCUA’s requirements. For this reason, we find that the reputation risk associated with issuing and selling securities is similar in nature to the reputation risk already assumed by FCUs.

Operational risk is the risk to earnings and capital from inadequate or failed internal processes, people or systems, or from external events; and from the processes for measuring, monitoring and controlling these exposures. Operational risk includes transaction, compliance, and legal risks. While engaging in asset securitization will involve a new level of complexity for FCUs and require that they develop new processes and technical expertise, the operational risk involved in issuing and selling securities is basically the same or substantially similar to those FCUs already face when making and selling loans to third party securitizers, engaging in loan participations, or engaging in other complex financial services related activities already approved for FCUs. Accordingly, we find that the operational risk associated with issuing and selling securities is similar in nature to the operational risk already assumed by FCUs.

Strategic risk is the risk to earnings and capital arising from adverse business decisions or improper implementation of those decisions. This risk is a function of the compatibility of an FCU’s strategic goals, the business strategies developed to achieve those goals, the resources deployed against those goals, and the quality of implementation. While engaging in asset securitization is a complex undertaking, the strategic risk involved in issuing and selling securities is substantially similar to the strategic risk already faced by FCUs competing to offer financial services to consumers in today’s constantly evolving marketplace. Accordingly, we find that the strategic risk associated with issuing and selling securities is similar in nature to the strategic risk already assumed by FCUs.

Safety and Soundness

While we find that the authority to issue and sell securities is within an FCU's incidental powers under the FCU Act, an FCU still must comply with all applicable legal requirements and give due consideration to safety and soundness concerns before engaging in asset securitization activities. To carry out its responsibilities, FCU management must consider whether its policies for securitizing assets are realistic and carefully designed to enable the FCU to serve the interests and needs of the membership. In addition to meeting various legal requirements, securitizing assets will require management to provide direction and instruction for officers, employees, and committees delegated the responsibility for implementing new activities and services.

FCU management is responsible for developing proper internal safeguards such as management oversight, internal controls and quality control. An FCU should consult with its own legal counsel and other professional advisers before securitizing assets. Management must exercise due diligence before devoting resources to a new activity or entering into any arrangements with third parties. An FCU must also examine the credit, liquidity, reputation, operational, and strategic risk involved before engaging asset securitization activities. Moreover, an FCU must

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29 In addition to the FCU Act and NCUA’s regulations, FCUs are subject to numerous other federal laws and regulations. FCUs are also subject to various state and local laws, most of which FCUs are also required to comply with.
adjust its risk management process and insurance coverage to correlate with additional risk taken on by engaging in this new activity.

Finally, before securitizing any assets, an FCU may complete and submit an application to engage in the activity because it is not an activity that is preapproved under NCUA’s regulations as being within a credit union’s incidental powers. The requirements for preparing and submitting such an application can be found in § 721.4 of NCUA’s regulations. It is critical that an FCU wishing to issue and sell securities work closely and diligently with NCUA to ensure that its asset securitization program is designed and implemented successfully.

This legal opinion applies only to federal credit unions. A federally insured, state-chartered credit union interested in securitizing assets should look to applicable state law to determine whether or not it is authorized to engage in such activities.

If you have any questions, please contact Senior Staff Attorney John H. Brolin at (703) 518-6540.

Sincerely,

/s/

Michael J. McKenna
General Counsel

GC/JHB
SSIC 3000
17-0670

30 12 C.F.R. § 721.2.