

Proposed Rule Summary

Prepared by the NASCUS Regulatory Affairs Department
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NCUA

Part 704 Corporate Credit Unions

[With amendments to Parts 702, 703, 709, 747]

NCUA is proposing major changes to Part 704, Corporate Credit Unions. Revisions include changes to corporate credit union capital, investments, asset-liability management, governance, and CUSO activities. The proposal establishes a new capital scheme, including risk-based capital requirements; impose new prompt corrective action (PCA) 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. The proposal also 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.

Comments due:

Comments are due to the NCUA by March 9, 2010.

The complete proposed rule may be viewed here:

http://www.ncua.gov/Resources/RegulationsOpinionsLaws/proposed_regs/Part70411-25-2009FederalRegisterAcceptedVersion.pdf

Rule at a Glance

Capital

- Replaces current 4% minimum capital ratio with three new minimum ratios: 1) 4% minimum leverage ratio (5% to be well capitalized); 2) 4% tier one risk-based capital ratio (6% to be well capitalized); and 3) 8% total risk-based capital ratio (10% to be well capitalized)
- Limits the capital that a corporate may use to calculate the leverage ratio and the tier-one risk based capital ratio to “core” capital
- Requires that a corporate contributing capital to another corporate after the effective date of the rule deduct the investment from its own capital
- Requires that retained earnings constitute a certain portion of capital
- Extends the three year term requirement to five years

- Eliminates the currently permissible adjustable balance type of capital accounts
- Forbids a corporate from redeeming contributed capital prior to maturity without prior regulatory approval
- Allows corporates the option to condition membership or the receipt of services upon the purchase of PIC
- Establishes PCA for the corporate system
- Phases in capital thresholds over a 10 year period
- Eliminates the wholesale corporate

Investments

- Prohibits investments in collateralized debt obligations (CDOs) and net interest margin (NIM) securities
- Requires a minimum six percent leverage ratio to qualify for expanded investment authority and eliminates Part II expanded authority: makes “A-” the lowest possible rating for an NRSRO-rated investment purchased by a corporate with expanded investment authority
- Requires corporates examine the NRSRO rating from every NRSRO that publicly rates a particular investment and only employ the lowest of those ratings
- At least 80 percent of a corporate’s investments must be rated by at least one NRSRO
- Reduces the single obligor limits from 50% of capital to 25% of capital
- Limits subordinated positions in a structured security to the lesser of 100% of capital/5% of assets in any given sector class and the lesser of 400% of capital/20% of assets in the aggregate
- Limits derivatives activity

Asset Liability Management

- Establishes new limits on cash flow mismatches and an additional NEV stress test that applies credit spread widening to both assets and liabilities
- Requires every corporate conduct net interest income (NII) modeling
- Prohibits the average weighted life of a corporate’s assets exceeding two years
- Limits a corporate’s ability to pay a market-based redemption price to no more than its book value
- Limits both aggregate and secured borrowing: aggregate borrowing limited to the lower of 10 times capital or 50% of shares and capital; and secured borrowing restricted to liquidity purposes only with a maximum maturity of 30 days
- Caps aggregate of all investments from any one member or entity to 10% of the corporate credit union’s moving daily average net assets

Corporate Credit Union CUSOs

- Corporate credit union CUSOs may only engage in activities approved by NCUA

- Expands NCUA access to CUSOs beyond just books and records, to physical plant

Governance

- All corporate board members must hold either a CEO, CFO, or COO position at their member credit union or other member entity
- Requires a majority of the board be representatives of NPCU members
- Establishes term limits for board members
- Requires disclosure of compensation of each senior executive officer and director
- Prohibits golden parachutes

Summary of Proposed Part 704

The chart below is provided by NCUA in the preamble of proposed Part 704.

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 <i>Board responsibilities</i> moved to 704.13. Effective one year after publication of final rule, new 704.4 (<i>Prompt corrective action</i>) 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, <i>Board responsibilities</i> , 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, <i>Disclosure of executive and director compensation</i> , added.
704.20 None.	Yes. New 704.20, <i>Golden parachute and indemnification payments</i> , added.
Appendix A Model Forms	Yes. Renamed <i>Capital Prioritization and Model Forms</i> .
Appendix B Expanded Authorities and Requirements	Yes.
Appendix C None.	Yes. Effective one year after publication of final rule, new Appendix C, <i>Risk-Based Capital Credit Risk-Weight Categories</i> , added.

Structure of the Corporate System

As discussed above, NCUA is eliminating the wholesale corporate. The proposed rule eliminates references to the retained earnings requirement and replaces it with a regulatory capital structure that applies equally to all corporate. To further facilitate the elimination of the third tier, the proposed rule amends the existing 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. This would prevent a corporate's board from being controlled by other corporate.

NCUA is also eliminating any distinctions between corporates in field of membership (FOM) policy. As a result, 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.

Definitions

The proposed rule contains numerous changes to terms and definitions contained in current §704 as well as introduces new terms. For example, current §704's "paid-in-capital" is renamed "perpetual contributed capital" (PCC) and "membership capital accounts" are renamed "nonperpetual contributed capital accounts" (NCAs).

Capital

Under current Part 704 corporate credit unions are generally required to meet only one mandatory, minimum capital requirement: achieve and maintain a ratio of capital to moving daily average net assets of at least 4%. NCUA proposes replacing the current structure with a risk-weighted, tiered system modeled after existing banking capital regulator structures.

In doing so, NCUA has also sought to eliminate some of the complexities of bank capital structures that do not reflect the unique nature of the credit union system. For example, the proposal employs average asset calculations in the capital ratio denominators, and not the period-end assets employed by the banking regulators. This difference reflects the corporate's unique role as a liquidity provider.

The proposed changes to the capital requirements of §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 §704
- Proposed amendments to §704.2 revise definitions of terms used in the capital standards. The changes define the permissible components of a corporate's capital base, including which items qualify as core capital; 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
- Proposed §704.4 establishes, prompt corrective action for corporate credit unions

The proposed rule establishes three standards that a corporate must satisfy in order to meet its minimum capital requirement:

- 1) A leverage ratio of adjusted core capital to moving daily average net assets (DANA) of 4% or greater.
- 2) A tier 1 risk-based capital ratio of that same adjusted core capital over moving daily average net risk-based assets (DANRA) of 4% or greater.
- 3) A total risk-based capital standard expressed as a percentage of total capital to moving DANRA of 8% or greater.

Core Capital

A corporate's core capital, or Tier I capital is its retained earnings and PCC. Calculation of the adjusted core capital under the proposal requires the corporate to make several modifications to core capital:

- 1) Corporates must deduct an amount equal to the amount of the corporate's intangible assets that exceed .5% of the corporate's moving DANA. However, because corporate's do not generally maintain intangibles on their books, the proposal includes a provision allowing intangibles of a *de minimus* amount (.5% of total assets) to be treated just like other assets in the capital calculation.

- 2) Corporate must deduct investments, both equity and debt, from consolidated CUSOs.
- 3) Starting on or after 12 months following the publication of the final rule, a corporate that contributes new capital or renews existing capital to another corporate must deduct an amount equal to the aggregate of such new or renewed capital.

NCUA specifically invites comment on the 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.

Current part 704 encourages, but does not require, corporates to achieve and maintain retained earnings at 2% of assets. The proposed §704 will phase in retained earning requirements.

Six years after the date of publication of the final rule, the initial adjustment to core capital 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 2%. In other words, to achieve the minimum 4% capitalization, a corporate 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 5% 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.

Ten years after the date of publication of the final rule, a corporate will have to deduct from core capital any amount of PCC that causes PCC to exceed retained earnings. Therefore, for a corporate to have a 4% 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.

Beginning three years after the publication of the final rule, corporate will have to report the ratio of its retained earnings to its moving daily average net assets on the Call Reports. If this ratio is less than 0.45%, the corporate must submit a retained earnings accumulation plan to the NCUA for approval. Failure to do so will trigger PCA sanctions. Those sanctions could include possible 1) replacement of the board and senior management; 2) liquidation; or 3) conservatorship or consolidation of the corporate.

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. The moving DANRA means the average of daily average net risk-weighted assets for the month being measured and the previous 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.

Total risk-based capital ratio

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

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% of the original amount of that instrument (net of redemptions). The proposed amortization schedule tracks the amortization used by the banking regulators.

Other changes to corporate capital structure include:

- NCUA approval is required before nonperpetual contributed capital may be redeemed prior to maturity or the end of the notice period.
- Perpetual contributed capital (PCC) transfers to the continuing entity in a merger or charter conversion.
- The holder of PCC may transfer its interests to any third party.

The proposed rule allows NCUA to 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. In the case of state-chartered corporate, NCUA would consult the state regulator.

Pursuant to the proposal, a greater minimum capital requirement may be appropriate 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 its business relationships;
- Has a portfolio reflecting weak credit quality or a significant likelihood of financial loss;
- Has inadequate underwriting policies, standards, or procedures;
- Has failed to manage necessary retained earnings growth; or
- Has a record of operational losses that exceeds the average of other corporate.

Additional NCUA authority with respect to corporate capital

In addition to the above provisions, the proposed rule would allow NCUA:

- To disregard any transaction entered into by a corporate primarily for the purpose of evading the requirements §704.
- To require capital ratios be computed on the basis of period-end, rather than average, assets.
- To require the discounting or deduction of assets from the computation of core, supplementary, or total capital.
- To require a corporate to apply another risk-weight factor that more appropriately reflects true risk.

Risk-based capital ratios and asset risk-weightings

Under the proposed rule, 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, including its consolidated CUSOs.

Although the proposed rule allows both core and supplementary capital to be used in meeting the risk-based capital requirement, the amount of supplementary capital that may be counted toward that requirement is limited in relation to the credit union's core capital.

On-balance sheet asset risk weighting

The proposed amendments sets forth a system of risk-weighted assets similar to that used by the other federal banking regulators: risk-weights of 0, 20, 50, and 100%.

0% risk-weighting (Category 1): presents a nearly non-existent level of credit risk, such as:

- Cash
- Securities issued by and other direct claims on the U.S. government
- Notes and obligations issued by/guaranteed by the FDIC or the NCUSIF

20% risk-weighting (Category 2): presents a significantly lower level of risk than standard risk assets, such as:

- Cash items in the process of collection
- Assets conditionally guaranteed by the US government
- Certain securities issued by the U.S. government or its agencies which are not backed by the full faith and credit of the US government
- Certain securities issued by US government-sponsored agencies
- Assets guaranteed by US government-sponsored agencies
- Balances due from and all claims on domestic depository institutions
- Book value of paid-in Federal Home Loan Bank stock

50% risk-weighting (Category 3): presents a moderate level of credit risk as compared to standard risk assets, such as:

- Qualifying mortgage loans and qualifying multifamily mortgage loans
- Certain privately-issued mortgage-backed securities
- Qualifying residential construction loans

100% risk-weighting (Category 4): All assets not classified elsewhere or deducted from calculations of capital are assigned to this category, which comprises standard risk assets such as:

- Consumer loans
- Commercial loans
- Home equity loans
- Non-qualifying mortgage loans
- Residential construction loans

In the case of indirect ownership of assets, such as a mutual fund, the proposed rule provides that the investments are assigned to risk-weight categories based upon the risk-weight that would be assigned to each category of assets in the pool. However, in no case will any such investment be assigned a total risk-weight of less than 20%.

Off-balance sheet items

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 example:

- 100% - direct credit substitutes, including guarantees backing financial claims, such as outstanding securities, loans, and other financial obligations including those on behalf of CUSOs and standby letters of credit
- 50% - transaction-related contingencies such as performance bonds, performance standby letters of credit, warranties, and standby letters of credit related to particular transactions
- 20% - 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
- 10% - unused portions of eligible Asset-backed Commercial Paper (ABCP) liquidity facilities with an original maturity of one year or less
- 0% - unused commitments that are less than one year in maturity or that the corporate can, at its option, unconditionally (without cause) cancel

Ratings-based approach to risk-weighting

The proposed rule gives corporate the option of using a ratings based approach to weight 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.

Finally, the proposed rule contains some miscellaneous limitations on the risk-based capital requirements:

- A low-level exposure provision limits the maximum risk-based capital requirement to the maximum contractual loss exposure.
- Another provision limits the amount of risk-based capital to support mortgage-related securities or participation certificates retained in a mortgage loan swap.
- The double counting of assets for purposes of risk-weighting is prohibited.
- Corporates must risk-weight recourse obligations and direct credit substitutes retained or assumed by the corporate on the obligations of its CUSOs, unless the corporate's equity investment is deducted from credit union's capital and assets.

Prompt Corrective Action.

NCUA proposes applying PCA to corporate credit unions.

For state-chartered corporate credit unions, NCUA proposes to consult with state regulators before taking any discretionary actions under PCA.

The proposal establishes five categories of corporate capital classification: 1) well capitalized; 2) adequately capitalized; 3) undercapitalized; 4) significantly undercapitalized; and 5) critically undercapitalized. The definition of those categories is discussed below.

Much of PCA is predicated upon certain time sensitive triggers. The proposed rule provides that the effective date of classification 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 proposed 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.

Capital measures and capital category definitions

Capital Category	Total Risk Based Capital	Tier I Risk Based Capital	Leverage Ratio	Other
Well Capitalized	10% or greater	6% or greater	5% or greater	Not subject to any order or written agreement
Adequately Capitalized	8% or greater	4% or greater	4% or greater	
Undercapitalized	Less than 8%	Less than 4%	Less than 4%	Failure of any one of the categories is fatal
Significantly Undercapitalized	Less than 6%	Less than 3%	Less than 3%	Failure of any one of the categories is fatal
Critically Undercapitalized	Less than 4%	Less than 2%	Less than 2%	Failure of any one of the categories is fatal

Under the proposal, NCUA has the authority to reclassify a corporate's capital category based on supervisory criteria other than capital, such as a determination by NCUA that the corporate received a less-than-satisfactory rating (i.e., three or lower) for any rating category 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. NCUA would also have the authority to 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 such a situation, NCUA must offer the corporate notice and opportunity to be heard before carrying out such a supervisory downgrade. The relevant procedures are spelled out in the proposed rule.

Capital restoration plans

Under PCA, any corporate that is downgraded to undercapitalized, or a lower capital category, must submit a capital restoration plan to NCUA within 45 days of such a classification. The capital restoration plan must include information regarding 1) the steps the corporate will take to become adequately capitalized; 2) the levels of capital to be attained during each year in which the plan will be in effect; 3) how the corporate will comply with the other PCA restrictions or requirements; 4) the types and levels of activities in which the corporate will engage; and 5) any other information NCUA may require.

If NCUA rejects a plan, the corporate must submit a revised plan within the time specified by the NCUA.

Under the proposed rule, a corporate may be subject to the sanctions of a significantly undercapitalized corporate under the following circumstances:

- An undercapitalized corporate that fails to submit a timely, written capital restoration plan.
- An undercapitalized corporate, until it has submitted, and NCUA has approved, a capital restoration plan.
- Any undercapitalized corporate that fails in any material respect to implement a capital restoration plan.

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.
- The corporate also must not acquire any interest in any entity, establish or acquire any additional branch office, or engage in any new line of business.

A significantly undercapitalized corporate is prohibited from doing any of the following:

- 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).

The proposed rule would also give NCUA discretionary authority to take one or more of the following actions:

- Requiring recapitalization or merger
- Further restricting the corporate's transactions with affiliates
- Restricting the interest rates that the corporate pays on shares and deposits
- Restricting the corporate's asset growth or requiring reduction in 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
- Requiring divestiture or liquidation of any interest in any CUSO or other entity
- Conserve or liquidate the corporate

In addition, the proposal provides that corporates that are critically undercapitalized are subject to additional requirements and restrictions:

- 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 approved by NCUA.
- Interest, although not payable, may continue to accrue under the terms of any subordinated debt to the extent otherwise permitted by law, however dividends on contributed capital do not continue to accrue.

Furthermore, any critically undercapitalized corporate is prohibited 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
- 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

Miscellaneous provisions

The proposed rule 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.

Corporate Investments and Asset-liability Management

In order to mitigate excessive concentration risk, the NCUA is proposing changes to the investment authorities and asset-liability management provisions of the corporate rules.

The proposed rule would prohibit corporate credit unions from making investments in collateralized debt obligations and net interest margin securities. However, the rule would allow senior tranches of Re-REMICs consisting of senior mortgage- and asset-backed securities as permissible investments.

Expanded authorities

Current Part 704 contains expanded authorities labeled as Base-plus, Part I, Part II, Part III, Part IV, and Part V. The proposed rule revises Base-plus and Part I authority, and eliminates the current Part II authority.

To qualify for Part I authority, a corporate must achieve and maintain a leverage ratio of at least 6%. Part I currently permits investments with lower NRSRO ratings. To control for credit risk, the proposed rule limits the aggregate investments purchased under this authority to the lower of 500% of capital or 25% of assets. Current authority to engage

in repurchase and securities lending agreements in an amount up to 300% of capital is eliminated, limiting all such transactions to 200% of capital.

Under the current rule, a Part I corporate's NEV may decline as much as 28% if the corporate has a minimum capital ratio of at least 5%, and as much as 35% if the corporate has a minimum capital ratio of at least 6%. The proposed rule would replace that standard with the new leverage ratio standards of 7% and 8%. There would be a 12 month phase in of this provision.

The proposal modifies the current Part IV derivatives authority to ensure that corporates only use derivatives to mitigate interest rate and credit risk or to create structured products equivalent to what a corporate could purchase directly. NCUA would specifically approve derivative transactions for the above purposes.

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.

The proposed rule would expand the existing authority permitting a corporate to invest in an investment company registered with the SEC provided the prospectus restricts the investment portfolio to investments and investment transactions that are permissible for the corporate credit to engage in directly. NCUA would allow such investments in collective investment funds maintained by a national bank or a mutual savings bank as well subject to the same requirement.

Concentration limits

The proposed rule reduces the 50% single obligor limit to 25%. The proposed rule also adds a new explicit regulatory concentration limits by discreet investment sector. The proposed sector concentration limits are divided into 10 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

Under the proposal, the maximum amount of a corporate's investment in each of these 10 sectors is limited to a certain multiple of capital: either the lower of 500% of capital or 25% of assets, or the lower of 1000% of capital or 50% of assets. The specific limits are:

- The lower of 1000% of capital or 50% of assets for each of these sectors: corporate debt obligations, municipal securities, FFELP student loan asset-backed securities, and registered investment companies.
- The lower of 500% of capital or 25% of assets on the other sectors: residential mortgage-backed securities, commercial mortgage-backed securities, private student loan asset-backed securities, auto loan/lease asset-backed securities, credit card asset-backed securities, and other asset-backed securities.

NCUA specifically requested comment on whether there should be additional concentration sublimits in any of the above sectors, particularly whether further limits on corporate debt obligations by industry of the obligor are needed.

The proposed rule also requires 1) the corporate to identify the underlying assets in each fund in which it invests; 2) then categorize each asset into one of the other nine sectors; and 3) include those assets when calculating compliance with those sector limits. If current data on the underlying assets is not readily available, the proposed rule permits use of the most recent available data.

The proposal also includes a catchall sector for any investments that do not fall within one of the ten sectors above and limits those concentrations to the lower of 100% of capital or 5% of assets. NCUA may approve a higher limit in appropriate cases.

The proposed rule excludes certain assets entirely from both the proposed sector concentration limits and the single obligor concentration limit:

- Fixed assets
- Loans and investments in CUSOs
- Investments issued by the United States or its agencies or its government sponsored enterprises
- Investments fully guaranteed or insured as to principal and interest by the United States or its agencies
- Investments in other federally-insured credit unions and deposits in other depository institutions

Investment repurchase agreements are also excluded from the sector concentration limits but not the single obligor concentration limit.

The proposed rule also limits a corporate's aggregate investment in subordinated securities to the lower of 400% of capital or 20% of assets and the amount of subordinated securities in any single asset sector to the lower of 100% of capital or 5% of assets. The rule defines subordinated securities to cover all support tranches, including senior mezzanine tranches.

The proposed rule retains existing §704.10 which requires submission of an investment action plan 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.

Credit ratings

Current §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). The proposed rule establishes two new limits on the use of NRSROs.

- 1) A corporate must use the lowest available NRSRO rating for compliance purposes.
- 2) A minimum of 90% of a corporate's investment holdings, by book value, must be rated by at least two NRSROs

The proposed rule would also require that a corporate monitor any new post-purchase NRSRO ratings on investments it holds.

Also, long term investments must be rated at least AA- at the time of purchase.

Asset liability management

One issue that has concerned NCUA was the early redemption of certificates. Therefore, the proposed rule would permit early 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.

With respect to mismatches between the average life of its assets and liabilities, a corporate faces exposure to several forms of market risk. NCUA proposes 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. NCUA will require average life (AL) mismatch NEV modeling in addition to the existing IRR NEV modeling.

NCUA proposes requiring an AL NEV stress test to measure the economic impact on capital resulting from a credit spread widening of 300bp. A corporate must limit its risk so that, when the spread widening shock is applied, its NEV ratio does not decline below 2% and the NEV itself does not decline more than 15%. All investments must be tested, excluding derivatives and equity investments, and all borrowings and shares must be tested, excluding contributed capital.

The proposed rule would also add a separate spread widening test that assumes a 50% slowdown in prepayment speeds. Corporates must structure their assets and liabilities so that, when the spread widening shock is applied, the NEV ratio does not decline below 1% and the NEV does not decline more than 25%.

In addition, the proposal would require corporates to measure the effect that failed triggers (delinquency triggers and cumulative loss triggers) have on average-life NEVs

NCUA specifically invites comment on the proposed AL NEV limits. In addition, NCUA provides several illustrations of the testing with model balance sheets, and seeks comments on the illustrations and the assumptions in the modeling.

Net interest income modeling

The proposed rule creates a new net interest income (NII) modeling requirement. 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, NCUA proposes limiting the weighted average life (WAL) of a corporate's assets to two years. A corporate must test its assets at least monthly for compliance (when calculating average life, the proposal requires that the corporate assume that issuer options will not be exercised). If testing reveals non-compliance, the corporate must report to NCUA immediately.

While the testing described above necessitates a corporate calculate the effective duration and spread duration for each of its assets and liabilities, NCUA also proposes adding a specific requirement that 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.

The proposed rule retains the existing rule's notification requirements if testing reveals an NEV decline in violation of the associated regulatory limits. However, the new rule will also contain PCA consequences for violations.

A PCA adequately capitalized or well capitalized 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 proposal treats violation of the two-year average asset life requirement, and the NII testing requirement, in a similar fashion. Violations that persist for 10 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 proposal prohibits a 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 10% of the

corporate's moving daily average net assets. This prohibition would not become effective for 30 months so as to allow affected corporates a deliberate and orderly transition.

Liquidity management

The current corporate rule says nothing about maintaining adequate liquidity to support a corporate's payment systems obligations. The proposed rule would require that a corporate demonstrate accessibility to sources of internal and external liquidity and that it keep a sufficient amount of cash and cash equivalents on hand to support payment systems obligations.

The proposed rule modifies the existing aggregate borrowing limit restricting it to the *lower* of ten times capital or 50% of capital and shares.

NCUA also expressed concern about secured borrowing and the related risks for the corporate and the NCUSIF. Therefore, the proposed rule permits secured borrowing for nonliquidity purposes only if the corporate is well capitalized (core capital exceeds 5% of moving DANA). Furthermore, such borrowing would be restricted to an amount equal to the difference between the corporate's core capital and 5% 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 (corporate are not precluded from renewing liquidity-related borrowings on a rolling basis).

Phase-in of Capital and PCA Requirements

As noted above, NCUA plans to phase-in the new capital and PCA requirements over a 10 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.

During the first year after publication of the final rule, corporate will continue to comply with the existing §704.3 capital ratio requirement and its associated capital definitions. After the first year, the phase-in will commence as follows:

- Beginning with the first anniversary of the final rule publication, corporates must be in compliance with the new risk-based capital provisions and with PCA.
- Between the first and third anniversaries, corporates will continue to comply with the existing minimum capital ratio in addition to the new risk-based capital ratios.

- Beginning with the third anniversary, corporates will be subject to the new leverage ratio [but not yet subject to the additional requirement that retained earnings constitute a specified minimum part of core capital].
- Beginning with the sixth anniversary, corporates will be subject to the retained earnings part of the various capital ratios, and the requirements to have at least 100bp of retained earnings to satisfy the adequately-capitalized 4% minimum leverage ratio, and 150bp of retained earnings to achieve a 5% leverage ratio to be considered well capitalized.

NCUA developed four scenarios, using a mix of earnings, growth, and capital contribution assumptions, to analyzing the ability of corporates to reach adequate capitalization by year seven. In all four scenarios, NCUA assumed that PCC and NCA would be used only to the extent that they qualify for inclusion in the proposed capital measures. To establish available PCC and NCA, NCUA “created” an average size natural per person credit union and applied that to the number of current members in each corporate.

The proposed rule contains a detailed discussion and illustration of the various scenarios and why NCUA believes almost all corporate could reach the proposed regulatory capital standards under three of the four scenarios [under one scenario, only eight corporates reach the thresholds after seven years].

Corporate CUSOs

NCUA is concerned that corporate CUSOs present a systemic risk for a variety of reasons, and the Agency is proposing to extend oversight and control over these entities.

The proposal would require corporate CUSOs to agree to limit 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 proposed rule also:

- 1) Expands the current requirement to permit access to the CUSO’s “books, records, and other pertinent documentation,” to “personnel, facilities, equipment, books, records, and any other documentation that the auditor, directors, or NCUA deem pertinent.”
- 2) Prescribes that the CUSO specifically agree to abide by all the requirements set forth in §704.11.

NCUA specifically seeks comments on whether it should reduce the CUSO investment and loan limits in the current rule.

Corporate Governance

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.

Corporate credit union directors

Stating that leadership of a corporate credit union requires special expertise, NCUA is proposing 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. NCUA however specifically declined to mandate training requirements.

NCUA is also proposing to impose a six-year limit on continuous service as a corporate director. The service term limit would apply to the corporate member's representation, not just to an individual. Furthermore, NCUA is proposing to phase in the requirement, by allowing any sitting directors to finish their natural term without regard for current years of service.

NCUA also proposes to prohibit an individual from being 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. In addition, the proposal would prohibit any member of a corporate from having more than one of its officers sitting on the board of the corporate at one time.

In addition, the proposal requires that a majority of a corporate's directors, including the chair of the board, serve on the board as representatives of natural person credit union members.

Disclosure of executive and director compensation

NCUA proposes requiring corporate credit unions to disclose certain information about the compensation and benefits of senior executive officers and directors in a manner similar to the current IRS Form 990 completed by state-chartered credit unions. However, while similar to the Form 990, NCUA is promulgating a distinct disclosure requirement, not merely completion of the Form 990.

NCUA's disclosure requirement would mandate:

- Each corporate prepare and maintain the annual disclosure of executive and director compensation as a dollar value.

The proposal does not stipulate the format of the disclosure, and NCUA specifically seeks comments "on the question of whether the rule should specify the form that the disclosure

should take, including the identification of specific categories that must be used, such as direct salary, bonus, deferred compensation, etc.”

- Each corporate allow any member to receive a copy of the most current disclosure, and all disclosures for the previous three years upon request within five business days of receiving the request.
- Each corporate distribute the most current disclosure to all its members at least annually.

The proposed rule would allow a corporate to supplement the required disclosure, at its option, with information that may put the disclosures in appropriate context.

Citing concerns of undue influence in merger discussions, NCUA proposes when a merger is being considered, any arrangement resulting in a material increase in compensation (defined by NCUA as an increase in current compensation of more than 15% or \$10,000, whichever is greater) for any senior executive officer or director of the merging corporate must be included in the annual disclosure. In addition, the proposed rule specifies that material increase in compensation for any senior executive officer or director must be disclosed to NCUA in the merger plan.

NCUA is also requiring disclosure of material compensation increase in the merger context to the members of Federal corporate credit unions. **Because state law governs whether members of a state-chartered credit union are entitled to vote, NCUA is not proposing to extend this requirement to state-chartered corporate credit unions.**

NCUA is also concerned with the “reverse” merger scenario, 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. NCUA seeks comments on whether 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.

Limitations on golden parachute and indemnification provisions

Citing §206(t) of the FCUA, NCUA proposes prohibiting golden parachute payments. The proposed rule would generally prohibit a corporate from making, or agreeing to make, any golden parachute payment, defined as 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 in troubled condition, as defined by §701.14(b)(4). The proposal also prohibits golden parachute payments in the event a corporate has become insolvent or “undercapitalized” under PCA.

The prohibition would be effective immediately upon the finalization of the rule, and would apply to all new employment contracts as well as existing contracts that are renewed or modified in any way after finalization.

The proposed rule contains three exceptions to the golden parachute provision:

- When a troubled corporate needs to hire a senior manager with expertise to help put the corporate back on a sound financial footing.
- Reasonable severance arrangements in the context of an unassisted merger for the management of the merging corporate [may not exceed 12 month salary].
- A general exception that permits severance arrangements on an exceptional basis.

All three of these exceptions would require prior NCUA approval.

Prohibited indemnification payments

NCUA also proposes to prohibit 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.

The proposal prescribes certain circumstances under which 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 would not materially adversely affect the corporate credit union's safety and soundness.
- The administrative action ultimately does not result in a civil money penalty, removal order, or cease and desist order against the IAP.
- The IAP agrees to reimburse the corporate for any portion of the advanced indemnification payments which subsequently become prohibited indemnification payments.

Corporates are permitted 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, however such insurance cannot pay for any penalty or judgment against an IAP.

The rule preserves the right of any liquidating agent to disregard any prior approved golden parachute or indemnification agreement.

******* NCUA states that currently, the Agency is primarily concerned with the problems in the corporate system and *at this* time intends to apply the governance provisions only to corporates, and not to natural person credit unions.**