October 4, 2010 *(updated October 20, 2010)*

NCUA's Changes to Its Corporate Credit Union Rule, 12 C.F.R. Part 704

(Please note: there are a number of new definitions in the final rule, many of which are very significant for understanding the final rule. While key words are explained in this summary, reviewing the definitions section of the final rule may be useful. Also, not all the provisions of the current rule have been changed under the final rule, so the regulation citations skip any unchanged sections. Finally, the new rule does not apply to the corporate credit unions that were conserved on September 27, 2010.)

CUNA, working with its Corporate Credit Union Task Force, chaired by Terry West, CEO of VyStar Credit Union, urged NCUA to make a number of changes in the final rule. More specifically, CUNA had called on NCUA to provide reasonable flexibility for corporates in meeting their capital requirements over time, improvements in the asset-liability provisions that regulated cash flow mismatches between assets and liabilities too rigorously, and term limits for corporate credit union board members among its recommendations. The NCUA Board made improvements in those areas.

NCUA has already announced that it plans to issue another corporate credit union proposal likely in November. Issues the Board plans to address in the proposal are expected to include whether corporate credit unions may charge membership fees to natural person credit unions; whether privately insured credit unions should be required to help pay for the corporate credit union losses; and whether natural person credit unions should be limited to joining only one corporate credit union at a time.

CUNA with our Corporate Credit Union Next Steps Working Group, also chaired by Terry West, will be monitoring closely the implementation of the agency's legacy assets plan, the application of the final corporate rule and helping to develop CUNA's comments on the upcoming corporate credit union proposal. We will report to the credit union system on these developments.

Meanwhile, the provisions in the final rule will generally become January 18, 2011, although a number of provisions will have delayed effective dates, as indicated in the summary. Click here for the final rule and click here for other resources from NCUA.

If you have any questions regarding the final rule, please email Senior Vice President and Deputy General Counsel Mary Dunn, Regulatory Counsel Luke Martone, or Regulatory Counsel Dennis Tsang, or call us at (800) 356-9655.

DESCRIPTION OF THE REVISIONS TO PART 704, CORPORATE CREDIT UNIONS

1. **Capital Requirements, § 704.3** (Generally effective as of October 20, 2011; this means that for the first year following publication of the rule, corporate credit unions may comply with the current, single 4% capital requirement.)

   - Under the final rule, beginning October 20, 2011, corporate credit unions will be required to maintain three capital ratios in order to be adequately capitalized:
     - Leverage ratio of 4%;
     - Tier 1 risk-based capital ratio of 4%; and
     - Total risk-based capital ratio of 8%.[1]
   - The capital requirements follow those for banks under Basel I standards. The Board said it chose these standards because it feels they are not overly complex and afford sufficient protection against risk. The Board said it has adapted the standards to fit the capital needs of corporates.
   - A certain percentage of leverage capital must be in the form of retained earnings: 100 basis points after six years and 200 basis points after ten years to be adequately capitalized. However, corporates will be able to use any capital, including retained earnings and member capital, to satisfy the leverage ratio requirement in the second and third years after the new capital rules apply.

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[1] The leverage ratio protects against losses that are other than credit losses. It is comprised of adjusted core capital in relation to the corporate's net assets. "Core capital" is the corporate's retained earnings and perpetual contributed capital (PCC). "Adjusted core capital" is core capital (Tier 1 capital) that has been modified as directed by the final rule, such as by deducting the corporate's intangible assets, investments in CUSOs, and new capital the corporate has contributed to another corporate. The final rule amends the definition of Tier 2 capital to include "supplementary capital" plus any PCC deducted from adjusted core capital.

- Corporates "supplementary capital" will be composed of NCAs, a portion of the allowance for loan and lease losses, and 45% of certain net unrealized gains on some equity securities. Supplementary capital will be counted in "total capital" for risk-based capital ratio purposes.
- The two risk-based capital ratios are designed to address credit risk in corporates' investments and other activities.
- The "Tier 1 risk-based capital ratio" is "adjusted core capital" (Tier 1 Capital) in relation to the corporate's net risk-weighted assets.
- The "total risk-based capital ratio" is total capital (which is adjusted core capital and supplementary capital, minus equity investments not already included when computing the adjusted core capital) divided by moving daily net risk-weighted assets. Equity investments are real property, equity securities, and other ownership interests such as partnerships and limited liability companies.

- After year three, a corporate must make progress in reaching the retained earnings requirements and must have 45 basis points of retained earnings or develop a retained earnings accumulation plan (REAP). A state chartered corporate must submit any REAP to both NCUA and the relevant state regulator, and both regulators will consult on the evaluations of the REAP.
- Paid-in capital will be renamed perpetual contributed capital (PCC) and membership capital accounts (MCAs) will be renamed nonperpetual capital accounts (NCAs), with corporates being able to issue PCC and NCAs to both members and nonmembers.
- PCC and NCAs can come from members or nonmembers. The final rule allows a corporate to condition membership, services, or prices for services, on the purchase of PCC; existing members are provided six months to purchase PCC. The rule also adds that NCUA (or the appropriate state regulator) must preapprove a corporate's determination to call PCC. The final rule requires corporates to return any existing three-year MCAs upon expiration of the term. The final rule provides that unconverted MCAs will have their entire balance available to absorb losses until the account is closed and will count partially as Tier 2 capital.
- Members may transfer their NCAs and PCC to nonnatural person third parties, subject to restrictions meant to mitigate the possibility of securities laws violations.
- NCAs that can be used to satisfy the new total risk-based capital ratio will be lengthened from the current minimum three-year period to five years. Adjustable balance NCAs are prohibited under the final rule.
- The terms and conditions for PCC and NCAs must be disclosed to members at account opening or the creation of the instrument, and in the case of NCAs, at least annually thereafter.
- NCUA will also be empowered to set individual capital requirements for a corporate that is receiving supervisory attention, has or is expected to have losses resulting in capital inadequacy; has a high degree of exposure to risk; has poor liquidity; is growing rapidly; has a record of losses that exceed those of similarly situated corporates; and for other reasons.
- The rule clarifies that contributed capital is "available to cover losses" exceeding retained earnings. "To the extent that any contributed capital funds are used to cover losses, the corporate credit union must not restore or replenish the affected capital accounts under any circumstances." Emphasis added.

2. **Prompt Corrective Action, § 704.4** (Generally effective as of October 20, 2011.)

- The current corporate rule does not impose broad-based prompt corrective action (PCA) requirements on corporate credit unions, unlike the rules for natural person credit unions, although NCUA has authority to impose safety and soundness sanctions.

- The final rule establishes capital categories and corresponding actions that apply to corporate credit unions in each category. The PCA requirements will be phased in over time; after year one, corporates must comply with the capital requirements under the final rule or be subject to PCA sanctions.
- The categories are as follows:
  - Well capitalized (all three must be met)
    - Total risk-based capital ratio: ≥ 10%;
    - Tier 1 risk-based capital ratio: ≥ 6%; and
    - Leverage ratio: ≥ 5%.
  - Adequately capitalized (all three must be met)
    - Total risk-based capital ratio: ≥ 8%;
    - Tier 1 risk-based capital ratio: ≥ 4%; and
    - Leverage ratio: ≥ 4%.
  - Undercapitalized (any of the three)
    - Total risk-based capital ratio: < 8%;
    - Tier 1 risk-based capital ratio: < 4%; or
    - Leverage ratio: < 4%.
  - Significantly undercapitalized (any of the three)
    - Total risk-based capital ratio: < 6%;
    - Tier 1 risk-based capital ratio: < 3%; or
    - Leverage ratio: < 3%.
  - Critically undercapitalized (any of the three)
    - Total risk-based capital ratio: < 4%;
    - Tier 1 risk-based capital ratio: < 2%; or
    - Leverage ratio: < 2%.
- The final rule allows NCUA to modify any of the percentages in the categories above "for good cause." In addition, NCUA may reclassify a corporate's PCA category for an unsafe or unsound condition or practice.
- Corporates that are less than adequately capitalized must file a written capital restoration plan with NCUA within 45 days.
- Such corporates will also be subject to mandatory supervisory actions such as restrictions on capital distributions and growth of assets, and prior approval for expansions. Significantly and critically undercapitalized corporates will be subject to other, additional sanctions such as restrictions on compensation to senior executives. Critically undercapitalized corporates will be subject to further restrictions such as limits on business activities and on payments on subordinated debt.
- For state chartered corporates, NCUA will work and consult with the appropriate state supervisory authority before taking action. Also, the final rule eliminates NCUA's authority to waive the prohibition on dividends.

- In addition, for undercapitalized corporates NCUA can require recapitalization; additional contributed capital; a higher rate of earnings' retention; restrict transactions with affiliates; restrict interest rates; order a new election; dismiss directors or senior executive officers, require qualified senior officers to be hired, subject to NCUA's approval; order divestiture; and/or conserve or liquidate the corporate if there is no reasonable prospect the corporate will become adequately capitalized. The final rule includes some "due process" enhancements beyond those contained in the proposed rule such as the right to request an informal hearing, a written notice from NCUA before it takes any action, and an opportunity to respond to NCUA.

3. **Investments, § 704.5** (Effective as of January 18, 2011.)

- The final rule retains current investment authority for securities, deposits, and obligations permitted under the Federal Credit Union Act; deposits in, the sale of federal funds to, and debt obligations of corporate credit unions, national and state banks, trust companies, and mutual savings banks; corporate CUSOs; marketable debt obligations of U.S. corporations; and domestically-issued asset basked securities.
- Authority for corporates to engage in securities lending and invest in investment companies registered with the SEC will also be retained. A corporate credit union may invest in a collective investment fund maintained by a national bank or mutual savings bank if the fund only makes investments that are permissible for the corporate.
- The final rule has several new prohibitions:
    - Private label residential MBS;
    - "Subordinated securities" (i.e., ABS tranches other than senior or super-senior);
    - Net interest margin securities (NIMs); and
    - Collateralized debt obligations (CDOs) other than senior tranches of Re-REMICs, consisting of senior mortgage- and asset-backed securities.
- The final rule also retains authority for corporates to enter into repurchase agreements.
- Corporates continue to be prohibited from:
    - Generally purchasing or selling derivatives;
    - Engaging in adjusted trading or short sales;
    - Purchasing mortgage serving rights, small business related securities, residual interests in collateralized mortgage obligations, residual interests in real estate mortgage investment conduits or residual interests in asset-backed securities; and
    - Purchasing stripped mortgage-backed securities, although investment in exchangeable collateralized mortgage obligations will be permitted under certain conditions.
- To the extent derivatives activities are permitted, they may only be used to reduce the corporate's overall risk.

- Current investments will be grandfathered, meaning corporate credit unions will generally not be required to divest investments, unless the investments do not meet other requirements. However, if a corporate retains an investment prohibited by the final rule, it must provide the OCCU Director with an investment action plan within 30 days of the effective date of the prohibition and comply with the Director's course of action.
- Part 704 currently allows corporates that meet certain requirements to qualify for expanded investment authority. The final rule eliminates the current authority for corporates to invest in securities other than A-.

4. **Credit Risk Management, § 704.6** (Effective as of January 18, 2011.)

- A corporate is required to follow its credit risk management policy, which must address the approval process associated with credit limits; due diligence; maximum credit limits with each obligor and transaction counterparty; and concentrations of credit risk.
- In general, the aggregate of all investments in a single obligor will be limited to 25% of capital or $5 million, whichever is greater. There are exceptions:
    - Investments in one obligor where the remaining maturity of all obligations is less than 30 days are limited to 50% of capital;
    - Investments in credit card master trust asset-backed securities are limited to 50% of capital in any single obligor;
    - Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 200% of capital;
    - Investments in non-money market registered investment companies are limited to 50% of capital in any single obligor;
    - Investments in money market registered investment companies are limited to 100% of capital in any single obligor; and
    - Investments in corporate CUSOs are subject to the limitations of § 704.11.
- A corporate must establish sector limits that do not exceed the following:
    - Permissible mortgage-backed securities (MBS) (including commercial MBS): the lower of 1000% of capital or 50% of assets.
    - Commercial MBS: the lower of 300% of capital or 15% of assets.
    - FFELP student loan asset-backed securities (ABS): the lower of 1000% of capital or 50% of assets.
    - Private student loan ABS: the lower of 500% of capital or 25% of assets.
    - Auto loan/lease ABS: the lower of 500% of capital or 25% of assets.
    - Credit card ABS: the lower of 500% of capital or 25% of assets.
    - All other ABS: the lower of 500% of capital or 25% of assets.
    - Corporate debt obligations: the lower of 1000% of capital or 50% of assets. (There are corporate debt obligation subsector limits to the lower of 200% of capital or 10% of assets for any one of 20 NAICS industry sectors.)
    - Municipal securities: the lower of 1000% of capital or 50% of assets.

    - Registered investment companies: the lower of 1000% of capital or 50% of assets (but the company's investments are aggregated with the corporates' investments for purposes of the other sector concentration limits).
    - Holdings of all other investments limited to 100% of capital or 5% of assets.
- The following are exempt from both the individual obligor and sector concentration limits: fixed assets, loans and loan participation interests, investments in CUSOs, investments guaranteed or issued by the U.S. Government or backed by the NCUSIF or FDIC (other than MBS), and settlement funds in federally insured depository institutions.
- The following are excluded from the sector concentration limits: investments in other federally insured credit unions, deposits and federal funds in other depository institutions, and investment repurchase agreements.
- All investments, other than in another depository institution, must have an applicable credit rating from at least one nationally recognized statistical rating organization (NRSRO). At least 90% of all investments by book value must have a rating by at least two public or nonpublic NRSROs. The NRSRO ratings should be used as a screening tool to exclude (not include) investments.
- At the time of purchase, long-term investments must be rated at least AA- by every NRSRO that provides a publicly available rating on that investment. At the time of purchase, short-term investments must be rated at least A-1 by every NRSRO that provides a publicly available rating on that investment.
- At least annually, a written evaluation of each credit limit with each obligor or counterparty must be prepared and approved by the corporate's board or appropriate committee. At least monthly, the board or committee must receive an investment watch list.

5. **Asset and Liability Management, § 704.8** (Generally effective as of January 18, 2011, except as noted below.)

- The corporate must have a written ALM policy which addresses the maximum allowable percentage decline in net economic value (NEV); the minimum allowable NEV ratio; policy limits and specific test parameters for required NEV analysis; modeling of indexes used as references in financial instrument coupon formulas; tests to estimate the impact of investments on the percentage in NEV compared to the base case NEV analysis.
- The corporate must have its ALM committee review its ALM reports at least monthly.
- The final rule creates a set of investment, credit risk, and ALM hurdles through which a corporate must run any contemplated investment purchase; an investment must clear all three hurdles.

- The final rule establishes a maximum limit of two years on the weighted average life (WAL) of a corporate's loan and investment portfolio and requires quarterly testing for compliance. In addition, the final rule allows the WAL of investments guaranteed or issued by the U.S. Government (or its agencies) to be multiplied by a factor of .50 when determining the WAL of the entire portfolio.
- A corporate must perform net interest income modeling at least quarterly, including once on the last day of the calendar quarter, to project earnings in multiple interest rate environments extended over at least two years.
- The final rule also retains the current interest rate risk (IRR) shock test.
- A corporate credit union must measure at least once a quarter, including once on the last day of the calendar quarter, the effective duration and spread durations of each of its assets and liabilities
- The final rule retains current provisions that address regulatory violations when there is a decline in NEV and the corporate cannot adjust its balance sheet within 10 calendar days to come into compliance. It includes a new provision that allows a corporate's net worth category to be downgraded for an extended decline in its NEV.
- As of April 20, 2013, a corporate will be prohibited form accepting from a member or nonmember credit union any investment, including shares, loans, PCC, or NCAs, if as a result of the investment, the aggregate of investments from that entity in the corporate would exceed 15% of the corporate's net assets.

6. **Liquidity Management, § 704.9** (Effective as of January 18, 2011.)

- The final rule retains provisions about general liquidity management, such as regular monitoring and demonstrating accessibility to sources of internal and external liquidity and keeping a sufficient amount of cash and cash equivalents, and adds the requirement that corporate's consider payment system obligations when determining a sufficient amount.
- The final rule provides that a corporate credit union may borrow up to the lower of 10 times capital or 50% of capital and shares, excluding CLF borrowing and borrowed funds created by the use of member reverse repurchase agreements.
- A corporate may continue to borrow on a secured basis for liquidity purposes, but the maturity of the borrowing may not exceed 30 days.
- Only a corporate with core capital of more than 5% of net assets may borrow on a secured basis for nonliquidity purposes. Secured borrowing for nonliquidity purposes may not exceed an amount equal to the difference between core capital and 5% of net assets.

7. **Corporate Credit Union Service Organizations (CUSOs), § 704.11** (Generally effective as of April 18, 2011, except as noted below.)

- The final rule retains current provisions on corporate credit union CUSOs.
- The final rule provides that currently only brokerage services and investment advisory services are permissible activities for corporate credit union CUSOs.

- However, under a new corporate CUSO rule, NCUA has established an approval process for other categories of activities. Any additional corporate credit union CUSO activities must be preapproved by NCUA and published on its website.
- The final rule does not grandfather any existing CUSO activities.
- Corporates will be required to divest themselves from any CUSO that is engaged in any activity not approved by NCUA by April 18, 2011. A corporate may take until October 20, 2011 to divest itself if it can show that the CUSO was engaged in an unapproved activity prior to publication of the final rule.
- The final rule expands NCUA's right to access books and records of corporate CUSOs to include access to the CUSO's personnel, equipment, and facilities.

8. **Corporate Governance, §§ 704.14, 704.19, 704.20** (Generally effective as of January 18, 2011, except as noted below.)

- The final rule requires at least a majority of directors of every corporate credit union, including the chair, to serve on the board as representatives of member natural person credit unions (effective as of October 20, 2013).
- The final rule requires that corporate directors be comprised only of individuals who currently hold the position at their credit union of Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, or treasurer/manager (effective as of February 17, 2011).
- The final rule retains current provisions regarding service on a corporate board. These include:
  - No member may have more than one representative on the corporate's board at one time;
  - No individual may serve on the corporate's board if any credit union member will have more than one representative on the board; and
  - The chair of the board may not serve at the same time as an officer, director, or employee of a credit union trade association.
- The final rule requires corporates to annually prepare and maintain a disclosure of the compensation in dollar terms of the top compensated employees. The corporate must disclose such compensation to its membership at least annually and upon member request. The disclosures must include the top five compensated employees for corporates with 41 or more employees, the top four compensated employees for corporates with 31 to 40 employees, and the top three compensated employees for corporates with 30 or fewer employees, as well as the CEO if not already included.
- Any corporate member will be authorized to obtain the most current disclosure and all disclosures of the prior three years upon request. The corporate will be able to include additional information for context, such as salary surveys.
- In a merger, corporates must disclose material increases in compensation, i.e., any increase of more than 15% or $10,000 whichever is greater, related to the merger for any senior executive officer or director of the merging corporate.

- Also, merger plans submitted to NCUA must describe the compensation arrangement, and federal corporate credit unions must describe the compensation arrangement in the materials provided to the members of the merging corporate before the merger vote.
- The final rule prohibits golden parachute payments at troubled corporates. Specifically, the rule precludes any payment or agreement by the corporate to make such payments in the nature of compensation for the benefit of current or former officials at the corporate ("institution-affiliated parties" under 12 U.S.C. § 1786(r) of the Federal Credit Union Act) when the corporate is undercapitalized, insolvent, under conservatorship or liquidation, or is terminating or suspending its NCUSIF coverage.
- The final rule prohibits certain indemnification provisions, regardless of the financial condition of the corporate.

9. Miscellaneous (Effective as of October 20, 2010.)

- Section 704.12, Permissible Services, has not been changed and corporate credit unions will continue to be authorized to engage in correspondent services, credit and investment management services, electronic financial services, liquidity services, asset and liability management services, payment services, trustee or custodial services, and the sale or lease of excess capacity. The procedure for adding services that are not preapproved has also been retained.
- Section 704.19, the provision regarding a wholesale corporate, i.e., U.S. Central, has been deleted, thereby removing the legal authority for wholesale corporate credit unions as well as their ability to have lower retained earnings than any other corporates.