

(1) Investments must be made pursuant to an explicit policy established by the corporate credit union's board of directors. Before purchasing an investment, the corporate credit union must conduct and document an analysis that reasonably concludes the foreign issue or issuer has no more than a minimal amount of credit risk;

(2) For each approved foreign bank line, the corporate credit union must identify the specific banking centers and branches to which it will lend funds;

(3) Obligations of any single foreign obligor may not exceed 25 percent of capital or \$5 million, whichever is greater; and

(4) Obligations in any single foreign country may not exceed 250 percent of capital.

#### Part III

(a) A corporate credit union that has met the requirements established by NCUA for this Part III may enter into derivative transactions specifically approved by NCUA to:

- (1) Create structured products;
- (2) Mitigate interest rate risk and credit risk on its own balance sheet; and
- (3) Hedge the balance sheets of its members.

#### (b) Credit Quality:

All derivative transactions are subject to the following requirements:

- (1) If the intended counterparty is domestic, the counterparty must meet minimum credit quality standards as established by the corporate's board of directors;
- (2) If the intended counterparty is foreign, the corporate must have Part II expanded authority and the counterparty must meet minimum credit quality standards as established by the corporate's board of directors;
- (3) The corporate must identify the criteria relied upon to determine that the counterparty meets the credit quality requirements of this part at the time the transaction is entered into and monitor those criteria for as long as the contract remains open; and
- (4) The corporate must comply with § 704.10 of this part if the credit quality of the counterparty deteriorates below the minimum credit quality standards established by the corporate's board of directors.

#### Part IV

A corporate credit union that has met all the requirements established by NCUA for this Part IV may participate in loans with member natural person credit unions as approved by the NCUA and subject to the following:

- (a) The maximum aggregate amount of participation loans with any one member credit union must not exceed 25 percent of capital; and
- (b) The maximum aggregate amount of participation loans with all member credit

unions will be determined on a case-by-case basis by the NCUA.

[75 FR 64851, Oct. 20, 2010, as amended at 77 FR 74111, Dec. 13, 2012]

### APPENDIX C TO PART 704—RISK-BASED CAPITAL CREDIT RISK-WEIGHT CATEGORIES

#### TABLE OF CONTENTS

#### I. Introduction

- (a) Scope
- (b) Definitions
- II. Risk-Weightings
  - (a) On-balance sheet assets
  - (b) Off-balance sheet activities
  - (c) Recourse obligations, direct credit substitutes, and certain other positions
  - (d) Collateral

#### PART I: INTRODUCTION

##### (a) Scope

(1) This Appendix explains how a corporate credit union must compute its risk-weighted assets for purposes of determining its capital ratios.

(2) Risk-weighted assets equal risk-weighted on-balance sheet assets (computed under Section II(a) of this Appendix), plus risk-weighted off-balance sheet activities (computed under Section II(b) of this Appendix), plus risk-weighted recourse obligations, direct credit substitutes, and certain other positions (computed under Section II(c) of this Appendix).

(3) Assets not included (*i.e.*, deducted from capital) for purposes of calculating capital under part 704 are not included in calculating risk-weighted assets.

(4) Although this Appendix describes risk-weightings for various assets and activities, this Appendix does not provide authority for corporate credit unions to invest in or purchase any particular type of asset or to engage in any particular type of activity. A corporate credit union *must have other identifiable authority* for any investment it makes or activity it engages in. So, for example, this Appendix describes risk weightings for subordinated securities. Section 704.5, however, prohibits corporate credit unions from investing in subordinated securities, and so a corporate credit union cannot invest in subordinated securities.

##### (b) Definitions

The following definitions apply to this Appendix. Additional definitions, applicable to this entire Part, are located in § 704.2 of this Part.

*Cash items in the process of collection* means checks or drafts in the process of collection that are drawn on another depository institution, including a central bank, and that are payable immediately upon presentation;

U.S. Government checks that are drawn on the United States Treasury or any other U.S. Government or Government-sponsored agency and that are payable immediately upon presentation; broker's security drafts and commodity or bill-of-lading drafts payable immediately upon presentation; and unposted debits.

*Commitment* means any arrangement that obligates a corporate credit union to:

- (1) Purchase loans or securities;
- (2) Extend credit in the form of loans or leases, participations in loans or leases, overdraft facilities, revolving credit facilities, home equity lines of credit, eligible ABCP liquidity facilities, or similar transactions.

*Depository institution* means a financial institution that engages in the business of providing financial services; that is recognized as a bank or a credit union by the supervisory or monetary authorities of the country of its incorporation and the country of its principal banking operations; that receives deposits to a substantial extent in the regular course of business; and that has the power to accept demand deposits. In the United States, this definition encompasses all federally insured offices of commercial banks, mutual and stock savings banks, savings or building and loan associations (stock and mutual), cooperative banks, credit unions, and international banking facilities of domestic depository institutions.

Bank holding companies and savings and loan holding companies are excluded from this definition. For the purposes of assigning risk-weights, the differentiation between OECD depository institutions and non-OECD depository institutions is based on the country of incorporation. Claims on branches and agencies of foreign banks located in the United States are to be categorized on the basis of the parent bank's country of incorporation.

*Direct credit substitute* means an arrangement in which a corporate credit union assumes, in form or in substance, credit risk associated with an on-balance sheet or off-balance sheet asset or exposure that was not previously owned by the corporate credit union (third-party asset) and the risk assumed by the corporate credit union exceeds the *pro rata* share of the corporate credit union's interest in the third-party asset. If a corporate credit union has no claim on the third-party asset, then the corporate credit union's assumption of any credit risk is a direct credit substitute. Direct credit substitutes include:

- (1) Financial standby letters of credit that support financial claims on a third party that exceed a corporate credit union's *pro rata* share in the financial claim;
- (2) Guarantees, surety arrangements, credit derivatives, and similar instruments backing financial claims that exceed a corporate

credit union's *pro rata* share in the financial claim;

- (3) Purchased subordinated interests that absorb more than their *pro rata* share of losses from the underlying assets, including any tranche of asset-backed securities that is not the most senior tranche;

- (4) Credit derivative contracts under which the corporate credit union assumes more than its *pro rata* share of credit risk on a third-party asset or exposure;

- (5) Loans or lines of credit that provide credit enhancement for the financial obligations of a third party;

- (6) Purchased loan servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced. Servicer cash advances as defined in this section are not direct credit substitutes;

- (7) Clean-up calls on third-party assets. However, clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the corporate credit union are not direct credit substitutes; and

- (8) Liquidity facilities that provide support to asset-backed commercial paper (other than eligible ABCP liquidity facilities).

*Exchange rate contracts* means cross-currency interest rate swaps; forward foreign exchange rate contracts; currency options purchased; and any similar instrument that, in the opinion of the NCUA, may give rise to similar risks.

*Face amount* means the notational principal, or face value, amount of an off-balance sheet item or the amortized cost of an on-balance sheet asset.

*Financial asset* means cash or other monetary instrument, evidence of debt, evidence of an ownership interest in an entity, or a contract that conveys a right to receive or exchange cash or another financial instrument from another party.

*Financial standby letter of credit* means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary:

- (1) To repay money borrowed by, or advanced to, or for the account of, a second party (the account party); or

- (2) To make payment on behalf of the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

*OECD-based country* means a member of that grouping of countries that are full members of the Organization for Economic Cooperation and Development (OECD) plus countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF's General Arrangements To Borrow. This term excludes any country that has rescheduled its external sovereign debt within

the previous five years. A rescheduling of external sovereign debt generally would include any renegotiation of terms arising from a country's inability or unwillingness to meet its external debt service obligations, but generally would not include renegotiations of debt in the normal course of business, such as a renegotiation to allow the borrower to take advantage of a decline in interest rates or other change in market conditions.

*Original maturity* means, with respect to a commitment, the earliest date after a commitment is made on which the commitment is scheduled to expire (*i.e.*, it will reach its stated maturity and cease to be binding on either party), provided that either:

(1) The commitment is not subject to extension or renewal and will actually expire on its stated expiration date; or

(2) If the commitment is subject to extension or renewal beyond its stated expiration date, the stated expiration date will be deemed the original maturity only if the extension or renewal must be based upon terms and conditions independently negotiated in good faith with the member at the time of the extension or renewal and upon a new, bona fide credit analysis utilizing current information on financial condition and trends.

*Performance-based standby letter of credit* means any letter of credit, or similar arrangement, however named or described, which represents an irrevocable obligation to the beneficiary on the part of the issuer to make payment on account of any default by a third party in the performance of a non-financial or commercial obligation. Such letters of credit include arrangements backing subcontractors' and suppliers' performance, labor and materials contracts, and construction bids.

*Prorated assets* means the total assets (as determined in the most recently available GAAP report but in no event more than one year old) of a consolidated CUSO multiplied by the corporate credit union's percentage of ownership of that consolidated CUSO.

*Qualifying mortgage loan* means a loan that:

(1) Is fully secured by a first lien on a one-to four-family residential property;

(2) Is underwritten in accordance with prudent underwriting standards, including standards relating the ratio of the loan amount to the value of the property (LTV ratio), as presented in the *Interagency Guidelines for Real Estate Lending Policies*, 57 FR 62890 (December 31, 1992). A nonqualifying mortgage loan that is paid down to an appropriate LTV ratio (calculated using value at origination, appraisal obtained within the prior six months, or updated value using an automated valuation model) may become a qualifying loan if it meets all other requirements of this definition;

(3) Maintains an appropriate LTV ratio based on the amortized principal balance of the loan; and

(4) Is performing and is not more than 90 days past due.

If a corporate credit union holds the first and junior lien(s) on a residential property and no other party holds an intervening lien, the transaction is treated as a single loan secured by a first lien for the purposes of determining the LTV ratio and the appropriate risk-weight under Appendix C. Also, a loan to an individual borrower for the construction of the borrower's home may be included as a qualifying mortgage loan.

*Qualifying multifamily mortgage loan.* (1) *Qualifying multifamily mortgage loan* means a loan secured by a first lien on multifamily residential properties consisting of 5 or more dwelling units, provided that:

(i) The amortization of principal and interest occurs over a period of not more than 30 years;

(ii) The original minimum maturity for repayment of principal on the loan is not less than seven years;

(iii) When considering the loan for placement in a lower risk-weight category, all principal and interest payments have been made on a timely basis in accordance with its terms for the preceding year;

(iv) The loan is performing and not 90 days or more past due;

(v) The loan is made in accordance with prudent underwriting standards; and

(vi) If the interest rate on the loan does not change over the term of the loan, the current loan balance amount does not exceed 80 percent of the value of the property securing the loan, and for the property's most recent calendar year, the ratio of annual net operating income generated by the property (before payment of any debt service on the loan) to annual debt service on the loan is not less than 120 percent, or in the case of cooperative or other not-for-profit housing projects, the property generates sufficient cash flows to provide comparable protection to the institution; or

(vii) If the interest rate on the loan changes over the term of the loan, the current loan balance amount does not exceed 75 percent of the value of the property securing the loan, and for the property's most recent calendar year, the ratio of annual net operating income generated by the property (before payment of any debt service on the loan) to annual debt service on the loan is not less than 115 percent, or in the case of cooperative or other not-for-profit housing projects, the property generates sufficient cash flows to provide comparable protection to the institution.

(2) For purposes of paragraphs (1)(vi) and (1)(vii) of this definition, the term value of the property means, at origination of a loan to purchase a multifamily property, the

lower of the purchase price or the amount of the initial appraisal, or if appropriate, the initial evaluation. In cases not involving purchase of a multifamily loan, the value of the property is determined by the most current appraisal, or if appropriate, the most current evaluation. In cases where a borrower refinances a loan on an existing property, as an alternative to paragraphs (1)(iii), (1)(vi), and (1)(vii) of this definition:

(i) All principal and interest payments on the loan being refinanced have been made on a timely basis in accordance with the terms of that loan for the preceding year; and

(ii) The net income on the property for the preceding year would support timely principal and interest payments on the new loan in accordance with the applicable debt service requirement.

*Qualifying residential construction loan*, also referred to as a residential bridge loan, means a loan made in accordance with sound lending principles satisfying the following criteria:

(1) The builder must have substantial project equity in the home construction project;

(2) The residence being constructed must be a 1-4 family residence sold to a home purchaser;

(3) The lending entity must obtain sufficient documentation from a permanent lender (which may be the construction lender) demonstrating that the home buyer intends to purchase the residence and has the ability to obtain a permanent qualifying mortgage loan sufficient to purchase the residence;

(4) The home purchaser must have made a substantial earnest money deposit;

(5) The construction loan must not exceed 80 percent of the sales price of the residence;

(6) The construction loan must be secured by a first lien on the lot, residence under construction, and other improvements;

(7) The lending credit union must retain sufficient undisbursed loan funds throughout the construction period to ensure project completion;

(8) The builder must incur a significant percentage of direct costs (*i.e.*, the actual costs of land, labor, and material) before any drawdown on the loan;

(9) If at any time during the life of the construction loan any of the criteria of this rule are no longer satisfied, the corporate must immediately recategorize the loan at a 100 percent risk-weight and must accurately report the loan in the corporate's next quarterly call report;

(10) The home purchaser must intend that the home will be owner-occupied;

(11) The home purchaser(s) must be an individual(s), not a partnership, joint venture, trust corporation, or any other entity (including an entity acting as a sole proprietorship) that is purchasing the home(s) for speculative purposes; and

(12) The loan must be performing and not more than 90 days past due.

The NCUA retains the discretion to determine that any loans not meeting sound lending principles must be placed in a higher risk-weight category. The NCUA also reserves the discretion to modify these criteria on a case-by-case basis provided that any such modifications are not inconsistent with the safety and soundness objectives of this definition.

*Qualifying securities firm* means:

(1) A securities firm incorporated in the United States that is a broker-dealer that is registered with the Securities and Exchange Commission (SEC) and that complies with the SEC's net capital regulations (17 CFR 240.15c3(1)); and

(2) A securities firm incorporated in any other OECD-based country, if the corporate credit union is able to demonstrate that the securities firm is subject to consolidated supervision and regulation (covering its subsidiaries, but not necessarily its parent organizations) comparable to that imposed on depository institutions in OECD countries. Such regulation must include risk-based capital requirements comparable to those imposed on depository institutions under the Accord on International Convergence of Capital Measurement and Capital Standards (1988, as amended in 1998).

*Recourse* means a corporate credit union's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold (in accordance with Generally Accepted Accounting Principles) that exceeds a *pro rata* share of that corporate credit union's claim on the asset. If a corporate credit union has no claim on an asset it has sold, then the retention of any credit risk is recourse. A recourse obligation typically arises when a corporate credit union transfers assets in a sale and retains an explicit obligation to repurchase assets or to absorb losses due to a default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly if a corporate credit union provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include:

(1) Credit-enhancing representations and warranties made on transferred assets;

(2) Loan servicing assets retained pursuant to an agreement under which the corporate credit union will be responsible for losses associated with the loans serviced. Servicer cash advances as defined in this section are not recourse obligations;

(3) Retained subordinated interests that absorb more than their *pro rata* share of losses from the underlying assets;

(4) Assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet;

(5) Loan strips sold without contractual recourse where the maturity of the transferred portion of the loan is shorter than the maturity of the commitment under which the loan is drawn;

(6) Credit derivatives that absorb more than the corporate credit union's *pro rata* share of losses from the transferred assets;

(7) Clean-up calls on assets the corporate credit union has sold. However, clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the corporate credit union are not recourse arrangements; and

(8) Liquidity facilities that provide support to asset-backed commercial paper (other than eligible ABCP liquidity facilities).

*Replacement cost* means, with respect to interest rate and exchange-rate contracts, the loss that would be incurred in the event of a counterparty default, as measured by the net cost of replacing the contract at the current market value. If default would result in a theoretical profit, the replacement value is considered to be zero. This mark-to-market process must incorporate changes in both interest rates and counterparty credit quality.

*Residential properties* means houses, condominiums, cooperative units, and manufactured homes. This definition does not include boats or motor homes, even if used as a primary residence, or timeshare properties.

*Residual interest.* (1) *Residual interest* means any on-balance sheet asset that:

(i) Represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with Generally Accepted Accounting Principles) of financial assets, whether through a securitization or otherwise; and

(ii) Exposes a corporate credit union to credit risk directly or indirectly associated with the transferred asset that exceeds a *pro rata* share of that corporate credit union's claim on the asset, whether through subordination provisions or other credit enhancement techniques.

(2) Residual interests generally include credit-enhancing interest-only strips, spread accounts, cash collateral accounts, retained subordinated interests (and other forms of overcollateralization), and similar assets that function as a credit enhancement. Residual interests further include those exposures that, in substance, cause the corporate credit union to retain the credit risk of an asset or exposure that had qualified as a residual interest before it was sold. Residual interests generally do not include assets purchased from a third party, but a credit-enhancing interest-only strip that is acquired in any asset transfer is a residual interest.

(3) Corporate credit unions will use this definition of the term "residual interests," and not the definition in §704.2, for purposes of applying this Appendix.

*Risk participation* means a participation in which the originating party remains liable to the beneficiary for the full amount of an obligation (e.g., a direct credit substitute), notwithstanding that another party has acquired a participation in that obligation.

*Risk-weighted assets* means the sum total of risk-weighted on-balance sheet assets, as calculated under Section II(a) of this Appendix, and the total of risk-weighted off-balance sheet credit equivalent amounts. The total of risk-weighted off-balance sheet credit equivalent amounts equals the risk-weighted off-balance sheet activities as calculated under Section II(b) of this Appendix plus the risk-weighted recourse obligations, risk-weighted direct credit substitutes, and certain other risk-weighted positions as calculated under Section II(c) of this Appendix.

*Servicer cash advance* means funds that a residential mortgage servicer advances to ensure an uninterrupted flow of payments, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the loan. A servicer cash advance is not a recourse obligation or a direct credit substitute if:

(1) The servicer is entitled to full reimbursement and this right is not subordinated to other claims on the cash flows from the underlying asset pool; or

(2) For any one loan, the servicer's obligation to make nonreimbursable advances is contractually limited to an insignificant amount of the outstanding principal amount on that loan.

*Structured financing program* means a program where receivable interests and asset-or mortgage-backed securities issued by multiple participants are purchased by a special purpose entity that repackages those exposures into securities that can be sold to investors. Structured financing programs allocate credit risk, generally, between the participants and credit enhancement provided to the program.

*Unconditionally cancelable* means, with respect to a commitment-type lending arrangement, that the corporate credit union may, at any time, with or without cause, refuse to advance funds or extend credit under the facility.

*United States Government or its agencies* means an instrumentality of the U.S. Government whose debt obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the United States Government.

*United States Government-sponsored agency or corporation* means an agency or corporation originally established or chartered to serve public purposes specified by the United States Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the United States Government.

## National Credit Union Administration

## Pt. 704 App. C

### PART II: RISK-WEIGHTINGS

#### (a) *On-Balance Sheet Assets*

Except as provided in Section II(b) of this Appendix, risk-weighted on-balance sheet assets are computed by multiplying the on-balance sheet asset amounts times the appropriate risk-weight categories. The risk-weight categories are:

(1) Zero percent Risk-Weight (Category 1).  
(i) Cash, including domestic and foreign currency owned and held in all offices of a corporate credit union or in transit. Any foreign currency held by a corporate credit union must be converted into U.S. dollar equivalents;

(ii) Securities issued by and other direct claims on the U.S. Government or its agencies (to the extent such securities or claims are unconditionally backed by the full faith and credit of the United States Government) or the central government of an OECD country;

(iii) Notes and obligations issued or guaranteed by the Federal Deposit Insurance Corporation or the National Credit Union Share Insurance Fund and backed by the full faith and credit of the United States Government;

(iv) Deposit reserves at, claims on, and balances due from Federal Reserve Banks;

(v) The book value of paid-in Federal Reserve Bank stock;

(vi) That portion of assets directly and unconditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country.

(viii) Claims on, and claims guaranteed by, a qualifying securities firm that are collateralized by cash on deposit in the corporate credit union or by securities issued or guaranteed by the United States Government or its agencies, or the central government of an OECD country. To be eligible for this risk-weight, the corporate credit union must maintain a positive margin of collateral on the claim on a daily basis, taking into account any change in a corporate credit union's exposure to the obligor or counterparty under the claim in relation to the market value of the collateral held in support of the claim.

(2) 20 percent Risk-Weight (Category 2).

(i) Cash items in the process of collection;

(ii) That portion of assets conditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country;

(iii) That portion of assets collateralized by the current market value of securities issued or guaranteed by the United States government or its agencies, or the central government of an OECD country;

(iv) Securities (not including equity securities) issued by and other claims on the U.S. Government or its agencies which are not backed by the full faith and credit of the United States Government;

(v) Securities (not including equity securities) issued by, or other direct claims on, United States Government-sponsored agencies;

(vi) That portion of assets guaranteed by United States Government-sponsored agencies;

(vii) That portion of assets collateralized by the current market value of securities issued or guaranteed by United States Government-sponsored agencies;

(viii) Claims on, and claims guaranteed by, a qualifying securities firm, subject to the following conditions:

(A) A qualifying securities firm must meet the minimum credit quality standards as established by the corporate credit union's board of directors or have at least one issue of long-term unsecured debt that is reasonably determined to present no more than a minimal amount of credit risk, whichever requirement is more stringent. Alternatively, a qualifying securities firm may rely on the creditworthiness of its parent consolidated company, if the parent consolidated company guarantees the claim.

(B) A collateralized claim on a qualifying securities firm does not have to comply with the requirements of paragraph (a) of this section of Appendix C if the claim arises under a contract that:

(1) Is a reverse repurchase/repurchase agreement or securities lending/borrowing transaction executed using standard industry documentation;

(2) Is collateralized by debt or equity securities that are liquid and readily marketable;

(3) Is marked-to-market daily;

(4) Is subject to a daily margin maintenance requirement under the standard industry documentation; and

(5) Can be liquidated, terminated or accelerated immediately in bankruptcy or similar proceeding, and the security or collateral agreement will not be stayed or avoided under applicable law of the relevant jurisdiction. For example, a claim is exempt from the automatic stay in bankruptcy in the United States if it arises under a securities contract or a repurchase agreement subject to Section 555 or 559 of the Bankruptcy Code (11 U.S.C. 555 or 559), a qualified financial contract under Section 207(c)(8) of the Federal Credit Union Act (12 U.S.C. 1787(c)(8)) or Section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or a netting contract between or among financial institutions under Sections 401-407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401-4407), or Regulation EE (12 CFR part 231).

(C) If the securities firm uses the claim to satisfy its applicable capital requirements, the claim is not eligible for a risk-weight under this paragraph II(a)(2)(viii);

(ix) Claims representing general obligations of any public-sector entity in an OECD

country, and that portion of any claims guaranteed by any such public-sector entity;

(x) Balances due from and all claims on domestic depository institutions. This includes demand deposits and other transaction accounts, savings deposits and time certificates of deposit, federal funds sold, loans to other depository institutions, including overdrafts and term federal funds, holdings of the corporate credit union's own discounted acceptances for which the account party is a depository institution, holdings of bankers' acceptances of other institutions and securities issued by depository institutions, except those that qualify as capital;

(xi) The book value of paid-in Federal Home Loan Bank stock;

(xii) Deposit reserves at, claims on and balances due from the Federal Home Loan Banks;

(xiii) Assets collateralized by cash held in a segregated deposit account by the reporting corporate credit union;

(xiv) Claims on, or guaranteed by, official multilateral lending institutions or regional development institutions in which the United States Government is a shareholder or contributing member;<sup>1</sup>

(xv) That portion of assets collateralized by the current market value of securities issued by official multilateral lending institutions or regional development institutions in which the United States Government is a shareholder or contributing member.

(xvi) All claims on depository institutions incorporated in an OECD country, and all assets backed by the full faith and credit of depository institutions incorporated in an OECD country. This includes the credit equivalent amount of participations in commitments and standby letters of credit sold to other depository institutions incorporated in an OECD country, but only if the originating bank remains liable to the member or beneficiary for the full amount of the commitment or standby letter of credit. Also included in this category are the credit equivalent amounts of risk participations in bankers' acceptances conveyed to other depository institutions incorporated in an OECD country. However, bank-issued securities that qualify as capital of the issuing bank are not included in this risk category;

(xvii) Claims on, or guaranteed by depository institutions other than the central bank, incorporated in a non-OECD country,

with a remaining maturity of one year or less;

(xviii) That portion of local currency claims conditionally guaranteed by central governments of non-OECD countries, to the extent the corporate credit union has local currency liabilities in that country.

(3) 50 percent Risk-Weight (Category 3).

(i) Revenue bonds issued by any public-sector entity in an OECD country for which the underlying obligor is a public-sector entity, but which are repayable solely from the revenues generated from the project financed through the issuance of the obligations;

(ii) Qualifying mortgage loans and qualifying multifamily mortgage loans;

(iii) Privately-issued mortgage-backed securities (*i.e.*, those that do not carry the guarantee of the U.S. Government, a U.S. government agency, or a U.S. government sponsored enterprise) representing an interest in qualifying mortgage loans or qualifying multifamily mortgage loans. If the security is backed by qualifying multifamily mortgage loans, the corporate credit union must receive timely payments of principal and interest in accordance with the terms of the security. Payments will generally be considered timely if they are not 30 days past due; and

(iv) Qualifying residential construction loans.

(4) 100 percent Risk-Weight (Category 4).

All assets not specified above or deducted from calculations of capital pursuant to § 704.2 and § 704.3 of this part, including, but not limited to:

(i) Consumer loans;

(ii) Commercial loans;

(iii) Home equity loans;

(iv) Non-qualifying mortgage loans;

(v) Non-qualifying multifamily mortgage loans;

(vi) Residential construction loans;

(vii) Land loans;

(viii) Nonresidential construction loans;

(ix) Obligations issued by any state or any political subdivision thereof for the benefit of a private party or enterprise where that party or enterprise, rather than the issuing state or political subdivision, is responsible for the timely payment of principal and interest on the obligations, *e.g.*, industrial development bonds;

(x) Debt securities not specifically risk-weighted in another category;

(xi) Investments in fixed assets and premises;

(xii) Servicing assets;

(xiii) Interest-only strips receivable, other than credit-enhancing interest-only strips;

(xiv) Equity investments;

(xv) The prorated assets of subsidiaries (except for the assets of consolidated CUSOs) to the extent such assets are included in adjusted total assets;

<sup>1</sup>These institutions include, but are not limited to, the International Bank for Reconstruction and Development (World Bank), the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investment Bank, the International Monetary Fund and the Bank for International Settlements.

(xvi) All repossessed assets or assets that are more than 90 days past due; and

(xvii) Intangible assets not specifically weighted in some other category.

(5) Indirect ownership interests in pools of assets. Assets representing an indirect holding of a pool of assets, *e.g.*, mutual funds, are assigned to risk-weight categories under this section based upon the risk-weight that would be assigned to the assets in the portfolio of the pool. An investment in shares of a mutual fund whose portfolio consists primarily of various securities or money market instruments that, if held separately, would be assigned to different risk-weight categories, generally is assigned to the risk-weight category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the investment objectives set forth in its prospectus. The corporate credit union may, at its option, assign the investment on a *pro rata* basis to different risk-weight categories according to the investment limits in its prospectus. In no case will an investment in shares in any such fund be assigned to a total risk-weight less than 20 percent. If the corporate credit union chooses to assign investments on a *pro rata* basis, and the sum of the investment limits of assets in the fund's prospectus exceeds 100 percent, the corporate credit union must assign the highest *pro rata* amounts of its total investment to the higher risk categories. If, in order to maintain a necessary degree of short-term liquidity, a fund is permitted to hold an insignificant amount of its assets in short-term, highly liquid securities of superior credit quality that do not qualify for a preferential risk-weight, such securities will generally be disregarded in determining the risk-weight category into which the corporate credit union's holding in the overall fund should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk-weighting of the mutual fund investment. For example, the use of hedging instruments by a mutual fund to reduce the interest rate risk of its government bond portfolio will not increase the risk-weight of that fund above the 20 percent category. Nonetheless, if the fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk-weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk-weight category.

(6) Derivatives. Certain transactions or activities, such as derivatives transactions, may appear on a corporate's balance sheet but are not specifically described in the Section II(a) on-balance sheet risk-weight categories. These items will be assigned risk-weights as described in Section II(b) or II(c) below.

#### (b) Off-Balance Sheet Items

Except as provided in Section II(c) of this Appendix, risk-weighted off-balance sheet items are determined by the following two-step process. First, the face amount of the off-balance sheet item must be multiplied by the appropriate credit conversion factor listed in this Section II(b). This calculation translates the face amount of an off-balance sheet exposure into an on-balance sheet credit-equivalent amount. Second, the credit-equivalent amount must be assigned to the appropriate risk-weight category using the criteria regarding obligors, guarantors, and collateral listed in Section II(a) of this Appendix.<sup>2</sup> The following are the credit conversion factors and the off-balance sheet items to which they apply.

(1) 100 percent credit conversion factor (Group A).

(i) Risk participations purchased in bankers' acceptances;

(ii) Forward agreements and other contingent obligations with a certain draw down, *e.g.*, legally binding agreements to purchase assets at a specified future date. On the date a corporate credit union enters into a forward agreement or similar obligation, it should convert the principal amount of the assets to be purchased at 100 percent as of that date and then assign this amount to the risk-weight category appropriate to the obligor or guarantor of the item, or the nature of the collateral;

(iii) Indemnification of members whose securities the corporate credit union has lent as agent. If the member is not indemnified against loss by the corporate credit union, the transaction is excluded from the risk-based capital calculation. When a corporate credit union lends its own securities, the transaction is treated as a loan. When a corporate credit union lends its own securities or is acting as agent, agrees to indemnify a member, the transaction is assigned to the risk-weight appropriate to the obligor or collateral that is delivered to the lending or indemnifying institution or to an independent custodian acting on their behalf; and

(iv) Unused portions of ABCP liquidity facilities that do not meet the definition of an eligible ABCP liquidity facility. The resulting credit equivalent amount is assigned to the risk category appropriate to the assets

<sup>2</sup>The sufficiency of collateral and guarantees for off-balance sheet items is determined by the market value of the collateral or the amount of the guarantee in relation to the face amount of the item, except for derivative contracts, for which this determination is generally made in relation to the credit equivalent amount. Collateral and guarantees are subject to the same provisions noted under paragraph II(d) of this Appendix C.



to be funded by the liquidity facility based on the assets or the obligor, after considering any collateral or guarantees.

(2) 50 percent credit conversion factor (Group B).

(i) Transaction-related contingencies, including, among other things, performance bonds and performance-based standby letters of credit related to a particular transaction;

(ii) Unused portions of commitments (including home equity lines of credit and eligible ABCP liquidity facilities) with an original maturity exceeding one year except those listed in paragraph II (b)(5) of this Appendix. For eligible ABCP liquidity facilities, the resulting credit equivalent amount is assigned to the risk category appropriate to the assets to be funded by the liquidity facility based on the assets or the obligor, after considering any collateral or guarantees.

(iii) Revolving underwriting facilities, note issuance facilities, and similar arrangements pursuant to which the corporate credit union's CUSO or member can issue short-term debt obligations in its own name, but for which the corporate credit union has a legally binding commitment to either:

(A) Purchase the obligations the member is unable to sell by a stated date; or

(B) Advance funds to its member, if the obligations cannot be sold.

(3) 20 percent credit conversion factor (Group C). Trade-related contingencies, *i.e.*, short-term, self-liquidating instruments used to finance the movement of goods and collateralized by the underlying shipment. A commercial letter of credit is an example of such an instrument.

(4) 10 percent credit conversion factor (Group D). Unused portions of eligible ABCP liquidity facilities with an original maturity of one year or less. The resulting credit equivalent amount is assigned to the risk category appropriate to the assets to be funded by the liquidity facility based on the assets or the obligor, after considering any collateral or guarantees.

(5) Zero percent credit conversion factor (Group E). (i) Unused portions of commitments with an original maturity of one year or less, except for eligible ABCP liquidity facilities;

(ii) Unused commitments with an original maturity greater than one year, if they are unconditionally cancelable at any time at the option of the corporate credit union and the corporate credit union has the contrac-

tual right to make, and in fact does make, either:

(A) A separate credit decision based upon the borrower's current financial condition before each drawing under the lending facility; or

(B) An annual (or more frequent) credit review based upon the borrower's current financial condition to determine whether or not the lending facility should be continued; and

(iii) The unused portion of retail credit card lines or other related plans that are unconditionally cancelable by the corporate credit union in accordance with applicable law.

(6) Off-balance sheet derivative contracts; interest rate and foreign exchange rate contracts (Group F).

(i) Calculation of credit equivalent amounts. The credit equivalent amount of an off-balance sheet derivative contract that is not subject to a qualifying bilateral netting contract in accordance with paragraph II(b)(6)(ii) of this Appendix is equal to the sum of the current credit exposure, *i.e.*, the replacement cost of the contract, and the potential future credit exposure of the contract. The calculation of credit equivalent amounts is measured in U.S. dollars, regardless of the currency or currencies specified in the contract.

(A) Current credit exposure. The current credit exposure of an off-balance sheet derivative contract is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current credit exposure equals that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. In determining its current credit exposure for multiple off-balance sheet derivative contracts executed with a single counterparty, a corporate credit union may net positive and negative mark-to-market values of off-balance sheet derivative contracts if subject to a bilateral netting contract as provided in paragraph II(b)(6)(ii) of this Appendix.

(B) Potential future credit exposure. The potential future credit exposure of an off-balance sheet derivative contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal by a credit conversion factor.<sup>3</sup> Corporate credit unions, subject to examiner review, should use the effective rather than the apparent or stated notional amount in this calculation. The conversion factors are:<sup>4</sup>

<sup>3</sup>For purposes of calculating potential future credit exposure for foreign exchange contracts and other similar contracts, in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts to each party falling due on each value date in each currency.

<sup>4</sup>No potential future credit exposure is calculated for single currency interest rate swaps in which payments are made based upon two floating rate indices, so-called floating/floating or basis swaps; the credit equivalent amount is measured solely on the basis of the current credit exposure.

Remaining maturity	Interest rate contracts (percent)	Foreign exchange rate contracts (percent)	Other derivative contracts (percent)
One year or less .....	0.0	1.0	10.0
Over one year but less than five years .....	0.50	5.0	12.0
Over five years .....	0.50	5.0	15.0

(ii) Off-balance sheet derivative contracts subject to bilateral netting contracts. In determining its current credit exposure for multiple off-balance sheet derivative contracts executed with a single counterparty, a corporate credit union may net off-balance sheet derivative contracts subject to a bilateral netting contract by offsetting positive and negative mark-to-market values, provided that:

(A) The bilateral netting contract is in writing;

(B) The bilateral netting contract creates a single legal obligation for all individual off-balance sheet derivative contracts covered by the bilateral netting contract. In effect, the bilateral netting contract provides that the corporate credit union has a single claim or obligation either to receive or pay only the net amount of the sum of the positive and negative mark-to-market values on the individual off-balance sheet derivative contracts covered by the bilateral netting contract. The single legal obligation for the net amount is operative in the event that a counterparty, or a counterparty to whom the bilateral netting contract has been validly assigned, fails to perform due to any of the following events: Default, insolvency, bankruptcy, or other similar circumstances;

(C) The corporate credit union obtains a written and reasoned legal opinion(s) representing, with a high degree of certainty, that in the event of a legal challenge, including one resulting from default, insolvency, bankruptcy or similar circumstances, the relevant court and administrative authorities would find the corporate credit union's exposure to be the net amount under:

(1) The law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

(2) The law that governs the individual off-balance sheet derivative contracts covered by the bilateral netting contract; and

(3) The law that governs the bilateral netting contract;

(D) The corporate credit union establishes and maintains procedures to monitor possible changes in relevant law and to ensure that the bilateral netting contract continues to satisfy the requirements of this section; and

(E) The corporate credit union maintains in its files documentation adequate to support the netting of an off-balance sheet derivative contract.<sup>5</sup>

(iii) Walkaway clause. A bilateral netting contract that contains a walkaway clause is not eligible for netting for purposes of calculating the current credit exposure amount. The term "walkaway clause" means a provision in a bilateral netting contract that permits a nondefaulting counterparty to make a lower payment than it would make otherwise under the bilateral netting contract, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the bilateral netting contract.

(iv) Risk-weighting. Once the corporate credit union determines the credit equivalent amount for an off-balance sheet derivative contract, that amount is assigned to the risk-weight category appropriate to the counterparty, or, if relevant, to the nature of any collateral or guarantee. Collateral held against a netting contract is not recognized for capital purposes unless it is legally available for all contracts included in the netting contract. However, the maximum risk-weight for the credit equivalent amount of such off-balance sheet derivative contracts is 50 percent.

(v) Exceptions. The following off-balance sheet derivative contracts are not subject to the above calculation, and therefore, are not part of the denominator of a corporate credit union's risk-based capital ratio:

(A) A foreign exchange rate contract with an original maturity of 14 calendar days or less; and

<sup>5</sup>By netting individual off-balance sheet derivative contracts for the purpose of calculating its credit equivalent amount, a corporate credit union represents that documentation adequate to support the netting of an off-balance sheet derivative contract is in the corporate credit union's files and available for inspection by the NCUA. Upon determination by the NCUA that a corporate credit union's files are inadequate or that a bilateral netting contract may not be legally enforceable under any one of the bodies of law described in paragraphs II(b)(5)(ii) of this Appendix, the underlying individual off-balance sheet derivative contracts may not be netted for the purposes of this section.

(B) Any interest rate or foreign exchange rate contract that is traded on an exchange requiring the daily payment of any variations in the market value of the contract.

(C) Asset-backed commercial paper programs.

(I) A corporate credit union that qualifies as a primary beneficiary and must consolidate an ABCP program that is a variable interest entity under Generally Accepted Accounting Principles may exclude the consolidated ABCP program assets from risk-weighted assets if the corporate credit union is the sponsor of the ABCP program.

(2) If a corporate credit union excludes such consolidated ABCP program assets from risk-weighted assets, the corporate credit union must assess the appropriate risk-based capital requirement against any exposures of the corporate credit union arising in connection with such ABCP programs, including direct credit substitutes, recourse obligations, residual interests, liquidity facilities, and loans, in accordance with Sections II(a), II(b), and II(c) of this Appendix.

(3) If a corporate credit union has multiple overlapping exposures (such as a program-wide credit enhancement and a liquidity facility) to an ABCP program that is not consolidated for risk-based capital purposes, the corporate credit union is not required to hold duplicative risk-based capital under this part against the overlapping position. Instead, the corporate credit union should apply to the overlapping position the applicable risk-based capital treatment that results in the highest capital charge.

*(c) Recourse Obligations, Direct Credit Substitutes, and Certain Other Positions*

(1) In general. Except as otherwise permitted in this Section II(c), to determine the risk-weighted asset amount for a recourse obligation or a direct credit substitute (but not a residual interest):

(i) Multiply the full amount of the credit-enhanced assets for which the corporate credit union directly or indirectly retains or assumes credit risk by a 100 percent conversion factor (For a direct credit substitute that is an on-balance sheet asset (*e.g.*, a purchased subordinated security), a corporate credit union must use the amount of the direct credit substitute and the full amount of the asset it supports, *i.e.*, all the more senior positions in the structure); and

(ii) Assign this credit equivalent amount to the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral. Section II(a) lists the risk-weight categories.

(2) Residual interests. Except as otherwise permitted under this Section II(c), a corporate credit union must maintain risk-based capital for residual interests as follows:

(i) Credit-enhancing interest-only strips. A corporate credit union must maintain risk-based capital for a credit-enhancing interest-only strip equal to the remaining amount of the strip even if the amount of risk-based capital that must be maintained exceeds the full risk-based capital requirement for the assets transferred.

(ii) Other residual interests. A corporate credit union must maintain risk-based capital for a residual interest (excluding a credit-enhancing interest-only strip) equal to the face amount of the residual interest, even if the amount of risk-based capital that must be maintained exceeds the full risk-based capital requirement for the assets transferred.

(iii) Residual interests and other recourse obligations. Where a corporate credit union holds a residual interest (including a credit-enhancing interest-only strip) and another recourse obligation in connection with the same transfer of assets, the corporate credit union must maintain risk-based capital equal to the greater of:

(A) The risk-based capital requirement for the residual interest as calculated under Section II(c)(2)(i) through (ii) of this Appendix; or

(B) The full risk-based capital requirement for the assets transferred, subject to the low-level recourse rules under Section II(c)(5) of this Appendix.

(3) Internal ratings-based approach—

(i) Calculation. Corporate credit unions with advanced risk management and reporting systems may seek NCUA approval to use credit risk models to calculate risk-weighted asset amounts for positions described in paragraphs II (c)(1) and (2) of this section of the Appendix C. In determining whether to grant approval, NCUA will consider the financial condition and risk management sophistication of the corporate credit union and the adequacy of the corporate's risk models and supporting management information systems.

(ii) Consistent use of internal ratings-based approach. A corporate credit union that has been granted NCUA approval to use an internal ratings-based approach and that has determined to use such an approach must do so in a consistent manner for all securities so rated.

(4) Limitations on risk-based capital requirements—

(i) Low-level exposure rule. If the maximum contractual exposure to loss retained or assumed by a corporate credit union is less than the effective risk-based capital requirement, as determined in accordance with this Section II(c), for the assets supported by the corporate credit union's position, the risk-based capital requirement is limited to

## National Credit Union Administration

## § 704.21

the corporate credit union's contractual exposure less any recourse liability account established in accordance with Generally Accepted Accounting Principles. This limitation does not apply when a corporate credit union provides credit enhancement beyond any contractual obligation to support assets it has sold.

(ii) Mortgage-related securities or participation certificates retained in a mortgage loan swap. If a corporate credit union holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, it must hold risk-based capital to support the recourse obligation and that percentage of the mortgage-related security or participation certificate that is not covered by the recourse obligation. The total amount of risk-based capital required for the security (or certificate) and the recourse obligation is limited to the risk-based capital requirement for the underlying loans, calculated as if the corporate credit union continued to hold these loans as an on-balance sheet asset.

(iii) Related on-balance sheet assets. If an asset is included in the calculation of the risk-based capital requirement under this Section II(c) and also appears as an asset on the corporate credit union's balance sheet, the corporate credit union must risk-weight the asset only under this Section II(c), except in the case of loan servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In that case, the corporate credit union must separately risk-weight the on-balance sheet servicing asset and the related recourse obligations and direct credit substitutes under this section, and incorporate these amounts into the risk-based capital calculation.

(5) Obligations of CUSOs. All recourse obligations and direct credit substitutes retained or assumed by a corporate credit union on the obligations of CUSOs in which the corporate credit union has an equity investment are risk-weighted in accordance with this Section II(c), unless the corporate credit union's equity investment is deducted from the credit union's capital and assets under § 704.2 and § 704.3.

(d) *Collateral*. The only forms of collateral that are recognized for risk-weighting purposes are cash on deposit in the corporate credit union; Treasuries, U.S. Government agency securities, and U.S. Government-sponsored enterprise securities; and securities issued by multilateral lending institutions or regional development banks. Claims secured by cash on deposit are assigned to the zero percent risk-weight category (to the extent of the cash amount). Claims secured by securities are assigned to the twenty per-

cent risk-weight category (to the extent of the fair market value of the securities).

[75 FR 64852, Oct. 20, 2010, as amended at 77 FR 74111, Dec. 13, 2012]

### § 704.21 Enterprise risk management.

(a) A corporate credit union must develop and follow an enterprise risk management policy.

(b) The board of directors of a corporate credit union must establish an enterprise risk management committee (ERMC) responsible for reviewing the enterprise-wide risk management practices of the corporate credit union. The ERMC must report at least quarterly to the board of directors.

(c) The ERMC must include at least one independent risk management expert. The risk management expert will have post-graduate education; an actuarial, accounting, economics, financial, or legal background; and at least five years experience in identifying, assessing, and managing risk exposures. The risk management expert's experience must also be commensurate with the size of the corporate credit union and the complexity of its operations. The board of directors may hire the independent risk management expert to work full-time or part-time for the ERMC or as a consultant for the ERMC.

(d) A risk management expert qualifies as independent if:

(1) The expert reports to the ERMC and to the corporate credit union's board of directors;

(2) Neither the expert, nor any immediate family member of the expert, is supervised by, or has any material business or professional relationship with, the chief executive officer (CEO) of the corporate credit union, or anyone directly or indirectly supervised by the CEO; and

(3) Neither the expert, nor any immediate family member of the expert, has had any of the relationships described in paragraph (d)(2) of this section for at least the past three years.

(e) The risk management expert is not required to be a director of the corporate credit union.

[76 FR 23871, Apr. 29, 2011]