NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 703 and 704

Investment and Deposit Activities; Corporate Credit Unions

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed rule.

SUMMARY: NCUA is issuing proposed revisions to the rule governing corporate credit unions (corporates). The rule was completely revised in 1997. The proposed amendments are based on NCUA's three-year experience with the rule and two advance notices of proposed rulemaking. The major revisions to the rule are in the areas of capital and credit concentration limits, with an emphasis on making these provisions more comparable to those of the other financial regulators while still taking into account the unique nature of corporates. The major changes to these two areas necessitate some substantive changes to other provisions of the rule. Several other minor revisions are generally either a clarification or a modernization of the existing rule.

DATES: Comments must be received on or before December 20, 2001.

ADDRESSES: Direct comments to Becky Baker, Secretary of the Board. Mail or hand-deliver comments to: National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314–3428. Fax comments to (703) 518–6319. E-mail comments to *regcomments@ncua.gov. Please send comments by one method only.*

FOR FURTHER INFORMATION CONTACT: Kent Buckham, Deputy Director, Office of Corporate Credit Unions, at the above address or telephone (703) 518-6640; or Mary Rupp, Staff Attorney, Office of General Counsel, at the above address or telephone (703) 518–6540.

SUPPLEMENTARY INFORMATION:

A. Background

On July 28, 1999, NCUA issued an advance notice of proposed rulemaking that requested comment on several issues the Board identified as areas of the corporate rule it was interested in clarifying or revising. 64 FR 40787, July 28, 1999. In addition, the Board welcomed comment on other sections of part 704 not addressed in the advanced notice. *Id.* As a result of those comments, the Board identified additional areas of part 704 it was interested in revising or clarifying and issued a second advance notice of proposed rulemaking. 65 FR 70319, November 22, 2000. The comments to both advance notices have greatly assisted the Board in drafting the proposed rule and will be discussed in the relevant section of the section-by-section analysis of the proposal.

B. Section-by-Section Analysis

Capital Section 704.3, Section 703.100

The Board requested comment on amending the various capital definitions so that they are more analogous to those used by other financial regulators.

Additionally, the Board sought specific comment on changes that would result in one measure of capital. Currently, the regulation provides two capital measures. One measure includes all the various components of capital. The second measure, which is utilized for credit concentration limits, is based on specific capital components. 12 CFR 704.6(c).

Sixteen of the 23 commenters that responded on this issue supported aligning capital requirements with other financial regulators but stressed the alignment must take into account the uniqueness of corporates. Only two commenters supported an alignment as proposed and five objected to any alignment.

The sixteen qualified commenters, as well as the negative commenters, emphasized there are currently no safety and soundness problems in the corporate system, corporates have significantly lower risk than commercial banks, and corporates are unique in their mission, ownership, and structure. The majority of assets owned by commercial banks are loans made to businesses or individuals. Corporates' assets are generally investment-grade quality investments. In addition, the assets of a corporate generally mature much sooner than the assets of a bank. For these reasons, the commenters noted corporates have significantly lower risk than banks.

The sixteen commenters, although not wanting identical capital requirements, note that some form of comparability would be helpful in promoting a clearer understanding of corporates by other regulators and Congress.

Several of these commenters noted that other financial regulators are looking at different, simplified capital requirements for smaller, non-complex institutions. A determination that an institution is non-complex would be based on structure, size, and complexity of operations. These commenters contended that corporates are most like the Federal Home Loan Bank System. The Federal Home Loan Bank System has new leverage and risk-based capital requirements. 12 CFR part 932.

Those opposed to any revision noted that nothing has changed since the last rewrite of the corporate rule to warrant a change and, while it is a worthwhile goal to have comparable capital requirements, the issues of which regulator to align with and how to take into account a corporate's reduced risk outweigh the benefits of changing the capital requirements.

The National Association of State Credit Union Supervisors (NASCUS) and the American Bankers Association (ABA) supported the proposed change. NASCUS stated that the proposed change would assist the 38 out of 48 state-chartered credit union supervisory authorities that also regulate banks. The ABA states the proposed changes would bring credit unions closer to banks, but did not go far enough.

The majority of those that responded to the issue of membership capital (MC) and paid-in-capital (PIC) strenuously objected to adding additional requirements to these accounts in order for them to qualify as capital. The proposal counted as capital only PIC that qualified as capital under generally accepted accounting principles (GAAP), that being, non-cumulative dividend, perpetual maturity PIC. The proposal would have changed the minimum withdrawal period for MC from three years to five years. The proposal was intended to make MCs more analogous to Tier 2 capital utilized by other financial institution regulators. The practical effect of the change would be that corporates could only count 60 percent of every dollar of three year MC in the net economic value (NEV) calculation. Some of the reasons for opposing this change were that: it isn't warranted because MC is at 100 percent risk until maturity; it could send the wrong message to the industry, namely, that corporates are in trouble; based on a change to NCUA's regulations, corporates just four years ago asked their members to extend their MC accounts from one year to three years; and it would make corporates less competitive with other financial institutions that don't require a capital commitment.

The commenters generally supported treating all MC, PIC, and reserves and undivided earnings (RUDE) as capital throughout the regulation.

The Board recognizes the unique nature of the credit union system and the vital role that corporates play. The risks inherent in corporates are different than found in most other financial institutions. However, the Board is also cognizant that the regulation must provide a sound capital structure that

helps maintain the confidence of members, the public, and Congress.

The Board is not proposing to change the current definitions of MC and PIC to require those accounts to follow GAAP in order to qualify as capital. The Board recognizes the high credit quality and liquidity of most corporate assets provide reasonable assurance that MC and PIC will be available to absorb losses.

The Board concurs that the various components of capital in the regulation should all be included in the definition of capital. The Board has eliminated the separate limitations based on ''the sum of reserves and undivided earnings and paid-in capital'' existing in the current regulation. 12 CFR 704.6, 704.7, 704.8 and 12 CFR part 704, Appendix B. In the proposed regulation, all references to capital include membership capital, paid-in capital, and RUDE.

The Board believes a corporate should have the regulatory flexibility to use the alternatives best fitting its specific needs in building a strong capital position. The current regulation limits the amount of PIC a corporate may issue to no more than the total of RUDE. The existing limitation was adopted as a means of building RUDE and due to the lack of any historical experience on the part of corporates in issuing PIC. Since the revised part 704 became effective in 1998, corporates have been successful in building RUDE and their PIC offerings. 62 FR 12929, March 19, 1997. Therefore, the Board is no longer requiring PIC to be no greater than total RUDE.

Additionally, the Board is changing the requirement that all nonmember PIC be approved by NCUA to provide regulatory relief. Nonmember PIC having terms and conditions identical to member PIC will not require prior NCUA approval. Nonmember PIC with different terms and conditions than member PIC will continue to require prior NCUA approval.

NCUA asked for comment on whether the rule should require the measure for adjusted balance MC accounts be based on a 12-month average, rather than the current practice of basing the measure on a particular point in time. The current rule is silent on this issue.

Seventeen of the 18 commenters responding to this issue objected to a 12-month average. Some of the reasons given in opposition to a 12-month average were that: it would be difficult operationally because members only prepare these figures quarterly or semi-annually; a corporate shouldn't be requiring more information from its members than the regulator; it would be a huge burden on small credit unions; some credit unions may leave the system because of the added burden; and the method and frequency of the adjustment should be left to the discretion of the corporate not the regulator.

The Board concurs with the commenters that tracking a 12-month average adjusted balance measure could place additional burden on corporates and on small natural person credit unions. However, the Board believes clarification of the requirements of adjusted balance accounts is necessary. Although not specifically stated in § 704.2, it was intended that the adjustment period would be annual and the adjustment measure would be a natural person credit union's assets. The Board is wary of an adjustment measure that could fluctuate rapidly, resulting in an outflow of MC if the measure declines. In a scenario where investments in a corporate are the measure and the adjustment period is monthly, a member credit union could potentially withdraw its investments and be refunded its entire MC balance within a matter of days. The Board's overriding goal is that MC has a level of ''permanence'' while allowing corporates the latitude to structure the accounts to best suit their needs, as well as the needs of their members. To that end, the Board is proposing the adjustment period may be no more frequent than once every six months. In addition, if a corporate uses a measure other than a member's assets, it must address the measure's permanence in its capital plan.

NCUA requested comment on whether there should be a minimum RUDE ratio of two percent for all corporates. RUDE ratio is defined as RUDE divided by moving daily average net assets (DANA).

Fifteen of the 21 commenters commenting on this issue objected to a minimum RUDE ratio of two percent. Those in opposition stated that there was no evidence it would have any impact on ensuring the stability of a corporate's capital. Those commenters stated it is not useful and the total capital ratio, coupled with minimum risk-based capital and NEV ratios, is a more appropriate way of determining capital adequacy. Several commenters questioned why it is necessary.

Some of the comments in support of this requirement stated it provides a meaningful measure to compare corporates to other financial institutions because most other regulators have similar minimum core capital requirements.

The Board remains convinced that a minimum RUDE ratio of two percent is useful in the overall determination of capital adequacy. Given the proposal to use one capital measure including all capital components, use the broader definition of capital for credit concentration limits, and lower the minimum credit rating requirements, the Board is convinced a minimum RUDE ratio of two percent will be beneficial. A minimum RUDE ratio requirement will provide a core capital level comparable to other financial institutions and ensure a level of protection to the holders of MC and PIC.

The Board believes the introduction of a minimum RUDE ratio negates the need for a minimum reserve ratio or the need for mandated reserve transfer levels. Corporates will be required to maintain a minimum RUDE ratio on an ongoing basis and make operational adjustments as necessary to meet that goal. As such, the proposed regulation eliminates the reserve ratio and reserve transfer requirements.

NCUA requested comment on whether there should be a credit-risk weighted capital requirement since corporates have capital in relation to risk that is comparable to the risked-based total capital of other financial institutions. This comparability may not be evident because of current definitions and the lack of a required measurement. The majority of commenters responding to this issue did not object to a requirement.

Although the Board gave strong consideration to adopting a credit-risk weighted capital requirement for corporates to enhance comparability with other financial institutions, the proposed rule does not have this requirement. The Board believes the adoption of a credit-risk weighted capital requirement is not warranted because of the high credit quality of corporates' assets. In addition, it would significantly increase the size of the existing rule and add a regulatory burden. Comparability with other financial institutions can be attainted through some of the other proposed capital revisions. The Board notes corporates may voluntarily choose to calculate and monitor credit-risk weighted capital.

A number of corporates responding to the issue of a credit-risk weighted capital requirement suggested reducing the qualifying portion of MC by 33⅓ percent each year after notice is given or before the term expires. Additionally, they recommended that PIC be reduced by 33⅓ percent each year of its last three years to maturity. The commenters indicated that these adjustments would make the capital ratio more comparable to that used by other financial institutions. The Board is desirous of a

periodic, rather than annual reduction in qualifying MC and PIC, once notice is given or the last three years to maturity is reached. As such, the Board proposes MC placed on notice, term MC that is three years from expiring, or PIC with three years to maturity be amortized on a monthly basis with no portion of the balance counting as qualifying capital during the last 12 months. To achieve that result, the Board proposes an amortization of those accounts of 1/24th per month so that the amount is fully amortized 12 months before the scheduled release of the funds.

The Board is also adding wording to the definition of PIC that was inadvertently left out of the current regulation. Specifically, the revision states PIC cannot be pledged against borrowings. This provision currently exists for MC. The provision is equally important for PIC as it absorbs losses before MC.

The proposal also clarifies that funds in MC and PIC accounts are not automatically releasable due to the merger, charter conversion, or liquidation of the natural person credit union member account holder. Further, in the event of the merger of the corporate, the MC and PIC accounts transfer to the continuing corporate.

Finally, the Board proposes taking the requirements for MC and PIC out of the definitions in § 704.2 and moving them to the capital requirements provision in § 704.3(b) and (c). Section 704.2 still has definitions of MC and PIC. The definitions of ''member PIC'' and ''nonmember PIC'' have been deleted from the definition section and the requirements for each are now included in proposed § 704.3(c).

The Board requested comment on amending § 703.100(c) to increase the limit of the aggregate purchase of member PIC and MC in one corporate from one percent to two percent. Additionally, the Board sought comment on adding an aggregate limit of PIC and MC in all corporates of four percent. Fifteen commenters supported both proposals, one commenter only supported the increase to two percent aggregate in one corporate, and one commenter objected to both proposals.

The NCUA Board believes the ability of natural person credit unions to purchase the capital instruments of corporates has been a positive force in bringing about capital redistribution within the credit union system. Many natural person credit unions rely heavily on corporates for liquidity, investment products, and other financial services. Historically, while capital in natural person credit unions has been very strong, corporate capital was not considered to be at desired levels. Since 1992, many natural person credit unions have committed their funds to build capital in the corporate credit union system.

The Board is persuaded both the corporate and the natural person credit unions receive a benefit if a greater level of capital acquisition in one corporate is allowed. However, the Board is also cognizant that any excessive concentration of natural person credit union funds in corporate credit union capital offers the potential for additional risk in the system. Currently, the regulation does not place a limit on the number of corporates from which a natural person credit union may purchase MC or member PIC. As such, a natural person credit union could theoretically purchase up to one percent of its assets in the MC or member PIC of more than 30 corporates. The Board believes there is a need to balance the ability of natural person credit unions to purchase higher levels of capital in the one or two corporates in which they primarily obtain services with the need to place a reasonable limitation on the total corporate capital one natural person credit union can acquire.

The existing regulation only limits ''member'' PIC. However, as a natural person credit union may acquire PIC of a corporate in which it is not a member, the regulation has been revised to set limitations on PIC as a whole.

The Board proposes raising the limitation on the aggregate purchase of MC and PIC in one corporate from one percent to two percent of assets. Further, the Board proposes adding a limitation on the aggregate purchase of MC and PIC in all corporates to four percent of assets.

The Board believes there is a need to clarify the existing wording on the limitations in § 703.100. Purchases of MC and PIC are limited to a percentage of the assets of the natural person credit union. As assets are a fluid rather than a static measure, a natural person credit union could be deemed in compliance with the regulatory limitation on one day, and out of compliance the next as assets grow and contract. Therefore, the Board is proposing to clarify the limitation is a percentage of the natural person credit union's assets measured at the time of purchase.

Board Responsibilities Section 704.4

This section of the regulation requires a corporate's board to approve and maintain comprehensive written strategic plans and operating policies and ensure senior management carries them out. One commenter expressed concern that use of the term ''operating policies'' may be construed to require a corporate board to develop operational policies or procedures. This is not the Board's intent. To clarify this, the Board proposes changing the term ''operating policies'' to ''policies'' throughout this section of the rule.

This commenter also expressed concern that using the word ''procedures'' in subsection (c) could be interpreted to require a corporate's board to approve operational procedures. This section was not intended to turn directors into operating managers. To clarify this, the Board proposes changing the title of this section to ''Other requirements.''

Investments Section 704.5

The Board proposes several changes to the investment related definitions in § 704.2. The Board proposes deleting the definitions of: Commercial mortgage related security; Market price; Mortgage servicing; Non secured obligation; Prepayment model; and Real Estate Mortgage Investment Conduit (REMIC). These terms are no longer used in the regulation.

The Board proposes amending the definitions of:

Asset-backed security (ABS). The Board proposes eliminating the overlap between the definitions of mortgage related securities and ABS and conforming the definition to the current instructions for the 5310 Call Report. The proposal excludes only mortgage related securities from the definition of ABS, rather than all mortgage backed securities.

Collateralized mortgage obligation (CMO). Currently, the definition of a CMO includes all multi-class bonds collateralized by mortgages or mortgage-backed securities. The Board proposes to narrow this definition to a multi-class mortgage related security. This conforms to the amended definition of an ABS.

Forward settlement. The Board proposes replacing ''settlement on a date other than the trade date'' with ''settlement on a date later than regular-way settlement.'' This change conforms the definition of forward settlement to the usage in § 704.5(g).

Quoted market price. The Board proposes defining a quoted market price as a recent sales price or a price based on current bid and asked quotations. This definition replaces the definition of market price, which is defined as the price at which a security can be bought or sold. Because market price is used to refer to the value of more than just securities, the Board proposes to omit the reference to a security. The

proposed definition is consistent with the definition of a quoted market price in accounting standards. Statement of Financial Accounting Standards No. 133, as amended and interpreted (FASB Statement No. 133).

Mortgage related security. The Board proposes replacing the phrase ''*i.e.*'' with the phrase ''*e.g.*'' The Board did not intend to limit the definition to the one stated example, privately-issued securities. This change makes the definition consistent with the definition in the Securities Exchange Act of 1934.

Regular-way settlement. The current definition refers to the specific number of days established for a type of security. The Board proposes to clarify this refers to the time frame the securities industry has established for immediate delivery. This change is consistent with the definition in § 703.100(a) and FASB Statement No. 133. The Board proposes examples of regular-way delivery to further clarify its intent.

Repurchase transaction. The current definition refers to resale of a security ''at a later date.'' The proposed definition refers to resale of a security ''at a specified future date and at a specified price.'' This is a non-substantive clarification that is consistent with the definition in § 703.100(i).

Residual interest. This proposed change deletes the reference to REMIC, which is redundant with CMO, and includes ABS residuals within the definition.

In conjunction with the changes to the investment definitions in § 704.2, the Board is proposing several changes to the investment provision of the rule. 12 CFR 704.5.

Policies section 704.5(a). The Board proposes combining the policy requirements in this section and deleting ''if any'' from § 704.5(a)(1) to clarify that a corporate must have ''appropriate tests and criteria'' to evaluate the investments it makes on an ongoing basis, as well as new types of investments.

Section 704.5(a)(2). Since the marketing of liabilities to members is not an investment or investment transaction, the Board proposes deleting that provision from the investment policy requirements. The Board proposes requiring a corporate's investment policy to address reasonable concentration limits for limited liquidity investments. To ensure safety and soundness prior to purchase, a corporate must identify characteristics of an investment that may place restrictions on the sale of an investment (such as privately placed securities) or limit the appeal of an investment to other potential investors. A corporate's board must assess its liquidity position and establish appropriate aggregate limits on such limited liquidity investments.

Authorized Activities

Section 704.5(c)(5). The Board proposes clarifying that ABS must be domestically issued. The Office of Corporate Credit Unions (OCCU) issued a guidance letter to all corporates dated May 19, 2000, noting many domestically issued ABS have some type of foreign exposure. As stated in that letter, the Board notes that any undue concentrations or safety and soundness issues arising from investments in domestically-issued ABS with foreign exposure will be addressed as a supervision issue. Examiners will evaluate the ability of corporate staff to analyze ABS structures containing significant foreign exposure. The degree of foreign credit analysis expertise required at a corporate will depend on the extent of foreign exposure. For example, if a corporate relies on a domestic mono-line insurance wrap of foreign receivables, examiners will review a corporate's credit analysis of the insurance company and determine whether credit concentration limits to the insurance company are appropriate.

Section 704.5(c)(6). This provision specifically authorizes investments in CMOs. Several corporates have noted CMOs are either within the meaning of mortgage related security or asset-backed security. Accordingly, the Board proposes to delete this provision. Investments in CMOs, as the Board proposes to amend that term, would continue to be authorized under § 704.5(c)(1), the mortgage related security provisions of 12 U.S.C. 1757(15). Investments in other real-estate related securities would continue to be authorized under § 704.5(c)(5), domestically-issued asset-backed securities.

Repurchase Agreements section 704.5(d). The Board proposes several changes to the requirements for repurchase agreements. The first amendment clarifies that a corporate must obtain a perfected first priority security interest in repurchase securities, either directly or through its agent. This change is consistent with the provisions in § 704.5(e), for economically similar securities lending transactions. The second amendment deletes the requirement to sell a security in the event of a default. This change conforms to cash market practice and provisions of the Bond Market Association's Master Repurchase Agreement that permit a corporate to retain the securities. The third amendment clarifies a corporate may obtain daily assessment of the market value of the repurchase securities either directly or through its agent. This change conforms to the cash market practices of a third-party custodian acting as agent in a tri-party agreement between the corporate, the repurchase counterparty, and the safekeeping agent. Fourth, the Board proposes deleting the phrase ''including a market quote or dealer bid indication and any accrued interest'' because the cash market practice is to use ''market value'' as defined in the Bond Market Association's Master Repurchase Agreement. Fifth, the rule clarifies a corporate must ensure compliance with the contract terms. The Board notes a corporate using an agent must ensure its agent adequately ensures compliance. Finally, the rule deletes the requirement to have sufficient market relationships established in advance to timely execute the disposition of repurchase securities. This regulatory provision is unnecessary, as the prevailing cash market practice requires sale or deemed sale in a commercially reasonable manner.

Securities Lending section 704.5(e). The Board proposes several changes to the requirements for securities lending transactions. The proposed rule clarifies that a corporate may act directly or through its agent. The requirement to assess collateral is currently based on a ''market quote or dealer bid indication.'' The Board proposes deleting the phrase ''including a market quote or dealer bid indication and any accrued interest'' because the cash market practice is to use ''market value'' as defined in the Bond Market Association's Master Securities Loan Agreement. The proposal requires a written contract with all agents and requires the corporate or its agent to ensure compliance with the loan and security agreements. The Board proposes to delete as redundant the requirements to approve any form of agreement attached to the written loan and security agreement and the right to approve any material modification to such agreement. These proposed changes are consistent with the proposed changes for repurchase transactions.

Investment companies Section 704.5(f). The Board proposes to clarify in § 704.5(f) that the prospectus is the document restricting the portfolio of an investment company. This change is non-substantive and is consistent with the provisions of § 703.100(d).

Prohibitions Section 704.5(h). This section prohibits pair-off transactions,

when-issued trading, adjusted trading, and short sales. These prohibitions restrict a corporate from effectively engaging in trading securities. Accordingly, the Board proposes adding ''trading securities'' to the list of prohibited activities. Trading securities means buying and selling ''securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time).'' FASB Statement No. 115.

The Board proposes retaining the prohibition on investments in residual interests in CMOs, adding a prohibition on investment in residual interests in ABS, including real-estate related ABS, and eliminating the redundant prohibition on investments in REMICs. The purpose of these revisions is to continue the prohibition on residual interests in multi-class bond issues collateralized by mortgages or mortgage-backed securities that are not within the revised definition of CMO. The prohibition on investments in the residual interests in ABS is being added for safety and soundness reasons.

The Board proposes deleting the prohibition against commercial mortgage related securities. The market for privately-issued commercial mortgage related securities is established. There does not appear to be undue risk relative to other debt obligations if a corporate can reasonably determine the value and price sensitivity of a commercial mortgage related security. The Board notes corporates currently may purchase certain commercial mortgage related securities, such as those issued by, or fully guaranteed as to principal and interest by, the Federal National Mortgage Association.

The prohibition against the purchase of mortgage servicing rights is being moved from the investment section, to the retitled Permissible Services section, because their classification as a service is more appropriate.

Credit Risk Management Section 704.6

The Board proposes adding a definition of ''obligor'' to the § 704.2 definition section to clarify the meaning of the term. The Board proposes to define ''obligor'' as the primary party obligated to repay an investment. The definition clarifies obligor does not include the originator of receivables underlying an asset-backed security, the servicer of such receivables, or an insurer of an investment.

Policies section 704.6(a). The Board proposes amending the policy requirements in this section to comply with the proposed new requirement in § 704.6(c) that credit limits be based on capital.

Section 704.6(a)(3). The Board proposes deleting the requirement that the credit risk management policy address loan credit limits, since these are addressed in the lending section.

Section 704.6(a)(4). The Board proposes adding to the examples of concentrations of credit risk an ''originator of receivables'' and an ''insurer.'' An ''originator of receivables'' includes a seller/servicer of receivables and an ''insurer'' includes a monoline insurance company.

Exemption Section 704.6(b). The Board proposes removing investments in subordinated debt of government sponsored enterprises from the exemption section. The issuance of subordinated debt is a recent market initiative. Subordinated debt ranks lower in payout priority than other debt issued or insured by a government sponsored enterprise. The Board believes minimum credit rating requirements and credit concentration limits should apply to lower ranking debt.

Concentration limits section 704.6(c). The Board proposes setting concentration limits in relation to capital. Twenty of the 21 commenters were in favor of setting credit concentration limits as a percentage of capital. Currently, credit concentration limits are based on percentages of RUDE and PIC, rather than the broader measure of capital. The only negative commenter in response to the Board's request for comment was the ABA. Most of the positive commenters qualified their support with the caveat that the definition of capital must give full credit to three-year MC and 20-year PIC. The Board's proposal adopts those comments.

NCUA requested comment on whether credit concentration limits should vary depending upon the credit rating of an investment, in other words, the lower the credit rating, the more restrictive the credit concentration limit. Although the majority of commenters agree there should be limits in relation to risk, they believe a corporate should determine the limits, rather than being controlled by the limits specified in regulations according to ratings of a nationally recognized statistical rating organization (NRSRO or rating agency). They state that a corporate's concentration limits should be a supervisory issue and not a regulatory one. Some commenters noted that NCUA in the past has admonished corporates not to rely solely on ratings from a ratings agency. One commenter stated there is no need for a regulation because, through a combination of expanded authorities, a risk-based capital requirement, and a maximum individual credit exposure limit to any one issuer, there are sufficient safeguards.

NCUA requested comment on establishing a limit for the aggregate credit exposure to a single obligor that has issued debt obligations across multiple rating categories. The majority of commenters responding to this issue believed there should be aggregate limits, but not as proposed. Most of these commenters suggested that the limit be a multiple of total capital, rather than tied to debt obligations across multiple rating categories. Many commenters gave examples of how, under the proposal, their ability to invest in AAA rated securities would be significantly curtailed, some as much as 80 percent. Those commenters noted that they would be forced to invest more heavily in U.S. Central Corporate Credit Union and United States government investments because they are exempt from the restrictions. This, they contend, could create additional risk problems for the whole corporate system. Several commenters noted that the proposal would severely limit their ability to invest in relatively safe, low risk repurchase agreements.

The credit exposure limit suggested by several commenters is one times capital and, for repurchase agreements, two times capital.

The Board is abandoning its proposal to set concentration limits depending upon an NRSRO's credit rating of an investment. The Board proposes to reorganize and streamline requirements for concentration limits, and to establish limits for the aggregate credit exposure to a single obligor.

First, in § 704.6(c)(1) the Board proposes a general concentration limit of 50 percent of capital or a *de minimis* limit of $5 million for the aggregate of all investments in any single obligor, whichever is greater. The 50 percent limit provides corporates with substantial flexibility in comparison to other depository institutions. The Board believes this limit is the most credit exposure a corporate should prudently take in investment-grade quality investments. NCUA requested comment on whether there should be a *de minimis* exemption from the general credit concentration limits, and if so, what amount. Fifteen of the 16 commenters that responded to this question supported a *de minimis* exemption, and most of those commenters suggested $5 million as an appropriate amount. The one negative commenter was the ABA. Accordingly,

and to permit smaller corporates to engage in block size transactions, investments in a single obligor may exceed 50 percent of capital up to a *de minimis* limit of $5 million.

This general concentration limitation is applicable to all investments and investment transactions. The current rule is divided into categories of investments and has different limitations, depending on the category. Certain classes of marketable debt obligations of domestic corporations were inadvertently omitted from the categories. These are now covered under the general limitation that includes all investments. The current rule allows a higher limit for mortgage back securities and ABS than for nonsecured obligations of any single domestic issuer. The Board sees no basis for this distinction since there can be substantial credit risk in privately issued mortgage-backed and asset-backed securities.

Second, in § 704.6(c)(2) the Board proposes exceptions to the general rule for repurchase and securities lending transactions, investments in corporate CUSOs, and investments in other corporates. The Board adopts the commenters suggestion to set the limit for repurchase and securities lending transactions at 200 percent of capital. This limit generally reflects the lower credit risk in these short-term, secured transactions. The inclusion of an exception for investments in corporate CUSOs is a clarification that those investments are subject to the limitations in § 704.11. NCUA requested comment on whether corporates should be exempt from credit concentration limits when investing in other corporates. Ten of the 15 commenters that responded to this question said they should not. These negative commenters believe that it would increase systemic risk and is, therefore, unjustifiable. Several commenters suggested that corporates should maintain a credit risk file for investments greater than $100,000 in any other corporate. To allow additional alternatives for moving liquidity within the corporate system and, therefore, the credit union movement, the Board proposes to remove the regulatory concentration limits on investments in any corporate. The Board believes the requirements for capital and RUDE for the receiving corporate will serve to limit the amount of investments any corporate may place in another corporate. The Board notes a corporate's credit risk management policy must address the risks of investments in corporates that are not fully insured by the National Credit Union Share Insurance Fund.

As stated above, the Board proposes basing credit concentration limits on capital. Currently, they are based on RUDE and PIC and a reduction in the sum of RUDE and PIC after the purchase of an investment triggers a suspension of additional transactions. The Board proposes amending this provision to apply the divestiture requirements in § 704.10 when a reduction in capital after the purchase of an investment results in a credit concentration that is higher than permitted by the regulation. The Board's intent is that a corporate consider the permanence of its MCs when evaluating its investment opportunities.

Credit ratings section 704.6(d). The Board proposes to clarify each investment must have an applicable credit rating. For example, a corporate must ensure investments in commercial paper are from an issuer that has received an acceptable commercial paper program rating. Similarly, a financial strength rating for deposits may be appropriate for uninsured deposits or the sale of federal funds. Investments in a corporate or corporate CUSO are exempt from this requirement.

The Board proposes lowering the minimum applicable rating for a long-term investment (including asset-backed securities) from AAA and AA to AA–(or equivalent). The market for asset-backed securities has matured since this rule was last amended. The Board is retaining the A–1 requirement for short-term investments and intends that this category include short-term ABS. The current rule inadvertently excludes them.

There has been some confusion regarding multiple credit ratings and the conditions for triggering the divesture requirements of § 704.10. The Board does not want to discourage a corporate from using multiple credit ratings in meeting the requirements of the regulation. Accordingly, the Board proposes the divestiture requirements of § 704.10 apply only if at least two ratings were downgraded when a corporate has relied on more than one rating to meet the minimum credit rating requirements at the time of purchase. This requirement is consistent with the guidance issued by OCCU in a letter dated October 5, 1999, to all corporates.

Reporting and documentation Section 704.6(e). The requirements for annual approval are clarified to apply to each credit limit with each obligor or transaction counterparty, rather than the undefined ''each credit line.''

Lending Section 704.7

Section 704.7(c)(1) and (2). These sections establish the maximum aggregates for secured and unsecured loans to one member. Currently, the aggregate limits are based on the higher of a percentage of capital or a percentage of RUDE and PIC. As with other provisions of the proposed rule, the Board proposes basing loan limits on capital. The proposed rule eliminates the option of basing secured and unsecured loan limits on a percentage of RUDE and PIC. In conjunction with this change, the Board proposes clarifying in these provisions and in § 704.7(d) that the aggregate limits are based on both revocable and irrevocable lines of credit. Currently, the rule only states ''irrevocable lines of credit.'' 12 CFR 704.7(c) and (d). The Board proposes deleting the modifier ''irrevocable'' from these sections to clarify this.

Section 704.7(d). This section addresses loans to members, but excludes member credit unions and corporate CUSOs. This provision provides a partial exemption from part 723. A number of commenters suggested the criteria for exemption be expanded. The Board agrees that there are other situations where a loan is guaranteed that are appropriate to include as part of the exemption. The Board proposes expanding the language in this provision to include not only loans guaranteed by credit unions but also loans fully secured by US Treasury or agency securities. This expansion will reduce the burden for corporates providing loans to members that are not credit unions. The rule is also being clarified to address the fact that the aggregate limits of § 723.16 are statutory and a corporate is not exempt from those unless it is a loan to a member credit union.

Section 704.7(g). The Board proposes revising the provision governing loan participations, to include a requirement that a corporate execute a master participation loan agreement prior to the purchase or the sale of a participation loan. This requirement mirrors the requirement in the natural person loan participation rule and is appropriate to ensure the interests of a corporate engaging in this activity are adequately protected. 12 CFR 701.22(b)(2). Although the Board believes corporates presently engaging in this activity are voluntarily executing a master participation loan agreement, the Board believes use of this agreement must be mandatory due to safety and soundness concerns.

The Board is deleting the language that a participation loan agreement may

be executed at any time prior to, during, or after the disbursement. The Board believes it is unnecessary to state this because this language could be confused with the requirements of a master participation loan agreement prior to the purchase or sale of a participation loan interest.

Several commenters suggested corporates be permitted to participate with natural person credit unions in making loans to natural person members. They urged NCUA to permit participation lending with and without recourse. Some of these commenters specifically stated this activity should be permissible without expanded authority. Another commenter believed participation lending should be allowed only as an expanded authority because a corporate must be able to demonstrate an appropriate level of infrastructure and financial capacity to engage in this activity.

The NCUA Board asked the OCCU to address the issue of permitting corporates to participate with natural person credit unions in making loans to natural person members. 62 FR 12929, 12934 (March 19, 1997). Based on OCCU's recommendation, the Board is proposing that corporates participate in loans with member natural person credit unions only as an expanded authority. This position is based on the need for corporates to demonstrate they have the ability to identify, measure, monitor, and control the risks associated with participation lending. Since a number of corporates do not exhibit a level of infrastructure commensurate with the risks associated with this activity, the Board will require corporates to apply for this authority through Appendix B, proposed Part V.

Finally, the Board is reorganizing this section. Subsection (c) is retitled ''Loans to members.'' Within this subsection are subsections: (1) The aggregate limits for loans to credit unions; (2) the aggregate limits for loans to CUSOs by reference to § 704.11; and (3) the aggregate limits for loans to other members. Subsection (d) is retitled ''Loans to nonmembers'' and sets forth the requirements for loans to nonmember credit unions. Within this subsection are subsections: (1) The requirements for loans to nonmember credit unions; and (2) the requirements for loans to nonmember CUSOs by referencing § 704.11.

To avoid confusion about the applicability of the member business loan rule to corporates, the Board is clarifying in the proposal that the statutory aggregate limits on member business loans apply to all corporate loans, except the statutorily excluded loans to credit union members. 12 U.S.C. 1757a and 12 CFR 723.16. Subsection (e) is retitled ''Member business loan rule'' and explains in subsection: (1) That part 723 does not apply to loans to member credit unions; (2) that the aggregate loan limits and some of the due diligence requirements of part 723 apply to corporate CUSOs as stated in § 704.11; and (3) that part 723 applies to loans to other members, unless it falls within the exception discussed above, and then it must comply with the aggregate loan limits but is exempt from the other requirements of part 723.

The Board proposes deleting subsection (f) ''Loans to corporate CUSOs'' because these loans are now addressed in proposed subsections (c), (d) and (e). Current subsections (g) and (h), with the changes to subsection (g) discussed above, are redesignated subsections (f) and (g).

Asset and Liability Management Section 704.8

In conjunction with several proposed amendments to the asset and liability management section, the Board proposes deleting from the § 704.2 definition section, the term ''Net interest income'' because it is no longer used in the regulation. The Board proposes amending the definition of ''Net economic value (NEV)'' and ''Fair Value.'' NEV means the fair value of assets minus the fair value of liabilities. Currently, the definition of NEV treats MC as a liability, and excludes PIC from liabilities, for purposes of the NEV calculation. The Board requested comment on amending the definition of NEV to exclude from liabilities both MC and PIC that are included in capital. All 22 commenters that responded to this issue supported a change to the definition of NEV. Most of those commenters believed that three-year MC and 20-year PIC should be part of the exclusion.

The Board proposes amending the definition of NEV to state that PIC and MC not qualifying as capital are included as liabilities for purposes of the NEV calculation. Therefore, PIC and MC qualifying as capital are excluded from liabilities for purposes of the NEV calculation.

The proposed change to the definition of NEV will have the effect of increasing the base case NEV ratio. For the quarters ending June 2000 through March 2001, corporates reported base case NEV ratios ranging from 1.98 percent to 7.89 percent, with a simple average ratio of 4.24 percent. For the same quarters the base NEV ratios under the proposed rule, which eliminates MCs from liabilities, would have ranged from 3.76 percent to 18.17 percent, with a simple average ratio of 8.87 percent.

The Board also proposes to delete from the definition of NEV the reference to off-balance sheet derivatives, since accounting standards now require material financial derivatives to be reported on the balance sheet.

Fair value. The Board proposes a number of changes to the current definition of fair value. The reference to a financial instrument is deleted. The phrase ''forced liquidation sale'' is clarified by stating a ''forced or liquidation sale.'' ''Market price'' is replaced with ''quoted market price.'' An estimate of fair value based on a valuation technique is required to be reasonable and supportable. An estimate of fair value may also be based on a quoted market price in an active market for a similar instrument or a current appraised value. The definition is amended to clarify examples of valuation techniques. Valuation techniques are required to incorporate assumptions that market participants would use in their estimates of values, future revenues, and futures expenses. These proposed changes more closely reflect the definition of fair value in accounting standards. FASB Statement No. 133, Appendix F.

The Board proposes the following amendment to § 704.8:

Policies. Section 704.8(a)(2). Several corporates requested that NCUA eliminate redundancies between the policy requirements of this section and § 704.5(a). Since appropriate tests and criteria for evaluating investment and investment transactions are required under investment policies, the Board is deleting that requirement but clarifying in proposed § 704.8(a)(6) that the asset and liability management policy provisions must address the test used to evaluate the impact of investments on the percentage decline in NEV, compared to the base case NEV. The Board proposes changing the term ''current NEV'' to ''base case NEV.'' This change provides uniform usage throughout the regulation.

Section 704.8(a)(5). The Board proposes to delete the requirement for a policy limit on decline in net income. It may be beneficial for a corporate to measure and establish limits on earnings exposures, such as projections of potential decline in net income in alternative interest rate scenarios. However, because the balance sheet of a corporate frequently is highly liquid and short term, earnings forecasts may necessitate many assumptions. These assumptions may limit the utility of earnings exposure measures for regulatory purposes.

Penalty for early withdrawals section 704.8(c). Currently, this section requires a corporate to impose a market-based penalty for early withdrawal, if early withdrawal is permitted. The Board proposes to limit such penalty to the estimated replacement cost of the certificate/share redeemed that is reasonably related to current offering rates of that corporate. This would permit a corporate to impose reasonable fees to cover the cost of the redemption, but would protect a withdrawing credit union from excessive penalties. In response to suggestions to provide flexibility to avoid market-based penalties, the Board notes a market-based penalty for early withdrawal is a critical factor in the confidence it places in the accuracy of the measurement of NEV. As an alternative to early withdrawal, corporates may consider providing share secured loans to members needing liquidity in advance of share maturity.

Interest rate sensitivity analysis section 704.8(d). The Board proposes deleting the requirement to conduct periodic net interest income simulations. As noted above, while earnings exposure measurements may be beneficial, the balance sheet of a corporate frequently is highly liquid and short term, necessitating many assumptions for an earnings forecast. These assumptions may limit the utility of earnings exposure measures.

NCUA requested comment on whether the minimum, base case NEV ratio that triggers monthly interest rate sensitivity analysis testing should be increased from two percent to three percent. Twelve of the 15 commenters supported the increase. The majority of those commenters premised their support on the exclusion of three-year MC from liabilities. As noted above, the proposed change to the definition of NEV will have the effect of increasing the base case NEV ratio. In light of the estimated increases in the base case NEV ratios discussed above, the Board proposes to set the minimum, base case ratio that triggers monthly testing at a level of three percent.

NCUA also requested comment on increasing the minimum NEV ratio from one to two percent. Eighteen of the 21 commenters that responded to this question approved of this change, but the majority of those commenters only support it if three-year MC is excluded from liabilities. One of the positive commenters believes the same limitations should apply to wholesale corporates. The negative commenters believe the change will drive deposits from the corporate system. Again, in light of the estimated increases in the base case NEV ratios, the Board proposes increasing the minimum NEV ratio to two percent.

The Board proposes explicitly stating in the rule that a corporate must limit its risk exposure to minimum NEV ratio levels based on a base case NEV ratio or any NEV ratio resulting from the tests set forth in § 704.8(d)(1)(i). This will eliminate confusion about the applicability of the minimum NEV ratio.

The current NEV decline limit for a base corporate (a corporate with no expanded authorities) is 18 percent of the base case NEV ratio. In conjunction with the proposed change to the definition of NEV, the Board proposes decreasing that limit to 10 percent. Base corporates reported base case NEV ratios ranging from 2.32 percent to 7.89 percent, with a simple average ratio of 4.34 percent, for the quarters ending June 2000 through March 2001. For the same quarters, the base case NEV ratios under the proposed rule would have ranged from 4.75 percent to 18.17 percent, with a simple average ratio of 9.58 percent.

The Board estimates the proposed NEV decline limits would have resulted in an average permissible NEV decline of 0.96 percent (9.58 percent × 10 percent, expressed as a percentage of the fair value of total assets) for the quarters ending June 2000 through March 2001. This is larger than the average permissible decline of 0.78 percent (4.34 percent × 18 percent) for the same period under the current rule. All base corporates reflected NEV decline limits under adverse rate shocks within the proposed NEV decline limits. Summary information from the analysis is presented in Table 1.

TABLE 1.—ANALYSIS OF PROPOSED PERMISSIBLE DECLINES IN NEV FOR BASE CORPORATES FOR THE QUARTERS ENDING JUNE 2000 THROUGH MARCH 2001

	Current base case NEV ratio for all corporates (in percent)	Permitted decline (as percent of fair value of assets)	Base case NEV ratio under the proposal	Proposed permitted decline (as percent of fair value of assets)
Simple average over 4 quarters	4.34	0.78	9.58	0.96
Minimum of all quarters	2.32	0.42	4.75	0.47
Maximum of all quarters	7.89	1.42	18.17	1.82

The Board proposes moving the base-plus expanded authorities requirements to Appendix B, so that all expanded authorities are in one place. In conjunction with that change, all references to base-plus in § 704.8 are deleted.

The Board proposes requiring all corporates to assess annually whether it is appropriate to conduct periodic, additional, interest rate risk tests. The amendment deletes the requirement to conduct tests based on unmatched embedded options. The tracking of unmatched embedded options may not be cost effective for credit unions that adhere strictly to a matched book of business approach.

The Board believes all corporates should assess whether there are indications of material risks, including interest rate risk and credit risk that may not be related to unmatched embedded options. For example, a corporate may not adhere to a matched book of business approach requiring a significant match between the maturity of assets and liabilities. In that case, measures of the NEV may have a significant exposure to changes in the shape of the Treasury yield curve. In contrast, another corporate may not hold material amounts of mortgage-backed securities and, therefore, may reasonably assert its NEV measures would be relatively insensitive to changes in prepayment projections. In both cases, there may be a significant exposure to widening spreads due to the credit risk inherent in the investment portfolios.

Regulatory Violations and Policy Violations section 704.8(e) and (f). The Board proposes non-substantive grammatical amendments to the provisions for regulatory and policy violations.

Corporate Credit Union Service Organizations (Corporate CUSOs) Section 704.11

The Board requested comment on amending the definition of a corporate CUSO to require that a CUSO be considered a corporate CUSO only if any corporate owns a minimum of 25 percent interest or the aggregate interest by all corporates exceeds 50 percent. 65 FR at 70322. Currently, the rule requires partial ownership by a corporate but does not specify a minimum ownership requirement. 12 CFR 704.11(a)(1).

Fifteen of the 17 commenters that responded objected to the proposed change. Some of the reasons given in opposition were that: the proposal will have the unintended effect of limiting a corporate's role as a liquidity provider in the credit union system; it will jeopardize the exemption in § 704.7(d) from portions of the business loan rule for loans made to corporate CUSOs; and, if the reason for the proposed change is that corporates are not doing due diligence in loans to corporate CUSOs, this should be handled as a supervisory issue, not as a regulation.

The Board agrees with the commenters' concern that a minimum investment requirement could have a negative impact on a corporate's role as a liquidity provider in the credit union system and, therefore, the Board will not impose a minimum investment requirement. But, because of safety and soundness concerns associated with a high concentration of loans with one borrower, the Board is adding some due diligence requirements to the corporate CUSO lending provision.

These due diligence requirements, taken from the member business loan rule, require that the corporate establish a specific loan policy that addresses loans to corporate CUSOs and review it annually. 12 CFR 723.5. The proposed rule will also require that the policy address, at a minimum, the applicable factors listed in the member business loan rule. 12 CFR 723.6(f)–(l). Loans that are fully secured by shares in the corporate making the loan or in other financial institutions are exempt from these requirements.

The Board has added a provision to clarify that the statutory limits on member business loans, as stated in § 723.16 of the member business loan rule, apply to corporate CUSOs. 12 U.S.C. 1757a.

The Board has also added a provision to clarify that GAAP is to be used in accounting for a corporate's investments in and loans to a CUSO for the regulatory limitations under § 704.11(b). By using the equity GAAP method, a situation could develop in which a corporate's initial investment is within the regulatory limitation but, as the CUSO operates with continued profitability and the corporate absorbs its proportionate share of the profits through no additional cash outlay, the corporate could exceed its regulatory limitation. Because divestiture at this point could be contrary to prudent business practice, the Board will require the corporate to account for the investment according to GAAP, but it will not require divestiture or prohibit future investments if the regulatory limit is exceeded under the equity GAAP method without any additional cash outlay. This change mirrors a change made to the natural person CUSO rule. 64 FR 33184, June 22, 1999.

The Board proposes some cosmetic changes to this section, so that it is easier to read. Proposed subsection (b) will only address the investment and loan limitations. The rest of current subsection (b), as well as the new due diligence requirements, are now in proposed subsections (c) through (e). Subsection (c) addresses due diligence; subsection (d) addresses separate structures; and subsection (e) addresses prohibited activities. Prior subsections (c) through (e) are redesignated (f) through (h).

Permissible Services Section 704.12

The Board requested comment on eliminating this provision currently titled ''Services.'' 64 FR 40788. This section states that a corporate: may provide services to its members; may provide services through a correspondent services agreement to nonmember natural person credit union branch offices operating in the corporate's geographic field of membership; and may not perform services for nonmember natural person credit unions through agreements with other corporates or pursuant to § 701.26 of NCUA's rules except with the permission of NCUA. Fourteen of the 16 commenters that responded to this issue suggested eliminating this provision because, in practice, the geographic area defined in a corporate's charter is likely to be a national one. One of the commenters that opposed eliminating the section identified itself as a small corporate and stated that the current process of requiring corporates to apply for expanded fields of membership should be preserved in order to ascertain that the applicant has the ability and structure to serve a larger geographic area.

The Board agrees that, based on current national fields of membership for most corporates, the rationale for limiting a corporate's authority to provide correspondent services no longer exists. The Board proposes eliminating this limitation on correspondent services.

Before 1998, services were defined to include investments, liquidity management, payment systems and correspondent services. 53 FR 20122, June 2, 1986. The current rule and its preamble do not define services, but the preamble to the proposed rule indicated that the Board intended to limit services. The proposal stated that the prior list of services had been interpreted too broadly and that the intent was that services be limited to ''traditional loan, deposit and payment services.'' 61 FR 28085, 28096 (June 4, 1996).

Upon further reflection, the Board believes that limiting services to ''traditional loan, deposit and payment services'' is too restrictive. As stated in the preamble to a prior corporate rule, ''[t]he purpose of this section is to grant [c]orporate [f]ederal credit unions the power to offer innovative programs and services to their members in the areas of investments, liquidity management, payment systems and correspondent services subject to applicable provisions of law, regulation, bylaws and any orders of the NCUA Board.'' 53 FR 20122, 20123.

The Board proposes retitling this section ''Permissible Services'' and permitting eight broad categories of financial services. The four broad categories of financial services included in the prior rule's definition will be reinstated as permissible financial services. The Board is adding to the 1986 definition four additional categories of financial services. They are: asset and liability management; electronic financial services; sale or lease of excess physical or information system capacity; and operational services associated with administering or providing financial products or services. Again, as in 1986, the Board will not issue a specifically authorized list of activities, but rather a list of broad categories, because ''technology, regulation and various financial groupings and networks are all changing rapidly.'' *Id.* With this approach, ''the staff believes corporates can be most responsive in a dynamic environment.'' *Id.*

The list of permissible financial services is intended to establish broad categories of permissible financial services. If a corporate believes a financial service falls within a broad category it is not required to seek an opinion from NCUA. The test a corporate should use to determine if a

financial service falls within one of the specifically authorized broad categories is whether it is the functional equivalent or logical outgrowth of a broad category and whether the financial service involves risks similar in nature to those already assumed as part of the business of corporates. An opinion from NCUA is recommended if there is doubt as to whether a specific financial service falls within one of the broad categories.

The Board also asked for comment on clarifying the definition of correspondent services. 12 CFR 704.2. Currently, correspondent services are defined as ''services provided by one financial institution to another and includes check clearing, credit and investment services, and any other banking services.'' *Id.* Thirteen of the fourteen commenters that commented opposed changing the definition. The reasons given were that, if the services are listed, they may become outdated and limiting and that the existing definition provides the appropriate balance of flexibility and guidance. The Board proposes defining correspondent services in the provision governing permissible financial services to members and allowing the same types of services to nonmembers through a correspondent services agreement as are permitted to members.

In addition to the issue of permissible financial services offered under a correspondent services agreement, the definition needs to clarify that a correspondent agreement is an agreement between two corporates for one of the corporates to provide services to the members of the other. Usually, the reason for the agreement is because the recipient corporate does not provide the services or the member's geographic location makes it impractical to do so.

Finally, the proposal moves the current prohibition on the purchase of mortgage servicing rights from the investment section of the rule to this section because servicing rights are more closely aligned with services than investments. In addition, the term ''mortgage servicing rights'' is replaced with ''loan servicing rights'' to reflect the intent behind the prohibition that the purchase of all loan servicing rights is prohibited.

Fixed Assets Section 704.13

The Board recognizes the ongoing need to evaluate the significance and relevance of existing rules. The current fixed asset requirement for corporates does not appear to offer any added value to the safety and soundness of corporates. None of the corporates have fixed assets at levels that approach the existing regulatory limit of 15 percent of capital.

Corporates operate on a very small net margin. An excessive investment in fixed assets will have a noticeable impact on earnings. The Board believes monitoring of fixed assets in corporates is best accomplished through ongoing supervision rather than through regulation. As such, the Board proposes eliminating this section.

Representation Section 704.14

The Board intended the definition of a credit union trade association to include its affiliates. The preamble to the final rule explains that '''[c]redit union trade association' includes but is not necessarily limited to, state credit union leagues and league service corporations, national credit union trade associations and their affiliates and service organizations, and local, state, and national special interest credit union associations and organizations.'' 59 FR 59357, 59358, November 17, 1994 (emphasis added). There is some confusion because § 704.14(a)(3) includes the term ''affiliates'' in limiting directors' ties to the same credit union trade association but § 704.14(a)(2) does not include the term ''affiliates'' in its prohibition of the chair of the board serving as an officer, director or employee of a credit union trade association. Although the definition of credit union trade association includes affiliates, it is necessary to include the term in § 704.14(a)(3) because for purposes of that provision, the trade association and its affiliate are considered one and the same.

To eliminate the confusion, the Board proposes deleting the definition of ''trade association'' from the definition's section of the rule and replacing it with the definition of a ''credit union trade association'' since this is the only way the term is used. The Board proposes using the definition in the 1994 preamble to the final rule quoted above. 59 FR 59358.

In addition, the Board is amending the requirement in § 704.14(a) that both federal and state-chartered corporates comply with the federal corporate bylaws governing election procedures. The intent behind this requirement is that all corporates' election procedures comply with § 704.14(a), not that state-chartered corporates must adopt the Federal Corporate Bylaws. The rule is being amended to reflect this.

Wholesale Corporate Credit Unions Section 704.19

The Board requested comment on whether the need for separate wholesale corporate regulatory requirements still exists and, if so, the appropriateness of the existing wholesale corporate regulatory requirements. Currently, separate wholesale corporate rules apply for minimum capital ratio, calculation of reserve transfers, minimum NEV ratio, maximum NEV volatility, and validation of the asset and liability management modeling system. 12 CFR 704.19(b) and (c).

Nine of the 13 commenters supported separate regulatory requirements for wholesale corporates. Some of the reasons in support were: their size; their unique role in the corporate credit union system; risks inherent in their portfolios; and scope of services offered. Most of the supporting commenters believed the existing rules are adequate. Some of the commenters suggested revising the rules to provide wholesale corporates more flexibility.

Commenters opposing separate wholesale corporate regulatory requirements noted the risks are similar regardless of whether or not the corporate is designated as a wholesale corporate. They questioned both the appropriateness and the need to differentiate between the two.

Although the Board agrees with the commenters that risks inherent in corporate balance sheets are similar regardless of whether or not the corporate is a wholesale corporate, there is one area, RUDE ratio, where the Board believes a separate rule is necessary. Providing a lower minimum RUDE ratio for wholesale corporates recognizes their unique position in the two tier corporate system. Wholesale corporate credit union members provide one level of RUDE. The Board does not believe a second level of RUDE, at the same level as corporate members, is warranted for wholesale corporates. The lower RUDE ratio is also justified because wholesale corporates have a greater ability to raise other forms of capital, including from non-credit union sources, if needed. Accordingly, the Board is establishing a 1 percent minimum RUDE ratio requirement for wholesale corporates, as opposed to the 2 percent minimum RUDE ratio requirement for other corporates.

As explained below, in all other areas, the Board sees no basis for maintaining different regulatory requirements for wholesale corporates. Capital should be commensurate with the risks taken. The Board proposes eliminating the requirement that wholesale corporates must maintain a minimum capital ratio of 5 percent. 12 CFR 704.19(b)(1). The Board proposes requiring wholesale corporates to maintain the same 4 percent minimum capital ratio as other corporates.

As with other corporates, the Board is eliminating the reserve ratio and reserve transfer requirements for wholesale corporates. 12 CFR 704.19(b)(2).

The Board believes exposures associated with interest rate risk are the same regardless of the type of corporate. Therefore, the Board proposes eliminating separate regulatory requirements for the minimum base case NEV ratio and the maximum decline in NEV for wholesale corporates. The existing rule for wholesale corporates establishes .75 percent as the minimum base case NEV ratio and limits the decline in NEV to no more than 35 percent when conducting the interest rate sensitivity analysis in § 704.8(d)(1)(i). 12 CFR 704.19(c). For the reasons cited for other corporates, the Board proposes requiring the same minimum base case NEV ratio of 2 percent for wholesale corporates. The Board also proposes establishing the same rules limiting the maximum decline in NEV to no more than 10 percent or as approved under Appendix B of this part.

The Board proposes eliminating the requirement that wholesale corporates must obtain an annual third-party review of their asset and liability management modeling system. 12 CFR 704.19(c)(2). The issue of whether a third-party review is required should not be based upon whether the corporate is a wholesale corporate, but rather, review should be undertaken by all corporates periodically, in accordance with industry standards, or when changes are made to their modeling system. The Board believes § 704.4(c)(5) and (7) adequately address audits and reviews of systems and that asset and liability management system review is best left as a supervision issue.

Appendix A to Part 704—Model Forms

The Board proposes additional wording to the model disclosure forms for MC and PIC accounts. The purpose of the disclosure forms is to establish the minimum terms and conditions. The Board desires that corporates have flexibility in designing capital accounts that best suit their needs and the needs of their members. Additional disclosure may be required based on the specific characteristics of a corporate's capital accounts. As such, the form no longer states corporates that utilize the minimum standard wording will be in compliance with the regulation. Any additional material terms and conditions must be disclosed.

The additional wording in the proposal clarifies that funds in MC and PIC accounts are not automatically releasable due to the merger, charter conversion or liquidation of the natural person credit union member account holder. Further, in the event of the merger of the corporate, the MC and PIC accounts transfer to the continuing corporate. The sample disclosure forms have also been revised to require disclosure on whether MC is a term certificate or an adjusted balance account. In the case of an adjusted balance account, the adjustment period and adjustment measure must be disclosed. In the case of PIC, the disclosure must note if the account is either term or perpetual.

Appendix B to Part 704—Expanded Authorities and Requirements

Currently, Appendix B provides corporates with incrementally greater authorities if additional infrastructure and capital requirements are met. The Board proposes introducing a more flexible approach to expanded authorities. The proposed changes to this section: move all expanded authorities to Appendix B; expand permissible credit ratings on investments; provide more options for the use of expanded powers; and allow more corporates the opportunity to participate in risk reducing derivative activities.

In addition, the proposed rule establishes minimum standards for any corporate participating in expanded authorities. The minimum standards require monthly NEV modeling and an annual updating of the self-assessment plan. NEV modeling is currently required for all expanded authority parts and so, including this as a minimum requirement is not a substantive change. The addition of the requirement to update the self-assessment plan annually is being proposed to ensure corporates operating with expanded authorities maintain the systems, controls and policies in place on an ongoing basis. This requirement is being incorporated into Appendix B, since the annual review requirements currently in § 704.4(a) have been interpreted as not applying to the expanded authorities self-assessment plan.

As part of its overall change to expanded authorities, the Board proposes tying mandatory capital levels to NEV volatility. The more volatile the NEV measure during instantaneous, permanent, and parallel shocks of the Treasury yield curve, the greater the risk. Recognizing that all corporates do not operate at the same levels of risk, the Board is proposing to reduce mandatory capital levels if NEV volatility is maintained at lower levels. As volatility increases, additional capital levels will be required.

Several commenters suggested changing the expanded authorities provision of the rule to a menu-driven approach, rather than bundling several activities under one category. Often, the corporate only wants to engage in one activity but it must get approval for all the activities in a given category. The commenters advocated the menu approach would reduce burden on corporates and the NCUA. The Board agrees with the commenters and proposes a modified, menu-driven approach, as explained below.

The current NEV decline limit for a base-plus corporate is 25 percent of the base case NEV ratio. The current NEV decline limits for Part I and II corporates are 35 percent and 50 percent, respectively.

The Board proposes decreasing the NEV decline limit for a base-plus corporate to 15 percent, as illustrated in Table 2. The Board also proposes a menu-driven approach for NEV decline limits for corporates requesting Part I or Part II Expanded Authorities. A corporate seeking Part I approval could request one of two NEV decline limits: 15 percent; or 20 percent, provided the corporate maintains a minimum capital ratio of 5 percent. A corporate seeking Part II approval could request one of three NEV decline limits: 15 percent; 20 percent, provided the corporate maintains a minimum capital ratio of 5 percent; or 30 percent, provided the corporate maintains a minimum capital ratio of 6 percent.

TABLE 2.—PROPOSED NEV DECLINE LIMITS

Current level of expanded authorities	Current NEV decline limit	Proposed level of expanded authorities	Proposed minimum capital requirement	Proposed NEV decline limit
Base plus	25	Base plus	4	15
Part I	35	Part I NEV 15	4	15
		Part I NEV 20	5	20

TABLE 2.—PROPOSED NEV DECLINE LIMITS—Continued

Current level of expanded authorities	Current NEV decline limit	Proposed level of expanded authorities	Proposed minimum capital requirement	Proposed NEV decline limit
Part II	50	Part II NEV 15	4	15
		Part II NEV 20	5	20
		Part II NEV 30	6	30

The Board's analysis of the effect of the proposed NEV decline limits on corporates with expanded authorities is summarized in Table 3. Although the proposed permissible NEV declines are smaller for some corporates with expanded authorities, no corporate's reported NEV declines under adverse rate shocks would violate the proposed NEV decline limits.

TABLE 3.—ANALYSIS OF PROPOSED PERMISSIBLE NEV DECLINES FOR BASE-PLUS, PART I, AND PART II CORPORATE CREDIT UNIONS SIMPLE AVERAGES FOR THE QUARTERS ENDING JUNE 2000 THROUGH MARCH 2001

[Percent]

	NEV ratio	NEV decline limit	Permitted decline as % of FV of assets
Base plus:			
Current rule	4.23	25	1.06
Proposed rule	9.24	15	1.39
Part I:			
Current rule	3.62	35	1.27
Proposed rule	8.44	20	1.69
Part II:			
Current rule	3.53	50	1.76
Proposed rule	6.51	30	1.95

The Board proposes permitting any corporate currently approved for Part I or Part II Expanded Authorities to request to lower its NEV decline limit in conjunction with a request to lower its minimum capital requirement from 5 percent or 6 percent, respectively.

The Board proposes moving Base-Plus Expanded Authorities from § 704.8(e) to Appendix B to include all expanded authorities in Appendix B. As previously discussed, the NEV testing requirements are being moved to the Minimum Requirements section of the proposed rule. The remaining authority relating to maximum NEV decline remains under the applicable expanded authority. The current NEV decline limit for a Base-Plus corporate is 25 percent of the base case NEV ratio. In light of the proposed change to the definition of NEV, the Board proposes to decrease that limit to 15 percent.

As discussed above in § 704.6 Credit Risk Management analysis, the Board proposes to establish limits for the aggregate credit exposure to a single obligor at 50 percent of capital. This limit provides corporates with substantial flexibility in comparison to other depository institutions. The Board believes that this limit is the most credit exposure a corporate should prudently take in investment-grade quality investments. This 50 percent limit would apply to all corporates.

Proposed § 704.6(c)(2)(i) increases the 50 percent limit to 200 percent for base and base-plus corporates for repurchase and securities lending transactions. The Board proposes expanding this increase for Part I and II corporates. Due to the increased infrastructure requirements for Parts I and II corporates, the Board proposes establishing a 300 percent limit for Part I corporates, and a 400 percent limit for Part II corporates.

Currently, corporates with Part I authority may purchase long-term investments rated no lower than AA–. The Board proposes lowering the minimum rating requirement for a long-term investment (including asset-backed securities) to A–. Currently, corporates may purchase a short-term investment rated no lower than A–1. For Part I corporates, the Board proposes lowering the minimum rating requirement for a short-term investment (including asset-backed securities) to A–2, provided that the issuer has a long-term rating no lower than A–. The Board believes these changes in permissible ratings represent reasonable increases in risk given the additional infrastructure requirements of a Part I corporate.

The Board proposes deleting the authority for Part I corporates to enter into repurchase transactions where the collateral securities are rated no lower than A (or equivalent). This authority is no longer necessary because the Board proposes permitting Part I corporates to purchase long-term investments rated no lower than A– (or equivalent).

The current rule permits Part I and II corporates to engage in when issued trading, when accounted for on a trade date basis. The Board proposes amending this provision to also permit pair-off transactions, when accounted for on a trade date basis. Although not specifically stated, the current rule by its absence of a prohibition, impliedly permits trading securities. The Board proposes prohibiting trading securities for base and base-plus corporates. Due to the increased infrastructure requirements for Part I and II corporates, the Board proposes permitting them to engage in this activity but will require trade date accounting to ensure all transactions are reflected in the accounting records of the corporate. This requirement parallels the requirement in § 703.100(l).

In both Part I and II, the Board proposes clarifying that the aggregate loan limits apply to both revocable and irrevocable lines of credit. Currently, the rule only states ''irrevocable lines of credit.'' The Board proposes deleting the modifier ''irrevocable'' to clarify this.

Currently, corporates with Part II authority may purchase long-term investments rated no lower than A– (or equivalent). The Board proposes lowering the minimum rating requirement for a long-term investment (including asset-backed securities) to BBB (flat). Currently, corporates may purchase a short-term investment rated no lower than A–1 (or equivalent). For Part II corporates, the Board proposes lowering the minimum rating requirement for a short-term investment (including asset-backed securities) to A–2 (or equivalent), provided that the issuer has a long-term rating no lower than BBB (flat). The Board believes these changes in permissible ratings represent reasonable increases in risk given the additional infrastructure requirements of a Part II corporate.

Currently, corporates with Part II authority must establish limits for secured and unsecured loans as a percentage of their capital plus pledged shares. The Board proposes limiting unsecured loans to 100 percent of capital. This proposed unsecured loan limit is the same as the current and proposed limit for a Part I corporate. The Board does not believe it is appropriate for any corporate to risk more than 100 percent of its capital to any one member credit union on an unsecured basis.

The Board proposes a number of changes to Part III expanded authorities. The Board proposes relaxing the long-term investment rating from AA− (or equivalent) to AA− (or equivalent). This change represents only a minor increase in risk, and provides Part III corporates with additional investment alternatives.

Currently, Part III requires for foreign investments, that the foreign country be rated no lower than AA (or equivalent) for political and economic stability. The Board proposes replacing this requirement with a requirement for a long-term foreign currency (non-local currency) debt rating no lower than AA− (or equivalent). The long-term foreign currency rating is based on a broader analysis than that of the political and economic stability rating. The Board believes this is a more appropriate rating for US dollar denominated investments.

The Board proposes relaxing the bank issuer/guarantor rating from AA (or equivalent) to AA− (or equivalent). This change represents only a minor increase in risk, and provides Part III corporates with additional investment alternatives.

The current rule limits non-secured obligations of any single foreign issuer to 150 percent of RUDE and PIC. The Board proposes to limit all obligations of any single foreign issuer/guarantor to 50 percent of capital. The Board believes that the limits for foreign issuers/guarantors should be parallel to those of domestic obligors and based on capital rather than RUDE and PIC.

The current rule limits non-secured obligations of any single foreign country to 500 percent of RUDE and PIC. The Board proposes to limit all obligations of any single foreign country to 250 percent of capital. This change equates the existing limit based on RUDE and PIC to a limit using the new definition of capital. The Board notes that sovereign risk is present in foreign debt obligations, whether secured or unsecured.

The Board proposes restructuring Part IV expanded authorities to provide more flexibility for corporates to use the authorities to reduce risk. The current rule requires corporates to have either Part I or II expanded authorities to qualify for Part IV. The proposal removes this requirement. The Board believes that all corporates demonstrating and possessing the resources, knowledge, systems, and procedures necessary to measure, monitor, and control the risks associated with derivative transactions should be permitted to use these powers. As with all expanded authorities, a corporate in its application must detail the specific types of activities it may utilize. The Board believes that, used properly, derivative activities can reduce risk to the institution and its members. For this reason, the Board is proposing this change.

The current rule states that a corporate may use derivatives only for ''creating structured instruments and hedging its own balance sheet and the balance sheets of its members.'' 12 CFR part 704, Appendix B, Part IV. The proposed rule restates those requirements, but in slightly different terms, to clarify the Board's intent. The Board believes corporates should be allowed to use derivatives to manage their own balance sheets, which may at times add risk, but that the use of derivatives for their members is still limited to hedging their members' balance sheets, which should only reduce risk.

The current rule is silent as to counterparty rating for derivative transactions with foreign and domestic counterparties. The Board proposes adding language to Part IV to clarify its intent that the rating requirements for counterparties be comparable to the ratings for the corporate's other parallel permissible activities.

As discussed in the lending section, new Part V gives corporates the authority to enter into loan participations with their member natural person credit unions. The Board proposes limiting the maximum aggregate amount of participation loans with one member credit union to 25 percent of capital and the maximum aggregate amount of participation loans with all member credit unions to 100 percent of capital. A corporate is not required to have any other expanded authority to qualify for Part V.

The proposed requirements for Part V that will be included in the *Guidelines for Submission of Requests for Expanded Authority* will require a corporate to submit: (1) An economic viability assessment of the participation lending program; (2) Proposed staffing, revised organizational charts and positions descriptions, and the qualifications and experience of participating staff; (3) Discussion of the inherent risks associated with the proposed program and how the corporate will identify, measure, monitor, and control these risks; (4) Proposed participation lending policies and procedures addressing limits on the aggregate amount of credit limits for participation loans purchased from any one credit union, an aggregate limit of participation lending based on capital (with a maximum up to 100 percent of capital), due diligence (off- and on-site) reviews to be performed by the corporate or its authorized agent, and practices relating to loan underwriting, loan documentation, collateral performance, loan servicing, and loan loss reserving; (5) Plans for a periodic independent review of the corporate's participation loan program; and (6) Due diligence requirements the corporate will follow prior to engaging in the sale or transfer of participation loan pools to third parties including: accounting issues, risk management, and legal issues.

Request for Comment

The Board is interested in receiving comment on all of the issues raised in this proposal, as well as any other issues the commenters believe will assist the Board in issuing its final rule.

Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact any proposed regulation may have on a substantial number of small entities (those under $1 million in assets). The rule only applies to

corporates, all of which have assets well in excess of $1 million. The proposed amendments will not have a significant economic impact on a substantial number of small credit unions and, therefore, a regulatory flexibility analysis is not required.

Paperwork Reduction Act

NCUA has determined that the proposed regulation does not increase paperwork requirements under the Paperwork Reduction Act of 1995 and regulations of the Office of Management and Budget.

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order. The executive order states that: ''National action limiting the policymaking discretion of the states shall be taken only where there is constitutional and statutory authority for the action and the national activity is appropriate in light of the presence of a problem of national significance.'' The risk of loss to federally insured credit unions and the NCUSIF caused by actions of corporates are concerns of national scope. The proposed rule, if adopted, will help assure that proper safeguards are in place to ensure the safety and soundness of corporates.

The proposed rule, if adopted, applies to all corporates that accept funds from federally insured credit unions. NCUA believes that the protection of such credit unions, and ultimately the NCUSIF, warrants application of the proposed rule to all corporates, including nonfederally insured. The proposed rule does not impose additional costs or burdens on the states or affect the states' ability to discharge traditional state government functions. NCUA has determined that this proposal may have an occasional direct effect on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. However, the potential risk to the NCUSIF without the proposed changes justifies them.

The Treasury and General Government Appropriations Act, 1999—-Assessment of Federal Regulations and Policies on Families

The NCUA has determined that this proposed rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Pub. L. 105–277, 112 Stat. 2681 (1998).

Agency Regulatory Goal

NCUA's goal is to promulgate clear and understandable regulations that impose minimal regulatory burden. We request your comments on whether the proposed rule is understandable and minimally intrusive if implemented as proposed.

List of Subjects

12 CFR Part 703

Credit unions, Investments.

12 CFR Part 704

Credit unions, Reporting and record keeping requirements, Surety bonds.

By the National Credit Union Administration Board on September 13, 2001.

Becky Baker,

Secretary of the Board.

Accordingly, NCUA proposes to amend 12 CFR parts 703 and 704 as follows:

PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

1. The authority citation for part 703 will continue to read as follows:

Authority: 12 U.S.C. 1757(7), 1757(8), and 1757(15).

2. Amend § 703.100 paragraph (c) by revising the second and third sentences and adding a fourth sentence to read as follows:

§ 703.100 What investments and investment activities are permissible for me?

* * * * *

(c) * * * Your aggregate purchase of paid-in capital and membership capital in one corporate credit union is limited to two percent of your assets measured at the time of purchase. Your aggregate purchase of paid-in capital and membership capital in all corporate credit unions is limited to four percent of your assets measured at the time of purchase. Paid-in capital and membership capital are defined in part 704 of this chapter.

* * * * *

PART 704—CORPORATE CREDIT UNIONS

3. The authority citation for part 704 will continue to read as follows:

Authority: 12 U.S.C. 1762, 1766(a), 1781, and 1789.

4. Amend § 704.2 as follows:

a. Remove the definition of ''*commercial mortgage related security*'', ''*correspondent services*'', ''*market price*'', ''*member paid-in capital*'', ''*mortgage servicing*'', ''*net interest income*'', ''*non member paid-in capital*'', ''*non secured obligation*'', ''*prepayment model*'', ''*real estate mortgage investment conduit (REMIC)*'', ''*reserve ratio*'', and ''*trade association*'';

b. Revise the definitions of ''*collateralized mortgage obligation (CMO)*'', ''*fair value*'', ''*forward settlement*'', ''*membership capital*'', ''*mortgage related security*'', ''*paid-in capital*'', ''*regular-way settlement*'', ''*repurchase transaction*'', and ''*residual interest*'';

c. Amend the definitions of ''*asset-backed security*'' by revising the last sentence, and ''*net economic value (NEV)*'' by revising the second and third sentences; and

d. Add new definitions for ''*obligor*'', ''*quoted market price*'' and ''*RUDE ratio*''.

§ 704.2 Definitions.

* * * * *

Asset-backed security * * * This definition excludes mortgage related securities.

* * * * *

Collateralized mortgage obligation (CMO) means a multi-class mortgage related security.

* * * * *

Fair value means the amount at which an instrument could be exchanged in a current, arms-length transaction between willing parties, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value. If a quoted market price in an active market is not available, fair value may be estimated using a valuation technique that is reasonable and supportable, a quoted market price in an active market for a similar instrument, or a current appraised value. Examples of valuation techniques include the present value of estimated future cash flows, option-pricing models, and option-adjusted spread models. Valuation techniques should incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility.

* * * * *

Forward settlement of a transaction means settlement on a date later than regular-way settlement.

* * * * *

Membership capital means funds contributed by members that: are adjustable balance with a minimum withdrawal notice of 3 years or are term

certificates with a minimum term of 3 years; are available to cover losses that exceed reserves and undivided earnings and paid-in capital; are not insured by the NCUSIF or other deposit insurers; and cannot be used to pledge against borrowings.

Mortgage related security means a security as defined in Section 3(a)(41) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(41)), *e.g.,* a privately-issued security backed by mortgages secured by real estate upon which is located a dwelling, mixed residential and commercial structure, residential manufactured home, or commercial structure.

* * * * *

Net economic value (NEV) * * * All fair value calculations must include the value of forward settlements and embedded options. Membership capital not qualifying as capital and paid-in capital not qualifying as capital are treated as liabilities for purposes of this calculation. * * *

Obligor means the primary party obligated to repay an investment, *e.g.,* the issuer of a security, the taker of a deposit, or the borrower of funds in a Federal funds transaction. Obligor does not include an originator of receivables underlying an asset-backed security, the servicer of such receivables, or an insurer of an investment.

* * * * *

Paid-in capital means accounts or other interests of a corporate credit union that: have an initial maturity of at least 20 years; are available to cover losses that exceed reserves and undivided earnings; are not insured by the NCUSIF or other share or deposit insurers; and cannot be used to pledge against borrowings.

* * * * *

Quoted market price means a recent sales price or a price based on current bid and asked quotations.

Regular-way settlement means delivery of a security from a seller to a buyer within the time frame that the securities industry has established for immediate delivery of that type of security. For example, regular-way settlement of a Treasury security includes settlement on the trade date (''cash''), the business day following the trade date (''regular way''), and the second business day following the trade date (''skip day'').

Repurchase transaction means a transaction in which a corporate credit union agrees to purchase a security from a counterparty and to resell the same or any identical security to that counterparty at a specified future date and at a specified price.

* * * * *

Residual interest means the remainder cash flows from a CMO or ABS transaction after payments due bondholders and trust administrative expenses have been satisfied.

RUDE ratio means the corporate credit union's reserves and undivided earnings divided by its moving daily average net assets.

* * * * *

5. Amend § 704.3 as follows:

a. Redesignate paragraphs (d) through (g) as paragraphs (f) through (i) and paragraph (b) as paragraph (d);

b. Remove paragraph (c);

c. Add paragraphs (b), (c), and (e); and

d. Revise redesignated paragraphs (f) heading, (f)(1) introductory text, (f)(2) and (f)(3)(iii), (g), (h)(1), (h)(2) introductory text, (h)(2)(i) through (h)(2)(iii), (i)(1) and (i)(2)(i)(A).

§ 704.3 Corporate credit union capital.

* * * * *

(b) *Requirements for membership capital*—(1) *Form.* Membership capital funds may be in the form of a term certificate or an adjusted balance account.

(2) *Disclosure.* The terms and conditions of a membership capital account must be disclosed to the recorded owner of the account at the time the account is opened and at least annually thereafter.

(3) *Three-year remaining maturity.* When a membership capital account has been placed on notice or has a remaining maturity of three years, the amount of the account that can be considered membership capital is reduced by a constant monthly amortization that ensures membership capital is fully amortized one year before the date of maturity or the end of the notice period. The full balance of a membership capital account that is being amortized, not just the remaining non-amortized portion, is available to absorb losses in excess of the sum of reserves and undivided earnings and paid-in capital until the funds are released by the corporate credit union at the time of maturity or the conclusion of the notice period.

(4) *Release.* Membership capital may not be released due solely to the merger, charter conversion or liquidation of a member credit union. In the event of a merger, the membership capital transfers to the continuing credit union. In the event of a charter conversion, the membership capital transfers to the new institution. In the event of a liquidation, the membership capital may be released to facilitate the payout of shares with the prior written approval of NCUA.

(5) *Sale.* A member may sell its membership capital to a credit union in the corporate credit union's field of membership, subject to the corporate credit union's approval.

(6) *Liquidation.* In the event of liquidation of a corporate credit union, membership capital is payable only after satisfaction of all liabilities of the liquidation estate, including uninsured share obligations to shareholders and the National Credit Union Share Insurance Fund (NCUSIF), but excluding paid-in capital.

(7) *Merger.* In the event of a merger of a corporate credit union, membership capital shall transfer to the continuing corporate credit union. The three-year notice period for withdrawal of membership capital shall remain in effect.

(8) Adjusted balance accounts:

(i) May be adjusted no more frequently than once every six months; and

(ii) Must be adjusted in relation to a measure (*e.g.,* one percent of a member credit union's assets) established and disclosed at the time the account is opened without regard to any minimum withdrawal period. If the measure is other than assets, the corporate credit union must address the measure's permanency characteristics in the capital plan.

(iii) *Notice of Withdrawal.* Upon three years written notice of intent to withdraw membership capital, the balance of the account will be frozen (no further adjustments) until the conclusion of the notice period.

(c) *Requirements for Paid-in capital*—(1) *Disclosure.* The terms and conditions of any paid-in capital instrument must be disclosed to the recorded owner of the instrument at the time the instrument is created.

(2) *Three-year remaining maturity.* When a paid-in capital instrument has a remaining maturity of 3 years, the amount of the instrument that may be considered paid-in capital for this part is reduced by a constant monthly amortization that ensures the paid-in capital is fully amortized 1 year before the date of maturity. The full balance of a paid-in capital instrument that is being amortized, not just the remaining non-amortized portion, is available to absorb losses in excess of the sum of reserves and undivided earnings until the funds are released by the corporate credit union at maturity.

(3) *Release.* Paid-in capital may not be released due solely to the merger, charter conversion or liquidation of a member credit union. In the event of a merger, the paid-in capital transfers to the continuing credit union. In the event of a charter conversion, the paid-in capital transfers to the new institution.

In the event of a liquidation, the paid-in capital may be released to facilitate the payout of shares with the prior written approval of NCUA.

(4) *Callability.* Paid-in capital accounts are callable on a pro-rata basis across an issuance class only at the option of the corporate credit union and only if the corporate credit union meets its minimum level of required capital and NEV ratios after the funds are called.

(5) *Liquidation.* In the event of liquidation of the corporate credit union, paid-in capital is payable only after satisfaction of all liabilities of the liquidation estate, including uninsured share obligations to shareholders, the NCUSIF, and membership capital holders.

(6) *Merger.* In the event of a merger of a corporate credit union, paid-in capital shall transfer to the continuing corporate credit union.

(7) Paid-in capital includes both member and nonmember paid-in capital.

(i) Member paid-in capital means paid-in capital that is held by the corporate credit union's members. A corporate credit union may not condition membership, services, or prices for services on a credit union's ownership of paid-in capital.

(ii) Nonmember paid-in capital means paid-in capital that is not held by the corporate credit union's members. Nonmember paid-in capital does not require NCUA approval if all terms and conditions are identical to member paid-in capital. Nonmember paid-in capital with unlike terms and conditions requires NCUA approval. In determining whether or not to approve a nonmember paid-in capital instrument, NCUA will consider features such as maturity, capital amortization schedule, participation, voting, acceleration, redemption, or other rights of the holder. NCUA will also consider the purpose and financial impact of the proposed paid-in capital issuance and the corporate credit union's financial condition and management capabilities.

* * * * *

(e) *RUDE ratio.* A corporate credit union will maintain a minimum RUDE ratio of 2 percent. A corporate credit union must calculate its RUDE ratio monthly.

(f) *Individual capital ratio requirement.* (1) When significant circumstances or events warrant, NCUA may require a different minimum capital ratio for an individual corporate credit union based on its circumstances. Factors that may warrant a different minimum capital ratio include, but are not limited to, for example:

* * * * *

(2) When NCUA determines that a different minimum capital ratio is necessary or appropriate for a particular corporate credit union, NCUA will notify the corporate credit union in writing of the proposed capital ratio and, if applicable, the date by which the capital ratio should be reached. NCUA also will provide an explanation of why the proposed capital ratio is considered necessary or appropriate for the corporate credit union.

(3) * * *

(iii) After the close of the corporate credit union's response period, NCUA will decide, based on a review of the corporate credit union's response and other information concerning the corporate credit union, whether a different minimum capital ratio should be established for the corporate credit union and, if so, the capital ratio and the date the requirement will become effective. The corporate credit union will be notified of the decision in writing. The notice will include an explanation of the decision, except for a decision not to establish a different minimum capital ratio for the corporate credit union.

(g) *Failure to maintain minimum capital ratio, RUDE ratio requirement.* When either a corporate credit union's capital ratio or RUDE ratio falls below the minimum required by paragraphs (d), (e), or (f) of this section, or appendix B to this part, as applicable, operating management of the corporate credit union must notify its board of directors, supervisory committee, and NCUA within 10 calendar days.

(h) *Capital restoration plan.* (1) A corporate credit union must submit a plan to restore and maintain its capital ratio or its RUDE ratio at the minimum requirement if either of the following conditions exists:

(i) The capital ratio or RUDE ratio falls below the minimum requirement and is not restored to the minimum requirement by the next month end; or

(ii) Regardless of whether the capital ratio or RUDE ratio is restored by the next month end, the capital ratio or RUDE ratio falls below the minimum requirement for three months in any 12-month period.

(2) The capital restoration plan must include the following, at a minimum:

(i) Reasons why the capital ratio or RUDE ratio fell below the minimum requirement;

(ii) Descriptions of steps to be taken to restore the capital ratio or RUDE ratio to the minimum requirement within specific time frames;

(iii) Actions to be taken to maintain the capital ratio or RUDE ratio at the minimum required level and increase it thereafter;

* * * * *

(i) * * *

(1) If a corporate credit union fails to submit a capital restoration plan; or the plan submitted is not deemed adequate to either restore capital and/or RUDE or restore capital and/or RUDE within a reasonable time; or the credit union fails to implement its approved capital restoration plan, NCUA may issue a capital directive.

(2) * * *

(i) * * *

(A) Increase the amount of capital and/or RUDE to specific levels;

* * * * *

6. Amend § 704.4 by removing the word ''operating'' wherever it appears in paragraphs (a) and (b) and revising paragraph (c) introductory text to read as follows:

§ 704.4 Board responsibilities.

* * * * *

(c) *Other requirements.* The board of directors of a corporate credit union must ensure:

* * * * *

7. Amend § 704.5 as follows:

a. Revise paragraphs (a)(1) and (2), (c)(5), (d)(1), (e)(1), (3) and (4), (f), and (h)(2) and (3);

b. Remove paragraphs (c)(6), (d)(3) and (d)(6);

c. Redesignate paragraphs (d)(4) and (d)(5) as paragraphs (d)(3) and (d)(4); and

d. Revise redesignated paragraphs (d)(3) and (4).

§ 704.5 Investments.

(a) * * *

(1) Appropriate tests and criteria for evaluating investments and investment transactions prior to purchase; and

(2) Reasonable concentration limits for limited liquidity investments (*e.g.,* private placements and funding agreements).

* * * * *

(c) * * *

(5) Domestically-issued asset-backed securities.

(d) * * *

(1) The corporate credit union, directly or through its agent, receives written confirmation of the transaction, obtains a perfected first priority security interest in the repurchase securities and either takes physical possession or control of the repurchase securities or is recorded as owner of the repurchase securities through the Federal Reserve Book-Entry Securities Transfer System;

* * * * *

(3) The corporate credit union, directly or through its agent, receives daily assessment of the market value of the repurchase securities and maintains adequate margin that reflects a risk assessment of the repurchase securities and the term of the transaction; and

(4) The corporate credit union has entered into signed contracts with all approved counterparties and agents, and ensures compliance with the contracts.

* * * * *

(e) * * *

(1) The corporate credit union, directly or through its agent, receives written confirmation of the loan, obtains a perfected first priority security interest in the collateral and either takes physical possession or control of the collateral or is recorded as owner of the collateral through the Federal Reserve Book-Entry Securities Transfer System;

(2) * * *

(3) The corporate credit union, directly or through its agent, receives daily assessment of the market value of collateral and maintains adequate margin that reflects a risk assessment of the collateral and terms of the loan; and

(4) The corporate credit union has entered into signed contracts with all agents and, directly or through its agent, has executed a written loan and security agreement with the borrower. The corporate or its agent ensures compliance with the agreements.

(f) *Investment companies.* A corporate credit union may invest in an investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a), provided that the prospectus of the company restricts the investment portfolio to investments and investment transactions that are permissible for that corporate credit union.

* * * * *

(h) * * *

(2) Engaging in pair-off transactions or trading securities, including when-issued trading, adjusted trading, or short sales; and

(3) Purchasing stripped mortgage-backed securities, small business related securities, or residual interests in CMOs or asset-backed securities.

* * * * *

8. Amend § 704.6 by revising paragraphs (a) introductory text and paragraphs (a)(3), (a)(4), and (6) through (e) to read as follows:

§ 704.6 Credit risk management.

(a) *Policies.* A corporate credit union must operate according to a credit risk management policy that is commensurate with the investment risks and activities it undertakes. The policy must address at a minimum:

* * * * *

(3) Maximum credit limits with each obligor and transaction counterparty, set as a percentage of capital. In addition to addressing deposits and securities, limits with transaction counterparties must address aggregate exposures of all transactions, including, but not necessarily limited to, repurchase agreements, securities lending, and forward settlement of purchases or sales of investments; and

(4) Concentrations of credit risk (*e.g.*, originator of receivables, insurer, industry type, sector type, and geographic).

(b) *Exemption.* The requirements of this section do not apply to investments that are issued or fully guaranteed as to principal and interest by the U.S. government or its agencies or enterprises (excluding subordinated debt) or are fully insured (including accumulated interest) by the National Credit Union Share Insurance Fund or Federal Deposit Insurance Corporation.

(c) *Concentration limits*—(1) *General rule.* The aggregate of all investments in any single obligor is limited to 50 percent of capital or $5 million, whichever is greater.

(2) *Exceptions.* Exceptions to the general rule are:

(i) Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 200 percent of capital;

(ii) Investments in corporate CUSOs are subject to the limitations of § 704.11; and

(iii) Aggregate investments in corporate credit unions are not subject to the limitations of paragraph (c)(1) of this section.

(3) For purposes of measurement, each new credit transaction must be evaluated in terms of the corporate credit union's capital at the time of the transaction. A subsequent reduction in capital that results in noncompliance with this section will require compliance with § 704.10.

(d) *Credit ratings.* (1) All 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).

(2) At the time of purchase, long-term investments must be rated no lower than AA- (or equivalent) and short-term investments must be rated no lower than A–1 (or equivalent).

(3) Any rating(s) relied upon to meet the requirements of this part must be identified at the time of purchase and must be monitored for as long as the corporate owns the investment.

(4) Any rating relied upon to meet the requirements of this part at the time of purchase that is downgraded below the minimum rating requirements of this part must be reviewed by the board or an appropriate committee within 30 calendar days of the downgrade.

(5) Investments are subject to the requirements of § 704.10 if:

(i) One rating was relied upon to meet the requirements of this part and that rating is downgraded below the minimum rating requirements of this part; or

(ii) Two or more ratings were relied upon to meet the requirements of this part and at least two of those ratings are downgraded below the minimum rating requirements of this part.

(e) *Reporting and documentation.* (1) A written evaluation of each credit limit with each obligor or transaction counterparty must be prepared at least annually and formally approved by the board or an appropriate committee. At least monthly, the board or an appropriate committee must receive a watch list of existing and/or potential credit problems and summary credit exposure reports, which demonstrate compliance with the corporate credit union's risk management policies.

(2) At a minimum, the corporate credit union must maintain:

(i) A justification for each approved credit limit;

(ii) Disclosure documents, if any, for all instruments held in portfolio.

Documents for an instrument that has been sold must be retained until completion of the next NCUA examination; and

(iii) The latest available financial reports, industry analyses, internal and external analyst evaluations, and rating agency information sufficient to support each approved credit limit.

9. Amend § 704.7 by removing paragraphs (c) through (g), adding paragraphs (c) through (f) and redesignating paragraph (h) as paragraph (g) to read as follows:

§ 704.7 Lending.

* * * * *

(c) *Loans to members*—(1) *Credit unions.* (i) The maximum aggregate amount in unsecured loans and lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, must not exceed 50 percent of capital.

(ii) The maximum aggregate amount in secured loans and lines of credit to any one member credit union, excluding those secured by shares or marketable securities and member reverse

repurchase transactions, must not exceed 100 percent of capital.

(2) *Corporate CUSOs.* Any loan or line of credit must comply with § 704.11.

(3) *Other members.* The maximum aggregate amount of loans and lines of credit to any other members must not exceed 15 percent of the corporate credit union's capital plus pledged shares.

(d) *Loans to nonmembers*—(1) *Credit unions.* A loan to a nonmember credit union, other than through a loan participation with another corporate credit union, is only permissible if the loan is for an overdraft related to the providing of correspondent services pursuant to § 704.12. Generally, such a loan will have a maturity of one business day.

(2) *Corporate CUSOs.* Any loan or line of credit must comply with § 704.11.

(e) *Member business loan rule.* Loans or lines of credit to:

(1) Member credit unions are exempt from part 723 of this chapter;

(2) Corporate CUSOs must comply with § 704.11; and

(3) Other members must comply with part 723 of this chapter unless the loan or line of credit is fully guaranteed by a credit union or fully secured by US Treasury or agency securities. Those guaranteed and secured loans must comply with the aggregate limits of § 723.16 but are exempt from the other requirements of part 723.

(f) *Participation loans with other corporate credit unions.* A corporate credit union is permitted to participate in a loan with another corporate credit union provided the corporate retains an interest of at least 5 percent of the face amount of the loan and a master participation loan agreement is in place before the purchase or the sale of a participation. A participating corporate credit union must exercise the same due diligence as if it were the originating corporate credit union.

* * * * *

10. Amend § 704.8 as follows:

a. Remove paragraphs (a)(2), (a)(5) and (e);

b. Redesignate (a)(3) and (a)(4) as (a)(2) and (a)(3), (a)(6) and (a)(7) as (a)(4) and (a)(5), and (f) and (g) as (e) and (f);

c. Add paragraph (a)(6);

d. Revise redesignated paragraphs (a)(2), (e) and (f); and

e. Revise paragraphs (c), (d)(1)(i) through (iii) and (d)(2) introductory text.

§ 704.8 Asset and liability management.

(a) * * *

(2) The maximum allowable percentage decline in net economic value (NEV), compared to base case NEV;

* * * * *

(6) The tests that will be used, prior to purchase, to evaluate the impact of investments on the percentage decline in NEV, compared to base case NEV.

* * * * *

(c) *Penalty for early withdrawals.* A corporate credit union that permits early certificate/share withdrawals must assess a market-based penalty equal to the estimated replacement cost of the certificate/share redeemed. The market-based penalty must be reasonably related to current offering rates of that corporate credit union.

(d) * * *

(1) * * *

(i) Evaluate the risk in its balance sheet by measuring, at least quarterly, the impact of an instantaneous, permanent, and parallel shock in the Treasury yield curve of plus and minus 100, 200, and 300 basis points on its NEV, and NEV ratio. If the base case NEV ratio falls below 3 percent at the last testing date, these tests must be calculated at least monthly until the base case NEV ratio again exceeds 3 percent;

(ii) Limit its risk exposure to levels that do not result in a base case NEV ratio or any NEV ratio resulting from the tests set forth in paragraph (d)(1)(i) of this section below 2 percent; and

(iii) Limit its risk exposures to levels that do not result in a decline in NEV of more than 10 percent.

(2) A corporate credit union must assess annually if it should conduct periodic additional tests to address market factors that potentially can materially impact that corporate credit union's NEV. These factors should include, but are not limited to, the following:

* * * * *

(e) *Regulatory violations.* If a corporate credit union's decline in NEV, base case NEV ratio or any NEV ratio resulting from the tests set forth in paragraph (d)(1)(i) of this section violates the limits established by this rule and is not brought into compliance within 10 calendar days, operating management of the corporate credit union must immediately report the information to the board of directors, supervisory committee, and NCUA. If any violation persists for 30 calendar days, the corporate credit union must submit a detailed, written action plan to NCUA that sets forth the time needed and means by which it intends to correct the violation. If NCUA determines that the plan is unacceptable, the corporate credit union must immediately restructure the balance sheet to bring the exposures back within compliance or adhere to an alternative course of action determined by NCUA.

(f) *Policy violations.* If a corporate credit union's decline in NEV, base case NEV ratio, or any NEV ratio resulting from the tests set forth in paragraph (d)(1)(i) of this section violates the limits established by its board, it must determine how it will bring the exposure within policy limits. The disclosure to the board of the violation must occur no later than its next regularly scheduled board meeting.

11. Amend § 704.11 by revising paragraph (b), redesignating paragraphs (c) through (e) as paragraphs (f) through (h) and adding paragraphs (c), (d) and (e) to read as follows:

§ 704.11 Corporate Credit Union Service Organizations (Corporate CUSOs).

* * * * *

(b) *Investment and loan limitations.* (1) The aggregate of all investments in and loans to member and nonmember corporate CUSOs must not exceed 15 percent of a corporate credit union's capital. A corporate credit union may loan to member and nonmember corporate CUSOs an additional 15 percent of capital if the loan is collateralized by assets in which the corporate has a perfected security interest under state law.

(2) If the limitations in paragraph (b)(1) of this section are reached or exceeded because of the profitability of the CUSO and the related GAAP valuation of the investment under the equity method without an additional cash outlay by the corporate, divestiture is not required. A corporate credit union may continue to invest up to the regulatory limit without regard to the increase in the GAAP valuation resulting from the corporate CUSO's profitability.

(3) The aggregate of all loans to corporate CUSOs must comply with the aggregate limits of § 723.16 of this chapter.

(c) *Due diligence.* A corporate credit union must comply with the due diligence requirements of §§ 723.5 and 723.6(f) through (l) of this chapter for all loans to corporate CUSOs. This requirement does not apply to loans fully secured by shares in the corporate credit union making the extension of credit or in other financial institutions.

(d) *Separate entity.* (1) A corporate CUSO must be operated as an entity separate from a corporate credit union.

(2) The corporate credit union investing in or lending to a corporate CUSO must obtain a written legal

opinion that the corporate CUSO is organized and operated in a manner that the corporate credit union will not reasonably be held liable for the obligations of the corporate CUSO. This opinion must address factors that have led courts to ''pierce the corporate veil'' such as inadequate capitalization, lack of corporate identity, common boards of directors and employees, control of one entity over another, and lack of separate books and records.

(e) *Prohibited activities.* A corporate credit union may not use this authority to acquire control, directly or indirectly, of another financial institution, or to invest in shares, stocks, or obligations of another financial institution, insurance company, trade association, liquidity facility, or similar organization.

* * * * *

12. Revise § 704.12 to read as follows:

§ 704.12 Permissible services.

(a) A corporate credit union may provide the following financial services to its members: credit and investment services; liquidity and asset and liability management; payment systems; electronic financial services; sale or lease of excess physical or information system capacity; and operational services associated with administering or providing financial products or services.

(b) A corporate credit union may only provide financial services to nonmembers through a correspondent services agreement. A correspondent services agreement is an agreement between two corporate credit unions, whereby one of the corporate credit unions agrees to provide services to a member of the other corporate credit union.

(c) A corporate credit union is prohibited from purchasing loan servicing rights.

§ 704.13 [Removed and Reserved]

13. Remove and reserve § 703.13.

14. Amend § 704.14 by revising paragraph (a) introductory text, redesignating paragraphs (b) through (d) as (c) through (e), and adding a new paragraph (b) to read as follows:

§ 704.14 Representation.

(a) *Board representation.* The board will be determined as stipulated in its bylaws governing election procedures, provided that:

* * * * *

(b) *Credit union trade association.* As used in this section, it includes but is not limited to, state credit union leagues and league service corporations, national credit union trade associations and their affiliates and service organizations, and local, state, and national special interest credit union associations and organizations.

* * * * *

15. Amend § 704.19 by revising paragraph (b) and removing paragraph (c) as follows:

§ 704.19 Wholesale corporate credit unions.

* * * * *

(b) *Capital.* A wholesale corporate credit union will maintain a minimum RUDE ratio of 1 percent.

16. Revise appendix A to part 704 as follows:

Appendix A to Part 704—Model Forms

This appendix contains sample forms intended for use by corporate credit unions to aid in compliance with the membership capital account and paid-in capital disclosure requirements of § 704.2.

SAMPLE FORM 1

Terms and Conditions of Membership Capital Account

(1) A membership capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A membership capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the membership capital account transfers to the continuing credit union. In the event of a charter conversion, the membership capital account transfers to the new institution. In the event of liquidation, the membership capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) A member credit union may withdraw membership capital with three years' notice.

(4) Membership capital cannot be used to pledge borrowings.

(5) Membership capital is available to cover losses that exceed reserves and undivided earnings and paid-in capital.

(6) Where the corporate credit union is liquidated, membership capital accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF.

(7) Where the corporate credit union is merged into another corporate credit union the membership capital account shall transfer to the continuing corporate credit union. The three-year notice period for withdrawal of the membership capital account will remain in effect.

(8) {**If an adjusted balance account**}**:** The membership capital balance will be adjusted __(1 or 2)__ time(s) annually in relation to the member credit union's ____(assets or other measure)____ as of __(date(s))____. {**If a term certificate**}**:** The membership capital account is a term certificate that will mature on __(date)__.

When an account is opened, the notice must also contain the following statement:

I have read the above terms and conditions and I understand them.

I further agree to maintain in the credit union's files the annual notice of terms and conditions of the membership capital account.

The notice form must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

The annual disclosure notice form must be signed by the chair of the corporate credit union. The chair must then sign a statement that certifies that the notice has been sent to member credit unions with membership capital accounts. The certification must be maintained in the corporate credit union's files and be available for examiner review.

SAMPLE FORM 2

Terms and Conditions of Paid-In Capital

(1) A paid-in capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A paid-in capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the paid-in capital account transfers to the continuing credit union. In the event of a charter conversion, the paid-in capital account transfers to the new institution. In the event of liquidation, the paid-in capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) The funds are callable only at the option of the corporate credit union and only if the corporate credit union meets its minimum required capital and NEV ratios after the funds are called.

(4) Paid-in capital cannot be used to pledge borrowings.

(5) Paid-in capital is available to cover losses that exceed reserves and undivided earnings.

(6) Where the corporate credit union is liquidated, paid-in capital accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, and membership capital holders.

(7) Where the corporate credit union is merged into another corporate credit union the paid-in capital account shall transfer to the continuing corporate credit union.

(8) Paid-in capital is perpetual maturity {**or**} Paid-in capital is a term account with a maturity of ____(at least 20)____ years.

When a paid-in capital instrument is created, the notice must also contain the following statement:

I have read the above terms and conditions and I understand them.

I further agree to maintain in the credit union's files the annual notice of terms and conditions of the paid-in capital instrument.

The notice form must be signed by either all of the directors of the credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

The annual disclosure notice form must be signed by the chair of the corporate credit union. The chair must then sign a statement that certifies that the form has been sent to credit unions with paid-in capital accounts. The certification must be maintained in the corporate credit union's files and be available for examiner review.

17. Revise appendix B to part 704 as follows:

Appendix B to Part 704—Expanded Authorities and Requirements

A corporate credit union may obtain all or part of the expanded authorities contained in this section if it meets all of the requirements of this part 704, fulfills additional management, infrastructure, and asset and liability requirements, and receives NCUA's written approval. The additional requirements and authorities are set forth in this Appendix and in the NCUA publication *Guidelines for Submission of Requests for Expanded Authority.*

A corporate credit union seeking expanded authorities must submit to NCUA a self-assessment plan supporting its request. A corporate credit union may adopt expanded authorities when NCUA has provided final approval. If NCUA denies a request for expanded authorities, it will advise the corporate of the reasons for the denial and what it must do to resubmit its request. NCUA may revoke these expanded authorities at any time if an analysis indicates a significant deficiency. NCUA will notify the corporate credit union in writing of the identified deficiency. A corporate credit union may request, in writing, reinstatement of the revoked authorities by providing a self-assessment plan detailing how it has corrected the deficiencies.

Minimum Requirements

In order to participate in any of the authorities set forth in Base-Plus, Part I, Part II, Part III, Part IV, and Part V of this Appendix, a corporate credit union must:

(a) Evaluate monthly the changes in NEV and the NEV ratio for the tests set forth in § 704.8(d)(1)(i); and

(b) Update its self-assessment plan for approved expanded authorities annually.

Base-plus

A corporate which has met the minimum requirements for this Base-plus may in performing the rate stress tests set forth in § 704.8(d)(1)(i), allow its NEV to decline as much as 15 percent.

Part I

(a) A corporate credit union which has met the minimum requirements for this Part I may:

(1) Purchase long-term investments rated no lower than A– (or equivalent);

(2) Purchase short-term investments rated no lower than A–2 (or equivalent), provided that the issuer has a long-term rating no lower than A– (or equivalent);

(3) Engage in short sales of permissible investments to reduce interest rate risk;

(4) Purchase principal only (PO) stripped mortgage-backed securities to reduce interest rate risk;

(5) Enter into a dollar roll transaction; and

(6) Engage in trading securities including pair-off transactions and when-issued trading, when accounted for on a trade date basis.

(b) Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 300 percent of capital.

(c) In performing the rate stress tests set forth in § 704.8(d)(1)(i), the NEV of a corporate credit union which has met the requirements of this Part I may decline as much as:

(1) 15 percent; or

(2) 20 percent if the corporate credit union has a 5 percent minimum capital ratio and is specifically approved by NCUA.

(d) The maximum aggregate amount in unsecured loans and lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, must not exceed 100 percent of the corporate credit union's capital. The board of directors will establish the limit, as a percent of the corporate credit union's capital plus pledged shares, for secured loans and lines of credit.

Part II

(a) A corporate credit union, which has met the minimum requirements for this Part II, may:

(1) Purchase long-term investments rated no lower than BBB (flat) (or equivalent);

(2) Purchase short-term investments rated no lower than A–2 (or equivalent), provided that the issuer has a long-term rating no lower than BBB (flat) (or equivalent);

(3) Engage in short sales of permissible investments to reduce interest rate risk;

(4) Purchase principal only (PO) stripped mortgage-backed securities to reduce interest rate risk;

(5) Enter into a dollar roll transaction; and

(6) Engage in trading securities including pair-off transactions and when-issued trading, when accounted for on a trade date basis.

(b) Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 400 percent of capital.

(c) In performing the rate stress tests set forth in § 704.8(d)(1)(i), the NEV of a corporate credit union, which has met the requirements of this Part II, may decline as much as:

(1) 15 percent;

(2) 20 percent if the corporate credit union has a 5 percent minimum capital ratio and is specifically approved by NCUA; and

(3) 30 percent if the corporate credit union has a 6 percent minimum capital ratio and is specifically approved by NCUA.

(d) The maximum aggregate amount in unsecured loans and lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, must not exceed 100 percent of the corporate credit union's capital. The board of directors must establish the limit, as a percent of the corporate credit union's capital plus pledged shares, for secured loans and lines of credit.

Part III

(a) A corporate credit union, which has met the minimum requirements of either Part I or Part II of this Appendix and the additional requirements for Part III, may invest in:

(1) Debt obligations of a foreign country; and

(2) Deposits in, the sale of federal funds to, and debt obligations of foreign banks or obligations guaranteed by these banks.

(b) All foreign investments are subject to the following requirements:

(1) Short-term investments must be rated no lower than A–1 (or equivalent);

(2) Long-term investments must be rated no lower than AA– (or equivalent);

(3) A sovereign issuer, and/or the country in which a bank issuer/guarantor is organized, must have a long-term foreign currency (non-local currency) debt rating no lower than AA– (or equivalent);

(4) A bank issuer/guarantor must be rated no lower than AA–;

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

(6) Obligations of any single foreign issuer/guarantor may not exceed 50 percent of capital; and

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

Part IV

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

(1) Create structured products;

(2) Manage its own balance sheet; and

(3) Hedge the balance sheet of its credit union members.

(b) All derivative transactions are subject to the following requirements:

(1) If the counterparty is domestic, the counterparty rating can be no lower than the minimum rating for comparable term permissible investments.

(2) If the counterparty is foreign, the counterparty rating can be no lower than the minimum rating for comparable term permissible investments under Part III Authority.

Part V

A corporate credit union, which has met the requirements for this Part V, may participate in loans with member natural person credit unions as approved by NCUA and subject to the following limitations:

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

(b) The maximum aggregate amount of participation loans with all member credit unions shall not exceed 100 percent of capital.

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