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# Part II

# National Credit Union Administration

## 12 CFR Parts 703 and 704
## Investment and Deposit Activities; Corporate Credit Unions; Final Rule

**NATIONAL CREDIT UNION ADMINISTRATION**

**12 CFR Parts 703 and 704**

## Investment and Deposit Activities; Corporate Credit Unions

**AGENCY:** National Credit Union Administration (NCUA).

**ACTION:** Final rule.

**SUMMARY:** NCUA is issuing final revisions to the rule governing corporate credit unions (corporates). The major revisions to the rule are in the areas of capital, credit concentration limits and services. The amendments enable corporates to remain competitive in the marketplace while retaining NCUA's historic focus on the safety and soundness of the corporate credit union system. The major changes to these 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:** This rule is effective November 25, 2002, except that the revision of the definition ''paid-in capital'' in §704.2 is effective July 1, 2003. Compliance with this rule is not required until January 1, 2003.

**FOR FURTHER INFORMATION CONTACT:** Kent Buckham, Director, Office of Corporate Credit Unions, 1775 Duke Street, Alexandria, Virginia 22314–3428 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, and November 22, 2000, NCUA issued advance notices of proposed rulemaking (ANPRs). 64 FR 40787, July 28, 1999; 65 FR 70319, November 22, 2000. Based on the comments received in response to the ANPRs, the Board issued a proposed rule. 66 FR 48742, September 21, 2001. In response to the comments received, particularly in the area of capital, the Board issued a revised proposed rule for another round of public comment. 67 FR 44270, July 1, 2002. The Board received 37 comments on the revised proposal: 22 from corporate credit unions, six from natural person credit unions, four from credit union trade associations, two from bank trade associations, two from state credit union leagues and one from a research firm. The commenters appreciated the Board's willingness to issue a revised proposal. The comments to the revised proposed rule have greatly assisted the Board in drafting the final rule and will be discussed in the relevant section of the section-by-section analysis.

### B. Section-by-Section Analysis

*Natural Person Credit Union Investments, Section 703.100*

As in the initial proposed rule, the Board retained an increase in the limit on a natural person credit union's aggregate purchase of paid-in capital (PIC) and membership capital (MC) in one corporate to 2 percent of the credit union's assets measured at the time of purchase. Additionally, the Board retained the limit on a credit union's aggregate purchase of PIC and MC in all corporates of 4 percent.

Two commenters, both bank trade groups, noted continued opposition to the proposed increase. The commenters argued that it increases exposure to individual credit unions and raises the overall systemic risk. One commenter expressed support for the proposal but indicated the limit should be based on the natural person credit union's net worth rather than on its assets.

The Board remains convinced the revised limits on natural person credit union investments in PIC and MC in an individual corporate and in the aggregate are in the best interest of the credit union system. These changes have been retained in the final rule.

*Definitions, Section 704.2*

Daily Average Net Assets (DANA)

Although not specifically addressed in the rule, nineteen commenters continued to oppose the guidance on DANA issued by the Office of Corporate Credit Union (OCCU) in 2000 that was discussed in the preamble. Corporate Credit Union Guidance Letter No. 2000–03, August 30, 2000. The letter addressed the inclusion of future dated ACH items and uncollected cash letters that are perfectly matched on both the asset and liability sides of the balance sheet in the definition of DANA. As noted in the revised proposal, the issue is whether such transactions should be recorded on their settlement date (the date the funds are posted) or on the advice date (the date the corporate receives an advice indicating the funds will posted on a specific future date). 67 FR at 4270. All of the commenters on this issue noted their preference for recording these transactions on the settlement date.

The commenters stated that, while the American Institute of Certified Public Accountants (AICPA) has not taken an official position on this specific issue, there exists professional accounting guidance supporting exclusion of future dated ACH transactions from the definition of DANA. For example, the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concept's No. 6—Elements of Financial Statements defines liabilities as ''probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entitles as a result of past transactions or events.'' FASB No. 6 goes on to state that an item is not a liability ''if the item involves a future sacrifice of assets that the entity will be obligated to make, but the events or circumstances that obligate the entity have not yet occurred.'' A number of commenters indicated they are under no legal obligation to pay the transactions on the advice date. Several commenters also noted that some corporates have received opinions from their CPA firms indicating accounting for such transactions as of the advice date is not in accordance with Generally Accepted Accounting Principles (GAAP).

The Board believes it is important to have consistency among corporates, as well with the other financial regulators. To ensure NCUA's position on this issue is consistent with that taken by the other financial regulators, NCUA staff contacted the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Office of Thrift Supervision and the Federal Reserve Board. All of these financial regulators require their financial institutions to report future dated ACH transactions on their call reports as of the advice date. None of the financial regulators exclude future dated ACH transactions from their regulatory ratio calculations. As such, NCUA's position is consistent with the other financial regulators.

The Board remains convinced that a corporate should report future dated ACH items and uncollected cash letters on the advice date for both regulatory and 5310 (Corporate Credit Union Call Report) reporting purposes. For other financial statement reporting, corporates should follow their CPA firm's guidance.

*Capital, Section 704.3*

One commenter indicated the Board should not set a regulatory standard for each type of capital account, including retained earnings. The commenter suggests each corporate set its own limits for each type of capital it wants to hold. NCUA should just set a minimum overall capital level. Several commenters indicated that PIC should be counted equally with regular reserves and undivided earnings (RUDE) in all areas of the regulation.

One commenter recommended limiting the aggregate amount of MC and PIC that can be used to satisfy the total capital requirement to 100 percent of RUDE. One commenter indicated that the amount of MC that can be counted as ''core capital'' should be limited to 50 percent of retained earnings and PIC.

The Board is not persuaded to revise the treatment of the various capital accounts. The Board believes there is a very important distinction between internally generated capital, retained earnings, and other types of capital accounts. The Board continues to believe an adequate level of internally generated capital is essential to avoid erosion of member confidence in the event losses occur. The final regulation provides an adequate capital structure and appropriate types of capital accounts for corporates.

*Requirements for Membership Capital, Section, 704.3(b)*

The Board addresses the comments to this provision in conjunction with its discussion of the comments on Appendix A, Model Forms.

*Requirements for Paid-in Capital, Section, 704.3(c)*

One commenter suggested removing the prohibition conditioning membership, services, or prices for services on a credit union's ownership of PIC. The commenter indicated that PIC is no longer considered a temporary measure to strengthen capital, and the same restriction is not placed on MC. The Board continues to believe it is in the best interest of natural person credit unions and their members to be able to obtain the most efficient and cost effective services available. The Board does not want, in effect, to force natural person credit unions to commit to a long-term PIC account as a means of obtaining service or membership. PIC was intended to be an additional means for corporates to strengthen their levels of capital. The Board believes a natural person credit union's decision to invest in PIC should be based on its commitment to the corporate, not a requirement to obtain services. Forcing natural person credit unions to obtain PIC as a condition of membership may have the unintended consequence of having them seek products and services outside the system.

Fifteen commenters requested a ''grandfathering'' period ranging from 12 to 24 months on the implementation of the revised definition of PIC. While supportive of the change making PIC a perpetual, non-cumulative dividend account, the commenters believe that immediate adoption of the definition might give a competitive advantage to those corporates that issued PIC under the existing regulatory definition. Several commenters noted that some corporates held off issuing PIC to see what the regulatory changes were before dedicating the time and expense to that endeavor.

The Board views the issuance of PIC as a business decision for corporates. In response to the comments, the Board will permit corporates to issue PIC under the current definition of PIC until June 30, 2003. The effective date of the revised definition of PIC is delayed until July 1, 2003.

*Earnings Retention Requirement, Section, 704.3(i)*

Based on comments to the proposed rule, the Board in the revised proposal eliminated the requirement that established a minimum RUDE to moving DANA ratio of 2 percent. Three commenters opposed this action and requested the minimum RUDE ratio be reinstated.

In place of a minimum RUDE ratio, the Board proposed an earnings retention requirement. Five commenters indicated they supported the intent of the earnings retention requirement, but not the proposal in full. Seven commenters opposed the earnings retention requirement.

A number of commenters suggested the process for calculating the earnings retention ratio is virtually impossible because dividends are paid throughout the month on various accounts. Due to the timing of when financial statements are prepared, losses or expenses may not be fully appreciated until after dividends have already been paid. A corporate might pay dividends without realizing it had gone below the 2 percent level.

Four commenters indicated that PIC should be included with retained earnings in the earnings retention calculation. Another commenter suggested excluding the gains/losses on the sale of fixed assets and other non-operating gains/losses from the earnings retention calculation. One commenter suggested calculating the earnings retention requirement only on a quarterly basis, and another commenter suggested calculating on a year-to-year rather than month-to-month basis. One commenter believed that a total capital ratio alone would be sufficient for monitoring capital in corporate credit unions. Another commenter suggested that capital requirements for each corporate be based on the risk in that specific institution.

Twenty-seven commenters objected to the dividend restrictions in § 704.3(i)(5). Numerous commenters expressed concern that the dividend restrictions might give their competitors an advantage over credit union deposits. Many also expressed concern that natural person credit unions would seek riskier investments if they believed the corporate may be unable to pay dividends. This could result in a negative impact on the entire credit union system. Several commenters also noted that smaller natural person credit unions would be the most severely affected as they rely heavily on the dividends they earn from their deposits in corporates. Two commenters recommended that a corporate that falls below 2 percent be allowed to pay dividends, but be required to submit an earnings retention plan. Two other commenters objected to the dividend restrictions for state-chartered corporates because it moves control over undivided earnings out of the hands of the corporates and the state regulators and into the hands of the federal deposit insurer. One commenter noted that, even if NCUA were flexible in its approach to approving dividend payments, the perception of increased risk would have inflicted damage to the credit union network. Several commenters indicated that NCUA already has adequate regulatory and supervisory tools to ensure corporates build and maintain an appropriate level of capital.

Ten commenters recommended the adoption of a credit-risk weighted capital requirement as the best means of measuring capital in corporate credit unions.

The Board continues to believe that an earnings retention requirement is the appropriate means of ensuring adequate retained earnings on an ongoing basis. As noted in the preamble of the revised proposed rule, the Board is concerned that a minimum RUDE ratio may have the unintended consequence of limiting the traditional role of corporates as depositors of excess liquidity for natural person credit unions. The Board also believes, as stated numerous times in the past, that a credit-risk weighted capital requirement is not the best measure of risk in corporates. 67 FR at 44273.

The Board agrees failure to pay dividends would have a dramatic impact on a corporate, its members, and, potentially, the entire credit union system. The intent of proposed § 704.3(i)(5) was to ensure cooperative action between the corporate and NCUA and, if applicable, the state regulator in building retained earnings that have fallen below the minimum desired level. Therefore, the Board is persuaded that

§ 704.3(i)(5) should be revised to address the commenters' concerns while retaining the original intent of the proposed regulation. Any restriction on the payment of dividends has been eliminated from the final rule.

The final rule requires operational management of corporates to notify the board of directors, supervisory committee, OCCU Director and, if applicable, the state regulator if the retained earnings ratio falls below 2 percent. Notification of the occurrence is sufficient if the decrease in the retained earnings ratio is due solely to the increase in moving DANA and the dollar amount of retained earnings has remained constant or increased. This places no additional burden on a corporate that has an influx of funds due to excess liquidity in natural person credit unions.

If a corporate's retained earnings ratio declines below 2 percent due, in full or in part, to a decline in the dollar amount of retained earnings and the retained earnings ratio is not restored to at least 2 percent by the next month end, the corporate will be required to submit a retained earnings action plan.

The Board believes NCUA has sufficient supervisory authority over corporates, coupled with the notification and the retained earnings action plan requirements, to work with officials to address a decline in the retained earnings ratio below 2 percent in a timely and effective manner.

The Board is satisfied that the existing retained earnings ratio calculation method is sufficient. The timing of the notification within 10 calendar days is based on the date the determination is made that the retained earnings ratio has fallen below 2 percent. If necessary, the timing of the submission of a retained earnings action plan within 30 calendar days is based on the next month end after the month in which the retained earnings ratio has fallen below 2 percent. In some cases, the determination may be made during the month, while in other cases the determination may not be made until after the books are closed at the end of the month.

*Board Responsibilities, Section 704.4*

The revised proposed rule changed the term ''operating policies'' to ''policies'' throughout this section and changed the title of subsection (c) to ''Other requirements.'' The commenters supported this change and it has been retained as proposed.

*Investments, Section 704.5*

The revised proposed rule deleted several investment related definitions no longer used in the regulation and amended the definitions of: Asset-backed security (ABS), Collateralized mortgage obligation (CMO), Forward settlement, Quoted market price, Mortgage related security, Regular-way settlement, Repurchase transaction, and Residual interest. One commenter suggested including the acronym ''ABS'' in the title for asset-backed security. The Board agrees, and the final rule includes the acronym. No commenters objected to the other provisions, and they have been deleted or amended as proposed.

Two commenters expressed concern about possible erroneous categorizations of home equity backed securities on the 5310 Call Report in light of the revised definitions of mortgage related security and asset-backed security. If there is any uncertainty about appropriate reporting, a corporate is encouraged to discuss the matter with its corporate examiner.

One commenter suggested deleting the definitions of: Credit enhancement; Dealer bid indication; Industry recognized information provider; Matched; and Small business related security, if they are no longer used in the regulation. The Board agrees and is deleting the first four terms since they are no longer used but is retaining the definition of ''small business related security'' since that term is used in § 704.5(h)(4).

*Policies, Section 704.5(a)*

The revised proposed rule combined the policy requirements in this section and deleted ''if any'' from § 704.5(a)(1) to clarify a corporate must have ''appropriate tests and criteria'' to evaluate investments it makes on an ongoing basis, as well as new investments. No comments were received on these provisions, and they have been retained as proposed.

The revised proposed rule deleted the requirement in § 704.5(a)(2) that the investment policy address the marketing of liabilities to its members. No comments were received on this provision, and it is deleted in the final rule.

The revised proposed rule added a requirement for a corporate to establish appropriate aggregate limits on limited liquidity investments. As with the initial proposed rule, the revised proposed rule defined ''limited liquidity investment'' to mean an investment without a quoted market price. The preamble specified ''limited liquidity investment'' means ''a private placement or funding agreement.'' 67 FR at 44274, 44285.

One commenter did not object to the proposed definition and supported the proposed requirements for limited liquidity investments. Another commenter was concerned with the proposed definition. The commenter noted using the term ''quoted market price'' in the definition was problematic, since sales prices on most ABS and MBS are not publicly available and dealers do not post bid and asked quotes. The Board agrees and has revised the definition in the final rule so that it is consistent with the revised proposed preamble. The final rule limits ''limited liquidity investments'' to private placements and funding agreements. The requirements for limited liquidity investments are retained as proposed.

*Authorized Activities, Section 704.5(c)(5).* The revised proposed rule clarified an ABS must be domestically issued. No comments were received on this provision, and it is retained as proposed.

*Section 704.5(c)(6).* The revised proposed rule deleted this section, which provided specific authorization for CMOs. These investments are still authorized under § 704.5(c)(1) and (5). No comments were received on this provision, and it is deleted in the final rule.

*Repurchase agreements, Section 704.5(d).* The revised proposed rule made several changes to the requirements for repurchase agreements to conform them to current market practices. No comments were received on this provision, and it is retained as proposed.

*Securities lending, Section 704.5(e).* The revised proposed rule made several nonsubstantive changes to the requirements for securities lending transactions to clarify the rule and conform it more closely to current market practices. No comments were received on this provision, and it is retained as proposed.

*Investment companies, Section 704.5(f).* Section 704.5(f) of the revised proposed rule allows a corporate to invest in an investment company, for example, a mutual fund ''provided that the prospectus of the company restricts the investment portfolio to investments and investment transactions that are permissible for that corporate credit union.'' One commenter stated that the prospectus of an investment company does not restrict the investment portfolio of an investment company, and suggested that the quoted language be changed to read ''provided that all investments and investment transactions, as described in the prospectus of the company, are permissible for that corporate credit union.'' The Board appreciates the issue

the commenter raises but does not believe a change is necessary.

A mutual fund must file a registration statement with the Securities and Exchange Commission (SEC) on Form N–1A. The prospectus is Part A of Form N–1A. According to the SEC's instructions for completing Part A, the prospectus will ''describe the Fund's principal investment strategies, including the particular type or types of securities in which the Fund principally invests or will invest.'' SEC Final Rule, Registration Form Used by Open-End Management Companies (Item 4), 63 FR 13916, 13951, March 23, 1998.

To the extent that a prospectus for a particular mutual fund only discloses the securities it ''principally'' invests in, the fund might hold other investments that are impermissible for the corporate credit union. This is unacceptable. A corporate may not own investments indirectly through a mutual fund that it is prohibited from owning directly.

While the SEC's instructions on completing a prospectus do not require the prospectus disclose all permissible investment types, the instructions do not prohibit such disclosure either. Where the prospectus' description of investment types includes only investments permissible for corporates, and that it will not hold investments other than those described, the mutual fund will be permissible for the corporate.

The Board also notes that Part B of the registration statement, the Statement of Additional Information (SAI), provides additional information about the mutual fund's investment policies and permissible investment types. For example, the SAI will ''[d]escribe any investment strategies, *including a strategy to invest in a particular type of security,* used by an investment adviser of the [mutual] fund in managing the fund that are *not* principal strategies * * *.'' Final Rule, Registration Form Used by Open-End Management Companies (Item 12(b)), 63 FR 13916, 13956, March 23, 1998, (emphasis added). In addition, the SAI will ''[d]isclose, if applicable, the types of investments that a Fund may make while assuming [a temporary defensive position as described in the prospectus.]'' *Id.,* Item 12(d).

If a prospectus is not clear, a corporate should obtain the SAI on any particular mutual fund directly from the fund company. A fund's prospectus, when read in conjunction with the SAI, should provide sufficient information on the types of investments the fund may make and whether they are restricted to those permissible for the corporate.

*Prohibitions, Section 704.5(h).* The revised proposed rule permitted trading securities but required transactions to be accounted for on a trade date basis and, in addition, no longer prohibited engaging in pair-off transactions and when-issued trading. The revised proposed rule retained the prohibitions on engaging in adjusted trading and short sales. No comments were received on these provisions and they are retained as proposed in the final rule.

The revised proposed rule prohibited investments in residual interests in ABS, deleted the prohibition on commercial mortgage related securities, and moved the prohibition on the purchase of mortgage servicing rights from the investments section to the permissible services section. The Board notes that the prohibition on the purchase of mortgage servicing rights, as explained in the permissible services section, is being retained as an impermissible investment. One commenter agreed with the deletion of the prohibition on investments in commercial mortgage-related securities. The commenter noted the market for privately-issued commercial mortgage-related securities has become well-established in recent years. The Board agrees, and these provisions have been deleted or amended as proposed.

*Credit Risk Management, Section 704.6*

The revised proposed rule defined ''obligor'' to mean the primary party obligated to repay an investment and excluded from the definition the originator of receivables underlying an asset-backed security, the servicer of such receivables, or an insurer of an investment. No comments were received on this definition, and it is retained as proposed.

The revised proposed rule deleted the definitions of ''short-term investment'' and ''long-term investment'' since they are no longer used. The revised proposed rule also deleted the definition of ''expected maturity,'' since that term was only used in the definitions of these deleted terms. No comments were received on these definitions, and they are deleted in the final rule.

*Policies, Section 704.6(a).* The revised proposed rule amended the policy requirements to base credit limits on capital, rather than RUDE and PIC. A few commenters supported this provision. This provision is retained as proposed.

The revised proposed rule deleted the requirement that the credit risk management policy address loan credit limits. The revised proposed rule added to the examples of concentrations of credit risk an ''originator of receivables'' and an ''insurer.'' No comments were received on these provisions, and they are retained as proposed.

*Exemption, Section 704.6(b).* The revised proposed rule required subordinated debt of government sponsored enterprises to meet the rule's credit risk management requirements. No comments were received on this provision, and it is retained as proposed.

*Concentration limits, Section 704.6(c).* The revised proposed rule established a general credit 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. One commenter, a bank trade group, asserted these changes would increase concentration limits. It claimed without explanation that the proposed 50 percent of capital limit would not have the overall effect of reducing credit concentration limits from the prior limits as stated in the preamble to the proposed rule. 67 FR at 44275. The Board disagrees. Using July 2002 month-end data for an unsecured obligation, the proposed 50 percent of capital limit, in comparison to the current limits, would decrease the corporate system's aggregate maximum investment in the unsecured obligations of a single obligor from $5.43 billion to $2.95 billion, reflecting a reduction in credit concentration of $2.48 billion. For secured obligations, there would be a large reduction because, unlike the revised proposal that had a limit of 50 percent of capital, corporates with Part I or Part II expanded authorities currently have no limitation.

Eleven commenters opposed the general credit concentration limit as too restrictive. Some commenters noted there is a relatively small number of AAA rated obligors. Thus, the proposed limits could force increased aggregate exposure to lower quality credits. A number of these commenters suggested a general credit concentration limit of 100 percent of capital on investments rated no lower than AA- (or equivalent) or A–1 (or equivalent). Two commenters recommended an increase to the credit concentration limit for investments rated AAA (or equivalent); one recommended a limit of 100 percent of capital. One commenter suggested differentiating between single obligor debt instruments and ABS or MBS, noting single obligor instruments, such as corporate debt instruments, are entirely dependent upon the performance of the issuing entity. Two commenters suggested NCUA generally reconsider the limits, with one suggesting NCUA permit a higher

percentage concentration limit for investments rated AA (double A flat) or higher.

As the Board noted in the revised proposed rule, the Board believes this 50 percent limit is the most credit exposure a corporate should prudently take in investment-grade quality investments. *Id.* The Board continues to believe the corporate network must exercise caution in placing membership capital at risk, and these provisions are retained as proposed.

Section 704.6(c)(2) of the revised proposed rule provided exceptions to the general credit concentration rule. For repurchase and securities lending transactions, the proposed limit was 200 percent of capital. Investments in corporate CUSOs were subject to the limitations in § 704.11. Investments in wholesale corporate credit unions and aggregate investments in other corporates were exempt. One commenter recommended limiting the exemption to wholesale corporates. The commenter asserted it was difficult to envision efficiencies for corporates investing in other non-wholesale corporates. As stated in the preamble to the revised proposal, the Board continues to believe that the benefits to the corporate system of applying this exemption to all corporates outweigh any potential concerns, and the Board is retaining the exemption in the final rule. 67 FR at 44275.

Revised proposed § 704.6(c)(3) deems an investment as ''nonconforming'' if it fails a credit concentration requirement because of a reduction in capital following the purchase of that investment. A corporate is required to exercise reasonable efforts to bring nonconforming investments into conformity within 90 days. Investments that remain nonconforming for 90 days are deemed to ''fail'' a requirement, and a corporate will have to comply with the requirements in § 704.10. No comments were received on this provision, and it is retained as proposed.

Two commenters recommended deleting § 704.6(c)(4), since proposed § 704.6(c)(3) addressed the same issue. The Board notes that § 704.6(c)(4) was deleted in the revised proposed rule and will remain deleted in the final rule.

*Credit ratings, Section 704.6(d).* This section reduced the applicable credit rating to AA- (or equivalent) for investments with long-term ratings and A–1 (or equivalent) for investments with short-term ratings. The revised proposed rule triggered the investment action plan requirements of § 704.10 if at least two ratings were downgraded and a corporate had relied on more than one rating to meet the minimum credit rating requirements at the time of purchase.

A state-chartered corporate supported this proposal, but believed additional investment authority was needed. The corporate noted its state supervisory authority permitted investment in all investment grade categories. Further, the commenter noted typical cash market practice for repurchase transactions is to require investment grade securities; the commenter noted it is more difficult to arrange repurchase agreements at favorable rates if the securities must be restricted to those with ratings in the top grades of the investment grade categories.

As noted in the preamble to the revised proposed rule, in light of the substantial flexibility already provided to corporates, the Board remains convinced a base level corporate should not be permitted to acquire more than limited credit risk exposure. Expanded authority provisions allow a broader spectrum of credit risk, and require increased due diligence by corporates that obtain such authority. 67 FR at 44276. Thus, this section is retained as proposed.

The proposed rule clarified investments in a corporate or a CUSO do not require a rating. One commenter recommended corporates be permitted to invest in other non-wholesale corporates only if that corporate had a credit rating from at least one nationally recognized statistical rating organization (NRSRO). It is not current market practice for corporates to obtain depositor ratings. While an NRSRO rating is a useful tool for investors to evaluate credit risk, it is no substitute for due diligence. The Board is convinced a corporate should be permitted to decide whether to purchase shares or deposits in another corporate. Thus, this provision is retained as proposed.

One commenter requested clarification of ratings relied upon ''at the time of purchase.'' The commenter noted this might mean either the trade or settlement date. The commenter asserted industry practice was to assign an assumed rating for new-issue securities and not to provide an official rating until settlement date. The commenter suggested there was the potential for a corporate to be unable to purchase new-issue securities until settlement date when the official rating was assigned if the interpretation of ''at the time of purchase'' were trade date. The Board agrees industry practice is to assign an assumed rating for new-issue securities and not to provide an official rating until settlement date. However, the Board understands it is also industry practice that purchase offers are contingent on assignment of the assumed rating. This means a purchasing corporate could refuse delivery on the settlement date if a security did not receive the bargained for rating. Thus, ''at the time of purchase'' means the security must have either an official permissible rating on the trade date if purchase is not contingent on receipt of an official permissible rating or, for a new issue, an assumed permissible rating on the trade date and an official permissible rating on the settlement date.

To avoid confusion regarding the investment watch list requirements of § 704.6(e)(1), the revised proposed rule clarified in § 704.6(d)(4) that it is applicable only when the corporate relied upon more than one rating to meet the minimum credit rating requirements at the time of purchase. If there is a subsequent downgrade below the minimum requirement, then the investment must be placed on the investment watch list.

One commenter recommended a technical change in § 704.6(d)(4) to delete the words ''any rating that'' following ''investment watch list'' and to substitute ''any investment for which a rating.'' The Board agrees, and the final rule reflects that substitution.

*Reporting and documentation, Section 704.6(e).* The revised proposed rule clarified that requirements for annual approval apply to each credit limit with each obligor or transaction counterparty. No comments were received on this provision, and it is retained as proposed.

*Lending, Section 704.7*

*Section 704.7(c)(1) and (2).* Currently, the aggregate secured and unsecured loan and line of credit limits to any one member credit union are based on the higher of a percentage of capital or a percentage of RUDE and PIC. The Board proposed basing the loan limits on a percentage of capital and eliminating the option of basing them on a percentage of RUDE and PIC. The Board received no comments on this section and has adopted this change in the final rule.

Section 704.7(c) and (d) and Appendix B to Part 704 reference ''irrevocable'' loans and lines of credit. In the revised proposed rule, the Board deleted the modifier ''irrevocable'' while clarifying in the preamble that the loan and line of credit limits apply to both ''irrevocable'' and ''revocable'' loans and lines of credit. One commenter objected to the deletion of the word ''irrevocable'' in the revised proposed rule. This commenter

suggested re-inserting either ''irrevocable'' or ''committed'' in the final rule so that the limits do not apply to uncommitted lines of credit. The Board's intent is that the aggregate limits apply to all loans and lines of credit and, therefore, the Board is retaining the deletion in the final rule.

*Section 704.7(d).* This section addresses ''Loans to nonmembers'' and is subdivided into two subsections: Credit unions and Corporate CUSOs. A commenter suggested part 704 should not distinguish between corporate and natural person credit union CUSOs. This commenter recommended expanding § 704.7 to address loans to natural person credit union CUSOs rather than requiring those loans to comply with part 723. The rationale was that the part 723 collateral requirements put corporates at a disadvantage in the marketplace for natural person credit union CUSO related activities. In the final rule, the Board does not expand § 704.7 to address loans to natural person credit union CUSOs. The Board believes that the exceptions should only apply to loan limits for corporate CUSOs because these entities are wholly or partially owned by corporates. Also, loans to corporate CUSOs are currently required to comply with part 723's aggregate limits and most of that regulation's due diligence requirements.

*Section 704.7(e)(3).* This provision of the revised proposal, like the current rule, provides a partial exemption from the member business loan rule if a loan or line of credit to an ''Other member'' is fully guaranteed by a credit union or fully secured by U.S. Treasury or agency securities. One commenter requested clarification as to whether cash or shares are also included as permissible collateral to secure a loan, line of credit or letter of credit. Loans secured by cash or shares, rather than qualifying for a partial exemption, are not member business loans and, therefore, are not subject to any of the requirements of part 723. 12 CFR 723.1(b)(2).

Revised proposed § 704.7(e) clarified the applicability of the member business loan rule in part 723 to loans granted by a corporate. The Board did not receive any comments on this revision and, therefore, the Board retained this clarification in the final rule.

Revised proposed § 704.7(g) expanded the provision governing loan participations between corporates to include a requirement that a corporate execute a master participation loan agreement before the purchase or the sale of a participation loan. In conjunction with this requirement, the Board deleted the language that a participation loan agreement may be executed at any time before, during, or after the disbursement. No comments were received on this section, and this requirement is retained in the final rule.

The Board proposed allowing corporates to participate in loans with member natural person credit unions but only as an expanded Part V authority and with certain limitations. One commenter indicated proposed Part V authority should be a permissible activity for all corporates. The rationale was that, since natural person credit unions are permitted to engage in this activity, it is not a regulatory concern for NCUA. This commenter also stated that state law on participation lending should govern state-chartered corporates. As stated in the preamble to the proposed rule, since the Board believes ''a number of corporates do not exhibit a level of infrastructure commensurate with the risks associated with this activity,'' corporates should apply for approval before entering into loan participations with natural person credit unions. 66 FR at 48748. For these reasons, the final rule only allows corporates with Part V authority to engage in participation lending with natural person credit unions. These safety and soundness concerns apply to state-chartered corporates as well as federal corporates. Another commenter recommended the Board grandfather corporates who have received a waiver to engage in participation lending with member natural person credit unions. The Board agrees and corporates with existing waivers continue to have the authority to enter into loan participations to the extent previously granted without applying for Part V authority.

One commenter recommended expanding Part V to permit a wholesale corporate to join with its member corporate in participating in a loan that the wholesale corporate is permitted to purchase in its own right from a nonmember natural person credit union. The Board believes it needs additional time to study this issue, which is being raised for the first time in response to the revised proposed rule. The Board notes that, after additional study, it may be open to considering this activity as permissible either by amending the regulation to expand Part V or as a waiver to Part V.

Finally, the Board proposed reorganizing the lending section to make it easier to read. No commenter objected to the reorganization and the final rule incorporates these changes.

*Asset and Liability Management, Section 704.8*

The revised proposed rule deleted the term ''net interest income'' because it is no longer used in the regulation and amended the definitions of ''net economic value (NEV)'' and ''fair value.'' NEV means the fair value of assets minus the fair value of liabilities. The amended definition excluded from liabilities both PIC and MC, rather than excluding only PIC. One commenter again urged that all off balance sheet financial derivatives remain in the definition of NEV. As the Board explained in the revised preamble, for purposes of NEV measurement, GAAP does not require accounting for immaterial positions in financial derivatives on balance sheets. 67 FR at 44277.

The commenter also recommended limiting the aggregate amount of MC and PIC included in total capital to not more than 100 percent of RUDE in any NEV-related requirements. This would limit the aggregate amount of MC and PIC excluded from liabilities for purposes of NEV calculations to not more than retained earnings, resulting in NEV limits based on a percentage of two times the fair value of retained earnings. If a corporate were to realize a loss of substantially all of retained earnings, but not MC or PIC, the commenter's proposal would require a corporate without net unrealized gains to eliminate all interest rate risk. The Board does not believe this is the most advisable course of action to re-establish earnings. Instead, the Board has proposed conservative NEV limits based on capital, rather than a subset of capital. Under the Board's formulation, a loss of substantially all of retained earnings reduces the level of interest rate risk permitted, but does not require a corporate to eliminate all interest rate risk. Therefore, these provisions are deleted or amended as proposed.

The Board has made a technical change to the revised proposed definition of ''fair value.'' In the first sentence of the definition ''other than in'' is changed to ''as opposed to.''

*Policies, Section 704.8(a)(2).* The revised proposed rule eliminated the redundancies with § 704.5(a) and changed the term ''current NEV'' to ''base case NEV'' to provide uniform usage throughout the regulation. No commenters addressed these provisions, and they are deleted or modified as proposed.

*Section 704.8(a)(5).* The revised proposed rule deleted the requirement for a policy limit on decline in net income. One commenter supported this

deletion, and it is deleted in the final rule.

*Section 704.8(a)(6).* The revised proposed rule added a requirement for the asset and liability management policy to address the tests used before purchase, to include an estimate of the impact of proposed investments on the percentage decline in NEV, as compared to the base case NEV. One commenter opposed this requirement. The commenter advocated the tests should be reviewed as a supervisory issue. As noted in the preamble to the revised proposed rule, this provision is intended to require a corporate to establish an ongoing process to identify, estimate, monitor and control interest rate risk between the periodic complete NEV analyses. 67 FR at 44277. The Board believes a corporate's board should establish policy parameters for this process and has retained this section as proposed.

*Penalty for early withdrawals, Section 704.8(c).* The revised proposed rule clarified that the minimum penalty for early certificate/share withdrawal, if early withdrawal is permitted, must be reasonably related to the rate that the corporate would be required to offer to attract funds for a similar term with similar characteristics. The preamble noted a gain does not appear consistent with the notion of a penalty for early withdrawal. 67 FR at 44278.

No commenters addressed the text of the revised proposed rule, however, nine commenters objected to the statement in the preamble that a gain does not appear consistent with the notion of a penalty for early withdrawal. *Id.* The commenters asserted a gain could be paid on early withdrawal of a share certificate and still meet the requirement of a penalty for early withdrawal. The commenters noted this is consistent with the ''mark to market'' premise of a penalty sufficient to cover the estimated replacement cost of the redeemed certificate. The commenters also noted the need to be competitive with alternative instruments that could provide members with liquidity and gains, without the need to increase the balance sheet of both the corporate and the member by a share secured loan if a gain could not be paid.

The Board does not believe that the concept of a penalty can be equated with the payment of a gain and reiterates that a gain is not permissible in conjunction with a penalty for early withdrawal. In addition, the Board is concerned that contractual provisions for redemption of a deposit at a gain may have the unintended consequence of encouraging a run on a substantially impaired corporate by members seeking to obtain gains. The Board acknowledges holders of debt securities may freely transact with third-party participants in the secondary market at a price that may result in a gain to the holder. However, debt security issuers typically are not subject to repurchase demands by debt holders. This is because the holder of a typical debt security does not have the right to put the debt to the issuer at a market price.

*Interest rate sensitivity analysis, Section 704.8(d).* The revised proposal deleted the requirement to conduct net interest income simulations. One commenter supported the elimination of the requirement for net interest income simulations, and it is deleted in the final rule.

The revised proposed rule deleted the word ''Treasury'' to permit evaluation of the impact of shocks in appropriate yield curves on its NEV and NEV ratio, since the market has moved away from the Treasury yield curve as a benchmark. No comments were received on this provision, and it is amended as proposed.

*Section 704.8(d)(1)(i).* The revised proposed rule increased from two to three percent the minimum base case NEV ratio that triggers monthly interest rate sensitivity analysis testing. One commenter suggested setting the trigger at four percent, rather than three percent, since the base case NEV ratio for most corporates will increase significantly because of the new definition of NEV.

The Board is comfortable with a three percent NEV trigger for monthly testing in base corporates, in large measure because the corporate system has improved its ability to identify, measure, monitor and control interest rate risk since the existing regulation was adopted. In addition, the estimation requirements of amended § 704.8(a)(6) typically provide adequate information for a base corporate with a minimum base case NEV ratio of at least three percent to monitor and control interest rate risk between complete periodic reevaluations. The Board recognizes base case NEV ratios are likely to increase substantially under the amended definition of NEV. The section is retained as proposed.

Section 704.8(d)(1)(ii) limited a corporate's risk exposure to levels that do not result in any NEV ratio resulting from the specified parallel shock tests, or a base case NEV ratio, of less than two percent, rather than the current one percent. No comments were received on this provision, and it is retained as proposed.

*Section 704.8(d)(1)(iii).* The proposal reduced the NEV decline limit for a base corporate from 18 to 15 percent. This represented an increased level of risk compared to the current rule, since the proposal excluded MCs from liabilities and, therefore, increased the base case NEV.

Two commenters recommended the Board retain the 18 percent limit: one noted this represented little interest rate risk and the other was not aware of any significant deterioration of a base corporate because of interest rate risk. In contrast, one commenter suggested reducing the NEV decline limit to 10 percent, to avoid increasing the amount of interest rate risk permitted.

As noted in the preamble to the revised proposed rule, the Board is comfortable with the increased risk because the corporate system has improved its ability to measure interest rate risk since the existing regulation was adopted. 67 FR at 44278. In addition, the estimation requirements of amended § 704.8(a)(6) provide adequate information for a corporate to monitor and control interest rate risk between complete periodic reevaluations. The Board does not believe it is prudent to increase the amount of interest rate risk that a base corporate may undertake further than the proposed 15 percent decline in NEV. Corporates meeting the requirements for expanded authority provisions are permitted to undertake additional interest rate risk. Thus, this section is retained as proposed.

*Section 704.8(d)(2).* The revised proposed rule required all corporates to assess annually whether it is appropriate to conduct periodic, additional, interest rate risk tests. These additional tests formerly were triggered based on the level of unmatched embedded options. No comments were received on this provision, and it is retained as proposed.

*Regulatory Violations and Policy Violations, Section 704.8(e) and (f).* The revised proposed changes were non-substantive, grammatical amendments and also designated the OCCU Director to respond to regulatory violations. No comments were received on these sections, and they are retained as proposed.

*Divestiture, Section 704.10*

The Board did not propose any changes to this provision; however, because of confusion concerning this provision, the Board proposed retitling it ''Investment Action Plan.'' This change clarifies that divestiture is not the only remedy available under this section. No commenters opposed the title change; however, five commenters objected to the current inclusion of derivative contracts under the

divestiture requirements of this section. They stated that these contracts are not investments and should not be subject to this provision. The commenters noted that these contracts are not freely tradable between third parties, as is the case with traditional investment instruments, and the cost for a corporate to ''unwind'' a derivative contract can be excessive.

The Board has consistently interpreted derivatives as subject to the requirements for investments. 12 CFR parts 703 and 704. Further, the Board believes these transactions should be subject to the requirements for an investment action plan because of the credit risk of the counterparty. Risk mitigation within the contract will have a significant impact on the Board's willingness to allow the corporate to hold instruments where the issuing entity has been downgraded. The Board is aware there are costs involved in unwinding a derivative contract and will review each plan submitted by a corporate weighing the costs of unwinding the derivative versus the risks associated with holding it. In addition, the Board has added clarifying language to Appendix B, Part IV to clarify how § 704.10 applies to derivative contracts. The Board remains convinced that corporates should not be allowed to hold financial contracts or investments from counterparties with excessive levels of credit risk and so will continue to interpret derivatives as investments under this provision. The Board is revising the title as proposed.

*Corporate CUSOs, Section 704.11*

The revised proposed rule added new due diligence requirements for corporates' loans to corporate CUSOs. These requirements were taken from the member business loan rule. No commenters commented on this provision and the Board is adopting it in the final rule.

The revised proposed rule maintains a limit of 15 percent of capital for investments in corporate CUSOs, increases the aggregate limit for loans and investments to 30 percent of capital, and retains the additional 15 percent for loans that are fully secured. One commenter objected stating the proposal was too limiting. Another commenter suggested clarifying that the 30 percent aggregate limit for loans and investments does not include the additional 15 percent for loans that are fully secured. The Board believes the increased limits strike the appropriate balance between added flexibility and safety and soundness and is retaining them as proposed in the final rule. The Board notes that the 30 percent aggregate limit does not include the additional 15 percent for loans that are fully secured.

The preamble to the revised proposed rule explained that the current audit requirements in § 704.11(d)(3) do not require a separate CPA audit for wholly owned CUSOs. This modification mirrored the practice that is currently permissible for natural person CUSOs. 63 FR 10743, 10747, March 5, 1998. Six commenters suggested that this exemption be stated in the regulation and it also apply to majority owned CUSOs. The Board agrees and the final regulation states that a wholly owned or majority owned CUSO is not required to obtain a separate annual audit if it is included in the corporate's consolidated audit.

Based on a request from six commenters, the revised proposal amended § 704.11(b) so that it mirrors § 712.6 of the natural person CUSO rule. Section 704.11(b) prohibits a corporate from acquiring control directly or indirectly of another ''financial institution'' and § 712.6 prohibits a natural person credit union from acquiring control directly or indirectly of another ''depository financial institution.'' One commenter questioned the authority of the Board to limit ''financial institution'' with the modifier ''depository.'' The Board's long-standing interpretation of financial institution is that it means a deposit taking institution. 51 FR 10353, 10354, March 26, 1986. This interpretation has been reflected in the natural person CUSO rule since 2001 and the Board believes adopting it in the corporate CUSO rule is appropriate. 66 FR 40575, August 3, 2001. This commenter also objected to the current prohibition on a corporate investing in the shares, stocks or obligations of a CUSO that is a financial institution. The commenter notes that this prohibition is broader than either the limitation in the Federal Credit Union (FCU) Act or the natural person CUSO regulation that only prohibit ''acquir[ing] control directly or indirectly'' and do not prohibit ''invest[ing]'' in a financial institution. 12 U.S.C. 1757(7)(I); 12 CFR 712.6. The Board agrees and is deleting this prohibition from the final rule.

The revised proposal clarified that the aggregate limit of § 723.16, the member business loan rule, applies to loans to CUSOs. No comments were received on this clarification and the Board is retaining it in the final rule.

*Permissible Services, Section 704.12*

The revised proposal listed eight broad categories of permissible financial services for corporates with examples under each category. This was modeled after the broad categories in parts 712 and 721. The Board received no comments on this provision, except as to its applicability to state-chartered corporates, and is retaining it in the final as proposed.

The revised proposal, at the commenters' suggestion, added a provision similar to the provisions in parts 712 and 721 concerning adding new permissible services. It permits corporates to petition the Board to add a new service to § 704.12 and encourages them to seek an advisory opinion from the Office of General Counsel (OGC) on whether a proposed service is already covered by one of the authorized categories before filing a petition. The rule does not require a corporate to come to OGC for an opinion every time it wants to provide a service not specifically listed as an example under a broad category. An opinion from OGC is recommended if there is doubt as to whether a specific service falls within one of the broad categories. In those situations, a corporate that does not consult with OGC runs the risk of engaging in an impermissible activity and being subject to supervisory action. Six commenters objected to or requested clarification on the applicability of this provision to state-chartered corporates. The commenters suggest that, at a minimum, since a state-chartered corporate's authority to engage in an activity is derived from its state statute and not the FCU Act, the appropriate approach for state charters is to request a waiver, rather than a rule change, to add an activity that may be impermissible for federal corporates. The Board would then base its decision to grant or deny the waiver on any safety and soundness concerns it has with the proposed activity. The Board agrees with the commenters and is revising the final rule to reflect a waiver process for state-chartered corporates.

The revised proposal deleted the requirement that services to nonmember natural person credit unions through a correspondent services agreement could only be provided to those natural person credit unions' branch offices in the corporate's geographic field of membership. In addition, the revised proposal clarified that a correspondent services agreement is an agreement between two corporates for one of the corporates to provide services to the members of the other. One commenter reiterated its objection to the clarification that correspondent services can only be provided through an agreement with another corporate credit union. The Board remains committed to the fundamental principle that credit

unions, including corporates, are formed to serve their members and is adopting the requirements in the revised proposal for correspondent services in the final rule.

The revised proposal also moved the current prohibition on the purchase of ''mortgage servicing rights'' from the investment section to this section and renamed it ''loan servicing rights.'' The Board has reconsidered removing this prohibition from the investment section. The Board will retain the prohibition in the investment section to clarify that this is not a permissible investment. It will also include the prohibition in this section. Although this activity is a permissible service for natural person credit unions under limited circumstances, the Board has safety and soundness concerns with corporates engaging in this activity, and will continue to prohibit this service for corporates.

One commenter suggested clarifying that the prohibition on the purchase of loan servicing rights does not apply if a corporate has the authority to purchase loans and the purchase of servicing rights are in conjunction with that purchase. The Board agrees that the purchase of servicing rights in conjunction with the purchase of a loan is not prohibited.

*Fixed Assets, Section 704.13*

The revised proposal eliminated this section. No commenters commented on this change. Therefore, the revised proposal reflects this change.

*Representation, Section 704.14*

The revised proposal clarified the meaning of the term ''credit union trade association'' in § 704.14(a) by adding to the regulation the definition of ''credit union trade association'' that was in the preamble to the prior final rule. 59 FR 59357, 59358, November 17, 1994. The thirteen commenters that commented on this clarification objected to adding a definition of ''credit union trade association.'' The commenters erroneously perceived this as a change and stated that it unnecessarily limited the pool of qualified applicants and is not needed in light of the recusal provisions in § 704.14(d). The commenters stated that the restrictive definition ignores the reality that natural person CEOs on corporate boards are often the most active in the credit union community serving multiple roles at the chapter, league and national level. Several of these commenters suggested amending the definition so that it is not so limiting. They suggested only including the state credit union leagues of the state in which the corporate is headquartered. One commenter fails to see how loyalty is divided if the chair serves on the board of an affinity group such as a defense, automotive or educational trade association. This commenter suggests only prohibiting state or multi-state leagues.

The Board continues to believe that the chairman of the board of a corporate should not serve simultaneously as an officer, director or employee of a national credit union trade association. As the Board stated when this provision was originally drafted, ''the chair should be an individual whose loyalty is *in no way divided* between the corporate credit union and a trade association.'' 59 FR 59357, 59358, November 17, 1994 (emphasis added). The Board, however, agrees that the definition is broader than is necessary to accomplish its objective of having a chair ''whose loyalty is in no way divided'' and is deleting from the prohibition ''and their affiliates and service organizations, and local, state, and national special interest credit union associations and organizations.''

The revised proposal amended the requirement in § 704.14(a) that both federal and state-chartered corporates comply with federal corporate bylaws governing election procedures. All corporates will have to comply with § 704.14(a) governing election procedures but state-chartered corporates will not have to comply with federal corporate bylaws. No commenters commented on this amendment. The Board is retaining this change in the final rule.

*Wholesale Corporate Credit Unions, Section 704.19*

The revised proposed rule eliminated the proposed 1 percent minimum RUDE ratio requirement and replaced it with an earnings retention requirement when the retained earnings ratio falls below 1 percent.

Three commenters addressed the earnings retention requirement. One commenter disagreed with the proposal stating despite the two-tier corporate structure, the earnings retention requirement should be the same as established for retail corporates. This commenter is concerned with the potential for a significant financial crisis in the credit union industry if a wholesale corporate fails. The Board remains convinced a separate wholesale corporate earnings retention requirement is appropriate based upon the corporate system's tiered capital structure.

One commenter expressed concern with the earnings retention requirement being met by either the current month or rolling 3-month calculation. This commenter believes wholesale corporates should be permitted to meet the earnings retention requirement based on a rolling 12-month average as presently permitted for reserve transfers. The Board believes sufficient flexibility for meeting the earnings retention requirement exists by using either the current month or rolling 3-month calculation. The Board notes the OCCU Director may approve a decrease in the earnings retention amount in the rare event a lesser amount is necessary to avoid a significant adverse impact upon a wholesale corporate.

One commenter stated the .15 percent per annum earnings retention requirement when the retained earnings ratio is less than 1 percent and the core capital ratio is less than 3 percent neither considers the tiering of reserves in the corporate system nor the narrow margins necessary for a wholesale corporate to offer competitive investment products. This commenter believes the earnings retention factor should be .10 percent per annum when the retained earnings ratio is less than 1 percent and the core capital ratio is less than 3 percent. The Board is not persuaded by this argument. The Board considers wholesale corporates subject to .15 percent per annum earnings retention requirement to be thinly capitalized. The Board believes wholesale corporates have numerous options available to reduce the earnings retention requirement if the .15 percent per annum earnings retention requirement is too onerous. For example, wholesale corporates can issue additional PIC to increase the core capital ratio to at least 3 percent or they can use off balance sheet activities to shrink their balance sheet.

Two commenters disagreed with the payment of dividend language in revised proposed § 704.19(b)(5) for many of the same reasons commenters opposed the language contained in revised proposed § 704.3(i)(5) for retail corporates. One commenter recommended substituting a notification provision for the current language. The Board agrees and, for the reasons stated in § 704.3, the final rule replaces the limitations on the payment of dividends with notification and restoration plan requirements.

*Appendix A to Part 704—Model Forms*

The revised proposal added language to the model forms to clarify the treatment of MC and PIC in the event of the merger, liquidation, or charter conversion of a member credit union or the corporate credit union. Six commenters raised objections to the

proposed clarifications. The commenters expressed concern that the additional requirements, rather than being a clarification to the existing language, alter the contractual agreement between the corporate and its members. A number of commenters also noted the additional language might create potential legal, regulatory, and operational problems. One commenter recommended leaving the added language in Appendix A and making the additional disclosure voluntary. Several commenters noted that natural person credit unions are not bound by part 704, nor is a continuing entity in the event of a charter conversion. Further, the commenters contended that, in the case of a liquidation or charter conversion, the member holding the MC or PIC account ceases to exist. As the entity no longer exists, its membership automatically terminates and its shares, including MC and PIC, should be paid out in accordance with applicable law. The commenters argued the model forms conflict with the Corporate Federal Credit Union Bylaws, and they may also conflict with applicable state laws for state-chartered credit unions. Several commenters indicated the existing language was adequate and it should be left up to each corporate to determine how to handle MC in the event of a merger, liquidation, or charter conversion based on its own capital management plan and applicable laws and regulations.

The Board does not believe the language added to Appendix A and to the requirements for MC in § 704.3(b)(3) create any additional legal, regulatory, or operational problems. The current regulation requires all MC accounts to have a minimum three-year notice. 12 CFR 704.2. The regulation does not provide any exceptions to the three-year notice requirement. The clarifying language has been added because OCCU has received inquiries as to how to handle MC in the event of merger, liquidation or charter conversion.

In the event of a merger, the existence of the MC should be identified as part of the due diligence process. The continuing credit union has the right to put the MC on notice. If the continuing credit union is a member of the corporate, an adjusted balance account may be adjusted at the next adjustment period. If the account is not an adjusted balance account, the continuing credit union would not be in violation of § 703.100, as that section specifically states the measure is assets ''*at the time of purchase*'' of the MC. In the event of a charter conversion, as with a merger, the existence and requirements of the MC should be identified during the due diligence leading up to a charter conversion. The new entity may place the MC on notice and collect the funds at the end of the three-year notice period. In the event of a liquidation, the Liquidating Agent may submit a request to the OCCU Director to allow the corporate to release the funds before the end of the three-year notice period.

The existing regulation is very specific that the only means by which a credit union may obtain its funds in an MC account is after the three-year notice or if it sells it to another credit union with the concurrence of the corporate. 12 CFR 704.2. The language was drafted to provide as much ''permanence'' to the three-year accounts as possible so they could be considered as capital. The regulatory requirements in the corporate rule and the contractual provisions of the MC concerning the three-year notice requirement do not conflict with the general provision in the Corporate Federal Credit Union Bylaws governing withdrawal of shares. Article III, Section 5 of the bylaws states a corporate's board may not require a member to give more than 60 days notice of intent to withdraw. This general withdrawal provision is not intended to apply to accounts that the member is contractually obligated to maintain for a period in excess of 60 days. Based on the requirements of current § 704.2, there should be no outstanding MC with conditions that would cause legal, regulatory, or operational concerns due to the addition of the clarifying language.

One commenter suggested revising the wording of § 704.3(b)(5) by changing the words ''credit union'' to ''another member'' to permit one member of the corporate to sell its MC to another member rather than only to a credit union in the corporate's field of membership. The Board concurs with the recommendation and has adopted this change in the final rule.

*Appendix B to Part 704—Expanded Authorities and Requirements*

In the revised proposed rule the Board proposed changes to: expand permissible credit ratings on investments; permit corporates that pre-commit to a higher level of capital the option of a higher level of interest rate risk; ease the requirements for corporates to participate in risk reducing derivative activities; and permit corporates to participate in loan participations with natural person credit unions. In addition, the revised proposal eliminated the proposed requirement for corporates to update the self assessment plan originally submitted for expanded authority. No comments were received objecting to the removal of this requirement and it is retained as proposed.

Base-Plus

In the revised proposed rule, the Board proposed a maximum NEV decline of 20 percent. Several commenters believed the limit should remain at its current 25 percent level, and one commenter believed the level should be decreased. The Board remains convinced that the proposed level is appropriate given the requirement of monthly NEV analysis. The Board is adopting the limits from the revised proposed rule.

Parts I and II

In the revised proposed rule, the Board proposed NEV decline limits based on capital levels. Several commenters opposed the proposed limits recommending the limits remain at current levels, and one commenter recommended lower levels. The Board has greater confidence in the ability of the corporate credit unions to model their balance sheets accurately; therefore, the limits were proposed at levels where the corporates can manage their balance sheets without taking excessive levels of risk. The Board was not convinced to change the levels either up or down; therefore, the Board is adopting the limits from the revised proposed rule.

The Board will permit 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 or 6 percent, respectively.

In the revised proposed rule, the Board proposed limits for the aggregate credit exposure to a single obligor at 50 percent of capital. Several commenters objected that the 50 percent of capital general concentration limit was too restrictive, particularly for corporates with expanded authorities. The commenters recommended increasing concentration limits to 100 percent, particularly for long-term instruments rated not lower than AA– and short-term investments rated no lower than A–1. The Board continues to believe this limit is the most credit exposure a corporate should prudently take in investment quality investments.

In the revised proposed rule, the Board established a 300 percent of capital limit for Part I, and 400 percent limit for Part II on aggregate investments in repurchase and securities lending agreements with any one counterparty. Several commenters objected to the

limits stating that these levels will significantly reduce their existing limits. The Board continues to believe the proposed levels are prudent given the secured nature of the activity and the increased requirements for credit analysis for Part I and II corporates; however, the Board believes increasing the limits beyond those proposed would raise safety and soundness concerns. The Board is adopting the limits as proposed in the revised proposed rule.

In the revised proposed rule, the Board tied minimum capital ratings of short-term investments to a minimum issuer long-term rating. One commenter contended that the requirement tying short-term and long-term ratings together is not representative of credit risks in the marketplace because long-term and short-term credit ratings should be assessed independently. The Board remains convinced that the overall credit quality of the issuer must fall within the limits of this rule and is adopting the proposed requirements.

Part II

The Board proposed lowering the minimum credit rating requirement for a long-term investment (including asset-backed securities) to BBB (flat). Three commenters recommended that BBB (flat) concentration limit be reduced to 25 percent and the concentration limit for AAA rated investments be increased to 100 percent of total capital. One commenter recommended the concentration limit for AAA rated investments be set at 75 percent for Part I and 100 percent for Part II. One commenter stated that corporates with higher levels of expanded authority have demonstrated the ability to manage the risks inherent in these lower rated instruments. The commenter also noted that corporates are in the business of managing risk. One commenter was opposed to permitting any investment in BBB (flat) rated securities. Based on the comments and further analysis of the risk, the Board believes the limit for BBB+ and BBB (flat) rated instruments with Part II authority should be reduced from the revised proposed rule level of 50 percent to 25 percent of capital. The Board agrees with the commenters that corporates with Part I or II authority do have additional credit monitoring capabilities allowing them to move down the credit scale and this authority requires the additional infrastructure stipulated in this rule and its appendixes.

Part III

In response to the proposed rule, several commenters noted that Part III granted preference to foreign banks over other foreign counterparties. The revised proposal permitted corporates to purchase investments from any approved entity with an acceptable NRSRO rating within a country with an acceptable country rating. This change allowed corporates greater flexibility in managing their investments. No comments were received and the Board is adopting this change as proposed.

In addition, the revised proposal incorporated the changes from the proposed rule. No comments were received and, for the reasons stated in the revised proposal, the Board is adopting these changes as proposed. 67 FR at 44283.

Part IV

Part IV expanded authorities have been restructured to provide more flexibility among corporates seeking to use derivatives to reduce risk. The current rule requires corporates to have either Part I or II expanded authorities to qualify for Part IV. The proposal removed 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, the corporate in its application must detail the specific types of derivatives they may utilize. The Board believes that derivative transactions, used properly, reduce risk to the institution and its members.

In the revised proposed rule, the Board broadened the authority of corporates to enter into derivative transactions by adding government sponsored enterprises, member credit unions, and entities fully guaranteed by an entity with a minimum permissible rating for a comparable term investment. No negative comments were received, and the Board is adopting this change as proposed.

Several commenters noted that the revised proposed rule should state that Part III expanded authority was required for a corporate to enter into derivative contracts with a foreign counterparty. The Board has amended Part IV to clarify this.

In the revised proposed rule, Part IV (b)(1) detailed the requirements for counterparty credit ratings. Several commenters noted in their comments on § 704.10 that derivatives are not investments; therefore Section 704.10 should not apply. As previously stated, the Board has consistently interpreted derivatives as investments for purposes of parts 703 and 704. In addition, the Board believes that without credit mitigation within the contract, these instruments may present excessive levels of credit risk if a counterparty is downgraded. Therefore, Part IV is amended to clarify that compliance with § 704.10 is required if the counterparty is downgraded below permissible levels.

*Delegations of Authority*

Although not in the initial proposed rule, the Board, in an effort to streamline the regulatory approval process, has delegated to the OCCU Director in the revised proposal, the authority to act on its behalf in §§ 704.3(e), (g) and (i); 704.8(e); 704.10; 704.15; and 704.19(b).

*Technical Correction*

The Board has revised the wording in § 704.18(e) to conform to the new terminology in part 704.

**C. 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 final 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 final regulation does not increase paperwork requirements under the Paperwork Reduction Act of 1995 and regulations of the Office of Management and Budget. NCUA currently has OMB clearance for part 704's collection requirements (OMB No. 3133–0129).

*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 final rule will help assure that proper safeguards are in place to ensure the safety and soundness of corporates.

The rule 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 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 rule 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 final 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 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. The regulatory change is understandable and imposes minimal regulatory burden. NCUA requested comments on whether the proposed rule was understandable and minimally intrusive if implemented as proposed. No comments were received.

*Small Business Regulatory Enforcement Fairness Act*

The Small Business Regulatory Enforcement Fairness Act of 1996 (Pub. L. 104–121) provides generally for congressional review of agency rules. A reporting requirement is triggered in instances where NCUA issues a final rule as defined by Section 551 of the Administrative Procedure Act. 5 U.S.C. 551. The Office of Management and Budget is reviewing whether this rule is a major rule for purposes of the Small Business Regulatory Enforcement Fairness Act of 1996.

**List of Subjects**

*12 CFR Part 703*

Credit unions, Investments.

*12 CFR Part 704*

Credit unions, Reporting and recordkeeping requirements, Surety bonds.

By the National Credit Union Administration Board on October 17, 2002.

**Becky Baker,**

*Secretary of the Board.*

Accordingly, NCUA amends 12 CFR parts 703 and 704 as follows:

## PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

1. The authority citation for part 703 continues 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 amount 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 investment or adjustment. Your aggregate amount 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 investment or adjustment. 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 continues 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*'', ''*credit enhancement*'', ''*dealer bid indication*'', ''*expected maturity*'', ''*industry recognized information provider*'', ''*long term investment*'', ''*market price*'', ''*matched*'', ''*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*'', ''*reserves and undivided earnings*'', ''*short-term investment*'', and ''*trade association*'';

b. Revise the definitions of ''*capital*'', ''*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 definition heading and the last sentence, and ''*net economic value (NEV)*'' by revising the second and third sentences; and

d. Add new definitions for ''*core capital*'', ''*core capital ratio*'', ''*limited liquidity investment*'', ''*obligor*'', ''*quoted market price*'', ''*retained earnings*'', and ''*retained earnings ratio*''.

### § 704.2 Definitions.

* * * * *

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

*Capital* means the sum of a corporate credit union's retained earnings, paid-in capital, and membership capital.

* * * * *

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

*Core capital* means the corporate credit union's retained earnings and paid-in capital.

*Core capital ratio* means the corporate credit union's core capital divided by its moving daily average net assets.

* * * * *

*Fair value* means the amount at which an instrument could be exchanged in a current, arms-length transaction between willing parties, as opposed to 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.

* * * * *

*Limited liquidity investment* means a private placement or funding agreement.

* * * * *

*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 retained earnings and paid-in capital; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged 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 that is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization.

* * * * *

*Net economic value (NEV)* * * * All fair value calculations must include the value of forward settlements and embedded options. The amortized portion of membership capital and paid-in capital, which do not qualify 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: are perpetual, non-cumulative dividend accounts; are available to cover losses that exceed retained earnings; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged 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.

*Retained earnings* means the total of the corporate credit union's undivided earnings, reserves, and any other appropriations designated by management or regulatory authorities. For purposes of this regulation, retained earnings does not include the allowance for loan and lease losses account, accumulated unrealized gains and losses on available for sale securities, or other comprehensive income items.

*Retained earnings ratio* means the corporate credit union's retained earnings divided by its moving daily average net assets.

* * * * *

5. Amend § 704.3 as follows:

a. Amend paragraph (a) by revising the paragraph heading;

b. Redesignate paragraphs (d) through (g) as paragraphs (e) through (h) and paragraph (b) as paragraph (d);

c. Remove paragraph (c);

d. Add paragraphs (b), (c), and (i); and

e. Revise redesignated paragraphs (e) heading, (e)(1) introductory text, (e)(2) and (e)(3)(iii) and (f).

**§ 704.3 Corporate credit union capital.**

(a) *Capital plan.* * * *

(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.

(i) The initial disclosure 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; and

(ii) The annual disclosure notice must be signed by the chair of the corporate credit union. The chair must 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.

(3) *Three-year remaining maturity.* When a membership capital account has been placed on notice or has a remaining maturity of less than 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 one year before the end of the notice period. The full balance of a membership capital account being amortized, not just the remaining non-amortized portion, is available to absorb losses in excess of the sum of retained 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 liquidation, the membership capital may be released to facilitate the payout of shares with the prior written approval of the OCCU Director.

(5) *Sale.* A member may sell its membership capital to another member 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 transfers to the continuing corporate credit union. The minimum three-year notice period for withdrawal of membership capital remains 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 its capital plan.

(iii) *Notice of withdrawal.* Upon 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.

(9) *Grandfathering.* Membership capital issued before the effective date of this regulation is exempt from the limitation of § 704.3(b)(8)(i).

(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 and 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.

(2) *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 liquidation, the paid-in capital may be released to facilitate the payout of shares with the prior written approval of the OCCU Director.

(3) *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.

(4) *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.

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

(6) *Paid-in capital.* 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.

(7) *Grandfathering.* A corporate credit union's authority to include paid-in capital as a component of capital is governed by the regulation in effect at the time the paid-in capital was issued. When a grandfathered paid-in capital instrument has a remaining maturity of less than 3 years, the amount that may be considered paid-in capital 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 grandfathered paid-in capital being amortized, not just the remaining non-amortized portion, is available to absorb losses in excess of retained earnings until the funds are released by the corporate credit union at maturity.

* * * * *

(e) *Individual capital ratio requirement*—(1) When significant circumstances or events warrant, the OCCU Director 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:

* * * * *

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

(3) * * *

(iii) After the close of the corporate credit union's response period, the OCCU Director 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 must be reached. 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.

(f) *Failure to maintain minimum capital ratio requirement.* When a corporate credit union's capital ratio falls below the minimum required by paragraphs (d) or (e) 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 the OCCU Director within 10 calendar days.

* * * * *

(i) *Earnings retention requirement.* A corporate credit union must increase retained earnings if the prior month-end retained earnings ratio is less than 2 percent.

(1) Its retained earnings must increase:

(i) During the current month, by an amount equal to or greater than the monthly earnings retention amount; or

(ii) During the current and prior two months, by an amount equal to or greater than the quarterly earnings retention amount.

(2) Earnings retention amounts are calculated as follows:

(i) The monthly earnings retention amount is determined by multiplying the earnings retention factor by the prior month-end moving daily average net assets; and

(ii) The quarterly earnings retention amount is determined by multiplying the earnings retention factor by moving daily average net assets for each of the prior three month-ends.

(3) The earnings retention factor is determined as follows:

(i) If the prior month-end retained earnings ratio is less than 2 percent and the core capital ratio is less than 3 percent, the earnings retention factor is .15 percent per annum; or

(ii) If the prior month-end retained earnings ratio is less than 2 percent and the core capital ratio is equal to or greater than 3 percent, the earnings retention factor is .10 percent per annum.

(4) The OCCU Director may approve a decrease to the earnings retention amount if it is determined a lesser amount is necessary to avoid a significant adverse impact upon a corporate credit union.

(5) Operating management of the corporate credit union must notify its board of directors, supervisory committee, the OCCU Director and, if applicable, the state regulator within 10 calendar days of determining that the retained earnings ratio has declined below 2 percent. If the decline in the retained earnings ratio is due, in full or in part, to a decline in the dollar amount of retained earnings and the retained earnings ratio is not restored to at least 2 percent by the next month end, a retained earnings action plan is required to be submitted within 30 calendar days.

(6) The retained earnings action plan must be submitted to the OCCU Director and, if applicable, the state regulator and, at a minimum, include the following:

(i) Reasons why the dollar amount of retained earnings has decreased;

(ii) Description of actions to be taken to increase the dollar amount of retained earnings within specific time frames; and

(iii) Monthly balance sheet and income projections, including assumptions, for the next 12-month period.

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);

d. Revise redesignated paragraphs (d)(3) and the first sentence of (d)(4);

e. Add paragraph (h)(4); and

f. Add at the end of paragraph (c)(4) after the '';'' an ''and.''

**§ 704.5 Investments.**

(a) * * *

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

(2) Reasonable and supportable concentration limits for limited liquidity investments in relation to capital.

* * * * *

(c) * * *

(5) Domestically-issued asset-backed securities.

(d) * * *

(1) The corporate credit union, directly or through its agent, receives written confirmation of the transaction, 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 first priority security interest in the collateral by taking physical possession or control of the collateral, or is recorded as owner of the collateral 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 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 trading securities unless accounted for on a trade date basis;

(3) Engaging in adjusted trading or short sales; and

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

* * * * *

8. Amend § 704.6 by revising paragraph (a) introductory text and paragraphs (a)(3), (a)(4) and (b) 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 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 NCUSIF 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. An investment that fails a requirement of this section because of a subsequent reduction in capital will be deemed nonconforming. A corporate credit union is required to exercise reasonable efforts to bring nonconforming investments into conformity within 90 calendar days. Investments that remain nonconforming for 90 calendar days will be deemed to fail a requirement of this section and the corporate credit union will have to comply 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, investments with long-term ratings must be rated no lower than AA– (or equivalent) and investments with short-term ratings 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) When two or more ratings are relied upon to meet the requirements of this part at the time of purchase, the board or an appropriate committee must place on the § 704.6(e)(1) investment watch list any investment for which a rating is downgraded below the minimum rating requirements of this part.

(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) At least annually, a written evaluation of each credit limit with each obligor or transaction counterparty must be prepared and formally approved by the board or an appropriate committee. At least monthly, the board or an appropriate committee must receive an investment 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 one member 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, lines of credit and letters 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 not excluded under § 723.1(b) of this chapter 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 U.S. 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 paragraphs (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 ''; and'' at the end of redesignated paragraph (a)(5) in place of the period;

d. Add paragraph (a)(6);

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

f. Add a sentence to the end of paragraph (c); and

g. Revise paragraphs (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 estimate the impact of investments on the percentage decline in NEV, compared to base case NEV. The most recent NEV analysis, as determined under paragraph (d)(1)(i) of this section may be used as a basis of estimation.

* * * * *

(c) * * * This means the minimum penalty must be reasonably related to the rate that the corporate credit union would be required to offer to attract funds for a similar term with similar characteristics.

(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 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 15 percent.

(2) A corporate credit union must assess annually if it should conduct periodic additional tests to address market factors that may 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 the OCCU Director. If any violation persists for 30 calendar days, the corporate credit

union must submit a detailed, written action plan to the OCCU Director that sets forth the time needed and means by which it intends to correct the violation. If the OCCU Director determines that the plan is unacceptable, the corporate credit union must immediately restructure the balance sheet to bring the exposure back within compliance or adhere to an alternative course of action determined by the OCCU Director.

(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.

10a. Amend § 704.10 by revising the section heading and the first sentence of paragraph (a) to read as follows:

**§ 704.10 Investment action plan.**

(a) Any corporate credit union in possession of an investment, including a derivative, that fails to meet a requirement of this part must, within 30 calendar days of the failure, report the failed investment to its board of directors, supervisory committee and the OCCU Director. * * *

* * * * *

11. Amend § 704.11 by revising paragraph (b), redesignating paragraphs (c) through (e) as paragraphs (f) through (h), adding paragraphs (c), (d) and (e) and revising redesignated paragraph (g)(3) 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 member and nonmember corporate CUSOs must not exceed 15 percent of a corporate credit union's capital.

(2) The aggregate of all investments in and loans to member and nonmember corporate CUSOs must not exceed 30 percent of a corporate credit union's capital. A corporate credit union may lend 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.

(3) If the limitations in paragraphs (b)(1) and (b)(2) 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.

(4) The aggregate of all loans to corporate CUSOs must comply with the aggregate limit of § 723.16 of this chapter. This requirement does not apply to loans excluded under § 723.1(b).

(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 excluded under § 723.1(b).

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

(2) A corporate credit union investing in or lending to a corporate CUSO must obtain a written legal opinion that concludes 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 depository financial institution or to invest in shares, stocks, or obligations of an insurance company, trade association, liquidity facility, or similar organization.

* * * * *

(g) * * *

(3) Obtain an annual CPA opinion audit and provide a copy to the corporate credit union. A wholly owned or majority owned CUSO is not required to obtain a separate annual audit if it is included in the corporate credit union's annual consolidated audit; and

* * * * *

12. Revise § 704.12 to read as follows:

**§ 704.12 Permissible services.**

(a) *Preapproved services.* A corporate credit union may provide to members the preapproved services set out in this section. NCUA may at any time, based upon supervisory, legal, or safety and soundness reasons, limit or prohibit any preapproved service. The specific activities listed within each preapproved category are provided as illustrations of activities permissible under the particular category, not as an exclusive or exhaustive list.

(1) *Correspondent services agreement.* 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 the other corporate credit union or its members.

(2) *Credit and investment services.* Credit and investment services are advisory and consulting activities that assist the member in lending or investment management. These services may include loan reviews, investment portfolio reviews and investment advisory services.

(3) *Electronic financial services.* Electronic financial services are any services, products, functions, or activities that a corporate credit union is otherwise authorized to perform, provide or deliver to its members but performed through electronic means. Electronic services may include automated teller machines, online transaction processing through a website, website hosting services, account aggregation services, and internet access services to perform or deliver products or services to members.

(4) *Excess capacity.* Excess capacity is the excess use or capacity remaining in facilities, equipment or services that: a corporate credit union properly invested in or established, in good faith, with the intent of serving its members; and it reasonably anticipates will be taken up by the future expansion of services to its members. A corporate credit union may sell or lease the excess capacity in facilities, equipment or services, such as office space, employees and data processing.

(5) *Liquidity and asset and liability management.* Liquidity and asset and liability management services are any services, functions or activities that assist the member in liquidity and balance sheet management. These services may include liquidity planning and balance sheet modeling and analysis.

(6) *Operational services.* Operational services are services established to deliver financial products and services that enhance member service and promote safe and sound operations. Operational services may include tax payment, electronic fund transfers and providing coin and currency service.

(7) *Payment systems.* Payment systems are any methods used to facilitate the movement of funds for transactional purposes. Payment

systems may include Automated Clearing House, wire transfer, item processing and settlement services.

(8) *Trustee or custodial services.* Trustee services are services in which the corporate credit union is authorized to act under a written trust agreement to the extent permitted under part 724 of this chapter. Custodial and safekeeping services are services a corporate credit union performs on behalf of its member to act as custodian or safekeeper of investments.

(b) *Procedure for adding services that are not preapproved.* To provide a service to its members that is not preapproved by NCUA:

(1) A federal corporate credit union must request approval from NCUA. The request must include a full explanation and complete documentation of the service and how the service relates to a corporate credit union's authority to provide services to its members. The request must be submitted jointly to the OCCU Director and the Secretary of the Board. The request will be treated as a petition to amend § 704.12 and NCUA will request public comment or otherwise act on the petition within a reasonable period of time. Before engaging in the formal approval process, a corporate credit union should seek an advisory opinion from NCUA's Office of General Counsel as to whether a proposed service is already covered by one of the authorized categories without filing a petition to amend the regulation; and

(2) A state-chartered corporate credit union must submit a request for a waiver that complies with § 704.1(b) to the OCCU Director.

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

**§ 704.13 [Removed and Reserved]**

13. Remove and reserve § 704.13.

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, a credit union trade association includes but is not limited to, state credit union leagues and league service corporations and national credit union trade associations.

* * * * *

**§ 704.18 [Amended]**

15. Amend § 704.18(e)(1), including the table, by removing the words ''reserve ratio'' wherever they appear and adding in their place, the words ''core capital ratio'' and removing the words ''reserves and undivided'' wherever they appear adding in their place, the word ''retained.''

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

**§ 704.19 Wholesale corporate credit unions.**

* * * * *

(b) *Earnings retention requirement.* A wholesale corporate credit union must increase retained earnings if the prior month-end retained earnings ratio is less than 1 percent.

(1) Its retained earnings must increase:

(i) During the current month, by an amount equal to or greater than the monthly earnings retention amount; or

(ii) During the current and prior two months, by an amount equal to or greater than the quarterly earnings retention amount.

(2) Earnings retention amounts are calculated as follows:

(i) The monthly earnings retention amount is determined by multiplying the earnings retention factor by the prior month-end moving daily average net assets; and

(ii) The quarterly earnings retention amount is determined by multiplying the earnings retention factor by moving daily average net assets for each of the prior three month-ends.

(3) The earnings retention factor is determined as follows:

(i) If the prior month-end retained earnings ratio is less than 1 percent and the core capital ratio is less than 3 percent, the earnings retention factor is .15 percent per annum; or

(ii) If the prior month-end retained earnings ratio is less than 1 percent and the core capital ratio is equal to or greater than 3 percent, the earnings retention factor is .075 percent per annum.

(4) The OCCU Director may approve a decrease to the earnings retention amount set forth in this section if it is determined a lesser amount is necessary to avoid a significant adverse impact upon a wholesale corporate credit union.

(5) Operating management of the wholesale corporate credit union must notify its board of directors, supervisory committee, OCCU Director and, if applicable, the state regulator within 10 calendar days of determining the retained earnings ratio has declined below 1 percent. If the decline in the retained earnings ratio is due in full or in part, to a decline in the dollar amount of retained earnings and the retained earnings ratio is not restored to at least 1 percent by the next month end, a retained earnings action plan is required to be submitted within 30 calendar days.

(6) The retained earnings action plan must be submitted to the OCCU Director and, if applicable, the state regulator and, at a minimum, include the following:

(i) Reasons why the dollar amount of retained earnings has decreased;

(ii) Description of actions to be taken to increase the dollar amount of retained earnings within specific time frames; and

(iii) Monthly balance sheet and income projections, including assumptions for the ensuing 12-month period.

17. 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 § 704.3.

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 retained 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 will 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)_____.

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 retained 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 will transfer to the continuing corporate credit union.

(8) Paid-in capital is perpetual maturity and noncumulative dividend.

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.

18. 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 Appendix if it meets the applicable requirements of Part 704 and Appendix B, fulfills additional management, infrastructure, and asset and liability requirements, and receives NCUA's written approval. Additional guidance is set forth 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 credit union of the reason(s) 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 deficiency.

*Minimum Requirement*

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 evaluate monthly the changes in NEV and the NEV ratio for the tests set forth in § 704.8(d)(1)(i).

**Base-Plus**

A corporate that has met the requirements for this Base-plus authority may, in performing the rate stress tests set forth in § 704.8(d)(1)(i), allow its NEV to decline as much as 20 percent.

**Part I**

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

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

(2) Purchase investments with short-term ratings no lower than A–2 (or equivalent), provided that the issuer has a long-term rating no lower than A– (or equivalent) or the investment is a domestically-issued asset-backed security;

(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; and

(5) Enter into a dollar roll transaction.

(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 that has met the requirements of this Part I may decline as much as:

(1) 20 percent;

(2) 28 percent if the corporate credit union has a 5 percent minimum capital ratio and is specifically approved by NCUA; or

(3) 35 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 II**

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

(1) Purchase investments with long-term ratings no lower than BBB (flat) (or equivalent). The aggregate of all investments rated BBB+ (or equivalent) or lower in any single obligor is not to exceed 25 percent of capital;

(2) Purchase investments with short-term ratings no lower than A–2 (or equivalent), provided that the issuer has a long-term rating no lower than BBB (flat) (or equivalent) or the investment is a domestically issued asset-backed security;

(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; and

(5) Enter into a dollar roll transaction.

(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) 20 percent;

(2) 28 percent if the corporate credit union has a 5 percent minimum capital ratio and is specifically approved by NCUA; or

(3) 35 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 that has met the 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;

(2) Deposits and debt obligations of foreign banks or obligations guaranteed by these banks;

(3) Marketable debt obligations of foreign corporations. This authority does not apply to debt obligations that are convertible into the stock of the corporation; and

(4) Foreign issued asset-backed securities.

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

(1) Investments must be rated no lower than the minimum permissible domestic rating under the corporate credit union's Part I or Part II authority;

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

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

(4) Obligations of any single foreign obligor may not exceed 50 percent of capital; and

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

**Part IV**

(a) A corporate credit union that 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 sheets of its members.

(b) Credit Ratings:

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

(i) If the counterparty is domestic, the counterparty rating must be no lower than the minimum permissible rating for comparable term permissible investments; and

(ii) If the counterparty is foreign, the corporate must have Part III expanded authority and the counterparty rating must be no lower that the minimum permissible rating for a comparable term investment under Part III Authority.

(iii) Any rating(s) relied upon to meet the requirements of this part must be identified at the time the transaction is entered into and must be monitored for as long as the contract remains open.

(iv) Section 704.10 of this part if:

(A) 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

(B) 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.

(2) Exceptions. Credit ratings are not required for derivative transactions with:

(i) Domestically chartered credit unions;

(ii) U.S. government sponsored enterprises; or

(iii) Counterparties if the transaction is fully guaranteed by an entity with a minimum permissible rating for comparable term investments.

**Part V**

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

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

(b) The maximum aggregate amount of participation loans with all member credit unions will be determined on a case-by-case basis by the OCCU Director.

**§§ 704.3, 704.10, 704.15 [Amended]**

19. In addition to the amendments set forth above, in 12 CFR part 704 remove the acronym ''NCUA'' wherever it appears and add in their place, the words ''the OCCU Director'' in the following places:

a. Redesignated § 704.3(e)(3)(i) and (ii), (g)(2)(v) and (g)(3).

b. Section 704.10(a) introductory text, (b) and (c).

c. Section 704.15(a) and (b).

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