CORPORATE CREDIT UNION REGULATORY REFORM
SUMMARY OF DRAFT FINAL AMENDMENTS TO CORPORATE RULE
SEPTEMBER 1, 2010

INTRODUCTION

This document summarizes the major provisions in the final rulemaking amending Part 704, NCUA's rule on corporate credit unions (corporates). The final rulemaking includes provisions related to corporate capital standards, prompt corrective action, investment authorities, asset liability management, CUSO requirements, and corporate governance.

These amendments are designed to work collectively to strengthen corporates and the corporate system. No one change will prevent inordinate risk going forward, but all the provisions working in concert will be effective in preventing systemic risk. The final rule generally becomes effective 90 days after publication in the Federal Register, but some provisions, as discussed below and enumerated in Section 6, have delayed effective dates beyond 90 days.

1. CAPITAL STANDARDS

Currently, corporates have only one mandatory minimum capital requirement: they must maintain total capital (retained earnings, paid-in capital, and membership capital accounts) in an amount equal to or greater than 4% of their moving daily average net assets (MDANA).[1] Failure by a corporate to meet this minimum capital ratio triggers the requirement to file a capital restoration plan with NCUA and may cause NCUA to issue a capital restoration directive and take other administrative action. Although prompt corrective action (PCA) applies to natural person credit unions (NPCUs) and to banking entities, PCA does not currently apply to corporates. The current rule also provides that retail corporates with a retained earnings ratio of less than two percent must increase their retained earnings by a certain amount each quarter, but this reserving requirement only applies to a wholesale corporate credit union if its retained earnings ratio falls below one percent.

Final amendments to Part 704 capital rules

The final rule modifies the current corporate capital requirements to make them stronger and more consistent with the Basel I capital requirements imposed by the banking regulators on banks.

To be considered adequately capitalized, the final rule replaces the current 4% minimum total capital ratio with three minimum capital ratios:

- 4% minimum "leverage" ratio (5% to be well-capitalized (WC)),

[1] Corporates have other capital-related requirements, such as a core capital ratio and a retained earnings ratio, but failure to meet these requirements only triggers future earnings retention requirements and does not trigger a capital restoration plan requirement or other particular supervisory actions.

- 4% tier one risk-based capital ratio (6% to be WC), and
- 8% total risk-based capital ratio (10% to be WC).

The two risk weighted ratios ensure that the corporate has enough capital to protect itself against credit risk and the leverage ratio ensures that the corporate has enough capital to protect itself against other, noncredit risk (e.g., market and operational risk). Failure to meet any of these three minimum ratios triggers a capital restoration plan requirement and, potentially, other, new PCA provisions as discussed below.

The final rule replaces the term “paid-in capital” (PIC) with “perpetual contributed capital” (PCC), and the term “membership capital account” (MCA) with “nonperpetual capital account” (NCA).

The final rule limits the capital that a corporate may use to calculate two of the ratios (i.e., the permanent leverage ratio and the Tier 1 risk based capital ratio) to “Tier 1” capital or “core” capital, which would generally include only retained earnings (RE) and PCC, the two permanent forms of corporate capital.[2] All three forms of capital (i.e., RE, PCC, and NCAs) are used to calculate the total risk-based capital ratio. The final rule also provides for certain adjustments to capital; for example, by requiring that a corporate that contributes capital to another corporate after the effective date of the rule must, generally, deduct this new investment from its own capital. The leverage ratio uses moving daily average net assets (MDANA) in the denominator, while the two risk based capital ratios use moving *monthly* average net assets (MMANRA) in the denominator.

The final rule requires that RE constitute a certain portion of capital. For example, to be adequately capitalized, the corporate must have at least 100 basis points (bps) of RE after six years (i.e., RE must equal 1% of MDANA) and at least 200 bps after ten years. Similarly, to be well capitalized, the corporate must have at least 150 bps of RE after six years and 250 bps after ten years. A corporate that fails to make some progress towards these requirements (i.e., 45 bps after three years) will have to submit and comply with a RE accumulation plan (REAP), however, NCUA retains flexibility in approving appropriate REAP milestones.

The final rule toughens NCA requirements to make them consistent with Basel I standards: the three year term requirement of MCAs will be lengthened to five years, and the currently permissible MCA adjustable balance type of capital accounts will be eliminated. MCAs that are not converted to NCAs or PCC within one year must be put on notice by the corporate and, to the extent not needed to cover operational losses, returned to the member at the end of the notice period.

[2] The rule also includes a temporary, “interim leverage ratio” to facilitate the phase-in over time of the new capital requirements. See the chart discussing the phase-in of the capital requirements below.

The final rule also forbids a corporate from redeeming contributed capital prior to maturity without the prior approval of the NCUA and, for state chartered corporates, the appropriate SSA.

The current rule allows a corporate to issue PIC to both members and nonmembers, while MCAs may only be issued to members. The final rule permits a corporate to issue all forms of capital, both PCC and NCAs, to nonmembers, and permits members to sell or transfer their corporate capital to non natural person third parties, whether or not those third-parties are members.

The current rule prohibits a corporate from conditioning membership or the receipt of services upon the purchase of PIC, and the final rule eliminates this prohibition. If a corporate decides to condition membership, services, or the prices of services on the purchase of PIC, it must give members six months advance notice.

The final rule defines how a corporate's assets and activities will be risk-weighted for purposes of determining their risk-based capital ratios.

- Assets that appear on the corporate's balance sheet will, generally, be risk-weighted at 0 percent, 20 percent, 50 percent, or 100 percent, with less risky assets (e.g., treasury bills) given lower percentages, and more risky assets (e.g., fixed assets) given higher percentages. Activities that involve risk but do not appear on a corporate's balance sheet (e.g., an interest rate swap, or a guaranteed line of credit not yet drawn upon) are assigned a conversion factor and then risk weighted as if the underlying assets were, in fact, on the corporate's balance sheet. Recourse obligations (e.g., a recourse obligation on a transferred loan) and direct credit substitutes (e.g., a mortgage backed security that is subordinated to other securities in the same issuance) are generally treated as if the entire amount of the supported asset is on the credit union's balance sheet. Residual interests (e.g., retained, subordinated interests in a loan or loan participation transfer, or a retained credit enhancing interest-only strip) have different, more severe risk weighting calculations.

- The rule does not require a corporate to use Nationally Recognized Statistical Rating Organization (NRSRO) ratings when risk-weighting, but a corporate may employ a ratings-based risk weighting approach (RBA) option for certain investments that have an NRSRO rating.[3] When there is more than one NRSRO rating, the corporate must use the lowest rating, and if the corporate decides to use the RBA on a particular call report it must use the RBA for every eligible security that has an NRSRO rating.

[3] On July 21, 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA). Section 939A of the DFA requires federal agencies, within one year, to review the use of NRSRO ratings in regulations and seek to replace those ratings with other measurements of credit risk. This review may cause NCUA to further amend this provision of the final corporate rule, and others, in the future.

The final PCA provisions are similar to those currently applicable to banks and NPCUs. Each corporate will be assigned to one of five capital categories: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The potential consequences of failing to meet capital standards include restrictions on activities, restrictions on investments and asset growth, restrictions on the payment of dividends, restrictions on executive compensation, requirements to elect new directors or dismiss management, and possible conservatorship. The due process for credit unions and their employees associated with the new PCA provisions is generally set out in a new subpart to part 747 of NCUA's rules.

The final rule eliminates the special treatment that wholesale corporates receive with regard to RE reserving requirements.

Phase-in of the new capital provisions.

It will take some time for certain corporates to rebuild capital. Accordingly, the new capital and PCA provisions will be phased-in over time. Generally, the new PCA provisions and most of the new capital provisions will go into effect one year after the date of publication of the final rule, but some will be delayed more than one year. The following chart summarizes the capital phase-in timetable:

Months following pub-lication of final rule	Minimum Leverage Ratio	Min. Total RBC Ratio	Min. T1RBC Ratio	Min. Retained Earnings Ratio	Discussion
1 - 12	N/A	N/A	N/A	N/A	Old corporate rule 4% minimum total capital ratio remains in effect, subject to NCUA's Capital Order issued on April 29, 2010.
13 - 36	4% "Interim" ratio	8%	4%	N/A	Failure to meet any minimum capital ratio subjects corporate to PCA. *Interim* leverage ratio is defined to include any combination of NCAs, PCC, or retained earnings (RE) in numerator.
37 - 72	4% "Perm-anent" ratio	8%	4%	0.45%	If corporate does not have RE equal to 0.45% of assets, it must submit a retained earnings accumulation plan to NCUA; failure to meet any other minimum capital ratio subjects corporate immediately to PCA *Permanent* leverage ratio is defined to use only PCC and RE in numerator.
73 -120	4%	8 %	4%	1%	Corporate that fails to achieve and maintain a 1.0% RE ratio, or other minimum capital ratios, will be subject to PCA.
121 --	4%	8%	4%	2%	Corporate that fails achieve and maintain a 2.0% RE ratio, or other minimum capital ratios, will be subject to PCA.

For additional information about the effective dates of particular rule provision, see Section six below.

To facilitate the rebuilding of corporate capital, the new rule will also permit corporates, at their option, to give capital contributed after the publication of the final rule higher priority than existing contributed capital for purposes of absorption of operating losses and payment of liquidation claims.

2. INVESTMENT AUTHORITY

The current Part 704 generally prohibits certain types of investments, including derivatives, stripped mortgage backed securities (MBS), mortgage servicing rights, and residual interests in asset backed securities (ABS). The rule specifies, for permissible investment types, that investments must be rated no lower than AA- by at least one NRSRO at time of purchase. Corporates that qualify for Part I expanded authority, however, have additional investment authority, including the purchase of investments rated down to A-. Corporates that qualify for Part II expanded authority may purchase investments rated down to BBB (flat). Corporates that qualify for Part IV expanded authority may engage in derivatives transactions for certain specified purposes.

The current rule requires that corporates maintain an internal investment policy that includes "reasonable and supportable concentration limits" including limits by "investor type and sector." The current rule limits the aggregate of all investments in any single obligor to the greater of 50 percent of capital or $5 million, but includes no regulatory sector limits. The current rule does not limit investments that are structured to be subordinate, in terms of potential credit losses, to other securities.

Final amendments to Part 704 investment limitations.

The final rule prohibits investments in private label residential mortgage-backed securities (RMBS) and subordinated securities. Private label RMBs and subordinated securities, together, caused almost all of the credit losses in the corporate system since 2007. The final rule also prohibits investments in collateralized debt obligations (CDOs) and net interest margin (NIM) securities. CDOs and NIMs are complex and volatile investment types that have also proven problematic for corporates.

The final rule eliminates Part II expanded authority, thus making "A-"the lowest possible rating for an NRSRO-rated investment purchased by a corporate with expanded investment authority. To qualify for the new Parts I and II (i.e., the current Parts I and III) expanded investment authority, the final rule requires a corporate achieve and maintain higher capital levels, that is, a minimum six percent leverage ratio.

The final rule also requires that a corporate examine the NRSRO rating from every NRSRO that publicly rates a particular investment and only employ the lowest of those

ratings. It further requires that at least 90 percent of a corporate's investments be rated by at least two NRSROs. Downgrades below the minimum rating threshold will continue to trigger investment action plans.

The final rule will reduce the single obligor limits from 50 percent of capital to 25 percent of capital, with slightly higher limits for mutual fund investments. The final rule will also impose specific concentration limits by investment sector. Sectors include residential mortgage backed securities, commercial mortgage backed securities, student loan asset backed securities, automobile loan/lease asset backed securities, credit card asset backed securities, other asset backed securities, corporate debt obligations, municipal securities, money market mutual funds, and an "all others" category to account for the development of new investment types. The sector limits are, generally, 1) the lower of 500 percent of capital/25 percent of assets, or 2) the lower of 1000 percent of capital/50 percent of assets (for the less risky sectors).

The final rule excludes certain assets entirely from both the sector concentration limits and the single obligor concentration limit, including fixed assets, loans, investments in CUSOs, investments issued by the United States or its agencies or its government sponsored enterprises, and investments fully guaranteed or insured as to principal and interest by the United States or its agencies. Investments in other federally-insured credit unions, deposits in other depository institutions, and investment repurchase agreements are also excluded from the sector concentration limits but not the single obligor concentration limit. Investments in CUSOs continue to be subject to the current limitations in the CUSO rule.

The final rule generally limits a corporate's Part III (renumbered from Part IV) derivatives activity to derivatives used for the purposes of reducing the corporate's, or its member's, overall risk. A corporate that has acquired Part III expanded authorities for derivatives may engage in derivatives authority with counterparties down to an A- credit rating.

The final rule adds, or modifies, the following investment-related definitions: *Appropriate state regulator, Derivative, Equity investment, Equity security, Private label, Residual interest, Small Business Related Security, Subordinated security,* and *NRSRO.* The final rule substitutes the term *Investment settlement* for *Regular way settlement*, and redefines that term. The final rule also adds *Collective investment funds* as a permissible investment.

3. ASSET-LIABILITY MANAGEMENT (ALM)

The current Part 704 requires that corporates maintain an internal ALM policy. The rule requires that as part of that policy the corporate do net economic value (NEV) modeling to measure the risk of interest rate changes of up to 300 basis points, but the rule does not have any other requirements relating to the length of asset cash flows. The current rule limits a corporate's borrowing to the greater of 10 times capital or 50 percent of shares and capital, but does not place any additional limits on secured borrowings.

Final amendments to Part 704 ALM provisions.

The final rule establishes two limits on the expected life of a corporate's asset cash flows to ensure that they do not present excessive liquidity and extension risk, or aggravate existing credit risk:

- A prohibition on the weighted average life (WAL) of a corporate's loans and investments exceeding 2.0 years.

- A prohibition on the WAL of a corporate's loans and investments (assuming that prepayment speeds slow by 50 percent) exceeding 2.25 years.

The final rule allows the WAL of securities issued by, or fully guaranteed as to principal and interest by, the U.S. government or its agencies or its sponsored enterprises to be multiplied by a factor of 0.50 when determining the WAL of a corporate's entire portfolio. So, for example, a 4-year WAL agency security will be treated as if it has a 2-year WAL for purposes of compliance with the two WAL tests above.

The final rule places limits on both aggregate borrowing and secured borrowing. The current rule permits a corporate to borrow, in the aggregate, up to the greater of 10 times capital or 50 percent of shares and capital; and the final rule reduces that limit to the lower of those two figures. The final rule permits a corporate to borrow on a secured basis, but, generally, only for liquidity purposes and only with a maximum maturity of 30 days. A corporate may also borrow on a secured basis for nonliquidity purposes, but only if the corporate is well-capitalized and only in an amount equal to the corporate's excess capital. These borrowing limits will discourage a corporate from borrowing for investment arbitrage purposes.

The final rule prohibits a corporate from accepting from any member, or any nonmember credit union, any investment, including shares, loans, PCC, or NCAs, if, following that investment, the aggregate of all investments from that entity in the corporate would exceed 15 percent of the corporate credit union's moving daily average net assets. This prohibition, which will have a 30-month delayed effective date, will reduce the risk to the corporate of any particular member moving its business elsewhere.

The final rule requires a corporate to keep a sufficient amount of cash and cash equivalents on hand to support its payment systems obligations and to demonstrate adequate sources of liquidity; to calculate and record the effective and spread durations for individual assets and liabilities; and to conduct net interest income (NII) modeling. The final rule, however, does not prescribe specific standards for these activities and calculations.

4. CORPORATE CREDIT UNION SERVICE ORGANIZATIONS (CUSOs)

The current §704.11 does not specify the particular activities that a corporate CUSO may engage in but does provide that a CUSO must "primarily serve credit unions" and "restrict its services to those related to the normal course of business of credit unions."

The final rule retains these two requirements, but further requires that a corporate CUSO may only engage in activities preapproved by NCUA. Brokerage services and investment advisory services will be preapproved in the rule, and NCUA will approve or disapprove additional categories of activities upon request. This requirement for NCUA approval will have a delayed effective date 180 days following the publication of the final rule to provide time for application to NCUA and NCUA review. In addition, the final rule provides that once NCUA has approved an activity and published its approval on NCUA's website NCUA can only reverse or modify its approval via a formal rulemaking.

The current rule requires a corporate CUSO agree with the corporate to permit the corporate and NCUA complete access to the CUSO's books, records, "and other pertinent documentation." The final rule strengthens this requirement by specifically requiring the CUSO agree to allow access to its books, records, personnel, equipment, and facilities.

5. CORPORATE GOVERNANCE

The current Part 704 places limitations on board representation, including limits on the number of trade organization representatives. The current rule does not, however, place any experience or knowledge requirements on individual corporate directors, nor does it limit the representation of corporate managers and officials on the boards of other corporates. The current rule does not require any disclosure of senior executive compensation to the members of a corporate,[4] nor does it place any limits on "golden parachute" severance packages for corporate senior executives. The corporate rule does not address indemnification, although §701.33 of NCUA's rules has indemnification provisions generally applicable to FCUs.

Final amendments to Part 704 corporate governance provisions.

The final rule requires that all corporate board members hold either a CEO, CFO, or COO position at their member credit union or other member entity. The final rule also requires that a majority of a corporate's board members be representatives of NPCU members. Additionally, no person may sit on the boards of two or more corporates at the same time, nor may a single organizational member have more than one individual

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[4] The Internal Revenue Code, and state law, may require some disclosure for state chartered corporates, but not for federal charters.

representative on the board of any given corporate. The final rule phases some of these new requirements in over time (e.g., 36 months for the majority NPCU director requirement).

The final rule requires that each corporate prepare, on an annual basis, a document that discloses the compensation, in dollars, of its most highly compensated employees.[5] Compensation is broadly defined, and includes benefits, deferred payments, informal arrangements, and payments made to acquaintances and relatives. Any member of the corporate may obtain a copy of the disclosure upon request, and the corporate must also distribute the information to its members at least once a year, in the annual report or by some other means of its choosing. The credit union may include with the disclosure additional information if necessary to put the disclosure in context. With respect to any corporate merger, a merging federally-chartered corporate must affirmatively disclose to both NCUA and its members any material, merger-related increase in compensation (i.e., an increase of more than 15% or $10,000, whichever is greater) for any senior executive or director. A state-chartered corporate must also make the merger-related disclosure, but only to NCUA unless state law requires otherwise.

The final rule prohibits golden parachutes, that is, payments made to an institution affiliated party (IAP) that are contingent on the termination of that person's employment and received when the corporate making the payment is either troubled, undercapitalized, or insolvent. The final rule also generally prohibits a corporate, regardless of its financial condition, from paying or reimbursing an IAP's legal and other professional expenses incurred in administrative or civil proceedings instituted by NCUA or a state regulatory authority where the IAP is ultimately found liable. For federal corporates, the indemnification limits are in addition to the requirements of §701.33.

6. SUMMARY OF AFFECTED PROVISIONS AND EFFECTIVE DATES

The matrix below summarizes the provision of NCUA's rules affected by this rulemaking, along with the effective dates for each provision.

Current Rule Provision	Amended?	Delayed Effective Dates? (e.g., "+12 months" means delayed 12 months following date of publication of final rule in Federal Register)
704.1 *Scope*	No.	N/A

[5] The disclosure includes the three, four, or five most highly compensated employees at each corporate, with the exact number of employees depending on the size of the corporate. The compensation of the corporate's CEO must also be disclosed, even if the CEO is not among the most highly compensated at the corporate.

Current Rule Provision	Amended?	Delayed Effective Dates? (e.g., "+12 months" means delayed 12 months following date of publication of final rule in Federal Register)
704.2 *Definitions*	Yes. Removed and replaced twice. Second replacement introduces capital and PCA definitions.	First replacement of 704.2. +90 days Second replacement of 704.2. +12 months *Adjusted Core Capital* -- deduct PCC or NCA at other corporate. +12 months -- deduct certain excess PCC. +72 months to +120 months -- deduct PCC in excess of retained earnings. +120 months *Permanent Leverage Ratio.* +36 months
704.3 *Corporate credit union capital*	Yes.	Current 704.3 replaced. +12 months 704.3(a)(3): If RE ratio less than 0.45, must submit REAP. +36 months 704.3(f)(4): Corporate with unconverted MCAs must notify MCA holders of account status. +14 months
704.4 *Board respon-sibilities*	Yes. The current *Board responsibilities* is redesignated as 704.13. New 704.4 *Prompt corrective action* (PCA) added.	Current 704.4 replaced with PCA section. +12 months
704.5 *Invest-ments*	Yes.	+90 days
704.6 *Credit risk manage-ment*	Yes.	+90 days
704.7 *Lending*	No.	N/A
704.8 *Asset and liability Manage-ment*	Yes.	Generally, +90 days 704.8(k): Prohibition on a corporate receiving more than 15 percent of business from one member or credit union. +30 months
704.9 *Liquidity manage-ment*	Yes.	+90 days
704.10	No.	N/A

Current Rule Provision	Amended?	Delayed Effective Dates? (e.g., "+12 months" means delayed 12 months following date of publication of final rule in Federal Register)
Investment action plan		
704.11 *Corporate CUSOs*	Yes.	Generally, +90 days 704.11(e)(1): Requirement for NCUA approval of corporate CUSO activities. +180 days. 704.11(e)(2): Requirement that corporate divest from CUSO engaged in unapproved activities. +12 months
704.12 *Permissible services*	No.	N/A
704.13 [Reserved]	Yes.	The current 704.4 *Board responsibilities* redesignated as 704.13. +90 days.
704.14 *Represen-tation*	Yes.	Generally, +90 days. 704.14(a)(2): Requirement that only CEO, CFO, or COO may seek election to corporate board. +120 days 704.14(a)(9): Requirement that at least a majority of each corporate's directors be representatives of NPCUs. +36 months
704.15 *Audit require-ments*	No.	N/A
704.16 *Contract/ written agree-ments*	No.	N/A
704.17 *State-chartered corporate credit unions*	No.	N/A
704.18 *Fidelity bond coverage*	No.	N/A
704.19 *Wholesale corporate*	Yes.	Current 704.19 removed, and new 704.19, *Disclosure of executive and director compensation*, added. +90 days.

Current Rule Provision	Amended?	Delayed Effective Dates? (e.g., "+12 months" means delayed 12 months following date of publication of final rule in Federal Register)
credit unions		
704.20 None.	Yes.	New 704.20, *Golden parachute and indemnification payments*, added. +90 days.
Appendix A *Model Forms*	Yes.	Amended and renamed *Capital Prioritization and Model Forms.* +90 days. Appdx A, Part I: Corporates may determine that newly contributed capital has priority over existing capital. +90 days
Appendix B *Expanded Authorities and Require-ments*	Yes.	Generally, +90 days Part I(e): Substitute "leverage ratio" for "capital ratio." +12 months
Appendix C None.	Yes.	New Appendix C, *Risk-Based Capital Credit Risk-Weight Categories*, added. +12 months
702.105	Yes.	Conforming amendment (to substitute new capital terms). +12 months
703.14(b)	Yes.	Conforming amendment (to substitute new capital terms). +12 months
709.5(b)	Yes.	Conforming amendment (to substitute new capital terms). +90 days
Part 747, subpart M	Yes.	Add new subpart M on due process for PCA actions. +12 months