NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 704, 709, and 741

RIN 3133–AB67

Corporate Credit Unions; Involuntary Liquidation of Federal Credit Unions and Adjudication of Creditor Claims Involving Federally Insured Credit Unions in Liquidation; Requirements for Insurance

AGENCY: National Credit Union Administration (NCUA).

ACTION: Final rule.

SUMMARY: NCUA is issuing a final rule governing corporate credit unions. The rule strengthens capital requirements, establishes parameters to ensure that the risk on corporate credit union balance sheets is adequately managed, provides for corporate credit unions with more developed systems and infrastructures to take more planned and controlled risk, and sets forth special rules for wholesale corporate credit unions.

EFFECTIVE DATE: January 1, 1998.

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SUPPLEMENTARY INFORMATION:

A. Background

In April 1995, NCUA issued a proposed regulation to revise most of Part 704. 60 FR 20438, Apr. 26, 1995. In response to the comments received and results of risk-profile assessments of corporate credit unions using simulated modeling techniques, NCUA determined to issue a revised proposed rule for another round of public comment. 61 FR 28085, June 4, 1996. The proposed rule provided for a 90-day comment period, ending on September 3, 1996. On July 16, 1996, NCUA issued a proposed rule addressing the special circumstances of wholesale corporate credit unions. 61 FR 38117, July 23, 1996. The comment period to this proposal also ended on September 3, 1996. The comment period for both proposals subsequently was extended to October 18, 1996. 61 FR 41750, August 12, 1996. This final rule addresses both proposals.

A total of 289 comments were received on the proposals, 202 from natural person credit unions, 36 from corporate credit unions, 24 from state banking trade associations; 10 from state credit union leagues, 5 from state credit union regulatory authorities, 4 from national credit union trade associations, 4 from credit union organizations and consultants, 3 from other entities that do business with credit unions, and 1 from another type of trade association. The commenters complimented NCUA's efforts to strengthen the regulation and stated that progress had been made from the previous proposal but that changes were still necessary.

A general comment was a request to standardize the time frames for corporate credit unions to take various actions described throughout the regulation. The proposed regulation required corporate credit unions to take action in some cases in business days and in others in calendar days. There also were five different numbers of days for those actions. To make compliance easier, all dates in the final regulation have been changed to calendar days, and the number of days for compliance has been reduced to either 10 days, when only notification is required, or 30 days, when more substantive action is required.

A common thread in many of the comments was the comparison of corporate credit unions with natural person credit unions, banks, savings and loans, and other financial institutions. Another was the suggestion that NCUA take the same approach with corporate credit unions as its sister federal financial institution regulatory agencies take with their respective institutions. While these comparisons are understandable, NCUA cautions that in many cases, they are not appropriate.

Corporate credit unions differ from natural person credit unions, banks, savings institutions, and other financial institutions that serve consumers. They serve exclusively one class of customer: credit unions. Corporate credit union balance sheets, cash flows, and liquidity demands differ significantly from those of other financial institutions. In general, the volume of large dollar transactions present unique risks not seen in consumer-oriented institutions. As a result, while considering comparisons with other institutions and sister agencies, NCUA has been careful to put those comparisons into proper perspective and to regulate to the areas of risk.

A number of commenters strongly suggested that NCUA review the corporate regulation on an annual basis. While NCUA believes that a periodic review is necessary, it believes that circumstances and need should determine the frequency. NCUA has identified a number of issues, some of which are identified in this supplementary information section, that warrant further study relatively soon after the regulation is implemented. Accordingly, the Office of Corporate Credit Unions will present a report of these and other issues within 18 months of publication of the final rule.

B. Section-by-Section Analysis

Section 704.1—Scope

Part 704 applies directly to all federally insured corporate credit unions. It applies to non federally insured corporate credit unions, via Part 703 of the Rules and Regulations, if such credit unions accept shares from federally chartered credit unions. To clarify the application of Part 704, the proposed rule added language to the Scope section stating that non federally insured corporate credit unions must agree, by written contract, to adhere to the regulation and submit to NCUA examination as a condition of receiving funds from federally insured credit unions. Although a few commenters questioned the need for such a contract, the language has been retained in the final rule. Since the majority of natural person credit unions are federally insured, NCUA has a strong interest in ensuring that corporate credit unions which accept their funds remain safe and sound institutions.

Proposed Section 704.1(b), which set forth NCUA's authority to waive a requirement of Part 704, is retained in this final rule. NCUA may use this authority to respond to innovation at corporate credit unions and in the marketplace. NCUA envisions the approval of pilot programs involving new investments or activities. Such programs would be approved on a limited basis so that NCUA could assess their impact on corporate credit unions.

Language has been added to clarify that a state chartered corporate credit union's request for expanded authority must be approved by the state supervisory authority before being submitted to NCUA.

Section 704.2—Definitions

The proposed rule added a number of new definitions, revised others, and deleted some. A few commenters took exception to specific proposed definitions. Their comments and NCUA's responses are discussed below.

In response to a comment, the definitions of the following terms have been changed from the language that was proposed. The definition of ''adjusted trading'' has been amended to include transactions not ''used to defer

a loss.'' The definition of collateralized mortgage obligation has been changed so that the collateral may consist simply of ''mortgages,'' rather than ''whole loan mortgages.'' The word ''may'' has been added to the definition of ''commitment'' so that the list of items included in the term is not absolute. Although the definition of ''expected maturity'' was proposed to be deleted, it has been retained. A commenter noted that the term is used in the definitions of ''long-term investment'' and ''short-term investment.'' The definition of ''federal funds'' has been broadened to include transactions with domestic branches of foreign banks, various government-sponsored enterprises, and other non depository entities. The definition of ''securities lending'' has been expanded to more precisely describe the activity. The definition of ''wholesale corporate credit union'' has been changed in light of the addition of Section 701.19 to the regulation.

The proposed definition that elicited the most comments was that for ''market value of portfolio equity (MVPE).'' The proposed definition treated membership capital as a liability, rather than as part of MVPE. A number of commenters urged that it be included in MVPE. Before addressing that issue, it must be noted that NCUA has determined to replace the term MVPE in the rule with that of net economic value (NEV). The calculation itself has not been altered, merely renamed. The adoption of the term ''net economic value'' in place of ''market value of portfolio equity'' is preferred because of the potential confusion that results from the integral terms ''market'' and ''portfolio.'' The calculation of estimated fair value, for both assets and liabilities, is not only obtained from market sources. The term ''portfolio'' is more typically used to describe investment or loan assets in contrast to an entire balance sheet. While MVPE is a commonly used term in the profession of asset and liability management, many practitioners and other financial regulators have recently opted for new terminology. NEV better connotes the concept of intrinsic or fair value of the whole balance sheet than does MVPE.

The suggestion that ''capital is capital,'' whatever its form, is the basis for the argument that corporate credit unions should be permitted to include secondary capital in the base for all risk-taking activities. The calculation of NEV serves as the base for credit and interest rate risk limits as well as other activity restrictions, and many commenters suggested that corporate credit unions should have as much risk-taking potential as possible. NCUA disagrees that membership capital should be included in the definition of NEV.

The function of membership capital is to serve as a secondary resource for the absorption of risk when reserves and undivided earnings have been exhausted. The holder of membership capital has the option to sell the shares back to the corporate credit union three years after notification of intent to withdraw. This option makes the membership capital considerably less permanent than ''core'' capital, since it is not controlled by the corporate credit union and is potentially short-lived. NCUA regards this form of capital to be distinctly different and less reliable than internally generated capital or paid-in capital with far longer or no maturity. Permitting corporates to place this form of secondary capital directly at risk substantially, and inappropriately, increases the risk of a crisis in membership confidence when losses do occur.

NCUA views the balance between core capital and risk-taking as essential if the corporate credit union network is to maintain and enhance its ability to withstand financial crises, whether limited to one institution or systemic in nature. This final rule is designed to strengthen core capital so that the corporate credit union network can better withstand financial stress without placing an inappropriate reliance upon its membership resources. Corporate credit unions should gradually reduce their reliance on secondary capital as core capital accumulates over time.

To bolster the accumulation of core capital, the proposed rule authorized the issuance of paid-in capital, defined as funds obtained from credit union and non credit union sources, having no maturity, and being callable only at the option of the corporate credit union and only if the corporate credit union meets its minimum level of required capital after the funds are called. Paid-in capital is included in the definition of NEV, thus giving corporate credit unions the option of raising permanent capital from their membership. Only a few commenters addressed paid-in capital. To make clear that paid-in capital is subordinate to membership capital, the definition has been modified and expanded in this final rule. The requirement that the funds have no maturity has been deleted.

The final rule distinguishes between ''member paid-in capital'' and ''non member paid-in capital.'' The former is held by the corporate credit union's members, has a minimum 20-year maturity, and may not be a condition of membership, services, or prices. Member paid-in capital may be retired prior to the stated maturity only when the corporate credit union elects to ''call'' the shares. Non member paid-in capital is sold to the outside marketplace and must be approved by NCUA. Most of the features of non member paid-in capital remain unspecified in the regulation so that issuance can be tailored to reflect prevailing market demands. The marketplace is the most efficient distribution mechanism for capital, as the market immediately determines the value and liquidity of an issue based on an issuer's performance and the perceived risk of the issue.

NCUA believes that paid-in capital should not be issued unless the corporate credit union can convince the market or its members that it will use the new capital to create new value. The members, like the marketplace, need to risk-adjust the expected return on paid-in capital and expect a fair return. A capital offering that serves to increase risk without increasing value is in no one's interest.

The proposed separate definitions for ''reserves'' and ''undivided earnings'' have been unified in the final rule as ''reserves and undivided earnings.'' The following proposed definitions have been deleted because the term is no longer used in the regulation or is so self-evident as not to require a definition: ''business day,'' ''commitment,'' ''forward rate agreement,'' ''futures contract,'' ''gains trading,'' ''material,'' ''maturity date,'' ''mortgage-backed security,'' ''option contract,'' ''primary dealer,'' ''private placement,'' ''reverse repurchase transaction,'' ''secured loan,'' ''swap agreement,'' tri-party contract,'' ''United States Government or its agencies,'' and ''United States Government sponsored corporations and enterprises.''

A few definitions that were not proposed have been added to the final rule, generally to accommodate the granting of certain additional investment authorities. Corporate credit unions may engage in the forward settlement of transactions beyond regular way settlement, under certain conditions, and definitions of ''forward settlement'' and ''regular way settlement'' have been provided. Corporate credit unions with additional authorities have been authorized to engage in dollar roll transactions and when-issued trading, and definitions of those activities have been provided.

Section 704.3—Corporate Credit Union Capital

The proposal required that a corporate credit union without expanded authorities have a capital, or leverage,

ratio of 4 percent. Most of the comments, with the notable exception of those submitted by banking associations, were supportive of the minimum leverage ratio of 4 percent. It is important to discuss the dissimilarities between corporate credit unions and banks to understand why the level of required capital should be different. Banks primarily use capital to support exposures to credit risk in the form of commercial and consumer loans. Corporate credit unions primarily use capital to support exposures to liquidity and interest rate risk associated with investment in money market instruments and fixed income securities.

Corporate credit unions presently provide a contingent liquidity resource for members at the same time they offer correspondent financial services. An overwhelming portion of a corporate credit union's business consists of providing banker's bank services and issuing shares and share certificates as investment alternatives for members' excess funds. Corporate credit unions are not, in practice, primary-lending institutions.

Capital adequacy is the central tenet of the proposed regulation. The type and amount of risk assumed were fully considered when capital ratios and corresponding risk limitations were developed. Since corporate credit union assets are predominantly high-grade investment securities, not loans, the regulation did not adopt a base leverage ratio target in excess of 4 percent.

Additionally, the rule has a number of triggers to measure the adequacy of capital in a corporate credit union. These triggers are related to market risk exposures as measured by NEV. Risk measures are required on a regular basis, not only for the contemporary market environment, but for stressed conditions as well. Similar to the other federal financial institution regulators, NCUA is requiring the development of risk management infrastructures which better measure and control risk.

The scope of these new requirements will vary by institution but will be commensurate with the amount of risk assumed and the degree of depth and sophistication employed to control these risks. This approach will facilitate a more appropriate control of risk and thereby establish a better early warning detection system when capital adequacy begins to deteriorate. Thus, the 4 percent minimum capital ratio is appropriate based upon the type of assets held and the rigorous risk-assessment requirements of the rule.

Using risk-weighted assets to produce a risk-based capital calculation has been debated throughout the Part 704 revision process. Proponents have argued that the calculation captures a meaningful measure of credit risk exposure which helps members and the public ascertain credit-risk trends in corporate credit union balance sheets. Corporate credit unions have high risk-weighted capital-to-asset ratios relative to other financial institutions, making the ratio a favorable measure for comparative purposes.

Opponents have argued that the risk-based capital calculation is too arbitrary in assigning credit risk weights and that the absence of consideration for interest rate risk makes the numbers misleading. The most recent proposal for changes to the interagency risk-based capital standards adjusts some credit risk weights and adds a new calculation for interest rate risk by adding weights for the duration of each asset. The calculation appears to be complex and potentially unwieldy while providing limited regulatory value where corporate credit unions are concerned.

NCUA advocates meaningful measures for credit and interest rate risk exposure expressed in relation to capital. Concentration limits, for example, have been converted from a function of net assets to one of core capital. While the risk-weighted asset approach is not utilized, conservative credit risk limitations are explicitly defined in the regulation and additional credit risk measurement and reporting requirements have been developed in the new credit risk management section, Section 704.6.

NCUA does not discourage corporate credit unions that desire to calculate the risk-weighted capital-to-assets ratio from doing so but would suggest that they adopt the same standard used by other financial institutions and understand that the calculation is not a regulatory requirement.

The proposed regulation provided authority for NCUA to impose a higher or lower minimum capital requirement on a case-by-case basis, with prior notice to the corporate credit union. Some commenters supported this authority, while others expressed concern that the regulation did not specify all of the circumstances in which it could be exercised. They suggested that it could be abused by NCUA.

The proposed rule illustrated four situations which might cause NCUA to require reserve levels other than those specified in the regulation. The first two were examples of circumstances that could require a higher level, while the last two were examples that could warrant a lower one. While NCUA would like to be able to clearly define every situation in which such actions could be taken, changes in market conditions and the corporate credit union environment make that impossible. Leaving the regulation open provides NCUA more flexibility in addressing unusual or non recurring events, including those which may result in a reduction in reserve levels.

It should be noted that NCUA already has the authority, under Section 116(b) of the Federal Credit Union Act, to adjust reserve requirements for federal corporate credit unions. This regulation will ensure that such authority is available for state-chartered corporate credit unions, in the rare event that it is needed.

To address concerns about NCUA abuse, the rule was amended so that NCUA may take action when significant risk exposure exists only when it is unsupported by adequate capital or risk management processes.

The proposed regulation also provided authority for NCUA to issue a capital directive when a corporate credit union fell below its minimum capital requirement and failed to submit or follow an adequate capital restoration plan. The directive could order a corporate credit union to achieve adequate capitalization by taking one or more of a number of actions, such as reducing dividends and limiting deposits. Some commenters objected to this authority, arguing that it would give NCUA management control over a corporate credit union. NCUA disputes that directing a corporate credit union to take certain specific actions to return to a safe and sound level of capital constitutes taking ''control'' of the institution. In addition, the authority in question is one held by the other federal financial institution regulators and, as with the authority to impose an individual minimum capital requirement, would be exercised only rarely. Accordingly, it has been retained in the final rule.

A number of commenters expressed concern that the NCUA Board would delegate its capital directive authority to NCUA staff. Several comments specifically objected to delegating this authority to examiners. Some commenters requested that the NCUA Board specifically state in the rule that this and other authorities could never be delegated to staff.

These comments reflect a lack of understanding of Board practice regarding administrative actions. While the Board has delegated some administrative actions to regional and office directors, none of the authorities

can be redelegated to other staff members, including examiners. Additionally, none of the actions delegated are final.

Delegated actions have been limited to preliminary actions, such as notices of charges and temporary cease and desist orders, which must go to the Board for final action.

The Board does not intend to delegate its authority to take administrative actions to examiners and never intended that any action proposed in Part 704 be delegated to examiners. However, this Board is unwilling to put into the regulation a restriction that would limit a future Board from taking an action it believed to be necessary.

Proposed Section 704.3 provided that when taking action in the case of a state-chartered corporate credit union, NCUA provide notice to the state supervisory authority. NCUA agrees with comments that notice should be provided when any action is contemplated, not just one relating to capital. To simplify the regulation, a general provision for consultation has been added to Section 704.17, governing state-chartered corporate credit unions, and individual provisions to that effect have been deleted. It should be noted that, contrary to the suggestion of one commenter, consultation does not mean that the state authority must give its approval before NCUA may act. In order to protect the share insurance fund, NCUA must have the authority to take action whenever safety and soundness demands it.

Section 704.4—Board Responsibilities

Proposed Section 704.4 required the board of directors of a corporate credit union to approve comprehensive written plans and policies and to oversee senior management to ensure these plans and policies are carried out. To emphasize the board's ultimate responsibility for the actions it delegates, the proposed rule stated, ''The board of directors must know and understand the activities, policies, and procedures of the corporate credit union.'' While this was not intended to turn directors into operating managers, a large number of commenters expressed concern about this requirement. To mitigate this concern, this sentence has been deleted from the final rule. NCUA is confident that board members will provided appropriate oversight if they recognize and meet their common law fiduciary responsibilities.

Some commenters objected to the proposed rule's requirement that a corporate credit union have in place, for all line support and audit areas, back-up personnel with adequate cross-training. To lessen the burden, the final rule allows for back-up resources rather than personnel, which means that corporate credit unions could temporarily support their operations with staff from other corporate credit unions or consulting firms.

Two commenters noted that the proposed requirement that a corporate credit union follow generally accepted accounting principles (GAAP) conflicts with the classification of credit union shares as equity. Since there may be other departures from GAAP in the future, the final rule requires that corporate credit unions follow GAAP, except where law or regulation has provided for a departure from GAAP.

Currently, the shares classification is the only departure.

Finally, a number of commenters questioned the proposed rule's requirement that a corporate credit union retain external consultants to review the adequacy of resources supporting major risk areas. To address these concerns, the final rule requires the retention of such consultants only as appropriate.

Section 704.5—Investments

The proposed rule inadvertently failed to require that a corporate credit union establish an investment policy. This requirement has been added to the final rule. The policy must be consistent with the corporate credit union's other risk management policies and must address, at a minimum, appropriate criteria for evaluating standard investments and risk analysis requirements for any new investment type or transaction considered for a corporate credit union's portfolio and/or sale to a member.

Certain commenters asked for clarification of the ''risk analysis requirements.''

This provision addresses the evolutionary nature of instruments in the financial marketplace. It is expected that new money market and fixed income securities will be created. Some of these securities may be legally permissible but may be distinctly different from the universe of instruments previously available. It is not possible to anticipate what additional analytical parameters, if any, must be employed before a product comes to market. Therefore, NCUA believes that policies must clearly indicate that the potential risks of new products, not unlike new services, must be carefully evaluated.

Many corporate credit unions engineer new certificate offerings that are structured to mirror specific investment assets. Such structured certificates effectively transfer the risk of the asset through to the holder of the certificate (the member).

Corporate credit unions need to ensure that the risk characteristics that are inherent, and perhaps unique, in a new investment type be sufficiently identified and rigorously analyzed before being purchased for its portfolio or marketed and sold to its members. A corporate credit union should not dictate what a member buys, but it should understand a new product's implications and be able to explain them to a member.

The proposed rule authorized investments in corporate credit unions and corporate credit union service organizations (CUSOs). One commenter asked that investments in wholesale corporate credit unions and CUSOs be specifically authorized. This is not necessary, as wholesale corporate credit unions are a subset of corporate credit unions and are included when the latter term is used.

The proposed rule established an NCUA-modified High Risk Security Test (HRST) for REMIC/CMO securities. The commenters on the test generally expressed two views. The first was to urge adoption of the standard Federal Financial Institutions Examination Council (FFIEC) parameters for the HRST so that the test would be consistent with those used by other depository institutions. The second was to drop the use of the HRST altogether based upon the assertion that proper NEV calculations would capture the risk of the underlying cash-flows and their corresponding price sensitivities anyway. These comments were about evenly divided. One commenter suggested that the proposed NCUA-modified tests be retained while another expressed that HRST tests should only be required if a corporate's NEV ratio fell below 1 percent.

NCUA is persuaded that the requirement to produce net interest income and NEV measures, set forth in Section 704.8, should be sufficient to evaluate the individual risk characteristics of all financial instruments, including CMOs/REMICs. Because all instruments will have to be individually modeled for plus and minus 300 basis point shifts, the HRST is effectively part of the risk measurement process already.

When appropriately modeling CMO/REMIC cash-flows in conjunction with the calculation of net interest income and NEV sensitivity, the HRST is redundant. The test is useful indication, however, of potential price volatility and liquidity risk. Bonds which pass the

FFIEC test are regarded to have a substantially greater universe of potential buyers. Given the liquidity priority of corporate credit unions, it makes sense to subject bonds to a periodic analysis of factors which will drive the market's bias towards such securities. By utilizing the test employed by other depository institutions, corporate credit unions gain useful insight into the contingent liquidity potential of individual CMO/REMIC securities.

Several commenters urged that the requirement to run a monthly HRST be changed to quarterly. NCUA agrees that if the net interest income and NEV tests are appropriately prepared in accordance with the rule, the HRST requirement is less significant and that quarterly testing will be adequate.

Some commenters suggested that the rule allow for the use of fewer prepayment models where the proposal called for at least three models. The reason that the rule required three or more models was to avoid the risk of ''cherry picking'' one favorable prepayment model to cause a CMO/REMIC to pass whenever possible. With the advent of simulation modeling requirements for net interest income and NEV, NCUA accepts that a more sophisticated corporate credit union will have the capacity to appropriately analyze the risk of a CMO/REMIC security with fewer than three prepayment models. Thus, the requirement that the board approve at least three prepayment models for CMOs/REMICs was removed from the Part I and Part II authorities but retained at the base level.

The proposed rule established identical standards for repurchase and securities lending transactions. One commenter noted that these are distinguishable economic and legal transactions and urged that they be separated in the regulation. NCUA agrees and effected that separation. The proposed rule required that collateral securities be legal for corporate credit unions, except that CMO/REMIC securities that passed the FFIEC HRST were permissible provided that the term of the transaction did not exceed 95 days. A number of commenters asked that the 95-day limit be dropped. The whole exception is unnecessary, now, with the substitution of the FFIEC HRST for the NCUA-modified test.

The proposed rule authorized investment in a registered investment company, provided that the portfolio of such investment company was restricted by its investment policy, changeable only if authorized by shareholder vote, solely to investments that were permissible for the corporate credit union making the investment. In response to comments, the shareholder vote restriction has been deleted.

As proposed, the final rule provided a grandfather clause, allowing corporate credit unions to continue to hold investments that were permissible when purchased but have become impermissible because of regulatory changes. One commenter stated that this was inconsistent with proposed Section 704.10, governing divestiture. That section requires divestiture of or a written plan to keep an investment that fails a requirement of Part 704. It should be understood that the grandfather provision supersedes the divestiture provision.

Section 704.6—Credit Risk Management

Most corporate and natural person credit unions recommended only minor revisions to the credit risk management section. Some, however, objected to the requirement of any credit due diligence, given that minimum credit ratings were limited to the top of the investment-grade range. Credit ratings obtained from nationally recognized statistical rating organizations are a significant tool for investors to evaluate credit risk associated with a specific security, issuer, guarantor, or provider of credit. They are no substitute for due diligence, however, and should be regarded as only one part of the credit risk management process.

Significant exposures to credit risk require extensive and continuous credit analysis by professionally trained staff. Managing a large credit exposure requires considerable personnel and financial resources, which many corporate credit unions do not possess. Expanded authority provisions allow for a broader spectrum of credit risk, and increased credit due diligence by corporate credit unions that obtain such authorities is key. Conversely, the amount of credit analysis conducted by institutions that operate at the base level and maintain very limited exposure to credit risk is not expected to be significant.

Credit risk exposure can be limited by restriction of counterparty, dollar amount, and/or maturity. Those corporate credit unions that remain at the base level and do not assume significant exposures should be able to achieve an adequate degree of credit risk management by employing a combination of these techniques. If a corporate credit union expands its tolerance for credit risk, it must increase its due diligence accordingly. That may mean hiring adequately trained staff and/or increasing the frequency and depth of review.

Several commenters suggested that specific concentration limits on repurchase agreements be removed from the regulation and left up to a corporate credit union's board of directors. The regulation allows corporate credit unions with expanded authorities to develop their own credit limits for these transactions based upon the additional depth and scope of their credit risk management. The base level was designed to accommodate institutions with restricted capacity to handle credit risk. The concentration limits are commensurate with the very limited due diligence expected to support low credit risk strategies.

One commenter requested that NCUA clearly state that it supported corporate credit unions using outside providers for investment and credit due diligence. The implication is that a CUSO or other third party provider could become the primary arbiter of the appropriateness and selection of investment assets. The desire of corporate credit unions to create cost-effective approaches to risk management is understandable, but outsourcing risk-management evaluations diminishes the control, independence, and accountability of risk making decisions.

While discretionary judgments can be outsourced, the board and management's accountability for investment decisions cannot be delegated, and the issue of credit risk becomes particularly complicated. For example, how would a CUSO, serving multiple institutions, determine how to equitably alert all clients to a declining credit which requires disposition? The sale of distressed financial instruments often accelerates market value declines (not inappropriately) leaving other investors with unsold positions at an increasing disadvantage. In other words, which client gets out first? In the event of material credit-related losses, who bears responsibility for the justification of the exposure and what recourse would affected clients have with a CUSO?

Aside from accountability issues, NCUA fears that a CUSO serving numerous corporate credit unions with credit risk research would significantly increase the potential for a crisis in the credit union system. The incidence of systemic crises is not uncommon for U.S. depository institutions. Occurrences are infrequent but typically severe, such as investments in Penn Square, where numerous corporate credit unions were simultaneously affected to a significant degree.

Another commenter urged that NCUA remove the specific reporting and documentation requirements. NCUA developed this language to convey the minimum expectations for this important element of credit risk management. While modifications were made to this section to make it slightly more generalized, the need for some specificity was too critical to dismiss altogether.

Several commenters sought clarification on the credit risk management policy provision addressing concentrations of credit risk. The examples of concentration characteristics included in the regulation are ''industry type, sector type, and geographic.'' Commenters were concerned that NCUA would expect that all credit instruments be evaluated on the basis of a set list of concentration characteristics regardless of whether all of the characteristics applied to an individual instrument.

Examples were provided to indicate that there are a number of relevant concentration risks that can arise in the process of managing credit risk. Not all concentration types apply to all credit instruments. For example, a corporate credit union may need to consider whether a particular industry is disproportionately represented in its overall portfolio. To capture aggregate exposure, a corporate will need to summarize such concentration by reviewing across all transaction types.

Section 704.7—Lending

The proposed rule established limits on secured and unsecured loans to one member. A secured loan was defined to mean one in which the corporate credit union had perfected a security interest in the collateral. In response to comments, the requirement that the security interest be perfected has been deleted from the final rule. Further, exclusions have been added for loans secured by shares and marketable securities and for member reverse repurchase transactions.

The proposed rule required that a loan to a non credit union member be made in conformance with the member business loan rule. In response to comments, an exception has been provided for loans fully guaranteed by a credit union or credit unions. A few commenters suggested that corporate credit unions be permitted to participate with natural person credit unions in making loans to natural person members. In the past, NCUA was concerned that such activity could jeopardize a corporate credit union's banker's bank exemption from the Federal Reserve Board's Regulation D reserve requirements.

While NCUA believes that this area should be researched thoroughly, for several reasons, it will take no action now. First, the research necessary to analyze the potential impact of such loans would unnecessarily delay this final rule. In light of the few credit unions indicating interest, NCUA believes it more beneficial to finalize the rule and take the issue up at a later date. Second, if corporate credit unions were to participate in such loans, additional reserves would be necessary to cover the risk of default by natural persons. The public should have an opportunity to comment on such reserves before corporate credit unions are required to comply with them.

The NCUA Board has asked the Office of Corporate Credit Unions to study the issue and be prepared to make a recommendation when it provides its interim report to the Board 18 months after publication of this final rule.

Section 704.8—Asset and Liability Management

The proposed rule required a written asset and liability management (ALM) policy which addressed, among other things, the modeling of indexes that serve as references in financial instrument coupon formulas. Several commenters raised questions about this requirement. Many adjustable rate securities are available in the marketplace which have interest rate formulas linked to a number of reference rates, foreign currencies, and/or commodities. Corporate credit unions tend to buy variable rate securities which are linked to U.S. money market rates such as U.S. LIBOR or Fed Funds. Still others have purchased securities linked to constant maturity Treasuries (CMT), the Prime rate, or the 11th District Cost of Funds (COFI). It is important for an institution to evaluate the basis risk in such instruments to ensure that it has adequately measured the interest rate risk associated with the respective repricing behavior (vis-á-vis its cost of funds). The weaker the correlation between an index and the cost of funds, the greater the need to estimate the future behavior of the index.

The proposed rule required a corporate credit union to evaluate the risk in its balance sheet by measuring the impact of interest rate changes on its NEV and NEV ratio. A corporate credit union was required to limit its risk exposure to levels that did not result in an NEV ratio below 1 percent or a decline in NEV of more than 18 percent. The limit for corporate credit unions with Part I expanded authorities was 35 percent and for those with Part II authorities was 50 percent. Frequency of testing was a function of the NEV ratio. If NEV was 2 percent or above, testing had to be done quarterly. If it fell below 2 percent, monthly testing was required.

The proposed rule also required corporate credit unions with significant holdings of instruments with embedded options to perform additional testing beyond the 300 basis point parallel shift of the yield curve. The base test may not be sufficient to evaluate the potential risk to the balance sheet, particularly for those portfolios comprised of complex securities. Changes in the shape of the yield curve, shifts in the credit and liquidity risk premium reflected in spread changes, factors affecting prepayment speeds, and changes in volatility, will all have an impact. While the rule did not establish the testing frequency or the parameters to be used to evaluate the impact of these factors, it did require that the tests reflect these components of risk.

NCUA sought specific data from corporate credit unions to support the claim that a floor other than 1 percent was appropriate. It sought similar analytical support for challenges to the 18, 35, and 50 percent variation limits.

Most corporate credit union commenters pointed out that the minimum NEV ratio poses a major restriction on balance sheet growth even if such growth adds no incremental risk to the balance sheet. Commenters overwhelmingly supported keeping the minimum ratio at 1 percent of the fair value of assets, and some suggested removal of a minimum NEV ratio altogether. The vast majority of comments submitted were without supporting data. It is intuitive, however, that substantial growth in corporate credit union assets would exacerbate the risk of penetrating a floor of 2 percent or higher, since average core capital levels are presently between 2 percent and 3 percent of assets.

The use of a minimum NEV ratio is intended to establish a floor for primary capital which prevents a corporate credit union's core leverage ratio from falling dangerously low. It provides an estimate of the internal capacity of an institution to handle its risk exposures in the future and thus alerts the corporate credit union and NCUA to potential capital shortfalls.

Corporate credit unions have not historically had a growth inhibitor in the form of minimum capital ratios, and thus, the NEV ratio introduces a new element for management to control. While the NEV ratio does not indicate the nature or degree of risk that is

inherent in a balance sheet, it does indicate the degree of leverage. Capital is the reserve of funds available to manage all the risks of the institution, including those which are not part of the risks associated with changes in interest rates.

Measuring risk is an imprecise business because of the multitude of assumptions that are required to evaluate potential outcomes. NCUA believes that an NEV ratio below 1 percent would be imprudent because little room would remain for errors in measurement or for the potential confluence of business risks. An NEV ratio of 1 percent will provide a reasonable early-warning detection mechanism for capital inadequacy. The present levels of capital would not permit a substantially higher floor at this time without a risk of forced shrinkage in corporate credit union balance sheets.

Consistent with the base level thresholds established in the credit risk management section, an 18 percent NEV volatility limit is adopted to set a conservative market risk limit for corporate credit unions that do not possess the financial, system, or personnel resources to support a significant market-risk earnings strategy. The 18 percent limit allows corporate credit unions at the base authority level to entertain a modest mismatch between liabilities and assets (overnight and/or term) and capital investments inside of seven years.

NEV is an imperfect measure in the sense that it portrays the risk inherent in the balance sheet as one number. It is a present value of the asset cash-flows less a present value of the liability cash-flows plus/minus the time value of any embedded options. NEV does not indicate when the risk will occur but it does indicate the aggregate amount of potential risk. Used in conjunction with income simulation (a short-term view of risk), NEV provides a good method for simultaneously managing the earnings and net worth of an institution.

It is expected that corporate credit unions will have some degree of mismatch in the normal course of business because member demands for amount and maturity on the liability side of the balance sheet do not perfectly correlate to available market instruments on the asset side. The NEV calculations will capture the aggregate market risk and permit corporate credit unions, no matter how their respective mismatches are structured, to convey risk in a relatively simple and consistent manner.

An NEV volatility limit of 18 percent was criticized by many commenters as being too low and ''essentially a matched book.'' Any NEV variance can be achieved with a total matched book in place since the duration of the asset purchased with capital (not matched) will determine the net risk. If capital is invested in short duration instruments, the NEV volatility will be correspondingly low. If capital is invested in long duration instruments, the volatility will be higher. There is no precise level of NEV that equates to a ''matched book.'' The 18 percent NEV limit is the same as a net risk position with a price sensitivity equal to that of seven year zero-coupon Treasury bond. This is not an insignificant amount of market risk. It is a corporate credit union's choice whether it takes that risk in an overnight account or whether it spreads it out among various books of business (overnight, term, capital, etc.). Some institutions may choose to run matched books and take all the risk with their capital. Regardless, the maximum decline will be limited to 18 percent of base case NEV.

One aspect of using NEV which must be noted is the effect of negative convexity. Two corporate credit unions may have an equivalent net risk exposure at a given point in time, but the respective exposures will change very differently with subsequent changes in market factors, depending on the composition of assets. One may choose to take the bulk of its mismatch in the overnight account using optionless money market instruments and invest its capital in a medium-maturity debenture. The other may incur a mismatch by buying low duration floating rate securities which possess a considerable amount of option and basis risk.

In the first example, the sensitivity of NEV is fairly constant and the risk profile may be altered relatively quickly with the passage of time (by letting short maturities roll into overnight). In the latter example, the option and basis risk may not emerge until the interest rate environment has changed. Because securities with call, prepayment, and cap options can extend dramatically, it is possible for such a portfolio to go from a sensitivity of 18 percent to an exposure many times that amount in a short time as the institution calibrates its rate shocks to a new plus and minus 3 percent range.

Several corporate commenters suggested that an interim operating level be considered for moderate capacity corporates, consisting of an NEV volatility limit of 25 percent, with no additional investment or credit authorities. They argued that the cost of building a risk management infrastructure was essentially a barrier to entry for expanded authorities, and they viewed the higher NEV limit as a mechanism for funding the incremental costs of getting there. To compensate for the incrementally greater risk, the commenters suggested that qualifying corporate credit unions conduct the rate shock tests monthly, as opposed to quarterly, and that they also conduct the additional tests, beyond the 300 basis point parallel shift of the yield curve, regardless of their holdings of instruments with embedded options.

NCUA agrees that select corporate credit unions are capable of operating between the base and Part I limits, and has created a ''base-plus'' level. With NCUA approval, an institution can operate with an NEV volatility of 25 percent provided that it performs additional tests and has additional management and infrastructure. NCUA will assess the institution to verify that the incremental qualifications are resident. For example, more than one senior manager will be expected to have strong knowledge of investments and ALM. In addition to risk measurement, the ability for the institution to withstand the departure of a key staff member and the ability to achieve adequate separation between risk takers and risk monitors will be important.

Corporate credit unions qualifying for a 25 percent NEV variance will be expected to conduct risk modeling with greater vigilance than those operating with an 18 percent variance, and such institutions must establish commensurate policies, procedures, and internal controls. NCUA will expect corporate credit unions that qualify for a 25 percent NEV limit to demonstrate a greater ability and inclination to aggressively respond to adverse market developments than base authority institutions. Operating with an NEV volatility of 25 percent may increase current earnings, but it also raises the probability of experiencing future losses.

For corporate credit unions that want to run bigger mismatches, the Part I expanded authorities doubles the amount of permitted market risk from the base, allowing an NEV decline of 35 percent. This degree of mismatch has the aggregate risk sensitivity of a 15 year zero-coupon Treasury bond. Part II expanded authorities allows an NEV decline of 50 percent, equating to an aggregate risk sensitivity of a 24 year zero-coupon bond. The following table shows the risk sensitivities of zero-coupon bonds of various durations.

PRICE SENSITIVITY OF ZERO-COUPON TREASURY BONDS

[Prices as of 01/08/97]

Investment (years)	Price sensitivity +2% shock (percent)	Price sensitivity +3% shock (percent)
7	−13	−18
10	−18	−25
15	−26	−36
24	−38	−51

Source: Bloomberg; S <Govt>, TRA(O).

NCUA has allowed sophisticated and well-developed corporate credit unions to take much greater market risk than that permitted for institutions with base authorities. If a corporate credit union wishes to make market timing a substantial portion of its earnings strategy, the expanded authority levels provide ample room for managing sizable mismatches between assets and liabilities. But, at the base level, the rule must have prudent limitations on market risk that reflect the more limited capacity of many smaller and/or more conservative institutions which cannot afford or do not desire to commit the financial and personnel resources to build the appropriate risk-taking infrastructure that is required to support higher NEV volatility.

The base level is intended to establish a conservative territory where even the smallest and most thinly developed corporate credit union can continue to provide standard products and services without being subject to imprudent risks or burdened with excessive infrastructure costs. In order for the regulation to encompass the full spectrum of corporate credit unions, it must provide both a minimum safety and soundness barrier as well as a mechanism for expanding opportunities (commensurate with an increasing capacity to manage risk). The rule is structured to create distinctive operating classifications in response to the widely diverse corporate credit union network.

A number of commenters noted that NCUA was adopting specific limits on interest rate risk where other federal financial institution regulators have elected to handle it through supervision. NCUA acknowledges this difference but disagrees with the notion that its approach is inconsistent or inappropriate.

Corporate credit unions comprise a relatively small private financial network which serves a finite universe of members. The credit union system cannot afford the failure of a corporate credit union, whereas the failure of an individual bank or thrift is less consequential to the survival of all other banks and thrifts. Because of these differences, NCUA believes that explicit measures of risk tolerances are appropriate.

In addition, many corporate credit unions are making a transition from a traditional strategy where little interest rate risk was taken (achieved through maturity and rate-reset matching of assets and liabilities) to a strategy which assumes a variety of intentional market risk mismatches, including maturity, option, and basis risk. Explicit risk measures are essential in such an environment.

One corporate credit union commenter, joined by a number of its member credit unions, claimed that the rule encourages corporate credit unions to take credit risk as opposed to interest rate risk. This sentiment is troubling. The proposed rule is intended to promote and reinforce the discipline of comprehensive risk management, regardless of the risk type assumed.

If a corporate credit union intends to entertain significant exposures to market, credit, and/or liquidity risk in order to generate its spread income, the obligation to professionally control those risks is substantial. The expanded authority concept is predicated on the idea that professional risk taking must be supported by a state-of-the-art risk management infrastructure.

Section 704.9—Liquidity Management

Relatively few comments were received on this section of the proposed rule. However, in response to those comments, the rule has been amended so that a corporate credit union need only monitor its liquidity sources regularly, rather than continuously, and need not necessarily test its external lines to ensure that contingent sources of liquidity remain available. However, a corporate credit union must be able to demonstrate, whether through testing, written confirmation, or other means, that such sources remain available.

Section 704.10—Divestiture

Few comments were received on this section of the proposed rule, and except for changes to time frames to standardize them with others in the regulation and the addition of the supervisory committee to the list of entities which must receive a failed investment report, no changes have been made in the final rule.

Section 704.11—Corporate Credit Union Service Organizations (Corporate CUSOs)

The proposed rule defined a corporate CUSO as an entity that: (1) Has received a loan from and/or is at least partly owned by a corporate credit union; (2) primarily serves credit unions; (3) restricts its services to those related to the daily activities of credit unions; and (4) is chartered as a corporation under state law. A number of commenters pointed out that defining an entity that has received a loan from a corporate credit union as a corporate CUSO would severely restrict the ability of corporate credit unions to lend to natural person CUSOs. This was not intended, and that portion of the definition has been deleted.

Some commenters expressed concern that the restriction of services to those related to the daily activities of credit unions might unduly limit the activities of corporate CUSOs, since a legitimate activity might not occur every day. It was not the intent of the proposed rule to require that an activity occur every day; however, to allay concerns, the final rule requires that services be related to the normal course of business of credit unions.

In response to comments, the rule has been amended to permit corporate CUSOs to be structured as limited liability companies or limited partnerships, as well as corporations. NCUA agrees that these forms are appropriate for corporate CUSOs. Also in response to comments, the conflict of interest provision has been amended to permit a corporate credit union to share employees with a corporate CUSO. NCUA was persuaded that there is a legitimate business purpose for such an arrangement. However, such arrangements will be scrutinized to ensure there is no insider self-dealing. Further, the rule still prohibits corporate credit union directors and committee members from receiving compensation from a corporate CUSO.

Section 704.12—Services

Few comments were received on this section, and it is unchanged in the final rule. This section was intended to protect the integrity of federal corporate credit union fields of membership. However, should NCUA authorize national fields of membership for federal corporate credit unions, there may be a determination to eliminate this section at a future date.

Section 704.13—Fixed Assets

As proposed, the final rule permits a corporate credit union to invest in fixed assets where the aggregate of all such investments does not exceed 15 percent of the corporate credit union's capital. In response to one comment, NCUA wishes to clarify that the 15 percent refers to book value. As proposed, the final rule provides for a corporate credit

union to request a waiver of the limitation from NCUA. The proposed rule eliminated the current provision that allows a corporate credit union to proceed with its investment if it does not receive notification of the action taken on its request within 45 days. Three commenters objected to NCUA not having a deadline to respond, and the 45 day timeframe has been reinstated.

Section 704.14—Representation

The first proposal to revise Part 704, issued in 1995, amended the representation section to provide that only representatives of member credit unions were permitted to vote and stand for election. This involved changes to a number of paragraphs. When the proposed revision to Part 704 was reissued in 1996, NCUA determined not to go forward with the member-only proposal and intended to reverse all of the changes that had been made in that regard. Inadvertently, some of the changes were left in place. The final rule corrects this error.

Section 704.15—Audit Requirements

In response to the few comments received on this section, the language has been clarified and made more consistent with auditing terminology.

Section 704.16—Contracts/Written Agreements

No changes were made to this provision.

Section 704.17—State-Chartered Corporate Credit Unions

As noted earlier, a paragraph has been added which provides that NCUA will consult with the state supervisory authority before taking administrative action against a state-chartered corporate credit union.

Section 704.18—Fidelity Bond Coverage

In response to comments, the calculation of minimum bond has been clarified and a $5 million cap has been added to each category in the maximum deductible table.

Section 704.19—Wholesale Corporate Credit Unions

The commenters generally supported this section, and it has been retained as proposed.

Appendix A—Model Forms

Some changes have been made to Sample Form 2 in the final rule to accommodate the changes to the definition of paid-in capital.

Appendix B—Expanded Authorities and Requirements

The proposed rule introduced a multi-tier approach to the regulation of corporate credit unions. Proposed Appendix B set forth incrementally greater authorities for corporate credit unions and the infrastructure and capital requirements that were required to be in place to obtain such authorities. The commenters supported the multi-tier approach, and it has been retained in the final rule. Based on the comments received, several additional authorities have been added to Parts I and II. So that NCUA can effectively supervise the transition to this final rule, each corporate credit union is asked to inform NCUA, by April 15, 1997, of its initial decision regarding the level at which it wishes to operate.

One commenter thought that all investments should be grandfathered in a case where a corporate has its expanded authorities revoked. This observation raises an important issue. The final rule will shift the major focus of risk evaluation from individual financial instruments towards an aggregate or ''balance sheet'' risk assessment. While individual securities and transactions might be grandfathered from automatic divestiture, the revocation of expanded authorities would likely be precipitated by concerns about the overall risk profile of that institution. While individual transactions will not necessarily be singled out, a corporate credit union must be prepared to employ asset disposition to reduce excessive risk when exposures warrant.

For example, a substantial weakness in internal controls and/or major capital inadequacy would necessitate a reduction in risk. If expanded authorities are regarded to be adding risk to an already unacceptable exposure, then NCUA would have to consider a revocation of the authorities. This could prompt NCUA to mandate a risk reduction strategy that requires the institution to adopt asset disposition in order to achieve an appropriate and timely risk reduction. Once revocation occurs, any additional expanded-authority activities will cease and NCUA will evaluate, based on the unique circumstances, what corrective actions are necessary. Thus, while the rule does not predetermine the sale of specific expanded-authority transactions, forbearance from divestiture will not be assured.

Proposed Appendix C set forth guidelines for evaluating requests for expanded authorities. In response to the comments received, these guidelines have been removed from the regulation and put into a handbook format. Consequently, Appendix C has been deleted. The guidelines will be provided to all corporate credit unions.

Part 709—Involuntary Liquidation and Creditor Claims

No comments were received on this section, and it has been retained in the final rule.

Part 741—Requirements for Insurance

No comments were received on this section, and it has been retained in the final rule.

C. Regulatory Procedures

Regulatory Flexibility Act

NCUA certifies that the proposed rule, if made final, will not have a significant economic impact on small credit unions (those under $1 million in assets). The rule applies only to corporate credit unions, all of which have assets well in excess of $1 million. Accordingly, a Regulatory Flexibility Analysis is not required.

Paperwork Reduction Act

The reporting requirements in Part 704 have been submitted to and approved by the Office of Management and Budget under OMB control number 3133–0129. Under the Paperwork Reduction Act of 1995, no persons are required to respond to a collection of information unless it displays a valid OMB control number. The control number will be displayed in the table at 12 CFR Part 795.

Executive Order 12612

Executive Order 12612 requires NCUA to consider the effect of its actions on state interests. It states that: ''Federal action limiting the policy-making discretion of the states should be taken only where constitutional authority for the action is clear and certain, and the national activity is necessitated by the presence of a problem of national scope.'' The risk of loss to federally insured credit unions and the NCUSIF caused by actions of corporate credit unions are concerns of national scope. The final rule will help assure that proper safeguards are in place to ensure the safety and soundness of corporate credit unions.

The rule applies to all corporate credit unions 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 non federally insured corporate credit unions. NCUA, pursuant to Executive Order 12612, 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 these changes justifies them.

List of Subjects

12 CFR Part 704

Credit unions, Reporting and recordkeeping requirements, Surety bonds.

12 CFR Part 709

Claims, Credit unions, Liquidation.

12 CFR Part 741

Bank deposit insurance, Credit unions, Reporting and recordkeeping requirements.

By the National Credit Union Administration Board on March 7, 1997.

Becky Baker,

Secretary of the Board.

For the reasons set out in the preamble, NCUA amends 12 CFR chapter VII as follows:

1. Part 704 is revised to read as follows:

PART 704—CORPORATE CREDIT UNIONS

Sec.

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

§ 704.1 Scope.

(a) This part establishes special rules for all federally insured corporate credit unions. Non federally insured corporate credit unions must agree, by written contract, to both adhere to the requirements of this part and submit to examinations, as determined by NCUA, as a condition of receiving shares or deposits from federally insured credit unions. This part grants certain additional authorities to federal corporate credit unions. Except to the extent that they are inconsistent with this part, other provisions of NCUA's Rules and Regulations (12 CFR chapter VII) and the Federal Credit Union Act apply to federally chartered corporate credit unions and federally insured state-chartered corporate credit unions to the same extent that they apply to other federally chartered and federally insured state-chartered credit unions, respectively.

(b) The Board has the authority to issue orders which vary from this part. This authority is provided under Section 120(a) of the Federal Credit Union Act, 12 U.S.C. 1766(a). Requests by state-chartered corporate credit unions for waivers to this part and for expansions of authority under Appendix B of this part must be approved by the state regulator before being submitted to NCUA.

§ 704.2 Definitions.

Adjusted trading means any method or transaction whereby a corporate credit union sells a security to a vendor at a price above its current market price and simultaneously purchases or commits to purchase from the vendor another security at a price above its current market price.

Asset-backed security means a security that is primarily serviced by the cashflows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the securityholders. This definition excludes those securities referred to in the financial markets as mortgage-backed securities (MBS), which includes collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs).

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

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

Collateralized mortgage obligation (CMO) means a multi-class bond issue collateralized by mortgages or mortgage-backed securities.

Commercial mortgage related security means a mortgage related security where the mortgages are secured by real estate upon which is located a commercial structure.

Corporate credit union means an organization that:

(1) Is chartered under Federal or state law as a credit union;

(2) Receives shares from and provides loan services to credit unions;

(3) Is operated primarily for the purpose of serving other credit unions;

(4) Is designated by NCUA as a corporate credit union;

(5) Limits natural person members to the minimum required by state or federal law to charter and operate the credit union; and

(6) Does not condition the eligibility of any credit union to become a member on that credit union's membership in any other organization.

Correspondent services means services provided by one financial institution to another, and includes check clearing, credit and investment services, and any other banking services.

Credit enhancement means collateral, third-party guarantees, and other features that are designed to provide structural support and protection against losses to investors in a particular security.

Daily average net assets means the average of net assets calculated for each day during the period.

Dealer bid indication means a dealer's approximation of the bid price of a security.

Dollar roll means the purchase or sale of a mortgage backed security to a counterparty with an agreement to resell or repurchase a substantially identical security at a future date and at a specified price.

Embedded option means a characteristic of certain assets and liabilities which gives the issuer of the instrument the ability to change the features such as final maturity, rate, principal amount and average life. Options include, but are not limited to, calls, caps, and prepayment options.

Expected maturity means the date on which all remaining principal amounts of an instrument or bond are anticipated to be paid off on the basis of projected payment assumptions.

Fair value of a financial instrument means the amount at which an instrument could be exchanged in a current arms-length transaction between willing parties, other than in a forced liquidation sale. Market prices, if available, are the best evidence of the fair value of financial instruments. If market prices are not available, the best estimate of fair value may be based on the quoted market price of a financial

instrument with similar characteristics or on valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved, option pricing models, or matrix pricing models).

Federal funds transaction means a short-term or open-ended unsecured transfer of immediately available funds by one depository institution to another depository institution or entity.

Foreign bank means an institution which is organized under the laws of a country other than the United States, is engaged in the business of banking, and is recognized as a bank by the banking supervisory authority of the country in which it is organized.

Forward settlement of a transaction means settlement on a date other than the trade date.

Immediate family member means a spouse or other family member living in the same household.

Industry recognized information provider means an organization which obtains compensation by providing information to investors and receives no compensation for the purchase or sale of investments.

Long-term investment means, for the purpose of issue ratings, an investment that has an initial maturity, or expected maturity, greater than one year.

Market price means the price at which a security can be bought or sold.

Matched means, with respect to assets and liabilities, that the factors which affect cash flows of an asset are replicated in a corresponding liability.

Member paid-in capital means paid-in capital that: Is held by the corporate credit union's members; and has an initial maturity of at least 20 years. A corporate credit union may not condition membership, services, or prices for services on a credit union's ownership of paid-in capital. When a paid-in capital instrument has a remaining maturity of 5 years, the amount of the instrument that may be considered paid-in capital for the purposes of this part is reduced by a constant monthly amortization which ensures the recognition of paid-in capital is fully amortized when the instrument has a remaining maturity of 3 years. The terms and conditions of any member paid-in capital instrument must be disclosed to the recorded owner of such instrument at the time the instrument is created and at least annually thereafter.

Member reverse repurchase transaction means an integrated transaction in which a corporate credit union purchases a security from one of its member credit unions under agreement by that member credit union to repurchase the same security at a specified time in the future. The corporate credit union then sells that same security, on the same day, to a third party, under agreement to repurchase it on the same date on which the corporate credit union is obligated to return the security to its member credit union.

Membership capital means funds contributed by members which are available to cover losses that exceed reserves and undivided earnings and paid-in capital. In the event of liquidation of the 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. The funds have a minimum withdrawal notice of three years, are not insured by the NCUSIF or other share or deposit insurers, and cannot be used to pledge against borrowings. A member may sell its membership capital to a credit union in the corporate credit union's field of membership, subject to the corporate credit union's approval. The funds may be in the form of a term certificate, or may be in the form of an adjusted balance account. An adjusted balance account may be adjusted in relation to a measure (e.g., one percent of a member credit union's assets) established and disclosed by the corporate credit union at the time the account is opened without regard to any minimum withdrawal notice period. Upon written notice of intent to withdraw membership capital, the balance of the account will be frozen (no annual adjustment) until the conclusion of the notice period. The terms and conditions of a membership capital account must be disclosed to the recorded owner of such account at the time the account is opened and at least annually thereafter. Upon notification of intent to withdraw, the amount of the account on notice that can be considered membership capital is reduced by a constant monthly amortization which ensures the recognition of membership capital is fully amortized at the end of the notice period. The full balance of a membership capital account that has been placed on notice, not just the remaining non amortized portion, is available to absorb losses in excess of the sum of reserves and undivided earnings and paid-in capital until the funds are released by the corporate credit union at the conclusion of the notice period.

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)), i.e., 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.

Mortgage servicing means performing tasks to protect a mortgage investment, including collecting the installment accounts, monitoring and dealing with delinquencies, and overseeing foreclosures and payoffs.

Moving daily average net assets means the average of daily average net assets for the month being measured and the previous 11 months.

NCUA means NCUA Board (Board), unless the particular action has been delegated by the Board.

Net assets means total assets less Central Liquidity Facility (CLF) stock subscriptions, CLF loans guaranteed by the NCUSIF, U.S. Central CLF certificates, and member reverse repurchase transactions. For its own account, a corporate credit union's payables under reverse repurchase agreements and receivables under repurchase agreements may be netted out if the Generally Accepted Accounting Principles (GAAP) conditions for offsetting are met.

Net economic value (NEV) means the fair value of assets minus the fair value of liabilities. All fair value calculations must include the value of forward settlements and embedded options and of off balance sheet financial derivatives, such as futures, options, interest rate swaps, and forward rate agreements. Membership capital is treated as a liability for purposes of this calculation. The NEV ratio is calculated by dividing NEV by the fair value of assets.

Net interest income means the difference between income earned on interest bearing assets and interest paid on interest bearing liabilities.

Non member paid-in capital means paid-in capital that is approved by NCUA, upon application by the corporate credit union. In determining whether or not to approve any paid-in capital instrument, NCUA will consider such features as maturity, capital amortization schedule, participation, voting, acceleration, redemption, or other rights of the holder, if any. NCUA will also consider the strategic purpose and financial impact of the proposed paid-in capital issuance and the corporate credit union's financial condition and management capabilities.

Non secured obligation means an obligation backed solely by the creditworthiness of the obligor.

Official means any director or committee member.

Paid-in capital means accounts or other interests of a corporate credit union that: Are available to cover losses that exceed reserves and undivided earnings; are not insured by the NCUSIF or other share or deposit insurers; and are callable only at the option of the corporate credit union and only if the corporate credit union meets its minimum level of required capital after the funds are called. Paid-in capital includes both member paid-in capital and non member paid-in capital. 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. Paid-in capital shall not exceed reserves and undivided earnings.

Pair-off transaction means a security purchase transaction that is closed out or sold at, or prior to, the settlement or expiration date.

Prepayment model means an empirical method which produces a reasonable and supportable forecast of mortgage prepayments in alternative interest rate scenarios. Models are typically available from securities broker-dealers and industry-recognized information providers. These models are used in tests to forecast the weighted average life, change in weighted average life, and price sensitivity of CMOs/REMICs and mortgage-backed securities.

Real estate mortgage investment conduit (REMIC) means a nontaxable entity formed for the sole purpose of holding a fixed pool of mortgages secured by an interest in real property and issuing multiple classes of interests in the underlying mortgages.

Regular way settlement means delivery of a security from a seller to a buyer within the specified number of days established for that type of security.

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 later date.

Reserve ratio means the corporate credit union's reserves and undivided earnings plus paid in capital divided by its moving daily average net assets.

Reserves and undivided earnings means all forms of retained earnings, including regular or statutory reserves and all valuation allowances established to meet the full and fair disclosure requirements of § 702.3 of this chapter.

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

Section 107(8) institution means an institution described in Section 107(8) of the Federal Credit Union Act (12 U.S.C. 1757(8)).

Securities lending means lending a security to a counterparty, either directly or through an agent, and accepting collateral in return.

Senior management employee means a chief executive officer, any assistant chief executive officer (e.g., any assistant president, any vice president or any assistant treasurer/manager), and the chief financial officer (controller).

Settlement date means the date originally agreed to by a corporate credit union and a counterparty for settlement of the purchase or sale of a security.

Short sale means the sale of a security not owned by the seller.

Short-term investment means, for the purpose of issue ratings, an investment that has an initial maturity, or expected maturity, of one year or less.

Small business related security means a security as defined in Section 3(a)(53) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(53)), i.e., a security, rated in one of the four highest rating categories by a nationally recognized statistical rating organization, that represents ownership of one or more promissory notes or leases of personal property which evidence the obligation of a small business concern. It does not mean a security issued or guaranteed by the Small Business Administration.

Stripped mortgage-backed security means a security that represents either the principal or interest only portion of the cash flows of an underlying pool of mortgages.

Trade association means an association of organizations or persons formed to promote their common interests. For the purposes of § 704.14, the term includes entities owned or controlled directly or indirectly by such an association but does not include credit unions.

Trade date means the date a corporate credit union originally agrees, whether orally or in writing, to enter into the purchase or sale of a security.

Weighted average life means the weighted average time to principal repayment of a security based upon the proportional balances of the cash flows that make up the security.

When-issued trading means the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities.

Wholesale corporate credit union means a corporate credit union which primarily serves other corporate credit unions.

§ 704.3 Corporate credit union capital.

(a) *General.* A corporate credit union must develop and ensure implementation of written short- and long-term capital goals, objectives, and strategies which provide for the building of capital consistent with regulatory requirements, the maintenance of sufficient capital to support the risk exposures that may arise from current and projected activities, and the periodic review and reassessment of the capital position of the corporate credit union.

(b) *Capital ratio.* A corporate credit union will maintain a minimum capital ratio of 4 percent, except as otherwise provided in this part. A corporate credit union must calculate its capital ratio at least monthly.

(c) *Reserve transfers.* A corporate credit union's monthly reserve transfers are based upon the level of its reserve ratio. Where the reserve ratio is greater than or equal to 4 percent, the reserve transfer is optional. Where the reserve ratio is greater than or equal to 3 percent but less than 4 percent, the corporate credit union must transfer .10 percent of its moving daily average net assets. Where the reserve ratio is less than 3 percent, the corporate credit union must transfer .15 percent of its moving daily average net assets. Reserve transfers must be calculated on a monthly basis and funded on at least a quarterly basis.

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

(i) An expectation that the corporate credit union has or anticipates losses resulting in capital inadequacy;

(ii) Significant exposure exists, unsupported by adequate capital or risk management processes, due to credit, liquidity, market, fiduciary, operational, and similar types of risks;

(iii) A merger has been approved; or

(iv) An emergency exists because of a natural disaster.

(2) When NCUA determines that a different minimum capital ratio or reserve transfer level is necessary or appropriate for a particular corporate

credit union, NCUA will notify the corporate credit union in writing of the proposed ratio or level and, if applicable, the date by which the ratio should be reached. NCUA also will provide an explanation of why the proposed ratio or level is considered necessary or appropriate for the corporate credit union.

(3)(i) The corporate credit union may respond to any or all of the items in the notice. The response must be in writing and delivered to NCUA within 30 calendar days after the date on which the corporate credit union received the notice. NCUA may shorten the time period when, in its opinion, the condition of the corporate credit union so requires, provided that the corporate credit union is informed promptly of the new time period, or with the consent of the corporate credit union. In its discretion, NCUA may extend the time period for good cause.

(ii) Failure to respond within 30 calendar days or such other time period as may be specified by NCUA shall constitute a waiver of any objections to any item in the notice. Failure to address any item in a response shall constitute a waiver of any objection to that item.

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

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

(f) *Capital restoration plan.* (1) A corporate credit union must submit a plan to restore and maintain its capital ratio at the minimum requirement when either of the following conditions exist:

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

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

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

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

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

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

(iv) Balance sheet and income projections, including assumptions, for the current calendar year and one additional calendar year; and

(v) Certification from the board of directors that it will follow the proposed plan if approved by NCUA.

(3) The capital restoration plan must be submitted to NCUA within 30 calendar days of the occurrence. NCUA will respond to the corporate credit union regarding the adequacy of the plan within 45 calendar days of its receipt.

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

(2) A capital directive may order a corporate credit union to:

(i) Achieve adequate capitalization within a specified time frame by taking any action deemed necessary, including but not limited to the following:

(A) Increase the amount of capital to specific levels;

(B) Reduce dividends;

(C) Limit receipt of deposits to those made to existing accounts;

(D) Cease or limit issuance of new accounts or any or all classes of accounts;

(E) Cease or limit lending or making a particular type or category of loans;

(F) Cease or limit the purchase of specified investments;

(G) Limit operational expenditures to specified levels;

(H) Increase and maintain liquid assets at specified levels; and

(I) Restrict or suspend expanded authorities issued under Appendix B of this part.

(ii) Adhere to a previously submitted plan to achieve adequate capitalization.

(iii) Submit and adhere to a capital plan acceptable to NCUA describing the means and a time schedule by which the corporate credit union shall achieve adequate capitalization.

(iv) Meet with NCUA.

(v) Take a combination of these actions.

(3) Prior to issuing a capital directive, NCUA will notify a corporate credit union in writing of its intention to issue a capital directive.

(i) The notice will state:

(A) The reasons for the issuance of the directive; and

(B) The proposed content of the directive.

(ii) A corporate credit union must respond in writing within 30 calendar days of receipt of the notice stating that it either concurs or disagrees with the notice. If it disagrees with the notice, it must state the reasons why the directive should not be issued and/or propose alternative contents for the directive. The response should include all matters that the corporate credit union wishes to be considered. For good cause, including the following conditions, the response time may be shortened or lengthened:

(A) When the condition of the corporate requires, and the corporate credit union is notified of the shortened response period in the notice;

(B) With the consent of the corporate credit union; or

(C) When the corporate credit union already has advised NCUA that it cannot or will not achieve adequate capitalization.

(iii) Failure to respond within 30 calendar days, or another time period specified in the notice, shall constitute a waiver of any objections to the proposed directive.

(4) After the closing date of the corporate credit union's response period, or the receipt of the response, if earlier, NCUA shall consider the response and may seek additional information or clarification. Based on the information provided during the response period, NCUA will determine whether or not to issue a capital directive and, if issued, the form it should take.

(5) Upon issuance, a capital directive and a statement of the reasons for its issuance will be delivered to the corporate credit union. A directive is effective immediately upon receipt by the corporate credit union, or upon such later date as may be specified therein, and shall remain effective and enforceable until it is stayed, modified, or terminated by NCUA.

(6) A capital directive may be issued in addition to, or in lieu of, any other action authorized by law in response to a corporate credit union's failure to

achieve or maintain the applicable minimum capital ratios.

(7) Upon a change in circumstances, a corporate credit union may request reconsideration of the terms of the directive. Requests that are not based on a significant change in circumstances or are repetitive or frivolous will not be considered. Pending a decision on reconsideration, the directive shall continue in full force and effect.

§ 704.4 Board responsibilities.

(a) *General.* A corporate credit union's board of directors must approve comprehensive written strategic plans and operating policies, review them annually, and provide them upon request to the auditors, supervisory committee, and NCUA.

(b) *Operating policies.* A corporate credit union's operating policies must be commensurate with the scope and complexity of the corporate credit union.

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

(1) Senior managers have an in-depth, working knowledge of their direct areas of responsibility and are capable of identifying, hiring, and retaining qualified staff;

(2) Qualified personnel are employed or under contract for all line support and audit areas, and designated back-up personnel or resources with adequate cross-training are in place;

(3) GAAP is followed, except where law or regulation has provided for a departure from GAAP;

(4) Accurate balance sheets, income statements, and internal risk assessments (*e.g.*, risk management measures of liquidity, market, and credit risk associated with current activities) are produced timely in accordance with §§ 704.6, 704.8, and 704.9;

(5) Systems are audited periodically in accordance with industry-established standards;

(6) Financial performance is evaluated to ensure that the objectives of the corporate credit union and the responsibilities of management are met; and

(7) Planning addresses the retention of external consultants, as appropriate, to review the adequacy of technical, human, and financial resources dedicated to support major risk areas.

§ 704.5 Investments.

(a) *Policies.* A corporate credit union must operate according to an investment policy that is consistent with its other risk management policies, including, but not limited to, those related to credit risk management, asset and liability management, and liquidity management. The policy must address, at a minimum:

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

(2) Risk analysis requirements for any new investment type or transaction, not previously owned or marketed by the corporate credit union, considered for purchase by the corporate credit union and/or for sale to members.

(b) *General.* All investments must be U.S. dollar-denominated and subject to the credit policy restrictions set forth in § 704.6.

(c) *Authorized activities.* A corporate credit union may invest in:

(1) Securities, deposits, and obligations set forth in Sections 107(7), 107(8), and 107(15) of the Federal Credit Union Act, 12 U.S.C. 1757(7), 1757(8), and 1757(15), except as provided in this section;

(2) Deposits in, the sale of federal funds to, and debt obligations of corporate credit unions, Section 107(8) institutions, and state banks, trust companies, and mutual savings banks not domiciled in the state in which the corporate credit union does business;

(3) Corporate CUSOs, as defined in and subject to the limitations of § 704.11;

(4) Marketable debt obligations of corporations chartered in the United States. This authority does not apply to debt obligations that are convertible into the stock of the corporation;

(5) Asset-backed securities; and

(6) CMOs/REMICs that meet the Federal Financial Institutions Examination Council High Risk Security Test (HRST) requirements.

(i) The HRST must be prepared quarterly on all CMOs/REMICs, documented and reviewed by an appropriate committee, and retained while the instrument is held in portfolio and until completion of the next audit and NCUA examination.

(ii) A corporate credit union's board of directors must approve at least three prepayment models for CMOs/REMICs unless a median estimate from an industry-recognized information provider is used. These approved models must be used consistently for all subsequent compliance tests. Any changes in approved models should be infrequent and documented with a reasonable and supportable justification.

(iii) A corporate credit union must obtain prepayment estimates, based upon an instantaneous, permanent, parallel shift in market rates of plus or minus 100, 200, and 300 basis points, to conduct the HRST.

(A) If a median prepayment estimate is used, it must be obtained from an industry-recognized information provider. At purchase, the median estimate must be based on at least 5 prepayment models. At retesting, the median estimate must be based on at least 2 prepayment models.

(B) If individual prepayment models are used, estimates must be obtained from all of the models identified in the corporate credit union's investment policy. One of the individual prepayment models may be the median prepayment estimate from an industry-recognized information provider. All of the models identified in the investment policy must be used when purchasing and retesting a CMO/REMIC. At purchase, a CMO/REMIC must pass the tests for each prepayment model used. At retesting, the CMO/REMIC must pass the tests for a majority of the prepayment models used at the time of purchase.

(d) *Repurchase agreements.* A corporate credit union may enter into a repurchase agreement provided that:

(1) The corporate credit union, or its agent, nominee, or designee, 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;

(2) The repurchase securities are legal investments for that corporate credit union;

(3) In the event of default, the corporate credit union sells the repurchase securities in a timely manner, subject to a bankruptcy stay, to satisfy the commitment of any net principal and interest owed to it by the counterparty;

(4) The corporate credit union receives daily assessment of the market value of the repurchase securities, including a market quote or dealer bid indication and any accrued interest, and maintains adequate margin that reflects a risk assessment of the repurchase securities and the term of the transaction;

(5) The corporate credit union has entered into signed contracts with all approved counterparties. Such contracts must address any supplemental terms and conditions necessary to meet the specific requirements of this part. Third party arrangements must be supported by tri-party contracts in which the repurchase securities are priced and reported daily and the tri-party agent ensures compliance; and

(6) The corporate credit union has sufficient market relationships established in advance to timely execute

the disposition of the repurchase securities.

(e) *Securities Lending.* A corporate credit union may enter into a securities lending transaction provided that:

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

(2) The collateral is a legal investment for that corporate credit union;

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

(4) The corporate credit union, directly or through its agent, has executed a written loan and security agreement with the borrower, approved any form of agreement attached thereto, and obtained the right to approve any material modification to such agreement.

(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 portfolio of such investment company is restricted by its investment policy solely to investments and investment transactions that are permissible for that corporate credit union.

(g) *Forward settlement of transactions later than regular way.* A corporate credit union may enter into an agreement to purchase or sell an instrument, with settlement later than regular way, provided that:

(1) Delivery and acceptance are mandatory;

(2) The transaction is clearly disclosed in the appropriate risk reporting required under § 704.8(b);

(3) If the corporate credit union is the purchaser, it has adequate cash flow projections evidencing its ability to purchase the instrument;

(4) If the corporate credit union is the seller, it owns the instrument on the trade date; and

(5) The transaction is settled on a cash basis at the settlement date.

(h) *Prohibitions.* A corporate credit union is prohibited from:

(1) Purchasing or selling off balance sheet financial derivatives, such as futures, options, interest rate swaps, or forward rate agreements;

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

(3) Purchasing stripped mortgage-backed securities, residual interests in CMO/REMICs, mortgage servicing rights, commercial mortgage related securities, or small business related securities.

(i) *Conflicts of interest.* A corporate credit union's officials, employees, and immediate family members of such individuals, may not receive pecuniary consideration in connection with the making of an investment or deposit by the corporate credit union. Employee compensation is exempt from this prohibition. All transactions not specifically prohibited by this paragraph must be conducted at arm's length and in the interest of the corporate credit union.

(j) *Grandfathering.* A corporate credit union's authority to hold an investment is governed by the regulation in effect at the time of purchase. However, all grandfathered investments are subject to the requirements of §§ 704.8 and 704.9.

§ 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 and lending risks and activities it undertakes. The policy must address, at a minimum:

(1) The approval process associated with credit limits;

(2) Due diligence analysis requirements;

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

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

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

(c) *Concentration limits.* (1) Aggregate investments in mortgage-backed and asset-backed securities are limited to 200 percent of the sum of reserves and undivided earnings and paid-in capital for any single security or trust.

(2) Except for investments in a wholesale corporate credit union, aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 400 percent of the sum of reserves and undivided earnings and paid-in capital.

(3) Except for investments in a wholesale corporate credit union, the aggregate of all investments in non secured obligations of any single domestic issuer is limited to 100 percent of the sum of reserves and undivided earnings and paid-in capital.

(4) For purposes of measurement, each new credit transaction must be evaluated in terms of the corporate credit union's sum of reserves and undivided earnings and paid-in capital at the time of the transaction. A subsequent reduction in the sum of reserves and undivided earnings and paid-in capital will require a suspension of additional transactions until maturities, sales or terminations bring existing exposures within the requirements of this part.

(d) *Credit ratings.* (1) All debt instruments must have a credit rating from at least one nationally recognized statistical rating organization (NRSRO).

(2) The rating(s) must be monitored for as long as the corporate owns an instrument.

(3) At the time of purchase, asset-backed securities must be rated no lower than AAA (or equivalent), other long-term investments must be rated no lower than AA (or equivalent), and short-term investments must be rated no lower than A–1 (or equivalent).

(4) Any rated instrument that is downgraded by the NRSRO used to meet the requirements of this part at the time of purchase must be reviewed by the board or an appropriate committee within 30 calendar days of the downgrade. Instruments that fall below the minimum rating requirements of this part are subject to the requirements of § 704.10.

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

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

(i) A justification for each approved credit line;

(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 line.

§ 704.7 Lending.

(a) *Policies.* A corporate credit union must operate according to a lending policy which addresses, at a minimum:

(1) Loan types and limits;

(2) Required documentation and collateral; and

(3) Analysis and monitoring standards.

(b) *General.* Each loan or line of credit limit will be determined after analyzing the financial and operational soundness of the borrower and the ability of the borrower to repay the loan.

(c) *Loans to member credit unions.* (1) The maximum aggregate amount in unsecured loans and irrevocable lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, shall not exceed 50 percent of capital or 75 percent of the sum of reserves and undivided earnings and paid-in capital, whichever is greater.

(2) The maximum aggregate amount in secured loans and irrevocable lines of credit to any one member credit union, excluding those secured by shares or marketable securities and member reverse repurchase transactions, shall not exceed 100 percent of capital or 200 percent of the sum of reserves and undivided earnings and paid-in capital, whichever is greater.

(d) *Loans to members that are not credit unions.* Any loan or irrevocable line of credit made to a member, other than a credit union or a corporate CUSO, must be made in compliance with § 701.21(h) of this chapter, governing member business loans, unless such loan or line of credit is fully guaranteed by a credit union. The aggregate amount of loans and irrevocable lines of credit to members other than credit unions and corporate CUSOs shall not exceed 15 percent of the corporate credit union's capital plus pledged shares.

(e) *Loans to non member credit unions.* A loan to a credit union that is not a member of the corporate 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 only one business day.

(f) *Loans to corporate CUSOs.* A corporate credit union may make loans and issue lines of credit to corporate CUSOs, subject to the limitations of § 704.11.

(g) *Participation loans with other corporate credit unions.* A corporate credit union is permitted to participate in a loan with another corporate credit union and must retain an interest of at least 5 percent of the face amount of the loan. The participation agreement may be executed at any time prior to, during, or after disbursement. A participating corporate credit union must exercise the same due diligence as if it were the originating corporate credit union.

(h) *Prepayment penalties.* If provided for in the loan contract, a corporate credit union is authorized to assess prepayment penalties on loans.

§ 704.8 Asset and liability management.

(a) *Policies.* A corporate credit union must operate according to a written asset and liability management policy which addresses, at a minimum:

(1) The purpose and objectives of the corporate credit union's asset and liability activities;

(2) The tests that will be used to evaluate instruments prior to purchase;

(3) The maximum allowable percentage decline in net economic value (NEV), compared to current NEV;

(4) The minimum allowable NEV ratio;

(5) The maximum decline in net income (before reserve transfers), in percentage and dollar terms, compared to current net income;

(6) Policy limits and specific test parameters for the interest rate risk simulation tests set forth in paragraph (d) of this section; and

(7) The modeling of indexes that serve as references in financial instrument coupon formulas.

(b) *Asset and liability management committee (ALCO).* A corporate credit union's ALCO must have at least one member who is also a member of the board of directors. The ALCO must review asset and liability management reports on at least a monthly basis. These reports must address compliance with Federal Credit Union Act, NCUA Rules and Regulations (12 CFR chapter VII), and all related risk management policies.

(c) *Penalty for early withdrawals.* A corporate credit union that permits early certificate/share withdrawals must assess market-based penalties sufficient to cover the estimated replacement cost of the certificate/share redeemed.

(d) *Interest rate sensitivity analysis.* (1) A corporate credit union must:

(i) Evaluate the risk in its balance sheet by measuring, at least quarterly, the impact of an instantaneous, permanent, and parallel shock in the Treasury yield curve of plus and minus 100, 200, and 300 basis points on its NEV, NEV ratio, and net interest income. If the base case NEV ratio falls below 2 percent at the last testing date, these tests must be calculated at least monthly until the base case NEV ratio again exceeds 2 percent;

(ii) Limit its risk exposure to levels that do not result in an NEV ratio below 1 percent; and

(iii) Limit its risk exposures to levels that do not result in a decline in NEV of more than 18 percent, except as provided in paragraph (e) of this section.

(2) A corporate credit union that owns an aggregate amount of instruments which possess unmatched embedded options in a book value amount which exceeds 200 percent of the sum of its reserves and undivided earnings and paid-in capital must conduct periodically, as appropriate, additional tests that address market factors which potentially can impact the value of the instruments and that reflect the policy limits addressed in paragraph (a) of this section. These factors should include, but not be limited to, the following:

(i) Changes in the shape of the Treasury yield curve;

(ii) Adjustments to prepayment projections used for amortizing securities to consider the impact of significantly faster/slower prepayment speeds;

(iii) Adjustments to the market spread assumptions for non Treasury instruments to consider the impact of widening spreads; and

(iv) Adjustments to volatility assumptions to consider the impact that changing volatilities have on embedded option values.

(e) *Base-plus.* (1) In performing the rate stress tests set forth in paragraph (d)(1)(i) of this section, the NEV of a corporate credit union which has met the requirements of this paragraph (e) may decline as much as 25 percent.

(2) The corporate credit union must meet additional management and infrastructure requirements and receive NCUA's written approval. The additional requirements are set forth in the NCUA publication Guidelines for Submission of Requests for Expanded Authority. The procedures for processing base-plus authority are the same as those set forth in Appendix B

of this part for requesting expanded authorities.

(3) The corporate credit union must evaluate monthly the changes in NEV, NEV ratio, and net interest income for the tests set forth in paragraph (d)(1)(i) of this section.

(4) Regardless of the amount of instruments which possess unmatched embedded options, the corporate credit union must conduct periodically, as appropriate, the tests set forth in paragraph (d)(2) of this section.

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

(g) *Policy violations.* If a corporate credit union's NEV or NEV ratio for any required test(s) exceed the limits established by the board, it must determine how it will bring the exposures within policy limits. The disclosure to the board of the limit violation must occur no later than its next regularly scheduled board meeting.

§ 704.9 Liquidity management.

(a) *General.* In the management of liquidity, a corporate credit union must:

(1) Evaluate the potential liquidity needs of its membership in a variety of economic scenarios;

(2) Regularly monitor sources of internal and external liquidity;

(3) Demonstrate that the accounting classification of investment securities is consistent with its ability to meet potential liquidity demands; and

(4) Develop a contingency funding plan that addresses alternative funding strategies in successively deteriorating liquidity scenarios. The plan must:

(i) List all sources of liquidity, by category and amount, that are available to service an immediate outflow of funds in various liquidity scenarios;

(ii) Analyze the impact that potential changes in fair value will have on the disposition of assets in a variety of interest rate scenarios; and

(iii) Be reviewed by the board or an appropriate committee no less frequently than annually or as market or business conditions dictate.

(b) *Borrowing.* A corporate credit union may borrow up to 10 times capital or 50 percent of shares (excluding shares created by the use of member reverse repurchase agreements) and capital, whichever is greater. CLF borrowings and borrowed funds created by the use of member reverse repurchase agreements are excluded from this limit. The corporate credit union must demonstrate that sufficient contingent sources of liquidity remain available.

§ 704.10 Divestiture.

(a) Any corporate credit union in possession of an investment 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 NCUA. If the corporate credit union does not sell the failed investment, and the investment continues to fail to meet a requirement of this part, the corporate credit union must, within 30 calendar days of the failure, provide to NCUA a written action plan that addresses:

(1) The investment's characteristics and risks;

(2) The process to obtain and adequately evaluate the investment's market pricing, cash flows, and risk;

(3) How the investment fits into the credit union's asset and liability management strategy;

(4) The impact that either holding or selling the investment will have on the corporate credit union's earnings, liquidity, and capital in different interest rate environments; and

(5) The likelihood that the investment may again pass the requirements of this part.

(b) NCUA may require, for safety and soundness reasons, a shorter time period for plan development than that set forth in paragraph (a) of this section.

(c) If the plan described in paragraph (a) of this section is not approved by NCUA, the credit union must adhere to NCUA's directed course of action.

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

(a) A corporate CUSO is an entity that:

(1) Is at least partly owned by a corporate credit union;

(2) Primarily serves credit unions;

(3) Restricts its services to those related to the normal course of business of credit unions; and

(4) Is structured as a corporation, limited liability company, or limited partnership under state law.

(b) The aggregate of all investments in and loans to member and non member corporate CUSOs shall not exceed 15 percent of a corporate credit union's capital. However, a corporate credit union may loan to member and non member corporate CUSOs an additional 15 percent of capital if collateralized by assets in which the corporate credit union has perfected a security interest under state law. A corporate credit union may not use this authority to acquire control, directly or indirectly, of another financial institution, or to invest in shares, stocks, or obligations of another financial institution, insurance company, trade association, liquidity facility, or similar organization. A corporate CUSO must be operated as an entity separate from any credit union. A corporate credit union investing in or lending to a corporate CUSO must obtain a written legal opinion that the corporate CUSO is organized and operated in such 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 separate corporate identity, common boards of directors and employees, control of one entity over another, and lack of separate books and records.

(c) An official of a corporate credit union which has invested in or loaned to a corporate CUSO may not receive, either directly or indirectly, any salary, commission, investment income, or other income, compensation, or consideration from the corporate CUSO. This prohibition also extends to immediate family members of officials.

(d) Prior to making an investment in or loan to a corporate CUSO, a corporate credit union must obtain a written agreement that the corporate CUSO will:

(1) Follow GAAP;

(2) Provide financial statements to the corporate credit union at least quarterly;

(3) Obtain an annual CPA opinion audit and provide a copy to the corporate credit union; and

(4) Allow the auditor, board of directors, and NCUA complete access to its books, records, and any other pertinent documentation.

(e) Corporate credit union authority to invest in or loan to a CUSO is limited to that provided in this section. A corporate credit union is not authorized to invest in or loan to a CUSO under § 701.27 of this chapter.

§ 704.12 Services.

Except for correspondent services to a non member, natural person credit union branch office operating in the geographic area defined in the corporate credit union's charter, a corporate credit union may provide services only to its members, subject to the limitations of this part. A corporate credit union may not provide services to non members through agreements with other corporate credit unions or pursuant to § 701.26 of this chapter, except with the written permission of NCUA.

§ 704.13 Fixed assets.

(a) A corporate credit union's ownership in fixed assets shall be limited as described in § 701.36 of this chapter, except that in lieu of § 701.36(c)(1) through (4) of this chapter, paragraph (b) of this section applies.

(b) A corporate credit union may invest in fixed assets where the aggregate of all such investments does not exceed 15 percent of the corporate credit union's capital. A corporate credit union desiring to exceed the limitation shall submit a written request to NCUA. Requests shall be supplemented by such statements and reports as NCUA may require. If the corporate credit union does not receive notification of the action taken on its request within 45 calendar days of the date all required information has been received, it may proceed with its proposed investment in fixed assets.

§ 704.14 Representation.

(a) *Board representation.* The board shall be determined as stipulated in the standard corporate federal credit union bylaws governing election procedures, provided that:

(1) At least a majority of directors, including the chair of the board, must serve on the board as representatives of member credit unions;

(2) The chair of the board may not serve simultaneously as an officer, director, or employee of a credit union trade association;

(3) A majority of directors may not serve simultaneously as officers, directors, or employees of the same credit union trade association or its affiliates (not including chapters or other subunits of a state trade association);

(4) For purposes of meeting the requirements of paragraphs (a)(2) and (a)(3) of this section, an individual may not serve as a director or chair of the board if that individual holds a subordinate employment relationship to another employee who serves as an officer, director, or employee of a credit union trade association; and

(5) In the case of a corporate credit union whose membership is composed of more than 25 percent non credit unions, the majority of directors serving as representatives of member credit unions, including the chair, must be elected only by member credit unions.

(b) *Representatives of organizational members.* (1) An organizational member of a corporate credit union is a member that is not a natural person. An organizational member may appoint one of its members or officials as a representative to the corporate credit union. The representative shall be empowered to attend membership meetings, to vote, and to stand for election on behalf of the member. No individual may serve as the representative of more than one organizational member in the same corporate credit union.

(2) Any vacancy on the board of a corporate credit union caused by a representative being unable to complete his or her term shall be filled by the board of the corporate credit union according to its bylaws governing the filling of board vacancies.

(c) *Recusal provision.* (1) No director, committee member, officer, or employee of a corporate credit union shall in any manner, directly or indirectly, participate in the deliberation upon or the determination of any question affecting his or her pecuniary interest or the pecuniary interest of any entity (other than the corporate credit union) in which he or she is interested, except if the matter involves general policy applicable to all members, such as setting dividend or loan rates or fees for services.

(2) An individual is ''interested'' in an entity if he or she:

(i) Serves as a director, officer, or employee of the entity;

(ii) Has a business, ownership, or deposit relationship with the entity; or

(iii) Has a business, financial, or familial relationship with an individual whom he or she knows has a pecuniary interest in the entity.

(3) In the event of the disqualification of any directors, by operation of paragraph (c)(1) of this section, the remaining qualified directors present at the meeting, if constituting a quorum with the disqualified directors, may exercise, by majority vote, all the powers of the board with respect to the matter under consideration. Where all of the directors are disqualified, the matter must be decided by the members of the corporate credit union.

(4) In the event of the disqualification of any committee member by operation of paragraph (c)(1) of this section, the remaining qualified committee members, if constituting a quorum with the disqualified committee members, may exercise, by majority vote, all the powers of the committee with respect to the matter under consideration. Where all of the committee members are disqualified, the matter shall be decided by the board of directors.

(d) *Administration.* (1) A corporate credit union shall be under the direction and control of its board of directors. While the board may delegate the performance of administrative duties, the board is not relieved of its responsibility for their performance. The board may employ a chief executive officer who shall have such authority and such powers as delegated by the board to conduct business from day to day. Such chief executive officer must answer solely to the board of the corporate credit union, and may not be an employee of a credit union trade association.

(2) The provisions of § 701.14 of this chapter apply to corporate credit unions, except that where ''Regional Director'' is used, read ''NCUA Board.''

§ 704.15 Audit requirements.

(a) *External audit.* The corporate credit union supervisory committee shall cause an annual opinion audit of the financial statements to be made. The audit must be performed in accordance with generally accepted auditing standards and the audited financial statements must be prepared consistent with GAAP, except where law or regulation has provided for a departure from GAAP. The supervisory committee shall submit the audit report to the board of directors. A copy of the audit report, and copies of all communications that are provided to the corporate credit union by the external auditor, shall be submitted to NCUA within 30 calendar days after receipt by the board of directors. If requested by NCUA, the external auditor's workpapers shall be made available, at the auditor's office or elsewhere, for NCUA's review. The corporate credit union shall submit a summary of the audit report to the membership at the next annual meeting.

(b) *Internal audit.* A corporate credit union with average daily assets in excess of $400 million for the preceding calendar year, or as ordered by NCUA, must employ or contract, on a full- or part-time basis, the services of an internal auditor. The internal auditor's responsibilities will, at a minimum, comply with the Standards and Professional Practices of Internal Auditing, as established by the Institute

of Internal Auditors. The internal auditor will report directly to the chair of the corporate credit union's supervisory committee, who may delegate supervision of the internal auditor's daily activities to the chief executive officer of the corporate credit union. The internal auditor's reports, findings, and recommendations will be in writing and presented to the supervisory committee no less than quarterly, and will be provided upon request to the external auditor and NCUA.

§ 704.16 Contracts/written agreements.

Services, facilities, personnel, or equipment shared with any party shall be supported by a written contract, with the duties and responsibilities of each party specified and the allocation of service fee/expenses fully supported and documented.

§ 704.17 State-chartered corporate credit unions.

(a) This part does not expand the powers and authorities of any state-chartered corporate credit union, beyond those powers and authorities provided under the laws of the state in which it was chartered.

(b) A state-chartered corporate credit union that is not insured by the NCUSIF, but that receives funds from federally insured credit unions, is considered an ''institution-affiliated party'' within the meaning of Section 206(r) of the Federal Credit Union Act, 12 U.S.C. 1786(r).

(c) NCUA will notify, consult with, and provide explanation to the appropriate state supervisory authority before taking administrative action against a state-chartered corporate credit union.

§ 704.18 Fidelity bond coverage.

(a) *Scope.* This section provides the fidelity bond requirements for employees and officials in corporate credit unions.

(b) *Review of coverage.* The board of directors of each corporate credit union shall, at least annually, carefully review the bond coverage in force to determine its adequacy in relation to risk exposure and to the minimum requirements in this section.

(c) *Minimum coverage; approved forms.* Every corporate credit union will maintain bond coverage with a company holding a certificate of authority from the Secretary of the Treasury. All bond forms, and any riders and endorsements which limit the coverage provided by approved bond forms, must receive the prior written approval of NCUA. Fidelity bonds must provide coverage for the fraud and dishonesty of all employees, directors, officers, and supervisory and credit committee members. Notwithstanding the foregoing, all bonds must include a provision, in a form approved by NCUA, requiring written notification by surety to NCUA:

(1) When the bond of a credit union is terminated in its entirety;

(2) When bond coverage is terminated, by issuance of a written notice, on an employee, director, officer, supervisory or credit committee member; or

(3) When a deductible is increased above permissible limits. Said notification shall be sent to NCUA and shall include a brief statement of cause for termination or increase.

(d) *Minimum coverage amounts.* (1) The minimum amount of bond coverage will be computed based on the corporate credit union's daily average net assets for the preceding calendar year. The following table lists the minimum requirements:

Daily average net assets	Minimum bond (million)
Less than $50 million	$1.0
$50–$99 million	2.0
$100–$499 million	4.0
$500–$999 million	6.0
$1.0–$1.999 billion	8.0
$2.0–$4.999 billion	10.0
$5.0–$9.999 billion	15.0
$10.0–$24.999 billion	20.0
$25.0 billion plus	25.0

(2) It is the duty of the board of directors of each corporate credit union to provide adequate protection to meet its unique circumstances by obtaining, when necessary, bond coverage in excess of the minimums in the table in paragraph (d)(1) of this section.

(e) *Deductibles.* (1) The maximum amount of deductibles allowed are based on the corporate credit union's reserve ratio. The following table sets out the maximum deductibles, except that in each category the maximum deductible shall be $5 million:

Reserve ratio	Maximum deductible
Less than 1.0 percent	7.5 percent of the sum of reserves and undivided earnings and paid-in capital.
1.0–1.74 percent	10.0 percent of the sum of reserves and undivided earnings and paid-in capital
1.75–2.24 percent	12.0 percent of the sum of reserves and undivided earnings and paid-in capital.
Greater than 2.25 percent	15.0 percent of the sum of reserves and undivided earnings and paid-in capital.

(2) A deductible may be applied separately to one or more insuring clauses in a blanket bond. Deductibles in excess of those showing in this section must have the written approval of NCUA at least 30 calendar days prior to the effective date of the deductibles.

(f) *Additional coverage.* NCUA may require additional coverage for any corporate credit union when, in the opinion of NCUA, current coverage is insufficient. The board of directors of the corporate credit union must obtain additional coverage within 30 calendar days after the date of written notice from NCUA.

§ 704.19 Wholesale corporate credit unions.

(a) *General.* Wholesale corporate credit unions are subject to the preceding requirements of this part, except as set forth in this section.

(b) *Capital.* (1) A wholesale corporate credit union will maintain a minimum capital ratio of 5 percent.

(2) A wholesale corporate credit union shall make reserve transfers at the lower of .10 percent of its moving daily average net assets or the amount that would be required under § 704.3(c).

(i) Required transfers are to be made from earnings in either the prior calendar month or prior twelve-month period. Transfers made during the prior twelve-month period must be greater than or equal to the aggregate amount of required reserve transfers for each of the months in that twelve-month period.

(ii) NCUA and, in the case of state-chartered wholesale corporate credit unions, the state supervisory authority, must be notified within 30 calendar days of the close of any calendar month in which a wholesale corporate credit union's required reserve transfer exceeds earnings for that month. The notice must include the dollar amounts of the required reserve transfer and earnings for that month and for the prior twelve-month period. The notice must also provide an explanation of why the current month's required reserve

transfer exceeded earnings for that month.

(c) *Asset and liability management.* (1) In conducting the interest rate sensitivity analysis set forth in § 704.8(d)(1)(i), a wholesale corporate credit union must limit its risk exposure to levels that do not result, at any time, in an NEV ratio below .75 percent or a decline in NEV of more than 35 percent.

(2) A wholesale corporate credit union must obtain, at its expense, an annual third-party review of its asset and liability management modeling system.

Appendix A to Part 704—Model Forms

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

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 member credit union may withdraw membership capital with three years' notice.

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

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

(5) 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.

If the form is used when an account is opened, it must also contain the following statement:

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

The 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.

If the form is used for the annual notice requirement, it must be signed by the chair of the corporate credit union. The chair must then sign a statement which certifies that the form 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) Paid-in capital is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

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

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

(4) Paid-in capital is subordinate to membership capital and the NCUSIF.

If the form is used when a paid-in capital instrument is created, it must also contain the following statement:

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

The 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.

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

Appendix B to Part 704— Expanded Authorities and Requirements

A corporate credit union may obtain expanded authorities if it meets all of the requirements of this part 704, fulfills additional capital, management, infrastructure, and asset and liability requirements, and receives NCUA's written approval. The additional requirements and authorities are set forth in this Appendix and in the NCUA publication Guidelines for Submission of Requests for Expanded Authority. A corporate credit union which seeks expanded authorities must submit to NCUA a self-assessment plan which analyzes and supports its request. A corporate credit union may adopt expanded authorities when NCUA has provided final approval. If NCUA denies a request for expanded authorities, it will advise the corporate of the reasons for the denial and what it must do to resubmit its request. NCUA may revoke these expanded authorities at any time if an analysis indicates a significant deficiency. NCUA will notify the corporate credit union in writing of the identified deficiency. A corporate credit union may request, in writing, reinstatement of the revoked authorities by providing a self-assessment plan which details how it has corrected these deficiencies.

(a) In order to participate in the authorities set forth in paragraphs (b) through (d) of this Part I, a corporate credit union must:

(1) Have a minimum capital ratio of 5 percent;

(2) Evaluate monthly the changes in NEV, NEV ratio, and net interest income for the tests set forth in § 704.8(d)(1)(i); and

(3) Regardless of the amount of instruments which possess unmatched embedded options, conduct periodically, as appropriate, the tests set forth in § 704.8(d)(2).

(b) A corporate credit union which has met the requirements of paragraph (a) of this Part I is not bound by the concentration limits on investments set forth at § 704.6(c)(1) and (2). Instead, the corporate credit union must establish limits on such investments as a percentage of the sum of reserves and undivided earnings and paid-in capital that take into account the relative amount of credit risk exposure based upon, but not limited to, the legal and financial structure of the transaction, the collateral, all other types of credit enhancement, and the term of the transaction.

(c) A corporate credit union which has met the requirements of paragraph (a) of this Part I may:

(1) Except for investments in a wholesale corporate credit union, invest in non secured obligations of any single domestic issuer up to 150 percent of the sum of reserves and undivided earnings and paid-in capital;

(2) Purchase long-term investments rated no lower than AA-(or equivalent);

(3) Purchase asset-backed securities rated no lower than AA (or equivalent);

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

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

(6) Purchase CMOs/REMICs using fewer prepayment models than required in § 704.5(c)(6);

(7) Enter into a repurchase transaction where the collateral securities are rated no lower than A (or equivalent);

(8) Enter into a dollar roll transaction; and

(9) Engage in when-issued trading, when accounted for on a trade date basis.

(d) 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 paragraph (a) of this Part I may decline as much as 35 percent.

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

Part II

(a) In order to participate in the authorities set forth in paragraphs (b)–(d) of this Part II, a corporate credit union must:

(1) Have a minimum capital ratio of 6 percent; and

(2) Evaluate monthly the changes in NEV, NEV ratio, and net interest income for the tests set forth in § 704.8(d)(1)(i); and

(3) Regardless of the amount of instruments which possess unmatched embedded options, conduct periodically, as appropriate, the tests set forth in § 704.8(d)(2).

(b) A corporate credit union which has met the requirements of paragraph (a) of this Part II is not bound by the concentration limits on investments set forth at § 704.6(c) (1) and (2). Instead, the corporate credit union must establish limits on such investments as a percentage of the sum of reserves and undivided earnings and paid-in capital, that take into account the relative amount of credit risk exposure based upon, but not

limited to, the legal and financial structure of the transaction, the collateral, all other types of credit enhancement, and the term of the transaction.

(c) A corporate credit union which has met the requirements of paragraph (a) of this Part II may:

(1) Except for investments in a wholesale corporate credit union, invest in nonsecured obligations of any single domestic issuer up to 250 percent of the sum of reserves and undivided earnings and paid-in capital;

(2) Purchase long-term investments rated no lower than A− (or equivalent);

(3) Purchase asset-backed securities rated no lower than AA (or equivalent);

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

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

(6) Purchase CMOs/REMICs using fewer prepayment models than required in § 704.5(c)(6);

(7) Enter into a dollar roll transaction; and

(8) Engage in when-issued trading, when accounted for on a trade date basis.

(d) 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 paragraph (a) of this Part II may decline as much as 50 percent.

(e) The maximum aggregate amount in secured and unsecured loans and irrevocable lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, shall be established by the board of directors as a percentage of the corporate credit union's capital plus pledged shares.

Part III

(a) A corporate credit union which has met the requirements of paragraph (a) of either Part I or Part II of this Appendix may invest in:

(1) Debt obligations of a foreign country; and

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

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

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

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

(iii) A sovereign issuer, and/or the country in which a bank issuer/guarantor is organized, must be rated no lower than AA (or equivalent) for political and economic stability;

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

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

(vi) Non secured obligations of any single foreign issuer may not exceed 150 percent of the sum of reserves and undivided earnings and paid-in capital; and

(vii) Non secured obligations in any single foreign country may not exceed 500 percent of the sum of reserves and undivided earnings and paid-in capital.

Part IV

A corporate credit union which has met the requirements of paragraph (a) of either Part I or Part II of this Appendix may engage in derivatives transactions which are directly related to its financial activities and which have been specifically approved by NCUA. A corporate credit union may use such derivatives authority only for the purposes of creating structured instruments and hedging its own balance sheet and the balance sheets of its members.

PART 709—INVOLUNTARY LIQUIDATION OF FEDERAL CREDIT UNIONS AND ADJUDICATION OF CREDITOR CLAIMS INVOLVING FEDERALLY INSURED CREDIT UNIONS IN LIQUIDATION

2. The authority citation for part 709 continues to read as follows:

Authority: 12 U.S.C. 1766; Pub. L. 101–73, 103 Stat. 183, 530 (1989) (12 U.S.C. 1787 *et seq.*).

3. Section 709.5 is amended by revising paragraphs (b)(7) and (b)(8) and adding paragraph (b)(9) to read as follows:

§ 709.5 Payout priorities in involuntary liquidation.

* * * * *

(b) * * *

(7) In a case involving liquidation of a corporate credit union, membership capital;

(8) In a case involving liquidation of a low-income designated credit union, any outstanding secondary capital accounts issued pursuant to the authority of §§ 701.34 or 741.204(c) of this chapter; and

(9) In a case involving liquidation of a corporate credit union, paid-in capital.

* * * * *

PART 741—REQUIREMENTS FOR INSURANCE

4. The authority citation for part 741 continues to read as follows:

Authority: 12 U.S.C. 1757, 1766, and 1781–1790. Section 741.4 is also authorized by 31 U.S.C. 3717.

5. Section 741.219 is added to read as follows:

§ 741.219 Investment requirements.

Any credit union which is insured pursuant to Title II of the Act must adhere to the requirements stated in part 703 of this chapter concerning transacting business with corporate credit unions.

[FR Doc. 97–6417 Filed 3–18–97; 8:45 am]

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DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. 94–CE–34–AD; Amendment 39–9967; AD 97–06–10]

RIN 2120–AA64

Airworthiness Directives; Raytheon Aircraft Company (Formerly Beech Aircraft Corporation) Model 76 Airplanes

AGENCY: Federal Aviation Administration, DOT.

ACTION: Final rule.

SUMMARY: This amendment supersedes Airworthiness Directive (AD) 91–14–14, which currently requires repetitively inspecting the main landing gear (MLG) ''A'' frame assemblies for cracks on Raytheon Aircraft Company (Raytheon) Model 76 airplanes (formerly referred to as Beech Model 76 airplanes), and replacing any assembly found cracked. AD 91–14–14 resulted from reports of fatigue cracks developing on the MLG ''A'' frame assemblies of the affected airplanes. Raytheon has developed improved design MLG ''A'' frame assemblies, and the Federal Aviation Administration (FAA) has determined that Model 76 airplanes with an improved design ''A'' frame assembly installed on both the left and right MLG should be exempt from AD 91–14–14. This action retains the requirement of repetitively inspecting the MLG ''A'' frame assemblies for cracks and replacing any cracked ''A'' frame assembly only for those Model 76 airplanes that do not have the improved design parts installed. The actions specified by this AD are intended to prevent MLG failure because of a cracked ''A'' frame assembly, which could result in loss of control of the airplane during landing operations.

DATES: Effective May 16, 1997.

The incorporation by reference of certain publications listed in the regulations is approved by the Director of the Federal Register as of May 16, 1997.

ADDRESSES: Service information that applies to this AD may be obtained from the Raytheon Aircraft Company, P.O. Box 85, Wichita, Kansas 67201–0085. This information may also be examined at the FAA, Central Region, Office of the Assistant Chief Counsel, Attention: Rules Docket No. 94–CE–34–AD, Room 1558, 601 E. 12th Street, Kansas City, Missouri 64106; or at the Office of the Federal Register, 800 North Capitol Street, NW., suite 700, Washington, DC.