

NCUA Advanced Notice of Proposed Rulemaking Member Guide

Prepared by Midwest Corporate Federal Credit Union

This guide has been prepared to help credit unions better understand the issues surrounding the NCUA Advanced Notice of Proposed Rulemaking (ANPR) and clarify some specific requests for comments. This guide is not intended to lead the user to specific responses, but, to help the user form their own responses to the issues. If the user of this guide is interested in Midwest Corporate's official response to the ANPR, it can be viewed on Midwest Corporate's website, www.midwestcorporatefcu.org.

On January 28, 2009, among other actions, NCUA published an ANPR that requests comments regarding the corporate credit union system and the regulations that apply to corporate credit unions.

Should you decide to provide a comment to the NCUA, you do not have to comment on every aspect of the ANPR and you can comment on any area or issue you view as important regarding corporate credit unions that may not be covered within the ANPR. The ANPR is really a document meant to stimulate ideas, give an opportunity to express concerns, and to help guide future regulation promulgation for corporate credit unions.

The following comments from the question and answer portion of the NCUA February 12, 2009 Webinar Transcript may be of help in understanding what the NCUA is actually looking for in its ANPR:

JeanMarie Komyathy: What is to prevent this from happening in the future?

Larry Fazio: This is Larry. That's a really good question. That's one of the reasons why the Board when it took the action also approved issuing an advanced notice of proposed rulemaking to basically put all of the different issues and ideas about reform and restructuring the corporate system going forward on the table and to solicit broad stakeholder input relative to what the future needs of a design for a new corporate system to emerge out of this. Some of the things are, I think, apparent that need to be seriously considered are capital standards for the corporate credit unions relative to their book of business and their risk profiles, concentration limits or sector limits, however you want to call those, what source of authority should they have. And ultimately what will drive up the corporate system looks like in terms of the product and services that they deliver will be the needs of the credit union community, the credit union movement. And so, that's why the NCUA Board needs to hear from everyone and we certainly encourage everyone -- this is a major undertaking for the whole movement and so we need to hear from everybody about one, what do you need from your corporate system and what

sort of support are you willing to continue to provide in making a successful corporate system going forward assuming we restructure and reformat to make sure that we have prudential safety and soundness requirements in place, adequate capital, so on and so forth.

John Kutchey: Just to add to that. In the short term one of the questions that's come up in these prior webinars relates to if I put more deposit money, if I increase my level of deposits in the corporate system what are you doing with those funds? Basically, we're cash and cash equivalents at this point. The corporate credit unions have -- there are some restrictions in place from a supervisory perspective on where these funds can be put. So, trying to dilute the percentage of the securities as a percentage of the total assets in the corporate. So, that is something in the short term we're trying to do to keep another situation from occurring.

JeanMarie Komyathy: We appreciate the chance to comment, but many of the questions in the ANPR couldn't possibly be correctly or effectively answered by natural person credit unions as we aren't qualified to answer them. Are you seeking guidance by experts as well?

Larry Fazio: This is Larry. I'll take a first shot at that question. That's a great question, by the way. Let me just start off by saying we all appreciate that you can't necessarily be an expert on all of those issues. Many of the natural person credit unions wouldn't necessarily have expertise in many of those areas; however, one of the things we do need to hear from as many credit unions as possible, including small credit unions, is what they need in terms of ongoing future services from their corporate credit unions. So, even if you don't feel qualified to provide comments on all of the range of issues in the ANPR please do provide us comments on what you need in terms of the future services that the corporates would provide you. In terms of getting outside experts, the entire public is free to comment on the ANPR. In fact, we encourage that. We work with a variety of other government organizations. We're looking at best practices and models both within the United States and without. We are getting a lot of groups and individuals who have expertise in this area have voluntarily come forward that have some connection or interest in the credit union system or in the corporate system and are helping -- providing advice and ideas. I know several of the trade organizations have pulled together teams to study these issues and to look at them. And so, there's a broad base of research and support going into answering many of these questions. And so, yes, we are soliciting and looking to outside experts as well as internal experts on how to reform and restructure going forward in the corporate system.

David Marquis: This is Dave. Some of the small and medium-sized credit unions, you're not an expert on investments, that's why you put your money in the corporates in the first place, so you can't provide comments probably on

those type of technical issues. But as Larry said answer the question for us this way: If your corporate system vanished tomorrow what services that would no longer be there would be the most harmful to you in carrying out your day-to-day business that you couldn't find a way to get elsewhere real fast or at an affordable price? We need to know, especially from the 7,000 credit unions that are not necessarily very large institutions, what are you most dependent on in the corporate system that needs to be there in some form or fashion somewhere for the credit union community? (underline added for emphasis)

Larry Fazio: And ultimately, whatever comes out of this reforming and restructuring phase needs to be something that credit unions want to participate in. They're going to own it. It's going to serve you. It's going to be yours. And so, we want that to reflect what you want and need.

* Speakers were: David Marquis, NCUA Executive Director
John Kutchev, NCUA Acting Director of Examination & Insurance
Steve Farrar, NCUA Loss Risk Analysis Officer

As the NCUA's ANPR states in its summary,

In the light of current economic circumstances affecting the U.S. economy and, in particular, the financial sector, NCUA is evaluating and reconsidering the role corporate credit unions currently play in the credit union system, including corporates' membership structure, size, and types of services they offer. NCUA is also considering whether to amend its regulation governing corporate credit unions to clarify or revise current provisions, including those related to: capital; permissible investments; management of credit risk and liquidity; and corporate governance. NCUA seeks comment on these issues and any others commenters think NCUA should consider.

As you read the ANPR and address the issues it asks about, be careful to not be swayed by the form of the questions as they can at times be based on particular assumptions that may or may not be valid and there may be leading questions to a particular point of view. The key is to ascertain from the ANPR the area that is to be addressed and comment on the areas you are comfortable commenting on. Also, as noted in the excerpt from the NCUA Webinar Transcript, be sure to list what services you receive from your corporate credit union, the importance of receiving those services, and your opinion as to what the impact would be if you had to obtain those services elsewhere. The transcript excerpt also asked for you to indicate what you think the core services of a corporate credit union should include, or if you believe that there should not be limits on the services a corporate credit union can offer.

Comments must be received by the NCUA on or before April 6, 2009. Comments regarding the ANPR, and any other comments you may have, should be sent to the NCUA by one of the following methods (use only one method, do not send your comments multiple ways):

1. Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.
2. NCUA Web Site: http://www.ncua.gov/RegulationsOpinionsLaws/proposed_regs/proposed_regs.html. Follow the instructions for submitting comments.
3. E-mail: Address to regcomments@ncua.gov. Include “[Your name] – Comments on Advanced Notice of Proposed Rulemaking for Part 704” in the e-mail subject line.
4. Fax: (703) 518-6319. Use the subject line described above for e-mail.
5. Mail: Address to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.
6. Hand Delivery/Courier: Same as mail address.

ANPR Section A – Background

This section is just that, background on the corporate credit union’s role within the credit union movement and the services they provide.

ANPR Section B – Current Economic Climate and Remedial Measures Taken

This section outlines, in a very general way, the current economic situation that faces the corporate credit union network and the actions taken by the NCUA Board to address the issues of immediate concern.

ANPR Section C – Issues for Consideration

1. The Role of Corporates in the Credit Union System

Payment System

This section is asking about payment system functions within corporate credit unions. Payment systems refers to such services as check clearing processing, check collection services, ACH services, wire services, etc. One specific area covered in this section is could payment system risks be separated from other operational risks and how risks might be mitigated in this area.

This section also inquires about the concept of having two distinct corporate credit union charters, one for payment systems and one for investment services.

Liquidity and Liquidity Management

This section deals with how corporate credit unions fulfill their role as liquidity providers to the credit union movement. Corporate credit unions provide liquidity in the form of lines of credit and term loans to credit unions.

Liquidity management refers to how a corporate credit union plans for member needs for withdrawals and credit advances. This is generally done through managing the balance sheet to insure enough cash and cash equivalents are available. It has also been done by some corporate credit unions by relying on marketable securities being able to be sold and/or borrowing to raise cash.

Field of Membership Issues

This section seeks direction and comment on whether national fields of membership for corporate credit unions should be repealed to regional fields of memberships. The reason for this request is that some believe national fields of membership lead to aggressive competition between corporate credit unions resulting in more risk taking at some corporate credit unions, and that it may have contributed to the magnitude of the current problems facing the corporate credit union network.

Expanded Investment Authorities

Expanded authorities refer to NCUA Regulation Part 704 – Appendix B. These are operating authorities known as Base-Plus, Part I, Part II, Part III, Part IV, and Part V. Base-Plus and Parts I, II, III, and IV authorities, once granted to a corporate credit union, grants the corporate credit union the ability to invest in investments not otherwise permitted. Part V allows a corporate credit union to do loan participations with natural-person credit unions.

The following is NCUA Regulation Part 704 – Appendix B:

Appendix B to Part 704— Expanded Authorities and Requirements

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

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

Minimum Requirement

In order to participate in any of the authorities set forth in Base-Plus, Part I, Part II, Part III, Part IV, and Part V of this Appendix, a corporate credit union must evaluate monthly the changes in NEV and the NEV ratio for the tests set forth in § 704.8(d)(1)(i).

Base-Plus

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

Part I

- (a) A corporate credit union that has met the requirements for this Part I may:
- (1) Purchase investments with long-term ratings no lower than A- (or equivalent);
 - (2) Purchase investments with short-term ratings no lower than A-2 (or equivalent), provided that the issuer has a long-term rating no lower than A- (or equivalent) or the investment is a domestically-issued asset-backed security;
 - (3) Engage in short sales of permissible investments to reduce interest rate risk;
 - (4) Purchase principal only (PO) stripped mortgage-backed securities to reduce interest rate risk; and
 - (5) Enter into a dollar roll transaction.
- (b) Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 300 percent of capital.
- (c) In performing the rate stress tests set forth in § 704.8(d)(1)(i), the NEV of a corporate credit union that has met the requirements of this Part I may decline as much as:
- (1) 20 percent;
 - (2) 28 percent if the corporate credit union has a 5 percent minimum capital ratio and is specifically approved by NCUA; or
 - (3) 35 percent if the corporate credit union has a 6 percent minimum capital ratio and is specifically approved by NCUA.
- (d) The maximum aggregate amount in unsecured loans and lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, must not exceed 100 percent of the corporate credit union's capital. The board of directors must establish the limit, as a percent of the corporate credit union's capital plus pledged shares, for secured loans and lines of credit.

Part II

- (a) A corporate credit union that has met the requirements for this Part II may:
- (1) Purchase investments with long-term ratings no lower than BBB (flat) (or equivalent). The aggregate of all investments rated BBB+ (or equivalent) or lower in any single obligor is not to exceed 25 percent of capital;
 - (2) Purchase investments with short-term ratings no lower than A-2 (or equivalent), provided that the issuer has a long-term rating no lower than BBB (flat) (or equivalent) or the investment is a domestically issued asset-backed security;
 - (3) Engage in short sales of permissible investments to reduce interest rate risk;
 - (4) Purchase principal only (PO) stripped mortgage-backed securities to reduce interest rate risk; and
 - (5) Enter into a dollar roll transaction.
- (b) Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 400 percent of capital.
- (c) In performing the rate stress tests set forth in § 704.8(d)(1)(i), the NEV of a corporate credit union which has met the requirements of this Part II may decline as much as:
- (1) 20 percent;

- (2) 28 percent if the corporate credit union has a 5 percent minimum capital ratio and is specifically approved by NCUA; or
 - (3) 35 percent if the corporate credit union has a 6 percent minimum capital ratio and is specifically approved by NCUA.
- (d) The maximum aggregate amount in unsecured loans and lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, must not exceed 100 percent of the corporate credit union's capital. The board of directors must establish the limit, as a percent of the corporate credit union's capital plus pledged shares, for secured loans and lines of credit.

Part III

- (a) A corporate credit union that has met the requirements of either Part I or Part II of this Appendix and the additional requirements for Part III may invest in:
- (1) Debt obligations of a foreign country;
 - (2) Deposits and debt obligations of foreign banks or obligations guaranteed by these banks;
 - (3) Marketable debt obligations of foreign corporations. This authority does not apply to debt obligations that are convertible into the stock of the corporation; and
 - (4) Foreign issued asset-backed securities.
- (b) All foreign investments are subject to the following requirements:
- (1) Investments must be rated no lower than the minimum permissible domestic rating under the corporate credit union's Part I or Part II authority;
 - (2) A sovereign issuer, and/or the country in which an obligor is organized, must have a long-term foreign currency (non-local currency) debt rating no lower than AA- (or equivalent);
 - (3) For each approved foreign bank line, the corporate credit union must identify the specific banking centers and branches to which it will lend funds;
 - (4) Obligations of any single foreign obligor may not exceed 50 percent of capital; and
 - (5) Obligations in any single foreign country may not exceed 250 percent of capital.

Part IV

- (a) A corporate credit union that has met the requirements for this Part IV may enter into derivative transactions specifically approved by NCUA to:
- (1) Create structured products;
 - (2) Manage its own balance sheet; and
 - (3) Hedge the balance sheets of its members.
- (b) Credit Ratings:
- (1) All derivative transactions are subject to the following requirements:
 - (i) If the counterparty is domestic, the counterparty rating must be no lower than the minimum permissible rating for comparable term permissible investments; and
 - (ii) If the counterparty is foreign, the corporate must have Part III expanded authority and the counterparty rating must be no lower than the minimum permissible rating for a comparable term investment under Part III Authority.
 - (iii) Any rating(s) relied upon to meet the requirements of this part must be identified at the time the transaction is entered into and must be monitored for as long as the contract remains open.
 - (iv) Section 704.10 of this part if:
 - (A) one rating was relied upon to meet the requirements of this part and that rating is downgraded below the minimum rating requirements of this part; or

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

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

- (i) Domestically chartered credit unions;
- (ii) U.S. government sponsored enterprises; or
- (iii) Counterparties if the transaction is fully guaranteed by an entity with a minimum permissible rating for comparable term investments.

Part V

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

- (a) The maximum aggregate amount of participation loans with any one member credit union must not exceed 25 percent of capital; and
- (b) The maximum aggregate amount of participation loans with all member credit unions will be determined on a case-by-case basis by the OCCU Director.

Structure: two-tiered system

This section seeks comments on the two-tiered system of corporate credit unions. The two-tier system refers to a wholesale corporate credit union (i.e. U.S. Central FCU) and the retail corporate credit unions (i.e. Midwest Corporate). This is a very important section on which to comment. Questions are asked if the wholesale corporate credit union should be eliminated. Eliminating the wholesale tier will significantly impact the future operations of corporate credit unions as each retail tier corporate credit union will need to find alternative providers for services now provided by the wholesale corporate credit union. Also, eliminating the wholesale tier would likely encourage the retail tier corporate credit unions to act more independently of each other.

2. Corporate Capital

This area of the ANPR deals with what types and amount of capital would be appropriate for corporate credit unions. The current regulations define three different types of capital for a corporate credit union; reserves and undivided earnings (sometimes referred to as RUDE), Paid-in-Capital (PIC), and membership capital shares. RUDE and PIC combined are considered “core capital”. Total capital is the combination of RUDE, PIC, and membership capital shares. The current regulatory minimum capital requirement for a corporate credit union is a Total Capital to 12-month Daily Average Net Assets Ratio of 4.00%.

The ANPR also asks if risk-weighted asset classification capital ratios should be implemented that is in line with the standards used by other federal financial institution regulators.

Core Capital

This section asks the commenter for input as to proper levels of core capital, commonly referred to as “tier one capital”, which would currently be undivided earnings, other reserves, and member paid-in-capital. The ANPR also asks if member contributed core capital (PIC) should be required for a credit union to receive services from a corporate credit union.

Membership Capital

This section seeks comments on possible changes to membership capital share deposits. The ANPR asks such things as should this class of capital be eliminated or should terms be changed to make it qualify as tier two capital. There are also questions regarding the withdrawal notice feature that could have significant impact on the terms of this type of capital.

Risk-Based Capital and Contributed Capital Requirements

This section is straight forward in asking if risk-based capital, similar to that currently required by other federally regulated financial institutions, should be applied to corporate credit unions and should contributed capital be required for a credit union to receive services from a corporate credit union.

3. Permissible Investments

This area of the ANPR deals with what type of investments should be permitted for a corporate credit union in the future. NCUA Regulation Part 704.5 describes permissible investments for a corporate credit union (Part 704 – Appendix B describes additional authorities granted to corporate credit unions that apply for, and receive, expanded authorities ... Midwest Corporate does not have expanded authorities and operates under “Base Operating Authority”).

4. Credit Risk Management

This area of the ANPR asks how ratings from Nationally Recognized Statistical Rating Organizations (NRSROs) should be used in the future with regard to analyzing an investment. Examples of NRSROs are Standards & Poors, Moody’s, Fitch, etc. It also asks if specific limits should be placed on corporate credit unions with regard to concentrations, sector, or obligator. Comments are also sought on independent evaluations of credit risk in a corporate credit union’s investment portfolios and whether there should be a requirement for testing sensitivities to credit spread widening.

5. Asset Liability Management

This area of the ANPR asks one specific question regarding net interest income modeling and stress testing.

6. Corporate Governance

This area of the ANPR seeks comments on a variety of issues relating to corporate credit union governance, specifically as it relates to:

1. Minimum standards for corporate credit union directors with regard to experience and independence
2. Director term limits
3. Compensation for directors
4. Transparency for executive compensation

5. Minimum qualifications for directors and what those qualifications should be
6. Training requirement for directors
7. Should there be “outside directors” (see ANPR for definition)

The ANPR also asks if a wholesale corporate credit union (i.e. U.S. Central FCU) should be required to have some directors from natural person credit unions.

Request for Comments

The ANPR concludes with an invitation for comments on any parts of the current corporate credit union regulations (NUCUA Regulations Part 704) that may not have been specifically discussed within the ANPR. It also invites comments on any other “relevant” issues relating to corporate credit unions that may not have been specifically discussed within the ANPR.

End of ANPR Guide