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## NATIONAL CREDIT UNION ADMINISTRATION

### 12 CFR Parts 701, 723, and 742

RIN 3133-AD68

#### Fixed Assets, Member Business Loans, and Regulatory Flexibility Program

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

**ACTION:** Final rule.

**SUMMARY:** NCUA is revising certain provisions of its Regulatory Flexibility Program (RegFlex) to enhance safety and soundness for credit unions. Those provisions pertain to fixed assets, member business loans (MBL), stress testing of investments, and discretionary control of investments. Some of these revisions will require conforming amendments to NCUA's fixed assets and MBL rules.

**DATES:** The rule is effective November 29, 2010.

**FOR FURTHER INFORMATION CONTACT:** Frank Kressman, Senior Staff Attorney, Office of General Counsel, 1775 Duke Street, Alexandria, Virginia 22314 or telephone (703) 518-6540.

#### SUPPLEMENTARY INFORMATION:

##### A. Background—Regulatory Flexibility Program

The RegFlex Program exempts from certain regulatory restrictions and grants additional powers to those federal credit unions (FCUs) that have demonstrated sustained superior performance as measured by CAMEL ratings and net worth classifications. 12 CFR 742.1. An FCU may qualify for RegFlex treatment automatically or by application to the appropriate regional director. 12 CFR 742.2. Specifically, an FCU automatically qualifies when it has received a composite CAMEL rating of "1" or "2" for the two preceding

examinations and has maintained a net worth classification of "well capitalized" under Part 702 of NCUA's rules for six consecutive preceding quarters or, if subject to a risk-based net worth (RBNW) requirement under Part 702, has remained "well capitalized" for six consecutive preceding quarters after applying the applicable RBNW requirement. An FCU that does not automatically qualify may apply for a RegFlex designation with the appropriate regional director. 12 CFR 742.2(a) and (b). An FCU's RegFlex authority can be lost or revoked. 12 CFR 742.3.

The NCUA Board established RegFlex in 2002. 66 FR 58656 (November 23, 2001). Since then, NCUA has amended RegFlex a number of times to increase available relief for FCUs from a variety of regulatory restrictions or lessen the criteria required for obtaining RegFlex status. 71 FR 4039 (January 25, 2006); 72 FR 30247 (May 31, 2007); 74 FR 13083 (March 26, 2009).

##### B. March 2010 Proposal

###### 1. Overview

The current RegFlex rule provides RegFlex credit unions with regulatory relief in the following ten areas: (1) Charitable contributions; (2) nonmember deposits; (3) fixed assets; (4) MBLs; (5) discretionary control of investments; (6) stress testing of investments; (7) zero-coupon securities; (8) borrowing repurchase transactions; (9) commercial mortgage related securities; and (10) purchase of obligations from a federally insured credit union. In March 2010, the NCUA Board proposed amendments to the fixed assets, MBL, stress testing of investments, and discretionary control of investments provisions of the RegFlex rule and requested comment on those amendments. 75 FR 14372 (March 25, 2010). The following sections discuss those proposed amendments in greater detail.

###### 2. Fixed Assets

The Federal Credit Union Act authorizes FCUs to purchase, hold, and dispose of property necessary or incidental to their operations. 12 U.S.C. 1757(4). Generally, the fixed asset rule provides limits on fixed asset investments, establishes occupancy and other requirements for acquired and abandoned premises, and prohibits

certain transactions. 12 CFR 701.36. Fixed assets are defined in 701.36(e) as premises, furniture, fixtures, and equipment and includes any office, branch office, suboffice, service center, parking lot, facility, real estate where a credit union transacts or will transact business, office furnishings, office machines, computer hardware and software, automated terminals, and heating and cooling equipment. Section 701.36 prohibits an FCU with \$1 million or more in assets from investing in fixed assets, the aggregate of which exceeds five percent of the FCU's shares and retained earnings, although upon an FCU's application, a regional director may set a higher limit. 12 CFR 701.36(a)(1) and (2).

The RegFlex rule exempts RegFlex credit unions from the referenced five percent limit. 12 CFR 701.36(a)(1). In the proposal, NCUA stated it believed that investing in higher levels of non-earning assets can materially affect a credit union's earnings ability and, therefore, its viability. NCUA proposed to rescind this exemption for RegFlex credit unions. NCUA offered call report data to show that there is a higher percentage of earnings problems among credit unions with more than five percent of shares and retained earnings invested in fixed assets and that the percentage of earnings problems increases as the level of fixed assets increases. NCUA also included several examples to illustrate the kinds of fixed asset-related financial problems some credit unions have experienced.

###### 3. MBLs

The MBL rule requires a credit union making a business loan to obtain the personal liability and guarantee of the borrower's principals as part of the rule's collateral and security requirements. 12 CFR 723.7(b). Under the current rules, RegFlex credit unions are exempt from that requirement but may choose to require the principals' guarantee as part of their own underwriting standards and best practices. *Id.*

NCUA proposed to rescind this exemption for RegFlex credit unions. NCUA stated that it believed obtaining the principals' personal guarantee is a prudent underwriting practice that greatly enhances the likelihood of loan repayment and should be required of all credit unions. NCUA also stated that a

credit union that fails to do so subjects itself to increased risk, particularly in economic times when MBL delinquencies and MBL charge-offs are increasing. NCUA noted that credit unions would continue to have the option of seeking a waiver of the guarantee requirement under 723.10(e).

#### 4. Stress Testing of Investments

NCUA's investment rule requires an FCU to monitor the securities it holds. 12 CFR 703.12. Specifically, at least monthly, an FCU must prepare a written report setting out the fair value and dollar change since the prior month-end for each security held with summary information for its entire portfolio. 12 CFR 703.12(a). Similarly, at least quarterly, an FCU must prepare a written report setting out the sum of the fair values of all fixed and variable rate securities whose features include: (1) Embedded options; (2) remaining maturities greater than three years; or (3) coupon formulas that are related to more than one index or are inversely related to, or multiples of, an index. 12 CFR 703.12(b). If the sum in the quarterly report is greater than the FCU's net worth, then the report must estimate the potential impact, in percentage and dollar terms, of an immediate and sustained parallel shift in market interest rates of plus and minus 300 basis points on: (1) The fair value of each security in the FCU's portfolio; (2) the fair value of the FCU's portfolio as a whole; and (3) the FCU's net worth. 12 CFR 703.12(c). This calculation is known as "stress testing" the securities. Under the current rules, RegFlex credit unions are exempt from the requirement to stress test their securities.

NCUA noted in the proposal that because of low investment yields due to the current economic environment, many credit unions are incurring additional risk by investing in long-term instruments to increase yield and improve earnings. NCUA believes many credit unions are purchasing investment products they do not fully understand and are incurring significant interest rate and liquidity risk.

NCUA offered call report data to illustrate the degree to which credit unions are investing in products with longer maturities further out on the yield curve. Although this may help achieve greater yield in the short term, an increase in market rates could result in a significant decrease in product value and cause liquidity problems. NCUA stated that credit unions need to stress test their investments so they have a clearer understanding of their risk profile, can better manage risk, and

as a matter of safety and soundness and responsible business practices. Accordingly, the Board proposed to rescind the RegFlex exemption in this context.

#### 5. Discretionary Control of Investments

NCUA's investment rule requires an FCU to retain discretionary control over its purchase and sale of investments although, under the rule, an FCU will not be deemed to have delegated discretionary control to an investment adviser if the FCU reviews all recommendations from the investment adviser and authorizes a recommended purchase or sale transaction before its execution. 12 CFR 703.5(a). An exception to this general rule is that an FCU may delegate discretionary control over the purchase and sale of its investments to a person outside the FCU if the person is an investment advisor registered with the Securities and Exchange Commission and if the amount delegated is limited to up to 100 percent of the FCU's net worth at the time of delegation. 12 CFR 703.5(b). If an FCU exercises this limited authority, it must adjust the amount of funds held under discretionary control to comply with the 100 percent of net worth cap at least annually. *Id.*

Under the current rule, a RegFlex credit union is exempt from the discretionary control requirements in 703.5 that pertain to the 100 percent of net worth limitation. In the proposal, NCUA noted that it was becoming increasingly concerned about the safety and soundness of credit unions and their investments considering the recent investment climate and reports of fraudulent practices in the investment banking industry. Accordingly, the Board proposed to rescind the RegFlex exemption pertaining to discretionary control of investments.

### C. Summary of Comments and Discussion

#### 1. General

NCUA received 50 comments on the proposal: 30 from credit unions, 14 from credit union trade associations, 1 from a bank trade association, and 5 from other interested parties. Two commenters supported the proposal in its entirety. The vast majority of commenters opposed some aspect of the proposal and some supported some aspect of the proposal.

In broad terms, there was a consensus among commenters' opinion that the data and examples NCUA cited to support rescinding the four RegFlex exemptions were insufficient and highlighted a few extreme cases that do

not represent a systemic problem in the credit union industry. Similarly, commenters generally agreed that the purpose of RegFlex is still important and should be preserved and noted that NCUA has the authority to revoke RegFlex status for underperforming credit unions.

#### 2. MBL

The majority of those commenters who discussed the MBL aspect of the proposal opposed it. Most said that it would create a significant competitive disadvantage for credit unions where competing lenders may not have such a requirement. Most also stated that the personal guarantee requirement could result in credit unions losing their highest quality borrowers to competitors that do not require a guarantee.

Some noted that, even though the personal guarantee exemption is currently in place, most credit unions still obtain the guarantee on the bulk of their MBLs. They noted that the exemption should remain in place for those instances where it makes sense not to require a guarantee, such as when the borrower poses minimal credit risk, the underwriting is strong, or where other factors such as high collateral value is more important than a guarantee. Some commenters also noted that NCUA should not restrict a credit union's ability to make MBLs at a time when making small business loans is a national priority. Finally, many commenters stated that the process for obtaining a waiver from this requirement is too slow and cumbersome to deal with this issue.

NCUA has thoroughly considered these comments and appreciates the concerns the commenters have expressed. For the reasons discussed in the proposal as summarized above, NCUA still believes it is prudent to require all credit unions to comply with the personal guarantee requirement. NCUA recognizes that in the competitive MBL marketplace credit unions need to be free of unnecessary restrictions that hamper their ability to serve their members' business loan needs. NCUA does not believe this is an unnecessary restriction. Additionally, NCUA acknowledges that the current waiver process, in some circumstances, is too slow to accommodate the practical timing needs of processing MBLs. NCUA is committed to making the waiver process more user friendly in this context and will look into ways of doing so. However, NCUA believes it is in the interest of safety and soundness to rescind this exemption and reminds credit unions they will continue to have

the option of seeking a waiver of the guarantee requirement under 723.10(e).

### 3. Fixed Assets

The majority of those commenters who discussed the fixed asset component of the proposal opposed rescinding the exemption from the 5% fixed asset cap. About a third of them also noted that it could inhibit branching activities and credit union growth. Many commenters suggested raising the fixed asset cap to a higher level, such as 8–10% for all FCUs, or establishing a sliding scale where FCUs with higher net worth would have a higher fixed asset cap.

Some mentioned that the increasing need to purchase computer technology necessary to serve their members makes the 5% cap challenging. A few commenters noted that rescinding the exemption could be a hardship on those credit unions with long-term growth plans that are based, in part, on using the exemption. A handful of others suggested NCUA grandfather those credit unions already exceeding the cap.

NCUA believes that safety and soundness considerations dictate rescinding this exemption. Excessive investment in fixed assets often leads to other financial difficulties for credit unions. Also, the nature and timing of investing in fixed assets is such that credit unions have sufficient time to request a waiver from the 5% limitation if necessary even for credit unions that have begun executing their growth strategies.

Credit unions that have already exceeded the 5% limit on the effective date of this rule will be grandfathered at that limit. If their level of fixed assets subsequently trends downward, then so will the level at which they are grandfathered. Grandfathered credit unions are, however, still eligible to apply for a waiver to increase their fixed asset investments. For example, a credit union grandfathered at 8% whose fixed assets trend downward to 6.5% will have a new grandfathered limit of 6.5%. Further, if that same credit union then wishes to increase its fixed assets to 9%, then it may apply for a waiver to do so. Accordingly, the fixed assets exemption is rescinded as proposed.

### 4. Discretionary Control of Investments and Stress Testing of Investments

A relatively few commenters chose to discuss the discretionary control of investment authority and stress testing of investments components of the proposal. Among those that did comment, some opposed the proposal and others supported it. Accordingly, NCUA adopts the proposal to rescind

these exemptions on safety and soundness grounds.

## D. Regulatory Procedures

### *Regulatory Flexibility Act*

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact a rule may have on a substantial number of small entities (primarily those under ten million dollars in assets). This rule enhances safety and soundness without additional regulatory burden. Accordingly, this will not have a significant economic impact on a substantial number of small credit unions, and therefore, no regulatory flexibility analysis is required.

### *Small Business Regulatory Enforcement Fairness Act*

The Small Business Regulatory Enforcement Fairness Act (SBREFA) of 1996, Public Law 104–121, provides generally for congressional review of agency rules. A reporting requirement is triggered in instances where NCUA issues a final rule as defined by Section 551 of the Administrative Procedures Act, 5 U.S.C. 551. The Office of Information and Regulatory Affairs, an office within OMB, has reviewed this rule and determined that, for purposes of SBREFA, this is not a major rule.

### *Paperwork Reduction Act*

NCUA has determined that this rule will not increase paperwork requirements under the Paperwork Reduction Act of 1995 and regulations of the Office of Management and Budget.

### *Executive Order 13132*

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order. This final rule would not have a substantial 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. NCUA has determined that this final rule does not constitute a policy that has federalism implications for purposes of the executive order.

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

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

## List of Subjects

### 12 CFR Part 701

Credit unions.

### 12 CFR Part 723

Credit, Credit unions, Reporting and recordkeeping requirements.

### 12 CFR Part 742

Credit unions, reporting and recordkeeping requirements.

By the National Credit Union Administration Board on October 21, 2010.

**Mary Rupp,**

*Secretary of the Board.*

■ For the reasons discussed above, NCUA amends 12 CFR parts 701, 723, and 742 as follows:

## **PART 701—ORGANIZATION AND OPERATIONS OF FEDERAL CREDIT UNIONS**

■ 1. The authority citation for part 701 continues to read as follows:

**Authority:** 12 U.S.C. 1752(5), 1755, 1756, 1757, 1759, 1761a, 1761b, 1766, 1767, 1782, 1784, 1787, and 1789. Section 701.6 is also authorized by 31 U.S.C. 3717. Section 701.31 is also authorized by 15 U.S.C. 1601 *et seq.*, 42 U.S.C. 1861 and 42 U.S.C. 3601–3610. Section 701.35 is also authorized by 42 U.S.C. 4311–4312.

■ 2. Amend § 701.36 by revising paragraphs (d) introductory text and (d)(1) to read as follows:

### **§ 701.36 FCU ownership of fixed assets.**

\* \* \* \* \*

(d) *Regulatory Flexibility Program.* Federal credit unions that meet Regulatory Flexibility Program standards, as determined pursuant to Part 742 of this chapter, are exempt from the three-year partial occupancy requirement described in paragraph (b) of this section when acquiring unimproved land for future expansion pursuant to the terms of section 742.4(a)(3) of this chapter. For a Federal credit union eligible for the Regulatory Flexibility Program that subsequently loses eligibility:

(1) Section 742.3 of this chapter provides that NCUA may require the credit union to divest any existing fixed

assets for substantive safety and soundness reasons; and

\* \* \* \* \*

## PART 723—MEMBER BUSINESS LOANS

■ 3. The authority citation for part 723 continues to read as follows:

**Authority:** 12 U.S.C. 1756, 1757, 1757A, 1766, 1785, 1789.

### § 723.7 [Amended]

■ 4. Amend § 723.7 by removing the last sentence of paragraph (b).

## PART 742—REGULATORY FLEXIBILITY PROGRAM

■ 5. The authority citation for part 742 continues to read as follows:

**Authority:** 12 U.S.C. 1756, 1766.

### § 742.4 [Amended]

■ 6. Amend § 742.4 by removing the first sentence of paragraph (a)(3) and removing paragraphs (a)(4), (5), and (6) and redesignating paragraphs (a)(7), (8), and (9) as (a)(4), (5), and (6), respectively.

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## NATIONAL CREDIT UNION ADMINISTRATION

### 12 CFR Part 702

RIN 3133-AD81

### Prompt Corrective Action; Amended Definition of Low-Risk Assets

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

**ACTION:** Interim final rule with request for comments.

**SUMMARY:** NCUA is issuing this Interim Final Rule to amend the definition of “low-risk assets” for regulatory capital purposes. Assets in this category receive a risk-weighting of zero, reflecting the absence of credit risk. The amendment will expand the definition of “low-risk assets” to include debt instruments on which the payment of principal and interest is unconditionally guaranteed by NCUA as an agency of the Executive Branch of the United States.

**DATES:** This rule is effective October 28, 2010. Comments must be received on or before November 29, 2010.

**ADDRESSES:** You may submit comments by any of the following methods (Please send comments by one method only):

- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.

- **NCUA Web Site:** <http://www.ncua.gov/Resources/RegulationsOpinionsLaws/ProposedRegulations.aspx>. Follow the instructions for submitting comments.

- **E-mail:** Address to [regcomments@ncua.gov](mailto:regcomments@ncua.gov). Include “[Your name] Comments on Risk Portfolio Defined” in the e-mail subject line.

- **Fax:** (703) 518-6319. Use the subject line described above for e-mail.

- **Mail:** Address to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.

- **Hand Delivery/Courier:** Same as mail address.

### FOR FURTHER INFORMATION CONTACT:

Steven W. Wideman, Trial Attorney, at the above address, or *telephone:* (703) 518-6557.

### SUPPLEMENTARY INFORMATION:

**Public Inspection of Comments:** All public comments are available on the agency’s Web site at: <http://www.ncua.gov/Resources/RegulationsOpinionsLaws/RegulationComments.aspx> as submitted, except as may not be possible for technical reasons. Public comments will not be edited to remove any identifying or contact information. Paper copies of comments may be inspected in NCUA’s law library at 1775 Duke Street, Alexandria, Virginia 22314, by appointment weekdays between 9 a.m. and 3 p.m. To make an appointment, call (703) 518-6546 or send an e-mail to [OGCMail@ncua.gov](mailto:OGCMail@ncua.gov).

### A. Background

1. **Prompt Corrective Action.** In 1998, the Credit Union Membership Access Act, Public Law 105-219, 112 Stat. 913, mandated a system of regulatory capital standards for natural person credit unions entitled “Prompt Corrective Action” (“PCA”). 12 U.S.C. 1790d *et seq.* PCA imposes minimum capital standards and corresponding remedies to improve a credit union’s net worth. *Id.* The NCUA Board implemented a comprehensive system of PCA primarily under Part 702.<sup>1</sup> 12 CFR 702 *et seq.*

<sup>1</sup> Part 702 has been amended five times since it was originally adopted in 2000: First, to incorporate limited technical corrections. 65 FR 55439 (Sept. 14, 2000). Second, to delete sections made obsolete by adoption of a uniform quarterly schedule for filing Call Reports. 67 FR 12459 (March 19, 2002). Third, to incorporate a series of revisions and adjustments to improve and simplify PCA implementation. 67 FR 71078 (Nov. 29, 2002). Fourth, to add a third risk-weighting tier to the standard risk-based net worth component for member business loans. 68 FR 56537, 56546 (Oct. 1, 2003). A proposal to modify the criteria for filing a net worth restoration plan. 67 FR 7113 (Nov. 29, 2002), was never adopted. Fifth, to implement a

Under PCA, a natural person credit union’s “net worth ratio” determines its classification among five statutory net worth categories. 12 U.S.C. 1790d(c); 12 CFR 702.102. A credit union’s minimum required “net worth ratio” is based upon a risk-weighting applied to each of eight different portfolios of credit union assets.<sup>2</sup> *Id.* § 702.104. As a credit union’s “net worth ratio” declines, so does its classification among the five net worth categories, thus subjecting it to an expanding range of mandatory and discretionary supervisory actions. 12 U.S.C. 1790d(e), (f) and (g); 12 CFR 702.204(a)–(b).

2. **Corporate System Resolution.** In response to the unprecedented disruption in the nation’s credit markets over the last two years, NCUA and other federal banking regulators have taken a series of steps to preserve the nation’s confidence in financial institutions. Through its Corporate Stabilization Program, NCUA has taken specific actions to stabilize the corporate credit union (“CCU”) system and to address problems associated with the impact of the economic downturn on CCUs. Chief among these problems is the substantial devaluation of the mortgage-backed and asset-backed securities (“the distressed assets”) held in the investment portfolios of CCUs. In several cases, the realization of losses on these distressed assets has driven the CCU into insolvency, requiring NCUA to place the CCU into liquidation.

To monetize the distressed assets held by the liquidated CCUs, NCUA has embarked on a Corporate System Resolution Program primarily to sell those distressed assets to a trust established by NCUA. The trust will then resecuritize the distressed assets in the form of senior debt instruments denominated “NCUA Guaranteed Notes” (“NGNs”) that will be offered to public investors, including financial institutions.<sup>3</sup> The trust will pass through to the NGN-holders the monthly cash flows produced by the

statutory amendment allowing the acquirer in a merger of credit unions to combine the merging credit union’s retained earnings with its own to determine the acquirer’s post-merger “net worth.” 73 FR 72688 (Dec. 1, 2008).

<sup>2</sup> “Long-term real estate loans,” “Member Business Loans (‘MBL’) outstanding,” “Investments,” “Low-risk assets,” “Average-risk assets,” “Loans sold with recourse,” “Unused MBL commitments” and “Allowance.” 12 CFR 702.104.

<sup>3</sup> The first offering of this senior debt consists of \$3.8 billion in fixed- and floating-rate “NCUA Guaranteed Notes 2010-R1.” The underlying distressed assets of this debt are the residential mortgage-backed securities held by the liquidation estate of U.S. Central Federal Credit Union. Credit unions purchased a significant proportion of the first NGN offering. NCUA anticipates a series of similar NGN offerings.