

# Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

## NATIONAL CREDIT UNION ADMINISTRATION

### 12 CFR Part 704

RIN 3133-AE75

### Corporate Credit Unions

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

**ACTION:** Proposed rule.

**SUMMARY:** The NCUA Board (Board) proposes to amend its regulations governing corporate credit unions (corporates) and the scope of their activities. Specifically, the proposed amendments revise provisions on retained earnings and Tier 1 capital.

**DATES:** Comments must be received on or before September 1, 2017.

**ADDRESSES:** You may submit comments by any of the following methods, but 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/RegulationsOpinionsLaws/proposed\\_regs/proposed\\_regs.html](http://www.ncua.gov/RegulationsOpinionsLaws/proposed_regs/proposed_regs.html). Follow the instructions for submitting comments.
- *Email:* Address to [regcomments@ncua.gov](mailto:regcomments@ncua.gov). Include “[Your name]—Comments on Proposed Rule—Corporate Credit Unions” in the email subject line.
- *Fax:* (703) 518–6319. Use the subject line described above for email.
- *Mail:* Address to Gerard Poliquin, 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:

Yvonne Applonie, Director of Supervision, Office of National Examinations and Supervision, at the above address or telephone (703) 518–6595; or Marvin Shaw, Staff Attorney, Office of General Counsel, at the above address or telephone (703) 518–6553.

### SUPPLEMENTARY INFORMATION:

#### I. Background

The financial crisis of 2007–2009 took a heavy toll on the corporate credit union system. The crisis, largely mortgage related, greatly affected the investment portfolios of many corporates causing widespread liquidity problems, instability in the system, and failures. During this time period, NCUA took extraordinary short and mid-term measures to stabilize the corporate system. Among other things, it: (1) Made capital injections; (2) approved the Temporary Corporate Credit Union Share Guarantee Program, which guaranteed uninsured shares at participating corporates; (3) engaged the services of an independent, highly qualified third party to conduct a comprehensive analysis of expected non-recoverable credit losses for distressed securities held by corporates; (4) conserved five corporates;<sup>1</sup> and (5) created the NCUA Guaranteed Note Program.<sup>2</sup>

To provide longer term structural enhancements to the corporate system, the Board comprehensively revised part 704, the regulations governing corporates and their activities, in 2010.<sup>3</sup> The 2010 rule’s primary purpose was to establish a regulatory framework that provides a foundation for a healthy corporate system that: (1) Delivers important services to the corporates’ natural person credit union members, such as payment systems and liquidity; and (2) builds and attracts sufficient capital.<sup>4</sup> The 2010 rule also helped to prevent the recurrence of the kind of financial losses that led to the failure of the referenced five corporates and weakened the financial condition of several others.

The 2010 rule curtailed several of the practices that led to the referenced corporate failures. Specifically, it established investment concentration

limits, limited asset maturities, and prohibited investments in subordinated and private label mortgage-backed securities. Most relevant to this proposal, the 2010 rule also implemented a prompt corrective action (PCA) regime stipulating capital adequacy for corporates. Largely based on the Basel I requirements, the capital requirements of the 2010 rule emphasized the importance of corporates holding tangible and durable capital.

It has been nearly seven years since the Board issued the 2010 rule. In that time, NCUA’s efforts have had the intended effect of stabilizing the corporate system and improving the corporates’ ability to function and provide needed services to natural person credit unions. Additionally, the overall economy has improved greatly, thereby improving the economic landscape in which corporates operate. Further, the large concentration of troubled assets within the corporate system has been reduced through portfolio repositioning or NCUA intervention. The corporate system has significantly contracted and consolidated, with assets declining from approximately \$81.7 billion prior to the 2010 rule to approximately \$24.9 billion today. In that same time period, the number of corporates has declined from 26 to 11. Given all of these positive developments, the Board believes conditions are such that it is now safe and appropriate to revisit the capital standards of the 2010 rule. As discussed in more detail below, the proposed amendments to the corporate rule primarily affect the calculation of capital after corporates consolidate and set a retained earnings ratio target in meeting PCA standards.

#### II. Proposed Amendments

##### *Corporate Consolidations and Capital*

In 2015, the Board made further refinements to part 704. Specifically, the Board amended the definition of “Tier 1 capital” to include as a component of that term, the retained earnings acquired through a merger. Given that retained earnings acquired through a merger are currently not recorded on the continuing corporate’s financial statements, the amount must be recorded outside of the financial statements. This approach does not follow Generally Accepted Accounting

<sup>1</sup> The five were U.S. Central, Western Corporate, Members United Corporate, Southwest Corporate, and Constitution Corporate.

<sup>2</sup> As part of the corporate system resolution, NCUA created the NCUA Guaranteed Note Program to provide long-term funding for distressed investment securities (Legacy Assets) from the five failed corporate credit unions. Legacy Assets consisted of over 2,000 investment securities, secured by approximately 1.6 million residential mortgages, as well as commercial mortgages and other securitized assets.

<sup>3</sup> 12 CFR part 704; 75 FR 64786 (Oct. 20, 2010).

<sup>4</sup> 75 FR 64787, 64787 (Oct. 20, 2010).

Principles (GAAP), thus inhibiting transparency of capital adequacy. The Board believes a corporate will be more transparent presenting its capital adequacy by adopting conventions more closely aligned with its published financial statements. Accordingly, with respect to the definition of “retained earnings,” the Board proposes to incorporate “GAAP equity acquired in a merger” as a component of retained earnings. This amendment to the definition of “retained earnings” will, in turn, affect the definition of “Tier 1 capital,” which includes retained earnings as one of the components of Tier 1 capital.

More specifically, the current definition of “retained earnings” includes undivided earnings, regular reserve, reserve for contingencies, supplemental reserves, reserve for losses, and other appropriations from undivided earnings as designated by management or NCUA. Including “GAAP equity acquired in a merger” to that list gives recognition to standard accounting conventions for purposes of consolidating records between merged entities. As a practical matter, the Board has treated equity acquired in a merger as retained earnings, but did so in the context of defining contributed capital’s ability to cover losses. The Board believes that expressly including such equity acquired in a merger as retained earnings and referencing GAAP will clarify that this capital is available to cover losses, enhance transparency, and reduce ambiguity.

Further, the Board proposes to delete the phrase “the retained earnings of any acquired credit union, or an integrated set of activities and assets, calculated at the point of acquisition, if the acquisition is a mutual combination” from the current definition of “Tier 1 capital.” This provision becomes redundant as a result of the expanded definition of retained earnings which will include GAAP equity acquired in a merger.

#### *Retained Earnings Ratio*

In addition to the Board’s proposed amendments to the definitions of “retained earnings” and “Tier 1 capital” as discussed above, the Board also proposes to add a definition of “retained earnings ratio” to part 704.

The 2010 rule’s PCA provisions require corporates to meet a leverage ratio.<sup>5</sup> The leverage ratio primarily

consists of retained earnings and perpetual contributed capital (PCC).<sup>6</sup> Capital included in the leverage ratio incorporated the provisions of Tier 1 capital as defined by the bank regulatory agencies, with a notable exception. The Board recognizes that while corporates had been permitted to secure contributed capital from any source, history has shown that nearly all contributed capital has been invested by federally insured natural person credit unions. As such, depletions of corporate capital can lead to corresponding investment impairments and capital erosion at the natural person credit unions. This can lead to greater exposure of loss to the National Credit Union Share Insurance Fund. The 2010 rule encouraged corporates to build sufficient retained earnings to absorb losses without causing a corresponding loss to another party, such as a natural person credit union that purchased contributed capital from that corporate (*i.e.*, perpetual and non-perpetual capital as defined in the rule).

The incentive to build retained earnings was created by limiting the amount of contributed capital permitted to be included in calculating the corporate’s leverage ratio.<sup>7</sup> The limitation on PCC was phased-in over a period of ten years recognizing the erosion of corporate capital during the financial crisis and reasonable expectations for future corporate profitability.<sup>8</sup> Until October 2016, all PCC was included in the leverage ratio. Effective October 2016, part 704 requires corporates to deduct the amount of PCC exceeding retained

before October 21, 2013, the leverage ratio was defined as the ratio of total capital to moving daily average net assets. This ratio was called the “interim” leverage ratio. After October 21, 2013, the leverage ratio was redefined as the ratio of adjusted core capital to moving daily average net assets. This was called the permanent leverage ratio. In May 6, 2015 the NCUA Board approved changes to the regulation that sought to simplify and clarify the capital definitions in the regulations now that the major phase-in dates had passed. The definitions of core capital and adjusted core capital were combined into one definition called Tier 1 capital. The leverage ratio and other related capital ratio definitions were similarly amended to reflect the change to Tier 1 Capital.

<sup>6</sup> Perpetual Contributed Capital means accounts or other interests of a corporate credit union that are perpetual, non-cumulative dividend accounts; are available to cover losses that exceed retained earnings, are not insured by the National Credit Union Share Insurance Fund or other share or deposit insurers; and cannot be pledged against borrowings. In the event the corporate is liquidated, any claims made by the holders of the perpetual contributed capital will be subordinate to all other claims (including National Credit Union Share Insurance Fund claims).

<sup>7</sup> 12 CFR 704.2

<sup>8</sup> As financial intermediaries, the net margins for corporates have been low with a historical average net return on assets ratio of approximately 23 bps.

earnings by 200 basis points. Effective October 2020, corporates must deduct the amount of PCC exceeding retained earnings.

The 2010 revisions to part 704 have resulted in the intended effect. Specifically, all corporates have accumulated sufficient retained earnings to meet or exceed the adequate capitalization threshold under PCA through the October 2016 phase-in adjustment.

While the result has been positive, the Board recognizes that the language in the current rule is indirect and may disadvantage corporates working with third parties. The limitation on PCC for regulatory capital purposes does not recognize the full value of PCC that stands to absorb losses and protect counterparties. Further, the construct to reduce the inclusion of PCC as capital provides for inconsistent treatment compared to capital regulations governing other types of financial institutions, such as banks, and could promote confusion. Accordingly, the Board proposes to remove the requirement effective October 2020 to limit PCC counted as Tier 1 capital to the amount of retained earnings. Further, the Board proposes to permit a corporate to include in its Tier 1 capital all PCC that is sourced from an entity not covered by federal share insurance.

However, recognizing that retained earnings is critical to the health of the corporate system and the share insurance fund, the Board proposes to add a provision to part 704 requiring all corporates to achieve an eventual retained earnings ratio of 250 basis points. To that end, the Board proposes to add a definition of “retained earnings ratio” to mean “the corporate credit union’s retained earnings divided by its moving daily average net assets.” Upon attaining this benchmark, a corporate would be permitted to include all PCC, regardless of source, in its Tier 1 capital. The PCA thresholds will remain at their current limits. Until such time as a corporate achieves a 250 basis points retained earnings ratio, it must deduct the amount of PCC exceeding retained earnings by 200 basis points as an inducement to build retained earnings.

The Board believes this proposal will promote clarity as to the minimum amount of retained earnings to be held by a corporate to account for potential losses. In setting this minimum standard, the Board balances it with the risk mitigating provisions of current part 704 including investment concentration limits, NEV volatility limits, asset maturity limits, and investment prohibitions. As such, the Board is not contemplating amending other

<sup>5</sup> The leverage ratio is currently defined as Tier 1 Capital divided by moving daily average net assets. The leverage ratio and capital definitions were revised as part of the 2010 rule, which contained a series of phased in definitions over a three-year period. Beginning October 21, 2011 and

corporate risk taking authorities in part 704.

Appendix B to Part 704—Expanded Authorities and Requirements

Appendix B to part 704 enumerates the expanded authorities available to corporates and the procedures that a corporate must follow to be granted such authorities. The Part I expanded investment authority allows a corporate to take on additional risk in certain investment products. As part of this authority, a corporate’s NEV ratios may decline to specified amounts when meeting certain leverage ratios.

The Board proposes to add a “retained earnings ratio” requirement to the Part I expanded investment authorities. The Board believes that by doing so the retained earnings ratio requirement will limit the risk of the expanded investment portfolios. Specifically, the Board proposes to employ an indexed retained earnings requirement, which will correlate with the actual level of risk taking.

III. Regulatory Procedures

1. Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis of any significant economic impact a regulation may have on a substantial number of small entities (primarily those under \$100 million in assets).<sup>9</sup> This proposed rule only affects corporates, all of which have more than \$100 million in assets. Accordingly, NCUA certifies the rule will not have a significant economic impact on a substantial number of small credit unions.

2. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (PRA) applies to rulemakings in which an agency by rule creates a new paperwork burden or increases an existing burden.<sup>10</sup> For purposes of the PRA, a paperwork burden may take the form of a reporting or recordkeeping requirement, both referred to as information collections. The proposed rule does not contain information collection requirements that require approval by OMB under the Paperwork Reduction Act (44 U.S.C. 3501).

3. Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily

complies with the executive order to adhere to fundamental federalism principles. The proposed rule does not have substantial direct effects 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, therefore, determined that this proposal does not constitute a policy that has federalism implications for purposes of the executive order.

4. Assessment of Federal Regulations and Policies on Families

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

List of Subjects in 12 CFR Part 704

Credit unions, Corporate credit unions, Reporting and recordkeeping requirements.

By the National Credit Union Administration Board on June 23, 2017.  
Gerard Poliquin,  
Secretary of the Board.

For the reasons discussed above, the National Credit Union Administration Board proposes to amend 12 CFR part 704 as follows:

PART 704—CORPORATE CREDIT UNIONS

■ 1. The authority citation for Part 704 continues to read as follows:

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

- 2. Amend § 704.2 by:
  - a. Revising the definition of “Retained earnings”;
  - b. Adding a definition of “Retained Earnings Ratio”; and
  - c. Revising the definition of “Tier 1 capital” to read as follows:

§ 704.2 Definitions

Retained earnings means undivided earnings, regular reserve, reserve for contingencies, supplemental reserves, reserve for losses, GAAP equity acquired in a merger, and other appropriations from undivided earnings as designated by management or NCUA.

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

Tier 1 capital means the sum of items (1) through (2) of this definition from

which items (3) through (6) are deducted:

- (1) Retained earnings;
- (2) Perpetual contributed capital;
- (3) Deduct the amount of the corporate credit union’s intangible assets that exceed one half percent of its moving daily average net assets (however, NCUA may direct the corporate credit union to add back some of these assets on NCUA’s own initiative, or NCUA’s approval of petition from the applicable state regulator or application from the corporate credit union);
- (4) Deduct investments, both equity and debt, in unconsolidated CUSOs;
- (5) Deduct an amount equal to any PCC or NCA that the corporate credit union maintains at another corporate credit union;
- (6) Deduct any amount of PCC received from federally insured credit unions that causes PCC minus retained earnings, all divided by moving daily average net assets, to exceed two percent when a corporate credit union’s retained earnings ratio is less than two and a half percent.

■ 3. Amend by revising paragraphs (b)(2) and (b)(3) of Part I of Appendix B to Part 704 to read as follows:

Appendix B to Part 704—Expanded Authorities and Requirements

- (b)(1) \* \* \*
- (2) 28 percent if the corporate credit union has a seven percent minimum leverage ratio and a two and a half percent retained earnings ratio, and is specifically approved by NCUA; or
- (3) 35 percent if the corporate credit union has an eight percent minimum leverage ratio and a three percent retained earnings ratio and is specifically approved by NCUA.

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FEDERAL HOUSING FINANCE BOARD  
12 CFR Parts 930 and 932

FEDERAL HOUSING FINANCE AGENCY

12 CFR Part 1277  
RIN 2590-AA70

Federal Home Loan Bank Capital Requirements

AGENCY: Federal Housing Finance Board; Federal Housing Finance Agency.

ACTION: Proposed rule.

<sup>9</sup> 5 U.S.C. 603(a).  
<sup>10</sup> 44 U.S.C. 3507(d); 5 CFR part 1320.