equine piroplasmosis, Venezuelan equine encephalomyelitis, or equine infectious anemia has occurred on the premises of origin or on adjoining premises during the 60 days preceding exportation; and

(5) That, except as provided in § 92.301(g):

(i) The horses have not been in any country listed in § 92.301(c)(1) as affected with CEM during the 12 months immediately prior to their importation into the United States;

(ii) The horses have not been on any premises at any time during which time such premises were found by an official of the veterinary services of the national government of the country where such premises are located, to be affected with CEM;

(iii) The horses have not been bred by or bred to any horses from an affected premises; and

(iv) The horses have had no other contact with horses that have been found to be affected with CEM or with horses that were imported from countries affected with CEM.

(b) If a horse is presented for importation from a country where it has been for less than 60 days, the horse must be accompanied by a certificate that meets the requirements of paragraph (a) of this section that has been issued by a salaried veterinary officer of the national government of each country in which the horse has been during the 60 days immediately preceding its shipment to the United States. The dates during which the horse was in each country during the 60 days immediately preceding its exportation to the United States shall be included as a part of the certification.

(c) Following the port-of-entry inspection required by § 92.306 of this part, and before a horse offered for importation from any part of the world is released from the port of entry, an inspector may require the horse and its accompanying equipment to be disinfected as a precautionary measure against the introduction of foot-and-mouth disease or any other disease dangerous to the livestock of the United States.

§ 92.315 [Amended]

9. In § 92.315, in the undesignated center heading ''CANADA [18]'', footnote 18 and its reference in the center heading would be redesignated as footnote 16.

§ 92.319 [Amended]

10. In § 92.319, in the undesignated center heading ''COUNTRIES OF CENTRAL AMERICA AND WEST INDIES [19]'', footnote 19 and its reference in the center heading would be redesignated as footnote 17.

§ 92.321 [Amended]

11. In § 92.321, in the undesignated center heading ''MEXICO[20]'', footnote 20 and its reference in the center heading would be redesignated as footnote 18.

§ 92.324 [Amended]

12. In § 92.324, in the second sentence, footnote 21 and its reference in the text would be redesignated as footnote 19.

Done in Washington, DC, this 30th day of May 1996.

Terry L. Medley,

Acting Administrator, Animal and Plant Health Inspection Service.

[FR Doc. 96–13897 Filed 6–03–96; 8:45 am]

BILLING CODE 3410–34–P

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 704, 709, and 741

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: Proposed rule.

SUMMARY: NCUA is issuing proposed revisions to the rules governing corporate credit unions. As the credit union industry has become more complex and competitive, the demands on corporate credit unions have become greater. Corporate credit unions are providing a greater variety of more sophisticated services. The proposed rule is intended to strengthen corporate credit union capital and ensure that the risk on corporate credit union balance sheets is adequately managed and controlled.

DATES: Comments must be received on or before September 3, 1996.

ADDRESSES: Comments should be directed to Becky Baker, Secretary of the Board. Mail or hand-deliver comments to: National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314–3428. Fax comments to (703) 518–6319. Post comments on NCUA's electronic bulletin board by dialing (703) 518–6480. *Please send comments by one method only.*

FOR FURTHER INFORMATION CONTACT: Robert F. Schafer, Acting Director, Office of Corporate Credit Unions, at the above address or telephone (703) 518–6640; or Edward Dupcak, Director, Office of Investment Services, at the above address or telephone (703) 518–6620.

SUPPLEMENTARY INFORMATION:

A. Background

Part 704 was amended in 1992 to address a broad array of corporate credit union matters. *See* 57 FR 22626 (May 28, 1992). The regulation has been in effect for several years, during a time of great change in the credit union industry. NCUA has had an opportunity to see how the regulation has worked and to consider how it could be improved. Section 704.12, governing representation issues, was revised in 1994. *See* 59 FR 59357 (Nov. 17, 1994). In April 1995, NCUA issued a proposed regulation to revise most of the sections of Part 704. *See* 60 FR 20438 (Apr. 26, 1995). Comments were due by June 26, 1995. On May 17, 1995, NCUA extended the comment period an additional 60 days to August 25, 1995. *See* 60 FR 27240 (May 23, 1995). The supplementary information section noted that NCUA had been working with an outside firm to provide risk-profile assessments of corporate credit unions, using simulated modeling techniques, and that the process had proven to be more time-consuming than envisioned.

In response to the comments received and results of the modeling, NCUA determined to issue this revised proposed rule for another round of public comment. In developing this revised proposal, NCUA considered all of the written comments, the results of further modeling, and the input provided by corporate credit union representatives in a number of dialogue meetings conducted by NCUA.

It should be noted that the background section of the initial proposed rule observed that NCUA supervises all corporate credit unions but that only those that are federally chartered pay an operating fee to the agency. Questions were raised as to whether this put federally chartered corporate credit unions at a competitive disadvantage and whether all corporate credit unions should pay for NCUA's corporate credit union supervision program. NCUA asked for comment on whether it would be appropriate to assess all corporate credit unions an examination fee or to abolish corporate credit union fees altogether and require natural person credit unions, since they benefit from the existence of corporate credit unions, to make up the difference.

Most of those who commented on this issue favored assessing all corporate credit unions a fee, rather than having natural person credit unions pay for corporate credit union supervision. Many noted that not all natural person credit unions use their corporate credit union. NCUA has determined not to pursue the issue of funding corporate credit union supervision expenses in this proposed regulation. However, given the impact that the proposed rule could have on future supervision efforts, this issue will be reviewed in the future.

B. Comments

NCUA received over 1300 comments on the proposed regulation, the bulk of which were from natural person credit unions. Comments were also received from the national credit union trade associations and most of the corporate credit unions and state credit union leagues. Finally, comments were received from other trade associations, state credit union regulatory authorities, credit union organizations and consultants, a Member of Congress, other entities that do business with credit unions, and individuals.

The commenters generally opposed the proposed regulation, particularly the asset-liability management and capital requirements. The proposed regulation required that a corporate credit union identically match all of its shares and deposits, except for 25 percent of its overnight funds, to corresponding assets. The commenters stated that the proposal represented an attempt to eliminate risk from the system, whereas the appropriate role of a corporate credit union was to manage risk. They stated that the proposal would make it impossible for corporate credit unions to provide competitive products to their members and to generate sufficient income to meet the proposed minimum capital requirements. The proposed regulation required that corporate credit unions achieve primary capital levels of 4 percent of average daily assets by January 1, 1998.

The commenters also contended that the proposed rule would disproportionately affect small natural person credit unions, which rely more heavily on corporate credit unions for investments and other services. They argued that because the corporate credit unions would not be able to earn a spread on their investment activities, costs for services would increase and yield on investments would decrease.

C. Dialogue Meetings

After considering the comments and preliminary modeling results, NCUA determined that some changes to the proposed regulation might be appropriate. To obtain input on those changes, NCUA hosted a series of meetings with representatives of corporate credit unions, natural person credit unions, and national credit union trade associations. There was a productive exchange of information and views. This proposed rule incorporates a number of the suggestions received during the meetings.

D. Modeling

NCUA contracted with a mortgage investment and interest rate risk advisory firm (the firm) to estimate the market value of portfolio equity and interest rate sensitivity of the balance sheets of seven corporate credit unions. The modeling exercise was conducted to provide NCUA with an independent assessment of the relative market risk in a broad cross-section of corporate credit unions. The firm believes that market value of portfolio equity (MVPE) is the best measure of interest rate risk, as it can be computed quickly, captures interest and principal cash flows, provides an analysis of embedded option risk, and is more complete than income simulations. In addition, MVPE models are not driven by assumptions regarding future behavior or reactions to interest rate changes. The firm concluded that requiring corporate credit unions to use MVPE techniques would introduce a necessary risk analysis and reduction discipline. The firm stated that when properly implemented, MVPE techniques would significantly reduce the likelihood of another failure similar to that of Capital Corporate Federal Credit Union, which failed in early 1995. Interestingly, many of the commenters to the initial proposed rule recommended that NCUA use MVPE to measure interest rate risk.

The firm noted that managing market value correctly can reduce the volatility of earnings and net worth. The effects of good management decisions stand out when earnings are not significantly affected by unexpected changes in interest rates. Market value is the best measure of the firm's value and is usually the best benchmark to judge management's performance. Also, MVPE, and its volatility, is usually the best indication of risk to the insurer and regulators.

The firm analyzed the corporate credit unions' base MVPE and the sensitivity of MVPE for instantaneous and sustained parallel shifts in interest rates up and down 400 basis points in 100 basis point increments. It also provided a 12-month net interest income projection for the same interest rate scenario.

Additional tests included stresses on several market-related variables to determine their effect on MVPE. These included: (1) flattening and steepening the reference yield curve with a pivot at the three-year maturity; (2) increasing market volatilities by 50 percent from the reference levels; (3) stressing prepayment speed projections for mortgage-related securities 100 percent faster for the down 300 basis point scenario; (4) stressing prepayment speed projections for mortgage-related securities 50 percent slower for the up 300 basis point scenario; and (5) increasing market spreads by 50 basis points above projected spreads.

Project results concluded that large changes in prepayment expectations, widening spreads, and increases in volatility levels would adversely affect corporate credit union MVPEs. Changes in the shape of the yield curve did not have a significant adverse effect; this was due, in large part, to the relatively short asset duration of most corporate credit union balance sheets.

The balance sheets of the corporate credit unions studied were ''long the market,'' that is MVPE increased when interest rates declined and decreased when interest rates rose. This is a result of the effective duration of the corporate credit unions' assets being longer than that of their liabilities. Some corporate credit union assets were shown to be negatively convex, that is, projected gains to MVPE were smaller for interest rate declines than losses for equivalent interest rate increases. This negative convexity is caused by the presence of embedded options, found most commonly in mortgage-related securities and structured notes.

The firm determined that many corporate credit unions would need to upgrade their interest rate risk models to account for the impact of embedded options. It noted that the establishment of a minimum MVPE ratio would be a key aspect of any regulation attempting to control interest rate risk using MVPE techniques. According to the firm, the minimum should provide a safe margin above the exposures created by a positive or negative 300 basis point rate shift. This is necessary because, as the tests indicated, MVPE can also be affected by changes in the slope of the Treasury curve, prepayment activity that differs from that expected, changes in market spread levels, and changes in market volatilities.

E. Three-Tiered Approach

In developing this revised proposed rule, NCUA acknowledged the diversity within the corporate credit union network and the breadth of functions

that are provided. Accordingly, this proposal provides the flexibility for additional authorities for those corporate credit unions with a more developed infrastructure and codifies the requirements to obtain those authorities. Presently, such authorities are granted by waiver.

The basic regulatory requirements and authorities applicable to all corporate credit unions are set forth in the main text of Part 704. Thus, a corporate credit union that does not seek expanded authorities need read only the main text and Appendix A, which contains model disclosure forms that a corporate credit union may choose to use for capital accounts. A ''basic'' corporate credit union need not read Appendices B and C, which set forth additional authorities available to corporate credit unions and the requirements to obtain such authorities. The incorporation of expanded authorities allows for an element of self-determination that was not a component of the initial proposal. This approach is intended to remove the ''one-size-fits-all'' constraint and permit flexibility for a corporate credit union to choose a path consistent with its members' needs. The board of a corporate credit union may pursue, via a self- assessment, the level at which it wishes its institution to operate.

F. Effective Date and Transition

Section 704.18 of the initial proposal stated that the rule would take effect on January 1, 1996. Obviously, that date has passed. Due to the complexity of this rule, it is difficult to determine when a final rule will be issued, and thus to predict a reasonable effective date. Accordingly, rather than stating an effective date in this proposal, the final rule will announce an effective date that is approximately 1 year from the date the final rule is issued.

The preamble to the initial proposal stated that NCUA was considering requiring compliance with the investment section 30 days after issuance of the final rule, which would be prior to the effective date of the rest of the regulation. This was to deter corporate credit unions from ''loading up'' on investments that would no longer be permissible under the new rule. The commenters generally objected to this provision, and NCUA has determined not to proceed with it. As noted in proposed Section 704.6(g), a corporate credit union's authority to hold an investment is governed by the regulation in effect at the time of purchase.

As discussed above, if this proposal is made final, each corporate credit union will have to determine the level at which it wishes to operate. While a corporate credit union may change its level at a later date, it will have to make an initial decision regarding what its status will be when the final rule becomes effective. So that NCUA can effectively supervise the transition to the new regulation, each corporate credit union will be asked to inform NCUA, within 90 days of the final rule's publication, of its decision.

A corporate credit union that plans to operate with expanded authorities should submit its application for such authorities as soon as possible to ensure approval and implementation prior to the effective date. The application must demonstrate that the corporate credit union either has sufficient staffing and infrastructure to support the authorities or will make the necessary changes so that it will have such staffing and infrastructure. The application also must set forth the expected costs of such changes. Since there is no guarantee of approval, a corporate credit union normally will not implement these changes until it receives preliminary approval.

NCUA will work closely with a corporate credit union in evaluating its application. Once all issues are resolved, NCUA will issue a preliminary approval. If the issues cannot be resolved, NCUA will notify the corporate credit union. Once preliminary approval has been received, the corporate credit union must make the planned changes. Once NCUA has been notified that the corporate credit union is ready to begin using the expanded authorities, it will review the corporate credit union's operations. If they are sufficient to support the requested authorities, final approval will be granted.

Recognizing that an institution may not be at the required capital level or within the required MVPE limitations by the effective date of the regulation, NCUA plans to work with the corporate credit unions to develop realistic time frames for compliance. NCUA also is aware of the unique role of wholesale corporate credit unions and will make accommodations to allow such institutions to comply with the regulation.

G. 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, NCUA proposed to amend the Scope section so that it states both that the regulation applies to all federally insured corporate credit unions, and 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. Some commenters objected to this latter requirement, arguing that it meant that NCUA was holding non federally insured corporate credit unions to a higher standard than other investment alternatives available to natural person credit unions.

These credit unions may be held to a higher standard because they are differently situated than other natural person credit union investment alternatives. The failure of a corporate credit union, even one not federally insured, would affect the credit union system more dramatically than the failure of a bank or broker-dealer. First, the public would not necessarily distinguish between a federally and non federally insured corporate credit union: all would be tarnished. Second, it is likely that a far greater number of federally insured natural person credit unions would be affected by the failure of a corporate credit union than would be affected by the failure of a bank or broker-dealer. For these reasons, and because of NCUA's responsibility to protect the National Credit Union Share Insurance Fund (NCUSIF), NCUA has determined to retain in the revised proposed rule the requirement 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.

As in the first proposed rule, Section 704.1(b), which sets forth NCUA's authority to waive a requirement of Part 704, is retained in this revised proposal. NCUA again emphasizes that corporate credit unions are expected to comply with the rule and that waivers will not be granted as a matter of course.

Section 704.2—Definitions

As noted in the initial proposed rule, Part 704 currently incorporates by reference Part 703, which governs federal credit union investments, except where inconsistent with Part 704. To eliminate the confusion regarding the applicability of certain provisions of Part 703 to corporate credit unions, NCUA determined in the initial proposed rule to make the investment section in Part 704 stand on its own.

Among other tasks, this necessitated importing a number of definitions from Part 703 into Part 704. No commenters objected to this idea, and it is continued in this revised proposal.

The definitions that have been repeated, either identically or with minor changes, from current Part 703 are: ''adjusted trading,'' ''collateralized mortgage obligation,'' ''federal funds transaction,'' ''futures contract,'' ''immediate family member,'' ''market price,'' ''maturity date,'' ''real estate mortgage investment conduit,'' ''repurchase transaction,'' ''residual interest,'' ''reverse repurchase transaction,'' ''Section 107(8) institution,'' ''senior management employee,'' ''settlement date,'' ''short sale,'' ''stripped mortgage-backed security,'' and ''trade date.''

Since the issuance of the initial proposed rule, NCUA has issued a proposed revision to Part 703. 50 FR 61219 (Nov. 29, 1995). Proposed Part 703 contains a number of new definitions, some of which have been included in this revised proposed Part 704. These are: ''business day,'' ''commercial mortgage related security,'' ''fair value,'' ''industry-recognized information provider,'' ''mortgage related security,'' ''mortgage servicing,'' ''pair-off transaction,'' ''prepayment model,'' ''securities lending transaction,'' and ''small business related security.''

The initial proposed rule also introduced a number of new definitions, several of which have been included in this revised proposal. These are: ''embedded option,'' ''forward rate agreement,'' ''long-term investment,'' ''market value of portfolio equity,'' ''matched'' (''identically matched'' in initial proposal), ''official,'' ''option contract,'' ''penalty for early withdrawal,'' ''primary dealer,'' ''short-term investment,'' ''swap agreement,'' and ''wholesale corporate credit union.''

The initial proposal rule deleted a number of definitions because the terms were not used in the proposed regulation, or because the meaning was so self-evident as to not require definition. No commenters objected to this idea and it is continued in this revised proposal. The definitions that are proposed to be deleted are: ''average life,'' ''capital of a broker/dealer,'' ''claims,'' ''corporate reserves,'' non credit union member,'' ''original maturity,'' ''other reserves,'' ''risk-based capital,'' ''secondary capital,'' ''speculative activities,'' ''term subordinated debt,'' and ''United States depository institutions.''

Finally, this revised proposal has introduced definitions for the following terms: ''capital ratio,'' ''correspondent services,'' ''credit enhancement,'' ''daily average net assets,'' ''dealer bid indication,'' ''gains trading,'' ''membership capital,'' ''mortgage-backed security,'' ''moving daily average net assets,'' ''NCUA,'' ''non secured investment,'' ''paid-in capital,'' ''private placement,'' ''reserves,'' ''reserve ratio,'' ''secured loan,'' ''tri-party contract,'' and ''weighted average life.'' NCUA believes that the definitions are self-explanatory, but will clarify any that are confusing in the preamble to the final rule.

Section 704.3—Corporate Credit Union Capital

Section 704.11 of the current regulation establishes specific levels of capital that corporate credit unions must maintain, based on risk-weighted assets. Primary capital, which consists of reserves and undivided earnings, must be at least 4 percent of risk-weighted assets, and total capital, which consists of primary capital and membership capital share deposits, must be at least 8 percent of risk-weighted assets. In response to public expressions of concern regarding the relatively low levels of primary capital in corporate credit unions, Section 704.12 of the initial proposed rule established a new capital requirement based on the ratio of primary capital to average daily assets. The goal was for corporate credit unions to reach the minimum ratio of 4 percent of primary capital to average daily assets by January 1, 1998. The initial proposed rule also required that all corporate credit unions maintain a minimum ratio of 10 percent of capital to risk-weighted assets.

The proposed definition of primary capital included, in addition to reserves and undivided earnings, certain other reserve accounts and a new type of member-contributed capital, called a permanent capital share account (PCSA). Up to 50 percent of primary capital could consist of PCSAs, the most significant feature of which was that they could be redeemed only with the written concurrence of NCUA. In general, the commenters opposed this requirement. Corporate credit union commenters stated that they would be unable to sell such shares, and natural person credit unions stated that they would not purchase them.

With respect to the proposed capital requirements, the commenters stated that if PCSAs were to be retained, all such shares should be counted toward primary capital. In addition, the commenters objected to the new membership capital shares, called secondary capital share accounts, not being included in primary capital. They argued that such shares were at risk and should be counted. The commenters also argued that the asset and liability provisions were so stringent that it would be impossible to meet the 4 percent requirement in the time frame provided. Many commenters also objected to using two ratios to measure the adequacy of corporate credit union capital.

NCUA is proposing to move away from the concept of risk-based capital. Because corporate credit union assets tend to have relatively low credit risk, most corporate credit unions have high risk-based capital ratios, even if they have low levels of leverage capital to protect against interest rate or market risks. This revised proposal focuses on the capital that is available to protect against those risks. Comments are specifically requested on whether NCUA should require the calculation of the capital to risk-weighted assets ratio. In responding to this issue, commenters should bear in mind that NCUA would likely require that the ratio be calculated using the same risk weights and risk categories required by the other federal financial institution regulators.

Proposed Section 704.3(b) requires that a corporate credit union without expanded authorities have a capital ratio of 4 percent. Capital is defined as the sum of a corporate credit union's reserves and undivided earnings, paid-in capital, and membership capital. Membership capital accounts are similar to the current membership capital share deposits, except that they must have at least a three-year notice provision, rather than a one-year provision. Paid-in capital consists of funds obtained from credit union and non credit union sources. Paid-in capital has no maturity and is 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.

The capital (or ''leverage'') ratio is calculated by dividing a corporate credit union's capital by its moving daily average net assets. Including membership capital in the definition of capital means that most corporate credit unions are already at 4 percent. NCUA believes that 4 percent is appropriate, because it is the amount estimated to meet corporate credit union needs and is comparable to the levels established by the other financial institution regulators.

The role of membership capital relative to a corporate credit union's internally generated reserves and undivided earnings has been cause for extensive debate. NCUA regards

membership capital as a vital component of the corporate network's total capital structure. It is used in calculating the minimum leverage ratio (also included in total capital requirement for expanded authorities), the limit on loans to members, the limit on loans to CUSOs, and the limit on fixed assets. However, for purposes of market and credit risk exposure, this proposal sets the MVPE and concentration limits as a percentage of the sum of reserves and undivided earnings and paid-in capital. Indirectly, the member-contributed capital is in line to absorb losses, but the revised proposal seeks to restrict the incidence of losses to a corporate credit union's own equity.

The ability of a member to withdraw its capital contribution has been preserved in this revised proposal. The fact that a member may cancel its ownership stake, irrespective of any ability on the part of the corporate credit union to replace it, adds an extraordinary dimension to the capitalization of corporate credit unions. Some have argued that a mechanism needs to exist which permits a member to voluntarily provide a more permanent form of capital to its corporate credit union. Thus, the revised proposal permits a member to purchase paid-in capital. This establishes the alternative for a member to make a perpetual capital investment which the corporate credit union can use, along with its reserves and undivided earnings, for direct risk-taking purposes.

As members of a unique, private, and cooperative financial system, corporate credit unions will benefit from building appropriate internal capital reserves and, in turn, diminish the prospect of placing member funds directly at risk. Over time, the buildup of internal reserves will increase a corporate credit union's capacity to provide greater products and services to members while it decreases the risk to members that they will lose their capital stake due to market or credit risk exposures or other business losses incurred by their corporate credit union.

Proposed Part 703, noted above, limits a natural person credit union's purchase of capital shares in corporate credit unions to one percent of the investing credit union's assets. Commenters with opinions on this issue should direct them at proposed Part 703.

Since NCUA believes that the stability of the corporate system will be strengthened if each corporate credit union's reserves and undivided earnings plus paid-in capital ultimately equals 4 percent of net assets, proposed Section 704.3(c) establishes mandatory reserve transfers when the amount is below 4 percent. Although NCUA expects that a 4 percent capital ratio will be appropriate for most corporate credit unions without expanded authorities, a higher level may be necessary in the rare situation when, for example, a corporate credit union refuses to recognize a loss, or a loss not anticipated by the regulation occurs. A lower level may be appropriate in the event of a natural disaster or when, for example, a merger results in the continuing corporate credit union's reserves falling below 4 percent, and a workout plan has been approved. To accommodate increasing or decreasing the capital requirement, proposed Section 704.3(d) provides that NCUA may require a different minimum capital ratio for an individual corporate credit union based on its circumstances. Before imposing a different capital requirement, NCUA will provide notice to the corporate credit union and allow it to respond.

In rare circumstances, conditions may exist in a corporate credit union when additional reserves may be needed but are not available immediately. In those cases, NCUA may require a corporate credit union to increase the regularly scheduled reserve transfers with supplemental transfers which will ultimately raise the reserves to the required level. As an example, NCUA may require that a corporate credit union transfer 12 basis points each period, rather than the 10 basis points required by the regulations. This action may be taken in conjunction with a reserve transfer, or in lieu of the reserve transfer.

As noted earlier, NCUA and corporate credit union representatives have discussed this revised proposal during its development. As the 4 percent capital ratio requirement has been debated, some corporate credit union representatives have asked about the consequences of going below 4 percent, because, for example, the corporate credit union has accepted a large volume of shares. NCUA is committed to corporate credit unions maintaining capital at the required minimum, but realizes that there may be situations where a corporate credit union temporarily drops below that level. To accommodate sudden spikes in share growth, the capital ratio is calculated by dividing capital by the moving daily average net assets for the previous 12 months.

Proposed section 704.3(e) requires management of a corporate credit union to notify the board of directors, the supervisory committee, and NCUA within 10 business days when capital falls below the minimum required. The 10 business days refers to the time period after the books are closed at month end. It is important to notify the board and supervisory committee so that they can act promptly, including the calling of a special meeting, if necessary, to ensure compliance within the month.

If a corporate credit union is not in compliance by month end, proposed Section 704.3(f) requires that it submit a plan to restore and maintain its capital ratio at the minimum required level. For example, if a corporate credit union closes its books on March 31, and the capital ratio is 3.9 percent, it must notify the board of directors, the supervisory committee, and NCUA by April 10. If, on April 30, the capital ratio is at or above 4 percent, no further action is necessary. If, however, the ratio is at 3.95 percent, a plan must be submitted to NCUA by May 15.

Even if a corporate credit union comes into compliance by the end of the month, a plan is required if the corporate credit union drops below the required minimum two more times within 12 months from the first violation. Violating the required minimum three times in one year indicates a systemic problem that must be addressed. Failure to develop an adequate plan, fully supported by projections and estimates, increases the chances that NCUA will issue a capital directive, a procedure that is provided for in proposed Section 704.3(g).

A capital directive may 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. Unless a corporate credit union's capital level is severely under the required minimum, it is intended that capital directive will be issued only after verbal and written communication between NCUA and the corporate credit union has failed to result in an acceptable capital restoration plan or a plan has not been followed.

Since a capital directive will be issued only as a last resort, NCUA expects full and immediate compliance with any such directive. NCUA will view failure to comply with a capital directive as a serious issue.

It should be noted that the proposed regulation provides for consultation with the state regulator where a state-chartered corporate credit union is involved. NCUA will support state requirements for higher capital levels or shorter time frames for compliance.

Section 704.3(a) requires that a corporate credit union develop capital

goals, objectives, and strategies. A corporate credit union should develop various scenarios to accommodate slow, medium, and rapid asset growth. It also should consider setting goals higher than regulatory minimums in order to avoid non compliance due to unexpected growth. Preplanning for capital growth is needed if a corporate credit union anticipates applying for expanded authorities.

Section 704.4—Board Responsibilities

Currently, several different sections of Part 704 set out policy and operational requirements for corporate credit union boards of directors. For example, Section 704.3 requires boards to adopt and review strategic plans and to prepare business plans for certain material expenditures. Sections 704.4 through 704.7 require corporate credit unions to develop certain policies and goals in the areas of asset and liability management, capital, investments, and lending, but the board is accountable for the ratification of and adherence to such policies and goals. The initial proposed rule did not substantially change this approach, maintaining the requirement for board development of strategic and business plans in Section 704.3 and the requirement for credit union development of capital goals, objectives, and strategies in Section 704.6. Section 704.4, however, did combine the requirements for credit union development of investment and asset and liability management policies.

No significant comments were received in this area, but to emphasize the fact that the board sets the agenda and is ultimately responsible for the corporate credit union, Section 704.4 of this revised proposal requires a board to approve comprehensive written plans and policies. The board should oversee senior management to ensure that policy limits are consistent with the existing and forecast levels of capital and that all activities are conducted in a safe and sound manner and are consistent with the board's overall risk management philosophy. The board should also understand the role financial instruments play in the corporate credit union's business strategies and the mechanisms used to manage risks. The board must provide for adequate staffing and technological/financial resources to support the corporate credit union's activities. When a corporate credit union plans to enter a new market, the board evaluation should reflect the cost of establishing appropriate controls, procedures, and attracting professional staff with necessary expertise.

The emphasis upon board responsibilities is not intended to turn directors into operating managers. A board needs to delegate the development of goals, policies, and procedures to operating management. However, the board retains the ultimate responsibility for ensuring that such delegations are reasonably fulfilled. A board's active commitment to this can significantly improve its awareness and control of potential risks.

Section 704.5—Investments

Currently, Section 704.6 requires a corporate credit union to develop written investment policies and sets out a list of authorized investments and divestiture requirements. In the initial proposed rule, the policies provision was moved to Section 704.4, and the remaining provisions were revised and recodified at Section 704.5. Section 704.5 of the proposed rule also included the relevant provisions of Part 703, governing natural person federal credit union investments, rather than simply incorporating them by reference. No comments were received on this matter, and the split between Parts 703 and 704 has been maintained in this revised proposal.

Section 704.6 of the initial proposed rule restricted the aggregate of a corporate credit union's investment in any one institution, issuer, or trust to 25 percent of primary capital. It instituted minimum asset size and rating requirements for investments in depository institutions. It also tightened the standards for CMOs.

A number of commenters stated that the 25 percent of primary capital limitation was too low, arguing that it would concentrate corporate credit union investments in the hands of fewer issuers and create more credit risk in the industry. They also suggested that U.S. Government and Agency securities should be exempt from the restriction.

NCUA agrees that the 25 percent of primary capital concentration limit was too low and has also determined that concentration concerns should properly focus on credit risk. Therefore, new concentration limits are set forth in proposed Section 704.6, which governs credit risk management.

The weakness in the current CMO tests became evident during the bear market of 1994. While the fixed-rate CMO test proved reasonably adequate in preventing the purchase of many high risk fixed-rate CMOs, the floating-rate test proved inadequate. Many floating-rate CMOs were structured to enable them to pass the test even though they contained significant market risk resulting from option and basis risk.

This revised proposal expands the fixed rate CMO test to include limits on extension/contraction of weighted average life (WAL) and on price volatility. These are similar to the second two tests of the Federal Financial Institutions Examination Council (FFIEC) test for CMOs. Unlike the current rule, the proposal allows for bonds to extend from the initial expected WAL provision of five years to seven years. The price volatility test sets the maximum market value decline at 15 percent of the base case value. This means that the volatility of a CMO should not exceed the comparable price volatility of approximately a five year zero coupon bond.

This proposal expands the floating rate CMO test to include three new tests. There is an initial expected WAL limit, an extension/contraction WAL limit, and a price volatility limit. These tests were proposed in response to the volatile price history of floating rate CMOs and the inability of the FFIEC test to adequately capture cap and basis risk. The view that floating rate securities are immune from general market risks has been rudely dispelled over the past several years, and NCUA believes there is a need to subject such securities to rigorous prepurchase selection tests.

During the dialogue sessions with corporate credit unions, several participants argued have that a comprehensive MVPE analysis which captures option and basis risk eliminates the need for a special CMO test. The fact that total risk is addressed in MVPE, and subsequently limited as a percentage of reserves and undivided earnings plus paid-in capital, may make the CMO tests redundant and needlessly restrictive. Commenters are specifically requested to address this issue.

To control possible ''cherry picking'' involving the testing of CMOs (selecting a prepayment model that will allow a particular CMO to pass the tests), this revised proposal requires a corporate credit union board to approve at least three prepayment models, or a median estimate, that will be used in the tests. The models must be used for all subsequent tests.

Section 704.5(c) of this revised proposal establishes consistent, minimum standards for repurchase and securities lending transactions. These transactions create room for spread trade opportunities with minimal MVPE and credit risk. Proposed Section 704.5(c)(4) requires that collateral securities be legal for corporate credit unions, except that CMO/REMIC securities that pass the FFIEC HRST are permissible provided that the term of the transaction does not exceed 95 days. The 95-day limit will permit standard 3-month trades with such collateral.

Section 704.5(k) of the initial proposed rule carried over the provision from Part 703 authorizing investment in a mutual fund if the investments and investment transactions of the fund are legal for the purchasing credit union. Proposed Section 704.5(d) broadens this authority by permitting investment in an investment company that is registered with the Securities and Exchange Commission under the Investment Company Act of 1940, with the same restriction regarding the permissibility of the underlying investments and investment transactions. A mutual fund is the most common type of registered investment company, but credit unions have been authorized by opinion letter to invest in other types, such as money market mutual funds and unit investment trusts. The regulatory language has been changed to clarify that these other types of registered investment companies are permissible investments for corporate credit unions. A corporate credit union can determine if the investments and investment transactions of an investment company are permissible by reviewing the fund's prospectus and statement of additional information. Oral or other written representations regarding the fund's activities are not sufficient. The language also clarifies that investments such as asset-backed securities (ABS), which are specifically authorized for corporate credit unions but are not registered investment companies, are permissible regardless of the underlying instruments that make up the security.

Proposed Section 704.5(e) sets forth investment activities that are prohibited for corporate credit unions that are not operating with expanded authorities. Several prohibitions are carried over from Part 703. Proposed Section 704.5(e)(1) prohibits a corporate credit union from purchasing and selling off-balance-sheet financial derivatives. While derivatives can be important risk management tools, NCUA believes that they are appropriate only for corporate credit unions that have sophisticated risk management systems in place. Proposed Section 704.5(e)(3) prohibits a corporate credit union from purchasing commercial mortgage related securities and small business related securities because the market for these securities is undeveloped and the potential timing of cash flows from the securities is not widely disseminated.

Section 704.6—Credit Risk Management

Except for the concept of risk-based assets, the current regulation addresses credit risk only briefly. Section 704.6(a) requires that a corporate credit union's investment policies address, among other things, risk diversification and approved investment credit limits and credit ratings. Section 704.6(b) authorizes the purchase of certain investments only if they have specific minimum credit ratings.

The initial proposed rule did not significantly change this approach. Section 704.4 required a corporate credit union to develop policies regarding acceptable credit risk, to identify the credit risk associated with an asset prior to purchase, and to monitor such risks while an asset was held. Section 704.5 established minimum credit ratings for certain investments and required corporate credit unions to prepare quarterly evaluations of lines of exposure to foreign banks. Some commenters took exception to some of the required ratings and to the mandatory quarterly evaluations. In addition, there was a suggestion that credit risk be discussed more comprehensively.

This revised proposed rule addresses credit risk in a separate section and requires that the board of a corporate credit union adopt a written credit policy that reflects objectives and limits consistent with its risk management philosophy. Proposed Section 704.6 was developed in response to concerns that some corporate credit unions consider that credit risk management only requires the use of credit ratings. This section requires a corporate credit union to establish a credit risk management policy, sets concentration limits and minimum credit ratings for certain investments, and establishes specific reporting and documentation procedures.

In-depth credit risk management requires considerable human and financial resources. Many corporate credit unions may not wish to commit the resources necessary to assume significant credit risk exposure. Therefore, the proposed rule establishes conservative credit ratings and concentration requirements. It also permits an expansion of these basic credit authorities provided that credit risk management resources increase accordingly. For corporate credit unions that restrict their credit activities, a minimum due diligence process is required. However, if a corporate credit union increases its credit exposure, the requirements will increase accordingly.

Proposed Section 704.6(a) requires that a corporate credit union's credit risk management policy address how it will ensure that it has exercised due diligence in analyzing credit risk. The due diligence requirement will not be met solely by subscribing to a rating agency's credit research. To the extent that a corporate credit union assumes material credit risk exposures, the internal analysis must provide the basis for acceptable credit lines. The analysis should contain a rationale for the approved risk exposure. A corporate credit union choosing to accept greater risk exposure must have resident credit expertise commensurate with the level of risk assumed.

To ensure reduced risks to member credit unions, the proposal requires a corporate credit union to establish maximum credit limits based on its reserves, undivided earnings, and paid-in capital. NCUA believes that establishing limits based upon net assets provides a poor basis to support risk since the size of a corporate credit union's balance sheet does not meaningfully correlate to its capacity to absorb risk.

The proposal also requires that a corporate credit union establish limits on concentrations of credit risk that may occur, by, for example, sector (*e.g.,* automobile industry related receivables), industry (*e.g.,* banks), or region (*e.g.,* geographical concentrations of loans in private mortgage-backed securities). The policies must address the fact that diversification by issuer does not mitigate all pertinent credit risk factors. Absent the appropriate risk considerations, NCUA is concerned that the corporate credit union system's assets could become overly concentrated in one type of credit and be prone to a systemic credit crisis. The remedy is not to avoid credit risk but rather to analyze and manage it.

The credit risk management section establishes specific concentration limits for certain types of securities and money market transactions. These limits are higher than those set forth in the initial proposal. NCUA was persuaded that the more conservative limits could have the unintended consequence of forcing corporate credit unions to purchase securities from issuers with greater credit risk. A credit instrument which possesses structural components which reduce the risk of default is preferred to a credit instrument that is based upon the credit quality of the issuer. Therefore, the concentration limits make a distinction between securities which have an element of credit enhancement and non secured direct obligations. The latter have no collateral or securitization enhancements to absorb losses resulting from default.

Proposed Section 704.6(c)(1) provides that the aggregate investments in any single mortgage-backed security (MBS) or asset-backed security (ABS) or trust are limited to 200 percent of the sum of

the corporate credit union's reserves and undivided earnings and paid-in capital. MBS and ABS are instruments with substantial credit enhanced structures. The underlying instruments provide protection from a credit risk perspective. The limit on MBS and ABS was set higher than the limit on unsecured transactions because of the relative lower credit risk associated with these secured investments. This limit allows for an appropriate level of activity absent the substantial credit review process that is requisite for proportionately greater credit risk exposures.

Repurchase agreements provide opportunities for most corporate credit unions to obtain spread income while limiting MVPE exposure. Repurchase agreements and securities lending typically have a high degree of protection against default. Since these transactions are fully collateralized and valued on a daily basis, they have minimal credit risk exposure. The concentration limits set forth in proposed Section 704.6(c)(2) reflect the objective to maintain credit risk management requirements commensurate with exposures. It provides that a corporate credit union's 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. This limit does not apply to investments in a wholesale corporate credit union. The concentration limit restricts the volume of repurchase transactions with one counterparty and will require a corporate credit union to develop an adequate number of relationships to support the level of current and projected repurchase activity.

Proposed Section 704.6(c)(3) limits non secured transactions to 100 percent of the sum of a corporate credit union's reserves and undivided earnings and paid-in capital. To the extent that a corporate credit union cannot conduct an in-depth analysis of credit counterparties, this limit restrict exposures to an appropriate maximum. It is understood that preferences for risk taking (*i.e.,* credit versus market risk) may change over time. The expanded authorities address the capacity for a corporate credit union to assume greater levels of credit exposure if and when it chooses. NCUA is concerned about excessive exposures in non secured credit instruments that are not supported by the requisite due diligence.

Proposed Section 704.6(d) addresses credit ratings. It cannot be emphasized too strongly that a high rating is not a substitute for due diligence. Debt structures and counterparty creditworthiness must still be evaluated, and the approval of credit lines and limits must contain rationale which reasonably justifies the willingness of the corporate credit union to place its capital at risk. The proposed rule requires that downgraded instruments be reviewed by the corporate credit union. The corporate credit union must ensure that any decision to hold a downgraded instrument can be justified. The provision does provide flexibility to avoid automatic divestiture. The specific conditions for instruments with rating which fall below the regulatory minimum is addressed in proposed Section 704.10. Although the initial proposed rule contained entity ratings, these have not been included in this revised proposal due to the variability of standards on the part of the rating agencies.

In establishing a minimum rating for asset-backed securities, NCUA considered the additional legal and financial structure risks resident in such securities. The complexity of these factors is typically greater for lower rated bonds. Taking these other risk factors into consideration, it was decided that that ABS would be limited to AAA, despite the fact that the relative credit risk was not necessarily different from other similarly rated securities.

Proposed Section 704.6(b) exempts from the credit requirements of Section 704.6 securities issued by the United States government, its agencies, and enterprises. Although government-sponsored enterprises, such as Fannie Mae and Freddie Mac, have been exempted, they do possess some credit risk. A corporate credit union should not fail to consider that any material credit risk needs to be evaluated commensurate with the exposure taken. These entities should not be considered exempt from due diligence.

Section 704.7—Lending

Under Section 704.7 of the current rule, loans to one credit union member are limited to the corporate credit union's capital or 10 percent of its shares and capital, whichever is greater. The aggregate amount of loans to non credit union members is limited to 15 percent of the corporate credit union's capital. The aggregate amount of loans to credit union non members is limited to 25 percent of the corporate credit union's shares and capital, with the loans to one credit union non member being limited to capital or 10 percent of shares and capital, whichever is greater.

Out of concern that the existing limitation was too permissive and posed a potential threat to corporate credit unions and the NCUSIF, Section 704.8 of the initial proposed regulation limited loans to one member credit union to the corporate credit union's primary capital. Corporate credit unions were prohibited from lending to members that were not credit unions, except for loans to CUSOs and overdraft protection for clearing accounts, and were also prohibited from lending to non members.

A number of commenters argued that the limitation on loans to one member credit union was too low. They argued that there should be a separate limitation for secured and unsecured loans, due to the differing magnitude of potential risk. NCUA agrees, noting that the majority of corporate credit union lending to member credit unions is done on a secured basis. NCUA also notes that a limit based solely on capital, which includes membership capital, may be unfair to some corporate credit unions, which may choose not to issue membership capital. Therefore, Section 704.7(c) of this revised proposal limits unsecured loans to 50 percent of capital or 75 percent of the sum of the reserves and undivided earnings and paid-in capital, whichever is greater, and limits secured loans to 100 percent of capital or 200 percent of the sum of reserves and undivided earnings and paid-in capital, whichever is greater. NCUA believes that the unsecured limit represents a balance between safety and soundness concerns and the mission of corporate credit unions to make loans. The secured lending limit allows for adequate diversification of the loan portfolio with limited risk associated with any one borrower.

NCUA emphasizes that the term "secured loan" is defined to mean a loan in which the lender has perfected a security interest in the collateral. The rules for perfecting a security interest are governed by state law. For example, if collateral consists of loans, and state law requires possession of loan documents to perfect a security interest in a loan, then the corporate credit union must take possession of the documents. If this is not feasible, then the loan must be included in the corporate credit union's unsecured loan limit. To assess the impact of the unsecured vs. secured loan limits, NCUA seeks comments on restrictions imposed by state law on individual corporate credit unions' lending activities.

NCUA was convinced by comments that the corporate credit unions should have the ability to make loans to non credit union members. Section 704.7(d) of the revised proposal allows corporate

credit unions to make loans to members other than credit unions as long as the loans are in compliance with Section 701.21(h) of the NCUA Rules and Regulations, which governs member business loans. Additionally, the aggregate of loans to members other than credit unions cannot exceed 15 percent of the corporate credit union's capital plus pledged shares.

NCUA also was convinced that corporate credit unions should have the authority to make loans to non member credit unions in order to accommodate credit unions with branches in other states. Proposed Section 704.7(e) authorizes a corporate credit union to make an overdraft loan related to correspondent services to a non member credit union. Although such a loan generally will have a maturity of only one business day, NCUA will not take exception if, in the regular course of business, an overdraft loan occasionally has a maturity of two or three days.

Section 704.8—Asset and Liability Management

Section 704.4 of the current regulation requires a corporate credit union to develop and implement comprehensive written funds management policies and to prepare monthly reports showing the degree of mismatch between the sources and uses of funds. In addition, 704.6 requires a corporate credit union to develop written investment policies which address funds management strategies, among other things.

In response to the assumption of significant interest rate risk by many corporate credit unions, Section 704.4 of the initial proposed rule required that corporate credit unions identically match almost all shares and deposits to corresponding assets. In addition, corporate credit unions were required to calculate the fair value of all investment securities monthly, limit aggregate losses on available-for-sale assets to 15 percent of primary capital, limit investment in instruments with embedded options to capital, and impose early withdrawal penalties to guarantee protection from replacement risk. Most respondents to the original proposal pointed out that this combination was too restrictive to permit both a realistic management of asset and liability positions and an adequate provision of basic financial products and services.

To ensure that corporate credit unions were cognizant of potential interest rate risk exposures before they arose, proposed Section 704.4 required the performance of monthly ''shock test'' calculations to show the impact on net interest income and MVPE of interest rate changes. The supplementary information section of the proposed regulation indicated that NCUA would conduct analytical assessments of the proposed rule through simulation modeling techniques.

The linchpin of the asset and liability management section of this revised proposed rule is the use of MVPE. MVPE shocks provide a critical insight into potential risks to earnings and capital. Most financial institutions are comfortable viewing risk in terms of variability of income. MVPE adds the dimension of capital-at-risk to the assessment of risk exposure. Simulation models that produce estimates for both net interest income and MVPE provide a more comprehensive risk assessment.

NCUA is primarily focused upon the preservation of capital. MVPE simulations provide a long-term, dynamic, and forward-looking projection of the market risk impact upon capital. Coupled with net interest income sensitivity analysis, MVPE provides a mechanism to view earnings on a capital-at-risk basis. In most cases, the management of MVPE will rely upon the management of asset price volatility.

NCUA realizes that the level of MVPE that a corporate credit union targets is not static. As a corporate credit union assumes a greater mismatch between liabilities and assets, MVPE variability will rise. Corporate credit unions will need to make constant adjustments to the level of MVPE exposure based upon their market biases and preferences. It is assumed that a corporate credit union uncomfortable with positioning its balance sheet based upon assumptions about future market factors will minimize MVPE variability by matching a majority of assets and liabilities. The management of higher MVPE variability requires considerable human, financial, and system resources. The proposed regulation recognizes that some corporate credit unions will have sufficient infrastructure to permit them to incur more interest rate risk.

This proposal requires that a corporate credit union maintain a certain level of MVPE and that it not decline too drastically in response to interest rate shocks. However, effective risk management begins and ends with the board of directors. The board should consider that the regulatory limitations in this rule are outer boundaries. It is anticipated that boards will set policies within these boundaries, recognizing that shock tests can only approximate real world events are based upon a number of subjective inputs. Estimated results frequently vary from actual results, and corporate credit unions will need to develop procedures to ensure regulatory and board policy limits are not exceeded.

The board also is required to establish policy limits on the maximum decline in net income in both percentage and dollar terms. While NCUA does not address specific limits for net interest income or net income in the asset and liability management section, it recognizes that corporate credit unions must evaluate risk both from a liquidation and a going concern perspective. The board should receive reports which reflect the impact on both the net interest margin and the non interest components of income.

A corporate credit union also must model indexes so that it can establish a relevant correlation between its cost of funds and the reference indexes to which asset coupon formulas are linked. The risk that an index will change independently of the factors which affect liabilities creates basis risk. The MVPE calculation misses a significant risk when indexes (market and non market) are not modeled appropriately. This is particularly important for non market indexes, such as COFI, where correlations to funding behavior may be weak or changes may be difficult to project.

Proposed Section 704.8(e) requires a corporate credit union to evaluate the risk in its balance sheet by measuring the impact of interest rate changes on its MVPE and MVPE ratio. A corporate credit union must limit its risk exposure to levels that do not result in an MVPE ratio below 1 percent or a decline in MVPE of more than 18 percent. Frequency of testing is a function of the MVPE ratio. If MVPE is 2 percent or above, testing must be done quarterly. If it falls below 2 percent, monthly testing is required.

The MVPE floor provision of 1 percent is included in the regulation to reflect, in part, the potential that a forecast of the effect of interest rates on a corporate credit union's balance sheet will only approximate actual market effects of interest rates. This floor (remaining reserves and undivided earnings plus paid-in capital) must also absorb other risks which could affect the corporate's balance sheet such as operational, credit, legal, liquidity, settlement and systemic risk.

There has been considerable debate on the appropriate level of this floor. A floor as low as 1 percent provides a reduced cushion to absorb differences between forecast results and actual market conditions, the impact of interest rate risk not fully reflected by a 300 basis point parallel shock, and the other risks identified above. This increases

the potential that credit unions could lose membership capital during significant market disruptions. Therefore, a low floor may require NCUA to act more quickly and forcefully to protect both natural person credit union membership capital and the NCUSIF.

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

If all liabilities are matched with corresponding assets, investing all reserves and undivided earnings and paid-in capital in a 6-year zero coupon bond is about the same as an MVPE variance of 18 percent. This is a moderate but acceptable risk limit for corporate credit unions with limited risk management infrastructure. The firm's modeling results showed that corporate credit unions with matched assets and liabilities had MVPE variances of less than 5 percent when their balance sheets were subjected to plus and minus 300 basis point parallel shocks. Therefore, corporate credit unions that choose to remain with the base case authorities will have room to manage a mismatch of assets and liabilities while remaining within prudent limits.

The assumption of higher MVPE variability is possible through expanded authorities, but it is expected that a corporate credit union with that authority will aggressively alter its balance sheet in response to shifting market trends. Again, the MVPE variability limit should not be viewed as a static operating level for market exposure. Managing money via significantly mismatching assets and liabilities carries a host of attendant risks which must be constantly evaluated. A corporate credit union cannot run a mismatched portfolio with a ''buy and hold'' strategy. Instead, it must actively manage its balance sheet in response to changing market factors.

NCUA believes that the basic shock test set forth in this revised proposal will reflect most interest rate risk, although it may fail to capture some of the risk associated with other market conditions. One of the primary concerns with the MVPE calculations is the estimate of convexity risk resulting from embedded options. Most of the excessive MVPE variability experienced within the corporate network in recent years is the result of an excess of options written (e.g., prepayment options on amortizing securities and periodic and lifetime caps on variable rate bonds) versus options purchased (usually none). These options typically represent the most dynamic component of the MVPE variability.

Therefore, under the proposed rule, a corporate credit union with instruments which possess unmatched embedded options in excess of 200 percent of the sum of its reserves and undivided earnings and paid-in capital must conduct additional tests. NCUA recognizes that this is a naive hurdle since the book amount of an instrument with an option does not represent the actual amount of option risk. The development of a specific measure of option risk was not pursued because of the unwieldy nature of compliance. This level was chosen as an approximate threshold when aggregate unmatched option exposure could have a material effect upon MVPE. A number of tests, in addition to the standard rate shocks, are required when this hurdle is exceeded. For example, a corporate credit union must evaluate the effect on MVPE of non parallel shifts in the yield curve. Simulation tests done in conjunction with this proposal found that non linear shifts did not have a significant incremental effect on the test results. However, the pivot point was selected at the three year note. A corporate credit union would need to conduct a test which pivots around a point on the curve that reflects its balance sheet structure.

In addition, adjustments to prepayment speeds are necessary because the historical evidence indicates that prepayment projections have varied substantially from actual prepayment behavior. The adjustment to prepayment speeds in the firm's simulated model exercise yielded significantly different MVPE results.

The supply and demand factors which can dominate various investment sectors are reflected in the spread at which such investments trade relative to Treasuries. If a model maintains a static spread assumption in all tests it may not reflect a crucial form of market risk. Credit spreads can be driven by numerous factors, and a corporate credit union should be prepared to address the impact of such spreads.

A major potential component of option value is the measure of volatility. A corporate credit union must be able to measure the impact of how changes in volatility affect MVPE if it has a material exposure to option risk.

Proposed Section 704.8(f) sets forth procedures for violations of the regulatory MVPE limits. This proposed rule does not require the use of particular risk models, allowing corporate credit unions to use their own. NCUA regards the timely disclosure of violations as essential for this approach to remain valid. It is crucial that NCUA, the corporate credit union board, and the supervisory committee, be informed as soon as possible of any violation that is not corrected within 5 days. NCUA will work with the corporate credit union to assist it in returning to compliance.

Proposed Section 704.8(g) sets forth procedures for violations of board asset and liability policy. Again, NCUA must be informed, but after notification is provided to the board.

Section 704.9—Liquidity Management

The current rule does not address liquidity explicitly, although the requirements in Sections 704.4 and 704.6 regarding the development of funds management policies clearly include a concern for liquidity. Further, Section 704.8 provides that a corporate credit union may borrow up to 10 times capital or 50 percent of shares, whichever is greater. The initial proposed rule also did not contain a separate section regarding liquidity, but paragraph (j) of the asset and liability section did require corporate credit unions to develop contingency funding plans that ranked all sources of liquidity that were available to service immediate outflows of member funds. Proposed Section 704.9 authorized a corporate credit union to borrow up to 10 times capital or 50 percent of shares, whichever was *less*, and stated that borrowing could only be done for liquidity needs.

No significant comments were received on proposed Section 704.4(j), but a number of commenters objected to the proposed limitation on borrowed funds. In addition, many commenters questioned the restriction on borrowing only for liquidity purposes. In Section 704.9 of this revised proposal, NCUA has determined to leave the borrowing limit at the current level, that is 10 times capital or 50 percent of shares, whichever is greater. Further, the restriction on borrowing only for liquidity needs has been removed. However, this revised proposal requires that a corporate credit union take a number of actions to ensure that it can fulfill one of its primary functions, that of being a liquidity provider. A corporate credit union must evaluate the potential liquidity needs of its members in a variety of economic scenarios, continuously monitor sources of internal and external liquidity, ensure that it has sufficient investment securities classified as available-for-sale to meet liquidity needs, and develop a contingency funding plan.

Section 704.10—Divestiture

Currently, Section 704.6(d) provides that a corporate credit union in possession of an investment that does meet regulatory requirements must either sell the investment within 10 days or request NCUA permission to hold it. Section 704.5(a) of the initial proposed rule required divestiture within 10 days of any downgraded asset, and 704.5(h)(4) required the same of any CMO that failed the average life test or the price sensitivity test.

Many commenters objected to the general divestiture requirement, stating that it could result in one corporate credit union being required to sell a security at the same time that it was a legal investment for another corporate credit union. The commenters also objected to the absolute nature of both requirements and the fact that corporate credit unions were given only 10 days to sell the downgraded or failed securities. They stated that automatic divestiture within a short time frame could magnify losses if a corporate credit union were forced to sell in an adverse market.

With respect to instruments that have been downgraded but are still permissible under the regulations, proposed Section 704.6 now requires only that a corporate credit union review the investment and be able to justify any decision to hold. With respect to instruments that have failed a requirement of Part 704, proposed Section 704.10 requires that the board and NCUA be informed within 20 business days. If the investment continues to fail, the corporate credit union must provide NCUA with a plan within 25 business days that provides the characteristics and risks of the investment, how it fits into the corporate credit union's asset and liability management strategy, the impact of holding or selling, and the likelihood that the investment will again meet the requirements of Part 704. Although the proposed rule provides for NCUA to require submission of the plan in less than 25 days, it is anticipated that this would be necessary only if there were a serious safety and soundness problem.

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

Currently, the authority of corporate credit unions to invest in credit union service organizations (CUSOs) is contained in Section 704.6 and the authority to lend to CUSOs is contained in Section 704.7. In addition, rather than setting forth specific CUSO guidelines, Section 704.6 incorporates by reference much of Section 701.27, which governs natural person investments in and loans to CUSOs. NCUA determined, in the initial proposed rule, to address corporate credit union investments in and loans to CUSOs in one section and to explicitly include the applicable portions of Section 701.27. This was done in proposed Section 704.7.

NCUA also proposed to create a new term for corporate CUSOs: corporate service organizations (CSOs). A CSO was limited to serving only the corporate credit unions that had invested in or loaned to the CSO and/ or the members of such corporate credit unions. In addition, CSOs were authorized to provide only a few of the services authorized for natural person CUSOs. Finally, the proposed rule required that a CSO be chartered as a corporation under state law.

In response to comments and because ''CUSO'' is a term used and understood throughout the credit union industry, NCUA has determined to retain use of the term in the context of corporate credit unions. To avoid confusion with natural person CUSOs, however, this revised proposal does adopt the term ''corporate CUSO.'' In addition, for ease of reference, the definition of corporate CUSO has been included in Section 704.11, rather than being placed in Section 704.2.

The limitation on the types of entities that could be served by a CSO was designed to preserve the integrity of field of membership requirements. The thought was that if a corporate credit union could provide services to any natural person credit union through a CUSO, field of membership limitations would be less meaningful. Further, NCUA did not wish to address the issue of broadening corporate credit union fields of membership in the proposed regulation. The commenters, however, argued forcefully that CSOs should be able to provide services to non members. They suggested that a CSO should be permitted to develop expertise in a specific service which could benefit all natural person credit unions. NCUA agrees and the proposed rule allows corporate CUSOs to serve natural person credit unions that are not members of affiliated corporate credit unions.

In proposing to limit the services that could be provided by CSOs, NCUA was attempting to relate those services to the daily activities of corporate credit unions, that is, serving credit unions rather than natural persons. However, the commenters argued that CSOs should be able to participate in ventures related to services for members of natural person credit unions, such as shared branching and home banking. NCUA is persuaded that corporate CUSOs can have a broader purpose. Accordingly, this revised proposed rule requires simply that a corporate CUSO restrict its services to those related to the daily activities of credit unions. Section 701.27(d) of the NCUA Regulations provides guidance in this area.

Section 704.7 of the initial proposed rule limited the aggregate of all investments in and loans to member and non member CSOs to 15 percent of a corporate credit union's capital. Some commenters expressed concern that CUSOs involved in secondary mortgage market activities might need additional funds at certain times. This revised proposal allows a corporate credit union to loan to CUSOs an additional 15 percent of capital, provided that the loan is secured.

Section 704.7 of the initial proposal also incorporated some of the limitations and requirements of Section 701.27 (b) and (d). One of these was the requirement that the credit union ''ensure'' that it will not be held liable for the obligations of the CUSO. Some commenters stated that it was impossible to provide absolute assurance on this score. In response, Section 704.11(b) of this revised proposal requires a corporate credit union to 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. The point of this requirement is to obtain reasonable assurance that a corporate CUSO is operated as a sufficiently separate entity that a court would not ''pierce the corporate veil,'' conclude that the CUSO and corporate credit union were essentially the same organization, and hold the corporate credit union liable for the obligations of the CUSO. Since there seems to be some confusion on this issue, clarifying language has been added.

Since initial proposed Sections 704.7(b) and (c) received little comment, they have been retained in revised proposed Sections 704.11(c) and (d). Section 704.7(d) of the initial proposed rule required a corporate credit union to take steps to bring its investments and loans in line with the new regulation. Since CSOs were significantly more restricted than were CUSOs, it was possible that many investments in and loans to CUSOs would not have been authorized. This provision has not been retained in the revised proposed rule, as

corporate CUSOs will have much the same authority as existing CUSOs, and the majority of existing investments and loans will continue to be authorized. Finally, Section 704.11(e) of the revised proposed rule clarifies that the sole authority for a corporate credit union to invest in or loan to a CUSOs is that contained in Part 704.

Section 704.12—Services

Section 704.9 currently states that corporate credit unions may provide services involving investments, liquidity management, payment systems, and correspondent services. NCUA believed that this authority had, on occasion, been interpreted too broadly and proposed revising this section to eliminate the specific list of services. The initial proposal simply stated that corporate credit unions could provide services to their member credit unions, intending that to mean traditional loan, deposit, and payment services. The initial proposal also stated that a corporate credit union could provide services only to its members and could not provide services to non members through correspondent credit union arrangements or the service contract authority of Section 701.26 of the NCUA Rules and Regulations.

Some commenters expressed confusion regarding the prohibition against correspondent credit union arrangements. The intent was to prohibit arrangements whereby two corporate credit unions would agree for one to provide services to the members of another. NCUA has determined, however, that a corporate credit union may provide services to the members of another corporate credit union, provided that the second corporate credit union consents and NCUA has given its prior written approval. A corporate credit union also may provide correspondent services to non member, natural person credit union branch operating in the geographical area that the corporate credit union serves.

Section 704.13—Fixed Assets

Currently, Section 704.11 limits a corporate credit union's investment in fixed assets to 15 percent of capital. The initial proposed rule changed the limitation to 15 percent of primary capital, in order to control future large fixed asset investments. Some commenters argued that the proposed limitation was too restrictive, while others stated that corporate credit unions should not put a significant portion of their funds into fixed assets.

NCUA has determined that corporate credit unions may need to make greater investments in fixed assets, in order to better serve their member credit unions, and has set the limit in this revised proposed rule at 15 percent of capital. In addition, the requirements relating to the submission of waivers from the limitation have been condensed. As in the initial proposed rule, this revised proposal eliminates the provision regarding a corporate credit union proceeding with its investment if it does not receive notification of the action taken on its request within 45 days. This will ensure that NCUA has adequate time to review requests to invest more than 15 percent of capital in fixed assets.

Section 704.14—Representation

As noted earlier, NCUA amended the representation section of Part 704 in 1994. Those changes were made because NCUA was concerned about both real and apparent conflicts of interest. The initial proposed rule recodified that section as 704.13, and amended it further by providing that only representatives of member credit unions were permitted to vote and stand for election. It also incorporated by reference the provisions of Section 701.14 of the Rules and Regulations, governing changes in officials and senior executive officers in credit unions that are newly chartered or in troubled condition.

Although few comments were received on this section, NCUA has received assurances that this issue will be addressed by the corporate credit unions themselves and, thus, has determined not to go forward with the proposal to allow only representatives of member credit unions to vote and run for office.

For the reasons stated in the preamble to the initial proposed rule, this revised proposal again incorporates the provisions of Section 701.14.

Section 704.15—Audit Requirements

Currently, Section 704.13 only addresses the requirements for annual audits. The initial proposed rule recodified the provision at Section 704.14 and added a requirement for an internal auditor function for corporate credit unions with assets over $100 million. The proposed rule did not require the hiring of a full-time internal auditor, and the supplementary information section indicated that, based on the asset size and complexity of the institution, it would be permissible to hire a part-time auditor or contract with an outside firm to perform the function. The proposed rule did list specific responsibilities of the internal auditor.

Section 704.15 of the revised proposed rule segregates the audit requirements by external and internal functions. The external audit function relates to the annual opinion audit. Although the existing regulation contains the phrase reportable conditions letter, some commenters were confused about the meaning of the term. Accordingly, it has been deleted. This revised proposal requires that all correspondence provided to a corporate credit union by the external auditor be made available to NCUA.

A number of commenters stated that $100 million was too low a threshold for an internal auditor function requirement. NCUA agrees and has set a threshold of $400 million in this proposal. In addition, rather than listing specific responsibilities for the internal auditor, the revised proposed rule simply states that the auditor must meet the guidelines of the Standards and Professional Practices of Internal Auditing, as established by the Institute of Internal Auditors. This proposal also requires that the internal auditor report to the chair of the supervisory committee, who may delegate supervision of the internal auditor's daily activities to the chief executive officer of the corporate credit union. The authority to delegate was provided in response to comments that the supervisory committee normally is not directly involved in the daily operation of the corporate credit union,

Notwithstanding the statement in the supplementary information section that the proposed rule did not require the hiring of a full-time internal auditor, some commenters stated that the corporate credit union did not have the resources to hire such an auditor. Again, this is not required. Some corporates have the operational complexity to warrant a full-time internal auditor on staff. Other corporate credit unions may choose to hire a part-time internal auditor or contract with an outside firm to perform the internal auditor function.

Section 704.16—Contracts/Written Agreements

Neither the initial proposed rule nor this revised proposal made changes to this provision.

Section 704.17—State-Chartered Corporate Credit Unions

The initial proposed rule added new Section 704.16(b) to put non federally insured state-chartered corporate credit unions that receive funds from federally insured credit unions on notice that they were considered ''institution-affiliated parties'' within Section 206(r) of the Federal Credit Union Act and

subject to all of the enforcement provisions of the Act. There was no significant objection to the proposal and it has been retained in this revised proposed rule.

Section 704.18—Fidelity Bond Coverage

The currently regulation specifically lists the bond forms that NCUA has approved for corporate credit unions. NCUA has recently approved several new forms for credit unions, CUMIS Credit Union Bond 200, CUMIS Credit Union Bond 300, and CUMIS Credit Union Bond 400, all of which corporate credit unions may use, although some may not be appropriate for particular institutions. Rather than adding these to the proposal and then having to amend the regulation as other forms are approved in the future, this proposal deletes all references to specific bond forms. Instead of listing them in the regulation, NCUA will notify corporate credit unions of all approved forms as new forms are approved.

In current Section 704.17, the deductibles are based on a corporate credit unions primary capital to risk asset ratio. Since the initial proposed rule eliminated this ratio, the primary capital ratio was used in this section. The initial proposal also clarified that the minimum bond coverage would be based on a corporate credit union's average daily assets as of the preceding December 31. NCUA received few comments on this section.

Since the primary capital ratio is being eliminated in this revised proposed rule proposed Section 704.19 uses the corporate credit union's reserve ratio. NCUA requests comments on the effect of this change on a corporate credit union's deductible. In addition, the proposed rule deletes current Section 704.17(e), which allows a corporate credit union to request approval for reduced coverage. Under Section 704.1, a corporate credit union may request a waiver of any provision of Part 704.

Appendix A—Model Forms

Appendix A of the current rule sets forth a summary of risk weights and risk categories used to calculate a corporate credit union's capital to risk-weighted assets ratio. Since this revised proposed rule eliminates the required calculation of that ratio, the summary has been deleted. Appendix A of this revised proposal contains variations of the model disclosure forms that were set forth in Appendix C of the initial proposal.

Appendix B—Expanded Authorities and Requirements; Appendix C—Guidelines for Evaluating Requests for Expanded Authorities

Appendix B of the current rule sets out off-balance-sheet conversion factors that are used in calculating the capital to risk-weighted assets ratio. Since the ratio is not used in this proposal, the factors have been deleted. Appendix C currently contains a list of U.S. Government obligations and agencies. Rather than having a fixed list, which may become outdated as entities are created, dissolved, or changed, the proposed rule contains definitions of government agencies and enterprises and places the responsibility for determining an entity's status on the corporate credit union.

Appendix B of this revised proposal sets forth incrementally greater authorities for corporate credit unions and the infrastructure and capital requirements that must be in place to obtain such authorities. NCUA recognizes that each corporate credit union has partly evolved in response to unique competitive forces and member needs. The mission of a corporate credit union and its capacity to fulfill its respective goals can vary considerably from institution to institution. Expanded authorities were established to permit the corporate credit unions that qualify to obtain a reasonable expansion of market and credit risk limits. This mechanism permits the flexibility for self-determination and it avoids the consequence of regulating down to the least developed institutions at the expense of the most developed.

The expanded authorities are a natural extension of the existing waiver process whereby a corporate can submit a request to NCUA to obtain additional powers or an exemption from some provision of the rules and regulations. None of the incremental powers provided for in this proposal are beyond the scope of existing waiver authorities. Codifying these powers in the regulation standardizes the process and provides an established set of criteria for approval.

Authorities are segregated into four parts to allow for some measure of selectivity by corporate credit unions that may seek only limited expansions of their basic operating powers. These parts, and their respective guidelines for approval, are based upon an increasing scale of depth and complexity. Greater expansions of authority are supported by greater capacities to measure and control the corresponding risks.

Proposed Appendix C sets forth guidelines for evaluating requests for expanded authorities. The guidelines are based, in part, on a number of subjective factors. Factors include the areas of board, management and staff; systems and operations; credit risk management; liquidity risk management; audit and compliance; and legal.

The proposal requires that a corporate credit union seeking to use the expanded authorities set forth in Part 1 of Appendix B have a capital ratio of 5 percent and meet additional infrastructure criteria set forth in Appendix C. Additional capital is required because of the greater opportunity to take risk. Strengthened management, staff, and systems are required in order to safely manage that risk. A corporate credit union seeking to use the even more expanded authorities set forth in Part 2 of Appendix B must have a capital ratio of 6 percent and meet even stronger infrastructure criteria. Again greater risk requires greater protection against loss and greater ability to manage the risk.

The proposal requires that a corporate credit union seeking to invest in foreign obligations, as set forth in Part 3 of Appendix B, have a capital ratio of 5 percent, meet the infrastructure criteria required for corporate credit unions seeking the expanded authorities under Part 1 of Appendix B, and meet additional infrastructure criteria relating to automation of systems and staff experience with foreign credit. A corporate credit union seeking to use financial derivatives, as set forth in Part 4 of Appendix B, also must have a capital ratio of 5 percent and meet the infrastructure required for corporate credit unions seeking the expanded authorities under Part 1 of Appendix B. In addition, the corporate credit union must apply to NCUA for the specific derivatives authority sought and have additional staff and systems in place to adequately control the risks of such instruments.

Part 709—Involuntary Liquidation and Creditor Claims

Section 709.5(b) of the NCUA Rules and Regulations establishes a payout priority for claims against credit unions that are in involuntary liquidation. Currently, the seventh item is membership capital share deposits of corporate credit unions. Since the proposed rule uses the term ''membership capital,'' the words ''share deposits'' have been deleted. The proposed rule also provides for an eighth item, *i.e.,* paid-in capital.

Part 741—Requirements for Insurance

The initial proposed rule amended Section 741.3 of the NCUA Rules and Regulations, governing requirements for insured credit unions, to prohibit federally insured credit unions from transacting business with corporate credit unions that did not comply with Part 704 and were not examined by NCUA. There was no significant objection to the proposal and it has been retained in this revised proposed rule. In the interim, Section 741.3 has been recodified, so this revised proposed rule creates new Section 741.219, containing the same language as set forth in the initial proposal.

H. 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 collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)). Comments on the collection of information should be directed to Ms. Beauchesne, at the National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314–3428; Fax No. (703) 518–6433; E-Mail Address: SUEB@NCUA.GOV within 90 days from the date of this publication in the Federal Register. Comments should also be sent to the OMB Desk Officer at the following address: Mr. Milo Sunderhauf, OMB Reports Management Branch, New Executive Office Building, Room 10202, Washington DC 20530.

The collection of information requirements in this proposed regulation are found in 12 CFR [704.2; 704.3(a); 704.4(a); 704.6(a); 704.7(a); 704.8(a); 704.3(e)–(g); 704.5(b)(i)–(v); 704.6(e); 704.8(e)–(g); 704.10; 704.15(b); and Appendices A and B]. This information is required by corporate credit union management and staff in making critical operational decisions on an ongoing basis. Additionally, the information will be utilized by NCUA during the annual examination and the ongoing supervision process. The respondents and recordkeepers are corporate credit unions. Respondents and recordkeepers are not required to respond to this collection of information unless it displays a currently valid OMB control number.

Respondents: Corporate credit unions.

Estimated number of respondents and/or recordkeepers: 41.

Estimated average annual burden hours per respondent/recordkeeper: 3,909 hours.

Estimated total annual reporting and recordkeeping burden: 160,293 hours.

Estimated Total Annual Cost: $4,018,630.

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 proposed rule would 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.

I. List of Subjects

12 CFR Part 704

Credit unions, Reporting and recordkeeping requirements.

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 May 22, 1996.

Becky Baker,

Secretary of the Board.

For the reasons set out in the preamble, NCUA proposes to amend 12 CFR parts 704, 709, and 741 as follows:

1. Part 704 is revised to read as follows:

PART 704—CORPORATE CREDIT UNIONS

Sec.
704.1 Scope.
704.2 Definitions.
704.3 Corporate credit union capital.
704.4 Board responsibilities.
704.5 Investments.
704.6 Credit risk management.
704.7 Lending.
704.8 Asset and liability management.
704.9 Liquidity management.
704.10 Divestiture.
704.11 Corporate Credit Union Service Organizations (Corporate CUSOs).
704.12 Services.
704.13 Fixed assets.
704.14 Representation.
704.15 Audit requirements.
704.16 Contracts/written agreements.
704.17 State-chartered corporate credit unions.
704.18 Fidelity bond coverage.

Appendix A to Part 704—Model Forms

Appendix B to Part 704—Expanded Authorities and Requirements

Appendix C to Part 704—Guidelines for Evaluating Requests for Expanded Authorities

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

PART 704—CORPORATE CREDIT UNIONS

§ 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 must be approved by the state regulator before being submitted to NCUA.

§ 704.2 Definitions.

Adjusted trading means any method or transaction used to defer a loss 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).

Business day means a day other than a Saturday, Sunday, or federal holiday.

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 whole loan 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.

Commitment means any unconditional arrangement that obligates a corporate credit union to extend credit in the form of loans; to purchase loans, securities or other assets; or to participate in loans and leases. Commitments also include overdraft facilities, revolving credit, home equity, and mortgage lines of credit, and similar transactions. An obligation is conditional if the corporate credit union is not automatically obligated to extend funds.

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.

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, caps, floors, and prepayment options.

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 transfer of funds between U.S. depository institutions.

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 rate agreement means an over-the-counter contract between counterparties where one party agrees to pay the other a specified interest rate payment on a reference notional amount at a specified date in the future (settlement date). The amount paid or received at the settlement date of the contract is based on the market value of the contract. The market value depends upon the notional amount, the contract rate, and the prevailing market reference rate at the time of settlement.

Futures contract means a contract for the future delivery of commodities, including certain money market instruments and government securities, sold on commodities exchanges.

Gains trading means the purchase of a security as an investment portfolio asset and the subsequent sale of that same security at a profit after a short-term holding period.

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.

Market value of portfolio equity (MVPE) means the fair value of assets minus the fair value of liabilities. All fair value calculations must include the value of embedded options. Membership capital is treated as a liability for purposes of this calculation. The MVPE ratio is calculated by dividing MVPE by the fair value of assets.

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

Material means an amount that exceeds 5 percent of the corporate credit union's capital.

Maturity date means the date on which a security matures, and shall not mean the call date or the average life of the security.

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). 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. Membership capital may be sold to a member, 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 established and disclosed by the corporate credit union at the time the account is opened (e.g., one percent of a member credit union's assets). 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 backed security means a security that represents either an ownership claim in a pool of mortgages or an obligation that is secured by such a pool, where the cash flows are passed through to the holders of the security.

Mortgage related security means a security as defined in Section 3(a)(41) of the Securities Exchange Act of 1934, 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 interest income means the difference between income earned on interest bearing assets and interest paid on interest bearing liabilities.

Nonsecured investment means an obligation backed solely by the creditworthiness of the obligor.

Official means any director or committee member.

Option contract means a right, but not an obligation, to buy or sell a security at a specified price and settlement date in the future.

Paid-in capital means funds which are obtained from credit union and non credit union sources and are available to cover losses that exceed reserves and undivided earnings. Paid-in capital is nonvoting and subordinate to membership capital and the NCUSIF. The funds have no maturity 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. The terms and conditions of a paid-in capital account held by a member or non member credit union must be disclosed to the recorded owner of such account at the time the account is opened and at least annually thereafter.

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

Penalty for early withdrawal of a share, deposit, or liability means a fee which will, at a minimum, fully compensate a corporate credit union for the difference between fair value and book value of the asset that is divested (including any accumulated losses since the asset was purchased), or the replacement cost of funds, to meet the demand for early withdrawal.

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.

Primary dealer means a bank or investment dealer authorized to buy and sell government securities in direct dealings with the Federal Reserve Bank of New York in its execution of Fed open market operations.

Private placement means the sale of an entire issue to a small group of investors. Except for investments with tax shelter provisions, private placement to 35 or fewer investors are exempt from Securities and Exchange Commission registration requirements.

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.

Repurchase transaction means a transaction in which a corporate credit union agrees to purchase a security from a counterpart and to resell the same or any identical security to that counterpart 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 mean all regular or statutory reserves, including 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.

Reverse repurchase transaction means a transaction whereby a corporate credit union agrees to sell a security to a purchaser and to repurchase the same or any identical security from that

purchaser at a future date and at a specified price.

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

Secured loan means a loan collateralized by assets in which the lender has perfected a security interest under state law.

Securities lending transaction means a transaction in which a federal credit union agrees to lend a security to a counterparty.

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 counterpart 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 and Exchange Act of 1934, *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.

Swap agreement means a contract to exchange payments that are based upon a specified dollar amount at specified dates in the future.

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.

Tri-party contract means a repurchase agreement between two parties in which a third party acts as a custodian for the securities involved.

Undivided earnings means all forms of retained earnings, except:

(1) Regular or statutory reserves; and

(2) Valuation allowances established to meet the full and fair disclosure requirements of § 702.3 of this chapter.

United States Government or its agencies means the United States Government or instrumentalities of the United States, the debt obligations of which are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the United States Government.

United States Government-sponsored corporations and enterprises means agencies originally established or chartered to serve public purposes specified by Congress, the debt obligations of which are not explicitly guaranteed by the full faith and credit of the United States Government.

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.

Wholesale corporate credit union means a corporate credit union which meets the requirements of Part II of Appendix B of this part and 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 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. In the case of a state-chartered corporate credit union, NCUA also will provide notification and explanation to the state supervisory authority.

(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 10 business 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 10 business 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, and, in the case of a state-chartered corporate credit

union, in consultation with the state supervisory authority, 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, as applicable, operating management of the corporate credit union must notify its board of directors, supervisory committee, and NCUA within 10 business 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, and in the case of a state-chartered corporate credit union, to the state supervisory authority, within 30 business days of the occurrence.

(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. In the case of a state-chartered corporate credit union, NCUA also will provide notice to the state supervisory authority.

(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 10 business 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 its comments to be considered, the state supervisory authority must respond in writing within the same 10 business days. For good cause, the response time may be shortened or lengthened, including the following conditions:

(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 10 business 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. The board of directors must know and understand the activities, policies, and procedures of the corporate credit union.

(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 with adequate cross-training are in place;

(3) GAAP is followed;

(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 necessary retention of external consultants to review the adequacy of technical, human, and financial resources dedicated to support major risk areas.

§ 704.5 Investments.

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

(b) 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 and Section 107(8) institutions and deposits in 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, subject to these additional limitations:

(i) Fixed rate CMOs/REMICs must meet the following NCUA-modified Federal Financial Institutions Examination Council (FFIEC) High Risk Security Test requirements:

(A) The weighted average life may not exceed 5 years at the time of purchase;

(B) The weighted average life may not extend by more than 2 years, nor contract by more than 3 years for an instantaneous, permanent, and parallel shift in market rates of plus or minus 300 basis points;

(C) The extended weighted average life may not, in any case, exceed 7 years; and

(D) The investment's price may not decline by more than 15 percent for an instantaneous, permanent, and parallel shift in market rates of plus or minus 300 basis points;

(ii) Floating rate CMOs/REMICs must meet the following NCUA-modified FFIEC High Risk Security Test requirements:

(A) The weighted average life of the security may not exceed 7 years at the time of purchase;

(B) The weighted average life may not extend by more than 2 years, nor contract by more than 3 years for an instantaneous, permanent, and parallel shift in market rates of plus or minus 300 basis points;

(C) The extended weighted average life may not, in any case, exceed 9 years; and

(D) The investment's price may not decline by more than 10 percent for an instantaneous, permanent, and parallel shift in market rates of plus or minus 300 basis points;

(iii) The NCUA-modified FFIEC High Risk Security Tests must be prepared monthly on all CMO/REMICs, documented and reviewed by an appropriate committee, and retained until after completion of the next audit and examination;

(iv) 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; and

(v) 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 tests set forth in paragraph (b)(6) of this section.

(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.

(c) A corporate credit union may enter into a repurchase agreement or securities lending transaction provided that:

(1) The corporate credit union takes physical possession of the security, receives written confirmation of the purchase and a safekeeping receipt from a third party under a written custodial contract, or is recorded as owner of the security through the Federal Reserve Book-Entry Securities Transfer System;

(2) Collateral securities are legal investments for corporate credit unions, except that a corporate credit union may receive, as permissible collateral, CMO/REMIC securities that pass the FFIEC High Risk Security Test if the term of the repurchase transaction does not exceed 95 days from the date of settlement;

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

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

(5) The corporate credit union has entered into signed contracts with all approved counterparts. 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 collateral is 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 collateral securities.

(d) 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 management company is restricted by its investment policy, changeable only if authorized by shareholder vote, solely to investments and investment transactions that are permissible for that corporate credit union.

(e) A corporate credit union is prohibited from:

(1) Purchasing or selling financial derivatives such as futures, options, interest rate swap contracts, or forward rate agreement;

(2) Engaging in pair-off transactions, when issued trading, adjusted trading, gains 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.

(f) 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.

(g) 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, which addresses, 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 counterpart, 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 counterparts 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.,* sector, industry, and regional concentrations);

(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 counterpart 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.

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

(3) Any rated instrument that is downgraded by the nationally recognized statistical rating organization(s) used to meet the requirements of this part at the time of purchase must be reviewed by an appropriate committee within 20 business days of the downgrade. Instruments that fall below the minimum rating requirements of this part are subject to the divestiture requirements of 704.10.

(4) Investments in asset-backed securities must be rated no lower than AAA (or equivalent). All other investments must be rated no lower than A–1 (or equivalent) for short-term investments and AA (or equivalent) for long-term investments at the time of purchase and at any subsequent time by the nationally recognized statistical rating organization(s) used to meet the requirements of this part at the time of purchase.

(e) *Reporting and documentation.*

(1) A written evaluation of each credit line must be prepared at least annually and formally approved by an appropriate committee of the board. A watch list of existing and/or potential credit problems must be prepared at least monthly and provided to an appropriate committee of the board. Summary credit exposure reports, which demonstrate compliance with the corporate's risk management policies, must be continuously maintained, reviewed by appropriate staff, and provided monthly to the board.

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

(i) A justification for each approved credit line;

(ii) Prospectuses for all publicly traded securities and offering memoranda for private placements and securities that are exempt from the registration requirements of the Securities Act of 1933 or the margin requirements of the Securities Exchange Act of 1934; and

(iii) The latest available financial reports, industry analyses, internal and external analyst evaluations, and rating agency information for 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.* The maximum aggregate amount in 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, for unsecured loans and irrevocable lines of credit, or 100 percent of capital or 200 percent of the sum of reserves and undivided earnings and paid-in capital, whichever

is greater, for secured loans and irrevocable lines of credit.

(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. 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 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 market value of portfolio equity (MVPE), over specified periods of time, compared to current MVPE;

(4) The minimum allowable MVPE ratio under any condition;

(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 (e) of this section;

(7) Concentration limits that reflect the default, liquidity, and market risks of investments;

(8) Policy limits which address transaction types and amounts for all off-balance sheet risk (e.g., lines of credit or other contracts); and

(9) 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 the 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, 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) *Risk analysis.* A corporate credit union must adopt appropriate tests and criteria for evaluating each investment prior to its purchase. Risk analysis of the instrument type and industry sector must be conducted for any new product that is considered for purchase by the corporate credit union and/or for sale to members.

(e) *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 or minus 100, 200, and 300 basis points on its MVPE and MVPE ratio. If the base case MVPE ratio falls below 2 percent at the last testing date, these tests must be calculated no less frequently than monthly until the base case MVPE ratio again exceeds 2 percent; and

(ii) Limit its risk exposure to levels that do not result in a MVPE ratio below 1 percent at any time either from a calculation of a base case MVPE ratio or as a result of the tests indicated in paragraph (e)(1)(i) of this section.

(2) A corporate credit union must limit its risk exposures to levels that do not result in a decline in MVPE of more than 18 percent at any time.

(3) 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 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.

(f) *Regulatory violations.* If a corporate credit union's base case MVPE or MVPE ratio or the MVPE or MVPE ratio resulting from the tests indicated in paragraph (e)(1)(i) of this section decline below the limits established by this part and are not brought into compliance within 5 business days, operating management of the corporate credit union must report the information to the board of directors, supervisory committee, and NCUA on the sixth business day. If any of these measures remain below the limits established by this part by the 25th business day, 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 MVPE or MVPE 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. A specific written disclosure detailing the limit violation(s) and the intended course of action must be sent to NCUA within 25 business days after disclosure to the board.

§ 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) Continuously 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 an appropriate committee of the board 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, through periodic usage of external lines, that all 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 20 business days of the failure, report the failed investment to its board of directors 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, by the 25th business day after 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) 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.

(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 it is a secured loan. 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 or senior management employee of a corporate credit union which has invested in or loaned to a corporate CUSO, and immediate family members of such an individual, may not receive, either directly or indirectly, any salary, commission, investment income, or other income, compensation, or consideration from the corporate CUSO. This prohibition extends to any other corporate credit union employee if such employee deals directly with the corporate CUSO.

(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 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), 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, which will provide a written decision.

§ 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); and

(4) For purposes of meeting the requirements of paragraphs (a)(1) and (a)(2) 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.

(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 member credit unions.* (1) A member credit union 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 member credit union 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 reference is made to ''Regional Director,'' substitute ''NCUA.''

§ 704.15 Audit requirements.

(a) *External audit.* The corporate credit union supervisory committee shall cause an annual opinion audit to be made by an independent, duly licensed certified public accountant (CPA) and 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 days after receipt by the board of directors. The CPA's audit workpapers shall be provided upon request to NCUA. A summary of the audit report shall be submitted 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).

§ 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 employees, 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 as of December 31 of the preceding 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 above minimums.

(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.

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 up to a maximum of $1 million.

(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 20 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 days after the date of written notice from NCUA.

Appendix A—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 account 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 Account

(1) A paid-in capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) The funds have no maturity 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.

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

(4) Paid-in capital is nonvoting and subordinate to membership capital 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 paid-in capital account.

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—Expanded Authorities and Requirements

A corporate credit union may obtain expanded authorities if it meets all of the requirements of 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. 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 these additional authorities after NCUA has provided its written 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. Further guidance on the characteristics necessary to obtain additional authorities is available in Appendix C.

Part I

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

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

(2) Meet the management, staff, systems, compliance, legal, and risk assessment requirements specified in Appendix C.

(3) Evaluate monthly the changes in MVPE and the MVPE ratio for the tests set forth in § 704.8(e)(1)(i).

(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 short-term investments rated no lower than A–1 (or equivalent) and long-term investments rated no lower than AA– (or equivalent); at the time of purchase and at any subsequent time by same nationally recognized statistical rating organization(s) used at the time of purchase.

(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; and

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

(d) In performing the rate stress tests set forth in § 704.8(e)(1)(i), the MVPE 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 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 for unsecured loans and irrevocable lines of credit. The board 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;

(2) Meet the management, staff, systems, compliance, legal, and risk assessment requirements specified in Appendix C.

(3) Evaluate monthly the changes in MVPE and the MVPE ratio for the tests set forth in § 704.8(e)(1)(i).

(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 non secured obligations of any single domestic issuer up to 250 percent of the sum of reserves and undivided earnings and paid-in capital;

(2) Purchase short-term investments rated no lower than A–1 (or equivalent) and long-term investments rated no lower than A– (or equivalent) at the time of purchase and at any subsequent time by the nationally recognized statistical rating organizations used at the time of purchase.

(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; and

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

(d) In performing the rate stress tests set forth in § 704.8(e)(1)(i), the MVPE 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 Part I of this Appendix and the foreign investment criteria set forth in Appendix C, may invest in:

(1) Debt obligations of a foreign country;

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

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

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

(b) All investments with sovereign entities and foreign banks are subject to the following requirements:

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

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

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

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

Part IV

A corporate credit union which has met the requirements of paragraph (a) of Part I of this Appendix and the financial derivatives criteria set forth in Appendix C, 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.

Appendix C—Guidelines for Evaluating Requests for Expanded Authorities

This Appendix provides guidance for corporate credit unions which seek expanded authorities under Appendix B of part 704. These guidelines represent the prudent practices and acceptable qualifications which must be evident in a corporate credit union for NCUA to approve its request. There are four distinct expanded authority alternatives which are set forth Appendix B. Corporate credit unions which are granted expanded authorities must adhere at all times to the requirements set forth in Appendix B and Appendix C. NCUA will ensure that corporate credit unions continue to meet the necessary qualifications and remain in sound financial condition through its regular, on-going safety and soundness review. Provided that the corporate credit union is in sound financial condition, the primary areas which are used to evaluate each request for expanded authority are: board, senior management, and staff; systems and operations; credit risk management; liquidity risk management; audit and compliance; and legal matters.

Part I

(a) *General.* Requests for the expanded authorities as outlined in Appendix B, Part I, will be evaluated based on the criteria outlined in paragraphs (b) through (g) of this Appendix C, Part I.

(b) *Board, senior management, and staff.*

(1) The board has received adequate training and is sufficiently knowledgeable to make informed decisions regarding the risk activities of the corporate credit union and to properly evaluate the use of the expanded authorities.

(2) Senior management has in-depth experience in their direct areas of responsibility and a working knowledge of most key areas.

(3) The asset and liability committee (ALCO) members are conversant in investment activities and strategies and are

capable of individually explaining, justifying, and supporting the risk exposures of the corporate credit union.

(4) Senior investment managers and asset and liability managers have knowledge and experience commensurate with the potential expanded authorities of the corporate credit union.

(5) Staff supporting the asset and liability management functions have expert knowledge in developing and applying the assumptions, methodologies, and interrelationships between the financial factors driving the risk measurement results. The staff has the ability to adjust the model and customize applications consistent with the additional test requirements of § 704.8(e)(3).

(6) Qualified designated back-ups are in place and capable of assuming primary responsibilities. Back-ups are adequately trained to ensure that minimum disruption would occur in the event of the loss (temporary or permanent) of primary personnel.

(7) Qualified, cross-trained personnel are in place for all essential support positions.

(c) *Systems/Operations.* (1) Systems support and operational capacity are adequate to process, measure, monitor, and report all financial transactions. This includes the capacity to handle volume and complexity with timely and accurate results. Systems can provide sophisticated measures of valuation for a variety of simulated market scenarios. Systems can interface, and automation ensures a strong measure of control and standardization.

(2) The major financial-related areas, which require a particular emphasis upon support and control, are the accounting and risk measurement systems. Specific areas of infrastructure strength include, but are not limited to, the following areas:

(i) Valuation of instruments and risk measurement.

(A) Methodologies permit alternative scenario analysis in addition to those required in § 704.8(e)(3).

(B) Qualified staff are capable of challenging and validating the analytical applications and assumptions of the risk measurement methodologies.

(C) Simulations can be produced in a timely, accurate manner on at least a monthly basis.

(D) Variance analysis is conducted each month to evaluate and explain the reasons for differences between projected and actual results.

(E) The model(s) and supporting processes are capable of meeting the needs of management reporting for both compliance and decision-making.

(F) The model(s) and supporting statistical analyses used to measure risk are validated prior to use and periodically thereafter.

(ii) Accounting for transactions.

(A) Accounting processes are independent of the risk taking unit (investments).

(B) Accounting systems and processes are commensurate with instruments that have complex structures and/or embedded options, including off-balance sheet activities.

(C) Systems have a demonstrated ability to produce timely, accurate financial statements for internal and external purposes, in conformance with GAAP.

(D) There is an on-line, dedicated, and automated system capable of providing timely, accurate reports independent of the corporate credit union's risk taking unit. Reports are standardized and may be customized for both financial and risk reporting purposes. For example, systems would include:

(*1*) Automated data transfer;

(*2*) On-demand report generation based on current data;

(*3*) Ability to account for investments with complex structures and/or embedded options including off-balance sheet activities;

(*4*) Accounts for all investment characteristics and cash flows;

(*5*) General ledger treatment—amortization/accretion of discounts/premiums can be produced for dynamic cash-flow instruments and transactions;

(*6*) Security safeguards that ensure protection and integrity of input and output through a dedicated and controlled system environment;

(*7*) Ability to handle expanded authorities and changes in strategies and external market factors; and

(*8*) Establishment and maintenance of adequate back-up arrangements to minimize the disruption of major services and to address system problems timely.

(d) *Credit risk management.* The credit risk management function is independent and able to assess the inherent risk associated with all concentrations, limits and proposed transactions, including any additional authorities provided in Appendix B. The measuring and monitoring methodologies are sufficient to meet the scope and complexity of all credit related activities. (1) Management/Staff. (i) Credit risk management is independent from the risk taking unit and is directed by a level of senior management sufficient to ensure that credit risk activities remain consistent with board policies and objectives.

(ii) Analysts are qualified to identify and assess the inherent credit risk in all transactions that possess material credit exposures. Analysts have knowledge and experience in evaluating credit risk in the money and capital markets.

(2) Policies and procedures. (i) Procedures address the methodology for measuring and monitoring credit risk and the means of responding to a deterioration in credit.

(ii) There is a daily process of measuring and reporting the credit exposures in comparison to policy limits.

(iii) Procedures provide the risk taking unit with daily credit exposures and remaining limit capacity.

(iv) Credit limits and transaction types are approved by a credit risk committee to ensure consistency with corporate credit union objectives.

(v) Senior credit personnel have the direct authority to reduce, suspend, or revoke a credit limit.

(e) *Liquidity risk management.* (1) Effective controls exist for liquidity exposures arising from both market or product liquidity and instrument cash flows.

(2) Daily liquidity management procedures for investment activities are an integral part of the day-to-day operations.

(3) Management reporting includes an on-going daily liquidity assessment which is updated to reflect current changes to investment and funding positions.

(f) *Audit and compliance.* (1) The internal audit and compliance area has staff, or has engaged outside personnel, with expert knowledge and experience adequate to support the scope and complexity of all activities associated with expanded authorities.

(2) The scope of review addresses appropriateness of risk as well as general compliance issues.

(g) *Legal issues.* The corporate credit union has inside legal counsel or has access to outside counsel which can provide a specialized review of all associated legal matters.

Part II

(a) *General.* Requests for the expanded authorities as outlined in Appendix B, Part II, will be evaluated based on the criteria outlined in paragraphs (b) through (f) of this Appendix C, Part II.

(b) *Senior management and staff.* (1) Senior management is demonstrably familiar with key areas of the corporate credit union and conversant in technical factors affecting the institution's risk.

(2) Senior management is substantially represented by individuals who have extensive related experience with a depository institution, investment banker, or broker/dealer.

(3) Investment and risk management staff have substantial experience and have received extensive training to support expanded authorities.

(c) *Systems and operations.* (1) Qualified staff are capable of modeling securities and financial transactions to determine that components are valued consistent with the market. This means that the value of all transactions, securities, and options can be independently determined by corporate credit union staff.

(2) Senior management receives a daily position report detailing current activities, mark-to-market valuations, balance sheet positions, and other critical financial information.

(d) *Credit risk management.* (1) Management and staff. (i) Senior credit analyst(s) has extensive experience (e.g., years of experience, held positions of responsibility, and/or completed specialized credit training in capital markets) with particular emphasis on evaluating financial institutions and debt securities.

(ii) Sufficient number of analysts are on staff to ensure that all credits receive appropriate, timely, and in-depth analysis.

(2) Policies and procedures. (i) The credit risk management is a stand-alone unit.

(ii) There is a formal credit risk committee which approves all credit limits.

(e) *Audit and compliance.* (1) There is an independent, stand-alone risk compliance unit managed by senior staff who are capable of comprehending, evaluating, and challenging all potential risk areas of the corporate credit union.

(2) A highly qualified senior management executive is responsible for the unit.

(3) The unit is responsible for assuring the board of directors that staff in all potential risk areas are conducting their activities in conformance with all board policies and procedures.

(4) The unit is also responsible for assisting management in developing and enhancing the existing risk management processes to improve the areas where potential weaknesses or deficiencies are identified.

(5) The unit has specialized staff with extensive knowledge of systems, policies, and procedures used to govern all approved activities and which understands the inherent risk issues affecting those activities.

(f) *Legal issues.* The corporate credit union maintains inside counsel or has established relationships with outside legal firms which specialize in evaluating relevant contracts and transactions to ensure that the corporate credit union's legal and business interests are represented for all expanded authorities.

Part III

(a) *General.* Requests for the expanded authorities as outlined in Appendix B, Part III, will be evaluated based on the criteria for management, staff, systems, compliance, legal, and risk assessment specified in Part I of this Appendix C and the additional criteria outlined in paragraphs (b) and (c) of this Part III.

(b) *Senior management and staff.* (1) Senior management has addressed the unique potential risk impact of foreign investments and has contingency policies and procedures to address these factors.

(2) Staff includes qualified analysts with knowledge and experience evaluating cross-border risk.

(3) Analysts are experienced in evaluating sovereign and foreign institution credits and conduct a timely, in-depth analysis for all approved foreign limits.

(4) Analysts have training and/or experience in evaluating the political, economic and regulatory environment and the unique financial and accounting standards which affect the interpretation of financial data used to evaluate foreign counterparties.

(c) *Systems and operations.* (1) An automated system is in place which monitors all foreign investment exposures by entity and country and is updated daily or as exposures change; and

(2) Credit risk management procedures address the unique political, legal, and economic factors which potentially affect all approved foreign counterparties.

Part IV

(a) *General.* Requests for the expanded authorities as outlined in Appendix B, Part IV, will be evaluated based on the criteria for management, staff, systems, compliance, legal, and risk assessment specified in Part I of this Appendix C and the additional criteria outlined in paragraphs (b) through (h) of this Part IV.

(b) *Request to NCUA for authority.* The request for derivative authority must include, at a minimum, the following:

(1) A detailed description of the relevant products, markets and business strategies including examples of how each type of proposed transaction will work;

(2) The methodology for measuring exposures and the proposed limits on each type of transaction, as well as an aggregate limit based upon a percentage of capital at risk;

(3) The costs associated with establishing effective risk management systems and hiring and retaining professionals with derivative transaction experience;

(4) An analysis which justifies the reasonableness of the proposed activities relative to the corporate credit union's overall financial condition and capital level;

(5) An analysis of the risks that may arise from the use of derivatives which includes, at a minimum, market, credit, liquidity, operations, and legal risks;

(6) The detailed procedures the corporate credit union will use to effectively identify, measure, monitor, report, and control risks;

(7) The relevant accounting guidelines to be used;

(8) Internal control procedures detailing the segregating of duties between the staff that executes transactions and operational personnel that monitor and report activity; and

(9) The scope of the audit and internal risk monitoring functions.

(c) *Board, senior management, and staff.* (1) Board and senior management have sufficient knowledge and experience to understand, approve, and provide oversight for all proposed derivative activities.

(2) Board members and responsible management and staff have received adequate training to familiarize them with all relevant aspects of effective derivative use and related control issues before assuming risk exposures.

(3) Board and senior management understand and agree that the risk management process that will be used is appropriate and that actual and potential risk exposures will be clearly identified and fully disclosed to the board on a regular basis.

(4) Senior management has retained knowledgeable and experienced personnel in derivative transactions for both the management and operations functions.

(5) The manager directly responsible for these activities has extensive related experience with a depository institution, investment banker, or broker/dealer.

(d) *Systems and operations.* (1) The board has dedicated sufficient financial and personnel resources to support operations and systems development and maintenance. The sophistication of the systems support and operational capacity is commensurate with the size and complexity of the derivatives activity.

(2) Derivatives support systems provide accurate and timely transactions processing and allow for proper risk exposure monitoring and interfacing with other systems of the corporate credit union.

(3) The risk measurement system is capable of quantifying the risk exposures resulting from derivatives activities arising from changes in relevant market factors.

(4) The market risk measurement system is capable of producing prompt and accurate assessments at least monthly.

(5) The risk management system addresses, at a minimum, the following:

(i) Procedures that accurately identify and quantify risk levels on a timely basis;

(ii) Limits and other controls on levels of risk associated with counterparty credit, concentrations and other relevant market factors;

(iii) Limits on aggregate risk positions which capture the inter-connected effect of all positions;

(iv) Reports to senior management and the board that accurately present the types and amounts of risks assumed and demonstrate compliance with approved policies and limits; and

(v) Auditing procedures to ensure the integrity of risk management systems and confirm compliance with approved policies and procedures.

(6) Appropriate resources are devoted to operations sufficient to support the scope and complexity of the activities.

(7) Effective senior management supervision and Board oversight is in place to ensure that all derivative activities are conducted in a safe and sound manner.

(8) Comprehensive written policies and procedures are approved by the board and periodically reviewed thereafter as activity levels or market and business conditions warrant.

(9) Procedures support the proper control over the recordation, settlement, and monitoring of derivative transactions. Internal controls assure that proper processing procedures for all transactions and reconciliation of front and back office databases is done on a regular basis.

(10) Policies and procedures address risk management (market, credit, liquidity, and operations), legal issues, capital requirements, and accounting standards. In conjunction with the credit risk function, the methods of valuation (e.g. bid side or mid-market) are appropriate and the sources and methods of pricing are reasonable and supportable.

(e) *Credit risk management.* (1) Policies and procedures are in place to address, at a minimum, significant counterparty exposures, concentrations, credit exceptions, risk ratings, and non performing contracts. Management has established internal limits which are prudent and consistent with the corporate credit union's financial condition and management's expertise.

(2) Timely, detailed reports, which are consistent with the policy and procedure requirements, are available for board and senior management review. Reports consolidate activities by counterparty and are incorporated into aggregate credit exposure reports for other non derivative exposures.

(3) Approved counterparts have credit ratings no lower than operating parameters authorized for the corporate credit union under Part I of this Appendix B.

(4) Credit personnel are qualified to identify and assess the inherent credit risk in all proposed derivative transactions.

(5) Procedures ensure credit analysis of counterparties is performed before transactions are executed and there is periodic assessment of credit throughout the life of outstanding derivative transactions.

(6) Credit procedures address the availability and impact of credit exposure reduction techniques (*e.g.*, bilateral collateral agreements and/or mutual margining agreements).

(7) The corporate credit union can calculate the current mark-to-market (current exposure) as well as projected changes in value (potential exposure) when assessing credit exposure per transaction and counterparty.

(8) Reports track the aggregate and net exposures for each counterparty.

(9) Mark-to-market calculations are obtained independently from qualified sources as frequently as necessary.

(10) Policies and procedures address the issue of settlement risk and establish prudent settlement limits where applicable.

(f) *Liquidity risk management.* (1) Effective controls exist for liquidity exposures arising from both market or product liquidity and instrument cash flows.

(2) Policies address the exposures to cash flow gaps arising from derivative transactions and establish appropriate limits on the size and duration of such gaps (e.g., concentration of swap payments, margin calls, or early terminations).

(3) Liquidity management procedures for derivatives are an integral part of the day-to-day operations and are also incorporated into the overall liquidity stress test and contingency funding plan requirements of § 704.8.

(4) Monitoring procedures are integrated with the overall liquidity management process for all corporate credit union activities.

(g) *Audit and compliance.* (1) An independent risk management unit is responsible for measuring and reporting risk exposures taken in derivatives.

(2) Audit coverage is adequate to ensure timely identification of internal control weaknesses or system deficiencies. Audit coverage is provided by competent professionals who are knowledgeable about the risks inherent in derivative transactions and have commensurate experience auditing financial institutions which utilize the same or similar types of derivatives. The scope of the audit includes coverage of the accounting, legal, operating, and risk controls.

(3) All risk measurement applications and models are reviewed and validated annually.

(4) Controls are in place to ensure documentation is confirmed, maintained and safeguarded. Any documentation exceptions are monitored and reviewed by appropriate senior management and legal counsel.

(h) *Legal issues.* (1) The corporate credit union has in-house legal counsel or has access to outside counsel which can reasonably ensure that any derivatives related contracts adequately represent the legal and business interests of the corporate credit union.

(2) The corporate credit union has access to outside counsel which is expert in all financial derivatives contracts and related matters.

PART 709—INVOLUNTARY LIQUIDATION AND CREDITOR CLAIMS

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

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

3. Section 709.5 is amended by revising paragraphs (b)(6) and (b)(7); removing the period and adding a semicolon and the word ''and'' at the end of paragraph (b)(8); and adding paragraph (b)(9) to read as follows:

§ 709.5 Payout Priorities in Involuntary Liquidation.

* * * * *

(b) * * *

(6) Shareholders to the extent of their respective uninsured shares and the National Credit Union Share Insurance Fund, to the extent of its payment of share insurance;

(7) In a case involving liquidation of a corporate credit union, membership capital; 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 USC 1757, 1766, and 1781–1790. Section 741.11 is also authorized by 31 USC 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. 96–13518 Filed 6–3–96; 8:45 am]

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DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. 95–ANE–65]

RIN 2120–AA64

Airworthiness Directives; CFM International CFM56–5/-5B/-5C Series Turbofan Engines

AGENCY: Federal Aviation Administration, DOT.

ACTION: Notice of proposed rulemaking (NPRM).

SUMMARY: This document proposes the adoption of a new airworthiness directive (AD) that is applicable to CFM International (CFMI) CFM56–5/–5B/–5C series turbofan engines. This proposal would require initial and repetitive borescope inspections of the stage 1 disk bore of certain high pressure compressor rotor (HPCR) stage 1–2 spools for rubs and scratches, and replacement, if found rubbed or scratched, with a serviceable part. This proposal would also require removal and replacement of certain stationary number 3 bearing aft air/oil seals as terminating action to the inspection program. This proposal is prompted by a report of an engine found with a rub on the forward corner of the HPCR stage 1 disk bore due to contact with the stationary number 3 bearing aft air/oil seal. The actions specified by the proposed AD are intended to prevent a failure of the stage 1 disk of the HPCR stage 1–2 spool, which could result in an uncontained engine failure and damage to the aircraft.

DATES: Comments must be received by August 5, 1996.

ADDRESSES: Submit comments in triplicate to the Federal Aviation Administration (FAA), New England Region, Office of the Assistant Chief Counsel, Attention: Rules Docket No. 95– ANE–65, 12 New England Executive Park, Burlington, MA 01803- 5299. Comments may also be submitted to the Rules Docket by using the following Internet address: ''epdodcomments@mail.hq.faa.gov''. Comments may be inspected at this location between 8:00 a.m. and 4:30 p.m., Monday through Friday, except Federal holidays.

The service information referenced in the proposed rule may be obtained from CFM International, Technical Publications Department, One Neumann Way, Cincinnati, OH 45215; telephone (513) 552–2981, fax (513) 552–2816. This information may be examined at the FAA, New England Region, Office of the Assistant Chief Counsel, 12 New England Executive Park, Burlington, MA.

FOR FURTHER INFORMATION CONTACT: Robert J. Ganley, Aerospace Engineer, Engine Certification Office, FAA, Engine and Propeller Directorate, 12 New England Executive Park, Burlington, MA 01803–5299; telephone (617) 238–7138, fax (617) 238–7199.