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TO: ALL CREDIT UNIONS

FROM: COMPLIANCE & REGULATORY AFFAIRS

SUBJECT: AMENDMENT TO NCUA INVESTMENTS REGULATION
EFFECTIVE: JUNE 11, 2013

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Main Idea:	<p>Under NCUA regulations, credit unions are required to “conduct and document a credit analysis” on any investment and the investment’s issuer before investing.</p> <p>For many types of investments, the NCUA regulations previously had distinguished permissible investments from impermissibly risky investments based on how the investments were rated by well-established national credit rating agencies.</p> <p>The NCUA has now revised its regulations so that what constitutes a permissible investment is no longer determined solely by the ratings of such agencies. Instead, the NCUA regulations now provide:</p> <ul style="list-style-type: none">• That credit union investments must be at least “investment grade” to be permissible; and• That corporate credit union investments must involve “a minimal amount of credit risk” to be permissible. <p>The new rule defines these new standards and sets forth the various factors that can be considered in evaluating whether a particular investment meets these standards. The conclusions of credit rating agencies can be considered as part of the evaluation, but a good rating from such an agency is no longer determinative as to whether an investment meets the standard and therefore is permissible.</p>
Effective:	June 11, 2013
Regulation:	<p>The NCUA regulations address investments <i>by credit unions</i> at 12 CFR 703.1 – 703.20, and the new rule makes several changes to those regulations.</p> <p>The NCUA regulations address investments <i>by corporate credit unions</i> at 12 CFR 704.1 – 704.19, and the new rule makes several changes to those</p>

	regulations.
Coverage:	<p>Applies directly to all federal credit unions. As to the rule’s applicability to federally insured, state-chartered credit unions, CUNA’s compliance blog post for March 26, 2013, said the following:</p> <p>NCUA’s Section 703 regulation on investments only applies to federal credit unions. However, if a federally insured state chartered credit union (FISCU) holds an investment not permissible for an FCU, it may be subject to special reserving on that investment. In its new regulation (Section 741.3), NCUA points out that if an FISCU relies upon a ratings-based investment permissible under state law, the FISCU should go through the same “investment grade” analysis that an FCU is now required to do.</p>
Overview:	<p>Many analysts and experts blamed the “Great Recession” in part on shoddy investment ratings by credit rating agencies. For this reason, the Dodd Frank Act required all federal agencies, including the NCUA, to revise any regulations that had previously allowed investment risk to be evaluated based largely upon the ratings of such agencies.</p> <p>The NCUA’s regulations did, in many cases, allow regular credit unions and corporate credit unions to rely on the ratings of such agencies—which were referred to in the regulations as “nationally-recognized statistical rating organizations” (NRSROs). In order to comply with the Dodd Frank Act, the NCUA has revised its investment regulations to establish investment standards that do rely on NRSRO ratings.</p> <p>Here is the NCUA’s summary of the new standard (taken from the NCUA’s final rule, for which a link is provided below):</p> <p>[T]he NCUA Board is replacing the various NRSRO-based security creditworthiness standards in NCUA regulations with only two standards: “Investment grade” and “minimal amount of credit risk.” An <u>investment grade security</u> is one where the credit union determines that the issuer has an adequate capacity to meet all financial commitments under the security for the projected life of the asset or exposure, even under adverse economic conditions. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low, and the full and timely repayment of principal and interest on the security is expected. A <u>security with a minimal amount of credit risk</u> is one where the credit union determines that the issuer has a very strong capacity to meet all financial commitments under the security for the projected life of the asset or exposure, even under adverse economic conditions. An issuer has a very strong capacity to</p>

	<p>meet all financial commitments if the risk of default by the obligor is very low, and the full and timely repayment of principal and interest on the security is expected. As discussed below, “investment grade” is used in part 703 and, with one exception, “minimal amount of credit risk” is used in part 704.</p> <p>In evaluating the creditworthiness of a security, a credit union may consider any of the following factors, to the extent appropriate:</p> <ul style="list-style-type: none"> • Credit spreads (<i>i.e.</i>, whether it is possible to demonstrate that a security is subject to a particular amount of credit risk based on the spread between the security's yield and the yield of Treasury or other securities); • Securities-related research (<i>i.e.</i>, whether providers of securities-related research believe the issuer of the security will be able to meet its financial commitments, generally or specifically, with respect to the securities held by the credit union); • Internal or external credit risk assessments (<i>i.e.</i>, whether credit assessments developed internally by the credit union or externally by a credit rating agency, irrespective of its status as an NRSRO, express a view as to a particular security's credit risk); • Default statistics (<i>i.e.</i>, whether providers of credit information relating to securities express a view that specific securities have a probability of default consistent with other securities with a particular amount of credit risk); • Inclusion on an index (<i>i.e.</i>, whether a security, or issuer of the security, is included as a component of a recognized index of instruments that are subject to a specific amount of credit risk); • Priorities and enhancements (<i>i.e.</i>, the extent to which a security is covered by credit enhancements, such as overcollateralization and reserve accounts); • Price, yield, and/or volume (<i>i.e.</i>, whether the price and yield of a security are consistent with other securities that the credit union has determined are subject to a particular amount of credit risk and whether the price resulted from active trading); and • Asset class-specific factors (<i>e.g.</i>, in the case of structured finance products, the quality of the underlying assets).
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	NCUA will discuss these and other factors in supervisory guidance to be provided to FCUs and corporates before the effective date of this final rule.
Further Research:	<p>The NCUA's final rule, which includes the full text of the rule, as well as additional commentary, can be found here.</p> <p>CUNA's final rule analysis is available here. (Click the "Final Rule Analysis" subheading, then under the list of NCUA rules, click the "Alternatives to Credit Ratings" link to download a PDF of the analysis.)</p>

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