

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 701 and 741

Uninsured Secondary Capital Accounts

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed rule.

SUMMARY: The National Credit Union Administration (NCUA) seeks public comment on a proposal to allow low-income designated credit unions that offer secondary capital accounts to begin redeeming the funds in those accounts when they are within five years of maturity, and to require prior approval of a plan for the use of secondary capital before such accounts can be offered.

DATES: Comments must be received on or before September 27, 2005.

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

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

- *NCUA Web Site:* http://www.ncua.gov/RegulationsOpinionsLaws/proposed_regs/proposed_regs.html. Follow the instructions for submitting comments.

- *E-mail:* Address to regcomments@ncua.gov. Include “[Your name] Comments on Proposed Rule Part 701, Secondary Capital” in the e-mail subject line.

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

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

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

FOR FURTHER INFORMATION CONTACT: Steven W. Widerman, Trial Attorney, Office of General Counsel, at 703/518–6557; or Margaret Miller, Program Officer, Office of Examination and Insurance, at 703/518–6375.

SUPPLEMENTARY INFORMATION:

A. Background of Uninsured Secondary Capital Accounts

Authorization of Secondary Capital. The NCUA Board is authorized by law to permit credit unions serving predominantly low-income members to receive payments on shares from non-natural persons under conditions the Board sets. 12 U.S.C. 1757(6). In 1996,

the NCUA Board amended section 701.34 of its rules and regulations to authorize low-income designated credit unions (“LICUs”),¹ including State-chartered credit unions to the extent permitted by State law, to offer uninsured secondary capital (“SC”) accounts to non-natural person members and nonmembers. 12 CFR 701.34(b). The accounts were intended to provide LICUs a further means—beyond setting aside a portion of income—to build capital in order to serve two purposes: To support greater lending and financial services in their communities, and to absorb losses and prevent the credit union from failing. 61 FR 3788 (Feb. 2, 1996).

To ensure the safety and soundness of the LICUs that offered SC accounts, and to ensure that the accounts serve the intended purposes, existing section 701.34(b) imposes a variety of conditions. 61 FR at 3788. These conditions apply to State-chartered LICUs as well. 12 CFR 741.204. A LICU may offer SC accounts only after submitting a written plan for the use and repayment of the accounts. § 701.34(b)(1). The accounts must be established as uninsured, non-share instruments. § 701.34(b)(2) and (5). They must have a minimum maturity of 5 years and may not be redeemable prior to maturity. § 701.34(b)(3)–(4). An account holder’s claim against an offering LICU must be subordinate to all other claims of shareholders, creditors and the Share Insurance Fund. § 701.34(b)(6). And most importantly, SC funds on deposit (including interest paid into the account) must be available to cover losses in excess of the LICU’s net available reserves and undivided earnings. § 701.34(b)(7). The funds used to cover such losses may not be replenished or restored to the SC account. *Id.*

Net Worth Value. Beginning at 5 years remaining maturity, existing § 701.34(c)(1) requires an offering LICU to discount the capital value (now called “net worth value”) of its SC accounts at the rate of 20 percent per year. The purpose of discounting the net worth value is: To discourage overreliance on SC accounts to cover future operating losses; to encourage LICUs to continually replenish their sources of maturing SC; and to facilitate

net worth growth to support the expansion of lending and financial services in their communities. 61 FR at 3788, 3789. Even as its capital value is discounted, however, the full amount of SC on deposit remains available to cover losses. § 701.34(c)(2).

Prompt Corrective Action. In 2000, pursuant to Congressional mandate, NCUA adopted a system of “prompt corrective action” (“PCA”) consisting of mandatory minimum capital standards indexed by a credit union’s “net worth ratio” to five statutory net worth categories.² 12 U.S.C. 1790d; 12 CFR 702; 65 FR 8560 (Feb. 18, 2000). A credit union whose net worth ratio puts it in the top category, “well capitalized”, is essentially free of PCA. But as a credit union’s net worth ratio falls and its classification among the net worth categories declines below “well capitalized,” it is exposed to an expanding range of mandatory and discretionary supervisory actions designed to restore net worth. *E.g.*, 12 CFR 702.201(a), 702.202(a), 702.204(b).

Effect on LICUs. The original purpose of discounting the net worth value of SC beginning at 5 years remaining remains vital today. Under PCA, however, the requirement to do so reduces a LICU’s net worth ratio. While the “net worth” side of the ratio is discounted at the rate of 20 percent annually, the “assets” side of the ratio must remain the same because, as currently written, § 701.34(b) prohibits the redemption of SC accounts prior to maturity. § 701.34(b)(4). Redeeming SC accounts would correct the imbalance between the “net worth” and “assets” sides of the ratio. Without the ability to redeem SC accounts, discounting net worth value will dilute a LICU’s net worth ratio, possibly causing its classification among the net worth categories to fall and triggering further PCA.

A significant number of LICUs are exposed to the possibility that discounting the value of their SC will dilute their net worth ratio. December 2004 Call Report data shows that 55 of the 1019 LICUs offer SC accounts. These accounts have an aggregate balance of \$19.7 million. The number of LICUs offering SC accounts has remained relatively stable in recent years. Of the 55 LICUs presently offering SC accounts, 48 are classified “well capitalized” and 4 are classified “adequately capitalized,” indicating that 95 percent currently have net worth

¹ The NCUA Board is authorized by law to define “credit unions serving predominantly low-income members.” 12 U.S.C. 1757(6). To be so designated by the appropriate Regional Director, the NCUA Board generally requires the majority of a credit union’s members to earn less than 80 percent of the average national wage as determined by the Bureau of Labor Statistics, or to have annual household incomes below the national median as determined by the Census Bureau. 12 CFR 701.34(a)(2)–(3).

² The “net worth” of a LICU is defined as its retained earnings per GAAP plus any SC. 12 U.S.C. 1790d(o)(2); 12 CFR 702.2(f). The “net worth ratio” of a credit union is the ratio of its net worth to its total assets. 12 U.S.C. 1790d(o)(3); 12 CFR 702.2(g) and (k).

ratios that subject them to little or no PCA. A principal purpose of this rule is to prevent the discounting of SC from diluting the net worth of LICUs that offer SC accounts.

B. Proposed Modifications to Existing Section 701.34

1. Redemption of Secondary Capital

Existing § 701.34(b)(4) prohibits a LICU from redeeming SC accounts at any time prior to their maturity. As explained above, however, the requirement to discount SC threatens to dilute a LICU's net worth ratio if it cannot also redeem the SC no longer recognized as net worth ("discounted SC") at the same time. To protect LICUs from this threat, the proposed rule adds new subsection (d) permitting LICU's to redeem discounted SC under certain conditions, and eliminates the restriction on redemption in existing § 701.34(b).

Approval to Redeem. To redeem SC, the proposed rule requires a LICU to first obtain the approval of the appropriate Regional Director ("RD"). If the LICU is State-chartered, the proposed rule adds a new subsection (d) to § 741.204, requiring the approval of the appropriate State Supervisory Authority ("SSA") with the concurrence of the RD. A request to redeem must be submitted in writing for each year preceding maturity (unless the RD indicates in writing that the approval is for more than one year). If, within 45 days of the RD's receipt of its request to redeem, a LICU is not notified of the RD's and/or SSA's decision on the request, the LICU may proceed with the proposed redemption.

To obtain approval to redeem, the following redemption risks must be addressed:

First, the LICU must show sufficient post-redemption net worth to be "well capitalized." See note 2 *supra*. Being classified in the top net worth category frees a credit union of PCA. But as soon as net worth declines below "well capitalized," PCA forces that credit union to start rebuilding net worth by making quarterly transfers of earnings to net worth. 12 CFR 702.201(a). If not "well capitalized," however, a LICU that is "adequately capitalized" may seek RD approval to redeem, which will be granted or denied on a case-by-case basis (provided the other redemption criteria below are met).

Second, the SC funds to be redeemed must have been on deposit for at least two years. This requirement only affects SC having a 5-year maturity; SC with a maturity greater than 5 years is ineligible for redemption. LICUs

generally incorporate the receipt of SC into their long-term business plans and financial budgets. Allowing a LICU to redeem that SC within the first two years can impair its ability to implement its strategic and business plans, and to achieve its budget objectives and financial stability. For example, a LICU's business plan might call for a rapid and substantial expansion of products and services offered to members. In turn, the expenses associated with this expansion, including loan losses, could increase accordingly. Without a track record of the expenses these products and services entail, it is impossible to accurately project the full extent of these expenses; it can only be estimated. The purpose of the 2-year waiting period is to allow the actual expenses to be realized and to permit the expansion of products and services to stabilize. The track record that develops during that period will show the extent to which discounted SC may be needed to absorb the expenses and thus should not be redeemed.

Third, the LICU must demonstrate that the SC funds to be redeemed will not be needed to cover losses prior to maturity of the account. As previously noted, an essential feature of SC is its availability to cover operating losses in excess of net worth. For this reason, a redemption request should be denied when there is a reasonable expectation that discounted SC will be needed to cover post-redemption operating losses occurring prior to maturity of the account.

Fourth, the LICU must demonstrate that its books and records are current and reconciled. The purpose of this requirement is straightforward: To make sure the RD who is evaluating a redemption request has complete, accurate and up to date financial data to assess the LICU's financial condition and to verify its compliance with full and fair disclosure requirements.

Fifth, the LICU must identify any other funding that might be affected by the redemption of SC. For example, the Department of the Treasury's Community Development Financial Institutions ("CDFI") Fund may provide a LICU funding in the form of SC subject to a contractual condition that the LICU raise and hold matching SC from another source. If the LICU redeems the matching SC, it may be contractually required to redeem an equal measure of CDFI funding. Non-SC matching nonmember deposits and grants also may be similarly impacted if SC is redeemed prior to maturity.

Finally, the request for approval to redeem must be authorized by a

resolution of the LICU's board of directors. A board resolution documents that a majority of the board participated in a board decision. Maximum board member participation in deciding to redeem SC helps to overcome possible conflicts of interest between LICU officials and officials of the SC account holder.

Schedule for Redemption. For redemption requests that are approved, the proposed rule prescribes a schedule for redeeming SC accounts that is reciprocal to existing § 701.34(b)'s schedule for recognizing the net worth value of those accounts:

Remaining maturity	Redemption limit (percent)
Four to less than five years ..	20
Three to less than four years	40
Two to less than three years	60
One to less than two years ..	80

To the extent a proportion of SC is no longer recognized as net worth under the existing net worth recognition schedule, that same proportion may be redeemed under the redemption schedule. For example, when between "four to less than five years" remain until maturity, 80 percent of value of the account is recognized as net worth, meaning that 20 percent is not. See § 701.34(c)(1)(i). As the schedule above shows, the proposed rule allows the LICU to redeem the 20 percent that is no longer recognized as net worth. The last year of remaining maturity is omitted from the schedule because the maturity of the account effectively redeems the remaining SC. Balancing net worth recognition with redemption of SC protects a LICU's net worth ratio from being diluted.

2. Approval of Plan for Use of Secondary Capital

Existing § 701.34(b) requires a LICU seeking to offer SC accounts to "adopt, and forward to the appropriate Regional Director, a written plan for the use of the funds" in those accounts and "subsequent liquidity needs" to repay them upon maturity. § 701.34(b)(1). In the case of a LICU that is State-chartered, that plan must be submitted to both the RD and the SSA. 12 CFR 741.204(c). But in neither case do the existing rules require an SC plan to be approved before a LICU can offer SC accounts.

Inappropriate Use of Secondary Capital. In practice, SC sometimes is not used to achieve the goals for which it was conceived, *i.e.* building capital to support expansion of lending and financial services in LICUs'

communities, and serving as a cushion against losses. 61 FR 3788 (Feb. 2, 1996). Between 1999 and 2004, twenty-eight LICUs that offer SC accounts have been liquidated or merged, forcing the Share Insurance Fund to step in and absorb losses in nine cases. SC played a role in masking the magnitude of other problems (such as inefficient operations leading to an unreasonably high ratio of net operating expenses to assets, and inadequate underwriting) that led to most of these liquidations. To ensure safe and sound use of SC, the proposed rule requires prior approval—not just submission—of a LICU's SC plan, and establishes evaluation criteria for such plans.

Evaluation and Approval of Plan. The proposed rule revises existing § 701.34(b)(1) to require RD approval of the written SC plan that a LICU presently must submit before offering SC accounts. In the case of a State-chartered LICU, the rule revises § 741.204(c) to require SSA approval of the SC plan with the concurrence of the RD. Approval will be required only for plans submitted on or after the effective date of a final rule; existing SC plans will not be affected. If, within 45 days of an RD's receipt of an SC plan submitted for approval, a LICU is not notified of the RD's and/or SSA's decision on the plan, the LICU may proceed to offer SC accounts pursuant to the plan.

The proposed rule adds two more evaluation criteria to the two that existing § 701.34(b)(1) already prescribes for an SC plan (*i.e.*, what the SC will be used for and how it will be repaid when the accounts mature): It must demonstrate that the proposed use of SC conforms to the offering LICU's strategic plan, business plan and budget; and it must be supported by accompanying pro forma financial statements, including any off-balance sheet items, covering a minimum of the next two years. The purpose of these criteria is to project and document the future financial performance of the LICU in relation to the risks associated with offering SC accounts.

3. Clarification of Disclosure Requirements

Existing § 701.34(b)(11) requires that a "Disclosure and Acknowledgment" form "as set forth in the Appendix to this section be provided to and executed by" the SC account investor. The form recites the key terms and regulatory limitations that distinguish SC accounts (*e.g.*, that they are uninsured, subordinate to all other claims, and available to cover operating losses in excess of net worth) as well as the

individual terms of each investment (*e.g.*, investor's name, amount, term, how accrued interest is to be paid). The purpose of the form is to make sure "there is no misunderstanding on the part of the investors as to the nature of the accounts and the risks involved." 61 FR at 3788.

Proof of Disclosure. In many cases, the parties may see only a reprint or facsimile of the Appendix containing the "Disclosure and Acknowledgment" form without referring to § 701.34(b)(11), which clearly says who must sign it. But the Appendix itself does not specify who must sign the form—an official of the institutional investor or an official of the offering LICU—or require that person to date the form to show when it was provided to the investor. This ambiguity and lack of a date has led to misunderstandings, if not disputes, about when, if at all, the nature of SC accounts and the risks involved were disclosed to institutional investors.

A credit union official's signature on the form is no proof that the investor ever got the form, let alone when. And without a date, the signature of an institutional investor's official proves the form was received, but not when—before or after the funds were deposited in the SC account—thus failing to document that the investor was informed of the terms, limitations and risks before investing.³ The proposed rule rectifies this problem simply by including at the bottom of the form a signature block specifically for an official of the institutional investor that reads: "ACKNOWLEDGED AND AGREED TO this ____ day of (month and year) by (name of investor's official, name of investor, address and phone number of investor, and investor's tax identification number)."

Option to Redeem. Consistent with new subsection (d) allowing SC accounts to be redeemed, the proposed rule eliminates the "Disclosure and Acknowledgment" form's provision barring redemption prior to maturity. To also ensure that the option to redeem SC accounts remains with the offering LICU throughout, the proposed rule goes a step further, adding a provision to the form stating that SC accounts are "redeemable only at the option of the offering credit union." This will prevent

³ Existing § 701.34(b)(10) requires the parties to execute a "contract agreement * * * accurately establishing the terms and conditions of this section and containing no provisions inconsistent therewith." In practice, however, it is unclear that such contracts consistently and reliably do that—all the more reason that investors should receive the "Disclosure and Acknowledgment" before investing in an SC account.

LICUs and their institutional investors from agreeing by contract in advance of making an SC investment that the LICU will redeem it later on regardless of what circumstances may arise afterward.

4. Other Modifications

Apart from the substantive modifications explained above, the proposed rule makes several conforming and clarifying adjustments to existing § 701.34. The references to "reserves and undivided earnings" in existing § 701.34(b)(7) and the corresponding provision of the Appendix have been changed to "net worth" to reflect the adoption of that term pursuant to PCA. See 12 U.S.C. 1790d(o)(2). Existing §§ 701.34(b)(12) and (13) have been combined in a single, abbreviated section explaining the PCA authority to prohibit payment of principal, interest and dividends on SC accounts established after August 7, 2000. Finally, the "scale" used in existing § 701.34(c)(1) to recognize the capital value of SC accounts has been converted to schedule form to match the form of the corresponding redemption schedule in new subsection (d).

Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis describing any significant economic impact a proposed regulation may have on a substantial number of small credit unions (those having under \$10 million in assets). The proposed rule allows credit unions to redeem secondary capital accounts when they are within five years of maturity, without imposing any additional regulatory burden. If adopted, the proposed rule will not have a significant economic impact on a substantial number of small credit unions. Thus, a Regulatory Flexibility Analysis is not required.

Paperwork Reduction Act

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

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their regulatory actions on State and local interests. NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily adheres to the fundamental federalism principles addressed by the executive order. This proposed rule

would not have a substantial direct effect on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Accordingly, this proposed rule does not constitute a policy that has federalism implications for purposes of the Executive Order.

Treasury and General Government Appropriations Act, 1999

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

Agency Regulatory Goal

NCUA's goal is to promulgate clear, understandable regulations that impose a minimal regulatory burden. The proposed rule seeks to improve and simplify the existing rule on uninsured secondary capital accounts. We request your comments on whether the proposed rule would be understandable and minimally intrusive if implemented as proposed.

List of Subjects in 12 CFR Parts 701 and 741

Bank deposit insurance, Credit Unions, Reporting and recordkeeping requirements.

By the National Credit Union Administration Board on July 21, 2005.

Mary F. Rupp,

Secretary of the Board.

For the reasons set forth above, 12 CFR parts 701 and 741 are proposed to be amended as follows:

PART 701—ORGANIZATION AND OPERATIONS OF FEDERAL CREDIT UNIONS

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

Authority: 12 U.S.C. 1752(5), 1755, 1756, 1757, 1759, 1761a, 1761b, 1766, 1767, 1782, 1784, 1787, 1789 and Public Law 101-73. Section 701.6 is also authorized by 31 U.S.C. 3717. Section 701.31 is also authorized by 12 U.S.C. 1601 *et seq.*, 42 U.S.C. 1981 and 42 U.S.C. 3601-3610. Section 701.35 is also authorized by 12 U.S.C. 4311-4312.

2. Amend § 701.34 as follows:

a. Revise the section heading to read as set forth below;

b. Revise paragraphs (b) and (c) to read as set forth below;

c. Add new paragraph (d) before the Appendix to § 701.34 to read as set forth below; and

d. Revise the Appendix to § 701.34 following new paragraph (d) to read as follows:

§ 701.34 Designation of low income status; Offering of secondary capital accounts by low-income designated credit unions.

* * * * *

(b) *Offering of secondary capital accounts by low-income designated credit unions.* A Federal credit union having a designation of low-income status pursuant to paragraph (a) of this section may offer secondary capital accounts to nonnatural person members and nonnatural person nonmembers subject to the following conditions:

(1) *Secondary capital plan.* Prior to offering secondary capital accounts, the credit union shall adopt, and forward to the appropriate NCUA Regional Director for approval, a written "secondary capital plan" that, at a minimum:

(i) Identifies the purpose(s) for which secondary capital will be used; and how it will be repaid;

(ii) Explains how the credit union will provide for subsequent liquidity to repay secondary capital upon maturity of the accounts;

(iii) Demonstrates that the planned uses of secondary capital conform to the offering credit union's strategic plan, business plan and budget; and

(iv) Includes supporting pro forma financial statements including any off-balance sheet items, covering a minimum of the next two years.

(2) *Decision on plan.* If a LICU is not notified within 45 days of receipt of a secondary capital plan that the plan is approved or disapproved, the LICU may proceed to offer secondary capital accounts pursuant to the plan.

(3) *Nonshare account.* The secondary capital account must be established as an uninsured secondary capital account or other form of non-share account.

(4) *Minimum maturity.* The maturity of the secondary capital account must be a minimum of five years.

(5) *Uninsured account.* The secondary capital account shall not be insured by the National Credit Union Share Insurance Fund or any governmental or private entity.

(6) *Subordination of claim.* The secondary capital account holder's claim against the credit union must be subordinate to all other claims including those of shareholders, creditors and the National Credit Union Share Insurance Fund.

(7) *Availability to cover losses.* Funds deposited into the secondary capital account, including interest accrued and paid into the secondary capital account, must be available to cover operating losses realized by the credit union that

exceed its net available net worth (exclusive of secondary capital and allowance accounts for loan and lease losses), and to the extent funds are so used, the credit union shall under no circumstances restore or replenish the account. The credit union may, in lieu of paying interest into the secondary capital account, pay interest accrued on the secondary capital account directly to the investor or into a separate account from which the secondary capital investor may make withdrawals. Losses shall be distributed pro-rata among all secondary capital accounts held by the credit union at the time the losses are realized.

(8) *Security.* The secondary capital account may not be pledged or provided by the account-holder as security on a loan or other obligation with the credit union or any other party.

(9) *Merger or dissolution.* In the event of merger or other voluntary dissolution of the credit union, other than merger into another low-income designated credit union, the secondary capital accounts will, to the extent they are not needed to cover losses at the time of merger or dissolution, be closed and paid out to the account-holder.

(10) *Contract agreement.* A secondary capital account contract agreement must be executed by an authorized representative of the account holder and the credit union, accurately establishing the terms and conditions of this section and containing no provisions inconsistent therewith.

(11) *Disclosure and acknowledgement.* A "Disclosure and Acknowledgment" as set forth in the Appendix to this section must be executed by an authorized representative of the offering credit union and of the secondary capital account holder at the time of entering into the account agreement. An original of the account agreement and the "Disclosure and Acknowledgment" must be retained by the credit union for the term of the agreement, and a copy must be provided to the account holder.

(12) *Prompt corrective action.* As provided in §§ 702.204(b)(11), 702.304(b) and 702.305(b) of this chapter, the NCUA Board may prohibit a credit union classified "critically undercapitalized" or a "new" credit union classified "moderately capitalized", "marginally capitalized", "minimally capitalized" or "uncapitalized", as the case may be, from paying principal, dividends or interest on its uninsured secondary capital accounts established after August 7, 2000, except that unpaid dividends or interest shall continue to

accrue under the terms of the account to the extent permitted by law.

(c) *Accounting treatment; Recognition of net worth value of accounts.*

(1) *Equity account.* A low-income designated credit union that issues secondary capital accounts pursuant to paragraph (b) of this section shall record the funds on its balance sheet in an equity account entitled "uninsured secondary capital account."

(2) *Schedule for recognizing net worth value.* For such accounts with remaining maturities of less than five years, the credit union shall reflect the net worth value of the accounts in its financial statement in accordance with the following schedule:

Remaining maturity	Recognized net worth value (percent)
Four to less than five years ..	80
Three to less than four years	60
Two to less than three years	40
One to less than two years ..	20
Less than one year	0

(3) *Financial statement.* The credit union will reflect the full amount of the secondary capital on deposit in a footnote to its financial statement.

(d) *Redemption of secondary capital.* With the written approval of the appropriate Regional Director, secondary capital that is not recognized as net worth under paragraph (c)(2) of this section ("discounted secondary capital") may be redeemed according to the remaining maturity schedule in paragraph (d)(3) of the section.

(1) *Request to redeem secondary capital.* A request for approval to redeem discounted secondary capital must be submitted in writing on an annual basis and must demonstrate to the satisfaction of the appropriate Regional Director that:

(i) The offering credit union is classified "well capitalized" under part 702 of this chapter, provided however, that a Regional Director may, on a case-by-case basis, permit an "adequately capitalized" credit union that meets the other criteria in this paragraph to redeem discounted secondary capital;

(ii) The discounted secondary capital has been on deposit at least two years;

(iii) The discounted secondary capital will not be needed to cover losses prior to final maturity of the account;

(iv) The offering credit union's books and records are current and reconciled;

(v) The proposed redemption will not jeopardize other current sources of funding, if any, to the offering credit union; and

(vi) The request to redeem is authorized by resolution of the offering credit union's board of directors.

(2) *Decision on request.* If a LICU is not notified within 45 days of receipt of a request for approval to redeem secondary capital that its request is either granted or denied, the LICU may proceed to redeem secondary capital accounts as proposed.

(3) *Schedule for redeeming secondary capital.*

Remaining maturity	Redemption limit (percent)
Four to less than five years ..	20
Three to less than four years	40
Two to less than three years	60
One to less than two years ..	80

Appendix to § 701.34

A credit union that is authorized to offer uninsured secondary capital accounts and each investor in such an account shall execute and date the following "Disclosure and Acknowledgment" form, a signed original of which shall be retained by the credit union:

Disclosure and Acknowledgment

(Name of CU) and (Name of investor) hereby acknowledge and agree that (Name of investor) has committed (amount of funds) to a secondary capital account with (name of credit union) under the following terms and conditions:

1. The funds committed to the secondary capital account are committed for a period of ___ years.

2. Subject to the conditions set forth in 12 CFR 701.34, the funds committed to the secondary capital account are redeemable only at the option of the offering credit union and only with the prior approval of the appropriate regional director.

3. The secondary capital account is not a share account and the funds committed to the secondary capital account are not insured by the National Credit Union Share Insurance Fund or any other governmental or private entity.

4. The funds committed to the secondary capital account and any interest paid into the account may be used by (name of credit union) to cover any and all operating losses that exceed the credit union's net worth exclusive of allowance accounts for loan losses, and in the event the funds are so used (name of credit union) will under no circumstances restore or replenish those funds to (name of institutional investor).

5. By initialing below, (name of credit union) and (name of institutional investor) agree that accrued interest will be:

- ___ Paid into and become part of the secondary capital account;
- ___ Paid directly to the investor;
- ___ Paid into a separate account from which the investor may make withdrawals; or
- ___ Any combination of the above provided the details are specified and agreed to in writing.

6. In the event of liquidation of (name of credit union), the funds committed to the secondary capital account shall be subordinate to all other claims on the assets of the credit union, including claims of member shareholders, creditors and the National Credit Union Share Insurance Fund.

7. Under certain net worth classifications (see 12 CFR 702.204(b)(11), 702.304(b) and 702.305(b), as the case may be), the NCUA Board may prohibit (name of credit union) from paying principal, dividends or interest on its uninsured secondary capital accounts established after August 7, 2000, except that unpaid dividends or interest shall continue to accrue under the terms of the account to the extent permitted by law.

ACKNOWLEDGED AND AGREED TO by this ___ day of (month and year) by:

 (name of investor's official)
 (title of official)
 (name of investor)
 (address and phone number of investor)
 (investor's tax identification number)

PART 741—REQUIREMENTS FOR INSURANCE

1. The authority citation for part 741 continues to read as follows:

Authority: 12 U.S.C. 1757, 1766, 1781–1790, and 1790d. Section 741.4 is also authorized by 31 U.S.C. 3717.

2. Amend § 741.204 as follows:

a. Remove from paragraph (c) the citation "§ 701.34" and add in its place the citation "§ 701.34(b)(1)";

b. Add at the end of paragraph (c) after "Regional Director" the words: "for approval. The state supervisory authority shall approve or disapprove the plan with the concurrence of the appropriate NCUA Regional Director."

c. Add new paragraph (d) to read as follows:

§ 741.204 Maximum public unit and nonmember accounts, and low income designation.

* * * * *

(d) Redeem secondary capital accounts only in accordance with the terms and conditions authorized for Federal credit unions pursuant to § 701.34(d) of this chapter and to the extent not inconsistent with applicable state law and regulation. State chartered federally insured credit unions seeking to redeem secondary capital accounts must submit the request required by § 701.34(d)(1) to both the state supervisory authority and the NCUA Regional Director. The state supervisory authority shall grant or deny the request with the concurrence of the appropriate NCUA Regional Director.

[FR Doc. 05–14806 Filed 7–28–05; 8:45 am]

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