



National Credit Union Administration

February 15, 2019

U.S. MAIL and E-MAIL

XXXXXXX, President/CEO
XXXXXXX Federal Credit Union
XXXXXXXXXX
XXXXXXX, XX XXXXX

RE: XXXXXXXXX Federal Credit Union
Supervisory Review Committee Appeal Decision
(SRC-01-19)

Dear XXXXXXXX:

On October 10, 2018, the NCUA Secretary of the Board received your notice of appeal, which stated:

XXXXXX appeals the decision of its NCUA Regional Director (XXXXXX) that denied XXXXXX's Application for Secondary Capital. This decision was submitted to XXXXXX in a letter dated July 19, 2018. The basis for the denial was later re-stated by the Regional Director in its letter dated September 13, 2018.

I am writing to inform you that the NCUA's Supervisory Review Committee (SRC) has made a final decision to uphold the NCUA Regional Director's denial of XXXXXX's application for secondary capital. The basis of the SRC's decision is explained below.

As a low-income designated credit union, XXXXXX is eligible to request secondary capital authority from the NCUA pursuant to 12 CFR [§701.34](#). A chronology of major activities relating to XXXXXX's request for approval to issue secondary capital is as follows:

Date	Activity
December 12, 2017	XXXXXX submitted a secondary capital plan to the NCUA XXXXXX Regional Director requesting authority to issue \$25 million in secondary capital
January 23, 2018	XXXXXX applied for an exemption to the non-member deposit limitation
January 26, 2018	NCUA Regional Director denied XXXX's secondary capital plan, citing safety and soundness reasons
February 6, 2018	XXXXXX requested clarification from the Regional Director on the basis of denial of the secondary capital plan
February 13, 2018	NCUA Regional Director denied XXXXXX's application for an exemption to the non-member deposit limitation

Date	Activity
March 23, 2018	XXXXXXX met with the Regional Director and other NCUA staff to discuss the agency's denial of the secondary capital plan
June 4, 2018	XXXXXXX resubmitted a revised secondary capital plan requesting authority to issue \$XX million in secondary capital
July 19, 2018	NCUA Regional Director denied XXXX's revised secondary capital plan, citing safety and soundness reasons
August 16, 2018	XXXXXXX requested the Regional Director reconsider the revised secondary capital plan
September 13, 2018	NCUA Regional Director denied XXXXXX's request for reconsideration of the revised secondary capital plan, citing safety and soundness reasons
July 19, 2018	XXXXXXX appealed the NCUA Regional Director's denial of the revised secondary capital plan application to the NCUA Supervisory Review Committee for review pursuant to 12 CFR §746.107
October 31, 2018	NCUA SRC determined XXXX's appeal was complete
November 16, 2018	XXXXXXX emailed additional information requested by NCUA SRC
January 24, 2019	XXXXXXX and NCUA presented their cases before the NCUA SRC in an oral hearing at the NCUA headquarters in Alexandria, VA, in accordance with 12 CFR §746.107(c)(2)

The threshold issue in this case is whether this matter is appropriate for review by the NCUA SRC. NCUA's Rules allow a credit union to request SRC review after receiving a written decision issued by a program office in response to a request for reconsideration pursuant to §746.105. The SRC must receive the request for review within 30 days after receiving the written decision, and the matter for review must be a "material supervisory determination." The Rules state that a material supervisory determination means any written decision by a program office that may significantly affect the capital, earnings, operating flexibility, or that may otherwise affect the nature or level of supervisory oversight of an insured credit union. The Rule further states that the term includes "a determination on an application for additional authority where independent appeal procedures have not been specified in other NCUA regulations. 12 CFR §746.107(a).

The Committee finds that XXXXXX's request for SRC review is appropriate. As the above timeline illustrates, the credit union properly requested reconsideration of the denial of its plan from the program office, and then timely requested SRC review after receiving the written determination on their request for reconsideration. In addition, the written decision the credit union is requesting the SRC review meets the definition of a material supervisory determination, as the decision arguably significantly affects the capital, earnings, and operating flexibility of the credit union, and concerns a request for additional secondary capital authority.

Having successfully crossed the jurisdictional threshold, we may now review the Regional Office's written decision. Specifically, the issue before the SRC is whether the NCUA Regional Director's determination to deny XXXXXX's request for approval of its secondary capital plan on safety and soundness grounds was correct. In the cover letter of its notice of appeal to the SRC, XXXXXX objected to the basis of the NCUA Regional Director's denial and asserted that the NCUA Regional Director:

1. "...consistently failed to articulate how XXXXXX's SC Plan failed to meet any one or more of the five regulatory requirements for secondary capital pursuant to 12 CFR 701.34(b)(1)."
2. "...did not explain how XXXXXX failed to demonstrate a 'realistic means to retire the secondary capital without undue risk to the ongoing safety and soundness' of XXXXXX in its September 13, 2018 letter. The Regional Director stipulated in its July 19, 2018 Denial Letter that '[t]he 'Safety Net' component includes the purchase of \$XX million of zero-coupon U.S. Treasury STRIP securities, with the same maturity timeframes of the required loan payments.' This method of repayment has no impact upon any ongoing safety and soundness risk. The purchase of these securities will be made in the first year of the SC Plan and not in subsequent years."

XXXXXXX has argued that the NCUA Regional Director must approve an application for secondary capital if the five regulatory components for secondary capital plans set forth in [§701.34\(b\)\(1\)](#) have been addressed, and that the NCUA Regional Director went beyond her discretionary authority when denying XXXX's request(s) on a basis of overall safety and soundness concerns.

Supervisory Review Committee Determination

The NCUA SRC rejects the arguments made by XXXXXX as reasons to overturn the Regional Director's denial decision(s).

Authority of the Regional Director.

First, there is no duty for the Regional Director to approve a secondary capital application simply because the plan meets the five requirements of the rule. The credit union states that it reads the NCUA's regulations as stating that if the credit union's secondary capital plan meets the five requirements of 12 CFR §701.34 then the Regional Director must approve the plan. The credit union states that this is mandatory approval pursuant to 12 CFR §741.204(c). This argument, however, is not correct. As NCUA's counsel correctly reasoned at the oral hearing, the regulation must be read in its entirety. A complete reading of §741.204(c) shows that all federally insured credit unions must do certain things to be able to take advantage of benefits that come with being a LICU. Specifically, the regulation states that a credit union must do the following: Adhere to the requirements of §701.32 of this chapter regarding public unit and

nonmember accounts; obtain a low income designation in order to accept nonmember accounts; receive secondary capital accounts only if the credit union has a low income designation and then only in accordance with the terms and conditions in §701.43(b)(1); and redeem secondary capital accounts in accordance with the terms and conditions in §701.34(d).

Accordingly, §741.204(c) imposes obligations on the credit union in connection with secondary capital, rather than imposes a duty on the Regional Director to approve secondary capital applications. Moreover, this position is further supported in the preamble to the 1996 proposed rule that created this section of the regulations: “The new 741.204(c) establishes that state chartered federally insured credit unions may offer secondary capital accounts on the same terms and conditions as Federal credit unions, as long as the credit union has a low-income designation pursuant to 741.204(b) and the accounts are not inconsistent with state law or regulation.” Again, as NCUA Counsel correctly argued, the NCUA Board clearly did not intend to make this a mandatory provision or it would have said as much, rather than state that FISCUs may issue secondary capital accounts, provided they meet certain requirements. Thus, when read in its entirety and in the context provided by the preamble to the 1996 proposed rule on secondary capital, the Committee finds it is clear that the regulation does not impose a mandatory duty on the Regional Director to approve plans.

In this appeal, the credit union further argues that the Regional Director abused her discretion and acted beyond her authority by considering safety and soundness. The credit union once again argues that the Regional Director’s review is limited to only determining if the credit union has included all the information required by the regulation. However, this argument is also incorrect.

In 2006, the NCUA Board amended the secondary capital rule to require the approval of the plans by the regional directors. Prior to this amendment, LICUs were only required to submit a plan with certain information to the region, but there was no Regional Director approval. As noted in both the 2005 proposed rule, and the 2006 final rule, the NCUA Board believed that lenient practices by LICUs with respect to secondary capital had resulted in safety and soundness concerns. The purpose of the 2006 amendment, therefore, was to replace a simple review of provided information with a thorough, thoughtful review of all secondary capital plans to ensure the safety and soundness of credit unions. Thus, when read in entirety and in the context of the preamble of the rule, it is clear that the Board implemented Regional Director review and approval of secondary capital plans, to ensure the plan represented a safe and sound endeavor for the credit union. As such, it was well within the Regional Director’s authority and discretion to review XXXXXX’s safety and soundness exposure.

Regional Director’s Review and Determination.

In reviewing the Regional Director’s determinations in this matter, the Committee agrees with the Regional Director’s conclusion that high-risk elements reflected in the credit union’s proposed strategies for issuing and deploying secondary capital could pose an unsafe and unsound exposure for XXXXXX. This is further complicated by the fact that XXXXXX’s due diligence process did not fully assess these high-risk elements.

The SRC disagrees with XXXXXX's argument that the Regional Director erred in failing to articulate how the credit union's secondary capital plan did not meet the regulatory components set forth in [§701.34\(b\)\(1\)](#). The committee notes the Regional Director has a broad responsibility to determine if a secondary capital plan and management's risk management process represent a safe and sound endeavor for a credit union. Part of the Regional Director's responsibility when evaluating a secondary capital plan is to determine whether the requisite information from a credit union has merit and the proposed strategy does not expose the credit union to undue risk.

The SRC also finds XXXXXX's argument that the Regional Director did not explain how the credit union failed to demonstrate a "realistic means to retire the secondary capital without undue risk to the ongoing safety and soundness" as an insufficient grounds to overturn the denial decision. The SRC agrees with the Regional Director that XXXXXX's explanation of the "safety net" component in its plan (pairing secondary capital note maturity payments with zero-coupon Treasury securities with the same maturity timeframes) fails to address the larger safety and soundness concerns because, viewed in isolation, this ignores the risks inherent in the rest of XXXXXX's pro forma balance sheet. XXXXXX's plan calls for an extraordinary amount of borrowing as compared to historical levels seen in other credit unions, on top of the secondary capital issuance. The committee finds that the credit union's request represents significant leverage to the balance sheet.

In turn, the leverage introduces complexity and uncertainty surrounding the credit union's ongoing reliance on, and renewal of, borrowed funds. Any reliance on a high-leverage strategy, independent of secondary capital issuance, raises a credit union's burden of proof to demonstrate that its liquidity and contingency funding plans are commensurate with the higher levels of complexity and risk.¹ XXXXXX's discussion of risks does not appear to contemplate that having significantly higher amounts of leverage impacts the degree of liquidity risk in the credit union's balance sheet. Deteriorating credit risk is interrelated to liquidity risk; the level of correlation increases with the degree of financial leverage. Management's discussion of risk omitted this.

The SRC determined that XXXXXX's due diligence scenarios were overly optimistic and did not capture potential downside risks that could arise from credit and liquidity strains on the credit union's pro forma balance sheet. The secondary capital plan relied on considerable borrowing and deployment of funds into higher risk assets (for example, business loan participations) at a cost that implied a relatively modest net interest margin. This left little room for variability in the underlying assumptions. This strategy could expose XXXXXX to a higher potential volatility in its income and retained earnings, which would make it more susceptible to liquidity risk should it experience adverse financial pressures from deterioration in its credit portfolios and/or an unexpected rise in deposit and funding costs (or a combination thereof).

As a federally insured credit union with total assets over \$50 million, XXXXXX has a

¹ [§741.12\(d\)](#) requires an insured credit union with assets greater than \$50 million to have a written contingency funding plan commensurate with its complexity, risk profile, and scope of operations that sets out strategies for addressing liquidity shortfalls in emergency situations. Such contingency funding plans must include policies to manage a range of stress environments and identify likely liquidity responses to such events.

responsibility to tailor its liquidity policy and written contingency funding plans to the size and complexity of its business. As business plans shift toward a higher reliance on market-sensitive funds and higher-risk assets, liquidity risk generally increases and becomes more dynamic. This, in turn, increases the need for liquidity risk management tools, including a contingency funding plan that contemplates a range of liquidity-stress events and how a credit union would respond.

The absence of such scenarios from XXXXXX's plan and supporting analyses raised serious concerns about whether management has sufficient understanding of the key risks inherent in its strategy or the connection between higher leverage and risk to liquidity and net worth. Having reviewed all materials submitted by XXXXXX and the NCUA regional office and having considered comments provided by both parties at the oral hearing on January 24, 2019, the NCUA's Supervisory Review Committee's final decision is to uphold the NCUA Regional Director's denial of XXXXXX's application for secondary capital.

The Committee finds that the rule imposes no duty on the Regional Director to approve a secondary capital application because the plan meets the five requirements of the rule. The Committee also finds it is well within the Regional Director's authority to consider safety and soundness concerns when reviewing a secondary capital application for approval. Lastly, the Committee finds that the Regional Director's determination to deny the credit unions application is fully supported by the evidence. The Committee finds that the supporting due diligence for XXXXXX's secondary capital plan was insufficient. The credit union failed to assess key risks arising from the plan's reliance on high levels of market sensitive wholesale funding (nonmember deposits and borrowing) and deployment of funds into higher risk assets. The credit union's proposed strategy would expose XXXXXX to a higher potential volatility in its income and retained earnings, elevating liquidity risk to potentially imprudent levels.

Absent the information obtained from a thorough analysis of these risks, neither the credit union nor the Regional Director has a complete picture of how the downside risks might impact liquidity, earnings, and capital in adverse conditions. The Regional Director was correct to deny the application on the grounds of safety and soundness.

For the reasons outlined in this letter, the Supervisory Review Committee has decided to uphold the Regional Director's decision to deny your application for the \$XX million secondary capital request.

Pursuant to NCUA's regulations, 12 CFR [§746.109](#), you may appeal this decision to the NCUA Board within 30 calendar days of receiving this letter.² Such appeals must follow the requirements established in the regulation, and must be filed in writing with the Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314-3428. Please refer to the regulation for additional information.

Sincerely,

J. Owen Cole, Jr., Chairman
NCUA Supervisory Review Committee

cc: NCUA Board Secretary Gerard Poliquin
XXXXXX XXXXXXXX, Office of Examination and Insurance
SRC Member Todd Miller
SRC Member Kevin Rocks
Senior Staff Attorney Justin Anderson
Regional Director XXXXXXX XXXXXXX

² Alternatively, to the extent you intend to reapply instead of appealing this decision to the NCUA Board, the SRC recommends you address the deficiencies discussed in this letter and submit a new secondary capital plan to your region. It remains incumbent upon XXXXXXX to prepare a more comprehensive risk analysis that is commensurate with the planned levels of risk. The committee also encourages ongoing dialogue with the region to identify the necessary aspects of supporting due diligence most relevant to the underlying safety and soundness issues that were the basis of previous denials.