

February 4, 1998

Clifford N. Rosenthal, Executive Director
National Federation of Community Development Credit Unions
120 Wall Street
10th Floor
New York, NY 10005-3902

Re: Secondary Capital Program, Your Letter of December 2, 1997

Dear Mr. Rosenthal:

You have asked several questions concerning provisions of our secondary capital rule, 12 C.F.R. §701.34. We have rephrased some of your questions slightly for ease of understanding and added two questions you raised after we received your letter.

(1) Must interest earned on a secondary capital account be "reinvested" in the credit union or can it be paid directly to you, a secondary capital lender, for example, on a quarterly schedule or placed in a separate account apart from the secondary capital principal and withdrawn at your discretion?

Section 701.34(b)(7) provides that "[f]unds in the secondary capital account, including both principal and interest, must be available to cover operating losses." Therefore, interest earned on a secondary capital account must remain in the secondary capital account until the account matures.

(2) Are the rate and terms of interest on the secondary capital loan, such as late fees or terms for acceleration of interest payment, a matter solely for negotiation between NFCDCU as lender and recipient credit unions?

Other than the secondary capital account conditions required by regulation in §701.34(b)(1-11), a secondary capital lender and a recipient credit union may negotiate the rate and other terms of the secondary capital account. Since principal and interest must remain in the secondary capital account until maturity, there would be no need for terms regarding an acceleration of interest payments or for late fees prior to the maturity date of the account.

(3) May you, as lender, demand partial or full repayment of a secondary capital loan, using all available legal remedies, under any of the following circumstances:

(a) if the borrowing credit union misrepresents any material facts to you either at the time of entering into a loan agreement or subsequently?

(b) if the credit union violates any financial terms of a loan agreement, for example, if the recipient credit union fails to pay interest in full and on time, even though the credit union is solvent, or fails to repay principal at maturity?

(c) if the credit union violates any non-financial terms of our loan agreement, for example, if the recipient credit union fails to provide programmatic reports as promised, fails to make loans or generate primary capital as promised, or fails to report on its lending activity?

The legal remedies available to you, to the extent they are not limited by regulatory terms governing your agreement, will depend on state law. The loan agreement is a contract between the secondary capital lender

and the recipient credit union and, if there is a breach of the agreement, you can pursue state law remedies. We cannot provide advice about the remedies that would be available under the contract law of various states but, as a general matter, we believe a state court would necessarily consider the materiality of the breach and the facts in a particular case.

If a borrowing credit union misrepresents material facts either at the time of entering into a secondary capital loan or subsequently, it is possible that a state court could hold that a breach of contract exists and consider such remedies as partial or full repayment, as well as rescission.

Regarding your question about remedies for a violation of financial terms, as noted above, a secondary lender generally will be able to avail itself of state law remedies for violation of the terms of the agreement. Your examples in relation to this question concern the timely payment of interest and principal and we want to emphasize that, under our regulation, both principal and interest are at risk until the account matures. While state law might generally consider a failure to repay principal at maturity a material breach, if principal is used by the credit union as secondary capital in compliance with our regulation, a failure to repay principal at maturity would not be a breach of contract. In fact, to the extent that a credit union uses secondary capital to cover operating losses as the regulation contemplates, repayment of the full principal would violate the regulation.

Regarding a credit union's violation of non-financial terms, it is difficult to say whether such nonperformance would ever be actionable under state law. If a state court determined that nonperformance of such terms amounted to a material breach, it is possible that it might order partial or full repayment of the loan. The examples you provide --providing reports, making loans, and generating primary capital-- are the type of nonperformance issues that a credit union may be able to cure if put on notice by the secondary capital lender. We believe that a court would likely consider the ability of a contracting party to cure the breach and the particular facts in a case in determining whether a material breach of contract has occurred.

We note that attaching numerous conditions to the establishment of a secondary capital account may lead to questions as to whether it is truly intended to be an account within the meaning of NCUA's regulation. Our regulation specifically states that a secondary capital account contract agreement may not contain conditions that are "inconsistent" with the conditions of the regulation. 12 C.F.R. §701.34(b)(10).

(4) What action may NCUA take if, in its judgment, a loan agreement signed by a credit union and by secondary capital lender, conflicts with NCUA regulations?

If an account does not meet the requirements of §701.34, NCUA could require a credit union to stop accounting for it as secondary capital and require the credit union to divest the account. If the credit union did not voluntarily divest the account, NCUA could use various enforcement mechanisms to force the divestment, including a cease and desist order or civil money penalty. 12 U.S.C. §1786.

(5) Does a secondary capital account devalue by 20% increments one year after it is received, for every year, or does it devalue when it ends its 5 years or less term?

Although funds placed into a secondary capital account must remain in the account until maturity, under §701.34(c), the amount of the account recorded on the balance sheet as secondary capital does decrease by 20% increments starting in the fifth year before maturity. For further information on the accounting treatment for secondary capital accounts, you may want to review the [Accounting Manual for Federal Credit Unions](#), pages 6-180 to 6-182, 4-208 to 4-209.

(6) If a credit union debits a secondary capital account to cover credit union losses exceeding the credit

union's net available reserves and undivided earnings, and if the credit union later recoups those losses, then can the credit union replenish the secondary capital account?

No, it cannot. Section 701.34(b)(7) prohibits restoration or replenishment of a secondary capital account after the secondary capital account has been debited for operating losses sustained by the credit union.

Sincerely,

Sheila Albin
Associate General Counsel

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