

May 8, 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  
Second Response to Your Letter of December 2, 1997

Dear Mr. Rosenthal:

You have asked us to reconsider a portion of our opinion letter to you dated February 4, 1998, that responded to several questions you had raised regarding NCUA's secondary capital rule. 12 C.F.R. §701.34. Specifically, you want us to reconsider our opinion that interest earned on secondary capital accounts must remain in the account until maturity. On reconsideration, we conclude that, as long as interest is not paid into the secondary capital account, a credit union may make periodic interest payments to a secondary capital investor. A failure to pay any interest prior to the maturity of the account, however, cannot be a default under the secondary account agreement.

The National Federation of Community Development Credit Unions (NFCDCU) is preparing to make investments under its Secondary Capital Program. In a meeting among NFCDCU representatives and NCUA personnel on the February 23, 1998, you explained that the NFCDCU was borrowing money from banks and charitable foundations which it, in turn, will invest in secondary capital accounts. Although these loans to NFCDCU were being made on favorable, below-market terms, the lenders were requiring interest payments to be made during the term of the loans. For NFCDCU to make interest payments to its lenders, it would need to receive interest payments from the credit unions in which it intends to establish secondary capital accounts.

In your earlier letter, you asked if NCUA required that interest earned on a secondary capital loan be "reinvested" in the credit union or can it be paid directly to you, for example, on a quarterly schedule or into a separate account and withdrawn at your discretion. We answered:

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.

On reconsideration, we believe it would be permissible for a secondary account agreement to provide that a credit union may pay interest directly to the investor or into a separate account from which it could be withdrawn. However, if interest is paid and deposited into the secondary capital account, it must remain in the secondary capital account until the account matures. In any event, the failure of a credit union to pay interest prior to the maturity of the secondary capital account cannot be deemed to be an event of default under the terms of an account agreement. To do so would undermine the purpose of the account and the provisions of our regulation.

The intent of the secondary capital account rule is to provide low-income designated credit unions with a long-term, stable source of funding to be used to cover operating losses. These accounts should enhance the financial well-being of the credit union and provide a safeguard while enabling the credit union to expand

its lending and other services to members.

To clarify this matter further, we note that you had asked in your letter if NFCDCU, as lender, could demand partial or full repayment of a secondary capital loan, if a credit union violates any financial or reporting terms of your secondary capital agreement. In part, we responded that: "The legal remedies available to you, to the extent they are not limited by regulatory terms governing your agreement, will depend on state law." Our view of the regulatory requirements of §701.34 is that a secondary capital account agreement can permit but cannot require periodic interest payments during the term of the account. In brief, failure to pay interest during the term of the account cannot give the investor a right to demand partial or full repayment or be deemed to be a breach of the account agreement.

Sincerely,

Sheila A. Albin  
Associate General Counsel

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97-1226c

cc: Office of Community Development Credit Unions  
Office of Examination and Insurance

[s:opsltrs98/secondary capital]