

UNITED STATES OF AMERICA
BEFORE THE NATIONAL CREDIT UNION ADMINISTRATION

In the Matter of

XXXX
CREDIT UNION

Docket No. BD - 01-17

Appeal from determination by the
Supervisory Review Committee

Decision and Order on Appeal
Decision

This matter comes before the National Credit Union Administration Board (Board) pursuant to National Credit Union Administration Interpretative Ruling and Policy Statement (IRPS) 11-1, as amended by IRPS 12-1, as an appeal of a decision by NCUA's Supervisory Review Committee (SRC). The appeal was filed by XXXX (FCU) challenging the determination by the SRC to uphold the composite CAMEL 3 rating accorded the FCU following its December 31, 2015 examination. The SRC also upheld the examiner's rating of 3 for both Asset Quality and Earnings. In accordance with the IRPS, credit unions may appeal component and composite CAMEL ratings of 3 or worse to the SRC, and adverse determinations by the SRC may be appealed to the Board.

Background and SRC Determination.

The FCU, with assets of approximately \$XXXX and located in XXXX, filed its initial challenge of its year-end 2015 exam results with NCUA's Region XXXX Director, who reviewed the circumstances and issued a determination rejecting the challenge and supporting the exam findings. The FCU appealed that determination to the SRC. Following its review of the record and after hearing an oral presentation by the FCU, the SRC issued its initial determination by letter dated December 1, 2016, upholding the examination results. The FCU subsequently alleged that the SRC's determination contained errors of material fact and requested reconsideration. Upon its further review, and after a second oral presentation by the FCU, the SRC issued a revised final determination by letter of December 29, 2016, reaffirming its initial decision and upholding the Regional Director's determination. The FCU appealed that decision to the Board by undated letter received by the Board Secretary on January 27, 2017.

Discussion and Analysis.

The issue before the Board in this case is whether the exam ratings assigned by the examiner and reflected in the report of examination are supportable. As more fully discussed below, an evaluation of the criteria by which such ratings are determined, as applied to the circumstances

present at the FCU as of the effective date of the exam, supports the conclusion that the judgment of the examiner was sound, as reviewed and confirmed by the Regional Director and the SRC.

Asset Quality. The criteria by which this and other component elements in the CAMEL rating system are evaluated are described in NCUA's Letter to Credit Unions 07-CU-12, December 2007. As set forth in the LCU:

[A] rating of 3 is assigned to credit unions when asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risk require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk management practices.

Furthermore, in keeping with NCUA's explicit adoption of risk-focused exam principles, ratings ascribed to Asset Quality should reflect not only existing, but also potential, credit risk associated with loans and investments. Management's ability to identify, measure, monitor, and control credit risk is reflected in the rating. As noted in NCUA Letter to Federal Credit Unions 02-FCU-09, May 2002, the exam process should be forward looking with a focus on management's ability to identify and manage risk.

As described in the exam report effective as of December 31, 2015, loans comprised a significant portion of the FCU's asset base. Growth in loans over the three years ending with 2015 was substantial, averaging approximately 50 percent per year. As noted in the Regional Summary and also by the SRC, such rapid growth, while not uncommon in a small credit union, nevertheless means that the portfolio is rather unseasoned. Coupled with the fact that many of the loans booked in 2015 had credit scores in the subprime range, the portfolio may be fairly characterized as concentrated and relatively risky. As of the exam date, the FCU's net worth was just over 10 percent. Given an unseasoned, subprime portfolio equal to 200 percent of net worth, together with the operating losses sustained by the FCU in previous years, the question of whether the FCU's net worth was sufficient to withstand the risks it was confronting is properly raised in the exam report.

As noted by the examiner, toward the end of the examination period, the FCU had initiated a new Small Business Administration (SBA) loan program. With new obligations to service and underwrite business loans in compliance with mandates established by the SBA, the FCU had elected to undertake significant new responsibilities. The SRC properly considered whether the FCU had developed comprehensive business plans and strategies for administering its loan program. As characterized by the SRC in its revised determination, the FCU's business plan lacked any financial projections showing expected results from its movement into this new loan program. Without such planning, it is difficult to anticipate whether the program will be successful, particularly in view of the relatively low credit scores that are associated with some of the loans in the portfolio. As the SRC's revised determination also noted, the FCU's delinquency computation and reporting methods during the exam period were inaccurate, which added to the overall credit risk.

For the foregoing reasons, and as more fully described in the SRC's written determinations, the 3 rating for the Asset Quality component is fully supported and is hereby affirmed.

Earnings. The consideration in this category is the adequacy and sufficiency of a credit union's earnings to create and sustain a net worth that is capable of supporting its current and future financial and operational risk exposure. As described in LCU 07-CU-12, a rating of 3 for this component of the CAMEL rating is an indication that earnings "need to be improved." Thus, where a credit union's earnings do not support current and future capital and allowance funding requirements in an amount that is commensurate with the credit union's overall condition, growth, and risk factors, a rating of 3 is appropriate.

In the case of this FCU, earnings had actually been negative for the first three quarters of 2015. The FCU was able to make a profit for its last quarter in 2015 (which was sufficient to render its operations for the year positive) through the booking of fee income associated with the sale of the guaranteed portion of two loans booked at year-end pursuant to its entry into the SBA lending program. Net income for 2013 and 2014 was negative. In addition, the FCU's operating expense ratio, which was in excess of seven percent of average assets for 2015 and at similar ranges for the two years preceding, was viewed by the SRC as unsustainable for a credit union with the FCU's net worth level. (The average annual operating expense ratio for the FCU's peer group was four percent of average assets.) The FCU's net worth ratio had been declining during the three years ending with the exam period, due to the combination of asset growth and operating losses. The fact that most of its loans may be characterized as subprime, as well as relatively unseasoned as of the exam period, produces additional potential stress on earnings and provides further support for the current rating. On balance, the 3 rating for the earnings component is fully supported and is hereby affirmed.

Composite Rating. The foregoing circumstances form the basis on which the FCU's composite CAMEL rating is founded. As described in LCU 07-CU-12, the following characteristics apply with respect to a composite 3 credit union:

Credit unions in this group exhibit some degree of supervisory concern in one or more of the component areas. These credit unions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Credit unions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those rated a composite 1 or 2. Additionally, these credit unions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the credit union's size, complexity, and risk profile. These credit unions require more than normal supervision which may include enforcement actions. Failure appears unlikely, however, given overall strength and financial capacity of these credit unions.

The FCU is quite small, with assets of approximately \$XXXX. As of the exam date, it had just embarked on a new lending program involving the SBA, which carried with it new responsibilities and obligations. Its relatively unseasoned loan portfolio, which grew very

aggressively during the three years ending December 2015, had aggregate balances owed by borrowers with subprime credit scores equal to 200 percent of net worth. The examiner noted exceptions in the FCU's delinquency reporting processes. The FCU had experienced negative earnings in nine of its last ten quarters as of the exam's effective date. Operating expenses, at more than seven percent of average assets, were viewed as unsustainable over the long run, particularly in view of the FCU's declining net worth. The FCU had limited core deposits, with fully half the share balance comprised of two non-member deposits. One member's deposit of \$XXXX represented another 25 percent of total deposits, leaving the FCU vulnerable should that member decide to withdraw his shares.¹ In the judgment of the examiner, as supported by the Regional Director and the SRC, these circumstances warranted a higher than normal degree of attention and supervision for this FCU. Insofar as these concerns are articulated and documented in the exam report and the related written materials comprising this case, the composite rating is well supported and is hereby affirmed.

The Board has considered the arguments put forth by the FCU in its appeal materials. Most of the findings noted by the examiner are not refuted. Indeed, the FCU offered no objection to the examiner's specific corrective action recommendations as set out in the Examiner Findings and the Document of Resolution portions of the report, including a direction to establish a policy dealing with concentration risk and identifying acceptable risk levels and percentages. Instead, the FCU focuses its appeal on three main areas of dispute, each of which is discussed in detail below. Other objections by the FCU are also addressed below. None of these is sufficient to cast doubt on the validity of the conclusions reached in the exam report or the component and composite ratings documented therein.

Merits of SBA Program. Much of the FCU's appeal focuses on the credit union's involvement with the SBA's guaranteed lending program. In particular, the FCU asserts that its involvement with this program merits significantly greater acknowledgement and credit from NCUA than it has received thus far. The FCU characterizes its involvement with this program as a creative and innovative way for it and other small credit unions to achieve financial success, and in its appeal chides the NCUA for its unwillingness to take a "leap of faith" to provide greater support for its business model. Implying that its involvement with the SBA program, in itself, warrants a composite rating of 2, the FCU complains that its path of growth through participation in SBA's guaranteed loan program is of "apparently no use" to NCUA. The FCU also implies that NCUA has completely failed to understand or appreciate how participation in the SBA program works. In fact, however, the year-end 2015 exam report, which is the subject of this appeal, did not focus on the FCU's involvement with the SBA program, which had only just begun toward the end of the exam period. Accordingly, virtually all of the assertions made by the FCU concerning the merits of the SBA program are not relevant to the issues present in this case.

Impact of Composite 3 Rating. The FCU devotes substantial attention in its appeal materials to the impact its having been rated a composite 3 has had on its operations. In particular, the FCU identifies two problems it has encountered based on its rating. First, the FCU complains that its rating precludes it from securing any grant money made available through NCUA's Office of Small Credit Union Initiatives (OSCUI). It is true that some of the funding that OSCUI offers is

¹ In fact, these shares were owned by an FCU official, who passed away during the exam. It was unclear at the time whether his widow would maintain or withdraw the funds.

limited to applicants with composite ratings of 1 or 2. These circumstances are a function of the finite nature of the funding and the competition for that funding among eligible credit unions. There are other funding initiatives sponsored by OSCUI that are more generally available to any low income credit union regardless of its composite rating, including funds for training requests, internship expenses, and emergency expenses. In any event, the relative availability of OSCUI grant money has no bearing on the question of whether this particular FCU has received the appropriate composite rating. The purpose of the composite rating system is not to facilitate or support credit union access to OSCUI grant money.

Second, the FCU complains that its composite rating of 3 is costing it a significant amount of money. The FCU asserts that prospective secondary capital investors may require a relatively higher rate of return in exchange for investing in CAMEL 3 credit unions, and that this differential is, in this case, prohibitive. Again, however, this factor has no bearing on the question of whether the composite rating awarded to the FCU is supportable. Furthermore, CAMEL ratings are confidential and are not revealed by NCUA.

Risk-Focused Exam. In its appeal materials, including statements made during the first oral presentation before the SRC, the FCU challenges the examiner's forward looking focus on risk, rather than on static circumstances as they were at the time of the exam. The FCU points out, for example, that it had limited delinquencies or charge offs as of the examination period. In the view of the FCU, the SRC's focus on looking forward amounts to little more than idle speculation that requires a crystal ball to be of any value. The FCU implies that a matrix approach to examinations would be more useful and effective. As the SRC correctly noted in its decision, however, NCUA abandoned the matrix approach to examinations over ten years ago and has, quite clearly, adopted the risk-focused exam protocol.² Accordingly, this aspect of the FCU's challenge to the exam findings is of limited significance.

The Board has considered the other criticisms advanced by the FCU in support of its appeal and does not find them to be compelling.

Conclusion

As of year-end 2015, circumstances prevailing at the FCU, including a concentration in relatively high risk loans, high operating expenses, a relatively unseasoned loan portfolio, and periods of negative earnings, support the examiner's component ratings of 3 for Asset Quality and Earnings. These circumstances also support the examiner's conclusion that the FCU warranted a closer than normal level of supervision. Insofar as a composite rating of 3 would help to assure that level of supervision, it, too, is well-founded.

Order

For the reasons set forth above, it is ORDERED as follows:

The decision of the SRC denying XXXX FCU's challenge of NCUA Region XXXX's determination to accord component CAMEL ratings of 3 for Asset Quality and Earnings, as well

² This risk-focused approach is described in detail in Letter to FCUs 02-FCU-09.

as the Region's determination to accord XXXX FCU a composite CAMEL rating of 3, is affirmed, and the appeal by XXXX FCU is denied.

The Board's decision constitutes a final agency determination, which is reviewable in accordance with the provisions of Chapter 7, Title 5, United States Code. Such action must be filed within 60 days of the date of this final determination.

So **Ordered** this 25th day of May, 2017, by the National Credit Union Administration Board.

Gerard Poliquin
Secretary of the Board