



National Credit Union Administration

April 1, 2019

Federal Express and Email

Mr. XXXXX XXXXXXXXX, President/CEO  
XXXXXX Federal Credit Union  
XXX XXXXXXXXX XX  
XXXXXXX, XX XXXXX  
XXXXXXXXXX

RE: XXXXX Federal Credit Union  
Supervisory Review Committee Appeal Decision  
(SRC-02-19)

Dear Mr. XXXXXX:

On October 25, 2018, the NCUA Secretary of the Board received your notice of appeal, which stated:

XXXXXX appeals the decision of its NCUA Regional Director (Region XX) that denied XXXXXX's Application for Secondary Capital. This decision was submitted to XXXXXX in a letter dated August 2, 2018. The basis for the denial was later re-stated by the Regional Director in her letter dated September 28, 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 Committee'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 C.F.R. § 701.34. A chronology of major activities relating to XXXXXX's request for approval to issue secondary capital is as follows:

Date	Activity
June 18, 2018	XXXXXX submitted a secondary capital plan to the NCUA Region XXX Regional Director requesting authority to issue \$XX million in secondary capital.
August 2, 2018	NCUA Regional Director denied XXXXXX's secondary capital plan, citing safety and soundness reasons.
August 30, 2018	XXXXXX requested the Regional Director reconsider the revised secondary capital plan.
September 28, 2018	NCUA Regional Director denied XXXXXX's request for reconsideration of the revised secondary capital plan, citing safety and soundness reasons.

Date	Activity
October 25, 2018	XXXXXX appealed the NCUA Regional Director's denial of the revised secondary capital plan application to the NCUA SRC for review pursuant to 12 C.F.R. § 746.107.
November 6, 2018	NCUA SRC determined XXXXXX's appeal was incomplete.
November 21, 2018	XXXXXX emailed additional information requested by NCUA SRC.
March 1, 2019	XXXXXX and NCUA presented their cases before the NCUA SRC in an oral hearing at the NCUA headquarters in Alexandria, VA, in accordance with 12 C.F.R. § 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 12 C.F.R. § 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 C.F.R. § 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. "...did not articulate how XXXXXX's SC Plan failed to meet any one or more of the five regulatory requirements for secondary capital pursuant to 12 C.F.R. § 701.34 (b)(1)."
2. "...alleges that her authority to evaluate the safety and soundness of the SC Plan exists **in addition to** the regulatory criteria of 12 C.F.R. § 701.34(b)(1), rather than **in accordance with** this criteria. We believe this falls into the category of **excessive**

**discretion** that was rejected by the NCUA Board when the regulatory scheme for secondary capital was amended in 2006. Any “safety and soundness concerns” alleged by a Regional Director as a basis for denial of a secondary capital obligation must fall within the scope of the regulatory criteria stated in 12 C.F.R. § 701.34(b)(1). We believe that our request is in accordance with the terms and conditions of 12 C.F.R. § 701.34(b)(1), and sufficient for approval to receive the secondary capital requested.

3. “...fails to explain how the SC Plan “did not adequately support the credit union’s ability to repay the secondary capital upon maturity of the accounts.” There is no provision of 12 C.F.R. § 701.34(b)(1) that requires an LICU to demonstrate how its SC Plan provides for a liquidity relief valve for the credit union or its members.”

XXXXXX 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 12 C.F.R. § 701.34(b)(1) have been addressed, and that the NCUA Regional Director went beyond her discretionary authority when denying XXXXXX’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 C.F.R. § 701.34 then the Regional Director must approve the plan. The credit union states that this is mandatory approval pursuant to 12 C.F.R. § 741.204(c). This argument, however, is not correct. As NCUA’s counsel correctly reasoned at the oral hearing, and as the SRC has previously ruled (SRC-01-19), the regulation must be read in its entirety. A complete reading of 12 C.F.R. § 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 12 C.F.R. § 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 12 C.F.R. § 701.43(b)(1); and redeem secondary capital accounts in accordance with the terms and conditions in 12 C.F.R. § 701.34(d).

Accordingly, 12 C.F.R. § 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

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proposed rule that created this section of the regulations: “The new 12 C.F.R. § 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 12 C.F.R. § 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 SRC 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. The Plan presents safety and soundness concerns in the following areas: inadequate liquidity risk assessment, incomplete interest rate risk assessment, and no exit or stop-loss strategy. Furthermore, XXXXXX’s due diligence process did not fully assess these high-risk elements of the Plan.

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 12 C.F.R. § 701.34(b)(1). The SRC notes the Regional Director has 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

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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 Regional Director clearly communicated XXXXX's failure to address the risk associated with the Plan.

The SRC agrees with the Regional Director regarding the inadequate liquidity risk assessment. XXXXX'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 assess potential liquidity cash flow "event" scenarios across the institution's total balance sheet throughout the life of the Plan. The Plan fails to measure the potential impact to capital from liquidating securities under varying interest rate scenarios. The Plan did not address potential costs to exit nor increased dividend or borrowing costs from the extraordinary amount of borrowing. Finally, the Plan did not adequately support XXXXX's ability to repay the secondary capital upon maturity of the accounts, particularly under various stressed scenarios. The Plan also projects a low level of operational liquidity at its conclusion. In summary, XXXXX failed to consider all liquidity risks associated with the Plan.

The SRC further agrees with the Regional Director's conclusion that the Plan did not adequately support the assessment of potential interest rate risk from leveraging the balance sheet. XXXXX failed to analyze net economic value and net interest income under various what-if scenarios, and failed to document assumptions. The Regional Director's safety and soundness concerns with interest rate risk created by the Plan is well founded in light of XXXXX's failure to document a comprehensive analysis of the risk.

The Regional Director also cited XXXXX's failure to sufficiently discuss an exit or stop-loss strategy. XXXXX includes inadequate analysis of its capacity to deleverage the balance sheet under multiple scenarios. The denial properly cited the need for an exit or stop-loss strategy as a principle of safety and soundness. The Plan failed to demonstrate an ability to deleverage the balance sheet in the event of profitability difficulties, significant changes in economic conditions, or other challenges. The SRC concurs with the Regional Director regarding the absence of a sufficient exit or stop-loss strategy.

Having reviewed all materials submitted by XXXXX and the NCUA regional office and having considered comments provided by both parties at the oral hearing on March 1, 2019, the NCUA's Supervisory Review Committee's final decision is to uphold the NCUA Regional Director's denial of XXXXX's application for secondary capital.

The SRC 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 SRC 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 SRC finds that the Regional Director's determination to deny the credit union's application is fully supported by the evidence.

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

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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 is upholding the Regional Director's decision to deny the application for the \$XX million secondary capital request.**

Pursuant to NCUA's regulations, 12 C.F.R. § 746.109, you may appeal this decision to the NCUA Board within 30 calendar days of receiving this letter. 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,

Joy Lee, Panel Chairman  
NCUA Supervisory Review Committee

cc: NCUA Board Secretary  
Regional Director  
Office of General Counsel