



National Credit Union Administration

Office of Examination and Insurance

November 30, 2018

SENT BY FEDERAL EXPRESS AND EMAIL

XXXX

Chief Executive Officer

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Dear XXXX:

On October 18, 2018, you filed a request for review by the Director of the Office of Examination and Insurance (“E&I”) of your credit union’s \$XXXX million secondary capital request denial. Regional Director XXXX denied your original request on August 3, 2018, and denied a subsequent request for reconsideration on September 20, 2018.

On November 2, 2018, you provided a certification from your board of directors authorizing the request for review. You filed this request pursuant to 12 C.F.R. Part 746.106, which allows a credit union to seek my review of a written material supervisory determination by a program office. Specifically, you are seeking my approval to obtain \$XXXX million in secondary capital as outlined in your June 20, 2018 *Request for Secondary Capital*.

As discussed more fully below, I deny your \$XXXX million secondary capital plan.

Background

On June 20, 2018, XXXX submitted a secondary capital plan to the region. On August 3, 2018, Regional Director XXXX denied XXXX secondary capital plan based on the following three deficiencies:

- *“Your intended use of secondary capital does not clearly conform to your business plan as documented in the 2018 Operating Plan (Appendix C of your secondary capital plan). For example loan balances in your 2018 Operating Plan are materially different from the loan figures disclosed in your secondary capital plan’s pro forma financial statements.”*
- *“The pro forma financial statements included with your secondary capital plan are based on the sale of your XXXX portfolio before the start of the period. Given current market conditions, it is unclear if this is a realistic or clearly supported assumption. Moreover, the secondary capital plan narrative indicates that an additional \$XXXX million of XXXX loan restructures would be presumed if a portfolio sale cannot be consummated. However, this \$XXXX million figure is not clearly supported by detailed analysis of borrower cash flows, financial condition, etc.”*

- *“While the secondary capital plan appears to indicate that growth will not elevate your credit risk, pro forma financial statements do not provide enough detail to support this assertion. Your pro forma financial statements reflect total loan growth of XXXX percent each year for the first XXXX years of your plan, followed by XXXX percent total loan growth in each of the last remaining XXXX years of the plan. Despite the significant impact to your balance sheet, there is no additional details on the loan portfolio composition throughout the life of the plan.”*

On August 23, 2018, XXXX submitted a request for reconsideration to the region. On September 20, 2018, Regional Director XXXX affirmed XXXX earlier secondary capital plan denial based on the following three deficiencies:

- *“Your intended use of secondary capital does not conform to your strategic plan, business plan and budget. In your request for reconsideration you confirm that you have not aligned (or realigned) your strategic, business and budget planning with your SC plan. While the overarching goals of the SC plan may be similar to the board of directors’ current strategic objectives, your current business plans for reaching those objectives, financial projections and prospective risk profile are significantly different from your SC plan. It appears that the SC plan was created independent of your strategic, business and budget planning processes, and subsequent action has not been taken to fully reevaluate and sufficiently reconcile these discrepancies.”*
- *“Your request for reconsideration did not provide analysis that sufficiently supports the \$XXXX million estimated additional XXXX loss figure used as a core assumption in the SC Plan. You note that you continue to perform XXXX portfolio value analysis and provide several statements on the tenants used to derive this figure; however, you did not provide the underlying loan level analysis or sales estimates to support this assumption. Absent supporting detail, the reasonableness of this core assumption cannot be properly evaluated.”*
- *“Your request for reconsideration did not provide sufficient support to ascertain the credit risk posed by the loan growth assumptions in your SC plan. Although you provide general statements suggested limited changes to your current composition, you do not provide appropriate detail regarding the in-house loan programs, third party programs, loan participations or other lending strategies you will pursue. Additionally, you have not provided any detail regarding the credit risk characteristics of such programs or how you will control credit risk as you execute this loan growth. Your request for reconsideration points to your past history on credit risk; however, the historical operating environment is not reflective of the current interest rate environment or the elevated cost of funds inherent to the SC plan’s leveraging strategies. Additionally, as you know, your credit union currently exhibits elevated credit risk that has had a significant negative impact on the credit union. Absent detailed analysis of the credit risk profile of the SC plan, I cannot conclude the plan is safe and sound.”*

Discussion

E&I has jurisdiction to review Regional Director XXXX's decision, as your request for review was timely and is a material supervisory determination. 12 C.F.R. Part 746.103 defines a material supervisory determination as, "...a written decision by a program office (unless ineligible for an appeal) 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."

Regional Director XXXX's denial of your secondary capital request qualifies as a material supervisory determination because it has a significant impact on XXXX's operating flexibility and capital. As stated on page 13 of your Request for Secondary Capital, "*...in the first year of the pro forma financials, the firm's net worth will still increase from \$XXXX million to \$XXXX million as a result of secondary capital and the reinstatement of robust earnings, and its NWR will increase from XXXX% to XXXX%. The growth posture that XXXX intends to resume as a result of secondary capital should allow the firm to achieve a net worth ratio above XXXX% throughout the course of the SC Plan and return to a similar pattern of robust capitalization as the firm enjoyed prior to the XXXX impairment.*" Denying XXXX's secondary capital plan hinders the credit union's operating flexibility, ability to grow, and level of capital.

Following the receipt of your request, my staff reviewed the information provided, as well as requested and reviewed information provided the region. In addition, we discussed relevant law and agency guidelines with the NCUA's Office of General Counsel.

While your request for E&I Director review contained additional documentation that helped address some of the deficiencies noted in the region's earlier secondary capital plan denials, you indicated some of these documents (Attachments V – IX of your submission) were developed *after* the region's denials. As part of E&I's review of your appeal, 12 C.F.R. Part 746.106 states a credit union must submit to the Director of E&I "Any evidence relied upon by the insured credit union that was not previously provided to the appropriate program office making the material supervisory determination." However, the additional documentation you submitted, as noted above, did not exist at the time of the region's denials, so your credit union could not have relied upon it in concluding the region erred in its determination.

Further, the region did not have an opportunity to request or consider this evidence, since it did not exist at the time. Therefore, I am only considering the evidence provided to the region and other documentation you provided, or that my office requested in considering this appeal, that existed at the time of the region's denials. If you want the agency to consider the information developed after the region's denials, please re-apply to the region.

Based on my review of the information eligible for consideration, I find your secondary capital plan reflects significant loan growth – XXXX percent each year for the first XXXX years of

your plan followed by XXXX percent for the remaining XXXX years of the plan.¹ However, your secondary capital plan does not identify where growth within your loan portfolio is expected to occur, both in type and credit quality. The general information you did provide about your planned loan growth contains contradictory statements. For example, your *Request for Secondary Capital* dated June 20, 2018, states:

“XXXX expects to achieve healthy growth by an intense focus on loan originations and by developing financing solutions to a variety of diversified members through relationships with industry partners. The firm will also use its additional capital to benefit member performance, with an emphasis on expanding member relationships and developing products and services that convert members beyond their originating loan.”

However, your letter to Regional Director XXXX, dated August 23, 2018, requesting reconsideration of the secondary capital request states:

“The Plan does not anticipate any change to our business lines or incorporation of new programs.”

In addition, you state in Objective 2 of your *Revised Strategic Statement Assuming Issuance of Secondary Capital*, provided on October 18, 2018:

“Identify, pursue and build a pipeline of additional specialty finance programs. New Programs will be selected and existing programs will be evaluated based on risk and return factors including: yield, scale, liquidity, credit, competition, operational efficiency, portfolio diversification, reputation, etc.”

Further, you state in your letter to the Secretary of the Board, dated October 18, 2018:

“XXXX does not plan to use the additional secondary capital by creating new products and services; instead, XXXX plans to use the secondary capital to bolster its operating net worth position and allow XXXX to continue to moderately grow existing products and services.”

The above statements regarding the nature of your planned loan growth are clearly contradictory. In addition, when my staff spoke with XXXX management they were unable to ascertain with sufficient specificity the types and credit quality of the new loans you plan to add to your portfolio.²

¹ According to the pro forma financial statements provided with your June 20, 2018 Request for Secondary Capital, your total loans as of the fourth-quarter 2017 are \$XXXX and you plan to grow your loan portfolio by \$XXXX over the term of the secondary capital.

² My staff spoke with the credit union’s XXXX, XXXX, XXXX, and XXXX.

Therefore, I cannot fully assess the purpose for which the secondary capital will be used.³ In particular, I cannot determine the extent to which the secondary capital might facilitate growth in riskier forms of lending – and therefore the safety and soundness of your plan.

Decision

For the reasons noted above, my decision is to reject your \$XXXX million secondary capital request.

To the extent you intend to reapply, I recommend you address the deficiencies discussed above and submit a new secondary capital plan to the region. In addition, you need to include in your revised secondary capital plan: (1) the additional information on the XXXX impact loan level schedule you provided with your letter to the Secretary of the Board, dated October 18, 2018; (2) any additional information on your ongoing due diligence on your XXXX loan portfolio; and (3) your updated operating plan assuming issuance of secondary capital. I encourage you to engage in a dialogue with the region in developing your revised request.

Pursuant to NCUA's Regulations, 12 C.F.R. Part 746.107, you may appeal this decision to the Supervisory Review Committee within 30 calendar days of receipt of this letter. Such an appeal must follow the requirements of 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 Part 746.107 for additional information regarding the required contents of an appeal.

Sincerely,

Larry Fazio
Director

cc: Board Chairperson XXXX
Regional Director XXXX
Board Secretary Poliquin
XXXX

³ I would also note your credit union is exceeding target limits for XXXX established in the *Operating Plan*. Your August 23, 2018, letter to Regional Director XXXX, states "*This concentration continues to be monitored by XXXX's management, but does not require immediate action because their liquidity allows the ability to reduce the position for other opportunities.*"