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# National Credit Union Administration

Office of Examination and Insurance

March 26, 2019

SENT BY FEDERAL EXPRESS AND EMAIL

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President and Chief Executive Officer

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Dear XXXX:

On January 28, 2019, you filed a request for reconsideration by the Director of the Office of Examination and Insurance (“E&I”) of your credit union’s XXXX, examination report. E&I received your request on January 29, 2019. On February 11, 2019, you completed your request by providing a certification from your board of directors authorizing the request for review. On February 20, 2019, E&I requested additional information, which was received on March 6, 2019.

You are requesting a review of the material supervisory determination made on December 28, 2018 by Regional Director XXXX. You filed this request pursuant to 12 C.F.R. § 746.106, which allows a credit union to seek my review of a written material supervisory determination by a program office. Specifically, you seek my review of the “3” CAMEL composite rating assigned during your XXXX, examination.

As discussed more fully below, I deny your request to change the CAMEL composite rating as assigned during your XXXX examination.

## Background

At the conclusion of your examination (effective date XXXX), you requested the Region reconsider a number of items resulting from the examination. Your request for changes included the following items.

- Removing the Document of Resolution (DOR) item for insufficient strategic planning;
- Removing the DOR for weak earnings performance;
- Removing the DOR for budget monitoring,
- Removing the DOR for high operating expenses;
- Reconsidering the Capital Adequacy, Management, Earnings, and Liquidity CAMEL “3” component ratings; and

- Reconsidering the CAMEL “3” composite rating.

The Region denied your request in a Regional Director’s Letter on December 28, 2018 (see enclosure).

### Discussion

Pursuant to the NCUA’s regulations, 12 C.F.R. § 746.106, the Director of E&I has jurisdiction to review a program office’s material supervisory determination, if the request for review was preceded by a request for reconsideration with the program office, and filed within 30 days of a response from the program office. The NCUA’s regulations define a “material supervisory determination” as a 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. 12 C.F.R. § 746.103(a). Your request for review was timely and met the definition of a material supervisory determination.

Following the receipt of your request, my staff and I reviewed the information provided, as well as additional information requested from the Region and the credit union. My staff and I also discussed relevant law and agency guidelines with the NCUA’s Office of General Counsel and relevant national NCUA subject matter experts.

The determination provided below is the result of the review of documentation and communications with the parties involved (credit union, Region, etc.). Unless otherwise specified, all information is as of the XXXX, examination report.

### **CAMEL Composite Rating**

The CAMEL composite rating of “3” is a material supervisory determination as it affects the nature and level of supervisory oversight of an insured credit union. Your credit union is a XXXX and you are a XXXX. I recognize as a XXXX you have a specialized business model that impacts the way you serve your members and the financial performance of your credit union. My staff and I took this into account in evaluating your request for review.

### *Capital Strength*

The credit union’s net worth has declined from XXXX percent as of XXXX, to XXXX percent as of the XXXX, examination effective date. This decline is due to low or negative earnings since XXXX and relatively strong share growth through the end of XXXX. While the net worth ratio has been on an upward trend since year end XXXX, the improvement has been almost entirely due to negative asset growth. Given weak earnings and moderate level of credit risk, the credit union’s modest net worth level is less than satisfactory and does not fully support its risk profile.

### *Weak Earnings Performance*

Since XXXX, the credit union has had weak or negative earnings. The weak earnings performance is due to high operating expenses over this period (remaining well above XXXX percent), combined with an increase in loan loss expenses in XXXX and XXXX.<sup>1</sup> The credit union's investment in a relatively high level of fixed assets with the \$XXXX million building acquisition in XXXX will likely put additional pressure on net income in the near term.

As part of our analysis of current and prospective earnings, my staff and I reviewed the balance sheet and income forecast in the XXXX that you represented is part of the pre-purchase analysis you conducted when considering acquisition of the XXXX building. The 12 month forecasted income is only XXXX basis points. There is no support documenting how the key assumptions in the forecast were determined. My staff and I also noted weaknesses in the forecast. For example, the XXXX, forecast does not properly account for how the credit union funded the XXXX acquisition. The method of funding used, brokered non-member deposits, is more expensive than the approach incorporated in the forecast (a drawdown of cash).

Also, based on the budget materials you submitted, it is unclear how the XXXX building acquisition will affect the credit union's overall financial condition and operating performance. There is little to no documentation of key assumptions used in developing the budget.

Based on the reasons above, I conclude earnings may not fully support current and future capital and allowance funding commensurate with the credit union's overall condition, growth, and risk factors.

### *Management Deficiencies*

Management of the credit union has demonstrated several weaknesses in managing the financial condition of the credit union. The following deficiencies are of particular concern.

- As discussed above, management did not adequately analyze the financial impact of the purchase of its XXXX building.<sup>2</sup>

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<sup>1</sup> The credit union reported an improved return on average assets ratio of XXXX percent as of XXXX. I would note, however, that the credit union would have operated at a loss for XXXX had it not been for the extraordinary non-recurring gain associated with the lease buy-out. Without this gain, your credit union would have shown negative earnings and a negative ROA at year-end.

<sup>2</sup> I concur you did not need to update your Strategic Plan prior to purchasing your building. If the building acquisition is material to the credit union's strategy or business model, you should then update your Strategic Plan during the credit union's next planning session. Please work with the Region on their expectations regarding the Document of Resolution item currently outstanding related to your Strategic Plan.

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- Also as noted above, the credit union has failed to properly manage earnings. There are weaknesses in the budget and financial planning process.
- The credit union's liquidity management practices warrant improvement. You have low levels of liquidity and have been unduly relying on high cost, brokered nonmember deposits. Your cash and short-term investments were low at XXXX percent as of XXXX. The credit union has a history of maintaining low levels of liquidity - relying on borrowings, and now brokered nonmember deposits, to meet funding needs. With the decline in member shares, the credit union's ability to maintain adequate liquidity could be severely compromised if above market rates cannot be sustained on nonmember deposits.

Therefore, I conclude the credit union's risk management practices are less than satisfactory given the nature of the credit union's activities.

#### *Composite CAMEL Rating*

As described in Letter to Credit Unions (LCU 07-CU-12), the following characteristics apply with respect to a CAMEL composite "3" rating.

*"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 timeframes. 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."*

For the reasons discussed above, your credit union continues to exhibit some degree of supervisory concern in multiple areas. Your credit union is generally less capable of withstanding business fluctuations and risk management practice are less than satisfactory relative to your size, complexity, and risk profile. Therefore, your credit union's financial and operational condition are consistent with a CAMEL composite "3" rating.

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### **Final Determination**

Based on the information outlined above, I deny your request to change the CAMEL composite rating.

Pursuant to the NCUA's regulations, 12 C.F.R. § 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 § 746.107 of the NCUA's regulations for additional information regarding the required contents of an appeal to the Supervisory Review Committee.

Sincerely,

Larry Fazio, Director  
Office of Examination and Insurance

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