



Secondary Capital

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How to increase capital?

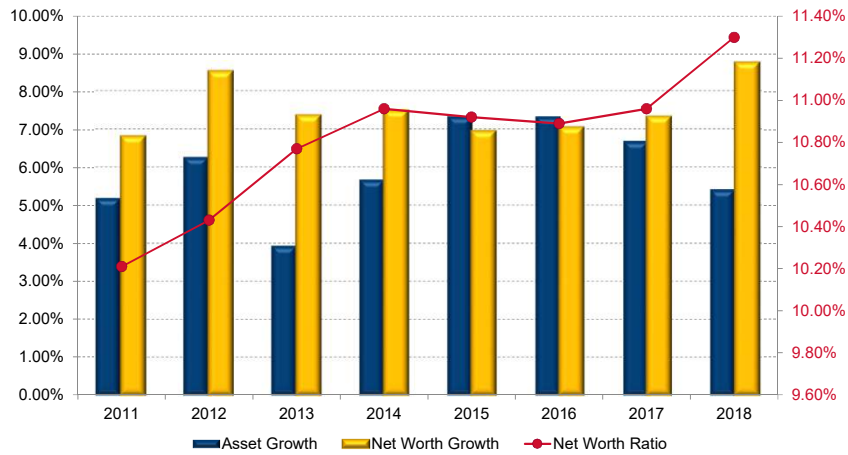
- Organically through earnings
- Apply to NCUA for permission to issue secondary capital
- Both



Assets & Net Worth

Strong earning has pushed net worth growth above asset growth and boosted the industry's net worth ratio.

The industry's net worth ratio is 11.3 percent, the highest level in 10 years.



Source: NCUA



3

Assets Yield & Net Spread

	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>
Loan Yield	5.76%	5.42%	5.01%	4.79%	4.64%	4.56%	4.56%	4.70%
Inv Yield	1.61%	1.27%	1.13%	1.24%	1.24%	1.35%	1.66%	2.04%
Asset Yield	4.32%	4.10%	3.88%	3.79%	3.78%	3.75%	3.81%	4.13%
Cost of Funds	-0.93%	-0.73%	-0.59%	-0.54%	-0.52%	-0.53%	-0.57%	-0.69%
Net Spread	3.39%	3.37%	3.29%	3.25%	3.26%	3.22%	3.24%	3.44%

Source: NCUA



4

Return on Assets (ROA)

	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>
Net Spread	3.39%	3.37%	3.29%	3.25%	3.26%	3.22%	3.24%	3.44%
Non-Int Inc	1.30%	1.43%	1.38%	1.31%	1.32%	1.35%	1.29%	1.38%
Non-Int Exp	-3.32%	-3.51%	-3.57%	-3.48%	-3.49%	-3.40%	-3.30%	-3.44%
Net Op Exp	2.02%	2.08%	2.19%	2.17%	2.17%	2.05%	2.01%	2.06%
Inc from Op	1.37%	1.29%	1.10%	1.08%	1.09%	1.17%	1.23%	1.38%
Provisions	-0.50%	-0.36%	-0.26%	-0.28%	-0.35%	-0.41%	-0.43%	-0.46%
Charge-offs	-0.91%	-0.73%	-0.57%	-0.50%	-0.48%	-0.55%	-0.60%	-0.58%
ROA (w Pro)	0.87%	0.93%	0.84%	0.80%	0.74%	0.76%	0.79%	0.92%
ROA (w CO)	0.46%	0.56%	0.53%	0.58%	0.61%	0.62%	0.63%	0.80%

Source: NCUA

5

Asset Growth Rate

- A credit union's asset growth rate is bound by the growth rate of equity.

$$\text{Maximum Asset Growth} = \frac{\text{ROA}}{\text{Net Worth Ratio}}$$

Examples:

- 8.85% = 1.00% / 11.30%
- 7.08% = 0.80% / 11.30%
- 5.31% = 0.60% / 11.30%



6

Enhancing your ROA

- Assess your earning asset allocation to determine if loans-to-assets ratio, loan mix and loan pricing is optimal.
- Assess your share mix and pricing to determine if your cost of funds and liability duration is optimal, given your asset allocations.
- Assess your net operating expense structure to determine if non-interest income and expense are appropriate. Evaluate your operating efficiencies.



7

History of Secondary Capital

- Low-income designation (LID) was established by NCUA in 1970, and approximately 48 percent of credit unions today have the designation.
- In 1996, NCUA approves LID CUs to count as capital uninsured secondary capital
- The first credit union to have secondary capital was in 1997
- By 2000, there were 25 LICUs with secondary capital
- Primary investors have been:
 - National Federation of Community Development CUs
 - National Community Investment Fund
 - CDFI fund
 - The Ford Foundation



8

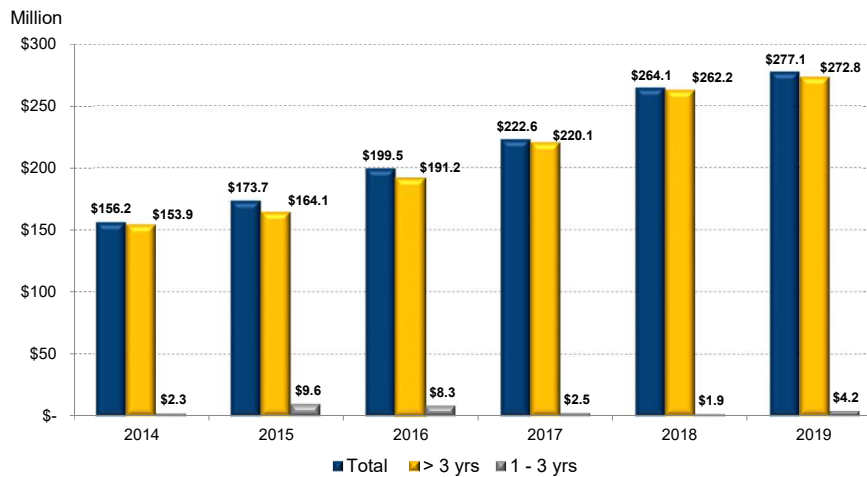
Secondary Capital Landscape

- As of March 31st, 2019
 - 67 credit unions had secondary capital on their balance sheet
 - The total amount outstanding was \$277 million
 - \$4 million has remaining terms between 1 and 3 years
 - \$273 million has remaining terms greater than 3 years
 - 10 credit unions have issued 87 percent of all the secondary capital



9

Secondary Capital Landscape



10

Benefits of Secondary Capital

- Provides capacity to increase assets and support greater lending and financial services to members.
- Should increase operational efficiencies.
- Should increase net income, which will replace secondary capital as repayments begin.



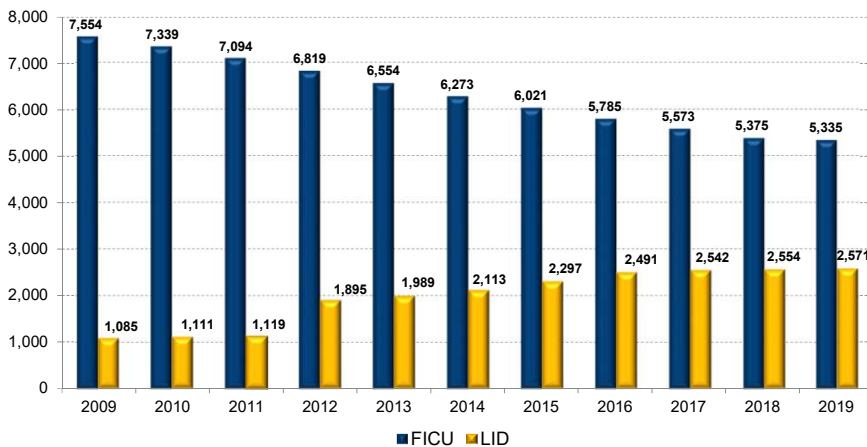
11

Requirement for Secondary Capital

- Must have low-income designation (LID). A federal credit union qualifies for LID when a majority of its membership (50%+ one member) qualifies as Low-Income Members.
 - “low-income members” include members with a family income 80% or less than the median family income for the metropolitan area where they live or national metropolitan area, whichever is greater. Members enrolled as students in a college, university or high school, or vocational school also qualify.

12

Increasing Number of LID CUs



13

Low-Income Designation Comparison

	LID Credit Unions	Non-LID Credit Unions
Primary Benefits - eligible to:		
Accept non-member deposits from any source	Yes	No, access to non-member deposits is restricted
Offer secondary capital accounts	Yes	No
Receive exemption from aggregate loan limit for member business loans (MBLs)	Yes	Only under limited circumstances. Otherwise, MBL limited to lesser of 1.75 times NE or 12.25% of assets
Apply for grants and low-interest loans from NCUA	Yes	No
Primary Benefits - eligible to:		
Receive consulting services from NCUA's office of Small Credit Union Initiatives (OSCU)	Yes	Limited to credit unions: <ul style="list-style-type: none"> < \$50 million in assets' < 10 years old, or Proposed charter groups.
Access resources of other federal government agencies and non-profits with lower barriers.	Yes	No

14

Community Development Financial Institutions

- Community development financial institutions (CDFIs) can be a bank, credit union, loan fund, microloan fund or venture capital provider.
- CDFIs share a common goal of expanding economic opportunity in low-income communities by providing access to financial products and services for local residents and businesses.
- The CDFI Fund was established by the Riegle Community Development and Regulatory Improvement Act of 1994 and promotes economic revitalization and community development in low-income communities through investment in and assistance to CDFIs.



LID Credit Unions vs CDFIs

	LID Credit Unions	CDFI Designation
Administered by:	The NCUA	Treasury's CDFI Fund
Criteria:	Majority of membership are "low income" – usually an automatic approval process	Non-automatic process. Requires substantive business plan. Applicants must show provisions of development services to underserved markets.
Advantages:	<ol style="list-style-type: none"> 1. Can accept non-member deposits from any sources. 2. Secondary capital counts toward net worth. 3. Exemption from Member Business Loan cap. 4. Community Development Revolving Loan Fund grants up to \$25,000. 	Grants up to \$2 million per year.

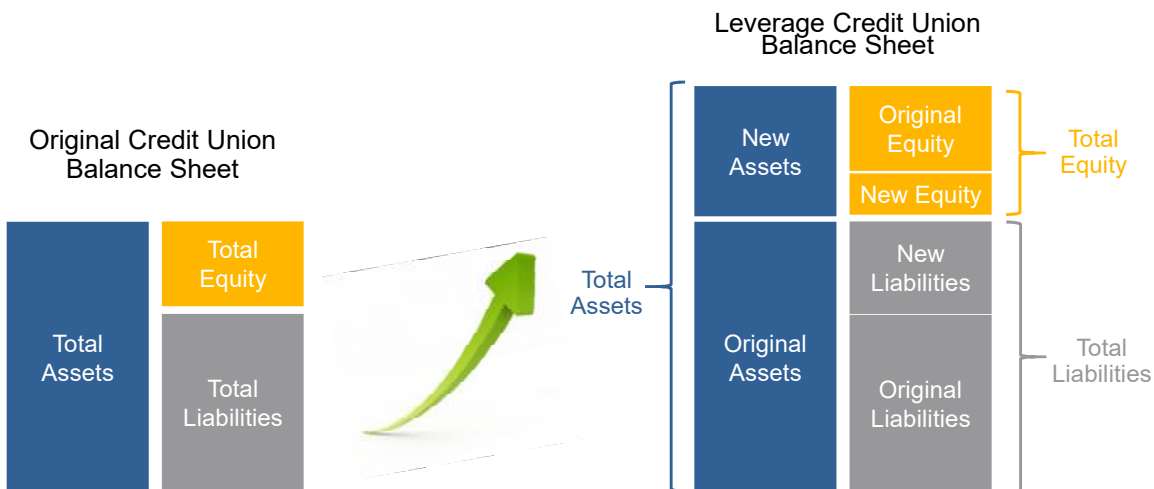


Financial Leverage

Financial leverage is the use of borrowed money (secondary capital) to support the growth in assets (loans and investments) with the expectation that the income from the new assets will exceed the cost of borrowings (secondary capital and borrowed funds).



Leverage Basics



Example

Credit Union Profile

Total Assets	\$250 million
Net Worth	\$20 million
Return on Assets (ROA)	0.75%
Return on Equity (ROE)	9.375%
Net Worth Ratio	8.00%

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            graph TD
            SCI[Secondary Capital Investor ($4million)] -- Note --> CU[Credit Union $300 million in Assets]
            CU -- P & I --> SCI
            CU -- Loans* --> M[Members ($50 million)]
            M -- P & I --> CU
            CU -- P & I --> B[Borrowings ($46 million)]
            B -- Funds --> CU
            
```

*might include investments until loans can be made

19

Example

Assumptions

- Credit union issues \$4 million in secondary capital.
- Increase earning assets by \$50 million:

• \$10 million in loans:	4.00%
• \$25 million in loan participations:	3.50%
• \$15 million in investments:	<u>2.25%</u>
Average yield:	3.23%
- Increase liabilities by \$50 million:

• \$4 million in secondary capital:	6.50%
• \$10 million in member deposits:	0.50%
• \$36 million in borrowings:	<u>2.50%</u>
Average cost:	2.42%
Net Spread	0.81%

Projected Results Year 1

Total Assets	\$300 million
Net Worth	\$24 million
Y1 ROA	0.76%
Y1 ROE	9.49%
Net Worth Ratio	8.00%

- The key assumption to model is the net spread. The strategy is to increase member loans and deposits over time.

20

Net Spread Assumptions

Product	All CUs (National Average Rate)	All Banks (National Average Rate)
5 Year CD-10K	2.42	1.92
4 Year CD-10K	2.16	1.67
3 Year CD-10K	1.96	1.56
2 Year CD-10K	1.74	1.39
1 Year CD-10K	1.40	1.10
6 Month CD-10K	0.92	0.67
3 Month CD-10K	0.56	0.42
Money market account-2.5K	0.36	0.25
Interest checking account-5K	0.12	0.14
Regular savings account-1K	0.17	0.19
Credit card, Classic	11.82	13.65
30 Year fixed-rate mortgage	4.50	4.56
15 Year fixed-rate mortgage	3.99	4.12
5/1 Year adjustable rate mortgage	3.92	4.25
3/1 Year adjustable rate mortgage	3.95	4.18
1 Year adjustable rate mortgage	3.75	4.14
Unsecured fixed rate loan, 36 months	9.47	10.27
Home equity loan, 5 year, 80%	4.94	5.40
Home equity loan, LOC, 80%	5.54	5.82
Used car loan, 48 months	3.75	5.50
Used car loan, 36 months	3.62	5.45
New car loan, 60 months	3.70	5.15
New car loan, 48 months	3.57	5.03

- ✓ Asset allocations
- ✓ Deposit and borrowing mix
- ✓ Deposit and loan rates
- ✓ Shape of the yield curve
- ✓ Timing of allocations

NCUA 3/29/2019

Secondary Capital Plan

At a minimum, the secondary capital plan must be approved by the CU board of directors and address the following regulatory requirements from 701.34(b)(1):

1. State the maximum aggregate amount of uninsured secondary capital the credit union plans to accept.
2. Identify the purpose for which the aggregate secondary capital will be used and how it will be repaid.
3. Explain how the credit union will provide for liquidity to repay the secondary capital upon maturity of the accounts.
4. Demonstrate the planned uses of secondary capital conform to the credit union's strategic plans, business plan and budget.
5. Include supporting pro forma financial statements, including any off-balance sheet items, covering a minimum of the next two years.



Some Factors to Consider

- How will secondary capital benefit your members?
- Does secondary capital fit the credit union's business plan?
- Is the board comfortable and does it understand leverage?
- Have you projected the net spread considering different allocations and yield curve scenarios?
- Have you evaluated your liquidity profile, assuming stressed scenarios?



23

Investing in Secondary Capital

Secondary capital is uninsured so its critical to perform your due diligence. Consider the issuing credit union's:

- Net worth ratio and financial profile
- Historical financial performance
- Business plan
- Loan performance
- Liquidity profile
- Contingency funding plans



24



Questions

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