Catalyst Strategic Solutions

2021 | SECONDARY CAPITAL USE CASES

SECONDARY CAPITAL:

A USEFUL TOOL FOR ACHIEVING GROWTH AND SUPPORTING LOW-INCOME MEMBERS

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The term “secondary capital” has been tossed around in certain circles the past several years. Some may be well-versed with the concept; others may have given it attention only recently. *Regulations limit use of secondary capital to credit unions designated as low-income credit unions (LICUs), to support activity that benefits their low-income membership.* For those new to the discussion, secondary capital is a way for LICUs to issue an unsecured, uninsured subordinated debt note and count the funds toward regulatory net worth for a certain period.

Note the “certain period” statement. These funds are not a permanent injection of capital. In fact, the NCUA requires the amount of funds counted toward net worth to decline by 20 percent (or the original amount) annually each of the final five years of the term.

The regulatory capital treatment of these funds makes this an extremely powerful tool for credit unions and drives the excitement around the concept, especially in a period when deposit growth is extremely high. These funds are not free, however, and can carry a relatively high cost. Cost, the non-perpetual nature of the capital treatment and the need to rapidly grow the balance sheet require LICUs to receive case-by-case determination of eligibility.

Who should consider secondary capital?

Certain use cases tend to be more viable than others. For example, credit unions that are providing strong support to low-income members but are having to restrict lending due to capital constraints would have a strong case. Also, credit unions seeking to expand their reach and services into new areas to further support their membership, especially in low-income areas, would be candidates as well. Justifiable, prudent use cases generally boil down to a combination of several factors:

1) Community support
2) Track record of strong loan growth
3) Ability to attract above-average deposit growth (many credit unions have already experienced strong deposit growth over the past year)
4) Strong liquidity management
5) Capacity to take the credit union to the “next level”

Do all these criteria need to be met, or are some more important than others?

It depends. Credit unions need to be able to clearly demonstrate three critical components:

1) The funds will be used to support their low-income membership (i.e., loan growth)
2) The financial health of the credit union will not be jeopardized by use of secondary capital
3) The credit union will have the ability to repay funds as they become due

Credit unions are not required to deploy all the funds to support low-income members, but they do need to show that funds will benefit their low-income members. In its simplest form, credit union lending provides support to low-income members, so expanding lending activity further serves this membership. Fortunately, demonstrating support of low-income members can take a myriad of other forms, such as financial literacy, community grants, non-profit support, scholarships, etc. Most credit unions are excellent at giving back to their communities, so this qualification is usually easy to achieve.

Demonstrating financial health over the full scope of the program can be a little trickier. In supporting credit unions through the secondary capital application and funding process, we have found that – to be successful – they need to have their lending engines ready to go, along with deposit demand to support rapid balance sheet growth. Fortunately, at this time, most credit unions have already realized more than enough deposit growth to support a healthy strategy. Validation of financial health will be established through multiple financial projections that show positive benefit across a variety of economic conditions.

A strong liquidity plan is the third critical component. To justify acceptance of secondary capital, credit unions must be able to illustrate their ability to safely repay the debt notes as they become due. Depending on the size of the issuance, the amount to be repaid can be significant, so it should be clearly modeled within the financial projections.

Wait, what do you mean by rapid balance sheet growth?

Keep in mind, secondary capital is treated as regulatory capital, not a borrowing. If you generally target a 10 percent net worth ratio, the injection of capital results in 10 times the growth in assets. Stated in dollar terms, if you target a 10 percent net worth ratio and get $10 million in secondary capital, this will support asset growth of $100 million. The amount of funds required to achieve the growth level, the types of assets planned, and the speed these milestones are accomplished can be critical factors in the success and viability of your plan.

"Remember, the cost of secondary capital has the potential to be quite high. For illustrative purposes, let's assume the cost is 5.50 percent."

At 5.50 percent, the $10 million in secondary capital from our example above translates into $550,000 in interest expense. To be successful, you must have a means of adding strong assets to your balance sheet, quickly. In addition to the pure cost of the secondary capital, you will likely take on an additional $90 million in deposits or borrowings to achieve the targeted asset levels. Assuming those funds cost you 0.50 percent, you add more interest expense of $450,000. Together, these combine for an increase in interest expense of $1 million.

Now let's look at the asset side. Just to break even, you need to quickly deploy $50 million into loans yielding two percent (after charge-offs), so that you don't drag down earnings with money sitting at 10 basis points (or lower).

In the end, the financial strategy to justify the use of secondary capital needs to be supported with sufficient growth engines. Organic loan demand and organic deposit demand are the keys to success. If you purchase assets, your net yield will likely be lower, and if you assume external funds, your cost will likely be higher.

Beyond earnings, it's important to demonstrate that credit union net worth will not deteriorate at the close of the program AND that the credit union has sufficient liquidity to repay the capital notes when they are due. Yes, investor funds are repaid.

The above example represents a simple use case of secondary capital. If your low-income credit union has the right mix of member demand and community support, secondary capital could be helpful in achieving strategies and goals hindered by natural capital growth.

To determine whether secondary capital is a good fit for your credit union, contact Catalyst Strategic Solutions for a no-obligation strategy session.

Send email **Book a meeting**

CATALYST
Strategic Solutions

css@catalystcorp.org | 800.301.6196 | catalyststrategic.org