FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol 16, Issue 2 High-Impact Capital: Using Secondary Capital to Expand Community Development Credit Union Capacity

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Introduction

Secondary capital is uninsured, subordinated, convertible debt that counts toward the net worth of a community development credit union (CDCU). In this article, Vermont Development Credit Union, the largest user of secondary capital, describes the benefits secondary capital offers CDCUs and community development investors, identifies problem areas, and offers recommendations to transform secondary capital into a real solution for the CDCU growth challenge.

Community Development Credit Unions

As banking becomes more sophisticated and computerized, Americans of low wealth increasingly find themselves squeezed out of the mainstream financial system. They cannot maintain the minimum account balances required to avoid high transaction fees. Their credit scores disqualify them for prime credit. Interest and fee structures exploit the financial setbacks to which their fragile circumstances make them vulnerable. They are increasingly driven into the arms of the burgeoning predatory lending industry. The lack of a level financial playing field, which former US Treasury Secretary Lawrence Summers termed a major civil rights issue,1 keeps millions of families from becoming homeowners, expanding small businesses, obtaining reliable rural transportation, financing higher education, and building assets. CDCUs have a grassroots community development mission to bring fair and affordable financial services to this underserved population. They may be the least well-known and understood of Community Development Financial Institutions (CDFIs). [see box 1.]

Box 1: The Alphabet Soup of CDCUs
Perhaps one reason CDCUs are poorly understood is that they define themselves in at least three different ways. The National Federation of Community Development Credit Unions (NFCDCU) counts 215 member credit unions with a community development mission. The federal regulatory and insurance body for credit unions, the National Credit Union Administration (NCUA) has designated nearly 1,000 credit unions as Low Income Credit Unions (LICUs), based on their having a majority low-income membership (at or below 80% of national median income, regionally adjusted[NCUA Rules and Regulations §701.34]). Federal law allows LICUs to accept non-member deposits and secondary capital. One hundred thirty-two credit unions are certified as CDFIs by the US Treasury CDFI Fund. There is considerable overlap between these groups. The great majority of CDCUs have LICU designation, though the reverse is not true - most credit unions with low-income designation are not CDCUs. All CDCUs are eligible to apply for CDFI certification. Vermont Development Credit Union, along with many others, is a CDCU, an LICU, and a CDFI. This article uses “CDCU” to mean credit unions with a community development mission and a majority low-income membership.

According to the CDFI Data Project,[2] 239 CDCUs in 43 states held a total of $3.1 billion in assets and closed 248,000 loans worth $1.2 billion in 2002. Their commitment to underserved populations is demonstrated by an average loan size of $5,000 and a 60 percent minority membership. The power of CDCUs lies in their capacity to leverage private capital for community development and their direct services to low-wealth people and communities.

Like the nearly 10,000 mainstream credit unions in the United States,[3] CDCUs are regulated depository institutions operating under federal or state charters whose depositors are insured by the National Credit Union Share Insurance Fund. Reflecting their origins in low-income settings and their mission to serve the underserved, CDCUs are often smaller and faster growing than mainstream credit unions and have lower operating margins. A study of 20 CDCUs receiving awards from the US Treasury's CDFI Fund found they averaged 20 percent annual growth,[4] twice the average annual growth rate for all federal credit unions between 1998 and 2003.[5]

Capital and Growth

A key ratio of the financial strength of a depository financial institution is its net worth ratio (NWR), the ratio between equity capital and total assets. This ratio measures a credit union's ability to absorb losses relative to its size. NCUA regulations classify credit unions with a NWR of at least 7 percent as well-capitalized. As of March 31, 2004, the average net worth ratio of all federal credit unions averaged 10.7%.[6]

As cooperatives whose member depositors each hold one share, credit unions cannot raise equity by selling stock as banks can. Instead, their principal source of growth capital is their earnings. Internally funded growth is based on a strict arithmetic: the rate at which total assets can grow without eroding NWR depends on the return on average assets (ROA). The 0.93% average ROA of all federal credit unions in the first quarter of 2004[7] supports an annual asset growth rate of 7.7%. To fund 10 percent annual growth a credit union must average 1.19% ROA. To fund 20 percent growth requires a ROA over two percent.[8]

CDCUs face a twofold growth challenge. First, the unmet need among their target population is so large that they typically grow at higher than average rates. Second, the high cost to serve a customer segment with relatively small balances and transactions tends to squeeze ROA. To meet growing demand, therefore, they must find sources of equity capital beyond their own earnings such as equity grants from philanthropic sources and the CDFI Fund and/or secondary capital.

Secondary Capital

In response to the new community economic development policies of the 1990s and the creation of the Community Development Financial Institutions Fund of the US Treasury, the NCUA in 1996 added regulations allowing Low Income Credit Unions (LICUs, see Box 1) to "offer secondary capital accounts." As Chairman Norman E. D'Amours explained, "Securing this new form of capital from institutional investors will enable LICUs to do more of what they do best: extend credit and provide quality financial services to underserved individuals."[9] Like the EQ2[10] pioneered by CDFIs, secondary capital is long-term subordinated debt that can be counted as equity. Unlike EQ2, secondary capital must comply with specific rules set out in §701.34 of NCUA Rules and Regulations [see Box 2]. While some mainstream credit unions would like to expand the availability of secondary capital to all credit unions,[11] it is currently a tool available only to LICUs.

Box 2: Secondary Capital Rules

- Only permitted for LICUs
- Five year minimum maturity
- Not redeemable prior to maturity
- Not insured
- Subordinated to all other liabilities, including claims of National Credit Union Share Insurance Fund
- May be used to cover operating losses to the extent these exceed reserves and undivided earnings

- May not be pledged by the lender/investor as security for any loan or obligation
- Lender/Investor must be non-natural person (not an individual)
- Lender/investor must execute a disclosure and acknowledgment using specific NCUA language
- Counted as debt for GAAP, but as equity for the purposes of calculating net worth until five years before maturity. In the last five years of its term, counted at 80%, 60%, 40%, 20% and 0% of par value, respectively.

Source: NCUA Rules and Regulations §701.34

Secondary capital offers distinct benefits to CDCUs and community development investors. For CDCUs, it creates equity capacity to meet community needs sooner than would be possible through internal growth. For investors, it leverages limited community development resources. While a $250,000 deposit or loan to a CDFI allows it to lend $250,000, the same amount in secondary capital allows a CDCU with a 12.5% target net worth ratio to take in an additional $1.75 million in deposits and expand its lending capacity by $2 million.[12] Under the CRA Investment Test, a secondary capital investor can receive enhanced consideration for making an investment with such significant quantifiable impact. For foundation investors, secondary capital can be a Program Related Investment (PRI), providing immediate distribution credits that count toward payout requirements, even though the funds will eventually return.[13]

By December 2003, 38 credit unions had secondary capital accounts totaling $12.8 million. Assuming an average 10 percent NWR, this investment creates $128 million in additional CDCU lending capacity. Total secondary capital at individual credit unions ranged from $15,000 to $3,475,000. In 18 CDCUs, secondary capital provided over 25 percent of net worth; in six, it provided over 50 percent.[14] (box 3 shows the ten largest users of secondary capital)

Box 3: Ten Largest Users of Secondary Capital

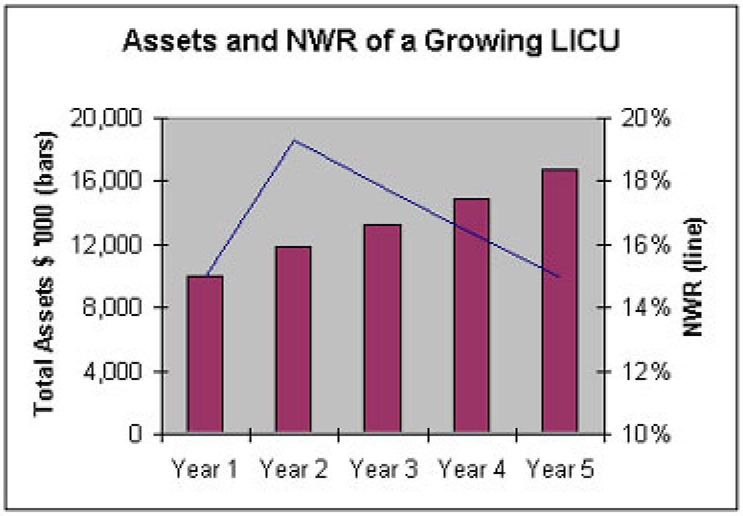
CDCU Name	State	Total Assets	Secondary Capital	NWR %	S/C as % of Net Worth
Vermont Development	VT	27,116,811	3,475,000	21.32%	60.1%
Alternatives	NY	45,475,228	2,325,000	9.60%	53.3%
Dakotaland	SD	71,220,950	1,550,000	8.94%	24.3%
Southern Oregon	OR	159,868,448	1,000,000	8.83%	7.1%
Appalachian	KY	12,901,389	700,000	12.18%	44.5%
Hope Community	MS	4,464,701	331,153	10.09%	73.5%
Winthrop	MA	32,580,281	300,000	6.96%	13.2%
Neighborhood Trust	NY	4,675,133	250,000	8.32%	64.3%
Northeast Community	CA	7,857,202	250,000	15.14%	21.0%
Lower East Side People's	NY	12,872,911	250,000	11.44%	17.0%

Source: NCUA call report data 12/31/2003

Practical Challenges

As currently structured and practiced, secondary capital provides only a temporary solution to the CDCU growth challenge. Consider the following simple model: a CDCU with $10 million in total assets that has set a target NWR of 15% expects to grow at a 15% annual rate into a $16.7 million institution. Most of its expansion will be fueled by deposits, which will grow from $8.5 m to $14.2 m. However, its relatively low profitability (ROA 0.5%) will yield total earnings of only $250,000 over the period. If these earnings are the sole source of additional equity, NWR will fall from 15% to 10.5%. A secondary capital investment of $750,000 will sustain the target 15% NWR.

$ '000	Year 1	Year 2	Year 3	Year 4	Year 5
Retained Earnings	1,500	1,550	1,610	1,676	1,750
Secondary Capital	0	750	750	750	750
Deposits	8,500	9,600	10,900	12,400	14,200
Total Assets	10,000	11,900	13,260	14,826	16,700
Net Worth Ratio	15.0%	19.3%	17.8%	16.4%	15.0%

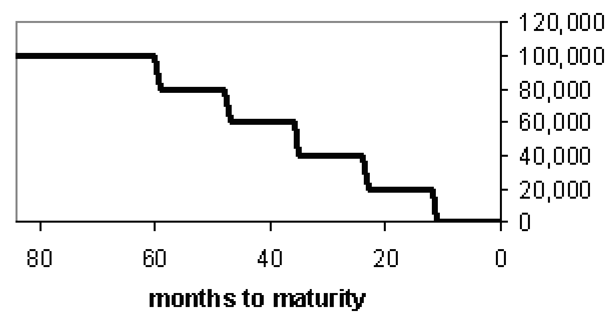


Immediately after receiving the secondary capital investment, the credit union has a temporarily higher NWR, which declines as the deposit base expands to fill the new capital capacity. The size of this “zigzag” can be damped by using multiple, smaller secondary capital investments at intervals. In practice, however, the thinness of the market and the time and expense to negotiate and document secondary capital investments inevitably create a pattern of “lumpy” investments and temporarily higher NWRs.

At the end of the five-year period, the CDCU in the model has grown into its new capital base and returned to its target 15% NWR.

This model works only if the secondary capital investment has a term of at least ten years. This is because NCUA regulations require CDCUs to discount the secondary capital that they count as net worth by 20 percent each year in the last five years before maturity as shown in Chart 2.

Chart 2: Equity Value of 7-year $100,000 Secondary Capital Investment



Typical secondary capital investments have a maturity of seven to ten years,[15] creating the danger that just when the CDCU needs net worth most, secondary capital contributes less of it. In contrast, bank trust preferred has a 30-year term and some EQ2 has terms of up to 20 years.

The “lumpiness” of secondary capital investments and the NCUA discounting rules reduce the efficiency with which CDCUs use secondary capital. A typical seven-year secondary capital investment may not be fully needed in the first two years and discounted in the last five.

A second problem with secondary capital is its temporary nature. In year five of our model, the CDCU needs to keep the secondary capital it has and obtain additional equity and/or secondary capital to continue its growth. As secondary capital is discounted and/or matures, a CDCU has four possible responses:

(1) Retire the secondary capital
(2) Persuade the investor to extend the term of the investment
(3) Find a new secondary capital investor to replace the secondary capital
(4) Replace the secondary capital with permanent equity.

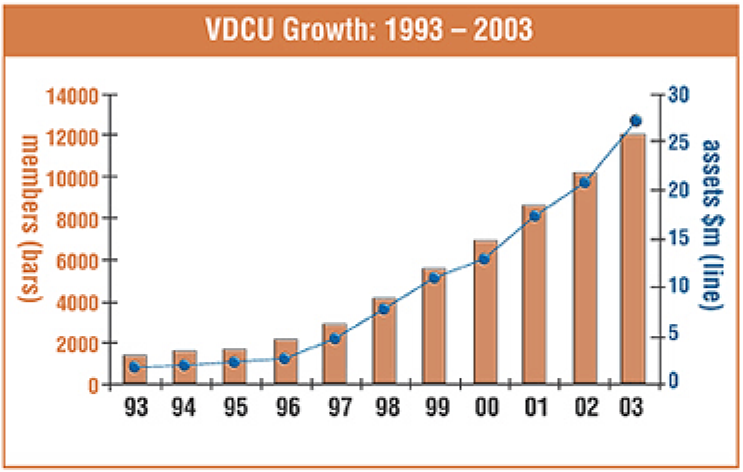
If the CDCU has grown according to plan, response (1) presents two unpalatable choices: accept a lower NWR (with serious consequences if the ratio falls below the 7 percent regulatory threshold), or shrink to a smaller total asset size and an acceptable NWR.

Response (2) may happen in two ways. Some secondary capital investors will agree to extend secondary capital terms on a case-by-case basis. Others build provisions into their original agreements[16] that extend the investment before it starts to be discounted provided the CDCU meets certain criteria for financial soundness and community impact. The first is typically only a short-term answer, and the second a one-time solution. Many investors have limited flexibility since they are themselves intermediaries who must repay their own investors. Others speak of the need to rotate their investments to other CDCUs, which suggests they may not fully understand the role of secondary capital in fueling growth.

Response (3) means recruiting new investors. This is challenging because the program- and CRA-driven investors who provide secondary capital find it less appealing to sustain an organization’s current size than fuel new growth.

Response (4) is the most desirable, but the hardest to achieve. Investors who expect equity to replace their secondary capital may overestimate the ability of fast-growing CDCUs to generate permanent equity through retained earnings. Equity grants, the other possible source, are hard to find in sufficiently large amounts.

A possible solution to this dilemma would be for investors to view some secondary capital investments as “probationary equity grants.” If a CDCU delivers growth in lending and community impact, the investor converts the secondary capital investment into a permanent equity grant that allows the CDCU to sustain its expanded capacity. If a CDCU does not achieve growth, it can repay the secondary capital investment while maintaining an acceptable NWR.



As currently practiced, secondary capital seems primarily designed to rescue poorly performing institutions. CDCUs that achieve losses beyond their equity base can “keep” secondary capital by converting it to equity. CDCUs that survive a rocky period but do not grow substantially can afford to repay it. For high-performing CDCUs, however, it provides only a temporary solution to a chronic capital shortage that will resurface when the secondary capital must be discounted and repaid.

Secondary Capital at VDCU

Since our founding in 1989, Vermont Development Credit Union (VDCU) has provided $120 million in loans and served 12,000 Vermonters in every county of the state.

As one of the nation’s fastest-growing CDCUs,17 with annual average growth of 31 percent in assets and 35 percent in loan portfolio over the last decade, VDCU embraced the concept of secondary capital as a tool for meeting the growing demand from our target population while maintaining our target 12-15 percent NWR. Our first investment of $175,000 came in 1998 from an NFCDCU program funded by the Ford Foundation. We now have the largest total secondary capital investment of any CDCU—$3,475,000, of which

$1,500,000 is in matching investments by the CDFI Fund. Interest rates vary from 3.5% to 5.0% and terms from five to eleven years.

To meet a narrow time window for matching funds and disbursements set by the CDFI Fund, VDCU expanded secondary capital substantially between 2001 and 2003. As a result, we could be said to have had "excess" secondary capital in 2003, when our NWR exceeded 20 percent.[18] Chart 3 shows VDCU's total historical and projected secondary capital, assuming neither new investment nor extensions of our existing investments. The dotted line shows the secondary capital that counts toward net worth.

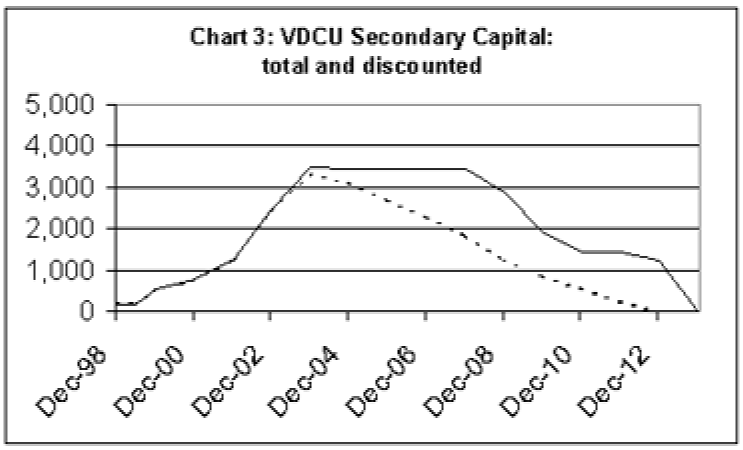
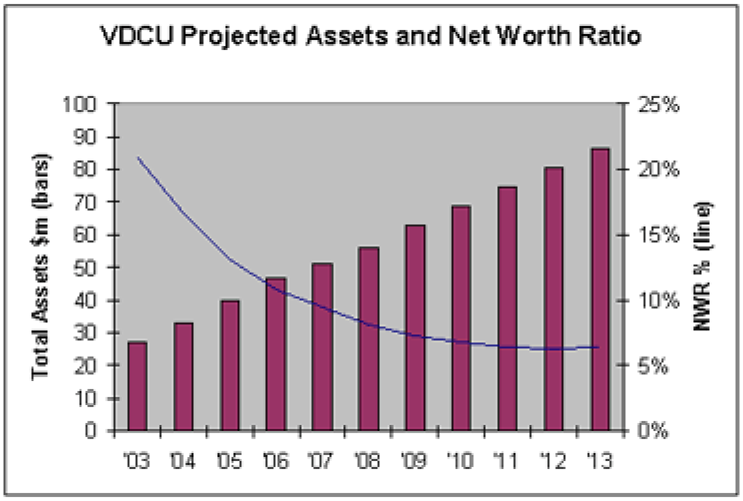


Chart 4 projects total assets and NWR assuming a modest 12 percent annual growth rate and 0.5% ROA. On this assumption, total assets would increase over the next decade from $27 million to $86 million. With no change in secondary capital agreements, the contribution of secondary capital toward net worth declines due to discounting and maturity. On these assumptions, VDCU's NWR will fall below our 12-15 percent target after 2005. To avoid this, we must achieve some combination of (a) extending, renewing, and replacing existing secondary capital investments, (b) converting secondary capital investments to equity, and (c) obtaining new permanent equity.



Conclusions and Recommendations

VDCU's experience with secondary capital leads us to the following conclusions and recommendations:

1. Secondary capital is a valuable tool by which investors can achieve a leveraged community development impact in CDCUs while retaining their capital and earning a financial return.
2. In part because of the rigidity of NCUA requirements, the pool of secondary capital investors seems unlikely to expand beyond the limited universe of CDFI intermediaries, foundations with PRI programs, CRA-motivated financial institutions, and the CDFI Fund.[19]
3. CDCUs that successfully grow into the new asset size made possible by secondary capital investments will need those investments to be constantly extended, renewed, or replaced by equity.
4. The NCUA discounting formula, whereby secondary capital is disqualified from counting as equity for up to 60 months, limits the value of secondary capital to the recipient without reducing the risk to the investor. NCUA and CDCUs should explore less costly ways to plan for orderly repayment of maturing secondary capital investments.
5. CDCUs and secondary capital investors should consider developing a standardized form of "evergreen secondary capital" that extends its

term on a rolling basis provided recipient CDCUs meet financial and community impact measures.

6. The CDFI Fund and other investors should consider converting secondary capital investments to equity grants if CDCUs achieve growth and impact goals.
7. CDCUs, regulators, and the philanthropic community should research whether less capital-intensive tools, such as standby arrangements and guarantees, can be structured to achieve the same results as secondary capital.

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[1]Remarks to CDFI Awardees in January 2001, reported by Caryl Stewart

[2]The data in this paragraph is taken from "Providing Capital, Building Communities, Creating Impact." CDFI Data Project. 2004

[3]At December 31, 2003, NCUA collected data from 9,488 credit unions www.ncua.gov

[4]Raynor, Jared: "Credit Union CDFI Core Awardee Impact Analysis." NFCDCU, August 2001.

[5]Association of Federal Credit Unions www.afcu.org

[6]www.afcu.org

[7]www.afcu.org

[8]calculations by the author

[9]"NCUA Allows Community Development Credit Unions to Raise Secondary Capital." NCUA. 1996.

[10]EQ2 is short for equity equivalent. See www.communitycapital.org

[11]http://www.cunamutual.com/cmg/newsReleaseDetail/0,1252,9189,00.html

[12]Excluding allowances for liquidity and loan losses

[13]The Grantsmanship Center http://www.tgci.com/magazine/97fall/faq.asp

[14]Data in this paragraph based on call report data at www.ncua.gov and author's analysis.

[15]NFCDCU currently offers terms of 6-7 years. The CDFI Fund matches the original interest rate and term of non-federal secondary capital investments, like those of NFCDCU.
[16]E.g. National Community Capital Association, which allows its 7-year agreement with VDCU to be extended up to 11 years.
[17]"[VDCU] consistently outperformed in all areas of growth." Raynor op. cit.
[18]While not strictly required as equity, this "excess" has not been idle. VDCU has been fully loaned-out throughout the period.
[19]We reached this conclusion after several would-be investors from other segments found themselves unable to comply with rigid NCUA requirements. Some CDCUs, however, believe that if mainstream credit unions are allowed to use secondary capital the market will expand to the benefit of CDCUs.

Antonia Bullard is associate director of Vermont Development Initiatives, the development affiliate of Vermont Development Credit Union (VDCU). VDI and VDCU share a mission to build wealth, community, and opportunity by providing affordable capital and financial services to underserved Vermonters. VDCU has served 12,500 Vermonters in 210 towns and invested $125 million in lending to lower-income Vermonters.

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