Critical Capital:
How Secondary Capital Investments Help Low-Income Credit Unions Hit Their Stride

By

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Executive Summary

Credit unions that serve predominantly low-income consumers or low-income credit unions (LICUs) tend to be smaller and experience greater challenges maintaining adequate net worth than mainstream credit unions or banks. Concerns regarding adequate net worth have increased since the National Credit Union Administration (NCUA) approved "Prompt and Corrective Action" (PCA) regulations in August 2000. PCA is an early warning system that is used by NCUA to identify credit unions that are not sufficiently capitalized.

NCUA has developed several policies to support LICUs, such as allowing them to accept deposits from non-members. In 1996, it approved a regulation that allows LICUs to increase their net worth by accepting secondary capital investments. The NCUA Board intended that the additional capital be used to support increased lending and services. Therefore, applicants are required to submit a long-term business plan to NCUA that describes how the secondary capital will promote institutional growth and stability and help the credit union achieve its goals.

The investments must have a term of at least five years and are subordinate to all other credit union debt. The interest rate of the investment is negotiated by the investor and credit union. Some investors limit the amount of secondary capital investments to a 1:1 ratio to total net worth.

During each of the last five years of the investment, the credit union must reduce the portion of the investment that is counted as net worth by 20 percent. The portion of the investment that is not counted as net worth is not repaid to the investor but is classified as subordinated debt. In most cases, the credit union and the investor will negotiate an agreement to repay the investment once it has been transferred 100 percent to subordinated debt.

In order to repay the investment and retain adequate net worth, LICUs must improve their net worth independent of the secondary capital investment. Therefore, income from lending, which is the largest source of income for most credit unions, as well as other sources of income, must increase.

The first secondary capital investment was made in 1997. By the end of 2000, there were 25 LICUs with secondary capital investments. Most of the investments are made by the National Federation of Community Development Credit Unions (NFCDCU), the National Community Capital Association (NCCA), the National Community Investment Fund (NCIF), and the Community Development Financial Institution Fund (CDFI Fund). Most investments have a fixed interest rate of 5 percent. At this time, no investments have reached maturity.

Secondary capital investments have been very effective. They have not only improved the capital ratio of LICUs – they also promoted their institutional growth, lending, and stability. Relative to their peers, LICUs that received secondary capital investments experienced larger increases in lending, shares, and deposits. In addition, member account balances, membership, and staffing of these LICUs increased at a higher rate. In most cases, older LICUs exhibited even stronger gains. However, maintaining adequate capital is a challenge for some LICUs that have received secondary capital investments.

Case studies of Alternatives Federal Credit Union, Episcopal Community Federal Credit Union, Near Eastside Community Federal Credit Union, and Saguache County Credit Union revealed that secondary capital investments can have substantial impacts on LICUs. These credit unions, which were chosen because they represent some of the best practices of the secondary capital investment program, expanded their lending considerably and made significant strides in improving finances, membership, and marketing.

Many of the credit unions that have received secondary capital investments have also raised deposits from non-members. Although not directly related to this study, credit union managers complained that NCUA's regulation that limits deposits from non-members to 20 percent of total deposits inhibits their ability to raise funding for the credit union. NCUA contends that non-member deposits carry more risk because the depositor is more likely to close the account than a member. However, some LICU staff argue that non-members are in better position to make long-term deposits than their members.

Policy Recommendations

It will require more time to assess the long-term impact of secondary capital investments. However, this short-term analysis documents that secondary capital investments have increased the capacity of LICUs to meet the financial service needs of lower-income and underserved individuals and communities. Credit union management, staff, and other stakeholders identified several challenges with the secondary capital program. The challenges and policy recommendations are:

- ***Some LICUs may experience difficulty repaying the investments and maintaining adequate capital***.
  The secondary capital investment program should be carefully studied over the next few years to determine the capacity of LICUs to repay the investments and maintain satisfactory capital.

- ***The pool of secondary capital investors is limited and should be expanded***.
  Credit union regulators and trade associations should make it a priority to educate foundations, banks, government agencies, and others on secondary capital investment opportunities. This could serve to not only expand the pool of investors or non-member depositors, but also help improve the profile of LICUs within and outside of the CDFI community.

- ***Some mainstream credit unions should be allowed to accept secondary capital investments***.
  Some consideration should be given to allowing mainstream credit unions to accept secondary capital investments. This recommendation, however, has several conditions. First and foremost, the credit union must document that it has an adequate level of service to lower-income consumers and communities. Second, new resources must be developed, otherwise the scarcity of secondary capital investors will become more pronounced. Third, eligibility criteria must be carefully examined -- the credit union should demonstrate a need for secondary capital investments. Fourth, policies should be established that would prevent an investor from using undue influence on credit union management.

- ***The policy of some investors that limits the investment to a 1:1 ratio of secondary capital to net worth should be lifted.***
  The ceiling of 1:1 ratio of secondary capital to net worth prevents an over-reliance on secondary capital investments and should be retained.

- ***NCUA regulators are not adequately trained regarding the reporting of secondary capital investments on financial statements.***
  NCUA and state credit union regulatory agencies should conduct regular training workshops for field staff on secondary capital investments. Particular attention should be paid to the proper classification of principal and interest payments on financial reports.

- ***It is difficult for fast growing LICUs to prepare long-term business plans, which are an integral component of secondary capital investment applications***.
  The submittal of a business plan as part of the application for secondary capital investments should be retained. However, investors should allow credit unions to update business plans if there are major changes in the economic environment or other factors.

- ***The fixed interest rate of the investments is not responsive to market trends***.
  Credit union management and regulatory agencies should explore the operational and financial feasibility of adopting a variable interest rate. In any case, the interest rate should be structured to reinforce increasing lending income rather than generating spread-income by investing the secondary capital.

- ***NCUA's policy limiting non-member deposits to 20 percent of total deposits is too restrictive***.
  NCUA should conduct a survey of LICUs with non-member deposits to determine whether these deposits are at high risk of withdrawal. The survey should examine the term of the deposits, the amount, and the relationship between the non-member depositor and the credit union.

Chapter I

Impact of Secondary Capitalization Investments on Low-Income Credit Unions

Introduction

Credit unions that serve lower-income consumers, called low-income credit unions (LICUs), tend to be smaller and experience greater challenges maintaining adequate capitalization than mainstream credit unions or banks. LICUs tend to generate lower-income and incur higher operating expenses (education, marketing, staff, and outreach, etc.) due to their membership base. At least half of the members of LICUs are lower-income, compared to an average household income of $43,480 for mainstream credit unions[1]. Bank customers have even higher incomes.[2]

In 1996, the National Credit Union Administration (NCUA) approved a new regulation to improve the capitalization of LICUs. The regulation allows LICUs to increase their capital by accepting secondary capital investments. However, secondary capital investments were not developed for the sole reason of improving financial status. As former NCUA Chairman Norman E. D'Amours noted:

> 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 who may not otherwise have access to them.[3]

The first secondary capital investment was made in 1997. By the end of 2000, there were 25 LICUs with secondary capital investments. NCUA allows a range of organizations to provide secondary capital investments, including banks, non-profit corporations, and government agencies. Most of the investments are made by the National Federation of Community Development Credit Unions (NFCDCU), the National Community Capital Association (NCCA), the National Community Investment Fund (NCIF), and the Community Development Financial Institution Fund (CDFI Fund).

This report assesses how secondary capital investments impact the lending volume and other key financial ratios of LICUs. It will require more time to assess the long-term impact of secondary capital investments. The goal of this report is to serve as an 'early signal system' so that procedural and other changes, if needed, may be affected sooner rather than later. Four LICUs whose secondary capital investments have been in place for at least three years are studied in depth. Alternatives FCU[4], Episcopal Community FCU, Near Eastside Community FCU, and Saguache County CU[5] represent some of the best practices of the secondary capital investment program. The case studies enabled an

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[1]Schultz, 1998.

[2]Seiburg, 1999.

[3]NCUA, 1996b.

[4]FCU denotes Federal Credit Union or federally chartered credit unions.

[5]CUs are credit unions that are state chartered.

analysis of how the investments helped these credit unions meet their membership, marketing, lending, expansion, and other goals.

Background on LICUs and community development credit unions (CDCUs) as well as an overview of secondary capital investment regulations and procedures comprise Chapter II of this report. Chapter III provides a short review of credit union accounting that demonstrates how secondary capital investments effect a LICU’s financial condition. An assessment of the impact of secondary capital investments comprises the next chapters. Chapter IV is an analysis of the 25 LICUs that received investments by 2000 and the case studies are profiled in Chapter V. Chapter VI concludes this report with a discussion of the benefits and challenges of secondary capital investment programs and several policy recommendations.

Chapter II

Background on Low-Income Credit Unions (LICUs) and Secondary Capital Investment Regulations and Policies

There are several terms for credit unions whose primary purpose is to serve lower-income people. Low-income credit union (LICU) designations are approved by the National Credit Union Administration (NCUA), a federal agency that regulates and insures credit unions. To qualify for this designation, at least half of a credit union's members must earn less than 80 percent of the median household income of the community it serves. Members of the National Federation of Community Development Credit Unions (NFCDCU), a nonprofit trade association, are known as community development credit unions (CDCUs). CDCUs are committed to providing community development services and lending, such as affordable home mortgages, small business loans, and financial services for lower-income consumers. Some LICUs are members of NFCDCU -- some are not. Likewise, some members of NFCDCU have not been designated as LICUs by the NCUA. This report focuses on LICUs, the only credit unions NCUA allows to accept secondary capital investments.

The financial condition of LICUs is an ongoing concern. In general, LICUs are often under-capitalized, although there has been some improvement since the early 1990s. The average and median net capital of LICUs increased by 257 percent and 126 percent respectively, from 1990 to 1996 (the year NCUA approved the secondary capital investment regulations). In addition, the net capital to assets ratio of LICUs improved from 8 percent to 12 percent. However, LICUs have much lower net capital ratios than mainstream credit unions. For instance, in 1996 the net capital to assets ratio of all credit unions with assets between $500,000 and $1,000,000 was 15 percent. There is also some evidence that Legacy LICUs, a term used in this report to designate those LICUs established by 1990, have even greater needs for additional capital. Their net capital ratio *declined* from 1990 to 1996.[6]

Concerns regarding adequate capitalization have increased since the NCUA approved "Prompt and Corrective Action" (PCA) regulations in August 2000[7] (see Table 1). PCA is an early warning system that is used by NCUA to identify credit unions that are not sufficiently capitalized. It stipulates the following net worth to asset ratios:

Table 1
National Credit Union Administration PCA Regulations

Capitalization Status	Net Worth Ratio
Well capitalized	7% and higher
Adequately capitalized	6%-7%
Under capitalized	4%-6%
Significantly undercapitalized	2%-4%
Critically undercapitalized	Less than 2%

[6] Williams and Wiles. 1998.

[7] NCUA, 2000a.

Credit unions with ratios of 6 percent or less must develop a 'net worth restoration plan' that addresses how they will improve their net worth. Credit unions that are defined as 'complex'[8] have more stringent capital requirements. Credit unions that are less than ten years old and have $10 million or less in assets are allowed more flexibility in implementing their net worth restoration plan.

Very few mainstream credit unions are subject to remedies under PCA. Over 95 percent of credit unions have capital ratios of 6 percent or more.[9] In contrast, one out of five LICUs have net worth ratios of 6 percent or below.[10]

Secondary Capital Investment Regulations and Programs

NCUA has granted LICUs several advantages over mainstream credit unions. LICUs have greater flexibility in determining their membership base and are allowed to accept deposits from non-members, such as banks, foundations, churches, and mainstream credit unions. In addition, NCUA permits LICUs to expand their net worth by accepting secondary capital investments. Secondary capital investments are distinguished from other forms of assistance because they are treated like equity and therefore increase net capital and net worth ratios.[11]

NCUA requires applicants to submit a business plan that describes how the secondary capital will support increased lending and services.[12] It also stipulates that the investments have a term of at least five years and investors are prohibited from withdrawing their investments before the term expires.[13] Further, NCUA may prohibit repayment if the credit union's net capital is inadequate.[14] The investments are subordinate to all other credit union debt and must be available to cover operating losses. NCUA does not stipulate the investment's interest rate. It is negotiated by the investor and the credit union. Although the NCUA prohibits individuals from making investments, the potential investor pool is quite extensive. It includes foundations, government agencies, banks, non-profit organizations, and corporations.[15]

During each of the last five years of the investment, the credit union must reduce the portion of the investment that is counted as net worth by 20 percent. The portion of the investment that is not counted as net worth is not repaid to the investor but is classified as subordinated debt. In most cases, the credit union and the investor will negotiate an agreement to repay the investment once it has been transferred 100 percent to subordinated debt. At this time, no investments have reached this point of maturity.

[8]Complex credit unions include those with multiple Fields of Membership or with significant long-term loans or investments.

[9]NCUA, 2001a.

[10]Joyce Jackson, 2000.

[11]Regulators may also allow equity or non-conditional grants to be included in equity in some cases.

[12]NCUA, 1996a.

[13]Investors may withdraw funds prior to the end of the term if the credit union defaults on its investment.

[14]NCUA, 1999.

[15]NCUA, 1999.

In addition to these regulations, some investors also limit the amount of their secondary capital investments to a 1:1 ratio to total net worth. These investors contend that the ceiling discourages an over reliance on secondary capital investments and decreases the chances that the credit union will be incapable of repayment. This ratio limitation may also help attract investors by improving security.

To repay the investment and retain adequate net worth, LICUs must improve their net worth independent of the secondary capital investment. Therefore, income from lending, which is the largest source of income for most credit unions, as well as other sources of income, must increase.

Allowing credit unions to accept investments is a major departure from long standing credit union tradition. Credit unions are governed by their members, each of whom receive one voting share, regardless of the amount of their funds on deposit. Non-member investors could potentially desire some control over the credit union commensurate with their investments, which could result in a diminution of governance by members.

The NCUA has addressed this issue by prohibiting secondary capital investors from holding a share in a credit union. They are in effect, non-voters. However, there are no policies prohibiting an investor from using its influence to affect changes in credit union management and priorities.

Sources of Secondary Capital Investments

Most secondary capital investments have been made by NFCDCU, NCCA, NCIF, and the CDFI Fund.[16] The investment process and policies of each investor is summarized below. NFCDCU is the largest secondary capital investor. Therefore, its procedures are described in detail.

National Federation of Community Development Credit Unions (NFCDCU)

NFCDCU is a trade association that provides technical and financial assistance to CDCUs. NFCDCU is the largest secondary capital investor. Its investment pool is funded by the Ford Foundation, Citibank, the National Community Investment Fund, the F.B. Heron Foundation, and the CDFI Fund. NFCDCU has taken several steps to provide security for investors. NFCDCU retains adequate reserves to pay investors. It has also established an investment loss reserve that can be tapped if the program incurs losses. These reserves are funded by grants from investors and others.

The investments may range from $10,000-250,000 and the interest rate is based on NFCDCU's cost of funds (COF). All of the investments to date have a 5 percent interest rate. NFCDCU investments have an initial term of seven years but can be extended by one-year increments. Several extensions are permitted, however the term of the investment can not exceed the maturity of the investment in the NFCDCU pool.

Applicants must be LICUs, have at least two years of lending experience, and be a member of NFCDCU. NFCDCU also requires applicants to have a net capital ratio, exclusive of secondary capital, of at least 6 percent. However, applicants are allowed to make transfers to reserves if net capital is not adequate. NFCDCU gives priority to credit unions with net capital ratios less than 9

[16]The North Carolina Minority Support Center makes investments in that state's CDCUs.

percent and limits 30 percent of its capital portfolio for credit unions that have been chartered for five years or less and for thinly capitalized credit unions.

Monitoring and evaluation are integral components of the program. NFCDCU secondary capital recipients are required to submit regular performance reports and financial statements, as well as audited reports. NFCDCU also makes its technical assistance staff available. If the credit union is in default, NFCDCU has the right to withdraw its investment. It can also seize any available assets if the credit union becomes insolvent.

National Community Capital Association (NCCA)

NCCA is a national association of CDFIs. It provides capital, technical assistance, and development services to CDFIs that serve economically disadvantaged communities. NCCA's application for secondary capital investments includes a review of six key areas:

1. Mission and strategy.
2. Staff and management.
3. Financing and performance.
4. Board and governance.
5. Capitalization.
6. Finance and operations.

National Community Investment Fund (NCIF)

NCIF is a CDFI that invests in independent and minority-owned financial institutions. NCIF's application process includes a review of four areas of the credit union.

1. The applicant must submit a statement that includes the amount requested and the proposed use of the funds.

2. Financial statements are required. Recipients must meet 3 of 4 key ratios related to lending, net capital, loan delinquencies, and expenses.

3. Applicants must submit a 3-5 year business plan that, among the factors, includes the use and projected impact of the investment, financial projections, and plans for repayment.

4. The credit union is required to submit copies of its procedural policies such as loan policies and collection procedures.

Community Development Financial Institution Fund (CDFI Fund)

The CDFI Fund is a government agency within the U.S. Treasury Department. It provides capital to CDFIs that operate in under-served communities. The central focus of its secondary capital investment application process is a review of the credit union's Comprehensive Business Plan. The plan should outline the mission, goals, and current capacity of the organization, and its objectives for the subsequent five years. Applicants must also submit documentation of matching funds, if required.

Successful applicants are required to enter into an Assistance Agreement with the CDFI Fund prior to award distribution. The purpose of the Assistance Agreement is to develop performance goals. The applicant must submit several reports to the CDFI Fund on an annual basis, including a description of its progress accomplishing goals outlined in their Comprehensive Business Plan. Other documents, such as financial statements, are required semi-annually.

Chapter III

Secondary Capital Investments and Credit Union Accounting

To understand the unique role of secondary capital investments, it is necessary to have some background on credit union accounting methods. Secondary capital investments impact credit union accounting in several ways. The initial investment increases net worth, which enables the credit union to engage in activities that increase assets without violating capital standards. As the investment matures, it revolves into a liability and net worth is decreased.

This section reviews the basic components of credit union interest and expense statements and balance sheets. This is followed by a description of the role of secondary capital investments.

Structure of Credit Union Financial Statements

Income and Expense Statement

This statement has four major components: gross income, total expenses, transfers to reserves, and undivided earnings (see Table 2). Interest income is the largest source of income for most credit unions. It includes income from lending as well as investment income. Of the two, loan income is most important because it is the largest single source of earnings for most credit unions. Credit unions also generate non-interest income, such as fees for services.

Table 2
Credit Union Income and Expense Statement

Gross Income
Interest Income
Non-Interest Income
Total Gross Income
Expenses
Interest Expenses
Non-Interest Expense
Total Expenses
Total Gross Income - Total Expenses = Net Income (Loss)
Transfers to Reserves
Undivided Earnings

Expenses are divided into interest and non-interest expenses. Interest expenses are the largest expense for most credit unions. It includes dividends to members as well as interest paid on borrowed funds. Interest expenses are sometimes referred to as cost of funds (COF) because it is the total cost of generating credit union funds. Non-interest expenses include the credit union's operating costs, such as rent, staff, administration, consultants, and travel.

Reserves are allowances or funds set aside for loan or other losses. The amount of reserves is usually stipulated by the credit union's regulatory agency. In general, the higher the loan delinquencies, defaults and charge-offs, the higher the required reserves.

There is a direct relationship between a credit union's income and net worth. The net income of the credit union, after paying interest and non-interest expenses and transferring funds to reserves, is added to undivided earnings or net income in the equity section of the balance sheet.

Balance Sheet

Assets, liabilities, shares and deposits, and equity are the four main categories of the balance sheet (Table 3). A balance sheet 'balances' because assets must equal liabilities, shares and deposits, and equity.

Table 3
Credit Union Balance Sheet

Assets	**Liabilities, Shares, and Equity**
Cash	**Liabilities**
Investments	Dividends and Interest Payable
Land and Building	Borrowings
Fixed Assets	Accounts Payable
Loans	**Total Liabilities**
	Total Shares and Deposits
	Equity
	Undivided Earnings
	Regular and Other Reserves
	Donated Equity
	Net Income
	Secondary Capital
	Other
	Total Equity
Total Assets	**Total Liabilities, Shares, and Equity**

Assets are items that the credit union owns. In addition to being the largest source of income, loan volume is usually the biggest category of assets for most credit unions. Other assets include cash, investments, real estate, or fixed assets (furniture, fixtures, and equipment).

Liabilities are items that the credit union owes to others. It includes loans that the credit union has borrowed as well as payments owed to vendors and suppliers. Total shares and deposits are also included on this side of the balance sheet because they are owed to credit union members.

Equity and net worth are often used interchangeably. However, they are slightly different in credit union financial accounting. Equity includes undivided earnings, regular and other reserves, donated equity, and net income. Undivided earnings are funds that have been transferred from the credit union's net income. Reserves are funds that are set-aside for loan or operating losses. Donated equity is equity grants that have been made to a credit union. Equity grants are funds that are not earmarked for any specific purpose. Net income is funds that remain after paying expenses that have not been transferred to undivided earnings. Secondary capital is also a component of equity. There are several additional categories of equity, including unrealized gains and net gains, non-conforming investments and other comprehensive income. These forms of equity tend to be negligible for most credit unions.

Net worth is a calculation that NCUA uses to assess whether a credit union is subject to PCA. Net income excludes unrealized gains and net gains and other comprehensive income. It also excludes, in most cases, donated equity.

Net capital is also an indicator of the financial condition. It is the sum of undivided earnings, secondary capital, and regular and other reserves. Net capital calculations exclude donated equity, unrealized gains and net gains, non-conforming investments, other comprehensive income and net income. Net capital represents a more 'liquid' form of equity.

With the exception of donated equity and secondary capital investments, net worth is savings that a credit union accrues from gross income.[17] Low equity indicates that a credit union's income does not adequately cover expenses. It also suggests that the credit union will not have sufficient funds to support itself during periods of low income.

A credit union can increase its net worth by four means:

- Increasing net income or transfers to undivided earnings.
- Building reserves.
- Raising equity grants.
- Accepting secondary capital investments.

The first two means to increase equity are dependent on increasing net income. Equity grants can be problematic for two reasons. First, equity grants are difficult to generate. Most investors prefer to make insured non-member deposits in LICUs. Second, some LICUs have experienced difficulty in persuading NCUA regulators to include donated equity in net worth calculations. As a result, secondary capital investments may be the easiest means for LICUs to increase their equity and net worth.

[17]NCUA, 2000b.

The amount of net worth or net capital is meaningless if it is not examined relative to the credit union's risk. The net worth and net capital ratios, which assess net worth or capital relative to assets, allow one to determine whether it is sufficient given credit union outstanding loans, which are the primary component of assets. Generally, the higher the ratio the better (although a low ratio could mean that a credit union's loan production is inadequate). The ratios are interactive. If assets increase, and net worth or net capital remains the same, the ratio will fall. Conversely, if assets fall, the ratio will rise.

The Role of Secondary Capital Investments

As mentioned above, equity is a determinant of the appropriate level of loan volume for a credit union. Equity in effect supports a credit union's lending. An increase in net worth enables a credit union to increase its lending or assets without violating capital requirements. Conversely, credit unions may not engage in activities that increase assets if they will result in an inadequate net worth ratio.

Secondary capital investments are treated differently from other forms of financial assistance to LICUs. They actually increase a credit union's equity, as the formula described in Table 4 notes.

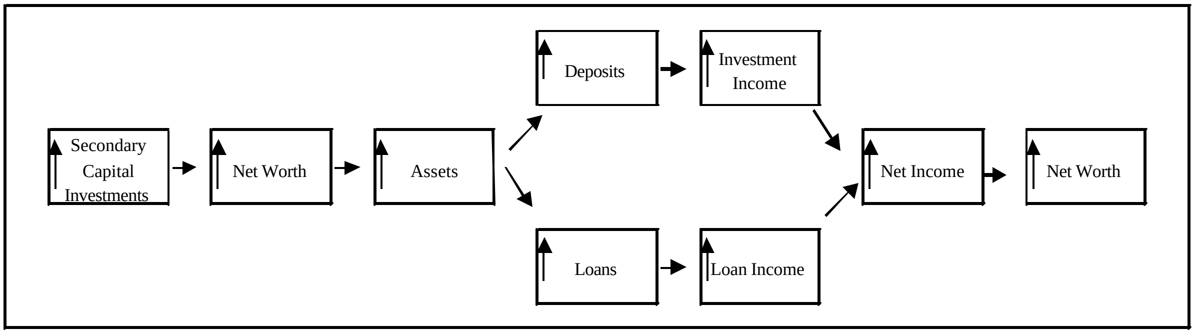
Table 4
Treatment of Secondary Capital Investments

Net Worth		**Total Assets**
		+ Cash
+ Undivided Earnings	**Net Worth**	+ Investments
+ Reserves	**----------- = Net Worth Ratio**	+ Land and Building
+ Net Income	**Total Assets**	+ Fixed Assets
+ **Secondary Capital**		+ Loans Outstanding

As Table 5 depicts, secondary capital investments increase net worth and therefore enable a credit union to increase its lending or other assets without violating PCA regulations. Therefore, secondary capital investments support the income and net worth growth of a credit union. However, financial growth is not a given. Credit union management must make a concerted effort to increase loan production and deposits, and minimize expenses, including loan defaults.

When an investor makes a secondary capital investment the credit union's net worth will increase by that amount. In the initial years of the investment, credit unions make interest-only payments. During each of the last five years of the investment, NCUA regulations require that credit unions decrease the amount of the investment that is classified as net worth by 20 percent. The balance is added to the credit union's subordinated debt or liabilities and the credit union makes interest payments on the entire investment. By the end of the fifth year, the entire investment will be classified as subordinated debt. The credit union and the investor can then negotiate a plan to repay the subordinated debt.

Table 5
Potential Financial Impacts of Secondary Capital Investments



LICUs may face several challenges with secondary capital investments -- although many of them can be overcome with a well-developed business plan that plots credit union growth and trends. Some LICUs' growth cycles may not be consistent with the term of the investment -- they may require longer-term investments. Others may need larger secondary capital investments because the credit union may be growing at a faster rate than their net worth can support. Credit unions also need to plan for the reduction in net worth attributable to the investment during its last five years because the amount of assets that the investment can support will decrease. Also, the LICU will be making interest payments on the entire investment. Last, LICUs must sustain adequate income in order to make interest and eventually principal payments. For most credit unions, this means significantly increasing lending volume.

Chapter IV

Analysis of Secondary Capital Low-Income Credit Unions (SCLICUs) 1994-2000

The following analysis examines the financial and other trends of LICUs that received secondary capital investments or SCLICUs by December 2000. This analysis is preliminary -- secondary capital investments have only been available since 1997. However, this is an opportune time to assess program impacts and consider changes to NCUA or investor policies.

Table 6 lists 25 LICUs that received secondary capital investments from 1997-2000. Most of the investments were made by the NFCDCU. In addition, NCIF, the CDFI Fund, and NCCA made several secondary capital investments.

Table 6
Profile of Community Development Credit Unions with Secondary Capital Investments
2000

Name	Year of Charter	Total Assets	Secondary Capital Investments	Members	State
Alternatives FCU	1978	$ 34,470,728	$1,400,000	8,748	NY
ASI FCU	1961	133,766,165	250,000	56,913	LA
B.O.N.D. Community FCU	1972	25,466,484	150,000	3,800	GA
Bexar County Teachers FCU	1950	1,276,483	200,000	531	TX
Boone County Community CU	1961	6,304,367	250,000	2,904	IA
Central Appalachian Peoples' FCU	1980	7,898,241	680,000	1,359	KY
Central Oklahoma FCU	1988	12,240,106	150,000	2,250	OK
Community Trust FCU	1982	3,934,080	50,000	2,998	FL
D. Edward Wells FCU	1959	3,394,204	250,000	2,477	MA
Dakotaland FCU	1935	40,083,507	250,000	6,885	SD
Episcopal Community FCU	1994	3,648,878	100,000	2,177	CA
Near Eastside Community FCU	1981	4,466,406	250,000	2,571	IN
Neighborhood Trust FCU	1995	5,555,239	105,000	3,006	NY
Northeast Community FCU	1981	6,971,314	150,000	1,010	CA
O.U.R. FCU	1969	4,010,016	200,000	2,792	OR
P.A. FCU	1970	768,652	100,000	582	LA
Prichard FCU	1984	868,752	50,000	568	AL
Progressive Neighborhood FCU	1995	2,221,459	100,000	1,523	NY
Rowan-Iredell Area CU	1942	1,958,735	55,965	1,095	NC
Saguache County FCU	1996	4,095,909	100,000	683	CO
Tri-County CU	1953	13,769,032	151,758	4,380	NC
Unified Singers FCU	1968	1,516,063	100,000	684	GA
Vermont Development CU	1989	12,892,131	870,000	6,226	VT
Victory-Masonic Mutual CU	1946	2,213,383	30,000	1835	NC
Zion United CU	1959	3,000,218	250,000	1,208	CO
Total		**$336,790,552**	**$6,242,723**	**119,205**	

Analysis of SCLICUs

The SCLICUs are a diverse group. They range in size from ASI FCU with $133 million in assets and 60,000 members, to P.A. FCU with less than $800,000 in assets and 510 members. Dakotaland, which received its charter in 1935, is the oldest; Saguache County is the youngest -- it was formed in 1996. In fact, three of the SCLICUs, Saguache County, Progressive Neighborhood, and Neighborhood Trust, were chartered after 1993. SCLICUs are also geographically diverse. Ten are located in the South, with seven from the Western states. The Northeast and Midwest are represented by eight SCLICUs.

This analysis compares the asset development, net capital, and share and deposits trends of SCLICUs to all LICUs from 1994[18] to 2000. It also examines dividends, operating efficiencies, cost of funds (COF), lending, membership, and staff. Only those LICUs established by 1994 are included in the 2000 analysis to prevent a skewing of results that might occur from including newer credit unions or those that recently received LICU designations. Further, this analysis is disaggregated. A subset of SCLICUs that were established by 1994, or Legacy SCLICUs, are analyzed separately. The analysis of Legacy SCLICUs eliminates some of the volatility that new SCLICUs may exhibit.

For the most part, the secondary capital investments have been effective. Relative to LICUs, SCLICUs have experienced larger increases in lending, shares, and deposits. In addition, member account balances, membership, and staffing of SCLICUs increased at a higher rate than LICUs. In most cases, Legacy SCLICUs exhibited even stronger gains. Interestingly, the only area where SCLICUs lagged behind LICUs was net capital ratios.

Assets

The mean and median assets of SCLICUs were higher than those of LICUs in both 1994 and 2000 (Chart 1). The mean assets of LICUs were $7 million in 2000 compared to $13.5 for SCLICUs -- a difference of almost 100 percent. Further, the rates of growth of assets from 1994 to 2000 are dissimilar. SCLICUs experienced a 75 percent increase in mean assets compared to a 44 percent increase for LICUs. The mean assets of SCLICUs founded before 1994, or Legacy SCLICUs, increased by 92 percent to $14.8 million. The growth and volume of median assets reflected comparable trends.

Net Capital

The net capital ratio of SCLICUs was almost 3-4 percent lower than the net capital ratio of LICUs in 1994 and 2000 (Chart 2). However there was some improvement. The net capital rate of SCLICUs grew from 6.5 percent in 1994 to 7.3 percent in 2000. Legacy SCLICUs had comparable net capital ratios in 2000.

[18] All 1994 figures are adjusted for inflation.

Chart 1
Mean Assets of LICUs, SCLICUs, and Legacy SCLICUs
1994 and 2000

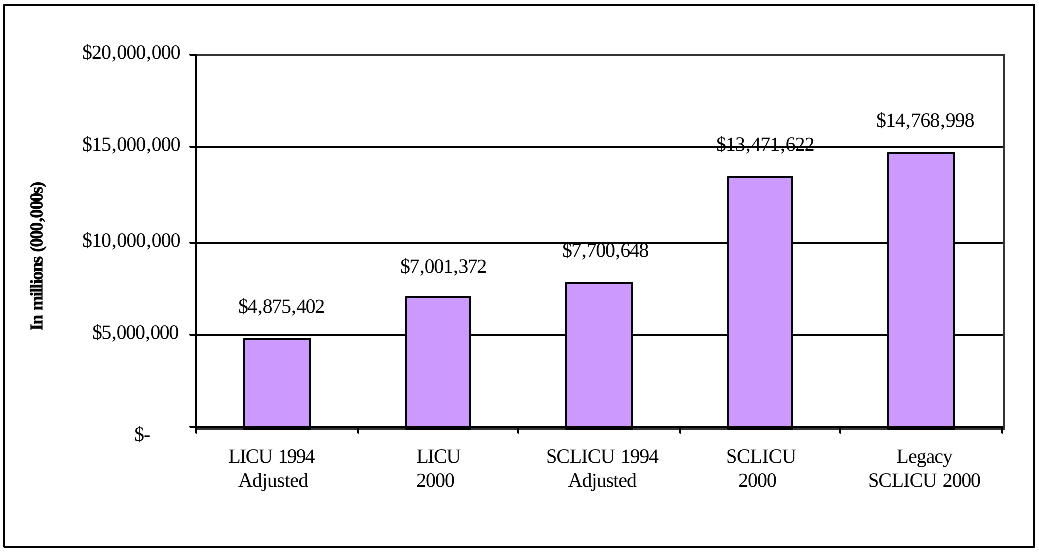


Chart 2
Net Capital Ratios of LICUs, SCLICUs, and Legacy SCLICUs
1994 and 2000

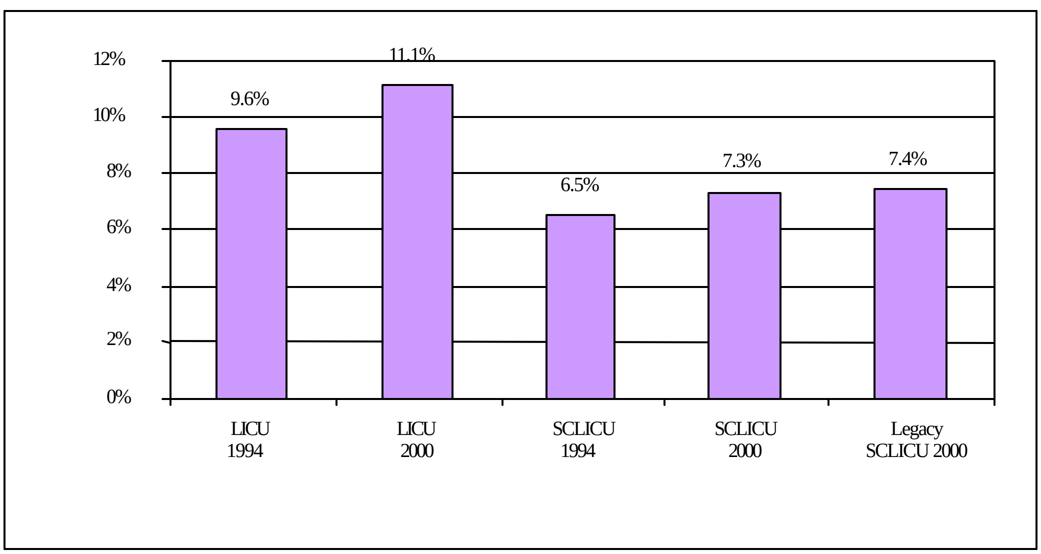
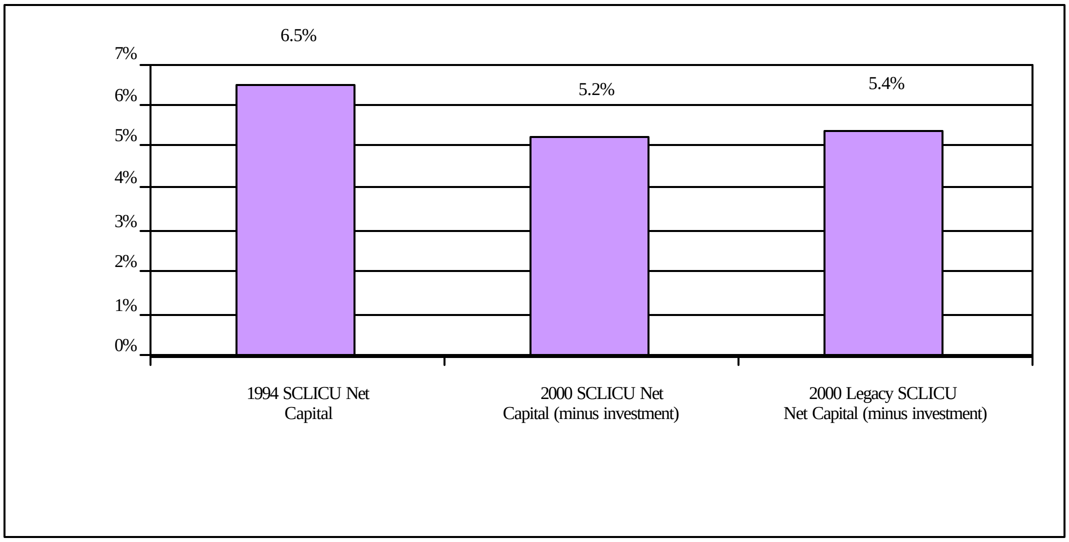


Chart 3
Net Capital Ratios Minus Secondary Capital Investments of SCLICU and Legacy SCLICU
1994 and 2000



This analysis also includes an examination of the net capital ratios of SCLICUs minus the secondary capital investments. Without the investments, the net capital ratios of SCLICUs decreased from 1994 to 2000 by 1.3 percent to 5.2 percent (see Chart 3). Legacy LICUs have slighter higher net capital ratios.

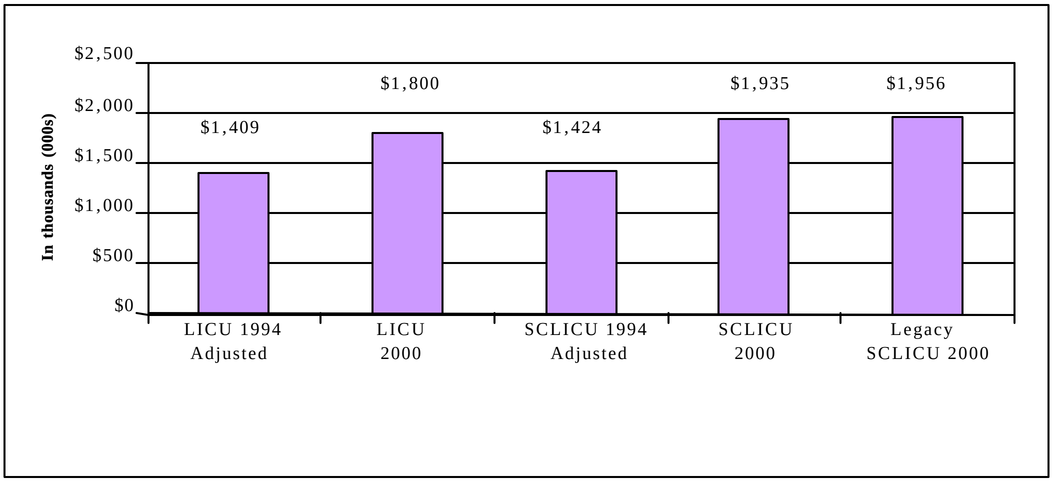
Shares and Deposits Accounts

The mean amount of share and deposits per SCLICU increased 70 percent from 1994 to 2000, for an average of $12 million in 2000. The mean amount of LICU deposit accounts was about one-half that of SCLICUs. LICUs also experienced a lower increase (50 percent) in deposits from 1994 to 2000. The deposit balances of Legacy SCLICUs increased by 86 percent to $13 million in 2000.

SCLICUs also exceeded LICUs in number of accounts. The mean number of deposit accounts for LICUs was approximately one-half that of SCLICUs in 1994 and 2000. In 2000, SCLICUs and Legacy SCLICUs had an average of 7,210 and 7,889 deposit accounts respectively. The mean number of deposit accounts of LICUs in 2000 was 3,387. In addition, SCLICUs experienced a 50 percent increased in accounts from 1994 to 2000, compared to a 28 percent increase for LICUs.

The mean balance of the SCLICU and LICU member accounts also grew. However, the rate of increase was higher for SCLICUs. The mean balance of SCLICU accounts increased by 36 percent from 1994 to 2000, in contrast to a 28 percent increase for LICUs (Chart 4). The deposit accounts of SCLICUs also have higher balances. In 1994, the mean balance per account for SCLICUs was $1,424. In 2000, the mean account balance was $1,935, compared to $1,800 for LICUs. The mean account balance of Legacy SCLICUs in 2000 was $1,956.

Chart 4
Mean Account Balances of LICUs, SCLICUs, and Legacy SCLICUs
1994 and 2000



Non-Member Deposits

Deposits by non-members are a slightly bigger component of the total deposits of SCLICUs than LICUs. In 2000, non-member deposits were 4.5 percent of all LICU deposits and almost 8 percent for SCLICUs. There was a significant difference in the rate of increase of the amount of non-member deposits. The mean amount of non-member deposits for SCLICUs was over $900,000 in 2000, a 267 percent increase from 1994. In contrast, the mean non-member deposit of LICUs increased by 76 percent from 1994 to 2000 (Chart 5).

Dividends and Cost of Funds

The mean dividend rate and COFs of SCLICUs and LICUs are comparable. SCLICU and Legacy SCLICUs had dividend rates of 3.4 percent in 2000. The mean dividend rate of LICUs was 3.1 percent in 2000. The 2000 COFs for SCLICUs and Legacy SCLICUs was 3.2 percent and 3.3 percent for LICUs.

Operating Efficiency

It appears that SCLICU management has become more adept at controlling operating expenses. As Chart 6 indicates, SCLICUs had a significantly higher operating expense ratio than LICUs in 1994. However, by 2000, the operating expense ratio of SCLICUs decreased to 54.3 percent. Legacy SCLICUs reduced their operating expense ratio to 53 percent in 2000. The operating efficiency ratio of all LICUs was slightly higher, at 54.7 percent in 2000.

Chart 5
Percent Non-Member Deposits of LICUs, SCLICUs, and Legacy SCLICUs
1994 and 2000

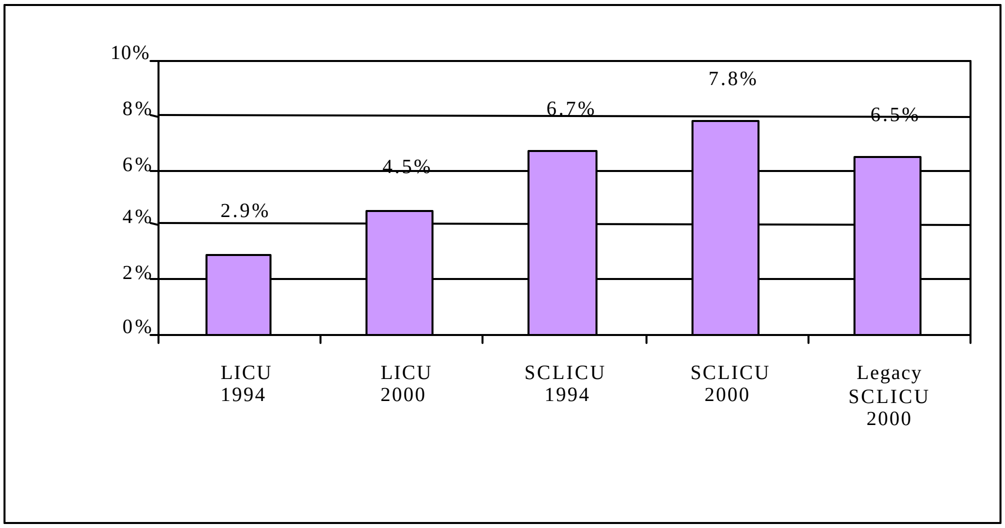


Chart 6
Operating Efficiency of LICUs, SCLICUs, and Legacy SCLICUs
1994 and 2000

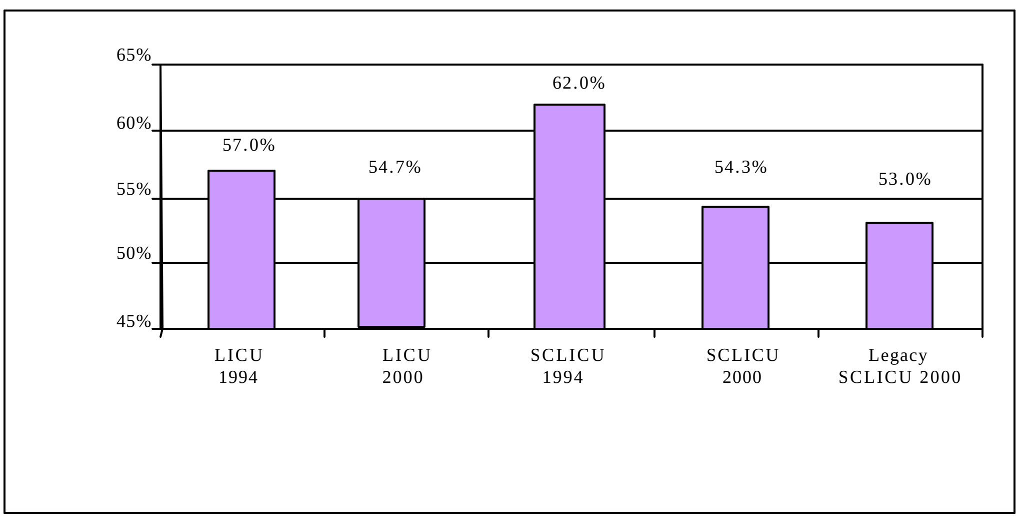
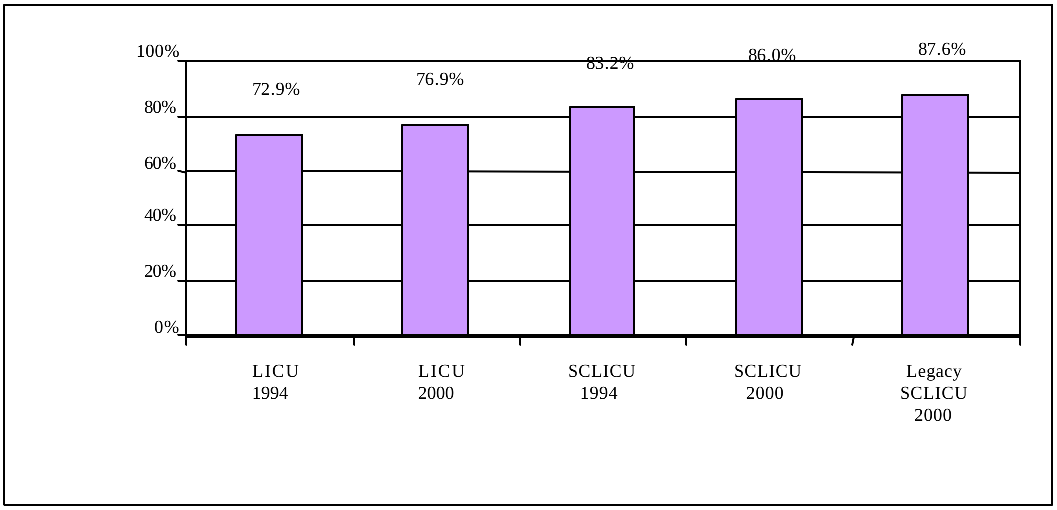


Chart 7
Loan to Share Ratios of LICUs, SCLICUs, and Legacy SCLICUs
1994 and 2000



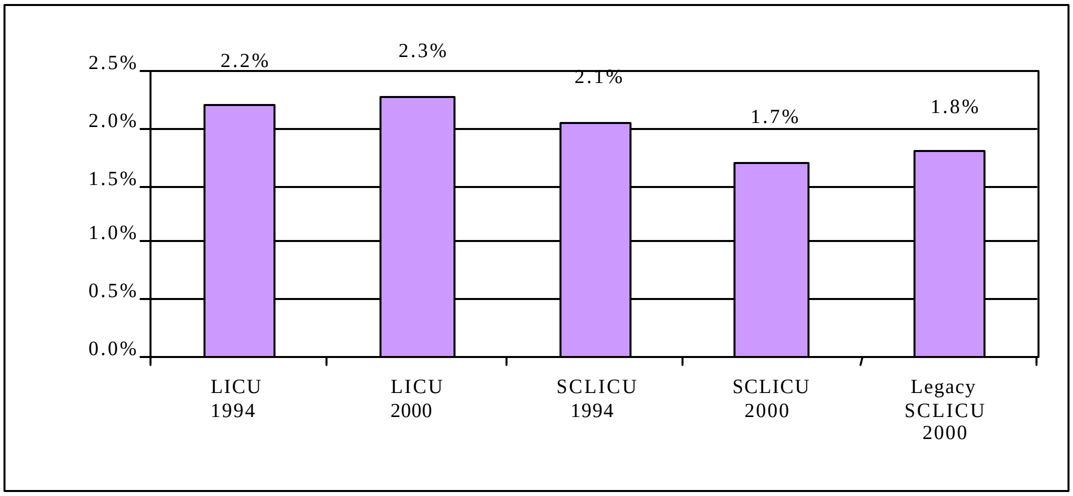
Lending

SCLICUs were more aggressive lenders than LICUs in both 1994 and 2000, (Chart 7) which may account for their lower net capital ratios. The 2000 loan to share ratios of SCLICUs and LICUs was, respectively, 86 percent and 76.9 percent. Legacy LICUs had the largest loan to share ratio at 87.6 percent. The rate of increase in loan to shares from 1994 to 2000 of LICUs and SCLICUs was comparable.

The number and size of SCLICU loans has grown. The mean number of loans per SCLICU in 2000 was 1,799, compared to 907 for LICUs. In 2000, Legacy SCLICUs held an average of 2,012 loans. There was also a major difference in the rates of increase in number of loans of LICUs and SCLICUs from 1994 to 2000. LICUs experienced a 29 percent increase in number of loans, compared to 73 percent increase for SCLICUs. SCLICUs also outpaced LICUs in loan size. The mean loan of SCLICUs grew by over $1,000 from 1994 to 2000 to $7,146. The mean loan for Legacy LICUs was $6,933 in 2000. The mean loan size for all LICUs was more modest, at $4,648 in 2000. SCLICUs and LICUs, however, experienced similar rates of increase in loan size from 1994 to 2000.

The growth in lending by SCLICUs did not result in an increase in loan delinquencies. In fact, the rate of SCLICU delinquencies decreased from 2.1 percent in 1994 to 1.7 percent in 2000 (see Chart 8). The loan delinquency rate of all LICUs in 2000 was 2.3 percent. Further, the rate of long-term delinquencies (over six months) of SCLICUs and Legacy SCLICUs decreased slightly from 1994 to 2000. The rate of charge-offs of SCLICUs increased negligibly from 1994 to 2000 by one-half of 1 percent.

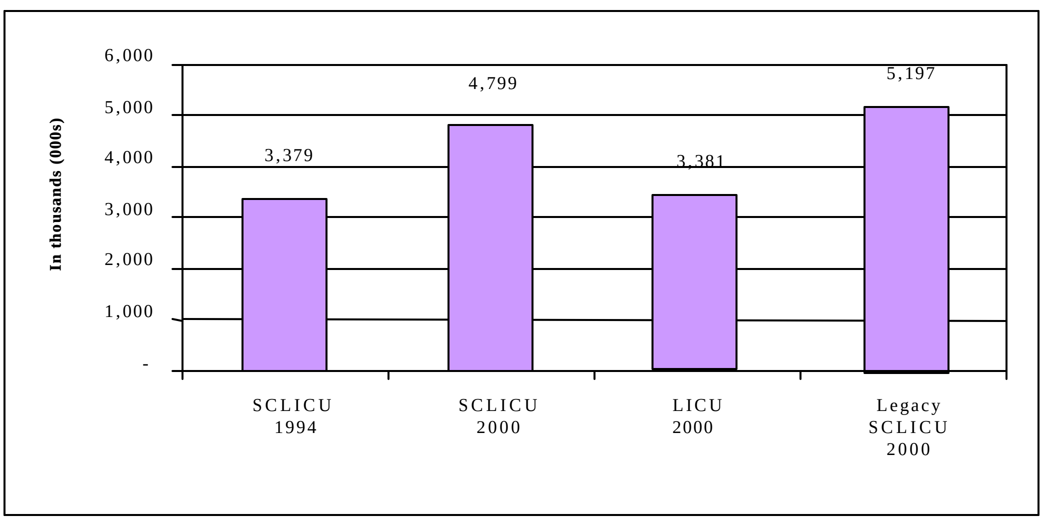
Chart 8
Loan Delinquency Rates of LICUs, SCLICUs, and Legacy SCLICUs
1994 and 2000



Membership

SCLICUs are serving more members. In 1994, they served an average of 3,379 members. By 2000, SCLICUs served an average of 4,799 members, approximately 1,400 more than the LICU mean membership of that year. Legacy SCLICUs served the highest number of mean members (5,197) (see Chart 9). Mean membership of SCLICUs also increased from 1994 to 2000 at a higher rate than LICUs.

Chart 9
Mean Members of LICUs, SCLICUs, and Legacy SCLICUs
1994 and 2000



Staff
Although their operating expenses fell relative to gross income, the average staff size of SCLICUs grew significantly from 1994 to 2000. The mean number of employees of SCLICUs increased by 226 percent, from four in 1994 to 13 in 2000. In contrast, LICUs had a mean staff of seven in 2000, a 57 percent increase from 1994. Legacy SCLICUs had a mean of 14 staff members in 2000. As a result of increasing staffing, the ratio of members to staff dramatically decreased for SCLICUs, from 849:1 to 1994 to 373:1 in 2000, compared to a ratio of 449:1 for LICUs in 2000.

Conclusions

Table 7 is a summary of the key characteristics and ratios of SCLICUs and LICUs in 1994 and 2000. In most cases, SCLICUs fare well when compared to LICUs. SCLICUs have higher assets and loan to share ratios, serve more members, and have lower loan delinquencies. SCLICUs also made major progress from 1994 to 2000; they decreased operating expenses and increased non-member deposits, staff, and number and balance of deposit accounts.

Table 7
Trends of LICUs, SCLICUs, and Legacy SCLICUs
1994[19] and 2000

	LICU 1994	LICU 2000	SCLICU 1994	SCLICU 2000	Legacy SCLICU 2000
Mean Assets	$4,875,402	$7,001,372	$7,700,648	$13,471,622	$14,768,998
Median Assets	$1,148,893	$1,719,618	$2,783,221	$ 4,095,909	$ 4,238,211
Percent Net Capital Ratio	9.6%	11.1%	6.5%	7.3%	7.4%
Total Deposits	$4,284,401	$6,097,234	$6,934,787	$11,786,977	$12,918,448
Mean Number Accounts	2,640	3,387	4,791	7,210	7,889
Mean Deposit Account Balance	$ 1,409	$ 1,800	$ 1,424	$ 1,935	$ 1,956
Mean Non-Member Deposits per Credit Union	$ 123,086	$ 216,463	$ 249,400	$ 915,995	$ 844,599
Percent Non-Member Deposits	2.9%	4.5%	6.7%	7.8%	6.5%
Percent Dividend	3.1%	3.1%	2.6%	3.4%	3.5%
Percent Cost of Funds (COF)	3.1%	3.3%	2.4%	3.2%	3.2%
Efficiency Ration (OE/Y)	57.0%	54.7%	62.0%	54.3%	53.6%
Loan to Share Ratio	72.9%	76.9%	83.2%	86.3%	87.7%
Mean Number Loans	704	907	1,041	1,799	2,012
Mean Loans Per Credit Union	$3,121,282	$4,687,310	$5,772,207	$10,176,942	$11,325,436
Mean Loans to Borrowers	$ 3,824	$ 4,648	$ 5,735	$ 7,147	$ 6,933
Percent Delinquent Loans	2.2%	2.3%	2.1%	1.7%	1.8%
Mean Members	2,031	2,611	3,379	4,799	5,197
Mean Staff	4	7	4	13	14
Members to Staff Ratio	604	449	849	373	380

[19]Where appropriate 1997 figures are adjusted for inflation.

Some might argue that the growth and superior ratios of SCLICUs are due to self-selection. In other words, the most aggressive and fastest growing credit unions pursue and receive investments. There is some legitimacy to this argument. Funding is competitive and therefore perhaps it is likely that the strongest credit unions receive investments. However, capital investors also provide secondary capital investments to LICUs that are thinly capitalized and relatively new. A few of the SCLICUs experienced dramatic decreases in net capital, loan to share ratios, and increases in loan delinquencies from 1994 to 2000.

Despite SLICUs improved capital ratios, maintaining adequate capital is an ongoing concern. Without the secondary capital investments net capital ratio is below PCA standards in 2000. This may be due to a number of factors, such as using resources to make more loans and hence increasing assets relative to net worth. After all, without the secondary capital investments, credit union managers may have opted to decrease loan production and assets to increase the net capital ratio. SLICUs have significantly better loan to share ratios than all LICUs. However, SCLICUs must plan to increase their net capital so they can begin repaying investments. Other alternatives include negotiating extended terms for current investments or raising additional secondary capital investments. Chapter VI contains a detailed policy discussion of these issues.

Chapter V

Secondary Capital Low-Income Credit Union (SCLICU) Case Studies

The following chapter contains case studies of four SCLICUs whose investments have been in place for at least three years: Alternatives FCU, Episcopal Community FCU, Near Eastside Community FCU, and Saguache County CU. These credit unions were selected because they represent some of the best practices of the secondary capital investments programs. They are also diverse in size and membership, thus illustrating that disparate credit unions have achieved improvements through the use of such programs.

The case studies begin with the history and background of each credit union. Then the goals and objectives identified in each credit unions' secondary capital investment business plan are described. The last section of each case study examines whether the credit unions were successful in meeting their goals and identifies notable changes in finances, membership, marketing, staffing, and lending.

Alternatives Federal Credit Union

History and Background

Alternatives Federal Credit Union (Alternatives FCU) was chartered in January 1979 to serve the financial service needs of local microenterprises and cooperatives. Since then the credit union has grown to include a range of consumer and business retail services and lending products.

Alternatives FCU serves Tompkins County, located in south central New York State. The county has a population of almost 95,000 with a median household income of $27,000. The median income of residents of Ithaca, the largest city in the county and the location of the main branch of the credit union, is $17,718. The county population is predominantly white, with 3 percent African-Americans, 3 percent Hispanics, and 7 percent Asians.

Credit union membership eligibility is tied to the Alternatives Fund, a not-for-profit 501(c)(6) established in 1970. The Fund is a trade association of community groups, cooperatives, employee-owned businesses, and individuals. Credit union members must be members of the Fund.

Alternatives FCU leverages local resources to serve the needs of low-income households who are generally left out of the financial mainstream. Credit union management has developed a model of asset development they call the Credit Path Model. It predicates a continuum from poverty to wealth, with affordable financial services and economic literacy at the base. Further up the Credit Path are consumer, real estate, and business lending.

Alternatives FCU has experienced tremendous growth in financial condition, programming, and staff. Total assets were $34 million in 2000, making Alternatives FCU one of the largest CDCUs in the country. Alternatives FCU has almost 6,000 members[20] and a staff of 32.

Alternatives FCU has an active lending program. Its outstanding loans totaled $22 million in 2000 and the loan to share ratio was 73 percent (Table 8). In addition, the Credit Union has also developed Individual Development Account (IDA) programs for housing, education, youth, and business development. Alternatives FCU also developed the Community Partnership Lending Program (CPLP), a cooperative lending vehicle. To join this innovative program, a nonprofit organization makes a deposit in Alternatives FCU that serves as a risk pool for loans made by the credit union to their program participants. Alternatives FCU will make loans for up to twice the amount of the deposited funds. Loans, which can be for a variety of purposes determined by the community partner, are made at an interest rate of 6 percent above the interest rate of the deposit. The credit union considers the CPLP as a means to increase lending to consumers. It is not a source of revenue for the credit union. However, program income does cover Alternatives FCU's administrative costs.

[20] Alternatives FCU's financial statement shows a decrease in members from 8,245 in 1999 to 5,839 in 2000. Credit union management explained the change by noting a change in membership accounting. Instead of adding accounts, the credit union now calculates actual members.

Alternatives FCU management has imposed stringent loan collection procedures. Credit union staff send delinquency notices three times a month and follow up with phone calls if the payments are not received within 30 days. When a loan is over 60 days delinquent, the borrower is encouraged to schedule a meeting with credit union staff and may receive a notice of foreclosure. As a result of these strategies, the delinquency rate, which reached a high of 6.55 percent in 1997, decreased to 3.71 percent in 2000.

Alternatives FCU recently received permission from the NCUA to construct a new facility. The new building will consolidate operations currently housed in two separate buildings. The plans for the new building include a bigger lobby, drive-thru facilities, and on-site parking. The new location, which is just a few blocks from the current facilities, should support the revitalization of the West End of Ithaca.

Table 8
Alternatives Federal Credit Union
December 2000

Type of Charter	Community
Year Established	1979
Charter	Federal
Full-Time Staff	32
Field of Membership (FOM)	Members of the Alternatives Fund (Consumers who live, work or own property in Tompkins County, N.Y.)
Operating Finances	
Total Assets	$34,470,728
Net Capital Ratio	10.6%
Cost of Funds	2.8%
Operating Efficiency Ratio	57.28
Shares and Deposits	
Total Shares And Deposits	$30,250.176
Number of Share/Deposit Accounts	12,606
Mean Share/Deposit	$2,400
Percent Non-Member Deposits	13.6%
Dividend	3.0%
Lending	
Total Loans	$22,044,089
Percent Delinquent Loans	3.71%
Loans to Share Ratio	72.9%
Membership	
Number of Current Members	5,839

Alternatives FCU Capitalization Program

Alternatives FCU has received four secondary capital investments from four sources since 1997, totaling $1,400,00 (see Table 9). The credit union's secondary capital investment business plan addressed home and small business lending, small business development, home ownership, education, and youth programs. The September 1997 business plan submitted to the NFCDCU has the following goals:

Increase Lending

- Expand CPLP by adding four new lending partners.
- Increase the micro loan portfolio to $5.1 million and provide technical assistance to 125 microenterprises.
- Close 66 home loans by expanding outreach for Flexible Mortgage products in partnership with Ithaca Neighborhood Housing Services.

Expand Dollars For Dreams Youth Credit Union

- Increase membership and assets of Dollars for Dreams youth credit union to 1,370 and $487,000 respectively.
- Expand Member Services.
- Establish an IDA program for home ownership or improvement, education, youth and small business development.

Table 9
Alternatives Federal Credit Union Secondary Capitalization Program
December 2000

Source of investment	NCCA	NCIF	CDFI Fund	NFCDCU
Amount of investment	$300,000	$300,000	$550,000	$250,000
Term of investment	10.5 years[21]	9 years	9 years	9 years
Date of investment	March 1999	October 1999	August 2000	December 1997
Redemption period	September 2009	October 2008	August 2009	December 2006
Rate of investment	4.5%	4.0%	4.0%-5.0%[22]	5.0%

Alternatives FCU Progress on Meeting Goals

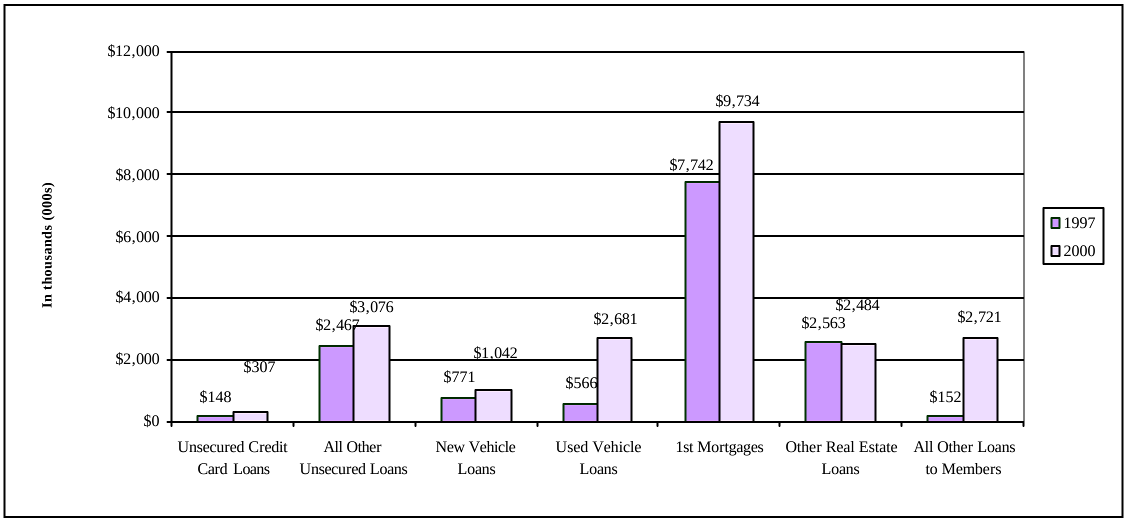
Alternatives FCU has achieved many improvements since the introduction of secondary capital. Dividends increased and loan delinquencies are well in hand. Members' savings account balances and net capital also improved from 1997 to 2000. In addition, the credit union decreased its operating efficiency ratio.

Increase Lending: Consistent with its business plan, Alternatives FCU did experience a dramatic increase in lending (Chart 10). Overall lending volume increased by 53 percent within three years of the credit union receiving the first secondary capital investment in 1997. The loan categories with the largest percent increases are miscellaneous loans to members, such as lines of credit, used vehicle loans, and unsecured credit card loans. First mortgages are the largest volume of loans, at $9.7 million in 2000, followed by unsecured loans ($3 million).

[21]The NCCA investment is for 6.5 years, with automatic annual extensions. If performance measures are met, the term could extend to 10.5 years.

[22]CDFI Fund matches the terms and rates of other investments. Of a total of $550,000 from the CDFI, $300,000 was made at an interest rate of 4 percent to match the NCIF investment, and $250,000 at 5 percent to match the investment from NFCDCU.

Chart 10
Alternatives Federal Credit Union Loan Volume
1997 and 2000



Alternatives FCU significantly expanded the CPLP by adding several new community partners. The Ithaca Housing Authority makes emergency loans for tenants through its Family Self-Sufficiency Program. The City of Ithaca has entered into an agreement with the credit union to make microenterprise loans to qualified, lower-income borrowers. Emergency small business and automobile loans are made through a partnership with ACCORD. ACCORD is a community action agency located in Allegheny County, a rural western New York community. The Minority Women Business Enterprises of Binghamton, a microenterprise development program, makes microenterprise loans.

A partnership with Catholic Charities provides loans for deposits on childcare or rental housing units. The Tompkins County Department of Social Services facilitates vehicular loans for low- and moderate-income consumers. Alternatives FCU continues to explore new partnerships.

Unfortunately, a CPLP partnership with Tompkins Community Action Agency (formerly Economic Opportunity Corporation) was discontinued in 1999. Loans were made to consumers who were facing severe challenges and therefore the delinquency rate was over 33 percent.

The hiring of a business lender in 1998 enabled the credit union to expand services for microenterprise development. The Tompkins County Urban Renewal Agency transferred administration of Community Enterprise Opportunities (CEO) program to the credit union. CEO provides microenterprise support and training. Further, community volunteers are recruited to provide training services. CEO provides a range of entrepreneurial classes, including seminars on internet-based marketing. The credit union has also launched a networking group for technology-based businesses in the region. CEO makes several types of business loans, including lines of credit, equipment loans, start-up loans, and small research loans that enable entrepreneurs to conduct feasibility analysis and develop business plans. Most of the participants of CEO are lower-income women, minorities, or people with disabilities. An average of 95 businesses are assisted each year.

The credit union has raised additional funding for microenterprise development. In 1998, Alternatives FCU also received a $80,000 grant from New York State Community Development Financial Institutions Fund for lending to minority and women-owned businesses. The grant was used for technical assistance and to fund a loan loss reserve. It also enabled the credit union to expand lending to minority entrepreneurs outside of the City of Ithaca. Alternatives FCU was designated a Small Business Administration (SBA) MicroLoan intermediary in 1999, enabling it to expand funding for pre- and post-loan technical assistance. The program allows for a 15 percent loan loss reserve. A grant from the USDA Rural Business Enterprise Program funds technical assistance and a microenterprise loan fund in nearby Cortland County, which has been hard pressed by the decline of its manufacturing sector.

Another innovation of small business lending is the Go Fund. Initially structured as a venture capital fund, the Go Fund makes subordinated equity investments in emerging, high risk/high reward firms. The loans are repaid through royalties tied to an increase in sales.

Alternatives FCU has offered home mortgages since 1981. It works with community organizations, such as City of Ithaca Neighborhood Housing Services and Butler Housing for Tompkins County (BHTC) to market and administer affordable housing loans.

The credit union also offers a specialized mortgage product. The Flexible Mortgage makes loans to consumers who may not meet traditional underwriting standards. These fixed-rate loans are for consumers whose financial status is likely to improve within two-five years. For instance, it can be used for a borrower who has a fluctuating income stream due to self-employment. The Flexible Mortgage has a 30-year amortization with balloon payment due within five years. Alternatives FCU does not charge title or mortgage insurance fees or points on the loans. Once the borrower closes on a Flexible Mortgage, the credit union works with them to improve their credit condition. Most of the borrowers refinance the loan with the credit union at more conventional terms within two and a half years.

Alternatives FCU was able to expand its residential real estate lending due to arrangements to sell its long-term, fixed-rate mortgages on the secondary market. The credit union currently works with PHH Mortgage Services and is exploring a new partnership with Fannie Mae. Fannie Mae’s Timely Payments Reward Program buys unconventional home mortgages or loans to consumers who do not meet standard credit scoring criteria.

Expand the Dollars For Dreams Youth Credit Union: The youth credit union program has expanded to two schools in the community and established 7,309 new accounts. The school credit union is now fully operational and offers a range of deposit services as well as small consumer loans. In addition, the Dollars For Dreams Youth Credit Union sponsors several financial literacy classes for school-aged children and trains students to serve as volunteer tellers. Much of the growth of the program was attributable to the work of a VISTA volunteer. Credit union staff now directs the program.

Expand Member Services: Alternatives FCU offers several IDA programs to members. The American Dream Demonstration, which began in the Spring of 1998, is a partnership with the Center for Enterprise Development (CFED). In total, 110 accounts were opened for total savings of $109,000. Youth members of the credit union own 13 of these accounts. The match rate is 3:1. Seventy-five savers have reached their goals.

The credit union also started two new IDA programs in 2001. The Community Enterprise (CEO) IDA Program is for women and minority graduates of the credit union's business management classes. There is a match rate of 1:1 and the proceeds can be used to purchase business equipment. The Challenge IDA Programs is a partnership with Challenge Industries, a non-profit organization that provides vocational training for lower-income people with disabilities. The match rate is 2:1 and the proceeds can be used to start or expand a small business.

Summary

Alternatives FCU has made tremendous progress on meeting the goals stipulated in its secondary capital investment plan. It has increased lending, expanded the youth credit union, and is well on its way to expanding IDA services.

The credit union's financial indicators have also improved. Its net capital ratio has increased from 6 percent in 1997 to 11 percent in 2000. Further, dividends have remained steady and so have loan delinquency rates. Members' savings have also grown, from a mean account balance of $2,032 in 1997, to $2,400 in 2000. The operating efficiency of the credit union has also improved, from 67 percent in 1997 to 57 percent in 2000. Last, the credit union improved its liquid assets by generating a significant amount of non-members deposits.

Episcopal Community Federal Credit Union

History and Background

The Los Angeles Episcopal Diocese founded the Episcopal Community FCU in 1994. The mission of the credit union is to provide financial services to the beleaguered South Central Los Angeles community. It was also established in response to the rebellion related to Rodney King's beating by Los Angeles police officers. Diocesan leadership asserts that the credit union is a component of its commitment to community ministry.

The goal of the Credit Union is to provide basic financial services and consumer and real estate loans. Episcopal Community FCU serves low-income communities that are under-served by mainstream financial institutions. Many consumers rely on check cashing outlets to conduct basic financial services such as check cashing and paying bills. Therefore, the credit union is committed to providing affordable financial services. In addition, a major focus of Episcopal Community FCU is credit counseling. The credit union is also committed to providing affordable loans. Many of its members have no credit rating. So the credit union also offers small consumer loans to help build their credit ratings.

The Field of Membership (FOM) of Episcopal Community FCU includes parishioners of Episcopal parishes of South Central Los Angeles, Southwest San Bernardino County, and North Orange County. In addition, the FOM contains clientele of Episcopal Church programs for lower-income residents, which provide after-school, mental health, and other social services.

The main office of the credit union is in Echo Park near South Central LA. There is also a branch at the California seaport of San Pedro. Due to its large FOM, credit union leadership plans to eventually have operations at up to 11 additional locations.

Credit union management estimates that its members are 40 percent Hispanic, 20 percent African-American, 20 percent European-American, and 10 percent other, including Asian-American. The FOM includes very diverse demographic community profiles. The city of Inglewood, which is located adjacent to the Los Angeles Airport, has a population of 109,600, over one-half of which are African-Americans and Hispanics. The city of Compton is very similar. It has a population of 90,500 and a median family income of $25,700. In contrast, Oxnard is a farming community with a large Hispanic population employed in the agricultural industry. Moreover, over one-half of Apple Valley's residents are retired persons on fixed incomes under $30,000.

Episcopal Community FCU has made great strides since its founding. Its membership has grown from 362 in 1994 to 2,253 in 2000 (Table 10). The assets of the credit union totaled $3.6 million in 2000 and its net capital ratio was 6.69 percent. The credit union has an active lending program. The ratio of loans to shares is almost 90 percent and the delinquency rate is 1.09 percent. Members also appear to be in better financial condition. The average share and deposit was $481 in 1994 and $1,555 in 2000. A challenge for the credit union is managing operation expenses. Over 60 percent of credit union income is consumed by operating expenses.

Table 10
Episcopal Community Federal Credit Union
December 2000

Type of Charter	Community
Year Established	1994
Charter	Federal
Full-Time Staff	3
Field of Membership (FOM)	Members and clientele of Episcopal churches in South Central Los Angeles and Southwest San Bernardino and North Orange Counties
Operating Finances	
Total Assets	$3,797,268
Net Capital Ratio	6.7%
Cost of Funds	2.4%
Operating Efficiency Ratio	60.5%
Shares and Deposits	
Total Shares And Deposits	$3,397,599
Number of Share/Deposit Accounts	2,185
Mean Share/Deposit	$1,555
Percent Non-Member Deposits	0%
Dividend	3.0%
Lending	
Total Loans	$2,990,371
Percent Delinquent Loans	6.0%
Loans to Share Ratio	88.0%
Membership	
Number of Current Members	2,253

The credit union opened a second branch in nearby San Pedro in partnership with the nonprofit Seaman's Association in 1996. A major industrial and cruiseline seaport, thousands of sailors and other ship staff trek through the San Pedro wharves every year. The Seaman's Association, which offers a myriad of support services, provides office space for credit union operations. The Episcopal Community FCU branch at San Pedro cashes checks, maintains deposit accounts, provides wire transfers, and provides other services for consumers who are vulnerable to predatory financial service providers and theft.

Episcopal Community FCU Capitalization Program

Episcopal Community FCU received $100,000 in secondary capital investments from the NFCDCU in 1998 (Table 11). The credit union planned to use the investments to accomplish the following goals within three years:

<u>Increase Membership and Expand Membership Services</u>

- Establish a checking account product.
- Open 1,945 new deposit accounts.
- Provide financial literacy training for youth.

- Increase membership by establishing a marketing program.
- Establish an IDA Program in partnership with other community organizations.

Improve the Financial Stability of the Credit Union

- Raise $231,000 in non-member deposits from parishes and institutions.
- Increase interest income.

Expand Lending

- Increase loan volume to $3.6 million.
- Establish a microenterprise loan program.

Table 11
Episcopal Community Federal Credit Union Secondary Capitalization Program
December 2000

Source of investment	NFCDCU
Total amount of investment	$100,000
Term of investment	7 years
Date of investment	1998
Redemption period	2005
Rate of investment	5.0%

Episcopal Community FCU Progress on Meeting Goals

Membership and Member Services: Membership in the credit union increased by 7 percent since receipt of the secondary capital investment. Although the number of share accounts increased by only 3 percent, Episcopal Community FCU is on target in reaching its shares and deposit goals. The credit union's business plan stipulated an increase in shares and deposits to $3.499 million by the end of 2000 -- the actual amount is $3.397 million. There was also an increase in the average share deposit balance of $176 from 1998 to 2000.

The credit union has become more engaged in financial literacy training. Credit union employees counsel each loan applicant. Credit union members who have serious financial difficulties are referred to the local consumer credit-counseling agency. Episcopal Community FCU also plans to begin providing financial literacy training for youth with the aid of a curriculum developed by the National Education Financial Endowment (NEFE).

The credit union remains committed to establishing a checking account product. However credit union management has encountered some difficulties. First, Episcopal Community FCU must raise funding to join COOP, a network of credit unions in California. COOP enables its member credit unions to offer ATM, debit, and other services. Second, the staff requires additional training. The credit union has been approved for a CDFI Fund grant to establish a checking account product and debit card program. In addition, the California Credit Union League has expressed interest in providing training and funding. Credit union management projects that these services will be operational by the second half of 2002.

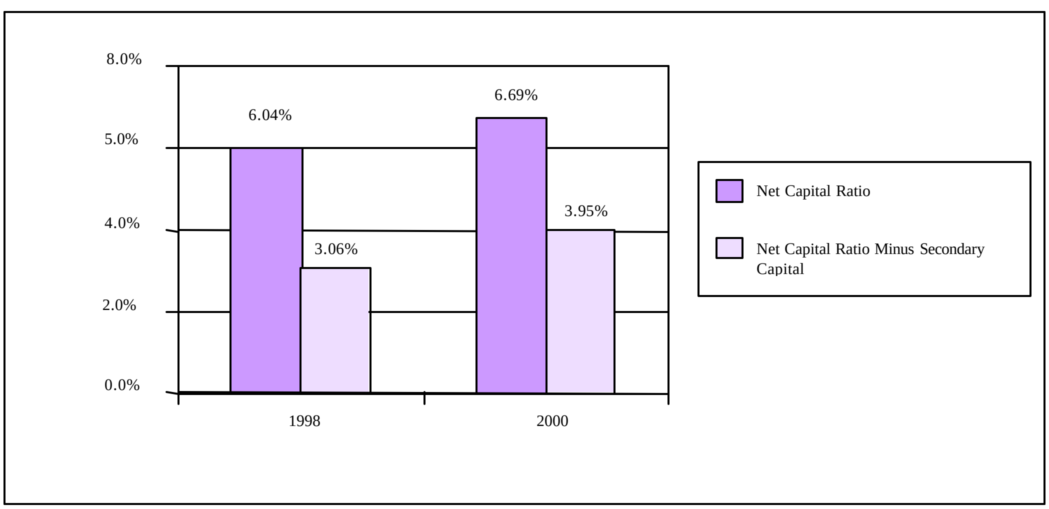
Episcopal Community FCU is part of a local cooperative that is planning to develop an IDA program. The Los Angeles IDA Collaborative is a coalition of local community organizations and non-profit social service agencies. The Credit Union will hold the IDA accounts, help participants develop savings plans, and manage the assets of the program. The Collaborative, which would like to kick off the effort with a pilot program with 20-25 participants, is currently in the process of raising administrative and program funding.

Episcopal Community FCU provides loans for first time homebuyers, second homes, and investment properties as well as conventional mortgages. The credit union markets its mortgage lending programs in a brochure, which features a toll-free hotline for interested borrowers. Brochures are available at parish churches and social service agencies. Credit union staff and volunteers also participate in local events where they distribute brochures.

The credit union's membership includes a significant number of Mexican-Americans or Mexican immigrants. To help these borrowers, Episcopal Community FCU provides low-cost wire transfers to Mexico.

Improve the Financial Stability of the Credit Union: Episcopal Community FCU's net capital ratio increased modestly, from 6.04 percent in 1998 to 6.69 percent in 2000 (Chart 11). Interest income, the bedrock of growing net capital, increased by 46 percent, from $190,055 in 1998 to $277,918 in 2000. Most of this increase is due to the credit union's aggressive and effective lending activities. Similar to many new credit unions, a continuing challenge of Episcopal Community FCU is controlling its operating expenses. The operating expense ratio was over 60 percent in 2000, which is about 5-10 points higher than average. The credit union has not raised non-member deposits but is confident they can do so if the funds are needed. However, there was an increase in deposits from churches and other institutional members of the credit union.

Chart 11
Episcopal Community Federal Credit Union Net Capital Ratios
1998 and 2000

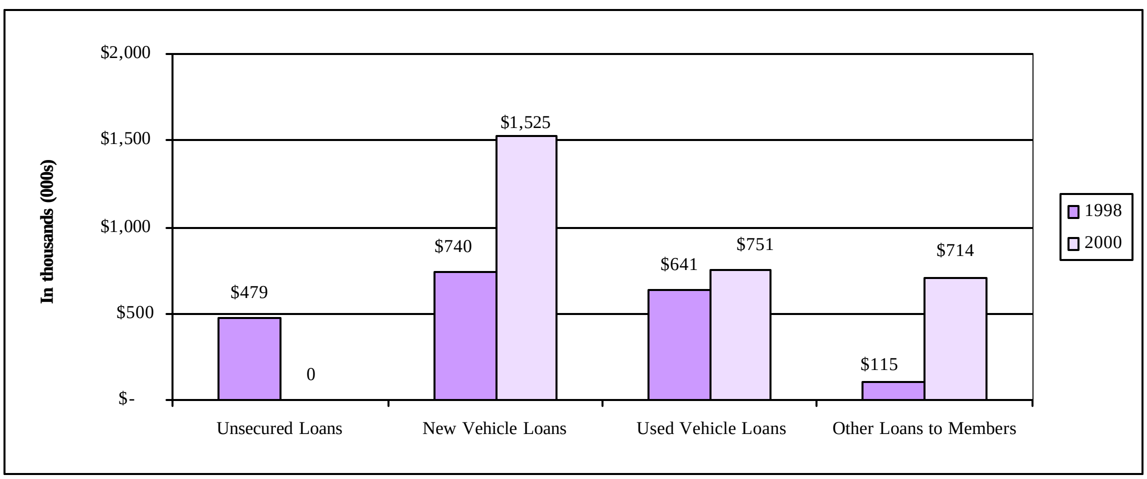


Lending: There was significant growth in credit union lending (Chart 12). In 2000, the credit union booked over $1.9 million in new loans -- most of which were for new automobiles. There was also a significant increase in used car loans (17 percent) and unsecured loans (519 percent). Total outstanding loans increased from $2.1 million to $3.2 million from 1998 to 2000. As a result, Episcopal Community FCU is well posed to achieve its goal of $3.6 million in loans by 2005.

The credit union's loan delinquencies fell by more than half, from 3.66 percent in 1998 to 1.09 percent in 2000. The credit union attributes its lower delinquency rate to the hiring of a part-time loan collector and assessing overdue loans on a weekly basis.

The credit union has stepped up lending to microenterprises in the community. A partnership with the Institute of Urban Research and Development (IURD) has enabled Episcopal Community FCU to increase its microenterprise lending. IURD, which is a program of the Episcopal diocese, received a $100,000 loan from the credit union to purchase 20 carts for vendors. IURD leases the carts to neighborhood vendors. The vendor carts serve as the security for the loan. The credit union also provided small loans directly to the vendors to enable them to acquire vendor licenses. In response to feedback from the Health Department of Los Angeles, the IURD also plans to establish El Pueblito, a café that will provide on-site entrepreneurial training for vendors. Vendors will learn about nutrition, sanitation and safety, food perpetration, and management skills, which are prerequisites for health licenses. El Pueblito should be opened by the Spring of 2002.

Chart 12
Episcopal Community Federal Credit Union Lending Volume
1998 and 2000



The credit union also assisted many other microenterprises and small businesses, including a janitorial cooperative, a catalog business, an airport transportation business, a taxi driver, and childcare providers. In addition, the credit union made several loans that allowed members to upgrade non-Y2K compliant computers.

Summary

Episcopal Community FCU has made significant advances on meeting the goals of its secondary capital investment program. Membership has increased modestly and account balances are on the rise. Its plans for checking accounts, debit cards, IDAs, and financial literacy programs have advanced. It has also engaged in additional marketing activities. The financial stability of the credit union has improved. In addition, the management is confident that the credit union will be able to raise additional funds through non-member deposits if necessary. However, operating expenses still remain fairly high.

As mentioned previously, the ability to repay secondary capital investments is related to a credit union’s ability to stimulate income. Episcopal Community FCU increased its lending by over 50 percent. Further, credit union management and staff achieved this increase while decreasing delinquencies. As a result of increased income from lending and service fees, its gross income has increased to almost $350,000 in 2000. In addition, the credit union's operating expense ratio also decreased, freeing more income for dividends and retained earnings.

Near Eastside Community Federal Credit Union

History and Background

Near Eastside Community Federal Credit Union (Near Eastside Community FCU), which received its charter in 1981, operates in the Highland-Brookside or near Eastside of Indianapolis. The credit union was organized by the Near East Side Community Organization (NESCO), a coalition of clergy and residents concerned about the community.

The Near Eastside Community FCU has suffered from population loss and plant closings. One in four households receive some form of public assistance, and 34 percent have incomes of less than $7,500 a year. In addition, housing and local infrastructure have deteriorated significantly.

The mission of Near Eastside Community FCU is "to promote savings and thrift as a means to economic empowerment and financial security; to promote the establishment of good credit for members; and to provide loans to members.[23]" Credit union leaders are also committed to providing low-cost retail services -- there is only one bank branch in the community, but there are 15 check cashers.[24] As an alternative to expensive check cashing services and other financial service providers, Near Eastside Community FCU provides savings and checking accounts and investment products such as share certificates (certificates of deposit), and Individual Retirement Accounts (IRAs).

Near Eastside Community FCU has grown to $4.5 million in assets, 3,000 share deposit accounts and 2,592 members over the last two decades (Table 12). In addition, the credit union has received almost $600,000 in non-member deposits from credit unions, community-based organizations, banks, and churches. Near Eastside Community FCU has also provided its members competitive dividends, ranging from 3.45 percent in 1995 to 2.29 percent in 1999. The 2000 dividend rate was 2.75 percent. The credit union also has a large lending program with a loan to share ratio of over 99 percent and $3.2 million in loans. The credit union is focused on reducing its delinquency rate. Delinquencies, which were 5.98 percent in December 2000, were cut to 3.4 percent by September 2001.

Near Eastside Community FCU, in partnership with the John H. Boner Community Center, administers an exemplary IDA program. The Near Eastside IDA Program is a participant in the Center for Entrepreneurial Development's (CFED) American Dream Demonstration Program. Near Eastside Community FCU assists in the administration of the program, raises funds, conducts financial literacy training, and provides savings accounts for program participants. By the end of 2000, there were 173 active IDAs with average savings of $214 generating a total match of $160,000. Over 80 of the participants had partially or fully utilized their IDAs for home purchase, small business development, post-secondary education or job training by September 2001.

[23]Near Eastside Community FCU 1997.

[24]Near Eastside Community FCU 1999.

Table 12
Near Eastside Community Federal Credit Union
December 2000

Type of Charter	Community
Year Established	1981
Charter	Federal
Full-Time Staff	7
Field of Membership (FOM)	Consumers who live, work or own properties in the Eastside Community of Indianapolis as well as some select employee groups.
Operating Finances	
Total Assets	$4,466,406
Net Capital	23.9%
Cost of Funds	2.3%
Operating Efficiency Ratio	26.0%
Shares and Deposits	
Total Shares And Deposits	$3,250,000
Number of Share/Deposit Accounts	3,207
Mean Share/Deposit	$1,014
Percent Non-Member Deposits	18.4%
Dividend	3.0%
Lending	
Total Loans	$3,219,836
Percent Delinquent Loans	6.0%
Loans to Share Ratio	99.0%
Membership	
Number of Current Members	2,592

Near Eastside Community FCU Capitalization Program

The Near Eastside Community FCU received a $595,000[25] operating grant and a $163,000 technical assistance grant from the CDFI Fund in 1999. The purpose of the equity grant is to support home ownership and improvement lending, expand access to financial services, and relocate the credit union's offices. The technical assistance grant will be used to upgrade the credit union's computer system, board and management training, mortgage training for lending staff, and to fund a feasibility/planning analysis of moving to a new location.

The credit union also received $250,000 in secondary capital from the NFCDCU in 1997 (Table 13). The purpose of the investment was to support Near Eastside Community FCU's goals:

Financial growth

- To increase assets to $6.8 million in five years.
- Increase capital ratio to 10.39 percent in five years.

[25]Near Eastside Community FCU's income grew by $600,000 from 1999 to 2000, due primarily by the CDFI Fund grant.

Membership
- Expend the FOM of the credit union to Martindale-Brightwood and other adjacent lower-income communities.
- Expand membership to 4,500 in five years.

Member Savings

- Increase savings of credit union members.

Lending

- Increase lending, with an emphasis on residential real estate lending.

Table 13
Near Eastside Community Federal Credit Union Secondary Capitalization Program
December 2000

Source of investment	NFCDCU
Total amount of investment	$250,000
Term of investment	7 years[26]
Date of investment	1997
Redemption period	2006
Rate of investment	5.0%

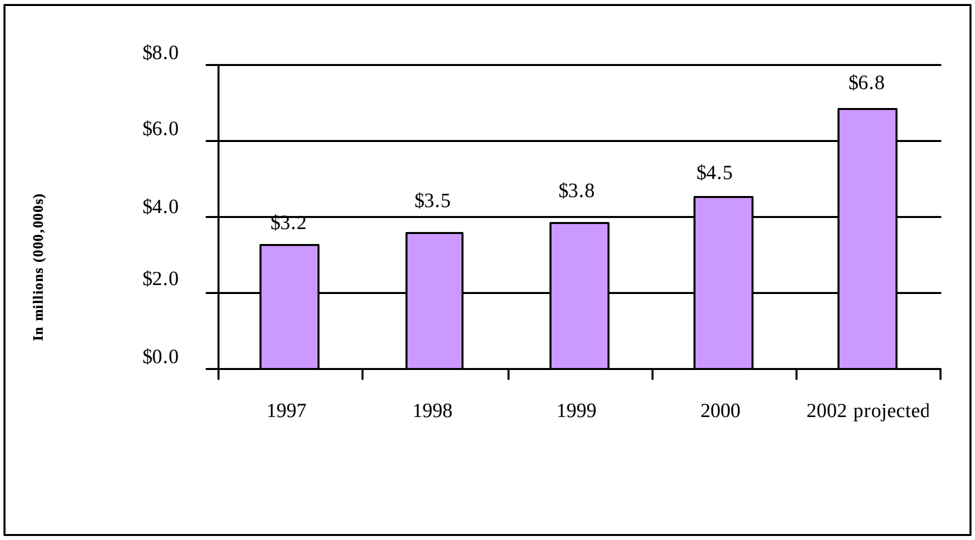
Near Eastside Community FCU Progress on Meeting Goals of Capitalization Program

For the most part, Near Eastside Community FCU has been successful in meeting its goals. In particular, Barbara Black, the credit union manager, attributes the secondary capital investment for giving the credit union the financial resources to increase lending.

Financial Growth: Since Near Eastside Community FCU received its secondary capital investment in 1997, it has experienced a 38 percent increase in assets. During that period, assets increased from $3.2 million to $4.5 million (see Chart 13). The credit union projected that its assets would increase to $6.8 million by 2002. This would require a 51 percent increase from 2000 to 2002, a very ambitious challenge.

[26]The term of the investment was extended by one year by NFCDCU in 2000.

Chart 13
Near Eastside Community Federal Credit Union Assets
1997-2002



Near Eastside Community FCU also significantly improved its net capital ratio, which increased from 12.1 percent in 1998 to 23.9 percent by 2000. Although the secondary capital investment was part of this increase, net capital actually increased independent of the investment. The 2000 net capital ratio of the credit union, minus the secondary capital investment, was 18.3 percent.

Membership: The Near Eastside community is under-served by financial institutions. Therefore, reaching additional members is not only vital to the health and growth of the credit union -- it is also a desperately needed service in the community. Total membership expanded from 1,881 in 1997 to 2,592 in 2000 -- a 19 percent increase. However, to increase membership to 4,500 by 2002 would require an additional 2,000 members.

There are two explanations why the credit union may fall short of its membership goals. First, the NCUA imposed restrictions on increasing FOMs in 1998-99 due to numerous court challenges and legislative debate regarding membership expansions.[27] Second, credit union management decided to delay expanding its FOM until it moves to a new facility.

Near Eastside Community FCU established several marketing campaigns in late 2001 and 2002 to increase its membership. They include special membership drives scheduled for each quarter.

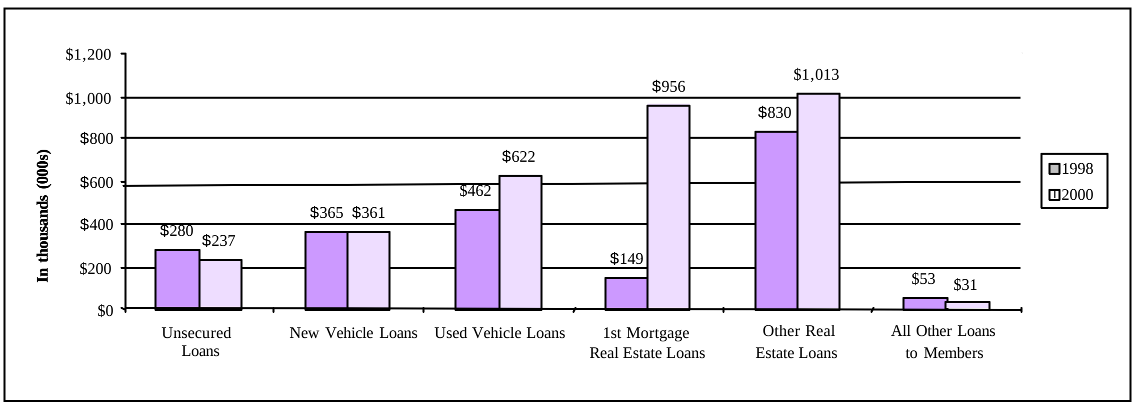
Member Savings: Near Eastside Community FCU sought to promote asset development and savings by promoting its account products: Regular Savings, children's accounts, Christmas Clubs, Individual Retirement Accounts, IDAs, and the Youth Credit Union. One means of determining whether members

[27]Banks contended that the Federal Credit Union Act limits the ability of credit unions to expand their membership by adding select employment groups (SEGS) to their FOM. Bankers were concerned about the competitive advantages of large mainstream credit unions. The case was eventually settled by the U.S. Supreme Court, which upheld the bankers' suit. However, the Credit Union Membership Access Act, enacted in August 1998, allows SEG expansions under certain conditions.

are increasing their savings is by examining mean shares and deposits. Mean shares and deposits increased by approximately 6 percent from 1996 to $1,189 in 1997. However, from 1997 to 2000, the mean share deposit decreased by 9.5 percent to $1,014. Further, this decrease is true when examining only member accounts, which decreased from a mean of $791 in 1997 to $728 in 2000. Near Eastside Community FCU management attributes the decrease in deposits to the demographics of its most recent members. Most of the new members are very low-income and have difficulty building savings. Further, to promote new membership, the credit union allows consumers to establish accounts with as little as $5.00.

Lending: Near Eastside Community FCU has significantly increased its lending activity (Chart 14). In 1998, a year after Near Eastside Community FCU received its secondary capital investment, its lending volume exceeded $2.1 million. By 2000, lending increased by 51 percent to $3.2 million. This is largely due to the institution of real estate loans; first mortgages increased by 543 percent, and unspecified home improvement and home equity loans increased by 22 percent. There was also a 35 percent increase in used vehicle loans.

Chart 14
Near Eastside Community Federal Credit Union Lending Volume
1998 and 2000



The increase in lending is largely attributable to the development of new loan products. The First Mortgage, Home Improvement and Home Equity lending programs have resulted in the closing of 66 home improvement and 18 real estate loans from 1998-2000. In addition, Near Eastside Community FCU made two loans for affordable housing purchases through a revolving loan fund administered by Eastside Community Investments, a community development corporation.

Used car loans also increased significantly, to $621,528 by 2000. The credit union is committed to making loans for used car purchases due to the link between employment and transportation and the difficulty members would face in obtaining affordable loans from other sources. The credit union offers a favorable interest for used car loans (10.8 percent in 2000).

The only area of lending that actually decreased from 1998 was unsecured loans (the credit union does not offer a credit card product). Credit union management contends that the institution has difficulty in offering competitive rates on consumer loans.

Unfortunately, the increase in mortgage lending has resulted in a growth in loan delinquencies, from 4.8 percent in 1998 to almost 6 percent in 2000. Loans for home improvement and home purchase are larger than consumer loans. Therefore, when a borrower becomes delinquent or in default, the impact is much greater on the credit union.

The credit union has taken several steps to reduce delinquencies. First, it is working with mortgage advisors to improve its real estate lending practices. Second, a mortgage committee was established to review the underwriting analysis of home mortgage applicants. Third, the management of credit unions is working diligently to monitor late payments. Fourth, the credit union refers the loans of unresponsive borrowers to a collection agency. As a result of these efforts, the credit union has reduced its delinquency rate from 5.98 percent in December 2000 to 3.42 percent by September 2001 -- a reduction of over two points in only nine months.

Summary

Near Eastside Community FCU has a good record of meeting its goals. Although the goal may not be met, the credit union experienced a significant growth in assets. The credit union has also developed a high net capital ratio. In fact, even after subtracting its secondary capital investment, the credit union's net capital ratio is 18.3 percent. Near Eastside Community FCU has experienced challenges in regards to increasing its FOM and membership. Credit union management will continue to pursue these goals by various means, including relocating to a larger facility.

The biggest impact of the secondary capital investment appears to be its role in stimulating lending. Near Eastside Community FCU developed several new home mortgage products and is a leader in making loans for used cars at affordable rates. The credit union will need to continue to balance the demand for loans with the need to minimize its lending risk.

Saguache County Credit Union

History and Background

Saguache County CU is the youngest credit union profiled in this report. Formed in 1996, the credit union had total assets of $4 million and almost 800 members as of 2000. Saguache County CU is chartered by the state of Colorado.

Saguache County is a sparsely populated rural community in Colorado, with almost 6,000 in population and a density of only two people per square mile. The community has the highest rates of poverty in Colorado -- 26 percent of the residents had incomes below the poverty line in 2000. Almost one-half of the residents are Hispanic.

The Moffat/Crestone Business Association, which promotes business development in the area, began planning the credit union in 1991. The business community continues to be a major supporter of the credit union, which has 81 business checking and savings accounts.

Before the formation of the credit union, residents and business owners had to drive up to 100 miles round trip to conduct their banking. The credit union founders were eager to begin offering a full range of services from the beginning. In addition, some organizers of Saguache County CU also believed that the community suffered from disinvestment due to geographic discrimination or redlining. So lending is also an important component of the credit union's mission.

The credit union has two branches, in Moffat and Center, Colorado. The Moffat office serves as the main headquarters for the credit union. The Center branch was acquired when Saguache County CU merged with Co-Operators Credit Union in January 2001. Co-Operators CU, formed in 1939, was a federally-insured, state chartered credit union. Unfortunately it suffered from loss of membership due to a decrease of cooperatively-owned firms in the community. The merger increased Saguache County CU's assets by $700,000 and increased its lending portfolio by $545,000.

Saguache County CU has almost 3,000 share accounts and 782 members. The credit union provides a range of services, including savings and checking accounts, certificates, money orders, travelers checks, IRAs, direct deposit and payroll deductions, wire transfers, and overdraft protection. The newest product is a no-fee checking account with no minimum monthly balance requirements. Saguache County CU also provides access to state transfer benefits (Temporary Assistance to Needy Families or TANF, Old Age Pensions, and Aid to the Needy Disabled) through Colorado's QUEST Program. QUEST terminals, located in the lobbies of both branches, give benefit recipients a voucher for payment. The voucher is then presented to a credit union teller for cashing.

The credit union had a loan portfolio of $3.4 million in 2000 (Table 14). In fact, although the credit union has a loan to share ratio of 86 percent, its delinquency rate is only .09 percent. Saguache County CU management credits its counseling program for this low rate of delinquencies. Counseling is provided on a one-on-one basis with loan applicants. The credit union loan officers meet with potential borrowers,

Table 14
Saguache County Credit Union
December 2000

Type of Charter	Community
Year Established	1986
Charter	State
Full-Time Staff	4
Field of Membership (FOM)	People who live, work or own businesses in Saguache County, Colorado
Operating Finances	
Total Assets	$4,095,909
Net Capital Ratio	4.6%
Cost of Funds	2.7%
Operating Efficiency Ratio	46.0%
Shares and Deposits	
Total Shares And Deposits	$3,882,101
Number of Share/Deposit Accounts	1,318
Mean Share/Deposit	$2,945
Percent Non-Member Deposits	23.0%
Dividend	2.8%
Lending	
Total Loans	$3,353,222
Percent Delinquent Loans	.09%
Loans to Share Ratio	86.4%
Membership	
Number of Current Members	782

review their credit reports, discuss financial management, and provide guidance on improving credit ratings. If appropriate, Saguache County CU will also make a debt consolidation loan. The local extension service also provides credit counseling to credit union members.

The credit union makes a significant number of automobile loans. In 2000, Saguache County CU's made a total of approximately $400,000 in loans for new and used vehicles. Credit union loan officers not only 'pre-qualify' borrowers, they also provide information on car buying and advise borrowers of the book value of cars.

The credit union also increased its home mortgage lending. Mainstream credit unions purchase Saguache County CU mortgages on the secondary market. Further, the Colorado Credit Union League coordinates loan participations between Saguache County CU and other state credit unions.

The credit union is not permitted to make business loans by its regulator. However, Saguache County CU has made several loans to support local entrepreneurs that are secured by personal collateral.

Saguache County CU has also raised significant funding from non-members. It has 31 non-member accounts totaling almost $900,000 -- most of which are from Colorado-based mainstream credit unions.

The credit union is very responsive to community needs. Its Board of Directors includes farmers, business owners, ranchers, homebuilders, and retired military personnel -- all of whom live and/or work in Saguache County. The credit union also conducts an annual planning session. The sessions, which are facilitated by the Colorado Credit Union League, address budget plans, membership issues, market outreach strategies, and the development of new credit union services.

Saguache County CU Capitalization Program

The credit union planned to accomplish the following goals with the assistance of a secondary capital investment (Table 15):

<u>Financial Growth and Stability</u>

- Increase capital to assets ratio.
- Decrease operating expenses.
- Increase loan reserves.

<u>Lending</u>

- Increase residential construction and home equity lending.
- Increase business, student and agricultural equipment lending.

<u>Membership Services</u>

- Provide debit cards.
- Expand hours.

<u>Marketing</u>

- Increase marketing budget.
- Conduct more extensive marketing.

Table 15
Saguache County Credit Union Secondary Capitalization Program
December 2000

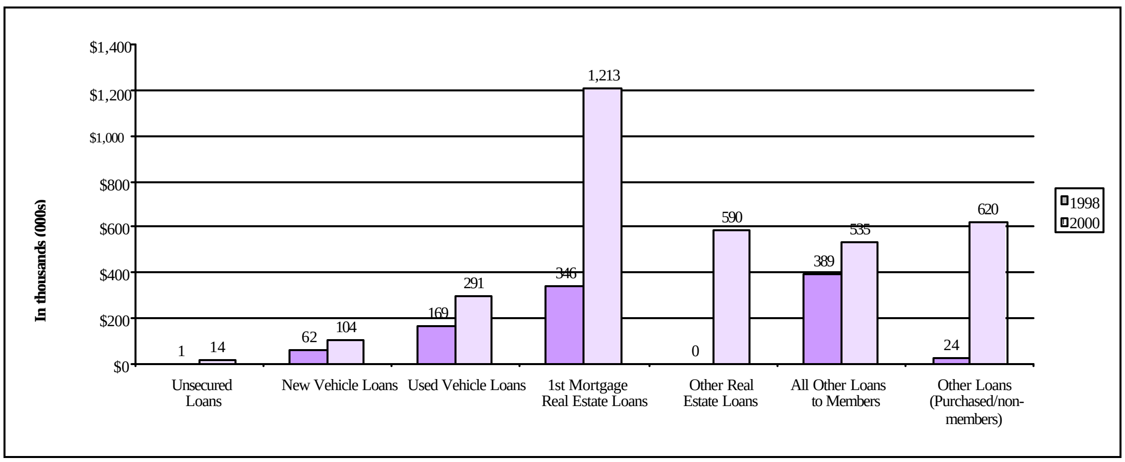
Source of investment	NFCDCU
Total amount of investment	$100,000
Term of investment	7 years
Date of investment	1998
Redemption period	2006
Rate of investment	5.0%

Saguache County CU Progress on Meeting Goals of Capitalization Program

Financial Growth and Stability: The financial condition of Saguache County CU has improved since its receipt of the secondary capital investment. However, maintaining a sufficient net capital ratio remains a challenge for this rapidly growing credit union. Although the credit union's net capital increased by about $45,000 from 1998 to 2000, its net capital ratio decreased from 7.02 percent to 4.63 percent. Further, without the secondary capital investment, the credit union's net capital would be 2.19 percent. On the positive side, the credit union decreased its operating expenses significantly. Its operating efficiency ratio decreased from 65 percent to 46 percent from 1998 to 2000. Further, loan loss reserves increased almost 3-fold for a total of $73,382.

Lending: Lending increased from just under $1 million in 1998 to $3.3 by 2000 -- an increase of 240 percent. The largest percent increase in lending was for unspecified unsecured loans, which increased by 2,023 percent from $668 in 1998 to $14,180 in 2000 (See Chart 15).

Chart 15
Saguache County Credit Union Lending
1998 and 2000



The largest volume of lending for Saguache County CU in 2000 was for first mortgage loans, which increased by 251 percent. There was also an increase in other real estate lending for second mortgages, construction, and home equity lines of credit. Saguache County CU has also made several home refinance loans. The credit union found that construction loans required intensive management due to the need to approve each payment to contractors. Therefore, the credit union board has decided to postpone the establishment of a construction loan product.

The credit union has made a variety of small business and agricultural loans, including loans for musicians, a horse stable, a woman-owned construction company, and a computer business. Because the credit union is not allowed by NCUA to make small business loans, these loans are secured by homes, automobiles, or other collateral and are therefore classified as consumer and home equity loans.

The credit union has not made student loans to date. However, Saguache County CU has made several auto loans to students. In addition, the credit union has determined a creative way to make personal loans to students by using their automobiles as collateral.

Membership Services: The credit union's membership continues to grow. Membership grew by 67 percent from 466 in 1998 to 782 by 2000. Saguache County CU enrolls approximately ten new members per month.

The credit union is still exploring the feasibility of developing a debit card program. Saguache County CU management expects to develop the program after staff training.

Saguache County CU is also in the process of translating its membership material to Spanish. The credit union also plans to use Spanish language financial literacy materials.

Marketing: The marketing budget of Saguache County CU grew to $3,054 in 2000. Most of the marketing funding is used to produce brochures describing the services of the credit union. The brochures are distributed at local community events and fairs. In addition, the local newspapers have published several articles about the credit union.

Summary

Saguache County CU has made substantial progress in meeting the goals of its secondary capital investment program. Net capital and loan loss reserves increased and the credit union decreased its proportion of operating expenses. The credit union is also poised to increase retained earnings from loan activity. Its lending increased by 240 percent in only two years and its delinquency rate is less than 1 percent.

The membership of Saguache County CU continues to grow. Increasing retail services is a continuing challenge until additional staff training occurs. In addition, careful management will be required to grow the net capital ratio and start making payments on the credit union's secondary capital investment.

Summary of Case Studies

The four credit unions described in these case studies represent the best practices of the secondary capital investment program and do not appear to face the same challenges paying back their investments as SCLICUs in general. Alternatives FCU, Episcopal Community FCU, Near Eastside Community FCU and Saguache County CU have made significant strides in improving finances, membership, and marketing. Each credit union also expanded their lending considerably. This is an indication that they will generate increased income and grow their net capital. In fact, three of the four credit unions have loan to share ratios of 86 percent and above. As expected, the net capital ratios of most of the credit unions have increased since the investment were made and they appear to have adequate resources to begin paying back the principal portion of their investments.

Chapter VI

Secondary Capital Investment Regulatory and Investment Policy Recommendations

Secondary capital investments not only improve the capital ratio of LICUs – they also promote institutional growth, lending, and stability. As a result, the investments increase the capacity of LICUs to meet the financial service needs of lower-income and under-served individuals and communities.

Credit union management and staff reported several challenges and difficulties with the secondary capital program. Their primary concern is the ability of the credit union to repay the investments and maintain adequate capital. Others suggested that the secondary capital investment program be expanded by increasing the pool of investors, allowing mainstream credit unions to accept secondary capital investments, or lifting the ceiling of the maximum investment amount. The lack of training of NCUA regulators regarding the treatment of secondary capital investments on financial statements was also discussed as well as difficulties with the application process. Credit union managers also contend that the fixed interest rate of the investments is not responsive to market trends and should be restructured. Last, although not directly related to this study, credit union managers identified obstacles to increasing non-member deposits.

Repayment of Investments

Most of the secondary capital investment investments are intended to be repaid within seven to ten years. As a result, investments can rotate to new LICUs. However, the funders recognize that more flexible terms might be required and therefore may grant one-year extensions under some conditions.

The secondary capital investment program has been operational only four years. However, there are some indications that some credit unions may have difficulty paying their investors without violating PCA net capital ratios. This may be due to several reasons:

- To increase lending, LICUs may need to increase operating and staff costs. These increased costs could decrease earnings and net worth.

- The amount of the secondary capital investment may not be sufficient to support increasing operating and other expenses.

- LICUs may need longer-term investments that support financial services as well as increased lending. Although providing services is an integral component of the mission of credit unions, the cost is relatively high and often subsidized by revenue from lending.

Recommendation: The secondary capital investment program should be carefully studied over the next year to determine the capacity of LICUs to repay the investments and maintain satisfactory capital. Several questions should be explored:

- Are the secondary capital investments large enough to support credit union growth?
- Does the term of the investment match the credit union's projected growth tenure?

- What is the feasibility of interest deferments?
- Is it possible to develop a system that ties repayment of investments to performance standards?

Expand the Secondary Capital Investment Program

Several CDCU managers and advocates would like to see the secondary capital investment program expanded. They recommend increasing potential investors, allowing mainstream credit unions to accept investments and increasing the ceiling on secondary capital investments.

Expanding the Investor Pool

Credit union managers report that secondary capital investments can be a tough sell to potential investors. First, the funds are not insured like non-member deposits. A portion or all of the investment can be lost if the funds are needed to pay operating expenses or to increase loan loss reserves. Second, secondary capital investments do not generate high rates of returns like venture capital, and therefore may only be attractive to a few investors. Third, the CDFI field is dominated by loan funds. Many philanthropists and investors are not familiar with LICUs and their unique needs for capital.

Expanding the pool of credit union investors may appear counter to the tradition of member-lead governance. Investors may pressure credit union management to incur greater risks in the interest of maximizing income. This could lead to favorable treatment of larger members' and investors' pressure to cut costs.

Recommendation: Credit union regulators and trade associations should make it a priority to educate foundations, banks, quasi-government agencies and others on secondary capital investment opportunities. This could serve to not only expand the pool of investors or nonmember depositors, but also help improve the profile of LICUs within and outside of the CDFI community. However, care should to be taken in drafting investment agreements so that the investors do not impede the nonprofit, cooperative structure or safe operation of the credit union.

Mainstream Credit Unions

A few LICU managers contend that mainstream credit unions should be eligible for secondary capital investments. They argue that expanding the eligibility criteria for secondary capital investments could serve to build support for expanding the program.

Mainstream credit union leaders agree. Although the majority of mainstream credit unions are adequately capitalized, some are struggling to maintain capital ratios required by regulators. Others assert that credit unions require more flexibility in raising capital to remain competitive with banks.

There is also some pressure from leaders in the mainstream credit union industry to expand their capital generating capacity. First, the Credit Union National Association (CUNA) Renaissance Commission identified the ability to raise capital as a primary concern. Second, state-chartered credit unions in California are seeking permission to raise capital by selling equity shares to members and nonmembers.

NCUA gave LICUs regulatory flexibility, including the ability to raise secondary capital investments, because they are committed to serving lower-income communities and consumers. Some community organizations and banks contend that mainstream credit unions, whose members tend to be middleincome,[28] do not address financial needs of under-served communities. In addition, unlike banks, credit unions are not subject to the Community Reinvestment Act (CRA) and therefore have no mandate to provide[29] services and loans to lower-income consumers or data on their impact. There is also the issue of need. Very few mainstream credit unions have net credit ratios below PCA standards. It has been estimated that as few as 5 percent of mainstream credit unions have net capital ratios below 6 percent.[30]

Recommendation: Some consideration should be given to allowing mainstream credit unions to accept secondary capital investments. This recommendation however, has several caveats. First and foremost, the credit union must document that it has an adequate level of service to lower-income consumers and communities. Second, new resources must be developed, otherwise the scarcity of secondary capital investors will become more pronounced. Third, eligibility criteria must be carefully examined -- the credit union should demonstrate a need for secondary capital investments. Fourth, policies should be established that would prevent an investor from using undue influence on credit union management.

Increase the Ceiling on Secondary Capital Investments

It has also been suggested that some investors should lift their ceiling of 1:1 ratio of secondary capital to net worth. This would allow credit unions to raise more secondary capital investments.

This suggestion has several structural challenges. The ceiling was established to prevent an over-reliance on secondary capital investments by credit unions. Further, credit unions may experience greater difficulty paying back larger investments.

Recommendation: The ceiling of 1:1 ratio of secondary capital to net worth should be retained.

NCUA Management

At the start of the program, some NCUA regulators classified secondary capital as a liability instead of equity. Although this problem is occurring less frequently, it is important that examiners correctly classify investments, especially as credit unions begin making principal payments.

Recommendation: NCUA and state credit union regulatory agencies should conduct regular training workshops for field staff on secondary capital investments. Particular attention should be paid to how principal and interest payments are classified on financial reports.

Application Process

Some of the credit union managers interviewed complained that the applications for secondary capital investments are too unwieldy. They were particularly concerned about developing future goals as part of the business plan, which may be especially difficult for new and rapidly growing credit unions.

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[28] Schultz 1998.

[29] A recent Woodstock Institute report, *Rhetorical and Realty: An Analysis of Mainstream Credit Unions' Record of Serving Low-Income People* showed that regular credit unions have a poor record of serving lower-income peole.

[30] NCUA 2001b.

The development of a business plan is critical to credit union management. Credit unions are entering into a serious liability when accepting secondary capital investments. A business plan facilitates planning by staff, board and members, and enables credit union managers to determine how the investment will improve credit union operations and facilitates evaluation. The business plan should also help identify the appropriate amount and term of the investment as well as determine net income necessary to repay the investment. Therefore, a business plan can increase the credit union's ability to repay the investment and give potential investors greater confidence and understanding of credit union dynamics.

Recommendation: The submittal of a business plan as part of the application for secondary capital investments should be retained. However, investors should allow credit unions to update business plans if there are major changes in the economic environment or other factors.

Interest Rate

Secondary capital investments do carry some risk -- they are subordinated to other debts and are unsecured. The interest rate, which is currently 5 percent for most investments, reflects these risks.

Several credit union managers assert that the ability to classify secondary capital investments as equity outweigh the costs of the 5 percent interest rate. Others contend that the interest rate is not responsive to market conditions, and is now much too high given current cost of funds. For instance, although the interest rate of investments has remained fixed, the prime interest rate ranged from 8.25 percent in January 1997 to 6.00 percent in January 2001.[31]

Recommendation: Credit union management and regulatory agencies should explore the operational and financial feasibility of adopting a variable interest rate. In any case, the interest rate should be structured to reinforce increasing lending income rather than generating spread-income by investing the secondary capital.

Non-Member Deposits

The NCUA limits non-member deposits to 20 percent of total deposits. NCUA regulators contend that non-member deposits carry more risk because the depositor is more likely to close the account than a member is. In addition, the federal insurance ceiling of $100,000 also limits non-member deposits.

Some credit union advocates contend that many of the institutions that provide non-member deposits are just as committed to credit unions as their members. In fact, they may be in a better position to make long-term deposits unlike a low-income member who may need to make regular withdrawals.

Recommendation: NCUA should conduct a survey of LICUs with non-member deposits to determine whether these deposits are at high risk of withdrawal. The survey should examine the term of the deposits, the amount, and the relationship between the non-member depositor and the credit union.

[31] Federal Reserve Bank of St. Louis.

Chapter VII

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Woodstock Institute

Woodstock Institute, a Chicago nonprofit incorporated in 1973, works locally and nationally to promote sound community reinvestment and economic development in lower-income and minority communities. It collaborates with community organizations, financial institutions, foundations, government agencies, and others to promote its goals.

The Institute engages in applied research, policy analysis, technical assistance, public education, and program design and evaluation. Its areas of expertise include: CRA and fair lending policies, financial and insurance services, small business lending, community development financial institutions, and economic development strategies.