Secondary Capital
Best Practices Guide

National Credit Union Administration

Contents

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Secondary capital is an important regulatory benefit for federally insured credit unions with a low-income designation. It allows these credit unions to build temporary capital from external sources. Without secondary capital, the growth rate of low-income credit unions is constrained by their ability to add capital only through retained earnings. If assets grow at a rate faster than capital grows internally, the credit union's net worth ratio declines. This constraint on the ability to add capital can also adversely affect a credit union's expense ratio by making it more difficult to achieve economies of scale.

Yet, secondary capital is not without its pitfalls, and credit unions must be fully aware of its implications. This guidebook provides interested low-income credit unions information on how to safely manage this type of capital.

I. Background

In 1996, the NCUA Board authorized low-income designated credit unions, including state-chartered credit unions (to the extent permitted by state law), to accept uninsured secondary capital from non-natural person members and non-natural person nonmembers, such as corporations and organizations.

The purpose of uninsured secondary capital is to provide a further means—beyond setting aside a portion of earnings—for these credit unions to build capital to support more lending and financial services in their communities and absorb potential losses, reducing their potential for failing.

This authority, for low-income credit unions only, is subject to various conditions, which includes the following:[1]

- Investors are limited to non-natural persons;
- NCUA must approve a secondary capital plan before a credit union can receive secondary capital;
- Secondary capital must have a minimum five-year maturity;
- Secondary capital is not insured by the National Credit Union Share Insurance Fund and is subordinate to all other claims against a credit union in a liquidation;
- Secondary capital cannot be pledged as security;

[1] NCUA Rules and Regulations 701.34 and 741.204

- There are specifically mandated disclosures and contracts;
- For the final five years of maturity, the secondary capital in a credit union's net worth is discounted at 20 percent per year; and
- NCUA approval is required before the discounted amount of secondary capital can be repaid to the investor.

As of December 31, 2014, NCUA Call Report data showed that of the 2,113 low-income designated credit unions, 76 reported secondary capital accounts totaling $178 million. Of these 76 credit unions, 73 were considered well-capitalized or adequately capitalized under Prompt Corrective Action. This means 96 percent of the low-income credit unions with secondary capital are subject to little or no Prompt Corrective Action provisions, compared to 99 percent of all credit unions.

However, without the secondary capital, only 50 of the 76 credit unions (66 percent) would be well-capitalized or adequately capitalized. The average return on assets for the 76 low-income credit unions with secondary capital was 18 basis points above similar credit unions.

II. Poor Practices

NCUA's supervisory experience with secondary capital in low-income credit unions has been mixed. The average annual failure rate for low-income credit unions with secondary capital was 2.9 percent from 2000–2013, compared to 0.8 percent for low-income credit unions without secondary capital.

A potential reason for this is secondary capital is temporary (if it is not refinanced, it matures), compared to retained earnings, which have no maturity. NCUA has noted a pattern of poor practices in some low-income credit unions with secondary capital that could account for the escalated failure rate. These include:

1. Poor due diligence, inaccurate cost benefit analysis and weak strategic planning in connection with establishing and expanding member service programs funded by secondary capital;
2. Premature and excessively ambitious concentrations of uninsured secondary capital to support unproven or poorly performing programs;
3. Failure to realistically assess and timely curtail programs that, in the face of mounting losses, are not meeting expectations;
4. Use of secondary capital solely to delay Prompt Corrective Action; and
5. Insufficient liquidity to repay secondary capital at maturity.

These experiences among low-income designated credit unions that accept secondary capital show the danger and consequences of leverage when used by institutions that do not conduct the necessary planning and risk management.

III. Best Practices

Secondary capital can make sense for well-run credit unions that are forced to constrain growth due to net worth requirements. Secondary capital can facilitate growth by supporting the net interest margin of the credit union's overall business. This can offset the higher marginal cost of secondary capital.

To illustrate, imagine a $100 million credit union that needs $10 million in asset growth to fund expanded services. It could easily attract $10 million in shares to accomplish this growth, but not without significantly diluting its net worth ratio. If instead, it obtains $1 million in secondary capital, and attract $9 million in additional shares, the credit union can accomplish the same result without the corresponding dilution in the net worth ratio.

While the secondary capital will likely carry a higher interest rate than the dividend rate of the additional shares, the total cost of the additional $10 million would be the lower blended rate of the secondary capital and shares.

The key to successfully employing this strategy is to maintain profitability sufficient to replace at least the discounted portion of the secondary capital and an appropriate percentage of asset growth. Otherwise, net worth will decline.

Here are financial ratios from a credit union that employed this strategy. A community development credit union with $69 million in assets and a 7.34 percent net worth ratio took in $1.6 million in secondary capital in 2010. The secondary capital had an interest rate of 2 percent for 13 years. The credit union used the secondary capital to leverage share growth, expand its branch network and expand commercial lending.

By December 31, 2014, the credit union was showing excellent financial results—very strong aggregate growth trends (shares, loans and members) from the date it attracted secondary capital, while maintaining a sound return on average assets and a well-capitalized net worth ratio.

Secondary Capital at Work

	2010	2011	2012	2013	2014
Share Growth	12.21%	12.12%	8.07%	4.81%	1.80%
Loan Growth	6.97%	15.72%	8.52%	6.28%	5.42%
Membership Growth	7.78%	6.05%	5.19%	4.99%	4.17%
Return on Average Assets	0.47%	0.33%	0.58%	0.34%	0.73%
Net Worth Ratio	9.92%	9.26%	9.15%	9.06%	9.63%
Net Worth Ratio without Secondary Capital	6.90%	6.54%	6.62%	6.65%	7.26%
Secondary Capital (in millions)	$1.6	$1.6	$1.6	$1.6	$1.6
Cash + Short Term Investments (in millions)	$6.2	$8.3	$9.4	$8.7	$7.7

Source: NCUA Call Report Data

In addition, it maintained adequate liquidity to repay the secondary capital, all while posting growth numbers that compared favorably to its peer group.

Summary

In summary, the best uses of secondary capital include:

- Supporting profitable growth without diluting capital;
- Expanding products and services;
- Diversifying capital sources; and
- Maintaining positive arbitrage consistent with asset-liability matching.

Misuses would be:

- Avoiding Prompt Corrective Action without corresponding improvements to the credit union's financial condition or operations (delaying the possible credit union failure);
- Expanding or implementing new programs without adequate cost-benefit analysis and planning; and
- Using excessive secondary capital concentrations instead of building net worth through retained earnings.

The key is adequate planning. Management must ensure the credit union will achieve adequate profitability, accumulate enough retained earnings and maintain adequate liquidity. Failure to do so could result in a capital or liquidity crisis for a credit union when the secondary capital matures.

IV. Secondary Capital Plans

Before accepting secondary capital, a credit union must submit a written secondary capital plan to its appropriate regional director for approval.

At a minimum, the plan must:

- State the maximum amount of secondary capital the low-income credit union plans to accept;
- Explain how the secondary capital will be used and how it will be repaid;
- Explain how the low-income credit union will manage its repayment;
- Demonstrate how this capital conforms with the credit union's strategic plan, business plan and budget; and
- Include supporting pro-forma financial statements for a minimum of two years.

V. Discounting and Early Redemption

The amount of secondary capital that counts as net worth is discounted starting five years from final maturity, as follows:

Secondary Capital Discount Schedule

Remaining Maturity	Amount Counted as Net Worth	Amount Counted as a Liability
Between 4–5 Years	80%	20%
Between 3–4 Years	60%	40%
Between 2–3 Years	40%	60%
Between 1–2 Years	20%	80%
Less than 1 Year Remaining	0%	100%

Source: NCUA Rules and Regulations

The amount of secondary capital not recognized as net worth can only be repaid to the investor with NCUA's prior written approval. At a minimum, the following conditions must be met for NCUA to consider early redemption:

- The credit union will have a post-redemption net worth classification of at least adequately capitalized;
- The discounted secondary capital has been on deposit for at least two years;

- The discounted secondary capital will not be needed to cover losses prior to maturity;
- The credit union's books and records are current and reconciled;
- The proposed redemption will not jeopardize other sources of credit union funding; and
- The credit union's board of directors authorized the redemption.

In addition to getting NCUA's approval, all secondary capital a low-income credit union accepts from the United States government or any of its subdivisions, as well as its matching secondary capital, if any, is eligible for early redemption. This is regardless of whether any part of the secondary capital has been discounted. To get this exception, the secondary capital must have been on deposit at the credit union for at least two years.

VI. CONCLUSION

Secondary capital can be an appropriate tool to support growth and improved services for low-income credit unions. While secondary capital can increase the cushion for growth, it cannot supplant the due diligence necessary to grow in a safe and sound matter. It is not a fix for credit unions experiencing financial or operational problems.

For additional information, contact the Office of Small Credit Union Initiatives at OSCUImail@ncua.gov or the appropriate regional office.

APPENDIX A

Frequently Asked Questions

1. **Does NCUA provide secondary capital?**

   Answer - No. NCUA is not a source of secondary capital funds.

2. **What are typical sources of secondary capital?**

   Answer – Historical sources include, but are not limited to, the following

   - Self-help groups or foundations that share the credit union's mission;
   - Banks that need Community Reinvestment Act credit. This can be researched on the FFIEC's website;
   - The credit union's sponsor;
   - Other credit unions (state-chartered credit union investors should consult with the state regulator to determine if this is allowed);
   - The U.S. Treasury's Community Development Financial Institutions Fund;
   - National Federation of Community Development Credit Unions;
   - Ford Foundation; and
   - Bank of America.

3. **Is it typical to find investors first before submitting a plan for approval by NCUA?**

   Answer – It is required. A credit union must have an investor, and the proposed amount and terms of the secondary capital first before submitting its plan.

4. **Is there a limit on the amount of secondary capital a credit union can hold?**

   Answer – Yes. Secondary capital is subject to the limit contained in Section 107 of the Federal Credit Union Act, 50 percent of shares and undivided earnings. But remember, excessive concentrations of secondary capital may be difficult to justify in the secondary capital plan.

5. **What tips are there for developing a successful secondary capital plan?**

   Answer – While not a guarantee for approval, the following are helpful tips for developing a successful plan.

   - Make sure the plan is based on realistic assumptions;
   - Make sure the plan provides for adequate net worth as the secondary capital is discounted;
   - Make sure the plan provides adequate liquidity to repay the secondary capital at maturity; and
   - Although the regulation only calls for two years of financial projections, extended projections may be necessary to ensure that the above net worth and liquidity requirements are met.

6. If the term of the secondary capital note is five years, does this mean you only get to count 80 percent as net worth from the beginning and 0 percent as net worth for the last year?

Answer – Yes, according to the required discounting schedule, that would be true.

7. Can a loan be structured with amortization over its term to ease the lump-sum repayment burden?

Answer – No. According to NCUA's regulations, the loan must be paid in a lump sum, unless the credit union is approved for early repayment by the regional director, and the appropriate state supervisory authority if the credit union is state-chartered.

8. Can NCUA prohibit repayment of secondary capital?

Answer – NCUA may prohibit a credit union from paying principal, dividends, or interest on its secondary capital if the credit union is classified as critically undercapitalized under Prompt Corrective Action. If the credit union is new, NCUA can also prohibit repayment if the credit union is classified as moderately capitalized, marginally capitalized, minimally capitalized or undercapitalized.

9. Can secondary capital be refinanced at maturity?

Answer – At maturity, the credit union has several options:

- Payback the secondary capital,
- Negotiate a refinance with the original investor, or
- Find a new investor.

If the credit union desires to "refinance" secondary capital, it needs to submit a new secondary capital plan to the appropriate regional director (and state supervisory authority if state chartered) in accordance with Section 701.34 of NCUA's Rules and Regulations.

10. What if secondary capital is my credit union's only form of net worth and its experiencing negative net income?

Answer - Funds deposited into a secondary capital account, including interest accrued and paid into the secondary capital account, must be available to cover operating losses realized by the low-income designated credit union that exceeds its net available reserves (exclusive of secondary capital and allowance accounts for loan and lease losses).

To the extent funds are so used, the low-income credit union must not restore or replenish the account under any circumstances. Losses must be distributed pro-rata among all secondary capital accounts held by the low-income credit union at the time the losses are realized.

Secondary capital received under the U.S. Treasury's 2010 Community Development Capital Initiative Program receives special priority. It may be:

- Excluded in the calculation of the pro-rata distribution until its matching secondary capital is depleted; or
- Included in the initial pro-rata distribution computation combined with its matching secondary capital and the pro-rata loss is first applied to the matching secondary capital.

11. What if a low-income credit union with secondary capital merges?

Answer – In the event of a merger or other voluntary dissolution of the low-income designated credit union, other than merger into another low-income credit union, the secondary capital accounts will be closed and paid out to the account investor to the extent the funds are not needed to cover losses at the time of merger or dissolution. If the continuing credit union in a merger is a low-income credit union and it does not want to keep the secondary capital account, it can request a redemption of the funds.

APPENDIX B

Secondary Capital Checklist

This checklist is separated into three parts:

- Secondary capital plan requirements,
- Secondary capital account requirements, and
- Accounting requirements.

Each category has its own required elements. For example, a credit union developing a secondary capital plan for submission to the appropriate regional director for approval should carefully review the required elements for secondary capital plans. In addition, a credit union should carefully review the secondary capital account and accounting sections for the requirements for implementing a secondary capital plan.

Reference in NCUA's Rules	Secondary Capital Plan Requirements	Yes / No
701.34(b)(1)	(i) Does the secondary capital plan state the maximum aggregate amount of uninsured secondary capital the low-income designated credit union plans to accept?	
701.34(b)(1)	(ii) Does the secondary capital plan identify the purpose for which the aggregate secondary capital will be used, and how it will be repaid?	
701.34(b)(1)	(iii) Does the secondary capital plan explain how the low-income designated credit union will provide for liquidity to repay secondary capital upon maturity of the accounts?	
701.34(b)(1)	(iv) Does the secondary capital plan demonstrate that the planned uses of secondary capital conform to the low-income designated credit union's strategic plan, business plan and budget?	

701.34(b)(1)	(v) Does the secondary capital plan include supporting pro-forma financial statements, including any off-balance sheet items, covering a minimum of the next two years? (Please note that while the regulation requires pro-forma financial statements for a minimum of two years, credit unions may provide more than two years of pro-forma financial statements. Additional pro-forma financial statements may help establish that a credit union meets all secondary capital plan requirements, such as repayment, liquidity, uses of secondary capital, etc.	

Reference in NCUA's Rules	Secondary Captal Account Requirements	Yes/No
701.34(b)(3)	***Non-share account.*** Are secondary capital account(s) established as uninsured secondary capital account(s) or other form of non-share account(s)?	
701.34(b)(4)	***Minimum maturity.*** Are minimum maturities of secondary capital accounts at least five years?	
701.34(b)(5)	***Uninsured account.*** Are secondary capital accounts clearly identified as not being insured by the National Credit Union Share Insurance Fund or any governmental or private entity?	
701.34(b)(6)	***Subordination of claim.*** Are secondary capital accounts set-up so an investors' claim against the low-income credit union is subordinate to all other claims, including those of shareholders, creditors, the National Credit Union Share Insurance Fund and CDCI funds issued by the U.S. Department of the Treasury?	

701.34(b)(7)	***Availability to cover losses.*** Are funds deposited into a secondary capital account, including interest accrued and paid into the secondary capital account, available to cover operating losses realized by the low-income designated credit union that exceed its net available reserves (exclusive of secondary capital and allowance accounts for loan and lease losses), and to the extent funds are so used, the low-income credit union shall not restore or replenish the account under any circumstances? The low-income credit union may, in lieu of paying interest into the secondary capital account, pay accrued interest directly to the investor or into a separate account from which the secondary capital investor may make withdrawals.	
701.34(b)(8)	***Security.*** Are secondary capital accounts not pledged or provided by the account investor as security on a loan or other obligation with the low-income designated credit union or any other party?	

701.34(b)(9)	***Merger or dissolution.*** Will the low-income designated credit union ensure, in the event of a merger or other voluntary dissolution of the low-income designated credit union, other than a merger into another low-income credit union, that the secondary capital accounts will be closed and paid out to the account investor to the extent they are not needed to cover losses at the time of the merger or dissolution?	
701.34(b)(10)	***Contract agreement.*** Will the low-income designated credit union ensure secondary capital account contract agreements are executed by an authorized representative of the account investor and of the low-income credit union reflecting the terms and conditions mandated by NCUA Rules & Regulations Section 701.34 and any other terms and conditions consistent with NCUA's Rules & Regulations?	

701.34(b)(11)	***Disclosure and acknowledgement.*** Will the low-income designated credit union ensure that an authorized representative of the credit union and of the secondary capital account investor each shall execute a "Disclosure and Acknowledgment" as set forth in the appendix to NCUA Rules & Regulations, §701.34, at the time of entering into the account agreement?	
701.34(b)(11)	***Disclosure and acknowledgement.*** Will the low-income designated credit union retain an original of the account agreement and the "Disclosure and Acknowledgment" for the term of the agreement, and provide a copy to the account investor?	

Reference in NCUA's Rules	Accounting Requirements	Yes/No
701.34(c)(1)	***Accounting treatment.*** Will the low-income designated credit union record its secondary capital accounts pursuant to §701.34(c) by ensuring secondary capital funds on its balance sheet are recorded in an equity account titled "uninsured secondary capital?"	
701.34(c)(2)	***Schedule for recognizing new worth value.*** Will the low-income designated credit union reflect the net worth value of the accounts in its financial statements in accordance with the schedule set forth in NCUA Rules & Regulations §701.34(2)?	
701.34(c)(3)	***Financial statement.*** Will the low-income designated credit union reflect the full amount of the secondary capital on deposit in a footnote to the credit union's financial statement?	

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