Credit union's capital raise should make bankers nervous

By

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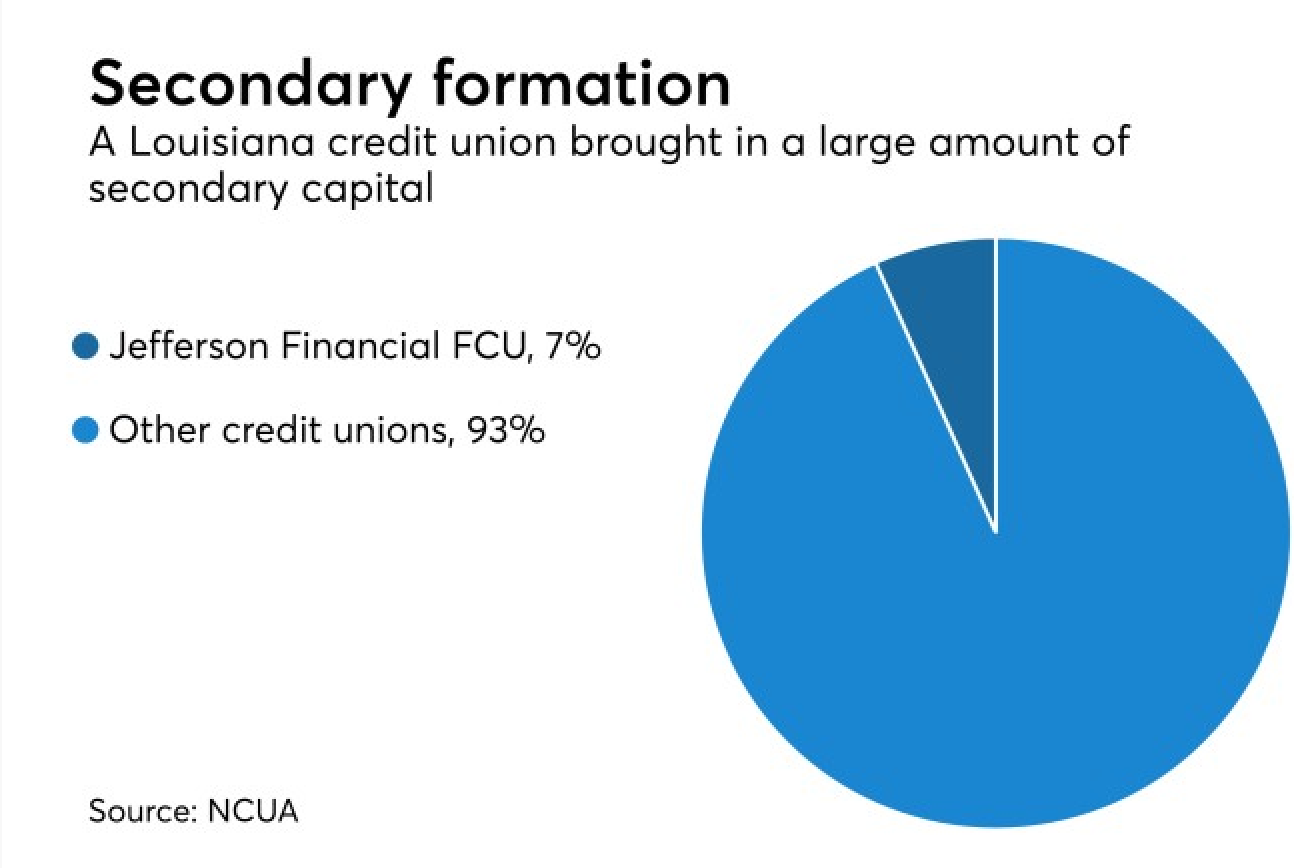
A Louisiana credit union just reeled in what is believed to be a record amount of outside capital.

Jefferson Financial Federal Credit Union in Metairie said on Nov. 13 that it had received the first installment of a planned $12 million capital infusion. The amount is so large that the firm that handled the injection believes it to be the largest ever for a credit union.

At the very least, it represents roughly 7% of all secondary capital held by credit unions, based on data from the National Credit Union Administration.

The $563 million-asset credit union’s groundbreaking deal —and the prospect of more like it in the months ahead — is certain to further incense banking groups that earlier this year pursued litigation in hopes of challenging moves by the NCUA to loosen regulations governing fields of membership and member-business lending.



“The ever-expanding list of permissible activities of credit unions is a continuing source of frustration to community banks everywhere,” said Ron Samford, the CEO of the $381 million-asset Metairie Bank, which competes against Jefferson.

“Not paying income taxes, making C&I loans, including anyone who breathes in the membership ranks, and now, raising capital — how many perks does an industry need to stay ahead of the competition from community banks?” Samford added.

While the NCUA has been mulling ways over the past year to expand credit unions’ access to outside capital, low-income designated credit unions such as Jefferson have had the authority to raise secondary capital since 1996. Through June, however, fewer than 100 low-income credit unions out of more than 2,000 had secondary capital on their books.

“There has always been an interest in secondary capital among low-income designated credit unions,” said Mark Rosa, Jefferson’s CEO. “Knowing where to start may have kept credit unions from proceeding.”

Rosa credits an effort by CU Capital Market Solutions, an Overland Park, Kan., credit union service organization, for spurring credit unions to seek secondary capital. The firm, which brokered Jefferson’s deal, has arranged more than $100 million of secondary capital for credit unions.

Adding capital is a big deal for Jefferson, which has grown at a sizzling pace since late 2015, adding assets at a clip that has eclipsed the increase in its net worth. As a result, its net-worth ratio has plummeted by more than 100 basis points, falling to 9.14% on Sept. 30. Absent the new capital, Jefferson would almost certainly have been forced to hit the brakes on its expansion.

As with mutual banks, credit unions primary source of capital is retained earnings. Credit unions must maintain a retained-earnings ratio of 7% or more to be considered well-capitalized.

“The rationale for [secondary] capital was to provide asset growth to expand both loan and deposit opportunities for my members, drive down my efficiency ratio and accelerate earnings,” Rosa said. “Without it, my asset growth would have to be much more measured.”

Unlike banks, which face few restrictions to raise capital, credit unions must draft detailed plans demonstrating how they intend to use the funds and obtain NCUA approval every time they want to approach investors. In Jefferson’s case, the process took about three months, said Ron Colvin, CU Capital Market Solutions' chief strategist.

"The development of a capital plan and the submission of an application is a very comprehensive an intricate process requiring a thorough knowledge of the institution and its needs, the regulations and how they all interconnect," Colvin said. "Every aspect of Jefferson's model was evaluated and then developed over a series of meetings."

The daunting prospect of "navigating and applying all the regulations" has likely deterred many credit unions from seeking secondary capital, Rosa said. That is what makes Jefferson Financials' deal so important for credit unions and worrisome for banks. Just knowing an impactful transaction is possible is likely serve as an eye-opener for credit unions straining to underwrite breakneck growth trends, experts on both sides of the issue believe.

Even bigger changes could be just over the horizon. Earlier this year, the NCUA issued a notice of proposed rulemaking on capital alternatives, which received more than 750 comment letters. While there was broad support for increased access to investor capital among credit unions, bank groups panned the idea.

CU Capital Market Solutions CEO Lew Lester downplayed criticism from banking advocates, claiming that increased use of secondary capital could create an investment opportunity for banks since credit unions can only seek funds from institutional investors and other financial institutions. Banks could also receive Community Reinvestment Act credit for investing, he added.

One bank seriously considered participating in Jefferson's capital raise, citing the income and CRA credit opportunities, before the proposal was scotched by its board, Rosa said. He declined to name the bank.

"I suspect the idea … caused anxiety to some" directors, Rosa added.

Jefferson's new capital takes the form of a 10-year note, with interest payments only during the first five years, and 20% reductions in principal during each of the final five years.

That structure could create problems for institutions that don't manage their capital carefully, said Keith Leggett, a retired American Bankers Association economist who writes frequently about credit unions.

"Secondary capital is not high-quality capital," Leggett said. "It has a maturity. Retained earnings are still credit unions' only source of permanent capital."