Debra Taylor Templin, CPA
310-963-3374
www.cucfo.com
CFO in a Box

Big vs Small: Credit Union Growth & Profitability

NCUA released the year-end data summary obtained from call reports submitted by federally insured credit unions (FICU's) in March. Credit unions with assets greater than $1 billion are the most profitable; through economies of scale they enjoy a competitive advantage the other 95% of credits unions only dream of. But that's not the whole story – how the Big Boys earn and spend their money tells us why they are so successful. The question is, can smaller credit unions learn from them even if their balance sheet is considerably less than ten digits in size? Following this narrative is a comprehensive margin analysis of 2017 credit union performance by asset size. Credit unions may want to use this report as a tool to evaluate performance in detail with the appropriate asset group. How does your credit union spend its money in comparison? If your credit union does not compare (that can be good or bad), do you know why?

The classification of a small credit unions is determined by those with total assets less than $100 million. However, there is a vast difference in complexity, profitability, and challenges among the 4,016 small credit unions (72% of total federally insured credit unions). The asset groups were expanded into four levels of small credit unions and four levels of large credit unions to compare their financial results in aggregate. Keep in mind, there are superstars as well as those that are struggling in each category.

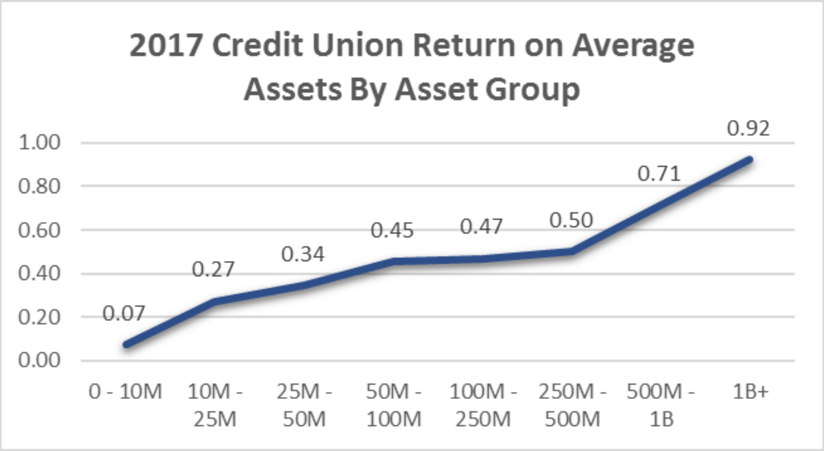
Besides profitability, growth is another factor that varies substantially from one asset group to another. In one sentence, the big are getting bigger and the small are going away. 5% of credit unions – those with assets greater than $1 billion - represent 64% of the total assets of all federally insured credit unions. Meanwhile, 53% of the credit unions that exited the industry in 2017, mostly by merging into another credit union, were credit unions with assets less than $10 million. Of the total 212 credit unions that exited, 100% had assets less than $250 million. These statistics are not new, the question is, can this be changed? Or is this the natural outcome of a mature industry that must now consolidate to remain competitive in a highly regulated environment? The answer is probably yes to both questions.

Geographic segregation did not appear to be a major contributing factor in determining growth and profitability, and the number of credit unions exiting the industry by state was mostly proportional to the total number of credit unions within that state. There are other environmental factors such as local and national economy, local employment, and whether the credit union is in a major metropolitan or rural area that influence a credit union's sustainability.

Profitability

It's no surprise that the largest credit unions are the most profitable. Those credit unions with total assets of more than $1 billion earned a return on average assets of 0.92% in aggregate, while those credit unions with total assets under $10 million earned only 0.07% in aggregate. That's a variance of 85 basis points, a big difference in profitability. Economies of scale is not the only factor driving this statistic.

	Asset Group	# CU's	Net Interest Margin	Non Interest Income	Operating Expenses	ROA
1	0 - 10M	1,533	3.37	0.66	3.71	0.07
2	10M - 25M	993	3.13	0.91	3.53	0.27
3	25M - 50M	781	3.07	1.08	3.55	0.34
4	50M - 100M	709	3.12	1.25	3.63	0.45
5	100M - 250M	692	3.18	1.40	3.70	0.47
6	250M - 500M	334	3.12	1.50	3.65	0.50
7	500M - 1B	244	3.11	1.50	3.51	0.71
8	1B+	287	2.91	1.29	2.79	0.92
	All CU's	5,573	2.99	1.33	3.09	0.78



Economies of scale: A proportionate saving in costs gained by an increased level of production; a competitive advantage that large entities have over small entities.

- Larger credit unions pay higher dividends and operate profitably with thinner net interest margins. The smallest credit union group has a net interest margin that is 45 basis points higher than the $1 billion or more asset group, mostly due to a lower cost of funds.
- Larger credit unions make almost twice as much on non-interest income (63 basis points comparing largest to smallest asset group), but most of this is other operating income such as income generated from CUSOs, mortgage servicing, and investment services, rather than fee income. The mid-size credit unions are earning even more – 150 basis points of average assets.
- Operating Expenses to average assets is 92 basis points greater for the smallest asset group compared to the largest asset group.
- Larger credit unions have a higher provision for loan loss expense (a difference of 18 basis points, largest to smallest), but non-operating income makes up the remaining difference, resulting in a return on average assets differentiation of 85 basis points, largest to smallest.

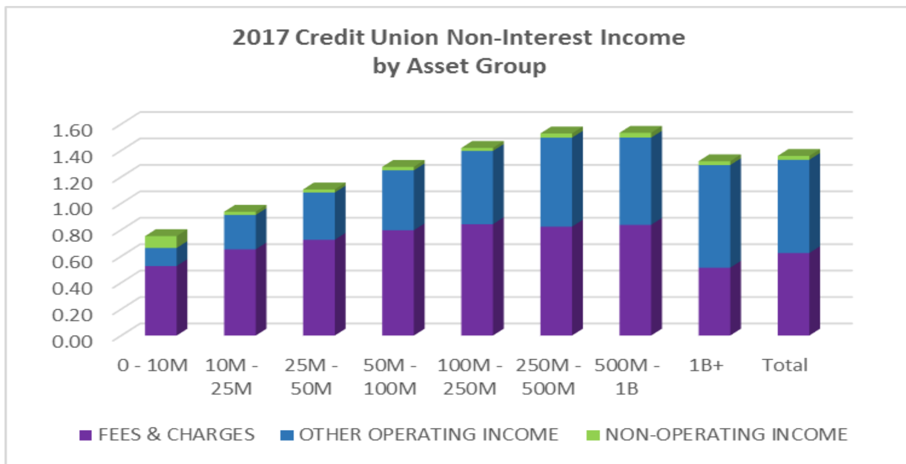
Could smaller credit unions use 85 basis points in other operating income? You bet! If credit unions lack the staffing or expertise to produce this level of income, could they outsource or collaborate with other credit unions to accomplish what they can't internally? Many smaller credit unions are doing just that and are thriving.

Income Generation

Historically, credit unions generated enough interest income to cover operating expenses. But with a decade long environment of low rates, most credit unions have learned to operate profitably with razor thin interest margins. But only the largest credit unions – those with assets greater than $1 billion – had a net interest margin greater than operating expenses in 2017:

	0 - 10M	10M - 25M	25M - 50M	50M - 100M	100M - 250M	250M - 500M	500M - 1B	1B+	All CU's
NET INTEREST MARGIN	3.37	3.13	3.07	3.12	3.18	3.12	3.11	2.91	2.99
OPERATING EXPENSE	3.71	3.53	3.55	3.63	3.70	3.65	3.51	2.79	3.09
	-0.34	-0.40	-0.47	-0.51	-0.51	-0.53	-0.40	0.12	-0.10

In aggregate, credit unions are no longer able to cover the costs of operating by interest income alone. Since the smallest credit unions – those with assets less than $10 million – pay lower dividends, the deficiency is less than that of other credit unions. In general, the larger the credit unions earn about the same in fee income relative to their asset size, but more income is generated from other operating income. The largest credit unions are earning 51 basis points in fee income and 78 basis points in other operating income, while the smallest credit unions are earning 53 basis points in fee income and 14 basis points in other operating income. Total non-interest plus non-operating income is between 75 and 153 basis points:



	0 - 10M	10M - 25M	25M - 50M	50M - 100M	100M - 250M	250M - 500M	500M - 1B	1B+	All CU's
FEES & CHARGES	0.53	0.65	0.72	0.80	0.84	0.82	0.84	0.51	0.62
OTHER OPERATING INCOME	0.14	0.26	0.36	0.45	0.55	0.67	0.66	0.78	0.70
NON-OPERATING INCOME	0.09	0.02	0.02	0.03	0.02	0.03	0.04	0.03	0.03
TOTAL NON-INTEREST INCOME	0.75	0.94	1.11	1.28	1.42	1.53	1.53	1.32	1.36

Non-fee income generation serves to increase profitability in a way that is member friendly while also providing a needed service – a win-win for everyone. Besides credit and debit card interchange, insurance sales are revenue streams most credit unions can implement. Income derived from mortgage originations and servicing are another source of other operating income. While small credit unions may not have the resources to hire a mortgage professional, they can obtain these services through outsourcing, collaboration, and CUSOs (credit union service organizations). The latest NCUA report of CUSOs reported that there were 946 registered CUSOs, with 739 of those providing lending services. This includes both origination and loan servicing. The top four CUSO services are lending, member services, payment processing, and other services.

Spending Habits

Most credit unions regularly compare their operating expense ratio to peer average since this is readily available from NCUA, however deeper analysis reveals some interesting trends. There are five expense categories that fluctuate among credit unions of different asset size.

	Asset Group	Comp	Travel	Occupancy	Operations	Marketing	Loan Servicing	Professional & Outside	Member Insurance	Regulatory Operating Fee	Misc	Total Non-Interest Expense
1	0 - 10M	1.96	0.03	0.17	0.83	0.04	0.13	0.37	0.01	0.04	0.13	3.71
2	10M - 25M	1.72	0.03	0.21	0.75	0.06	0.18	0.43	0.00	0.03	0.10	3.53
3	25M - 50M	1.68	0.04	0.22	0.71	0.08	0.22	0.46	0.00	0.03	0.10	3.55
4	50M - 100M	1.74	0.04	0.24	0.67	0.11	0.24	0.48	0.00	0.02	0.08	3.63
5	100M - 250M	1.84	0.04	0.25	0.70	0.12	0.25	0.39	0.00	0.02	0.09	3.70
6	250M - 500M	1.85	0.04	0.26	0.71	0.13	0.24	0.29	0.00	0.02	0.09	3.65
7	500M - 1B	1.82	0.04	0.25	0.64	0.14	0.23	0.29	0.00	0.02	0.09	3.51
8	1B+	1.44	0.02	0.18	0.51	0.12	0.20	0.19	0.00	0.01	0.12	2.79
	All CU's	1.58	0.03	0.20	0.57	0.12	0.21	0.25	0.00	0.01	0.11	3.09

Compensation: The largest credit union group has 529 employees per credit union, with average compensation of $79,975. The smallest credit unions have the most difficulty paying for experienced talent. The average credit union with assets less than $10 million has 2.58 employees with average compensation of $31,514. That's close to $12 per hour with a modest 25% benefits cost. So, the employees make minimum wage and the manager makes a little more than that, and they are tasked with running a credit union, making loan decisions, and complying with regulations. It no wonder these credit unions are going away, attracting and retaining a chief is a challenge difficult to overcome.

Operations: The largest credit union group enjoys economies of scale up to 32 basis points. Technology-related costs impact this area the most. As some core systems drop in price, the cost of home banking, bill pay, and remote deposit capture have made up the cost savings gained from core system pricing. Compliance-related costs may also factor into operations expense, which just move in one direction – up.

Marketing: The larger credit unions are spending 12 to 14 basis points on marketing efforts while the smallest credit unions are spending half that. Marketing is an investment in growth, but when net income is a concern, as it is for most small credit unions, the marketing budget is the first to get cut. Consequently, only those credit unions with assets greater than $500 million experienced membership growth in aggregate.

Loan Servicing: Larger credit unions are spending 20 basis points or more on loan servicing while credit unions under $25 million in assets are 13 to 18 basis points. Smaller credit unions may not have a costly credit card program or mortgage loans, which may account for this lower cost discrepancy. One question to consider - are these loan programs expenses or investments in member retention and growth? As with marketing, the budget must support a business model that prioritizes member retention and growth. If not, shopping for a merger partner may become the next strategy.

Professional & Outside Services: The larger credit unions have lower professional and outside services cost for two primary reasons – economies of scale and due to smaller credit unions outsourcing work that a larger credit union would normally perform in-house. Credit unions with assets between $10 million and $100 million have the highest cost, 43 to 48 basis points, as these credit unions are most likely to utilize outsourcing to remain competitive. Many small credit unions have growth goals and complex strategic initiatives that they would not be able to accomplish without working with others outside the organization. For some, this is the smartest thing they can do to remain competitive.

Growth

The number of credit unions continues to shrink, down 3.7% in 2017, ending the year at 5,573. Credit unions moved up to the next asset group (↑), moved down an asset group (↓), transferred into asset group (→), or exited the industry through merging or conservatorship (Bye-Bye).

The largest credit unions – those with assets greater than $1 billion – grew by 15 through merger and consolidation activity, resulting in an asset growth of 10.4% and member growth of 9% for these Big Boys in 2017.

↑	Moved Up to Next Asset Group
↓	Moved Down to Next Asset Group
→	Transferred into Asset Group
Bye-Bye	Merged or Conserved

Asset Group	2016	Assets ↑	Assets ↓	Assets →	Bye-Bye	2017	Exit % (of Total Exited)
0-10M	1,659	-23	0	10	-113	1,533	53%
10M - 25M	1,053	-40	-10	36	-46	993	22%
25M-50M	798	-33	-13	47	-18	781	8%
50M - 100M	724	-35	-7	40	-13	709	6%
100M - 250M	715	-30	-7	36	-22	692	10%
250M - 500M	335	-33	-1	33	0	334	0%
500M - 1B	229	-15	-3	33	0	244	0%
1B+	272	0	0	15	0	287	0%
	5,785	-209	-41	250	-212	5,573	100.0%

Geography

The most populous states tend to have the most credit unions. 49% of credit unions are in just ten states (2,719 of 5,573). Texas has the most credit unions (460) with 19 over $1 billion in assets and 339 under $100 million in assets. California has the highest number of credit unions with assets more than $1 billion (46), but there are also 159 credit unions with have assets less than $100 million and 97 in the range of $100 million and $1 billion in assets.

The top ten states with the most credit unions:

State	0 - 10M	10M - 25M	25M - 50M	50M - 100M	100M - 250M	250M - 500M	500M - 1B	1B+	Total
Texas	126	99	59	55	50	26	26	19	460
Pennsylvania	142	85	47	50	36	6	10	10	386
New York	118	71	48	41	30	19	7	20	354
California	41	29	48	41	44	23	30	46	302
Illinois	112	50	22	21	15	11	6	7	244
Michigan	24	31	39	40	51	22	17	11	235
Ohio	67	48	33	29	26	14	6	3	226
Louisiana	83	34	27	11	15	8	3	1	182
Massachusetts	42	35	20	12	24	10	16	7	166
New Jersey	69	30	21	16	18	8		2	164
	824	512	364	316	309	147	121	126	2,719

The Small Guys

Less than $10 million in assets: In the financial services industry, all credit unions are small, but these credit unions under $10 million are tiny. The smallest credit unions – those with assets less than $10 million – decreased by 126 with 113 exiting, representing 53% of the credit unions that exited the industry in 2017. These credit unions are very well capitalized (15.43% overall) but are challenged with profitability, asset growth and membership growth. Many are single sponsor charters vulnerable to changes of the organization they serve.

Assets $10 to $25 million: Credit unions with assets between $10 million and $25 million are similar to the smallest credit union group - challenged with asset and membership growth. Net worth ratios are a robust 13.18% overall. The total number decreased by 60 with 46 exiting, representing 22% of the credit unions that exited the industry in 2017. But this group is almost four times more profitable than the smallest credit unions and therefore stand a better chance of survival.

75% of those credit unions that exited in 2017 had assets less than $25 million. How do these two groups of small credit unions survive and thrive? For some, a community charter may be their only avenue for survival as an independent entity. But for others, a community charter may be that last nail in the coffin as attempts to attract consumers from a highly competitive marketplace end up alienating existing members. Additionally, a conversion to a community charter within a metropolitan already saturated with larger financial institutions is usually not successful long term.

Assets $25 to $100 million: The outlook for the remaining small credit unions is more positive. More credit unions in this category are growing into the next asset group rather than exiting the industry. They don't have the available resources that the larger credit unions have, but they have considerably more than the tiny credit unions. Perhaps the solution for small credit unions is not to grow into large credit unions, but rather to understand what makes the larger credit unions successful and integrate that information into their business model.

Alternatives and other thoughts to consider for credit unions below $100 million in assets:

- Focus on relationship management with the core sponsor or primary field of membership.
- Participate in collaborative activities that increase economies of scale.
- Expand the field of membership with select employer groups that share similar characteristics with the core sponsor - but consider carefully the unintended consequences of these changes.
- Imitate the desirable activities of the larger credit unions that are compatible with your business model, especially in other operating income.
- Incorporate a mindset that views marketing is an investment and spend wisely.
- Manage expenses but make income generation a priority in achieving profitability.
- Investigate the low-income designation to determine if this is appropriate for your credit union. This classification entitles credit unions to legislated benefits designed to help serve members recognized to have challenges accessing mainstream financial products and services.

- Utilize resources available to small credit unions –
    - NCUA Office of Credit Union Resources and Expansion (CURE) provides support to low-income, minority, and other credit unions needing assistance. They can be reached at 703-518-6610 or CUREMail@ncua.gov
    - CUNA's Small Credit Union Community
    - Credit union leagues and associations
- Stay involved and let your voice be heard through advocacy and networking
- Never under estimate the value you bring to your members and the community

Summary

To be successful and remain in business, credit unions need to grow and generate sufficient income. Without these two ingredients, the costs of operating will eventually outpace income. The largest credit unions are the most profitable through both economies of scale and differences in income generation and spending habits. Small credit unions face challenges with profitability and growth, and 78% of the credit unions that exited the industry in 2017 had assets less than $25 million. However, many small credit unions are thriving and remain an important component of the industry.

Analyzing industry trends allows us to identify potential opportunities for performance improvement. The following margin analysis and statistical reports were compiled from the December 2017 call report data for federally insured credit unions. Please address any questions or comments to debra@cucfo.com.

Debra Taylor Templin, CPA *is a sole practitioner specializing in virtual CFO services. With over 25 years of experience within the credit union industry, including ten years as Chief Financial Officer and seven years as Chief Executive Officer, Debra is able to deliver high level results that blend traditional values with progressive needs. She can be reached at debra@cucfo.com.*

FEDERALLY INSURED CREDIT UNIONS – MARGIN ANALYSIS
DECEMBER 31, 2017

	0 - 10M	10M - 25M	25M - 50M	50M - 100M	100M - 250M	250M - 500M	500M - 1B	1B+	All CU's
INCOME FROM LOANS	3.16	2.81	2.77	2.89	3.10	3.10	3.18	3.15	3.12
INVESTMENT INCOME	0.57	0.62	0.60	0.55	0.45	0.44	0.38	0.43	0.44
TOTAL INTEREST INCOME	**3.73**	**3.43**	**3.38**	**3.44**	**3.56**	**3.54**	**3.56**	**3.58**	**3.56**
DIVIDENDS	0.36	0.30	0.30	0.31	0.36	0.39	0.40	0.54	0.48
INTEREST ON BORROWED FUNDS	0.00	0.00	0.00	0.01	0.02	0.04	0.05	0.12	0.09
NET INTEREST MARGIN	**3.37**	**3.13**	**3.07**	**3.12**	**3.18**	**3.12**	**3.11**	**2.91**	**2.99**
PROVISION FOR LOAN LOSS	0.34	0.26	0.29	0.31	0.44	0.50	0.42	0.52	0.48
NET INTEREST INCOME AFTER PLL	**3.03**	**2.87**	**2.78**	**2.81**	**2.75**	**2.62**	**2.69**	**2.40**	**2.51**
FEES & CHARGES	0.53	0.65	0.72	0.80	0.84	0.82	0.84	0.51	0.62
OTHER OPERATING INCOME	0.14	0.26	0.36	0.45	0.55	0.67	0.66	0.78	0.70
NON-INTEREST INCOME	**0.66**	**0.91**	**1.08**	**1.25**	**1.40**	**1.50**	**1.50**	**1.29**	**1.33**
COMPENSATION EXPENSE	1.96	1.72	1.68	1.74	1.84	1.85	1.82	1.44	1.58
TRAVEL AND CONFERENCE	0.03	0.03	0.04	0.04	0.04	0.04	0.04	0.02	0.03
OFFICE OCCUPANCY	0.17	0.21	0.22	0.24	0.25	0.26	0.25	0.18	0.20
OFFICE OPERATIONS	0.83	0.75	0.71	0.67	0.70	0.71	0.64	0.51	0.57
EDUCATION/PROMOTION	0.04	0.06	0.08	0.11	0.12	0.13	0.14	0.12	0.12
LOAN SERVICING	0.13	0.18	0.22	0.24	0.25	0.24	0.23	0.20	0.21
PROFESSIONAL SERVICES	0.37	0.43	0.46	0.48	0.39	0.29	0.29	0.19	0.25
MEMBER INSURANCE	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
REGULATORY OPERATING FEE	0.04	0.03	0.03	0.02	0.02	0.02	0.02	0.01	0.01
MISCELLANEOUS EXPENSE	0.13	0.10	0.10	0.08	0.09	0.09	0.09	0.12	0.11
OPERATING EXPENSE	**3.71**	**3.53**	**3.55**	**3.63**	**3.70**	**3.65**	**3.51**	**2.79**	**3.09**
GAIN (LOSS) ON INVEST	0.00	0.00	0.00	0.01	0.01	0.01	0.01	0.02	0.01
GAIN (LOSS) ON DERIVATIVES	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
GAIN (LOSS) ON ASSETS	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.00	0.00
GAIN (LOSS) FROM MERGER	0.00	0.00	0.00	0.01	0.00	0.01	0.00	0.01	0.01
OTHER NON-OPERATING INCOME	0.09	0.03	0.02	0.01	0.02	0.02	0.02	0.01	0.01
NON-OPERATING INCOME	**0.09**	**0.02**	**0.02**	**0.03**	**0.02**	**0.03**	**0.04**	**0.03**	**0.03**
ROA	**0.07**	**0.27**	**0.34**	**0.45**	**0.47**	**0.50**	**0.71**	**0.92**	**0.78**

FEDERALLY INSURED CREDIT UNIONS – FINANCIAL STATISTICS
DECEMBER 31, 2017

	0 - 10M	10M - 25M	25M - 50M	50M - 100M	100M - 250M	250M - 500M	500M - 1B	1B+	All CU's
TOTAL ASSETS	6,385,797,959	16,471,636,875	27,765,873,221	50,628,557,030	109,830,008,534	119,492,530,232	172,698,689,276	875,618,423,127	1,378,891,516,254
% OF TOTAL	0.46%	1.19%	2.01%	3.67%	7.97%	8.67%	12.52%	63.50%	100.00%
TOTAL DEPOSITS	5,368,598,227	14,213,111,729	24,262,498,095	44,272,655,971	95,834,992,112	103,180,943,431	146,921,551,400	725,426,869,132	1,159,481,220,097
% OF TOTAL	0%	1%	2%	4%	8%	9%	13%	63%	100%
TOTAL LOANS	3,169,646,935	8,232,107,431	14,607,589,508	28,838,875,816	71,010,504,852	80,435,518,279	123,851,374,536	627,135,991,303	957,281,608,660
% OF TOTAL	0%	1%	2%	3%	7%	8%	13%	66%	100%
TOTAL LOANS #	477,169	997,409	1,566,390	2,883,397	5,784,007	5,979,144	8,456,337	38,507,541	64,651,394
LOANS GRANTED YTD - #	311,275	558,321	775,849	1,308,264	2,447,311	2,727,048	5,265,491	17,652,297	31,045,856
LOANS GRANTED YTD - $	1,764,772,032	3,868,576,785	6,454,720,178	12,376,401,901	30,364,979,259	34,625,855,713	56,373,827,880	335,143,739,848	480,972,873,596
% OF TOTAL	0%	1%	1%	3%	6%	7%	12%	70%	100%
TOTAL MEMBERS	1,235,988	2,237,186	3,222,832	5,476,483	10,725,036	11,121,317	14,534,976	62,769,698	111,323,516
% OF TOTAL	1%	2%	3%	5%	10%	10%	13%	56%	100%
FTE	3,960	5,175	7,971	14,697	31,309	32,044	41,934	151,808	288,896
AVE FTE/ CREDIT UNION	2.58	5.21	10.21	20.73	45.24	95.94	171.86	528.95	51.84
AVE COMPENSATION/FTE	31,514	54,409	57,863	59,176	63,196	67,289	72,623	79,975	72,892
MEMBERS/FTE	312	432	404	373	343	347	347	413	2,971
ASSETS/FTE	1,612,779	3,182,925	3,483,361	3,444,940	3,507,993	3,729,014	4,118,394	5,767,952	28,847,359
DEPOSITS/MEMBER	4,344	6,353	7,528	8,084	8,936	9,278	10,108	11,557	66,188
TOTAL EQUITY	985,415,194	2,170,778,975	3,318,653,678	5,889,213,066	12,102,919,498	13,196,913,882	18,866,586,017	94,615,001,395	151,145,481,705
NET WORTH RATIO	15.43%	13.18%	11.95%	11.63%	11.02%	11.04%	10.92%	10.81%	10.96%
LOAN TO SHARE RATIO	59.0%	57.9%	60.2%	65.1%	74.1%	78.0%	84.3%	86.5%	82.6%
RETURN ON EQUITY	0.45%	2.04%	2.84%	3.83%	4.17%	4.43%	6.32%	8.21%	6.89%
# CREDIT UNIONS	1,533	993	781	709	692	334	244	287	5,573
% OF TOTAL	28%	18%	14%	13%	12%	6%	4%	5%	100%
# BRANCHES/CREDIT UNION	0.99	1.20	1.72	2.56	4.15	7.09	10.84	23.56	3.68