NATIONAL ASSOCIATION OF CREDIT UNION SUPERVISORY & AUDITING COMMITTEES

Financial Statements and Key Ratios for Committees - 2023

TIM Transform Inspire Motivate

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Presented by Timothy Harrington, CPA

Tim Harrington is a Certified Public Accountant who has consulted with financial institutions since 1992. Since 1996, Tim has been President of TEAM Resources, a firm that provides consulting, strategic planning and training to financial institutions from coast-to-coast. He is the author of the popular the books

Eisenhower on Enlightened Leadership and

Living a Life that Matters and co-author of

A Credit Union Guide to Strategic Governance.

Tim is a faculty member of two national credit union schools on governance and management, and has spoken to hundreds of thousands of directors, executive management and staff throughout the Northern Hemisphere.

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Financially Literacy Policy NCUA Reg. 701.4

- Risks within our credit union
- Level of financial literacy Directors need
- Individual analysis and plan for each Director in order to achieve financial literacy
  - Can consider past education or experience
    - CPA, Financial background, etc.
  - Should include supplemental education where deficiencies are identified

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What do the Regulators look at and why?

They look at a set of sensible business financial measurements.

If you were looking to invest in stock of a bank, you would look at the same things.

These are KEY indicators of health.

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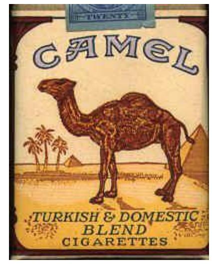
CAMELS
Just Good Ole' Financial Ratios

Capital Adequacy
Asset Quality
Management (includes volunteers)
Earnings
Liquidity – Cash Flow and Sources
Sensitivity – Interest Rate Risk



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CAMELS
like a Golf Score, lower is better

Measured on a Scale of 1 to 5

1 - Indicates strong performance

2 - Indicates satisfactory performance

3 - Some degree of supervisory concern in one or more of the component areas.

4 - Exhibit unsafe and unsound practices or conditions

5 - Exhibit extremely unsafe and unsound practices and conditions

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Basic Financial Statements

- Balance Sheet or
  - Statement of Financial Condition OR
  - Statement of Condition
- Income Statement

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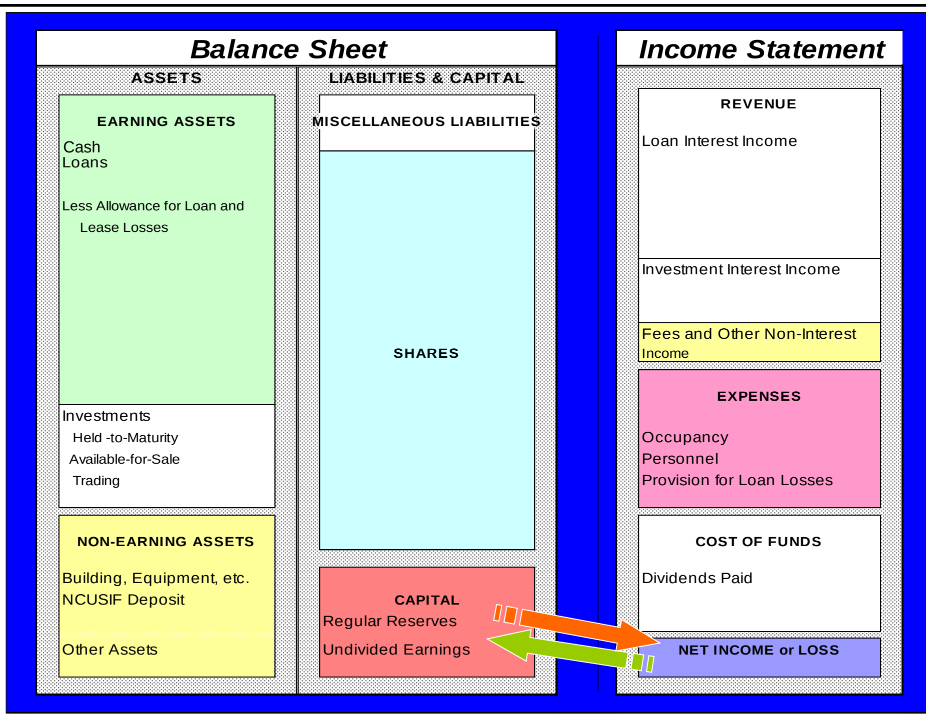

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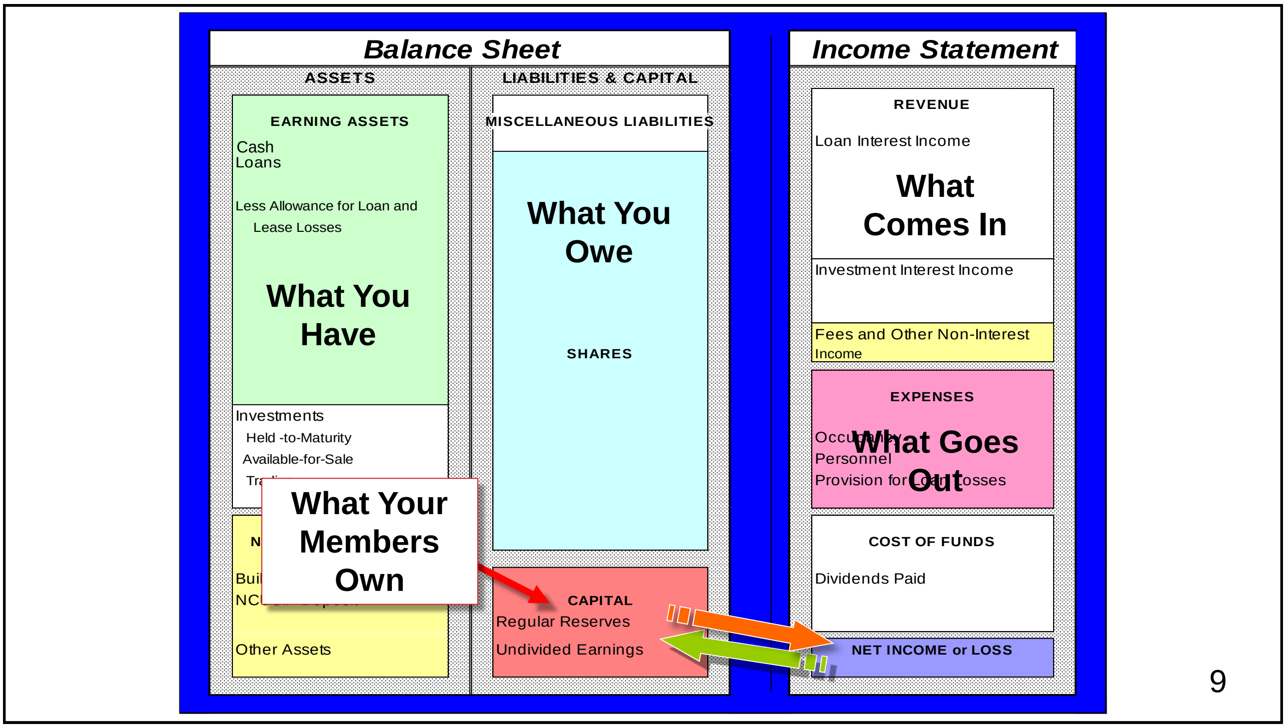

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Balance Sheet

ASSETS		LIABILITIES & CAPITAL	
EARNING ASSETS		**MISCELLANEOUS LIABS**	
Cash	$ 16,000	Miscellaneous Liabs	$ 15,100
LOANS		**SHARES**	
Unsecured	13,500		
Vehicle	110,000	Share savings	68,000
Real estate	30,000	Share drafts	35,000
Total loans	153,500	Money market	45,000
Less Allowance		IRAs	41,000
for Loan Loss.	(1,100)	Other	4,000
Net Loans	152,400	Total Shares	193,000
INVESTMENTS			
Held to maturity	50,000		
Avail for sale	5,000		
Allow Inv Loss			
TOTAL	55,000		
NON-EARNING ASSETS		**CAPITAL**	
Property and equip	1,500	Regular reserve	8,000
NCUSIF	2,000	Undivided earn	10,900
Other N. E. assets		Reserve for Investment losses	
Other assets	100	Total Capital	18,900
TOTAL ASSETS	$ 227,000	TOTAL LIABS & CAP	$ 227,000

Income Statement

REVENUE	
INTEREST INCOME	
Loans	$ 14,000
Investments	3,000
Non-Interest Income	
Fees/Serv Revs	1,900
TOTAL	18,900
EXPENSES	
Occupancy Personnel }	7,800
Provission for Loan Losses	1,000
TOTAL	8,800
COST OF FUNDS	
Dividends Paid	8,700
NET INCOME	
NET INCOME	$ 1,400

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What Should We Be Watching?

- **Enough Capital?** *Capital to Assets Ratio*
- **Enough Profit?** *Spread Analysis and ROA*
  - Yield on Assets (interest income ratio)
  - Cost of Funds (interest expense ratio)
  - Net Interest Margin
  - Operating expense ratio
  - Provision for Loan Loss ratio
  - Non-Interest Income ratio
  - Return on Assets (profit ratio)
- **Appropriate Risk?** *Delinquency & Charge-off Ratios*
- **Efficient use of Deposits?** *Loan to Share Ratio*

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Does Your Business Model Work?

- **Do you have enough Profit?**
- **Does your profit build enough Capital?**
- **Are you Growing?**
  - **Assets**
  - **Loans**
  - **Members**

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Why is Capital Important?

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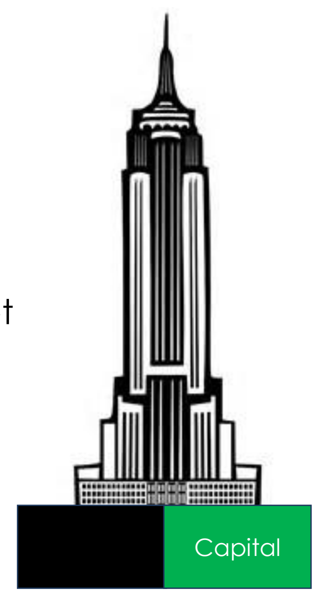
Capital to Assets

Capital is your ‘Stability’ account

- Grows with profit.
- Shrinks with losses.
- Measured as a percentage of Asset Size



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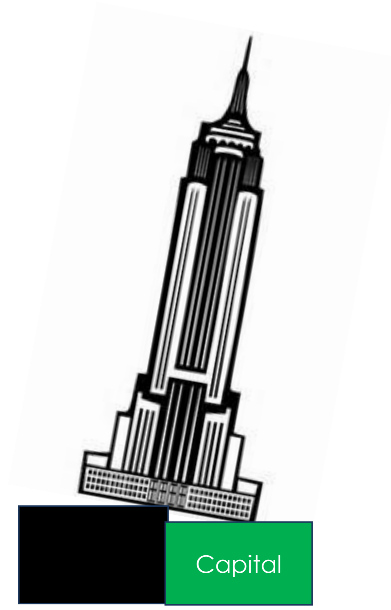
Capital to Assets

HOWEVER…

If Asset size grows,
and Capital size doesn't keep up,
your structure becomes unstable.



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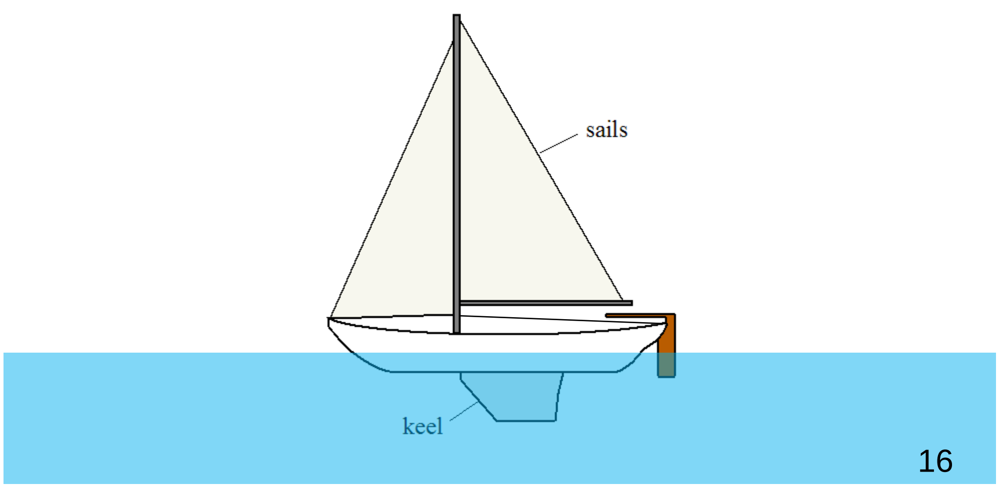
If Assets grow and Capital doesn't keep up, the credit union becomes unstable



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more Capital

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What is Capital (Net Worth)

Capital (Net Worth) is not cash

- It is the accumulated earnings and losses since you started the credit union.
- Tells you what portion of the assets belong to your members (collectively) and what part is dedicated to your depositors and other creditors
- It is your 'rainy day' fund
- It is your 'hibernation' fat
- You try to build enough to last 3 bad years and 2 recessions in a row

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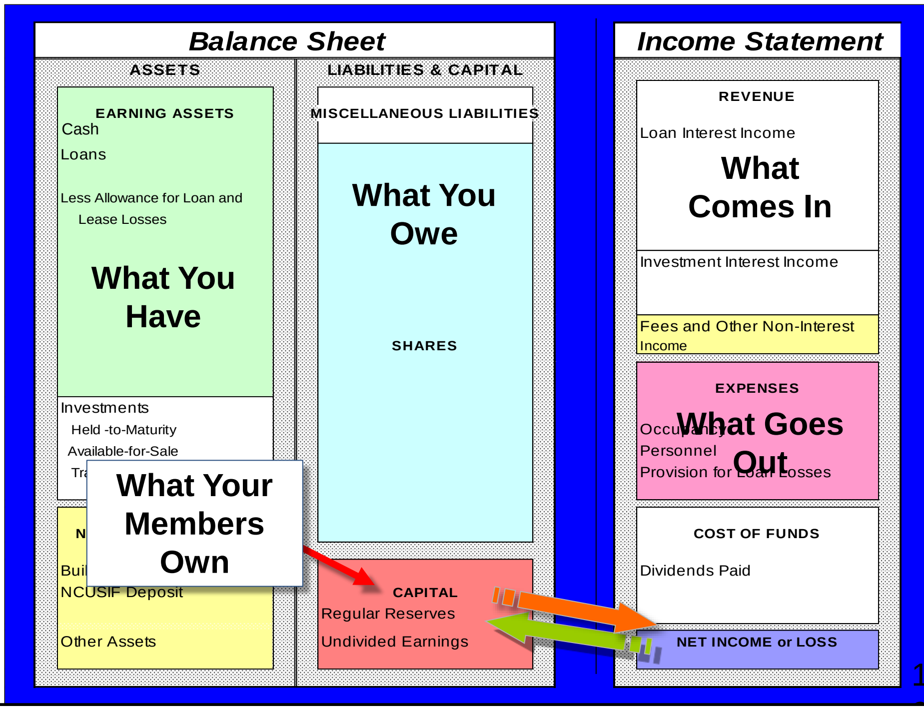

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Balance Sheet

ASSETS	
EARNING ASSETS	
Cash	$ 16,000
LOANS	
Unsecured	13,500
Vehicle	110,000
Real estate	30,000
Total loans	153,500
Less allowance	(1,100)
Net Loans	152,400
INVESTMENTS	
Held to maturity	50,000
Avail for sale	5,000
TOTAL	55,000
Less Allowance for Investment Losses	
NON-EARNING ASSETS	
Property and equip	1,500
NCUSIF	2,000
Other assets	100
TOTAL ASSETS	$ 227,000

LIABILITIES & CAPITAL	
MISCELLANEOUS LIABS	
Miscellaneous Liabs	$ 15,100
SHARES	
Share savings	68,000
Share drafts	35,000
Money market	45,000
IRAs	41,000
CDs	4,000
Total Shares	193,000
CAPITAL	
Regular reserve	8,000
Undivided earn	10,900
Total Capital	18,900
TOTAL LIABS/CAP	$ 227,000

Income Statement

REVENUE	
INTEREST INCOME	
Loans	$11,000
Investments	1,500
TOTAL	12,500
COST OF FUNDS	
DIVDENDS PAID	4,200
Net Interest Income	8,300
EXPENSES	
Provision for Loan Losses	1,000
Occupancy, Personnel, Systems	7,800
TOTAL	8,800
NON-INTEREST INCOME	
Fee Income	700
Service Charges	800
Other Income	400
	1,900
NET INCOME	$ 1,400

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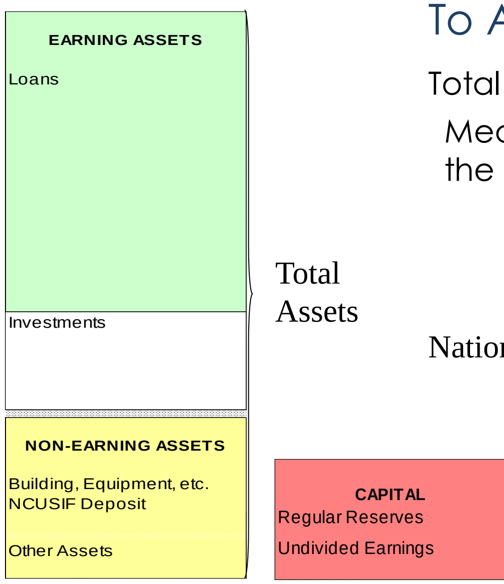
Capital (Net Worth) To Assets Ratio

Total Capital/Total Assets

Measures stability of the credit union



National Average = 10.74%

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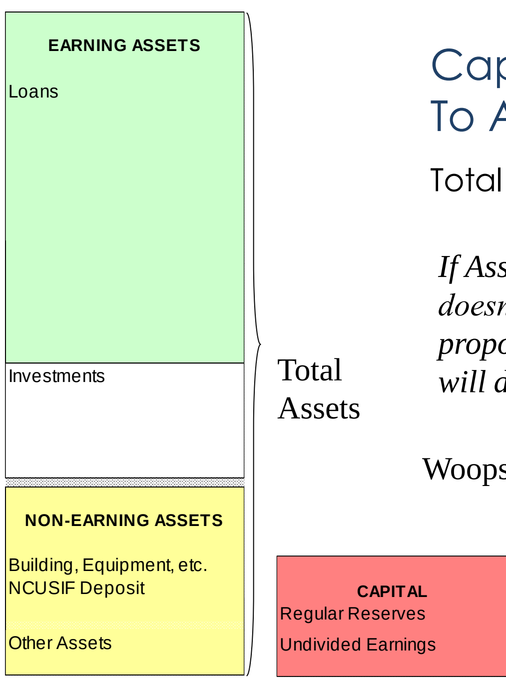
Capital (Net Worth) To Assets Ratio

Total Capital/Total Assets

If Assets grow, and Capital doesn't grow proportionately, the Ratio will decline



Woops! Now = 9.90%

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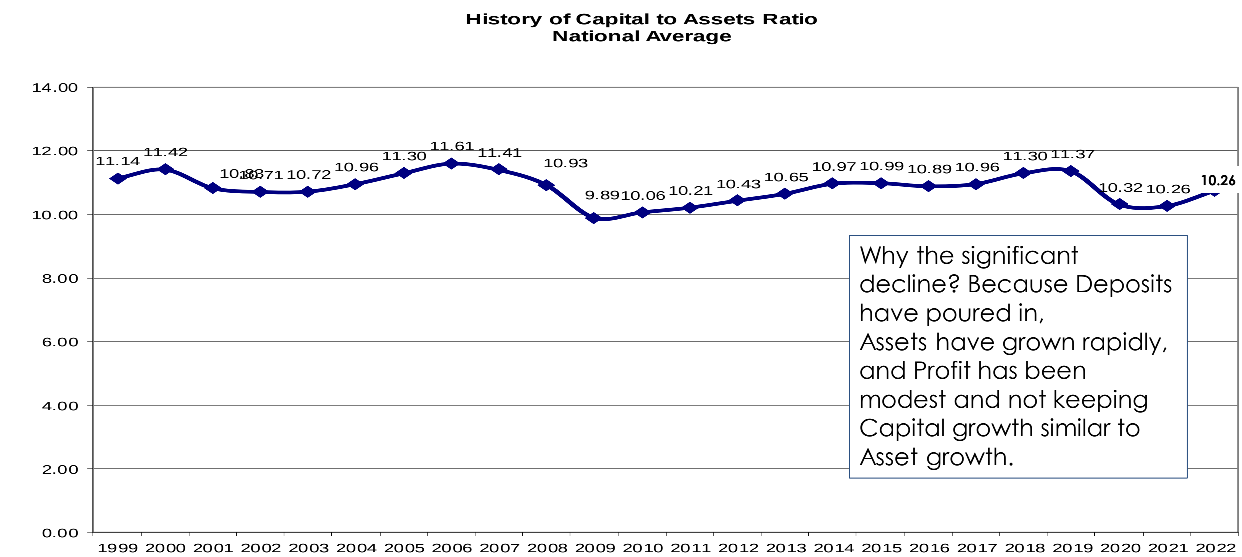

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NCUA Calculation a bit different

NET WORTH / TOTAL ASSETS

(Regular Reserve + Appropriation for Non-Conforming Investments [*SCU Only*] +Other Reserves + Undivided Earnings + Uninsured Secondary Capital [*Low-Income Designated CU Only*] + Net Income or (Loss)) / Total Assets *

*Total assets means a credit union's total assets as measured by either the:

(i) average quarterly balance of the four most recent calendar quarters; or

(ii) average monthly balance over the three calendar months of the calendar quarter; or

(iii) average daily balance over the calendar quarter; or (iv) quarter-end call report balance for the calendar quarter.

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How much Capital is enough?

Suggestion: Project worst 3 years imaginable
(combination of Asset Growth and Net Losses)
If at end, the ratio is greater than 4%, you probably have enough Capital

Prompt Corrective Action Rules
Depends on how much risk your assets and liabilities represent
Depends on level of growth
Depends on profitability of CU
Depends on future plans

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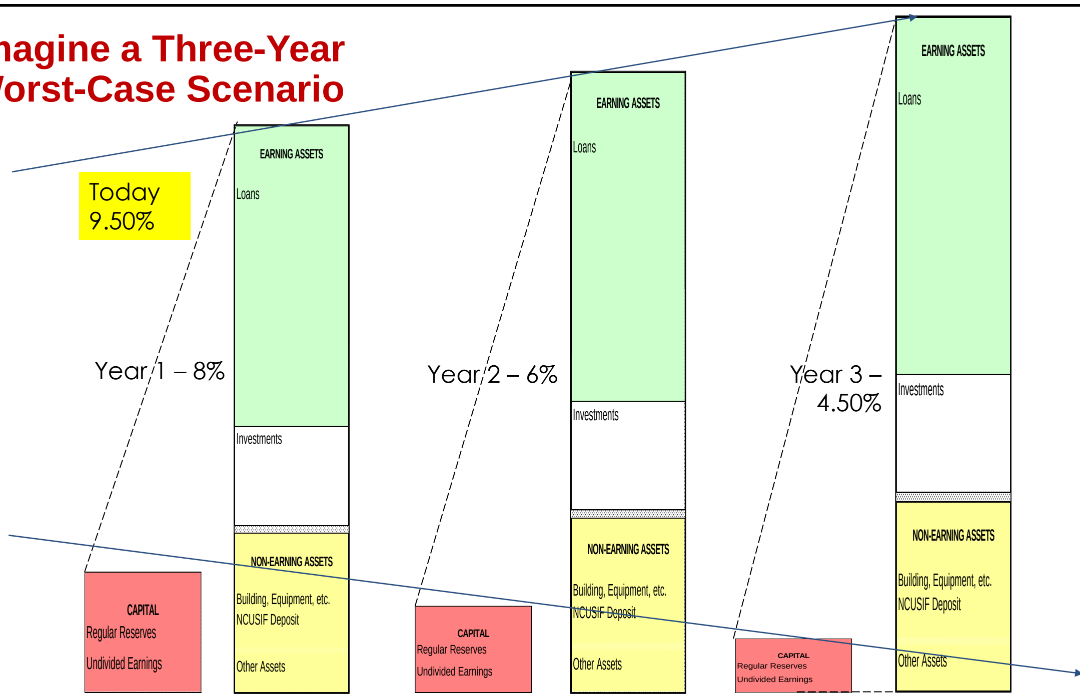
Imagine a Three-Year Worst-Case Scenario



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How much Profit do we need?

Capital Growth Calculator
Calculate ROA Needed
Five Year Projection

Fill in white cells, do not change gray cells

	12/31/2021	12/31/2022	12/31/2023	12/31/2024	12/31/2025	12/31/2026
ANTICIPATED ASSET GROWTH		10.00%	7.00%	-5.00%	6.00%	6.00%
TOTAL ASSETS	$ 227,000,000	$ 249,700,000	$ 267,179,000	$ 253,820,050	$ 269,049,253	$ 285,192,208
TOTAL CAPITAL	$ 18,900,000	$ 21,723,900	$ 24,046,110	$ 24,112,905	$ 26,904,925	$ 28,519,221
$ INCREASE IN CAPITAL (SAME AS NET PROFIT NEEDED)		$ 2,823,900	$ 2,322,210	$ 66,795	$ 2,792,021	$ 1,614,296
% INCREASe IN CAPITAL		14.94%	10.69%	0.28%	11.58%	10.00%
ACTUAL CAP/ASSETS %	8.33%					
DESIRED CAP/ASSETS %		8.70%	9.00%	9.50%	10.00%	10.00%
ROA NEEDED		1.18%	0.90%	0.03%		

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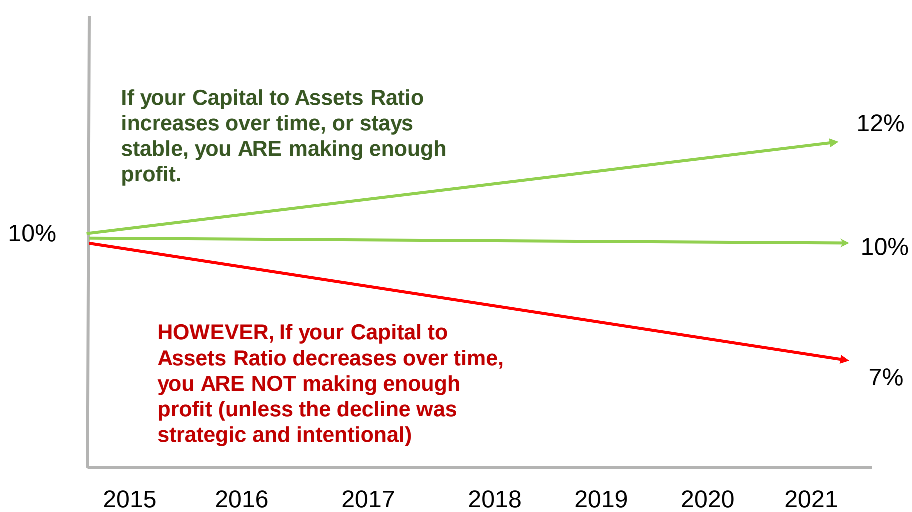
The Capital to Assets Gauge



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Prompt Corrective Action (PCA) Rules

• 7% or higher	Well capitalized
• 6%-6.99%	Adequately capitalized
• 4%-5.99%	Undercapitalized
• 2%-3.99%	Significantly undercapitalized
• Less than 2%	Critically undercapitalized

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Prompt Corrective Action (PCA) Rules

- **Mandatory Supervisory Actions**
  - Below 7% - transfer 0.1% of Total Assets to Regular Reserve each month
  - Below 6%
    - Develop a Net Worth Restoration plan
    - Limit asset growth
    - No new member business loans
- **Discretionary Supervisory Actions**

The lower you go, the more authority the regulators take away from management and the Board

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Capital for Complex CUs

Complex Credit Unions must calculate capital differently from those that are not complex

"Complex" refers to CUs >$500 MM with complex instruments

Must follow **Risk Based Capital Rule**

Can elect to use new **Complex Credit Union Leverage Ratio – CCULR**

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Why is Profit important?

It gives us Capital.

Why is Capital important?

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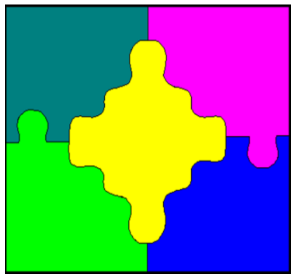
Understanding the Five Puzzle Pieces of Profitability



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ROA

ROA stands for Return on Assets (or Return on Average Assets-ROAA)

- It is a standard measure of profitability in financial institutions
- It tells you your profit as a percent of your credit union's asset size
- It allows you to compare your profitability to other credit unions of any size (as it is based on Asset size)
- It tells you how effectively the credit union is using its Assets and Liabilities

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Which CU is Doing Better?
Why we use Comparable ratios

		$10 Bil CU		$10 Mil CU
Interest income		$396,000,000		463,000
Cost of funds		(75,000,000)		(64,000)
Net Interest Margin		321,000,000		399,000
Operating costs		(329,000,000)		(332,000)
Provision for loan losses		(111,000,000)		(44,000)
Net loss before other income		(120,000,000)		23,000
NII – Non-interest income (Fee income, Other)		136,000,000		78,000
Net Profit or Loss		**$ 16,000,000**		**102,000**
Total Capital		**$ 500,000,000**		**$1,000,000**

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Which CU is Doing Better?
Why we use Comparable ratios

As a % of Average Assets		$10 Bil CU		$10 Mil CU
Yield: Interest income		3.96%		4.63%
Less: Cost of funds		(0.75%)		(0.64%)
Net Interest Margin (NIM-Spread)		3.21%		3.99%
Less: Operating costs		(3.29%)		(3.32%)
Less: Provision for loan losses		(1.11%)		(0.44%)
Net loss before other income		(1.20%)		0.23%
Plus: NII-Non-interest income (Fee income, Other)		1.36%		0.78%
Equals: Return on Assets (ROA)		**0.16%**		**1.02%**
Capital to Assets Ratio		**5.00%**		**10.00%**

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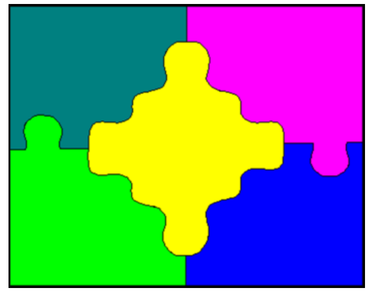
5 Puzzle Pieces of Profitability…and We Need to Make a Profit



Credit unions make money 2 ways:

- Interest Income
- Non-Interest Income

Credit unions spend money 3 ways:

- Cost of Deposits (Cost of Funds)
- Operating Expenses (cost of people, buildings, and systems)
- Provision for Loan Losses (cost indirectly caused by bad loans)

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Spread Analysis (ROA) National Averages

As a % of Average Assets	12/31/22	12/31/97
Yield: Interest income	3.38	7.63
Less: Cost of funds	(0.52)	(3.64)
Net Interest Margin	2.86	3.99
Less: Operating costs	(2.85)	(3.32)
Less: Provision for loan losses	(0.25)	(0.44)
Net loss before other income	(0.24)	0.23
Plus: Non-interest income	1.13	0.78
Equals: Net Profit or Loss (ROA)	0.89	1.02

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Spread Analysis (ROA)
National Averages

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What is Net Interest Margin?

Net Interest Margin is the difference between interest earned and interest paid.

Also known as:

- **NIM**
- **Spread**
- You don't control your Interest Income, the Market does
- You don't control you Interest Expense, the Market does

You try to control the spread between the Yield and the Cost of Funds

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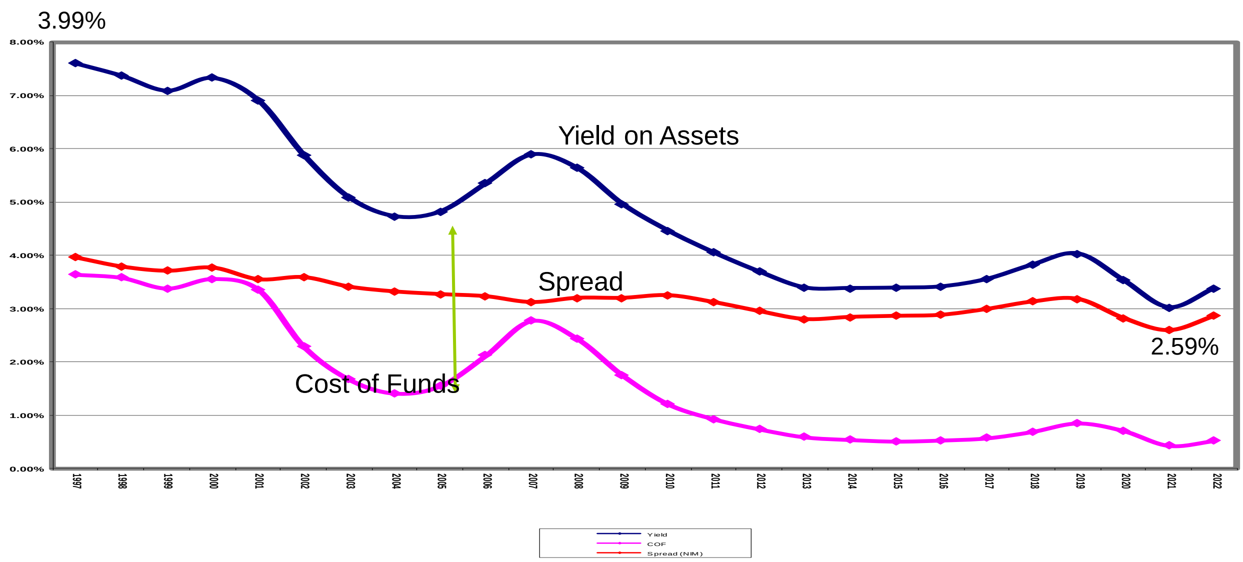
Spread or Net Interest Margin (NIM)

Goal: Can you keep it stable… or grow it?



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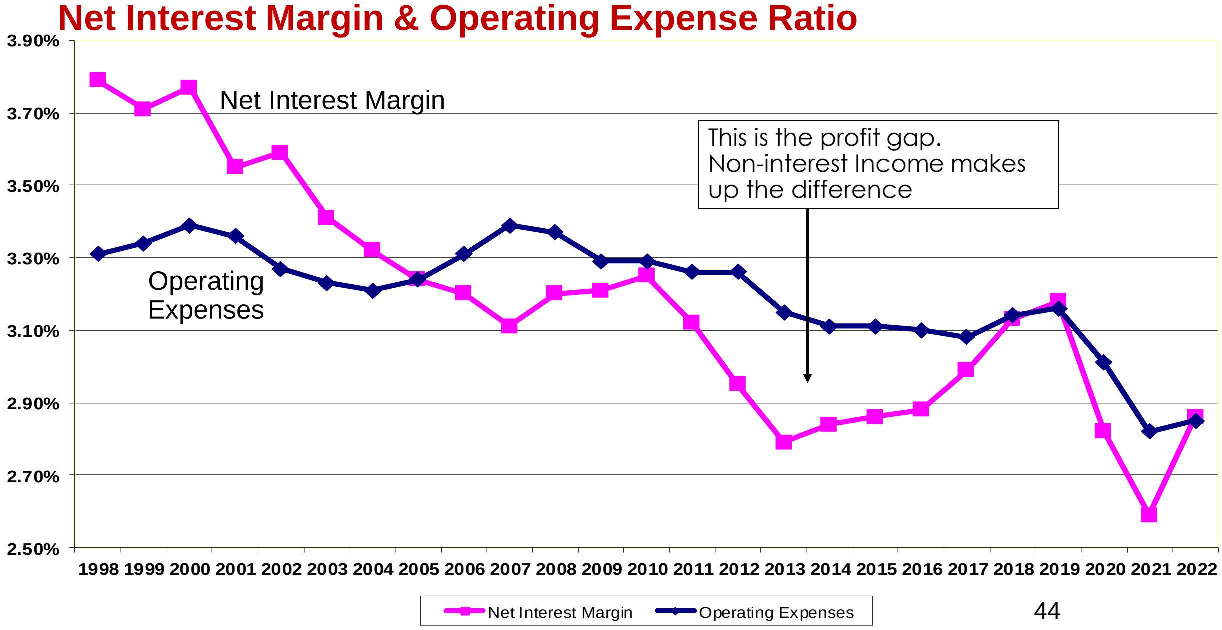
All Credit Unions

Net Interest Margin & Operating Expense Ratio



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Is Non-Interest Income (NII) Important?

Vital:

- Where a majority of CU profit is derived
- Has been growing in importance for decades
- NSF and Courtesy Pay income will likely be challenged by competitive pressure
  - Where will you make up the income?
- If you can’t get enough revenue from Non-Interest Sources, where do you need to get it?
  - From Interest Income… or Reduce Costs

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Sources of Non-Interest Income
Not Just Fees!!!

- **Fee Income** – NSF and late loan fee
- **Service Revenues** – Courtesy Pay
- **Commission Income** – sales of something
- **Interchange Income** – Debit and Credit cards
- **Sales of Mortgage Loans**
- **Other Non-Interest Sources** – CUSO selling some product or service

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Spread Analysis (ROA)
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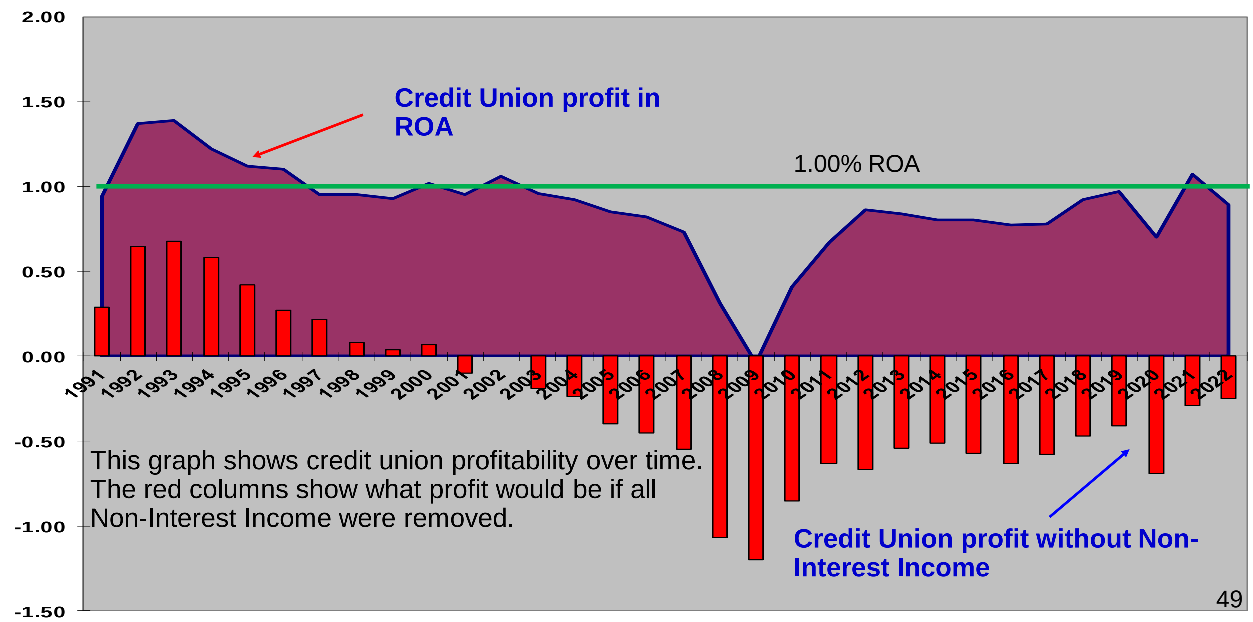
Non-Interest Income - Fee and Service Revenues



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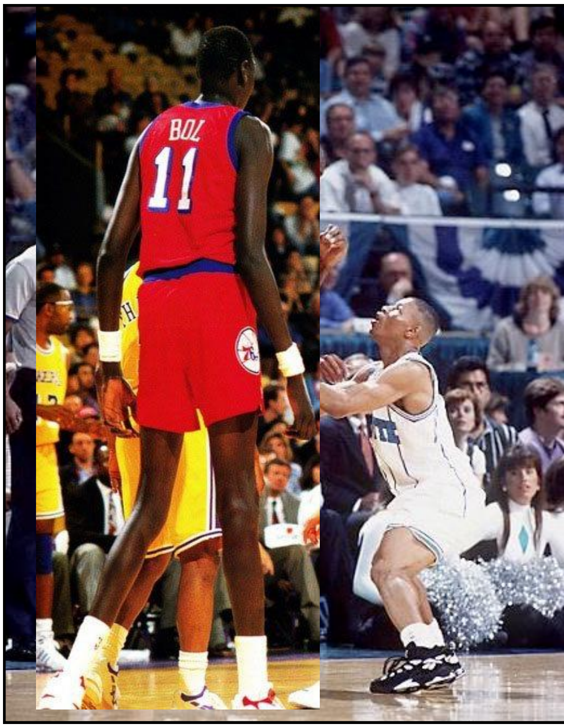

Why Peers don't really help

Manut Bol played at 7'7"
Muggsy Bogues played at 5'3"

On Average, they were 6'5"

Peer info is just a conglomeration of financial data from hundreds of credit unions.

Peer info does not:
- Reflect local market difference
- Strategic choices
- Business model differences

All Peer averages can show you is how different you are than the imaginary average

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Different Business Models
Different Spread Results
Know Your Model

	Avg CU	MOMMs CU	Low Op CU
Yield	3.38	5.31	2.29
Cost of funds	(0.52)	(0.51)	(1.10)
NIM	2.86	4.80	1.19
Operating exp	(2.85)	(4.87)	(0.66)
PLL	(0.25)	(0.08)	(0.00)
Net before NII	(0.24)	(0.15)	0.53
Non-Interest Income	1.13	1.79	0.21
ROA	0.89	1.65	0.74
Capital/Assets	10.3%	15.5%	13.0%

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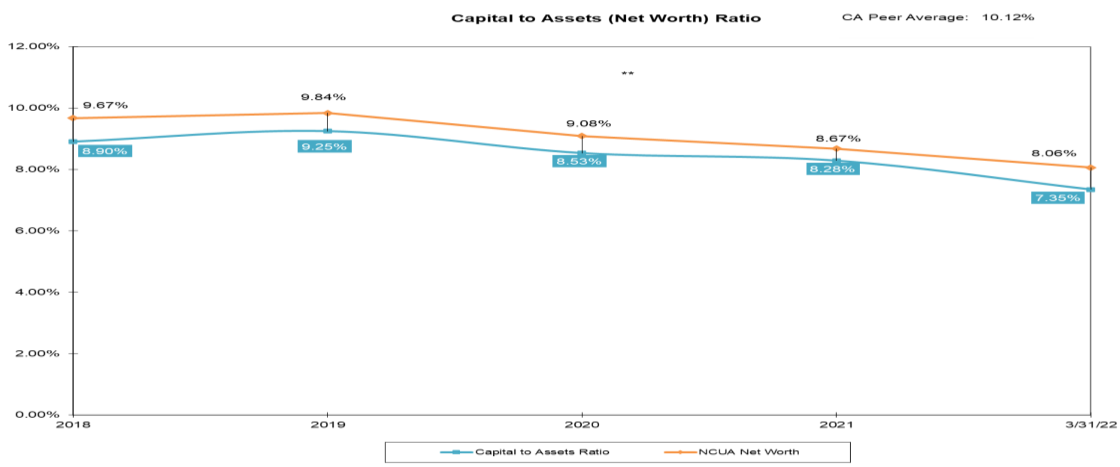
Spread Analysis	2017	2018	2019	2020	2021
Interest Income/Avg Assets	3.16%	3.56%	3.85%	3.63%	3.07%
Interest Expense/Avg Assets	0.31%	0.20%	0.26%	0.22%	0.11%
Net Interest Margin	2.85%	3.36%	3.59%	3.41%	2.96%
PLL /Average Assets	0.12%	0.35%	0.44%	0.40%	0.05%
Operating Expenses	3.06%	3.75%	3.47%	3.49%	3.34%
Other Revenues	1.09%	1.41%	1.18%	1.29%	1.02%
Return on Average Assets	0.75%	0.66%	0.86%	0.81%	0.59%



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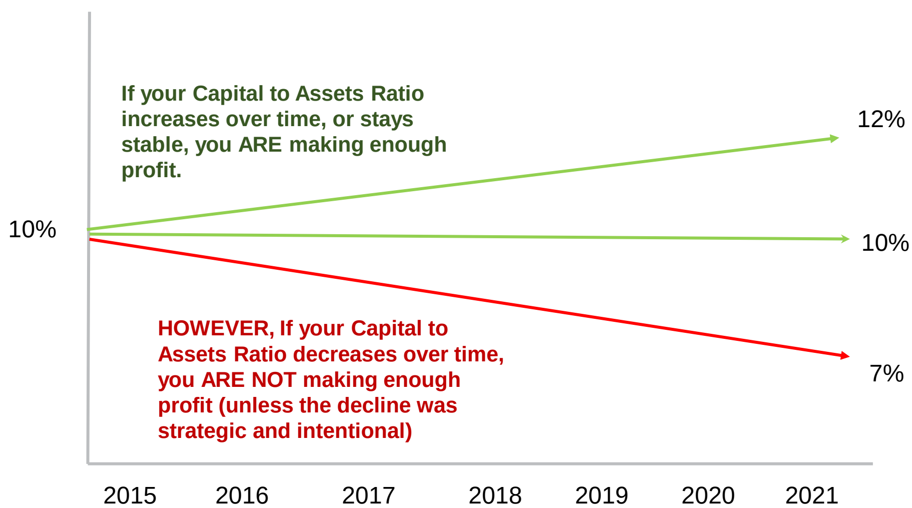
The Capital to Assets Gauge



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How much Profit do we need?

Capital Growth Calculator Calculate ROA Needed Five Year Projection	12/31/2021	12/31/2022	12/31/2023	12/31/2024	12/31/2025	12/31/2026
Fill in white cells, do not change gray cells						
ANTICIPATED ASSET GROWTH		10.00%	7.00%	-5.00%	6.00%	6.00%
TOTAL ASSETS	$ 227,000,000	$ 249,700,000	$ 267,179,000	$ 253,820,050	$ 269,049,253	$ 285,192,208
TOTAL CAPITAL	$ 18,900,000	$ 21,723,900	$ 24,046,110	$ 24,112,905	$ 26,904,925	$ 28,519,221
$ INCREASE IN CAPITAL (SAME AS NET PROFIT NEEDED)		$ 2,823,900	$ 2,322,210	$ 66,795	$ 2,792,021	$ 1,614,296
% INCREASe IN CAPITAL		14.94%	10.69%	0.28%	11.58%	10.00%
ACTUAL CAP/ASSETS %	8.33%					
DESIRED CAP/ASSETS %		8.70%	9.00%	9.50%	10.00%	10.00%
ROA NEEDED		1.18%	0.90%	0.03%		

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Allowance for Loan Losses (or Credit Losses)

2023 method: **CECL – Current Estimated Credit Losses**: (effective 1/1/2023) Amount based on management's best estimate of losses **over the life of the loan** (or life of the portfolio)

CECL is based on the likelihood of loss and expected future cash flows and less on 'historical' and.

ALL is a **Contra-Asset**, that means:

it's a 'negative' asset
it takes away from the assets

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CECL and the ALL

CECL is based on the estimate of future losses:

- By loan type
- By loan term
- By collateral type
- By credit tier
- by origination date
- Modified by:
  - Credit tier migration
  - Change in economic conditions
  - Etc.

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Balance Sheet

ASSETS

EARNING ASSETS	
Cash	$ 16,000
LOANS	
Unsecured	13,500
Vehicle	110,000
Real estate	30,000
Total loans	153,500
Less allowance	(1,100)
Net Loans	152,400
INVESTMENTS	
Held to maturity	50,000
Avail for sale	5,000
TOTAL	55,000
Less Allowance for Investment Losses	
NON-EARNING ASSETS	
Property and equip	1,500
NCUSIF	2,000
Other assets	100
TOTAL ASSETS	**$ 227,000**

LIABILITIES & CAPITAL

MISCELLANEOUS LIABS	
Miscellaneous Liabs	$ 15,100
SHARES	
Share savings	68,000
Share drafts	35,000
Money market	45,000
IRAs	41,000
CDs	4,000
Total Shares	193,000
CAPITAL	
Regular reserve	8,000
Undivided earn	10,900
Total Capital	18,900
TOTAL LIABS/CAP	**$ 227,000**

Income Statement

REVENUE	
INTEREST INCOME	
Loans	$11,000
Investments	1,500
TOTAL	12,500
COST OF FUNDS	
DIVDENDS PAID	4,200
Net Interest Income	8,300
EXPENSES	
Provision for Loan Losses	1,000
Occupancy, Personnel, Systems	7,800
TOTAL	8,800
NON-INTEREST INCOME	
Fee Income	700
Service Charges	800
Other Income	400
	1,900
NET INCOME	**$ 1,400**

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ALLOWANCE FOR LOAN & LEASE LOSSES

LOAN TYPE	Portfolio Balance this Month	Allowance Req. Previous Month	Allowance Req. this Month
Used Auto	$ 65,000,000	$ 507,000	$ 593,000
New Auto	$ 35,000,000	191000	$ 215,000
Credit Card	$ 10,000,000	$ 320,000	$ 350,000
Other Unsecured	$ 3,500,000	$ 45,000	$ 74,000
First Mortgage	$ 30,000,000	$ 23,000	$ 40,000
Home Equity Mortgage	$ 10,000,000	$ 14,000	$ 19,000
	$153,500,000		
TOTAL ALLOWANCE		$ 1,100,000	$ 1,291,000
ADJUSTMENT REQUIRED			$ 191,000

The ALLL increases to this amount

The Provision for Loan Loss Expense would be this amount for the month

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Balance Sheet

ASSETS

EARNING ASSETS

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LIABILITIES & CAPITAL

MISCELLANEOUS LIABS

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TOTAL LIABS/CAP	$ 227,000

Income Statement

REVENUE

INTEREST INCOME

Loans	$11,000
Investments	1,500
TOTAL	12,500

COST OF FUNDS

DIVDENDS PAID	4,200
Net Interest Income	8,300

EXPENSES

Provision for Loan Losses	1,000
Occupancy, Personnel, Systems	7,800
TOTAL	8,800

NON-INTEREST INCOME

Fee Income	700
Service Charges	800
Other Income	400
	1,900
NET INCOME	$ 1,400

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ALL Before Charge-offs

The ALL is like a reservoir of loan losses ready to be used. The loss has already been incurred at the time the loan became impaired. We are just waiting for the loan to finally wither and drop

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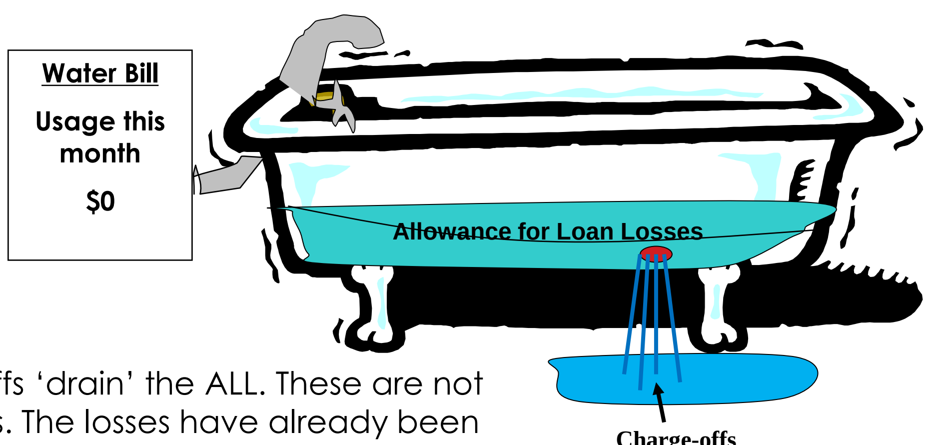
Loans Charged-off



Charge-offs 'drain' the ALL. These are not new losses. The losses have already been recognized. This is just when we finally remove the loan from the books.

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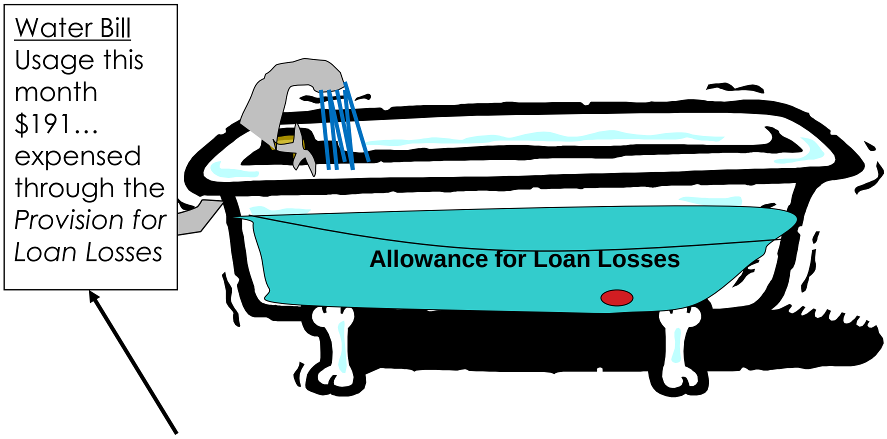
Refilling the ALL through the Income Statement – Provision for Loan Losses



The Provision for Loan and Lease Losses is the current monthly charge-to restore the ALL. It represents matching the expense to the period the loss actually occurred.

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Spread Analysis (ROA)
National Averages

As a % of Average Assets	12/31/22	12/31/97
Yield: Interest income	3.38	7.63
Less: Cost of funds	(0.52)	(3.64)
Net Interest Margin	2.86	3.99
Less: Operating costs	(2.85)	(3.32)
Less: Provision for loan losses	(0.25)	(0.44)
Net loss before other income	(0.24)	0.23
Plus: Non-interest income	1.13	0.78
Equals: Net Profit or Loss (ROA)	0.89	1.02

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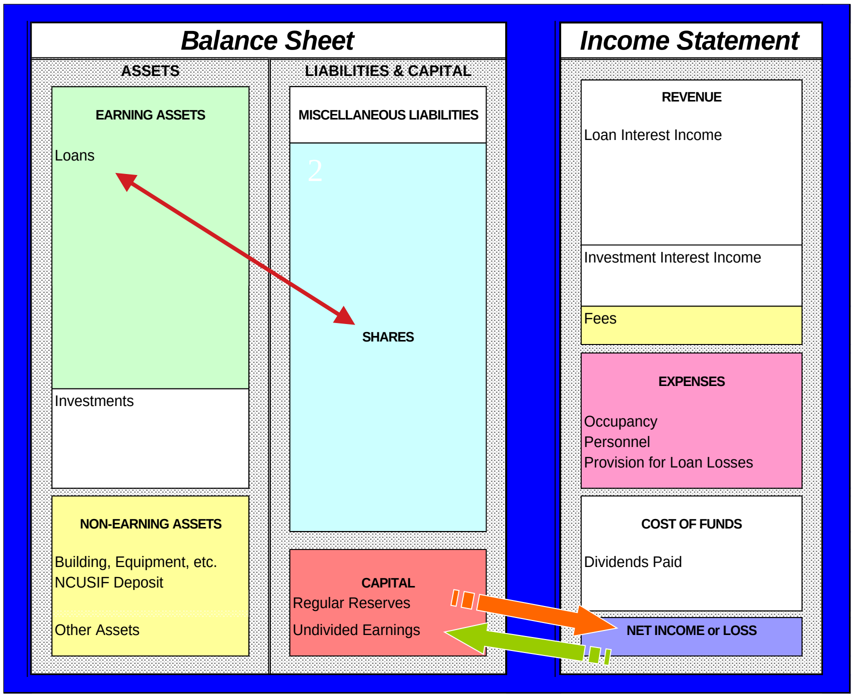

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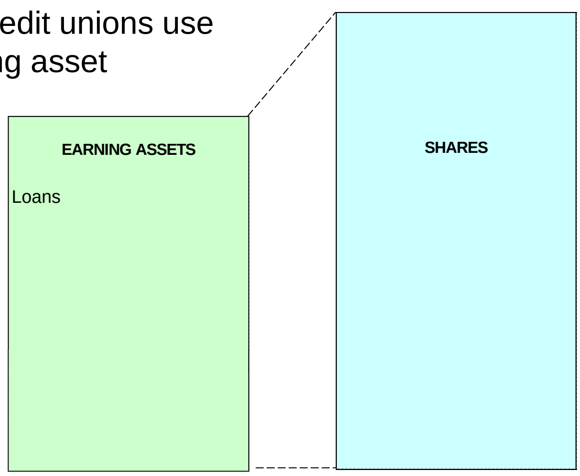
Loan to Share Ratio

Total Loans / Total Shares and Deposits

Measures the credit unions use of its best earning asset

National Average = 70.18%

What % of our Deposits is currently loaned out to members?



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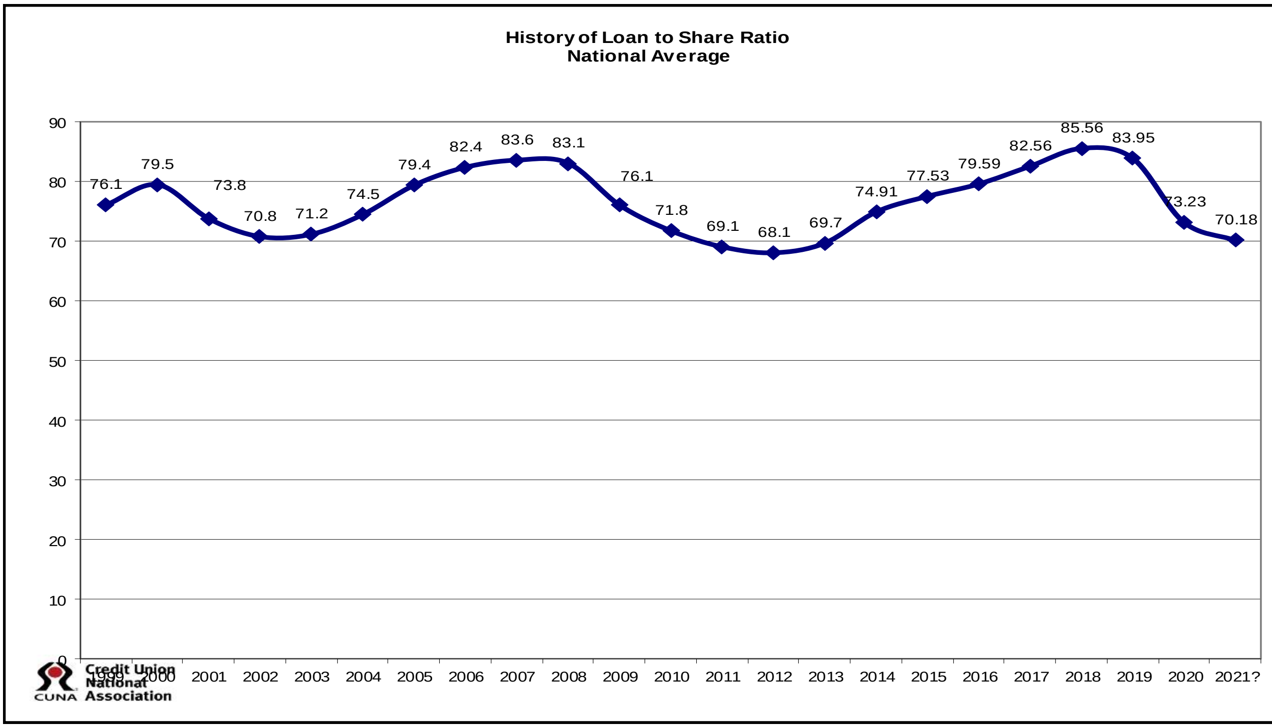

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Delinquency and Charge-offs

Delinquency ratio

Delinquent loans over 60 days old / Total loans

Charge-off ratio

Charge-offs (less recoveries) / Average loans

	Normal	12/31/22
Delinquency	0.75%	0.62%
Net Charge-offs	0.40%	0.34%
Combined	1.15%	0.96%

But what is considered a healthy ratio depends on the credit union's Business Model and Strategy

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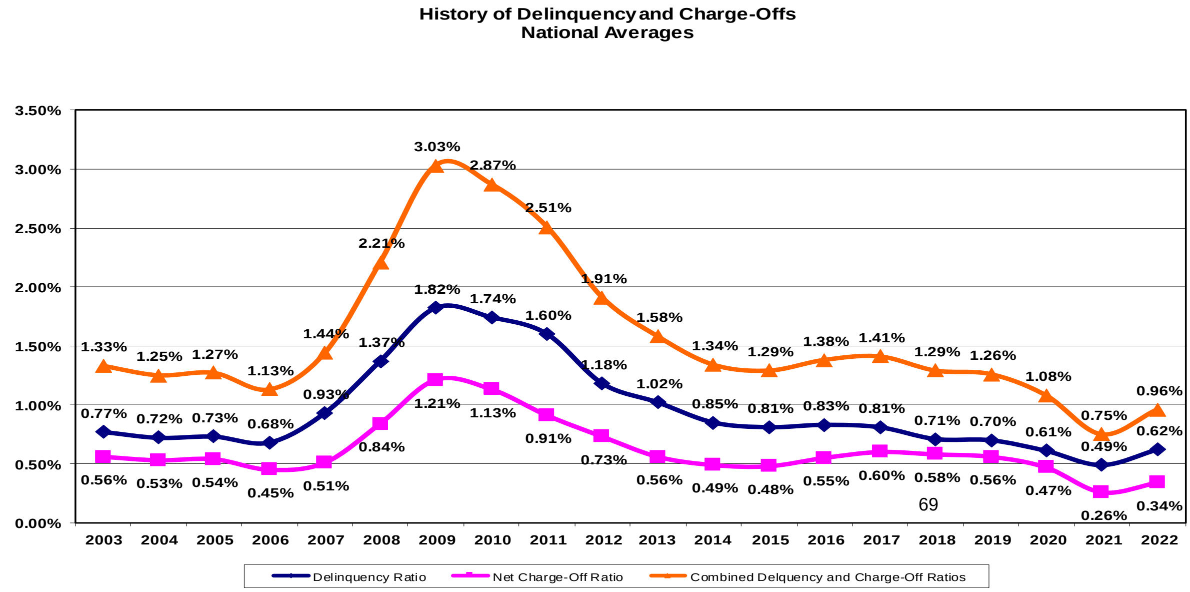
Delinquency and Charge-offs



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What Should You Focus On?

- Monitor your Capital to Assets Ratio (Net Worth Ratio)
- Monitor your Spread Analysis and ROA
- If the Capital to Assets Ratio is falling, determine what it would take to improve Profit (ROA) and return your Capital to Assets Ratio back to ‘stable’
- Monitor other Key Ratios in Graphic Form or a Dash Board

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What Should We Be Watching?

- **Enough Capital?** *Capital to Assets Ratio*
- **Enough Profit?** *Spread Analysis and ROA*
  - Yield on Assets (interest income ratio)
  - Cost of Funds (interest expense ratio)
  - Net Interest Margin
  - Operating expense ratio
  - Provision for Loan Loss ratio
  - Non-Interest Income ratio
  - **Return on Assets (profit ratio)**
- **Appropriate Risk?** *Delinquency & Charge-off Ratios*
- **Efficient use of Deposits?** *Loan to Share Ratio*

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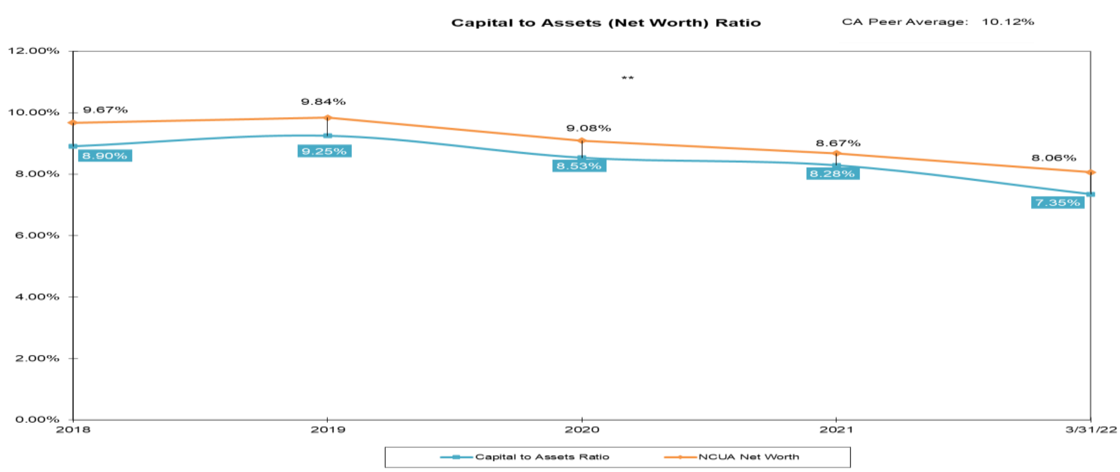
Spread Analysis	2017	2018	2019	2020	2021
Interest Income/Avg Assets	3.16%	3.56%	3.85%	3.63%	3.07%
Interest Expense/Avg Assets	0.31%	0.20%	0.26%	0.22%	0.11%
Net Interest Margin	2.85%	3.36%	3.59%	3.41%	2.96%
PLL /Average Assets	0.12%	0.35%	0.44%	0.40%	0.05%
Operating Expenses	3.06%	3.75%	3.47%	3.49%	3.34%
Other Revenues	1.09%	1.41%	1.18%	1.29%	1.02%
Return on Average Assets	0.75%	0.66%	0.86%	0.81%	0.59%



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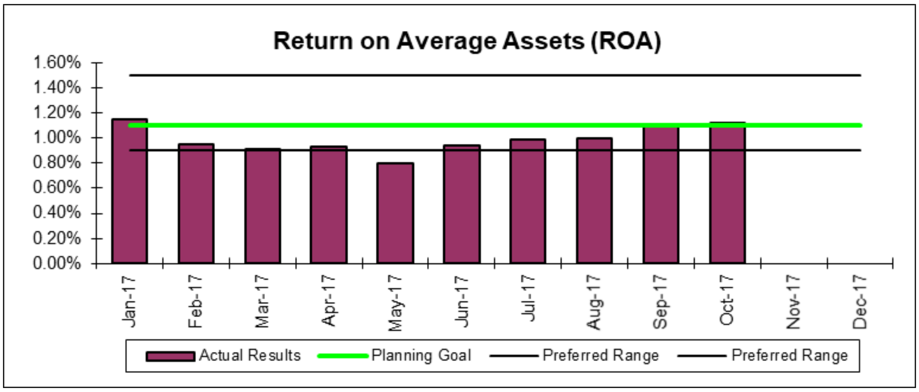
Using an Instrument Panel



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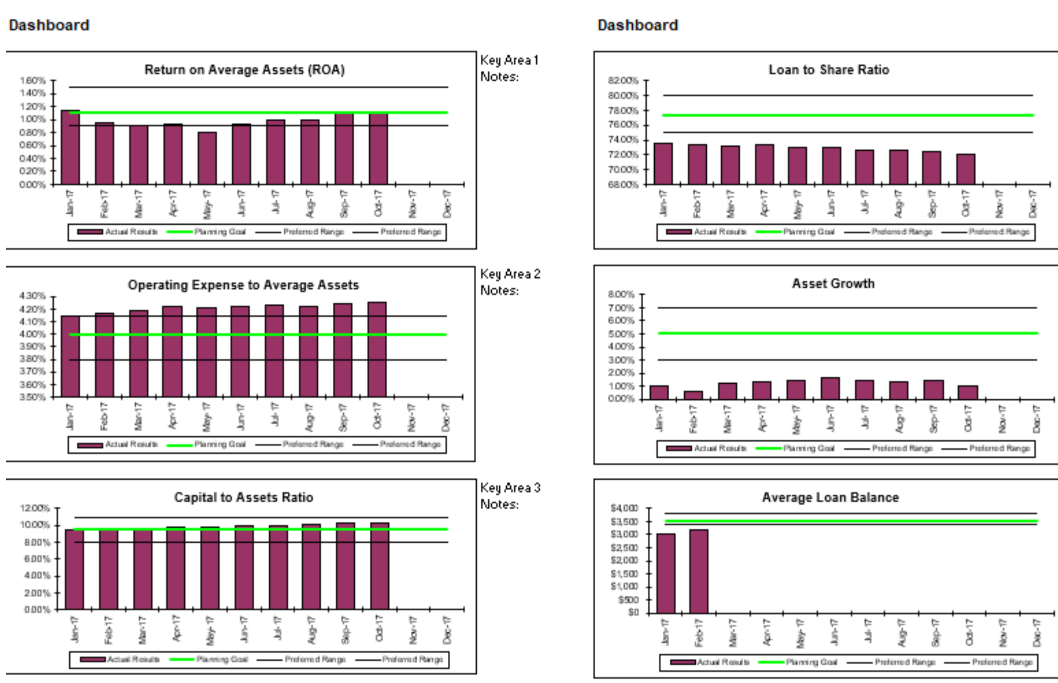
Free Download to Monitor your Key Ratios



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