CAPITAL MARKETS *monthly*

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GENERAL MARKET OVERVIEW

Capital Markets Monthly spends considerable time discussing the macroeconomic environment, focusing on how the capital markets work for credit unions. This month, we'll veer off course a bit to highlight some recent announcements from the NCUA.

Before we focus on the NCUA guidance and related insights for credit unions, it's worth noting that the Federal Reserve Board held rates steady at its recent meeting. Because of this, the market consensus is that rate cuts will happen later this year, but they will likely not be as aggressive as once predicted. A "soft landing" is considered likely, with an ease into stabilized, lower rates.

While this sounds great, and we hope it is the outcome, it's prudent to be wary of such a rosy economic outlook. While the Fed typically increases rates slowly and methodically by 25 basis points each time, when they cut rates, it's much more likely to be 75 basis points or more, as this is required to spur economic growth. Given where we are with the fed funds rate, a drop of 300 basis points would get us to the Fed's target range and dot plot projections. Like everyone else, we'll wait and see how it plays out.

Since August 2023, the NCUA has spilled ink on three separate occasions, advising credit unions on their liquidity management. We believe this is the most time the NCUA has spent on liquidity management in the past two decades, though this belief is difficult to confirm that far back in the archives. While liquidity management is always a priority with the NCUA as a trickle-down to credit unions, the emphasis placed on the practice is at truly heightened levels. *Continued on page 2*

Take a look at the following guidance from the NCUA on liquidity risk management that has been released in the past six months. Click on each title to read more.

Interagency Policy Addendum on Emergency Liquidity Sources
July 28, 2023

Advisory on Liquidity Risk Management
January 17, 2024

NCUA's 2024 Supervisory Priorities
January 23, 2024

There is a considerable amount to digest in the above guidance, so let's boil it down to three key takeaways.*

Access to emergency liquidity is important, regardless of the size of the credit union.

Per section 741.12 of NCUA's regulations, it outlines that all credit unions over $250 million in assets must have access to an emergency liquidity source. That source can either be the Federal Reserve Bank's Discount Window or the NCUA's Central Liquidity Facility. However, in the NCUA's "Advisory on Liquidity Risk Management," the NCUA – for the first time ever – wrote that all credit unions, regardless of size, should consider having access to an emergency liquidity source. While the NCUA did not specifically state that it is a requirement for credit unions to have access to one (or both) of these sources, the fact remains that access to emergency liquidity is of utmost importance in 2024. Considering last year's bank collapses (i.e. SVB, First Republic, Signature, etc.), it's apparent that the NCUA is looking to learn from those failures to ensure something of that nature does not happen to the credit union system. A first line of defense would be having access to an emergency liquidity source, and thus the emphasis on exactly that.

Structured liabilities = planned liquidity management.

The NCUA also highlights that credit unions should structure their liabilities to be congruent with asset growth. They go on to point out the difference between stable and volatile funding sources, and when they should be relied upon.

This point hints that credit unions need to be proactive and not reactive in their liquidity management. Credit unions should utilize the tools available to them in a responsible and proactive way. This means credit unions, in conjunction with forecasting cash flows, should actively manage their borrowings and brokered deposits to sync up with the needs of their growth plan. While lines of credit were created for unforeseen occurrences, proactively managing your liabilities to meet your growth initiatives is imperative to liquidity management.

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*This information is of the author's viewpoint and is not intended to provide advice or consulting in any way. The opinions are that of the authors and not necessarily that of Alloya Corporate Federal Credit Union.

Liquidity management starts at loan origination.

The NCUA has historically steered clear of providing credit unions guidance on their loan pricing and thus has left that decision (rightfully so) to credit unions themselves. However, the NCUA points out that loans should be priced to sell to a secondary market. This allows credit unions the flexibility to keep the loans on their books, or to sell the loans should the liquidity be needed. Furthermore, by offloading the asset, the risk associated with that asset is transferred to the purchaser as well, thereby reducing credit risk (first priority in "NCUA's 2024 Supervisory Priorities") to the originating credit union.

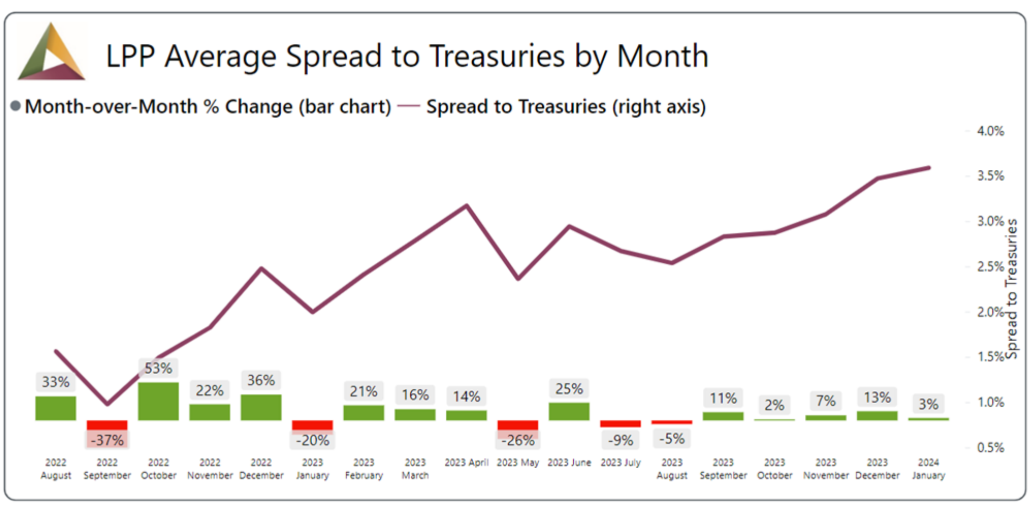
While it's believed the NCUA is mostly concerned with mortgage loans being priced according to the secondary market, they do not specify what loan types fall under this guidance. This leaves considerable interpretation for the reader and, thus, for the credit unions themselves. What's not up for interpretation, however, is that credit unions will need to follow markets far more closely and update their loan pricing far more regularly than they have historically.

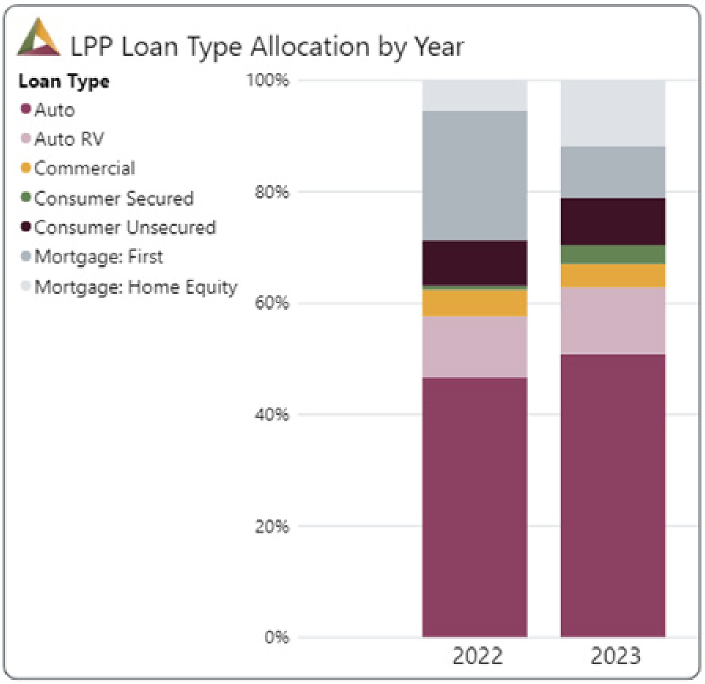
Last year, we wrote about a credit union who made a drastic switch in their loan pricing and began to adjust loan prices daily. This allowed them to keep loan prices in line with their respective secondary markets. By doing so, the credit union was able to sell hundreds of millions of newly originated loans, which previously would have been unsellable at a market price, and create a new balance sheet and liquidity management tool for themselves in the process.

Credit unions should look to duplicate this process. Regularly updating their loan prices to be in line with their respective secondary markets is a good first step in ensuring flexibility for liquidity management in the future.

LP MARKET OVERVIEW

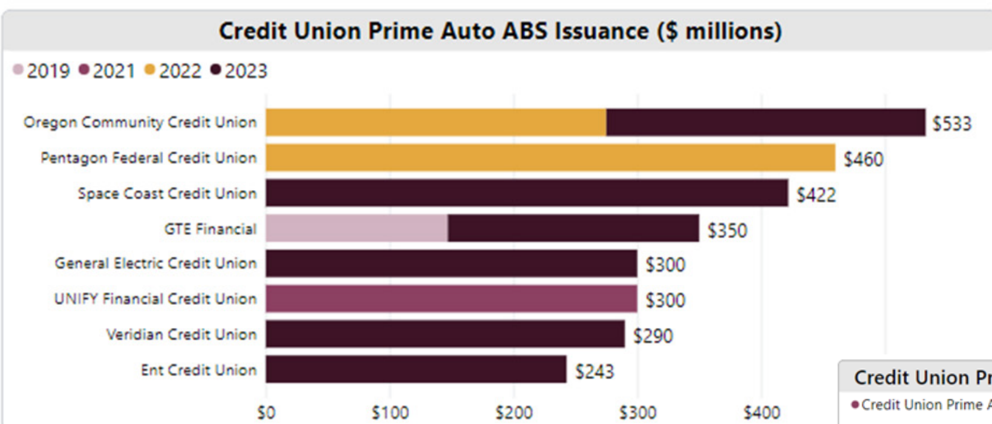
Loan participation (LP) spreads continue to march higher, rewarding investors and enticing new liquidity into the market. LP spreads are 350 basis points over comparable Treasuries and have increased steadily over the past five months. Contact Alloya's LP team for a more granular breakout of spreads by loan type and how they compare with alternatives in your decision-making process. *Continued on page 4*



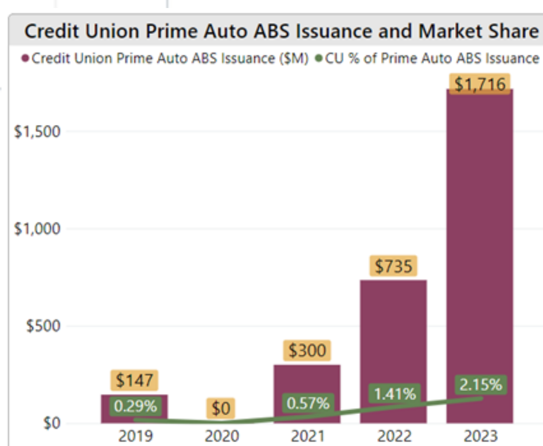


Speaking of loan types, Alloya's Loan Participation Platform (LPP) is off to a strong start for the year with activity across all loan types. At left is an allocation breakdown by broad loan type category of LPP trades over the past two years. As you can see, there is something for everyone, and we see deals with more specific, fine-tuned loan types within each category (e.g. indirect vs. direct, commercial real estate vs. commercial other secured). Recently, the Loan Participation Platform facilitated a transaction of a diversified portfolio of motorcycle loans. We continue to see attractive deals transacted through our platform. If you are unsure if your loans are right for loan participations, reach out to our team and we will work with you to fulfill your liquidity or investment needs. In general, we are seeing an increase in risk appetite as credit unions anticipate the top of the interest rate cycle.

ABS MARKET & SECURITIZATION

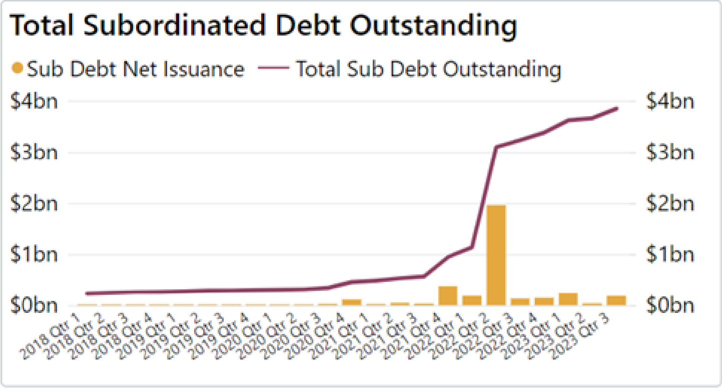


If 2022 was the year for loan participations, 2023 was the year credit unions made their mark among heavy hitters in the asset-backed security (ABS) space. Since 2019, eight pioneering credit unions have issued 10 prime auto ABSs, nearing $3 billion. Even more impressive than the volume is the increase in market share by credit unions in prime auto. Prime auto ABS market share climbed over 2% in 2023. ABS market experts predict 2024 will be another solid year of issuance, comparable to 2023. Time will tell if credit unions have the new loan production volume to continue the trend. Future editions of *Capital Markets Monthly* will continue to keep readers abreast of credit unions' foray into securitizations.



Footnote: As of 12/31/2023

Subordinated Debt



Credit unions use subordinated debt proceeds to support various initiatives, such as expanding operations, making strategic investments or meeting regulatory capital requirements. By accessing this additional capital, credit unions can better adapt to changing economic conditions and ensure their ability to fulfill their mission of serving members.

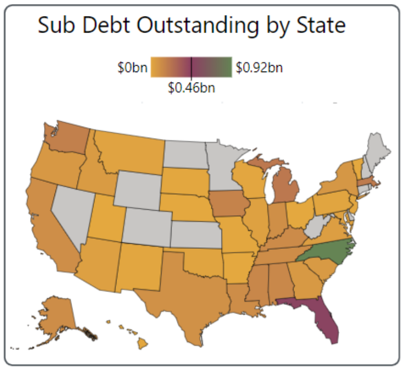
In 2024, we have seen an increase in credit unions seeking to acquire banks. Subordinated debt can be leveraged as a strategic financial tool to facilitate the acquisition process. The use of subordinated debt can offer several advantages for credit unions aiming to expand their operations and strengthen their market presence. Acquiring a bank often requires a significant upfront investment. Subordinated debt allows credit unions to raise additional capital, which provides the necessary financial firepower to support the acquisition, covering costs such as purchase price, integration expenses and potential restructuring.

By issuing subordinated debt, credit unions can enhance their regulatory capital ratios, meeting the necessary compliance standards for the acquisition. This ensures a smoother approval process from regulatory bodies and instills confidence in stakeholders regarding the financial soundness of the credit union.

Current Market

Subordinated Debt Issuance Rates

Issuance Size	IG Egan Jones	Kroll BBB-	Kroll BBB	Kroll BBB+	Unrated
50MM	8.500% +/-	8.500% +/-	8.500% +/-	8.500% +/-	8.500%-9.000% +/-
50MM-100MM	8.500% +/-	8.500% +/-	8.500% +/-	8.500% +/-	-
100MM+	8.500% +/-	8.500% +/-	8.500% +/-	8.500% +/-	-



	12/31/2018	12/31/2019	12/31/2020	12/31/2021	12/31/2022	9/30/2023
# of CU's with Sub Debt	66	68	80	106	150	159
Sub Debt Outstanding	$265M	$301M	$460M	$948M	$3,381M	$3,847M
Combined Sub Debt as % of NW	10.1%	9.2%	8.8%	11.9%	19.8%	19.4%
AVG Assets Size of Issuing CU's	$400M	$486M	$698M	$757M	$1,059M	$1,128M
AVG Net Worth Ratio of Issuing CU's	9.7%	9.8%	9.2%	10.4%	12.3%	12.6%

BALANCE SHEET STRATEGY

Sale-Leaseback Transaction

A sale-leaseback transaction can be a beneficial financial strategy for credit unions, offering advantages in terms of capital management, liquidity and operational flexibility.

By selling a property and then leasing it back, credit unions can unlock the capital tied up in real estate assets. This influx of capital can be used to fund strategic initiatives, such as technology upgrades, expansion or other investments, without having to resort to traditional loans or other forms of debt.

In 2024, we have seen an increase in credit unions considering sale-leasebacks. Many are considering a different strategy, which may be beneficial for more credit unions in today's market. Credit unions are looking to sell properties and lease them back, with the strategy of paying down expensive borrowings, as liquidity continues to be tight. This decrease in interest expense, coupled with their annual depreciation expense, may be enough for credit unions to offset the new lease expense. As asset size shrinks with borrowings reduced, the gain on sale of your properties will have a larger positive impact on your capital levels. Below is a hypothetical illustration of the sale-leaseback strategy to unlock capital.

Use case: A $600 million credit union with four properties executes a sale-leaseback strategy. The $11 million book value of the properties is sold for $15 million. Management will use the proceeds from the sale to reduce wholesale borrowings by $15 million, as well as to boost capital ratios with the $4 million gain-on-sale.

Balance Sheet Impact	Before	After	Comment
Borrowings	$40 million	$25 million	$15M cash from sale used to pay down borrowings
Assets	$600 million	$589 million	Decrease in property assets
Net Worth	$57 million	$61 million	$4M boost to capital from gain-on-sale
Net Worth Ratio	9.5%	**11.0%**	**Increase of 1.5% to net worth ratio**

Income Statement Impact	Before	After	Comment
Borrowings Expense (6%)	$2.4 million	$1.5 million	~$1m reduction in interest expense
Depreciation Expense	$0.4 million	$0	Foregone depreciation
Annual Lease Rents	$0	$1.2 million	Based on local market cap rates
Net Impact on Income	-	**+ $100,000**	**Net positive impact offsets new lease expense**

FINAL THOUGHTS

Stabilization is a welcomed word for 2024. Some economists are predicting a stabilization of the macro markets will come in the second half of the year, with Fed Chair Jerome Powell indicating just recently on a *60 Minutes* interview that a rate cut likely wouldn't happen until then due to falling inflation numbers. We believe this reprieve will be well-received by credit unions, a chance for credit unions to catch their breath and get back to some normalcy. While a return to normal is nice, that doesn't mean that we can turn our attention from the capital markets. Instead, it should be an indicator to continue to engage and monitor our situations, learning from recent events to ensure we're better suited the next time (and there will be a next time) this occurs.