DISCOVER FINANCIAL SERVICES REPORT

Summer 2012

FINANCIAL ANALYSIS

This report features quantitative financial analysis to determine what effect credit card lending has on participating credit unions. All data used to calculate the metrics within this report is from the June 30, 2012 credit union call reports collected by the National Credit Union Administration (NCUA). The data was then scrubbed for accuracy by Callahan & Associates. Four peer groups are used throughout the report: credit unions with credit card loan balances making up at least 8.5% of the total loan portfolio (high concentration), credit unions with credit card loan balances making up between 4.5% and 8.5% of the total loan portfolio (medium concentration), credit unions with credit card loan balances making up less than 4.5% of the total loan portfolio (low concentration), and credit unions that do not participate in credit card lending. The peer group of credit unions that do not participate in credit card lending was adjusted to include credit unions between $50 million and $1 billion in assets so that it allowed for a closer average asset size to the credit card lending peer groups. Credit unions that have sold their credit card portfolio within the last seven years were also excluded from these peer groups to remove the risk of skewed performance.

This report is broken out into three main sections: balance sheet metrics, income and expense metrics, and member relationships. This allows for a look at what is happening on both the balance sheet and income statement of credit unions, as well as how they are cultivating connections with members. The metrics that are examined within each section have been selected due to their direct relation to credit card lending or importance to the overall health of credit unions.

Balance sheet metrics are crucial when considering credit union performance because the balance sheet shows whether the credit union is growing in size and whether they are able to convert deposits into loans. Asset growth is a particularly important balance sheet metric, as it shows that members are utilizing their credit union more often and therefore are helping it grow.

Metrics related to the income statement are examined in the income and expense section. Credit unions have to remain profitable, because due to their charter they are unable to raise outside funds and must rely on retained earnings to generate capital. There may be variations between individual credit unions or peer groups based on their business model and what services they offer their members. Some income and expense metrics, particularly return on assets (ROA), need to be viewed in light of a credit union's unique strategy. If a credit union is strongly focused on returning potential profits to its members through no fees, high deposit rates, and/or low lending rates, this strategy may result in a lower ROA relative to industry peers.

Credit unions' continued success is dependant on forming deep and profitable relationships with their members today. Consumers have many choices when it comes to financial institutions, but an increasing number of consumers are turning to credit unions due to the emphasis placed on member value. As credit unions typically offer lower fees and more personalized service, credit unions should continue to see growth in their member base.

The results in almost all of these areas pointed to credit unions with some form of credit card portfolio exceeding their non-credit card lending peers. Credit unions with credit cards posted positive balance sheet growth through the end of the second quarter, and that growth was, on average, above the growth of peers with no credit card lending. Within income and expense metrics, credit card lending credit unions again trended above their peers for many metrics. They posted especially impressive numbers for non-interest income based metrics, a key area for credit unions as the low interest rate environment carries on. Member relationship metrics were nearly all in favor of credit unions that offered credit cards, reinforcing the value that credit cards can have for a financial institution.

The conclusion that can be drawn from the financial analysis for this report is that there is no single metric that can be the deciding proof about the value of credit card lending. Numerous metrics must be considered when seeing the impact credit cards can have for a credit union. After looking at components from the balance sheet and income statement and seeing credit card peer groups excelling in many of these areas, the value of credit card lending becomes clearer.

BALANCE SHEET METRICS

A main component of analyzing the value of credit card lending is balance sheet growth. Positive balance sheet growth indicates the credit union is serving existing members and attracting new members through competitive products. Inspecting balance sheet growth can show financial strength over a period of time.

One of the most important balance sheet growth metrics is loan growth. Last June, credit unions with high concentrations of credit cards in their portfolio posted negative 12-month loan growth. Their loan portfolio rebounded in 2012, with credit unions in this peer group reporting 2.0% growth. Credit unions with medium concentrations of credit card lending posted the highest loan growth at 5.2%. Across all peer groups with credit card lending, average loan growth was 4.0%, 1.9 percentage points higher than the credit unions with no credit card loans. Analyzing loan growth over five years shows a similar picture. Average five year loan growth for the credit unions with credit cards was 4.0% versus 2.9% for credit unions that do not offer credit cards.

All peer groups saw positive year-over-year share growth, as consumers increasingly turn to credit unions for their checking and savings needs. 12-month share growth was greatest for low and medium lending credit card credit unions, posting increases of 8.3% and 8.1%, respectively. The growth seen by credit card lending credit unions was significantly higher than the 5.0% share growth reported by their non-credit card peers.

Taking all assets into account, growth was highest for credit unions with credit union portfolios compared to the peer group with no credit card lending. Credit unions with no credit card portfolios had asset growth of 4.9% while the three credit card lending peer groups all posted asset growth numbers above or equal to 7.5%. Leading all peers were credit unions with a medium concentration of credit card lending with asset growth of 8.1% for 2012.

When looking at the balance sheet for credit unions, two key ratios to measure are loans-to-shares and the capital ratio. As share growth has greatly outpaced loan growth over the last few years, the loans-to-shares ratio for all peer groups has decreased continually from their values before the economic downturn. All peer groups maintained around 80% loans-to-shares in 2007, and this has decreased as members continue to pay down debt and save. The highest loans-to-share ratio in 2012 was 68.4% for credit unions with no credit card portfolios. Credit unions with high concentrations of credit card lending are not far behind with a 67.8% loans-to-shares ratio, and credit unions with medium concentrations of credit card lending have a 66.1% ratio, the lowest of all peer groups.

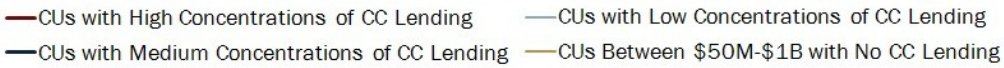
The capital ratio is relatively constant across all peer groups, with credit unions without credit card lending having the highest ratio at 11.8%. This indicates credit unions without credit cards have a slightly higher percentage of assets backed by capital.

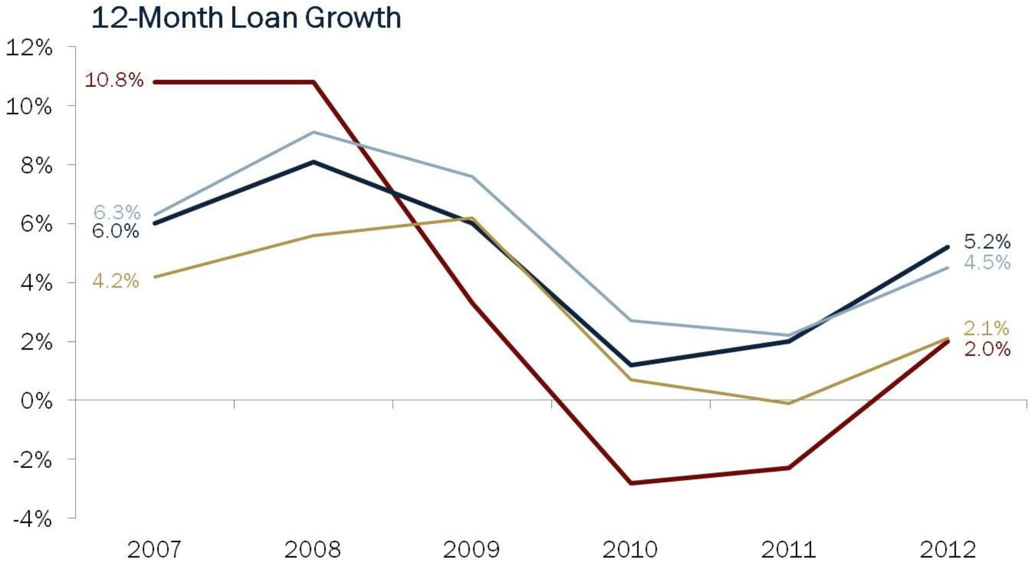
Overall, credit unions who offer credit cards show considerably higher balance sheet growth figures than credit unions without credit card lending. Credit unions with credit card portfolios show advantages in loan growth, share growth, and asset growth—all important measures when looking at the financial condition of an institution as well as the benefit to credit union members.

		CUs with Credit Card Portfolios	CUs without Credit Card Portfolios
12-Month Growth	Loans	3.99%	2.14%
	Shares	7.88%	5.04%
	Members	3.79%	1.33%

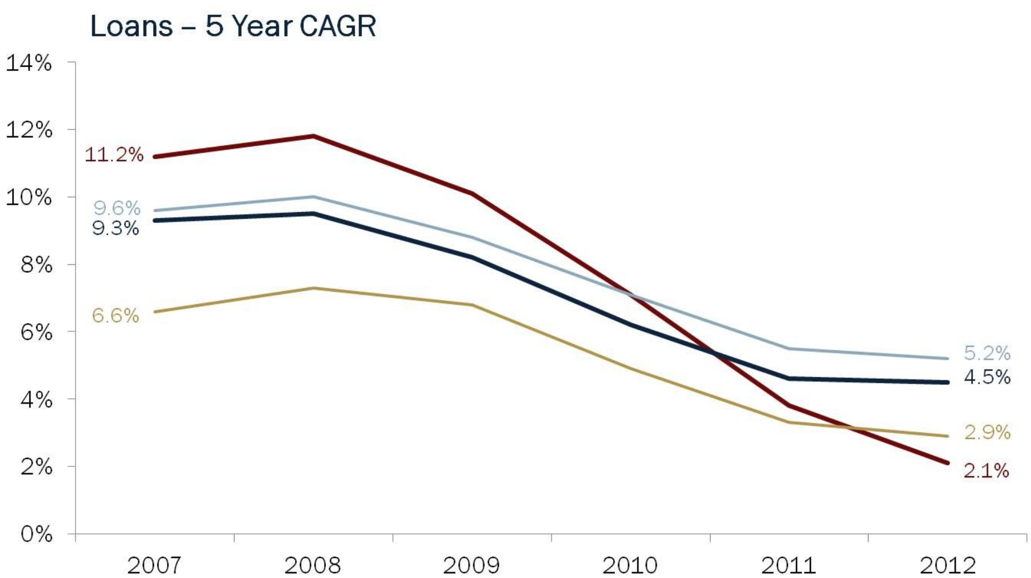
Credit unions with credit card loans in their portfolio outperformed their non-credit card lending peers in asset, loan, share, and member growth, helping to highlight the importance credit cards provide to credit unions.

All data on this page is as of June 30, 2012. The graphs on this page use the following legend:

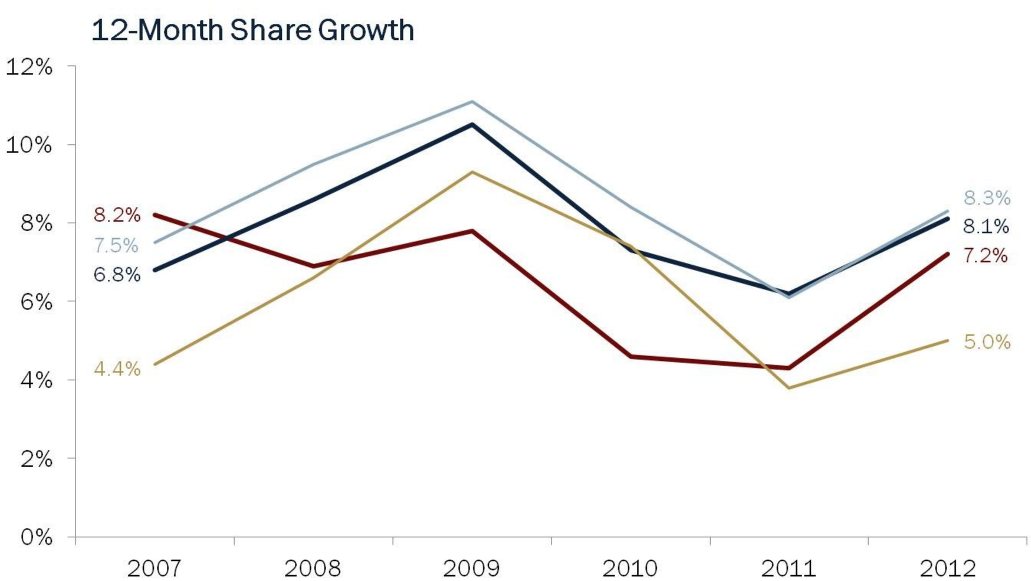




Definition: 12-month loan growth measures the annual growth in outstanding loan balances on the books of credit unions. Loan growth is driven by several factors including the state of the economy, the demographic make up of the membership, the level of risk the credit union is willing to manage, and the credit union's ability to gain market share. The overall market for loans is influenced by the membership's confidence in their ability to handle debt.



Definition: The compound annual growth rate (CAGR) for loans measures what the growth over a period of time (in this case, 5 years) would be if it had grown at a steady, annualized rate. It provides a long-term context to the numbers, while 12-month growth is focused on the short term.



Definition: Share growth is driven by several factors including the state of the economy, the socio-economic make up of the membership, the credit union's ability to pay market rates, and the credit union's ability to gain market share. Credit unions often see an influx in deposits during times of economic uncertainty, the result of credit union members generally having higher levels of trust in a financial institution to which they feel connected.

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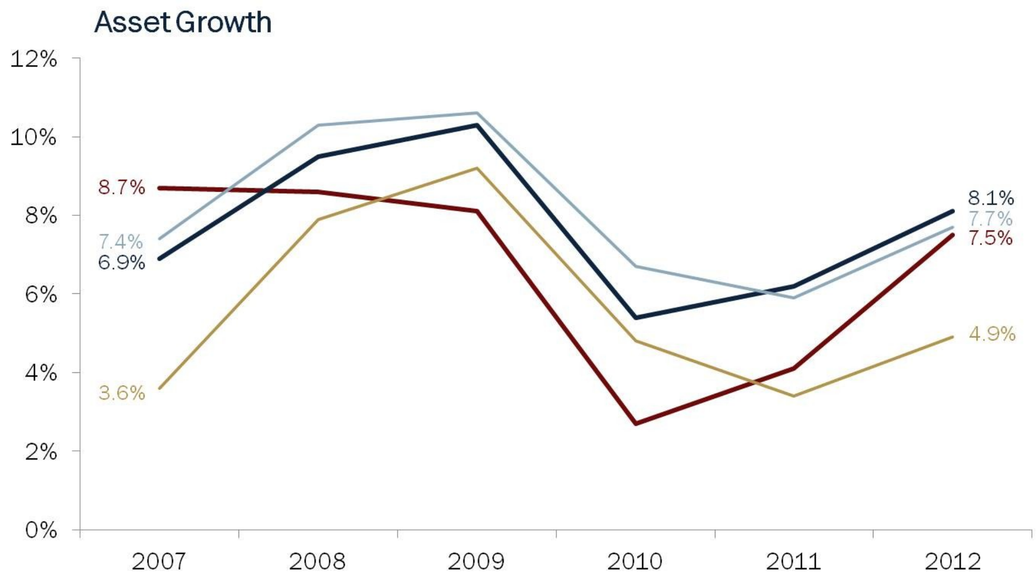
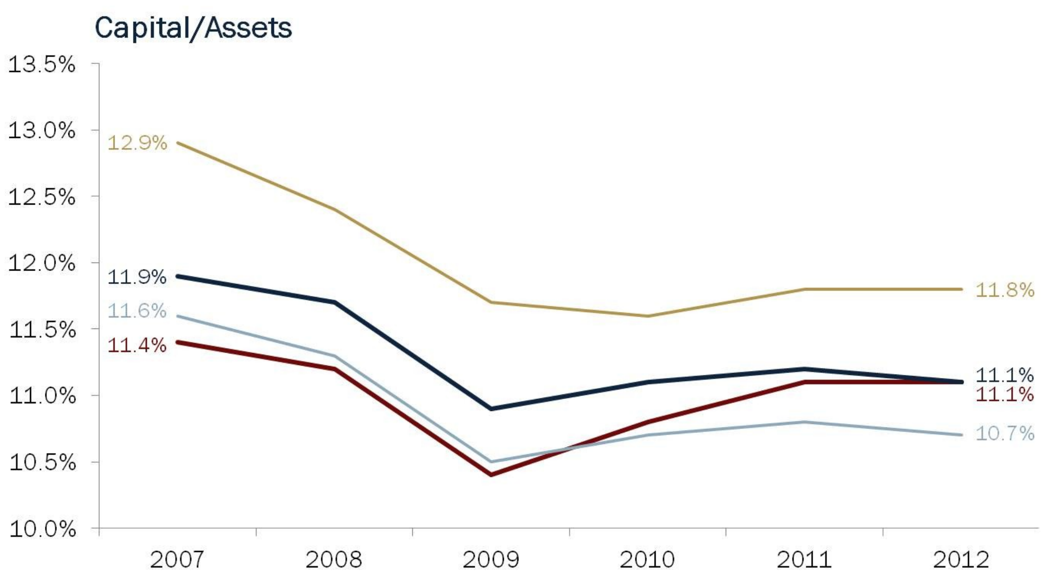
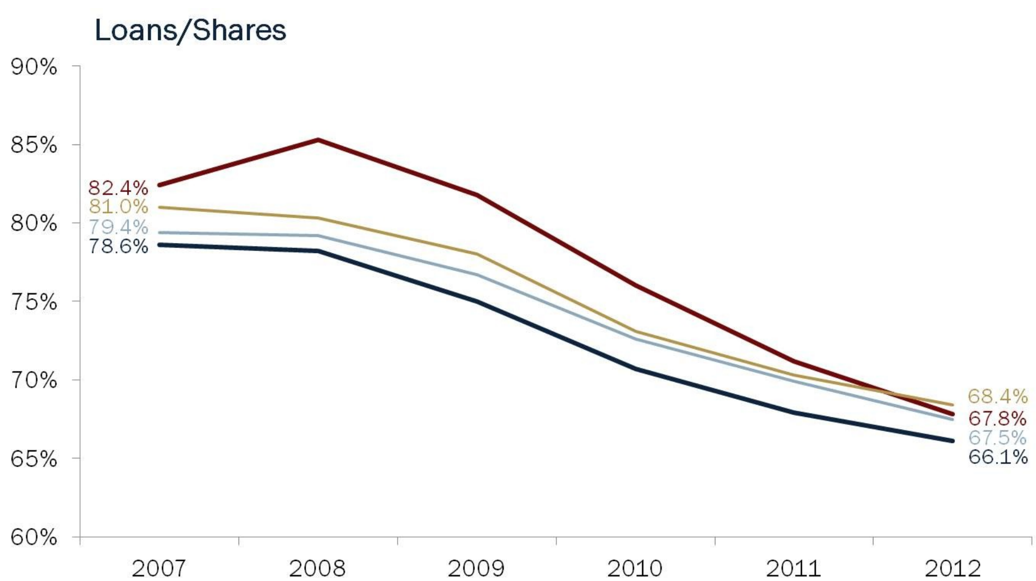
CUs with High Concentrations of CC Lending
CUs with Low Concentrations of CC Lending
CUs with Medium Concentrations of CC Lending
CUs Between $50M-$1B with No CC Lending



Definition: A credit union's growth is a function of external and internal factors. The external factors that impact asset growth include the state of the economy and the make up and size of the credit union's field of membership. The internal factors that impact asset growth include the quality of member service, the menu of products and services, and pricing philosophy. Credit unions with expanding and financially viable fields of membership have the opportunity to realize their potential by offering competitively priced financial services.



Definition: This measure evaluates what percent of a credit union's assets are backed by capital. While credit unions do not want this ratio to go too low, a very high percentage indicates that a credit union may not be using their assets productively. The Capital ratio and Net Worth ratio are two distinct measurements even though they are often inaccurately referred to as one and the same. The Capital Ratio specifically includes Allowance for Loan & Lease Losses while the Net Worth does not.



Definition: A credit union's loan to share ratio is driven by their loan and deposit acquisition performance. Most credit unions concentrate on building the loan portfolio while focusing less on deposits, unless liquidity is an issue. In general, loan growth can be influenced more by the credit union's operations (sale culture, marketing, product development, risk management, etc.) than deposit growth. Deposit growth is generally influenced more by non-operational factors, i.e. the demographics of the membership and economic conditions, than by operational factors. Overall, a higher ratio can lead to greater profitability.

Loan Composition

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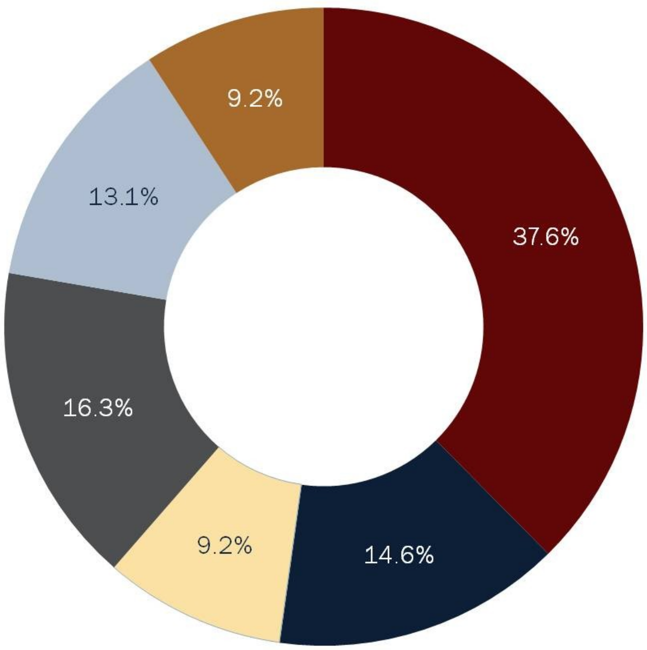
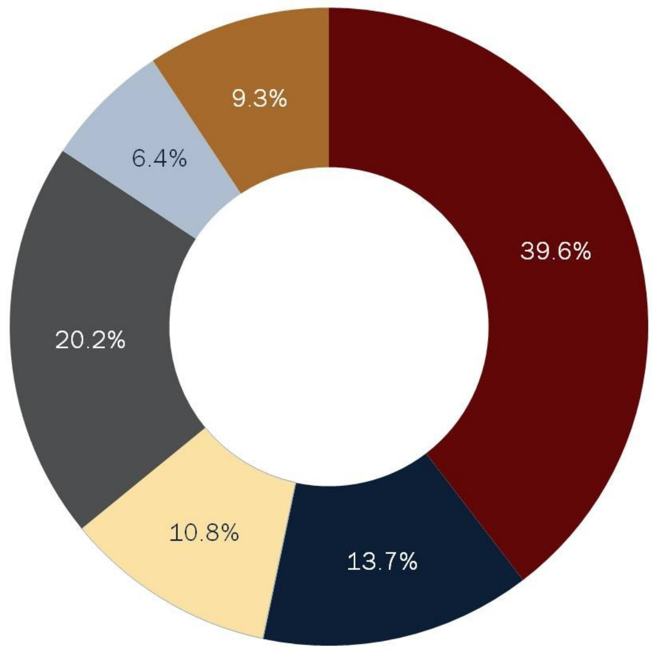
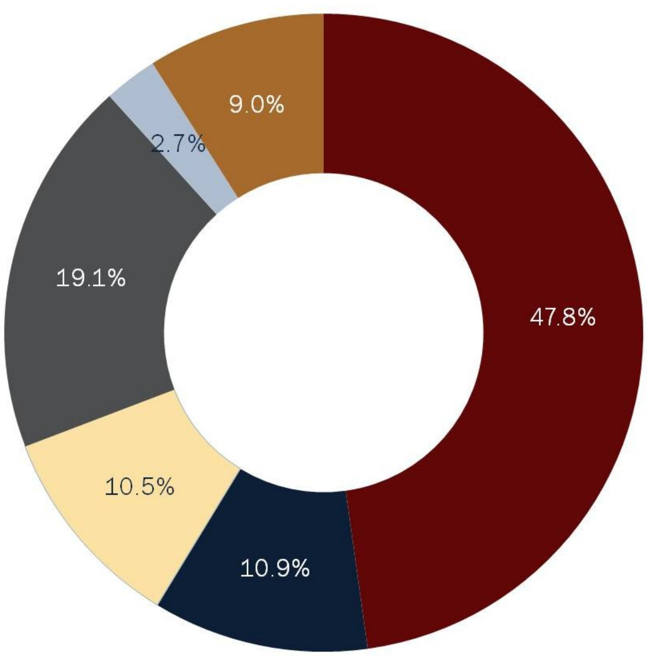
CUs with High Concentrations of CC Lending



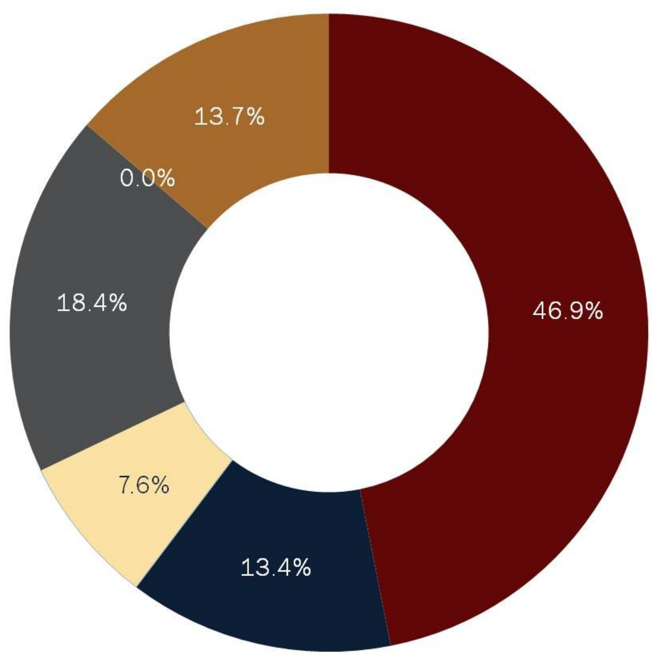
CUs with Medium Concentrations of CC Lending



CUs with Low Concentrations of CC Lending



CUs $50M-$1B with No CC Lending



INCOME AND EXPENSE METRICS

Many income and expense metrics are affected by credit card lending, including multiple non-interest income and efficiency metrics. Credit unions that participate in credit card lending outperform their non-credit card lending peers in most of these metrics.

Non-interest income is becoming an increasingly important source of income for credit unions, as loan interest income has decreased due to the low interest rate environment. The two main components of non-interest income are fee income and other operating income. Fee income as a percent of average assets was identical across three of the peer groups at 0.75%, but credit unions with low concentrations of credit card lending reported that fee income accounted for 0.62% of average assets. Credit unions that offer credit cards are seeing much higher levels of other operating income, as interchange income falls into this category. Interchange income is one of the largest components of non-interest income, despite numerous regulations over the last few years. Credit unions that have high concentrations of credit card lending had an other operating income to average assets ratio of 0.79%, 47 basis points above the credit unions that do not participate in credit card lending.

Fee income, which includes ATM and overdraft fees, was similar across all four peer groups. Credit unions with medium concentrations of credit card lending and credit unions that did not offer credit cards collected the most fee income per member at $79. Credit unions with low concentrations of credit card lending brought up the rear with $71. The impact of credit card lending can be seen in the other operating income per member ratio. Because of interchange income, credit unions that participate in credit card lending are seeing much higher levels of income in this category. Credit unions that had high concentrations of credit card lending collected $82 per member, $48 higher than the credit unions that did not participate in credit card lending.

When looking at non-interest income as a whole, credit unions that had high concentrations of credit card lending were the highest at 1.55% of average assets, while credit unions that did not offer credit cards reported that non-interest income made up 1.07% of their average assets. Diversifying income with non-interest income sources is especially important in the low-rate environment that is expected to continue until at least 2015. Credit unions that can rely on other channels of income besides interest income from loans and investments can help ensure that they will be better prepared to weather economic downturns like the recent recession. Credit unions with high concentrations of credit card lending were deriving 28.1% of their income from non-interest income sources versus 22.5% for their peers with no credit cards.

Total operating expenses were lowest at credit unions with low concentrations of credit card lending at 2.79% of average assets. Credit unions with high concentrations of credit card lending saw operating expenses make up 3.25% of their average assets. The credit unions that did not participate in credit card lending had an operating expense ratio of 3.18%.

The efficiency ratio is measured by dividing operating expenses by total income minus interest expense, and can help a credit union gauge what percentage of their income is going towards operating expenses. A lower ratio is desirable, and all three credit card lending peer groups are significantly below the credit unions without credit card programs. Credit unions with high concentrations of credit card lending had an efficiency ratio of 68.7%, with credit unions with low and medium concentrations right behind at 70.8% and 71.5%, respectively. Credit unions without credit card lending had an efficiency ratio of 79.3%.

Return on assets (ROA) is one of the most commonly used metrics in evaluating how efficiently a credit union can be profitable given its asset base. Credit unions that had high concentrations of credit card lending reported an ROA of 95 basis points in the second quarter, compared with a ROA of 60 basis points for credit unions that did not offer credit cards. All three credit card lending peer groups outperformed non-credit card lending peers in this metric.

Overall, credit unions that offer credit cards at any level are typically seeing more favorable ratios in this category. They are more efficient and are seeing higher and more diverse levels of income, allowing them to continue to invest in areas that will better serve their members in the future.

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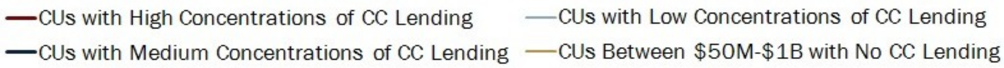
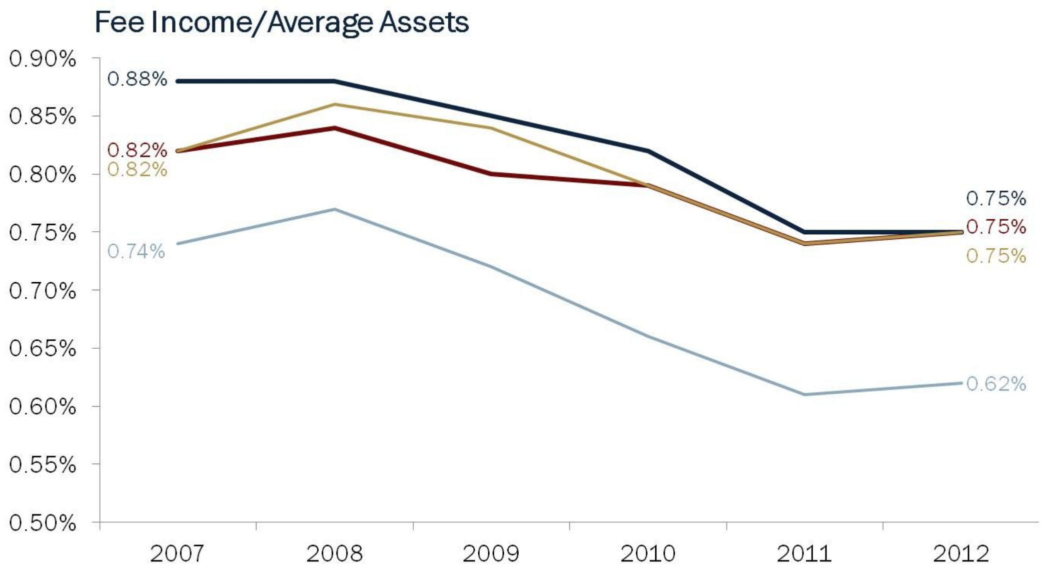
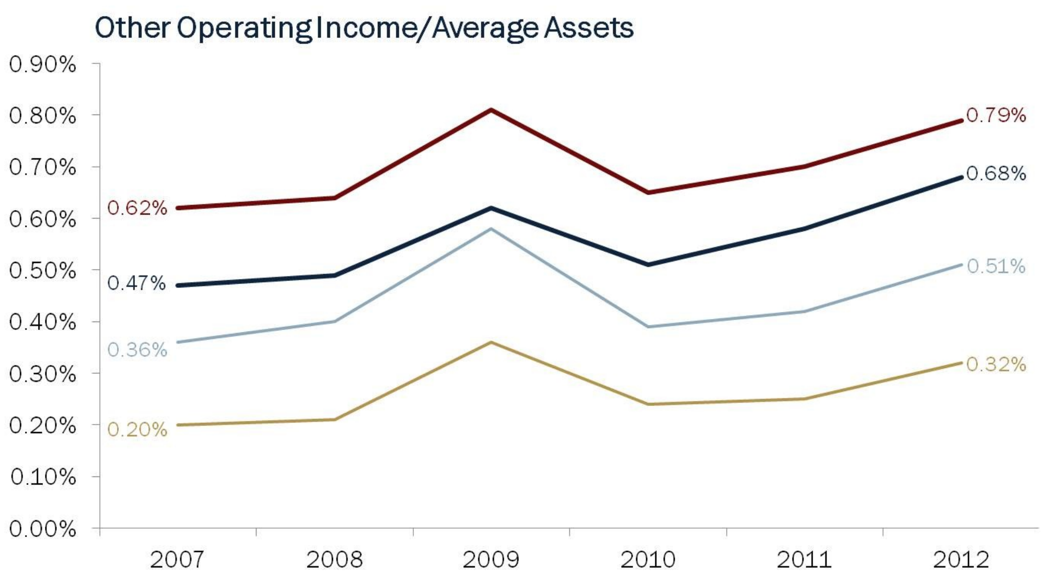
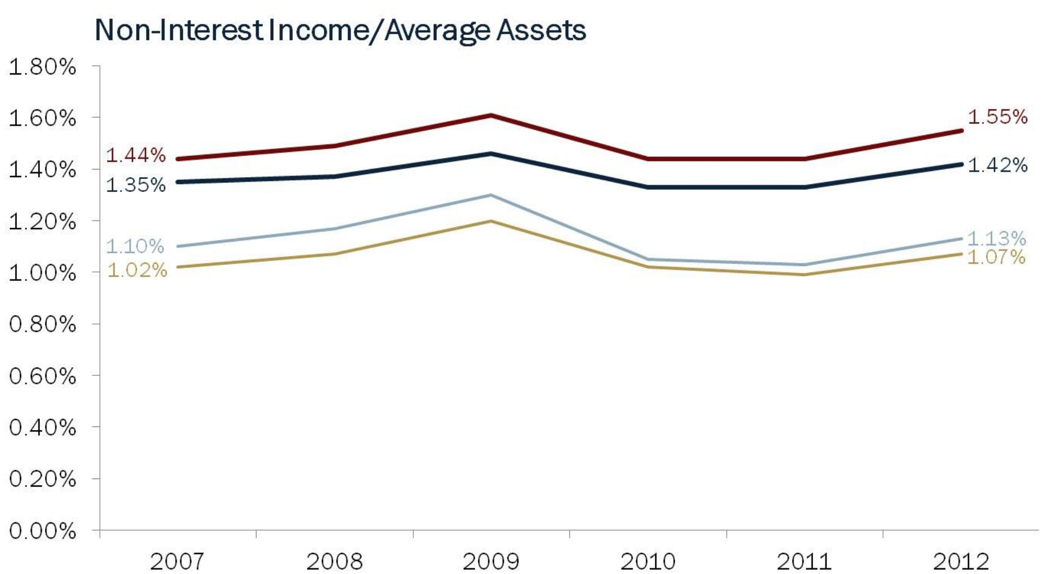




Definition: The amount of fee income is primarily driven by the credit union's fee strategy. The strategy is often a function of the credit union's field of membership and other aspects of the credit union's overall financial structure. The results of the credit union's spread management ability, which is net interest income, their level of productive operations, which translates into operating expenses, and their ability to generate other income from indirect sources, are generally the foundation of a credit union's fee strategy. A credit union's fee strategy is generally designed to fill in the shortfall between the results of all the other aspects of net income and the credit union's ROA goal.



Definition: Other operating income includes multiple components, including dividends from the NCUSIF, income or loss derived from selling real estate loans on the secondary market, interchange income, interest income earned on purchased participations not qualifying for true sales accounting under GAAP, and unconsolidated CUSO income.



Definition: Non-interest income factors that impact the ratio generally fall into two major categories: income generated directly from the member in the form of fees and income generated indirectly from members or other aspects of the credit union's operations, i.e. interchange income from credit and check cards and income from CUSO activity. Another factor in the ratio is the credit union's member participation both in terms of use of balance sheet products and the members' use of other products and services.

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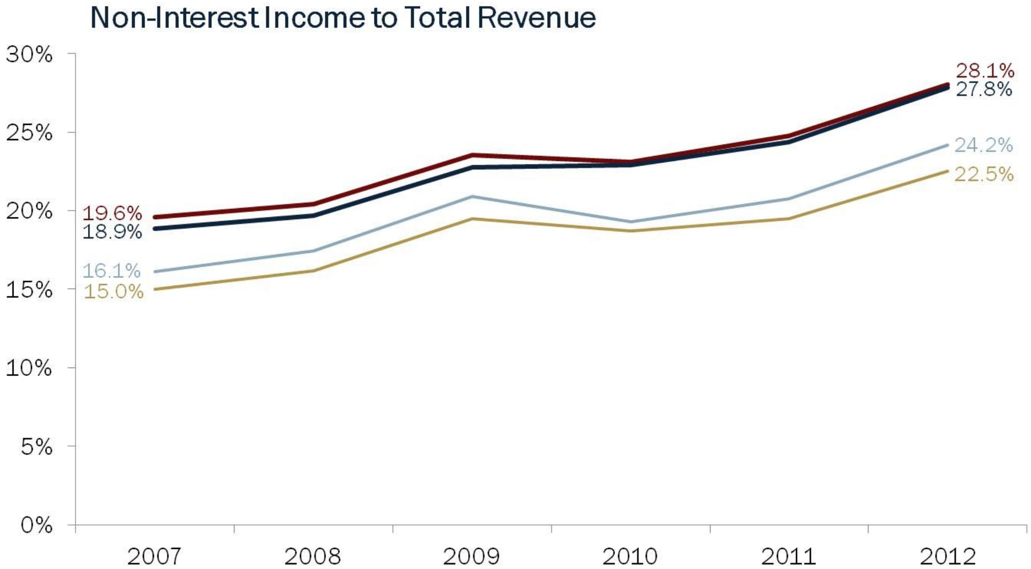
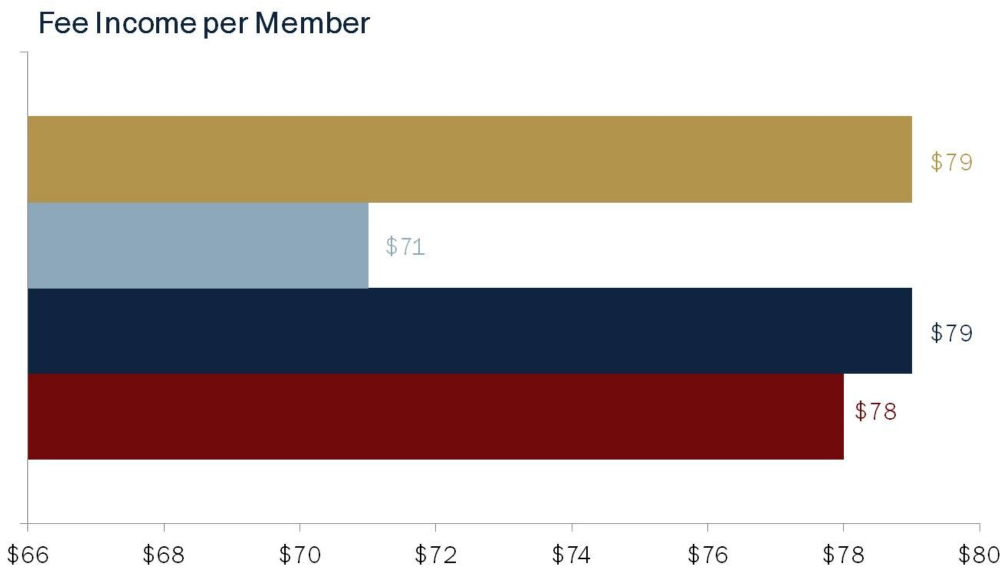


Definition: This ratio measures the relationship between total income and non-interest income. The higher the number, the more the credit union relies on income generated from sources other than asset based sources of income, i.e. interest on loans and investments. This ratio is most influenced by three strategic decisions: the credit union's lending philosophy, the credit union's philosophy towards spread management and the credit union's emphasis on developing non-balance sheet forms of income.



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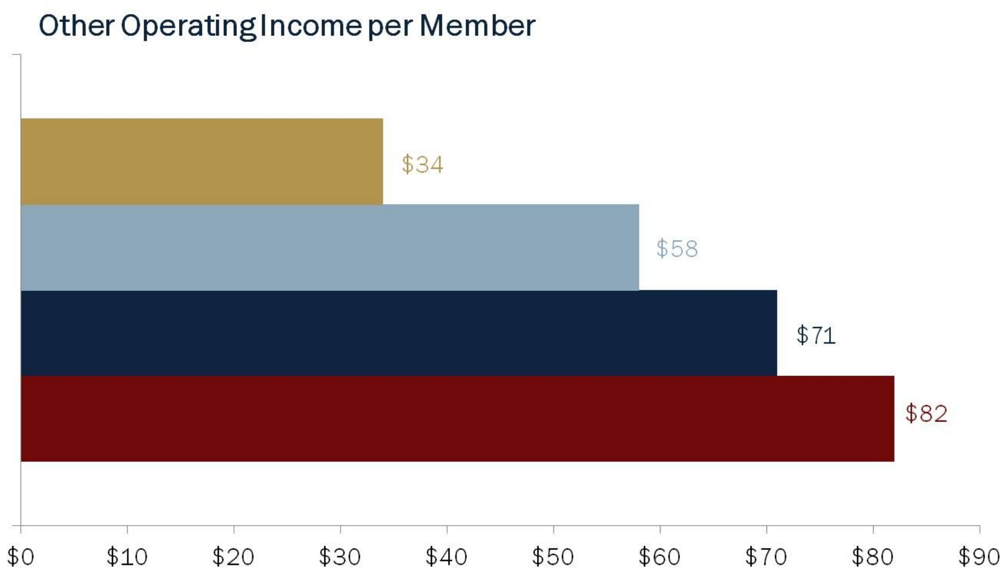

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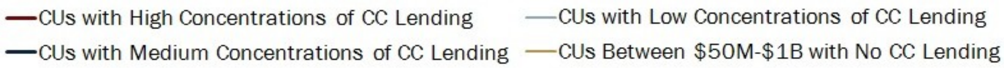
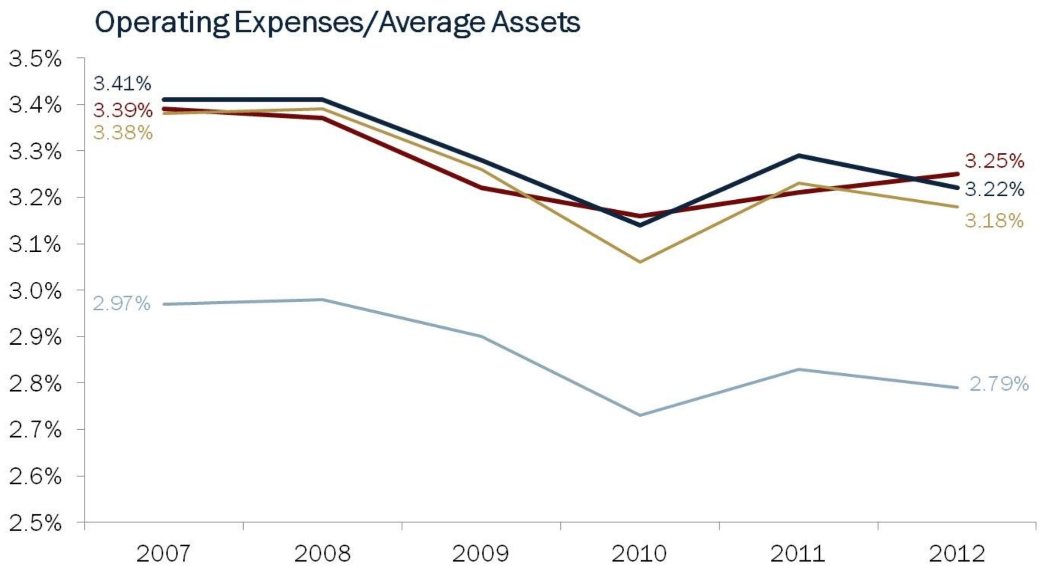
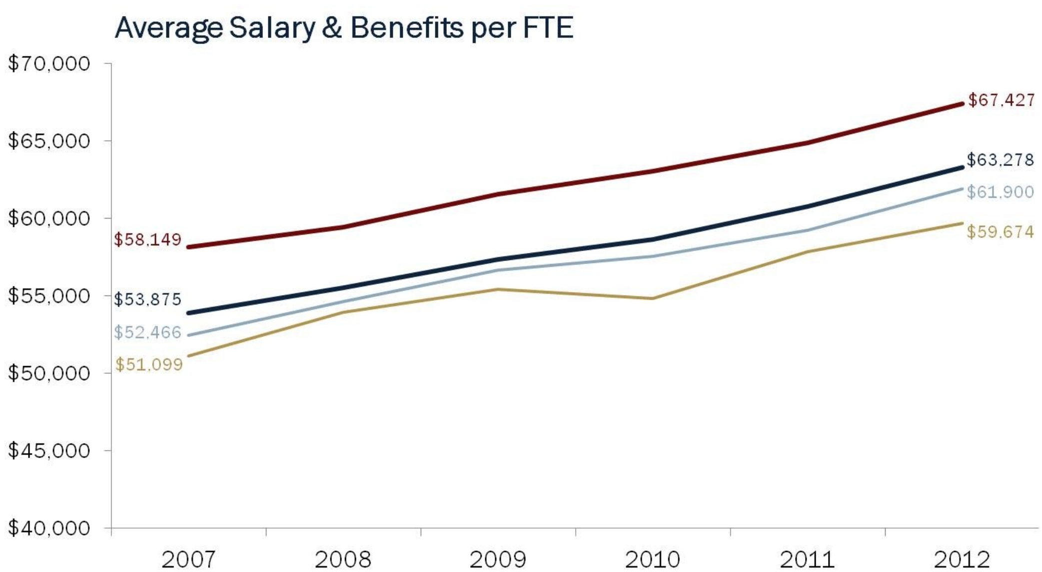
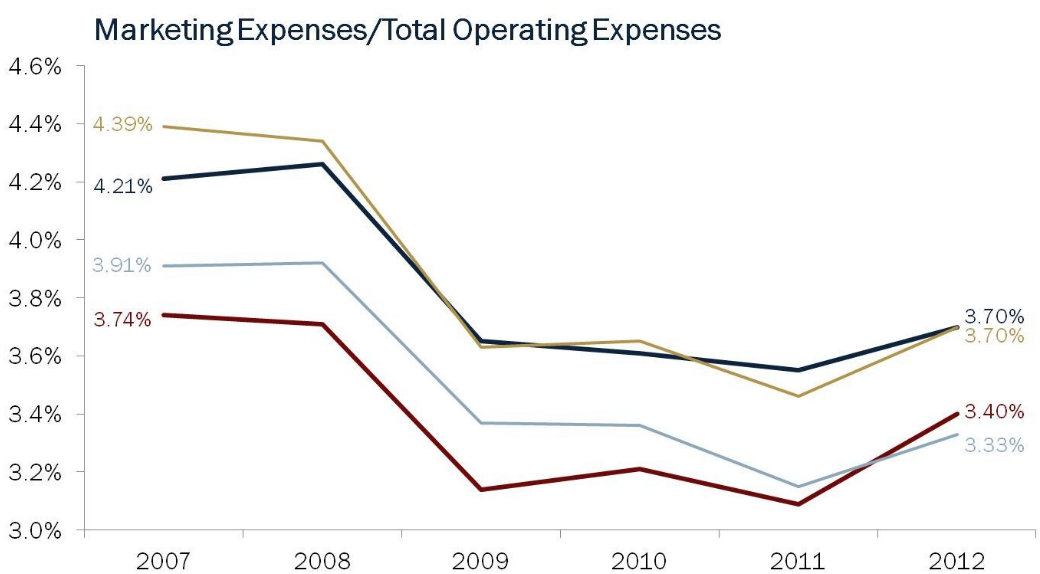




Definition: Operating expenses to average assets reflects both the operating efficiency and the operating strategy of a credit union. Managing operating expenses is a key aspect of the ability to generate a solid bottom line since net interest margins continue to trend lower. Whether through internally-driven economies of scale or cooperative efforts with other credit unions, initiatives to manage expenses more efficiently can have a significant impact on a credit union's market competiveness and the value it creates for members.



Definition: The total cost of a credit union's human resources is the largest single operating expense for most credit unions. The average salary and benefits paid per employee is a measure of several aspects of a credit union including its location, the productivity of employees, the board of directors' philosophy toward compensation and benefits, and the organizational structure. Credit unions that have developed highly productive operations generally will have fewer but higher paid employees, so while average cost per employee may be high, overall cost may be less than peers.



Definition: Marketing expenses to total operating expenses helps to put in perspective what credit unions are spending to promote themselves. As credit unions must continually be promoting themselves, this ratio is unlikely to vary too much in the long run.

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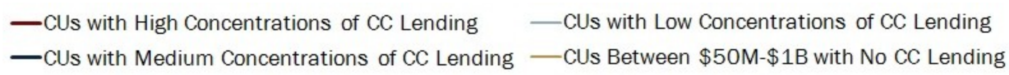
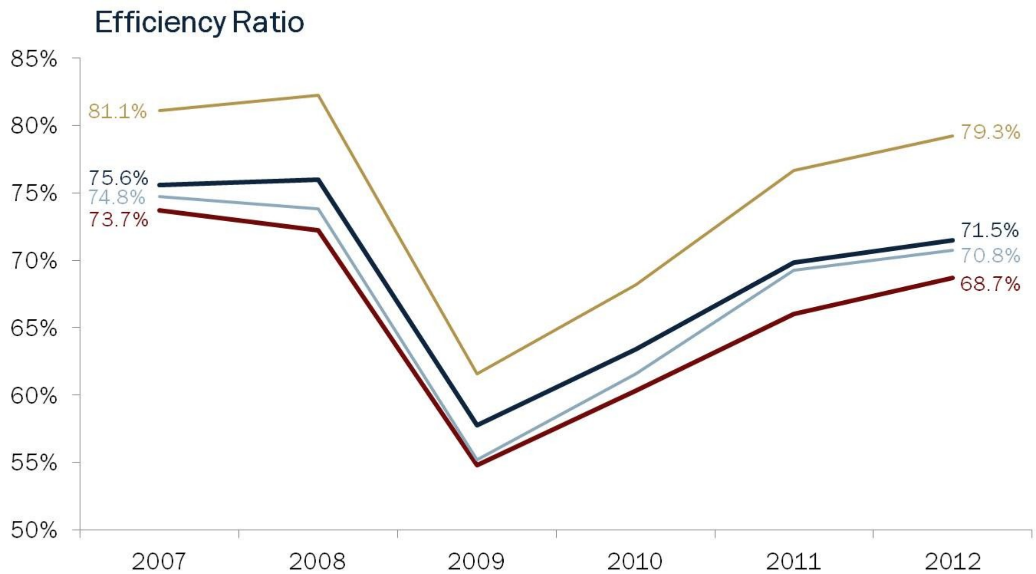
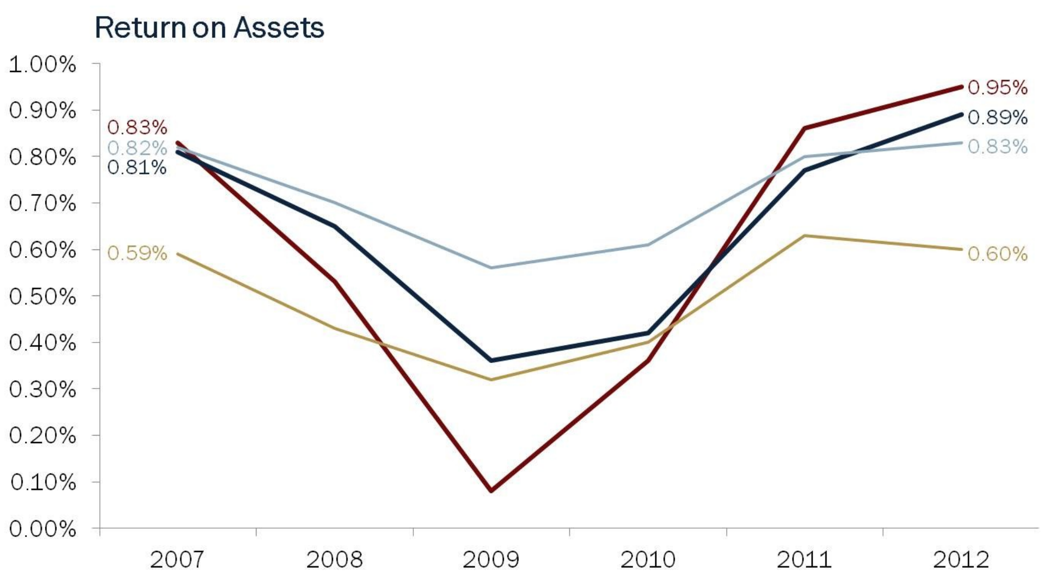




Definition: The efficiency ratio divides a credit union's operating expenses by total income minus interest expense. A lower efficiency rate is better, as it means the credit union is more comfortably able to cover operating expenses. The efficiency ratio can fluctuate over time, influenced in part by the interest rate environment in that income is generally more sensitive to changes in interest rates than expenses are. Credit unions with higher ratios of fee income to total income should see less fluctuation in the efficiency ratio than credit unions with little fee income.



Definition: Return on Assets (ROA) is an important gauge of a credit union's profitability. ROA provides insight into how efficiently a credit union is being run by management and their ability to generate profits from the assets available to the credit union. It reveals how much income management is able to generate from each dollar's worth of a credit union's assets. In general, a high ROA relative to one's peers reflects management's success at utilizing its assets to generate income.

Member Relationships

Holding a credit card with a financial institution can have a significant impact on how a member interacts with that institution. A credit card is a critical part of building a solid financial foundation, and much of the data in this section shows that credit unions that participate in credit card lending are seeing deeper and more profitable relationships with their members.

The overall average member relationship is calculated by adding the total dollar amount of loans (excluding business loans) and total dollar amount of shares together, and then dividing that by the number of total members. The three peer groups that offered credit cards had an average member relationship value of $15,587, $745 more than credit unions that do not offer credit cards. That peer group had an average member relationship of $14,842.

The average loan balance for credit unions that do not participate in credit card lending is over $18,600. This is higher than all credit card lending peer groups, as credit card loans are typically smaller than other types of loans because they are revolving in nature. The balance on a credit card can vary significantly from month to month, and many members completely pay down their balance at the end of the month to avoid interest charges.

On average, credit unions that offer credit cards have a stronger share draft penetration rate, which is the number of share draft accounts divided by the number of members. Credit unions that have high concentrations of credit card lending had a share draft penetration rate 9 percentage points higher than credit unions that do not offer credit cards. Share draft penetration is one of the most important metrics for member usage, as the financial institution where a member has their checking account is likely to be their primary financial institution. High share draft penetration rates lead to more robust and profitable members, and this is seen in the average accounts per member. Credit unions with high concentrations of credit card lending reported 0.6 loan accounts per member versus 0.4 accounts per member at the credit unions that do not do credit card lending.

Credit unions nationwide saw record member growth over the last year due to increased anti-bank sentiment and increased credit union promotion, and credit card lending peer groups reported higher growth than their non-credit card peers. Credit unions that have low concentrations of credit card lending posted member growth of 4.2%, more than three times credit unions that do not offer credit cards. Credit unions with credit cards also posted higher membership penetration figures, which is total members divided by potential members. Credit unions with high concentrations of credit cards were capturing 6.8% of potential members, 2.3 percentage points higher than their peers who do not do credit card lending.

Credit unions offering credit cards collected more non-interest income and total income per member than their peers without credit cards. Non-interest income has increased in importance as the low interest rate environment continues, and credit unions with high concentrations of credit card lending reported non-interest income per member of $161, $48 more than credit unions that do not participate in credit card lending. Total income per member was $69 higher at the credit unions with high concentrations of credit card lending versus credit unions that do not offer credit cards.

Although the credit unions that offer credit cards have seen increased income, operating expenses per member are similar across all peer groups.

Credit unions that offer credit cards have a higher troubled loan rate than credit unions that do not participate. The troubled loan rate is the sum of all delinquent loans and net charge-offs divided by outstanding loan balances. Credit unions that have high concentrations of credit card lending had a troubled loan rate 36 basis points higher than credit unions with no credit cards. This is due to credit cards having a larger percent of their loans being charged off than other types of loans, which is driving the troubled loan rate higher for credit unions that more heavily focus on credit card lending.

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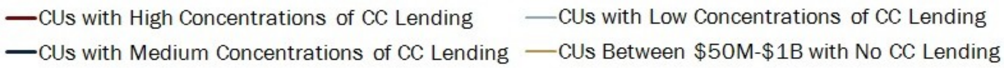
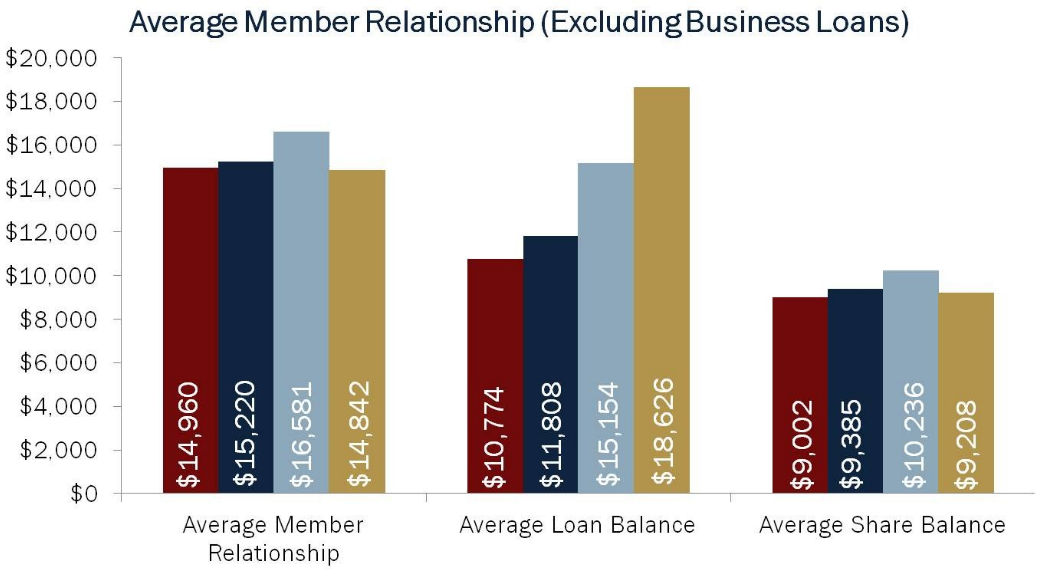
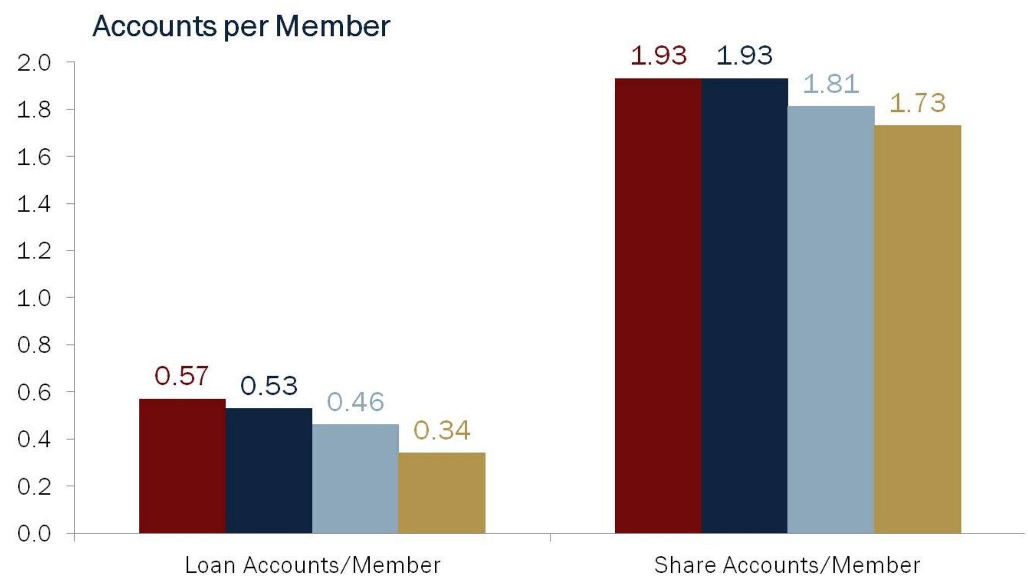
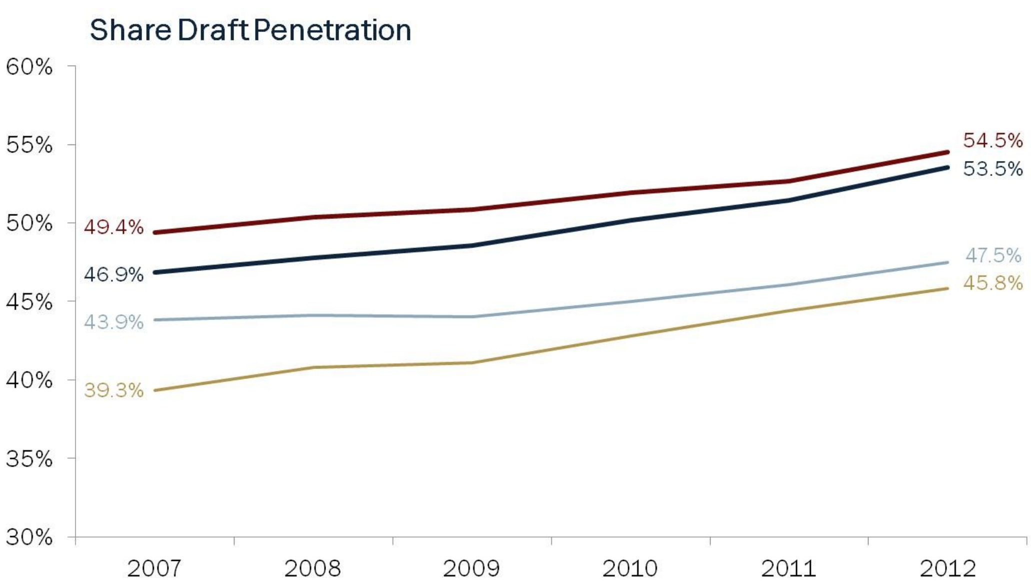




Definition: The average member relationship reflects how much a retail member is utilizing a credit union's share and loan products. A credit union's pricing strategy, underwriting policies, product mix, and the effectiveness of service levels and sales culture contribute to this performance measure. In addition, the makeup of the field of membership and current economic environment can have an impact. Factors that can contribute to higher share and loan balances include offering products at competitive rates, a more affluent membership, and offering a variety of loan and deposit products. A credit union's ability to market and sell loan and deposit products can also have a measurable impact on the average relationship per member.

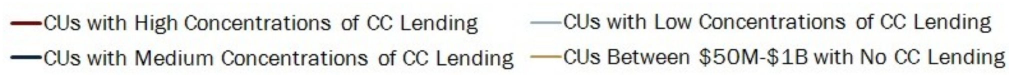


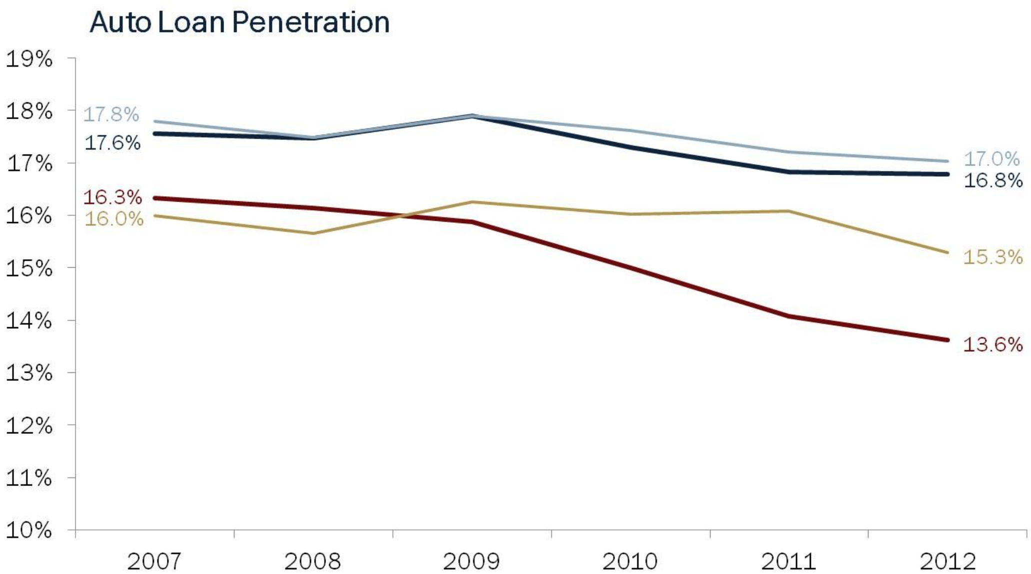
Definition: The number of share and loan accounts per member provides a rough metric for what the average member has in terms of share accounts and loans with the credit union.



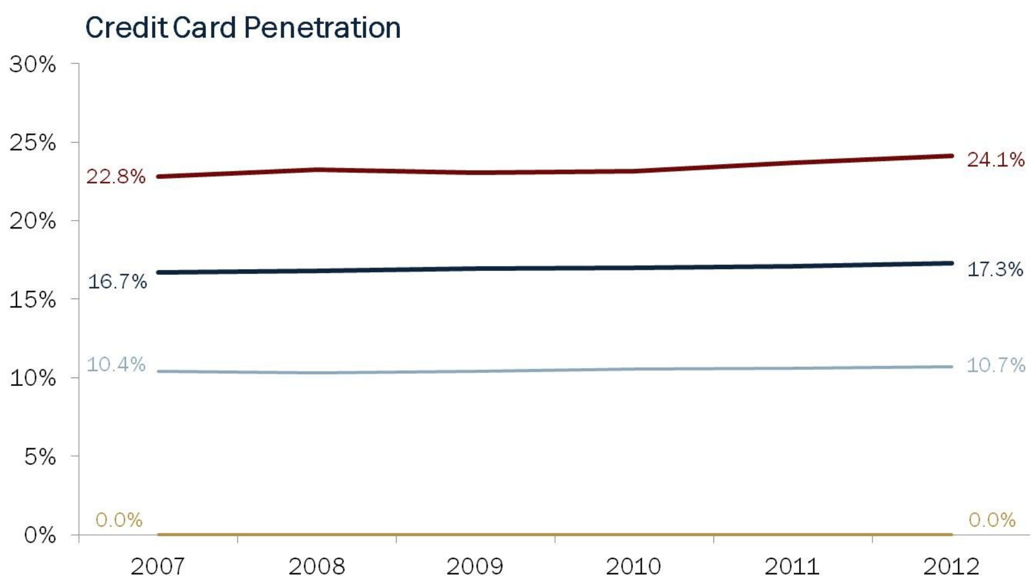
Definition: A credit union's share draft penetration is an excellent measure of the membership's participation in the credit union. The checking account is generally the central account for most families and indicates the financial institution that the member contacts first when looking for additional financial services. This account is the doorway to additional products and services. When priced appropriately, for example low or no dividends and appropriate fees, the account is also a net contributor to income.

All data on this page is as of June 30, 2012. The graphs on this page use the following legend:

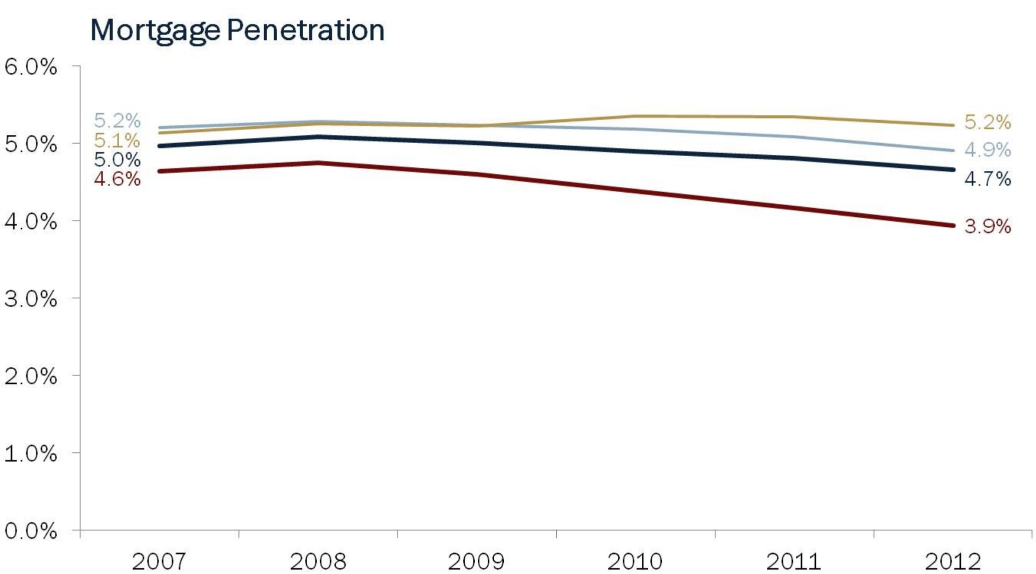




Definition: Auto loans are the primary source of income for most credit unions. Auto loans can be highly profitable, have broad market appeal, and can be a productive use of operational resources. However, auto loans can carry additional risk, particularly if the credit union does not have good risk control procedures. These loans are also not necessarily good relationship builders and the market place is highly competitive. Successful auto lending credit unions generally have relationships with auto dealerships either through buying programs/indirect lending programs, solid risk management policies/ procedures, several delivery channels for loans, and effective marketing/ sales programs.



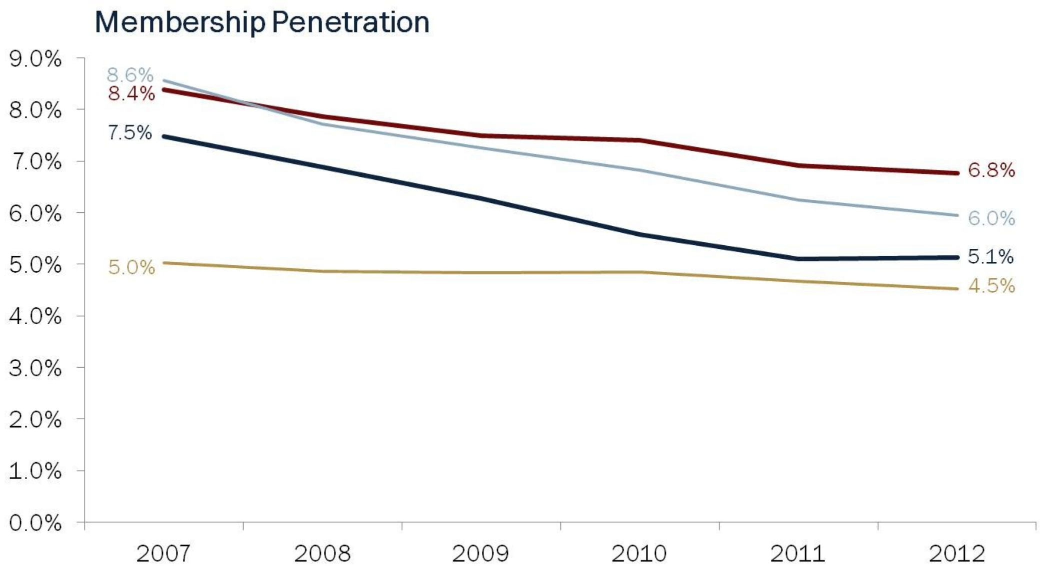
Definition: As a financial service, the credit card is as ubiquitous as a checking account. Most households have one credit card account and it is essential to function in today's society. A credit card account can therefore be a relationship building account along with the checking account and a real estate loan. Operationally, credit cards generally require a high resource allocation and the development, either internally or externally, of a high level of operational expertise. Credit cards also have unique risk management characteristics which can lead to extraordinary losses if not managed correctly.



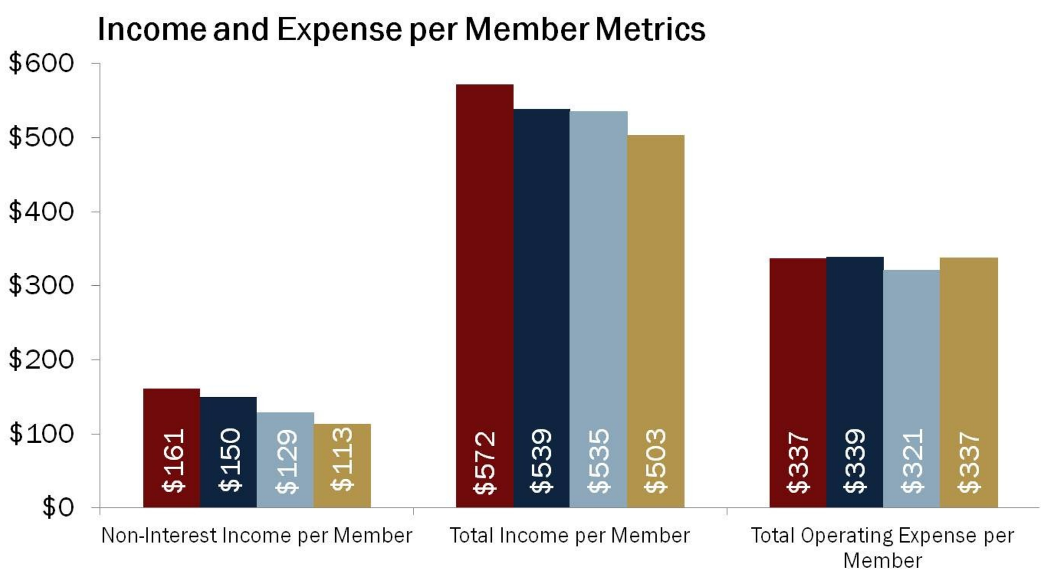
Definition: Mortgage penetration is measured by taking the total number of mortgage loans at a credit union and dividing it by the number of members. It assumes that each member only has one mortgage, so it can be inflated slightly at an individual credit union if they have lots of members with multiple mortgages. This metric historically is one of the lowest among the various penetration rates.

All data on this page is as of June 30, 2012. The graphs on this page use the following legend:

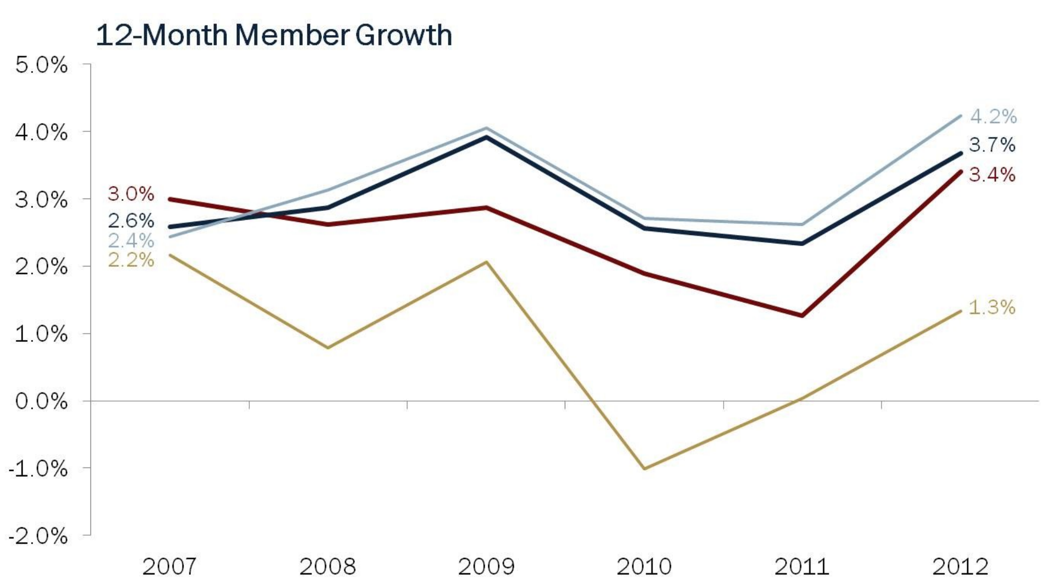
CUs with High Concentrations of CC Lending
CUs with Low Concentrations of CC Lending
CUs with Medium Concentrations of CC Lending
CUs Between $50M-$1B with No CC Lending



Definition: Membership penetration measures the actual number of members at a credit union compared to the number of members they could potentially have given their field of membership.



Definition: Non-interest income per member measures the amount of income generated per member, and generally the higher the number the higher the members' participation in the credit union. Non-interest income factors that impact the ratio generally fall into two major categories – income generated directly from the member in the form of fees and income generated indirectly from members or other aspects of the credit union's operations, i.e. interchange income from credit and check cards and income from CUSO activity.



Definition: Member growth is the result of applying business strategies to the credit union's marketplace. The business strategies used to acquire new members are driven by the board's philosophy towards service levels, delivery channels, product pricing, and the breadth of services offered. Consumers join a credit union for a variety of reasons but generally the predominant reason is that the credit union fulfills or meets some need. Therefore the variety of products and services offered will have a direct correlation to the number of members joining the credit union.

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CUs with High Concentrations of CC Lending
CUs with Low Concentrations of CC Lending
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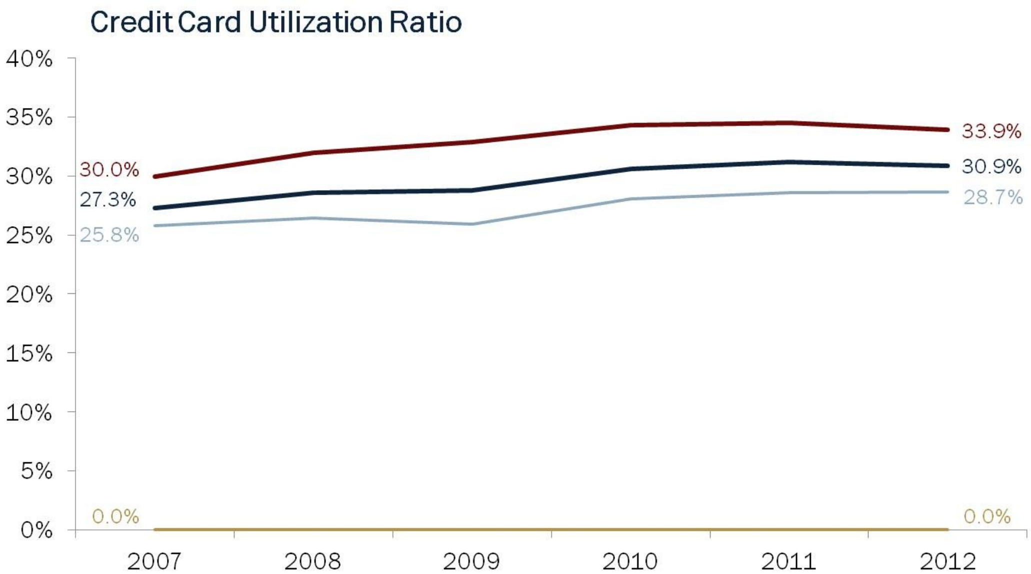
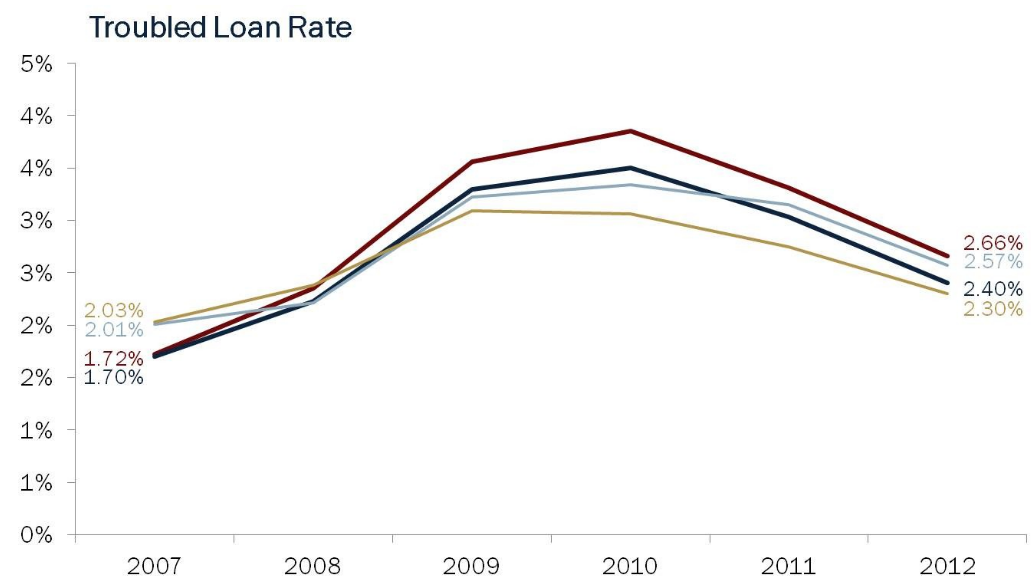


Definition: This credit card utilization ratio measures the amount of credit members are using as a percentage of the credit available to them. A high utilization ratio can be both harmful or helpful to a credit union depending on the members' payment history. With high utilization comes higher interest income from carrying a balance, while also increasing the chance that a member may fall behind on their payments.



Definition: The troubled loan rate is the sum of a credit union's delinquent and charged-off loans divided by total loan balances. The level of troubled loans a credit union can sustain is a function of several factors including the level of income generated by the loan portfolio, the quality of the credit union's management of credit risk and its ability to manage loan losses. Generally real estate loans have lower actual losses because of the value of the collateral; to a smaller extent this is also true with auto loans. High concentrations of troubled unsecured loans result in higher losses.