Credit Union National Association CUNA

Policy Analysis Issue Brief

A Looming Crisis

Mike Schenk, Chief Economist // March 11, 2020

Black swans have been circling like hungry vultures. And it appears one has now come home to roost.

Today, the U.S. economy faces its biggest threat since the Great Recession.

In our February economic forecast CUNA economists describe a generally healthy but slower-growing economy in 2020. That outlook rested on a foundation of a healthy household sector (which accounts for roughly 70% of U.S. economic activity): Unemployment had been scraping along near 50-year lows; Debt-to-income exposures were trending down and running near 20-year lows; equity markets were setting records; and national inflation-adjusted home prices eclipsed pre-recession levels.

Against that backdrop, consumers shrugged off a long list of shocks that included a damaging and counter-productive trade war, military action with alarming "locked-and-loaded" rhetoric in the Middle East, Brexit uncertainty, Hong Kong unrest, and a toxic political environment including impeachment and foreign interference in U.S. elections.

COVID-19 – first and foremost a world-wide humanitarian challenge – has rocked financial markets over the past few weeks. Public health concerns are growing significantly. And the mild U.S. economic slowdown we predicted just two short months ago will almost certainly be magnified.

Indeed, the U.S. economy may now be entering the early stages of a recession. At the very least, economic growth in the first half of 2020 will be more disappointing than CUNA economists originally forecast. Unemployment will be rising. Some regions of the country – and some sectors of the economy - will experience disproportionately harsh economic conditions.

These developments will have significant financial and operational consequences for credit unions. The effects, most of which already are observable, will become more pronounced going forward and some may be seen for years to come. They include:

- Near-zero interest rates with more distinct net interest margin pressure
- Faster savings and asset growth
- Potentially significant increases in loan delinquencies and losses
- Downward pressure on net income
- Lower net worth ratios

Understandably, these trends get the attention of credit union boards and senior management. A natural reaction is to jump into action to quickly take whatever steps are necessary to reverse those results.

But, as was the case entering the Great Recession, we urge caution in credit union responses.

It's certainly appropriate to closely monitor the situation and to evaluate the specific reasons for any negative results experienced by your credit union. However, it's also important to understand that financial challenges occurring because of the world health crisis and expected economic slowdown are neither signs of operational/oversight deficiencies nor are they likely to last for long.

That, of course, means the appropriate action to deal with these challenges will likely be modest for most credit unions.

Today, most credit unions have very strong balance sheets and near-record-high capital levels. Therefore, the best course of action is for credit unions to avoid knee-jerk reactions - to closely study financials and (when possible) - to let the capital position do its work: to temporarily let net income fall as a result of margin pressures and modest loan losses.

This will require both a careful review of your credit union's budget and financial situation and a clearly documented plan. But it is imperative to avoid doing unnecessary near-term harm to the credit union that would result from trying to maintain net income in the current environment. This means:

- Credit unions that have more than adequate capital should not find it necessary to penalize members of the credit union with higher loan rates, more and higher fees, lower dividend rates, service cutbacks or layoffs just to keep net income from falling.

- Rising delinquency and loan losses require close monitoring and active collections, but they do NOT necessarily call for a tightening of credit standards.

- The best response to a decline in net income caused by lower interest margins or rising loan losses may be to adjust your budget and then carefully let it happen.

In uncertain times like these I think back to the memo I received in my side-job as volunteer at a local credit union. It was sitting at my place in the board room just-after the shocking implosion of Lehman Brothers in September 2008. The world financial system clearly teetered on the brink of collapse.

Our then-CEO wrote:

> *A year ago, we didn't face the kind of economic uncertainty that we face today. We also weren't dealing with operational issues of the size and complexity that we are presently dealing with.*
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> *And yet, our greatest challenge may not be the condition of the economy. Or whether we can convert data processing systems. Or even our ability to absorb or avoid hits to our loan or investment portfolios.*
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> *Our greatest challenge, unlike anything else in our history, is to see beyond our own narrow self-interest, to forego our individual agendas in favor of our common purpose, to promise ourselves that tomorrow we all pull in the same direction no matter what we did. Or thought. Or experienced yesterday.*
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> *In short, to look less in the mirror and more out the window. Because out the window are the people who need our credit union to help them manage through this mess.*

Not all credit union board members got that memo. But collectively, all behaved as if they read it.

While we don't expect anything close to a "Great Recession" in the months ahead, the advice given by CUNA economists in 2008 seems appropriate today. There are often opportunities for well-positioned market participants in times of financial dislocation.

With strong capital positions and very stable balance sheets, we believe that many should continue to focus on the difference they make in members' lives in the current situation.

By keeping an even keel and letting capital absorb much of the short-term dislocation, credit unions can once again show both members and nonmembers the unique and substantial benefits of the cooperative structure.