Managing Through Tough Times

Issues and Considerations for Small Credit Unions

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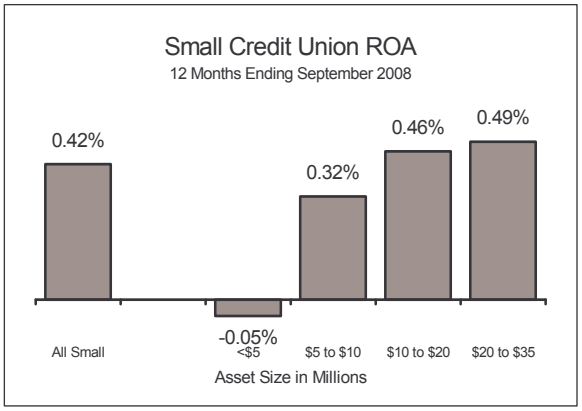
A dramatic deflation of the U.S. housing bubble spawned severe financial market dislocations, including a widely-reported credit crunch. The bottom-line economic impact of these developments has been stunning. The National Bureau of Economic Research recently announced that the U.S. economy is in recession and that the downturn began in December 2007.

Deteriorating labor markets are a key concern. Job declines totaled 533,000 in November 2008 and nearly two million since the start of the year. The Bureau of Labor Statistics reports the unemployment rate climbed to 6.8% in November (up from a cyclical low of 4.4% in June 2007). And the jobless rate is likely to rise, perhaps nearing 9% in 2009.

Some regions of the country – especially those with pronounced housing market adjustments – have experienced disproportionately harsh economic conditions. Regions which have avoided nasty consequences to date are likely to feel more pain.

Of course, these developments cause significant financial and operational issues for many credit unions. And those issues loom especially large at the nation's smallest credit unions.

Even in good times, small credit unions tend to face challenges in a way that larger credit unions don't. Pressures on small credit union leadership are great because they must be intimately involved in all aspects of credit union operations. Their small size, without the benefits of economies of scale, magnifies the challenges they face. Competitive pressures from large multi-state banks, non-traditional financial services providers, and field-of-membership overlaps each increasingly provide substantial challenges. Greater regulatory burdens, growing member sophistication, loss of sponsors, and difficulties in obtaining training and education also loom large for most of the nation's small credit unions.



A bad economy can make things even worse. Small credit unions have more intimate relationships with their members. And member needs increase in recessions: They experience more personal financial difficulty; job losses mount; retirement funds dwindle; debt loads balloon; divorce rates rise. Small institutions come under tremendous pressure as they attempt to advise and consult with these members.

Of course, there are bottom-line influences as well. Recently-released NCUA data shows that credit unions with less than $35 million in assets recorded return on assets (ROA) of just 0.42% (a year-to-date annualized result). That's down from 0.61% in 2007. Perhaps more disturbing, the recent results reveal that 23% of small credit unions were "unprofitable" (with negative ROA) -- up from 14% in 2007.

There are some hopeful signs, however. While many small credit unions continue to find growth elusive, growing small credit unions are actually easier to find today. Only about one-half of small credit unions grew in 2007, but over two-thirds recorded asset growth in the 12-months ending

September 2008. The group's 5.6% 12-month asset increase was the strongest in many years – boosted by members' flight to safety and their increased desire to build balances in short-term, liquid rainy day funds.

Asset quality in small credit unions is little-changed. Both delinquencies and net chargeoffs are about equal to their levels over the past five years. Also, the 14.2% net worth ratio average remains near all-time highs and 98.2% of the nations' nearly 6,000 small credit unions have net worth of 7% or more.

Notwithstanding these positive results, navigating today's treacherous economic waters can be difficult. Negative trends get the attention of credit union boards and senior management. A natural reaction is to jump into action. But is that the best course? As financial results come under increasing pressure how should small credit union boards react? CUNA's Small Credit Union Committee members recently convened and discussed these questions. While their answers may not be very unusual, they certainly offer food for thought.

First and foremost all agree there is no silver bullet. No correct answer. Responses will be as varied as small credit union operations. But there are common themes:

- Provide context. Ensure directors know how other credit unions are faring in these tough economic times. Knowing that other small credit unions face earnings challenges (and knowing the magnitude of those challenges) will help directors make more informed decisions and it will reduce the likelihood of overreaction. A collection of recent small credit union operating results appears on the CUNA web site (http://www.cuna.org/member/download/smallcu_trends.pdf).

- Since most small credit unions have more than adequate capital, they should strive to avoid penalizing members with higher loan rates, more and higher fees, lower dividend rates, service cutbacks or layoffs just to keep net income from falling for a year or two.

- Rising delinquency and loan losses require close monitoring and active collections, but they do NOT necessarily call for a tightening of credit standards. Avoid drastic underwriting changes, if possible. Now may be a good time to revisit and recalibrate loan quality parameters. The result, for many, may be a relaxation rather than tightening. The best response to a decline in net income caused by rising loan losses may be to adjust your budget and then carefully let income decline.

- This economic downturn is unlike any other in modern times. Mortgage defaults are increasing dramatically. For many small credit unions, one mortgage delinquency is a big event – today some are dealing with multiple delinquent and defaulting mortgages. Work carefully to develop a mortgage modification policy and guidelines to provide assistance to members during this economic downturn. Use creativity and care in providing options to members while being mindful of your credit union's loan portfolio risk and ways to manage that risk for the best interests of the members and the credit union.

- Use care pursuing new activities - don't "swing for fences" in an attempt to increase or maintain earnings. And try to avoid big strategic changes in uncertain times. Prudence suggests new activities be pursued in a limited way.

- Loan demand typically falls during economic downturns. Investments become increasingly important. Be conservative with investments and ensure that your current investment strategy is in sync with the rapidly-changing market realities.

- Be diligent with your asset liability management since market conditions are extremely volatile and your financials are vulnerable. If you haven't done so yet, set policy parameters on fixed rate mortgages, establishing a set percentage or dollar amount of fixed rate – long term mortgages that you carry on your balance sheet. The Federal Reserve is now effectively out of policy options on the short end of the yield curve. Discussion now centers on attempts to provide relief by buying mortgages and forcing mortgage rates down. There is a strong possibility of a large mortgage refinancing event over the coming months. But market interest rates will surely rise at some point. Those with relatively large portfolios of long-term, fixed-rate (i.e., rate-insensitive) assets will pay a steep price in a rising rate environment.

- Activities with outside, third party vendors require extra care in uncertain times. Vendors often suffer in a down economy so it is critical to keep close watch on their health. CUNA's Due Diligence Task force will be posting a guidebook "Guide to Third-Party Vendor Management" on the website. The guidebook contains advice and a sample policy. It is available free of charge on the CUNA web site here: http://www.cuna.org/initiatives/due_diligence.html

- Tell people about your share insurance. Most, but not all, know that credit union deposits carry federal insurance. Make sure they do. Stress that your deposits are backed by the full faith and credit of the U.S. government – just like bank deposits.

- Write down your plans and communicate your risk tolerance. Make sure regulators know that your credit union's leaders have carefully considered where the credit union is headed financially and that they've mapped out a reasonable plan to deal with the uncertain future.

Most small credit unions now have strong balance sheets and near-record-high capital levels. The appropriate course of action for most, therefore, is to take a long view. This means letting the capital cushion do its work and temporarily let net income fall as a result of the loan losses. It is imperative to avoid doing unnecessary harm to the credit union and its members that would result from trying to maintain net income in the current environment.

There are often opportunities for well-positioned market participants in times of financial dislocation. Small credit unions, like their larger counterparts, should seek ways to show both members and non-members the unique and substantial benefits of their cooperative structure.

Prepared by CUNA's Small Credit Union Committee:

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