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RAPID DEPOSIT GROWTH CAN THREATEN LENDING

Credit unions have generally received good marks for helping their members cope during the COVID-inspired economic downturn. And, of course, a couple trillion dollars injected into the economy has helped consumers, too.

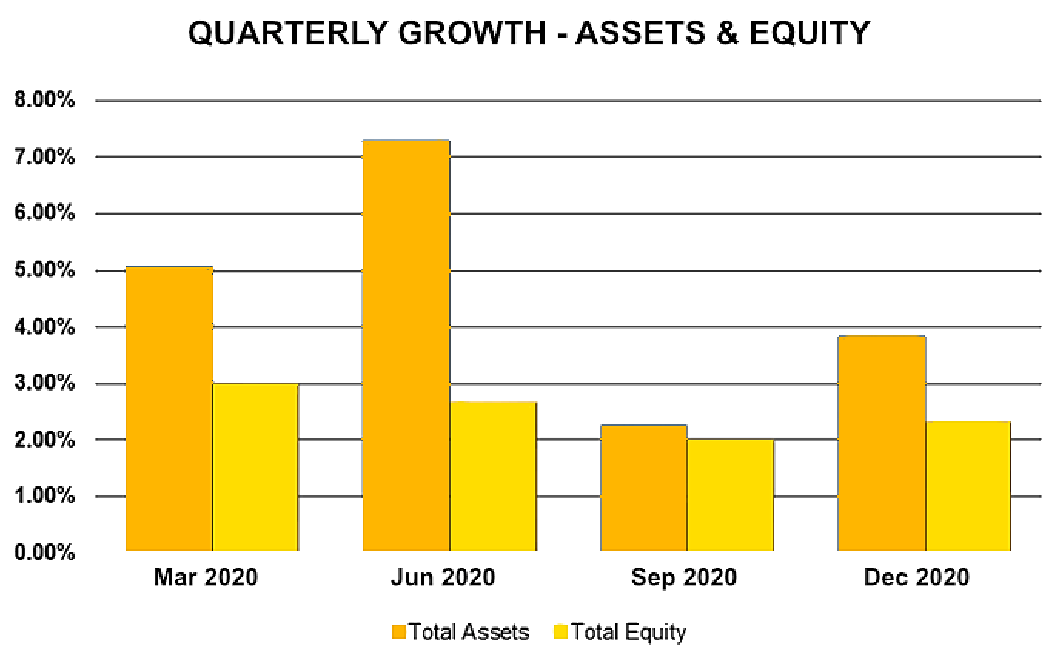
But the U.S. Government's multi-trillion-dollar booster shot may create adverse side effects – in some cases making it difficult for credit unions to deploy the funds into loans as quickly as they would like.

A quick look at a couple of trends underscores some unintended consequences. Fortunately, credit unions can take several measures to help offset impacts of the rapid deposit growth.

WHAT THE NUMBERS SAY

While credit unions were busy supporting members during the downturn, balance sheets swelled at speeds never seen before. Since the early days of the pandemic, the size and quickness of deposit growth has placed enormous pressure on capital levels.

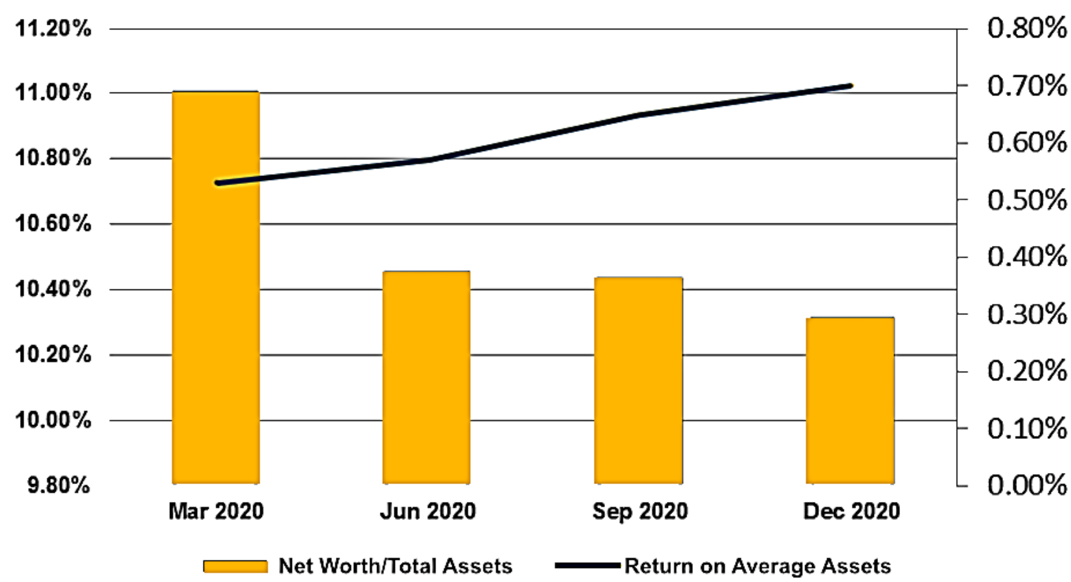
The graph below highlights how *asset growth* – driven by the influx of deposits – has outpaced *capital growth* in the credit union industry.



Growth in capital levels means that earnings remained positive. However, capital growth did not keep pace with asset growth. (Some credit unions have experienced deposit growth over 20 percent during the past year!)

Meanwhile, as indicated in the chart below, net worth ratios dropped 70 basis points between March 31 and December 31, 2020.

NET WORTH & ROA

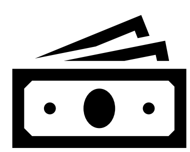


The pressure on capital wasn't due, however, to a decline in earnings. Indeed, credit union ROA remained healthy – and even increased as the year wore on.

So why the concern over capital levels? The bump up of deposits is temporary, and those funds are likely to leave, right? Not necessarily.

CAPITAL CONCERNS

As pointed out in a recent blog on "surge deposits," those funds could potentially remain on credit union balance sheets longer than many might like. This could mean that pressure on capital may not resolve in the near-term.



Other challenges related to interest rate risk exposures and balance sheet concentrations may surface, as well.

From a risk measurement perspective, lower net worth and equity levels also mean that credit unions will have to take proportionately less risk to maintain the same overall risk exposure. This is due to the mathematics –

the same dollar change in NEV, or earnings, divided into a lower base level will produce a larger percentage change. So, to maintain targeted risk levels, credit unions will have to reconsider desired balance sheet compositions.

From a composition perspective, most credit unions assign concentration risk and allocation limits for loans and investments as a percentage to net worth. With balance sheets expanding at a faster pace than net worth levels, holdings of certain asset types will have to be proportionately lower. This means credit unions may have to curtail lending activity in real estate, commercial, or other loan types sooner than they would like. This could have negative repercussions on their ability to meet member loan demand and potentially restrict earnings growth.

The challenges outlined above, however, are not insurmountable.

THERE ARE OPTIONS

Credit unions can consider several paths as they move forward to restore capital levels. Some, such as the Emergency Capital Investment Program and Secondary Capital, are faster than others.

Let's review four options:

1 First, if your credit union is holding excess cash, deploy those funds. Even though overnight and short-term rates are low, the yield curve has steepened over the last few months and the three- and five-year treasuries are currently 0.34 and 0.84 percent. These yields are more than double their level in early January and provide significant yield enhancement over cash. Furthermore, when factoring in the Fed's low for long monetary policy, the annual compounding effect is material.

2 Second, consider your balance sheet composition and liquidity needs and evaluate your credit union's investment strategies. Working with a good broker or advisor, it is possible to craft a strategy identifying yield pickup without notable changes to liquidity or interest rate risk exposures. (Of course, be cautious to not add credit or other risks in the process!) Similarly, evaluate your credit union's investment sectors and determine if there are better sectors available. Again, it is important to fully understand the risks of what you may be exploring. If you aren't comfortable, don't do it or find a trusted partner to help!

(3) Third, credit unions designated as a Community Development Financial Institution (CDFI) or a Minority Depository Institution (MDI) can apply for direct capital investment from the U.S. Treasury through the Emergency Capital Investment Program (ECIP). This can be an attractive and powerful opportunity for some credit unions. A key point to mention: interested credit unions will need to apply to the U.S. Treasury for funds ***and*** apply to the NCUA and/or your state examiner for permission to count these funds towards net worth. (Permission to count towards net worth doesn't happen automatically.) Credit unions can learn more about the ECIP program here.

(4) Finally, if your credit union has a low-income designation (LID), you can seek approval to raise secondary capital funds. This approval allows credit unions to raise external funds that can be counted towards net worth. This could be an excellent option for credit unions with existing loan demand and the ability to effectively deploy more funds. Catalyst Corporate's staff has helped credit unions through the secondary capital application and funding process and can help determine if this process makes sense for your credit union.

More information on secondary capital can be found here. (Similar to the Treasury program mentioned above, your credit union will need to formally apply for this approval from NCUA and/or your state examiner, but this will not require a U.S. Treasury application.)

CONCLUSION

The credit union industry is healthy. Earnings are positive and rising. Net worth exceeds 10 percent, and liquidity is extremely strong.

However, with economic activity likely to pick up in the months ahead, credit unions can position now to avoid concerns in the future, such as pulling back on lending, piercing concentration limits, or watching interest rate risk exposures rise. Shoring up capital positions is the best path to ensure credit unions can continue to meet member needs.

To learn more about ECIP or secondary capital, or to review the best path forward for your credit union, contact us today.

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