Virtual Conference Webinar Series
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# What Will Your Credit Union Look Like Post COVID-19?

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# Overview



- COVID-19 disruption
- Member and credit union behavior shifts
- Credit union financial and strategic implications
  - Lending, savings, earnings, capital
  - Consolidation activity
- Considerations for internal audit
- Questions

# COVID-19 Disruption



- Credit unions and the U.S. economy experienced a strong 10-year run
  - Growth, earnings, loan quality, unemployment
- Within 30 days, this all came to a halt
- Businesses are figuring out if they have a future and what it may look like
- Consumers either in crisis mode or at a minimum… what is my path forward?
- Credit unions are determining how to serve both of these groups

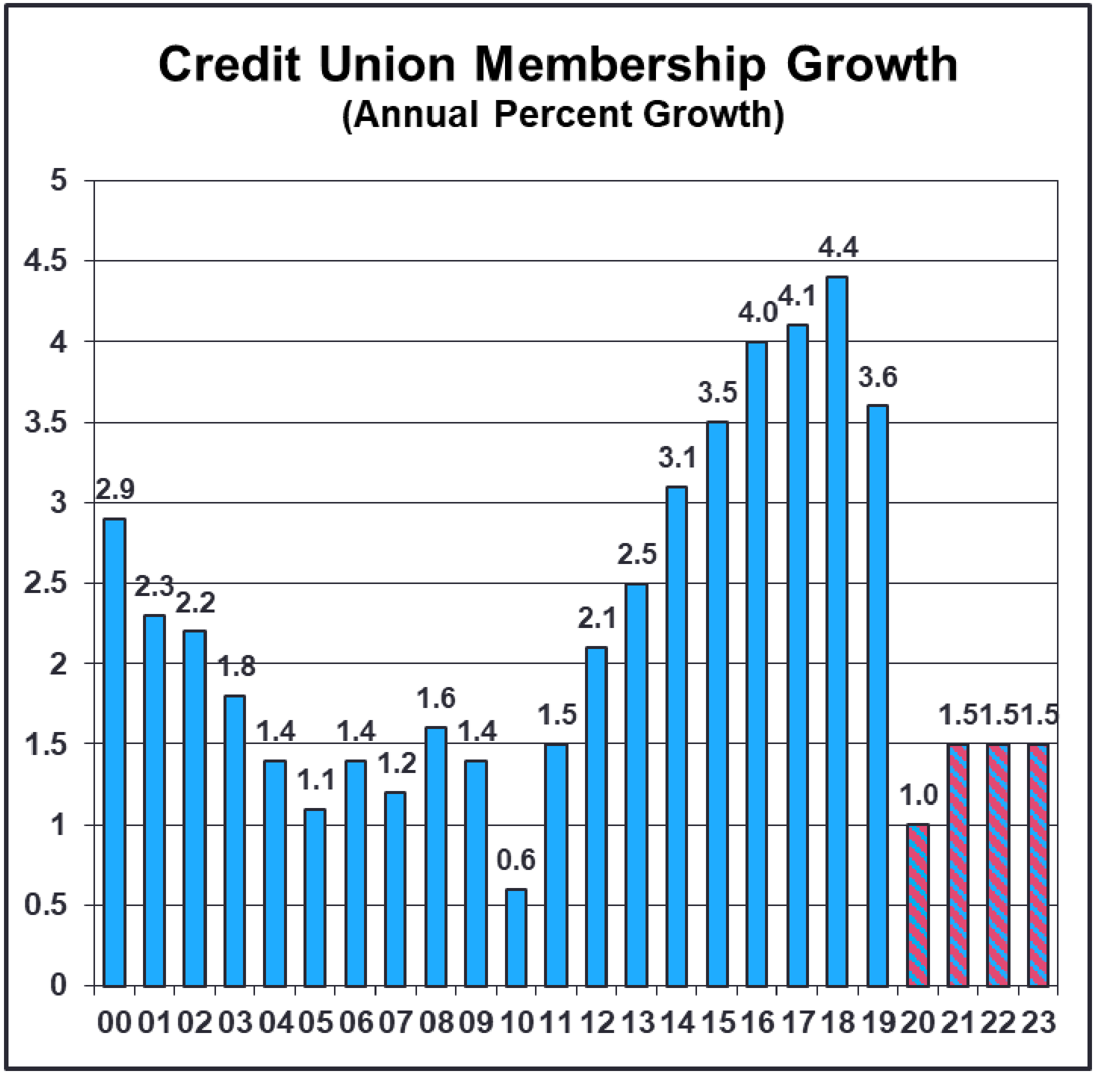
# Member Behavior



- Increase in “emergency fund” savings
- Decreased borrowing appetite
- Permanent changes in delivery systems utilized
- Further migration to online shopping
- Lower discretionary spending
- Decline in vacation travel and change in destinations
- Social distancing considerations will dictate attendance at large events and social gatherings
- Decline in use of public transportation

# Projected Performance






*Source: CUNA Mutual Group, Economic & Credit Union Update May 2020*

# Credit Union Behavior

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- Accelerated shift to electronic service delivery
  - Continued evaluation of a “branch”
- Expanded (and permanent) work from home
- Change in long-term corporate facility needs
- Work schedules (staggered / more flexible)
- Less travel for business and conferences, more use of video conferencing for meetings and training
- Expanded disaster recovery planning

# Lending: Interagency Guidance on COVID-19 Loan Modifications



## March 22, 2020 (Updated April 7, 2020):

- Included all banking regulators, NCUA, and Conference of State Bank Supervisors
- Encourages financial institutions to work with borrowers
  - Agencies will not criticize institutions for this
- Will not automatically categorize all COVID-19 related modifications as TDRs (referred to as Section 4013 modifications)
- Similar to other efforts made during natural disasters

# Lending: Interagency Guidance on COVID-19 Loan Modifications



- FASB: Short-term modifications made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief are not TDRs
  - Includes short-term (e.g., six months) modifications, such as payment deferrals
  - Borrowers considered current are those less than 30 days past due as of 12/31/19 at the time a modification program is implemented
- Deferrals granted due to COVID-19 should <u>not</u> be considered past due because of the deferral
- COVID-19 modified loans generally should not be reported as nonaccrual

# Lending



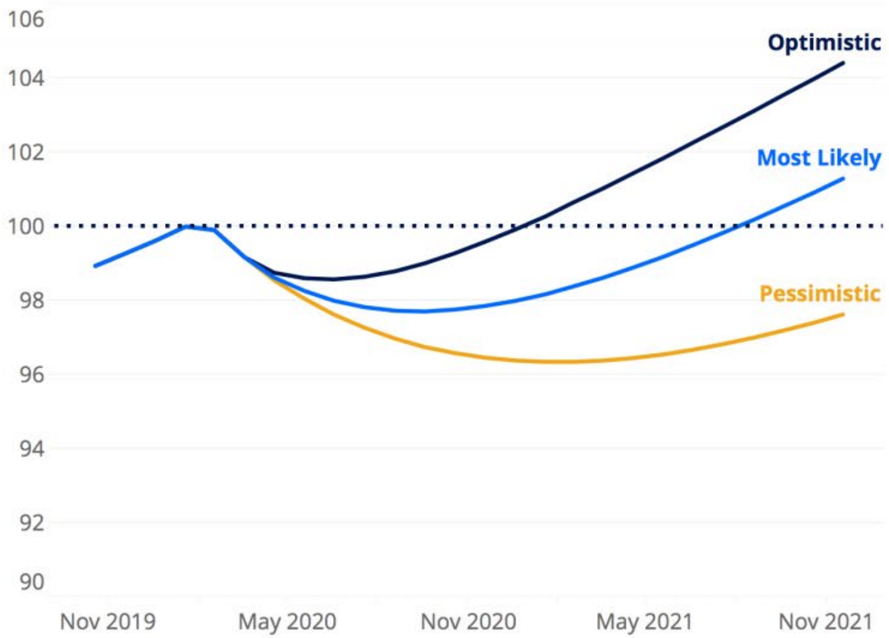
- Loan growth considerations
  - New auto and home sales decline
  - Unemployment and expanded work from home
  - Geographic and membership demographics
- Loan yields will continue to decline
  - 20 – 50 bp decline through 2021

# Housing Projections

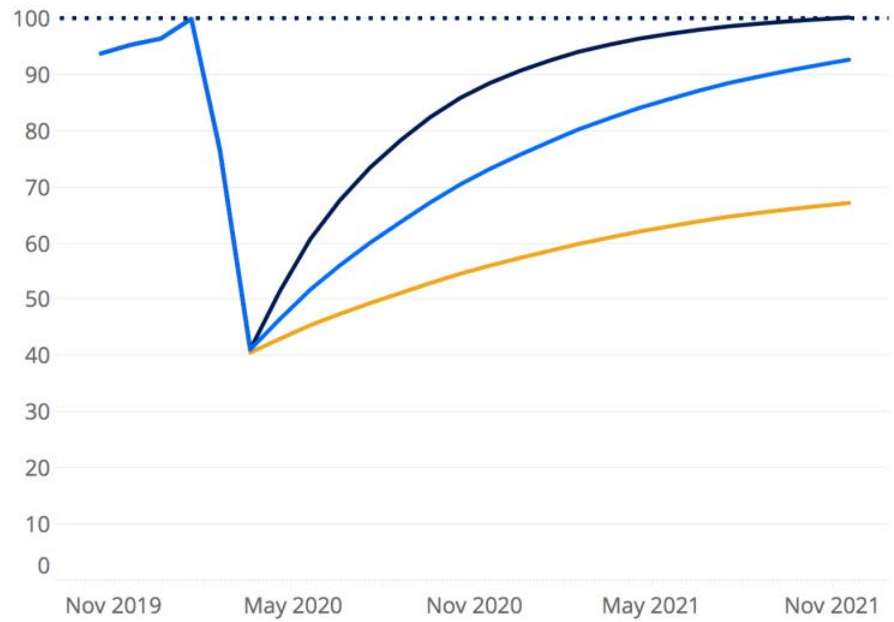


**Home prices will most likely fall 2%-3%. Prices and sales volumes largely expected to return to near pre-crisis levels by end of 2021.**

**Home Price Change by Scenario**




**Sales Volume by Scenario**




Zillow Economic Research

*Source: Zillow*



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# Projected Performance

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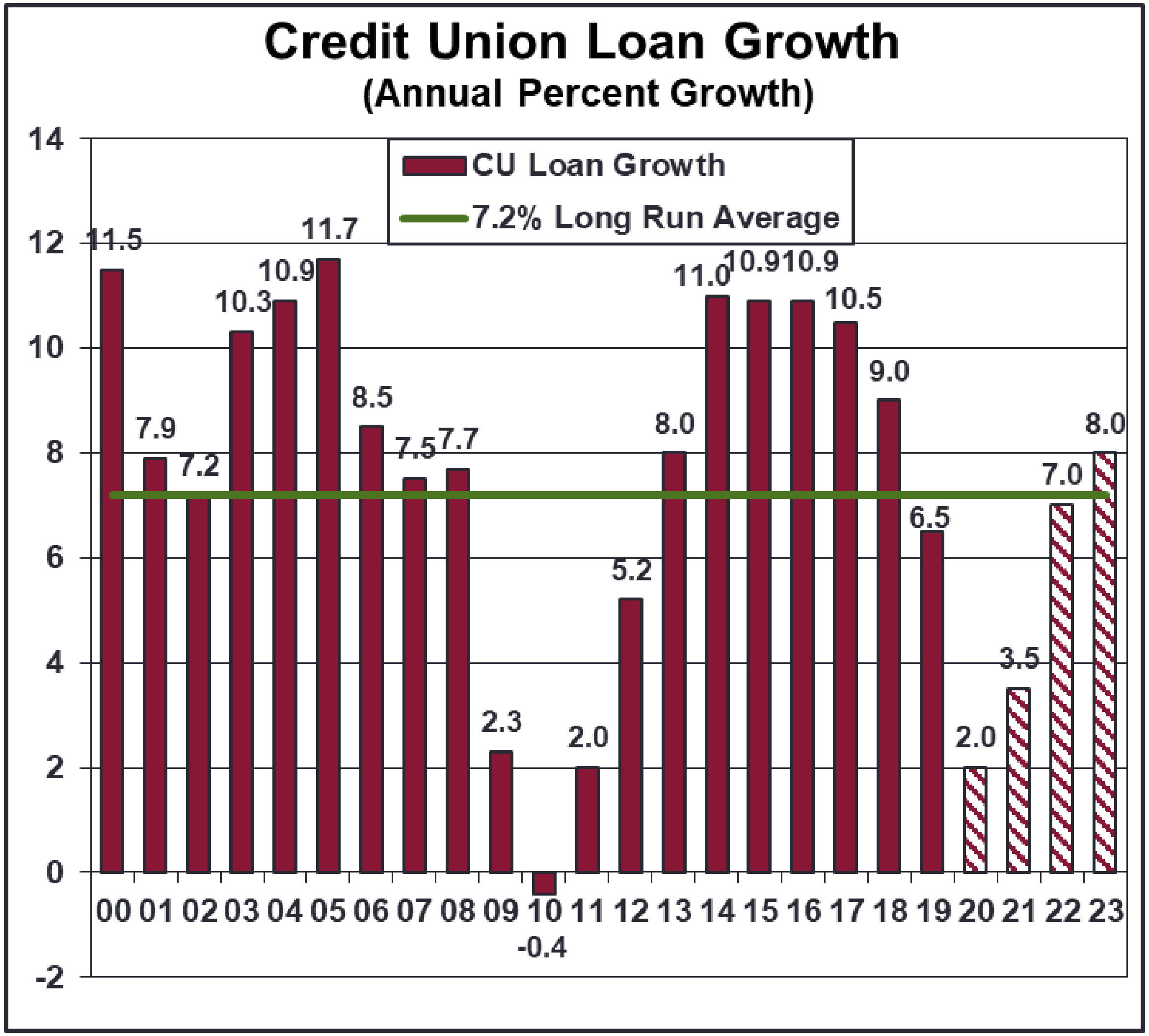


*Source: CUNA Mutual Group, Economic & Credit Union Update May 2020*

# Lending: Loan Quality and Losses



- Delinquency artificially low due to loan extensions and forbearances
- Under CARES Act, not considered TDRs
  - Income on deferrals (interest will accrue)
- Reality will be known in 3rd / 4th quarter
  - Deferrals come due
  - Member can begin payments with accrued interest added to the end of the loan or loan modification
  - Member cannot make payments; consider more permanent modification (maybe a TDR) or may have to charge-off

# Lending: Loan Quality and Losses



- Delinquency will increase in 3rd and 4th quarter
- Losses will hit in 4th quarter and in 2021
- Provision for loan losses will increase throughout the remainder of 2020
  - Environmental considerations will drive ALL increases in the next 6 months

# Projected Performance

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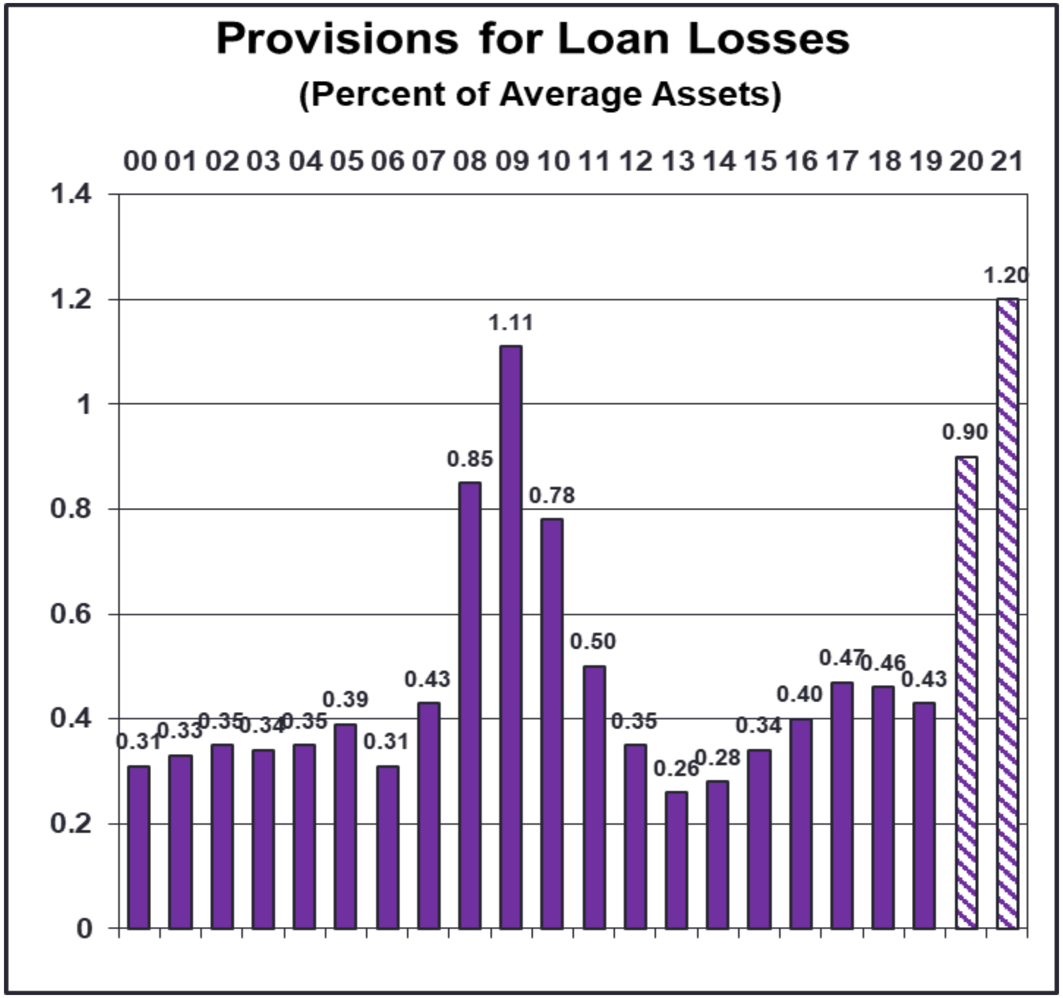





*Source: CUNA Mutual Group, Economic & Credit Union Update May 2020*

# Paycheck Protection Program Loans



- Part of the CARES Act and issued by the SBA
- Paycheck Protection Program (PPP) loans have favorable terms and credit unions receive large fees
- Received much national media attention (i.e., Ruth's Chris, the Lakes organization)
- The rules keep changing. Congress passed a bill to further change them on May 29, 2020 (currently in the Senate) which will make it easier to have a loan forgiven

# PPP Loans: Things to Consider



- Loan can be forgiven based on some behavior by the member
- Borrower uses proceeds for certain expenses (i.e., payroll) and loan can be partially/wholly forgiven
  - H.R. 7010: expands ability for small business to have PPP loan forgiven
- Do credit unions have a mechanism to track loans paid, forgiven, or still outstanding?

# Member Business Loans



- MBLs are inherently higher risk, but on an unprecedented run of virtually no losses for over 7 years
- MBL losses are usually 6-digits in nature and take months/years to resolve
- Early planning on workout strategy is key to minimize losses
- Section 4013 modifications make these issues much harder to recognize

# MBLs: Areas of Concern for 2020

- Is the loan properly risk rated?
  - Any loan that requested a 4013 modification is potential candidate for downgrade to at least a “monitor” or “watch” category
  - Are annual reviews updated for recent information? Using 2019 data will not tell story of what is happening in the business and 2020 data may not be available
  - Loan officers should visit members and add memos to the file for all Section 4013 loans and significant loans
  - Cannot generalize about MBLs as some businesses have seen increased revenue and others are on brink of bankruptcy

# Member Business Loans



- Strongly recommend “asset quality” loan review be performed in 2020 for significant loan portfolios
- Refer to NCUA Regulation Part 723 regarding the requirement for a “loan review”
  - The frequency and scope is not defined in the regulation. DM recently discussed this with the NCUA, which expects 35% coverage and an annual expectation on a credit union with only 4% of total assets in MBLs ($100 million in total MBLs)

# Allowance for Loan Losses Considerations



- Thoughts to consider:
  - Is your membership base affected? How bad?
  - How conservative were your loan to value limits?
  - How strong were your borrowers before 2020?
  - What are your concentrations? Are they impacted?
  - MBLs: Concentrations? Restaurants? Hotels?
- Other thoughts
  - How many members have 2 - 3 months of savings?
  - How many members will be fine after 2 - 3 months of loan payment deferrals?
  - How many will be fine with CARES Act stimulus, PPP loans, or unemployment?
  - Track credit score migration

# Allowance for Loan Losses
# Loan Operations Considerations



- Track PPP separately under a new class code
- For remainder of portfolio, use user-defined fields in core system
  - Need internal mechanism to monitor COVID-19 modifications separately from existing TDR process
- Ensure accuracy of delinquency reporting
  - Delinquency for deferrals as a result of the modification will be in accordance to what modification is made
- Tracking of concentrations within these buckets for monitoring of risk and any impact to the ALL
- Run updated credit scores and evaluate migration – early identification and ALL funding

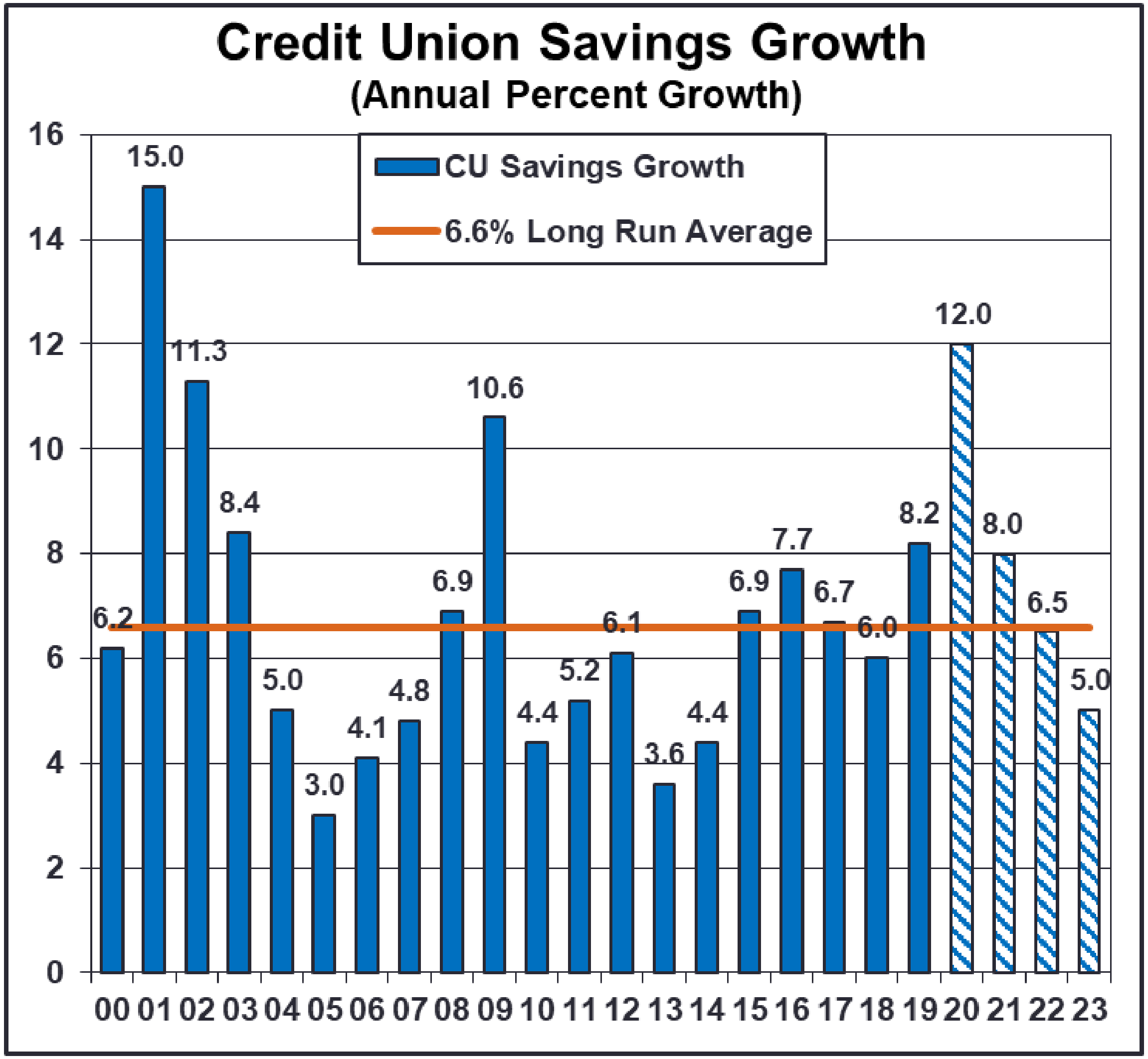
# Deposits



- Large influx of deposits due to stimulus packages
  - Funds will migrate out, but currently slow
  - Growth maintained in share/draft (low cost) accounts
- Will experience some flight to safety and consumer build up of savings / emergency funds
- Declining short-term interest rates
- Higher cost certificates and borrowings will roll off
- Decline in overall cost of funds
  - Decline 30 – 40 basis points by early 2021

# Projected Performance






*Source: CUNA Mutual Group, Economic & Credit Union Update May 2020*

# Earnings



- Decline in asset yield
  - Influx of deposits creating excess liquidity with low yield
  - Minimal loan growth causing declining loan/share ratio
- Net decrease in net interest margin
  - 30 – 50 bp decline by early 2021
- Decline in fee and other income
- Personnel costs will depend on permanent changes to service delivery systems
- Health care insurance increases

# Earnings



- Operating expenses
  - Occupancy costs may decline over the long run depending on continued work from home practices
  - Future facilities needs will provide cost savings opportunities
  - Technology costs, including security will increase to serve members' desires and remote work requirements
- Provision for loan losses increases
- Net income continues to decline in 2020 and 2021

# Projected Performance

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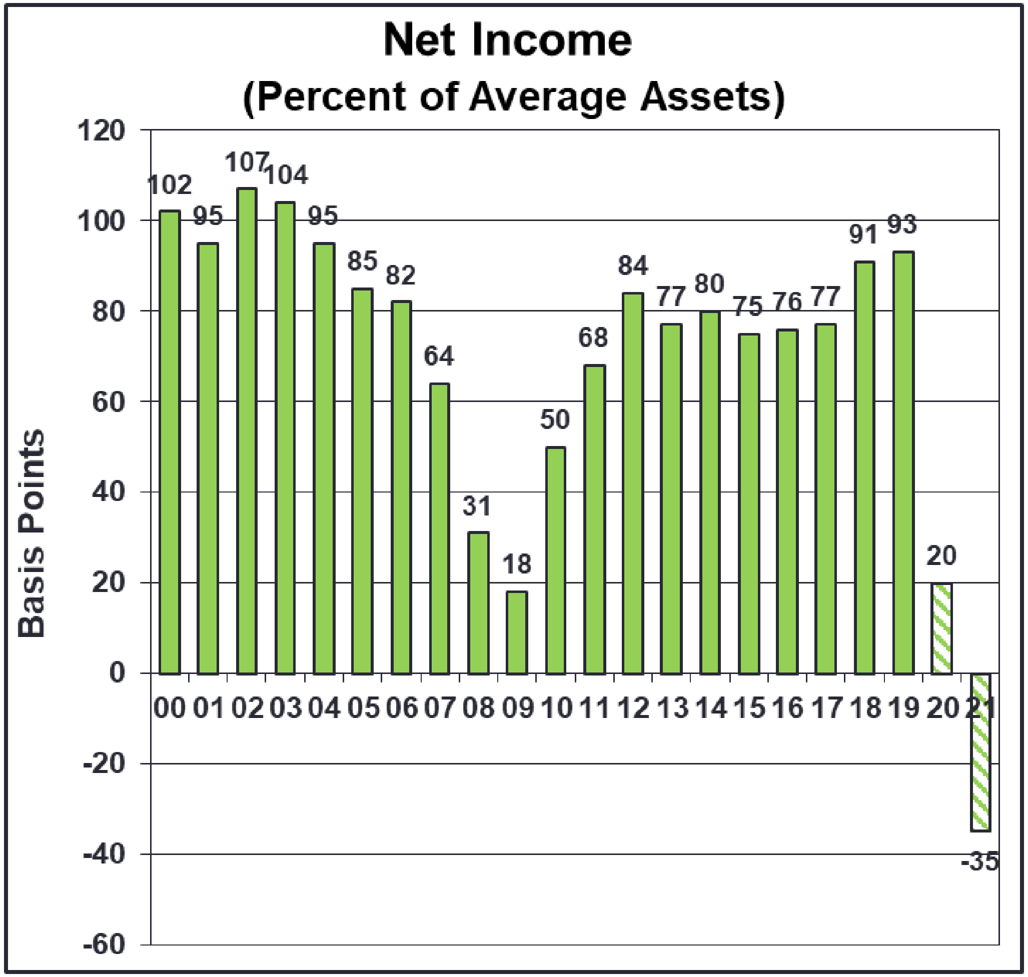




*Source: CUNA Mutual Group, Economic & Credit Union Update May 2020*

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# Capital



- Strong savings growth equates to strong asset growth for 2020
- Declining earnings for 2020 – 2021
- New worth ratio: declines in 2020 – 2021
  - Could decline 100 – 150 basis points by end of 2021
- NCUA regulatory relief for net worth ratios that fall below “well capitalized”

# US Merger Trends

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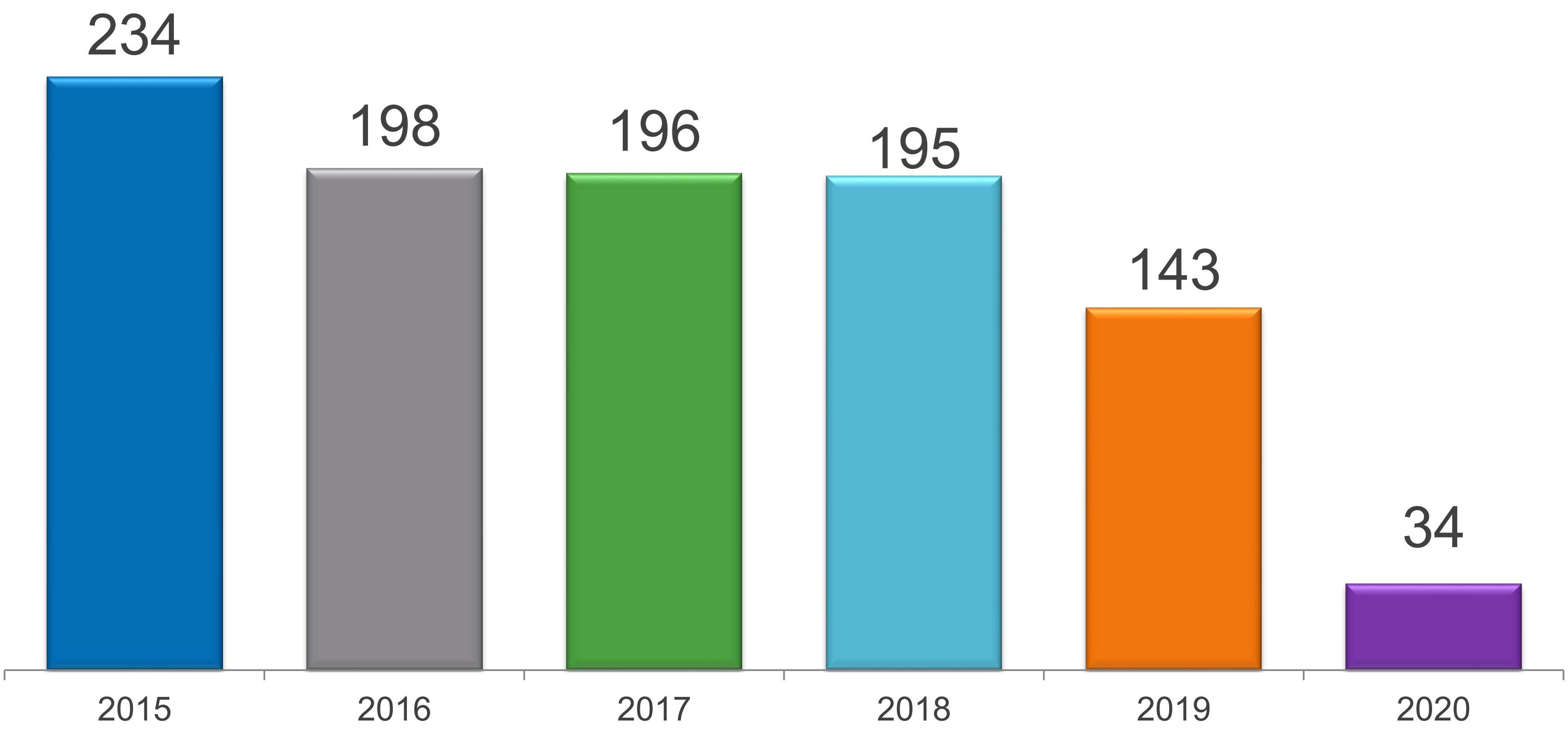


*Source: NCUA*
*2020 data as of March 31*



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# All Banks Acquired by Credit Unions Heatmap

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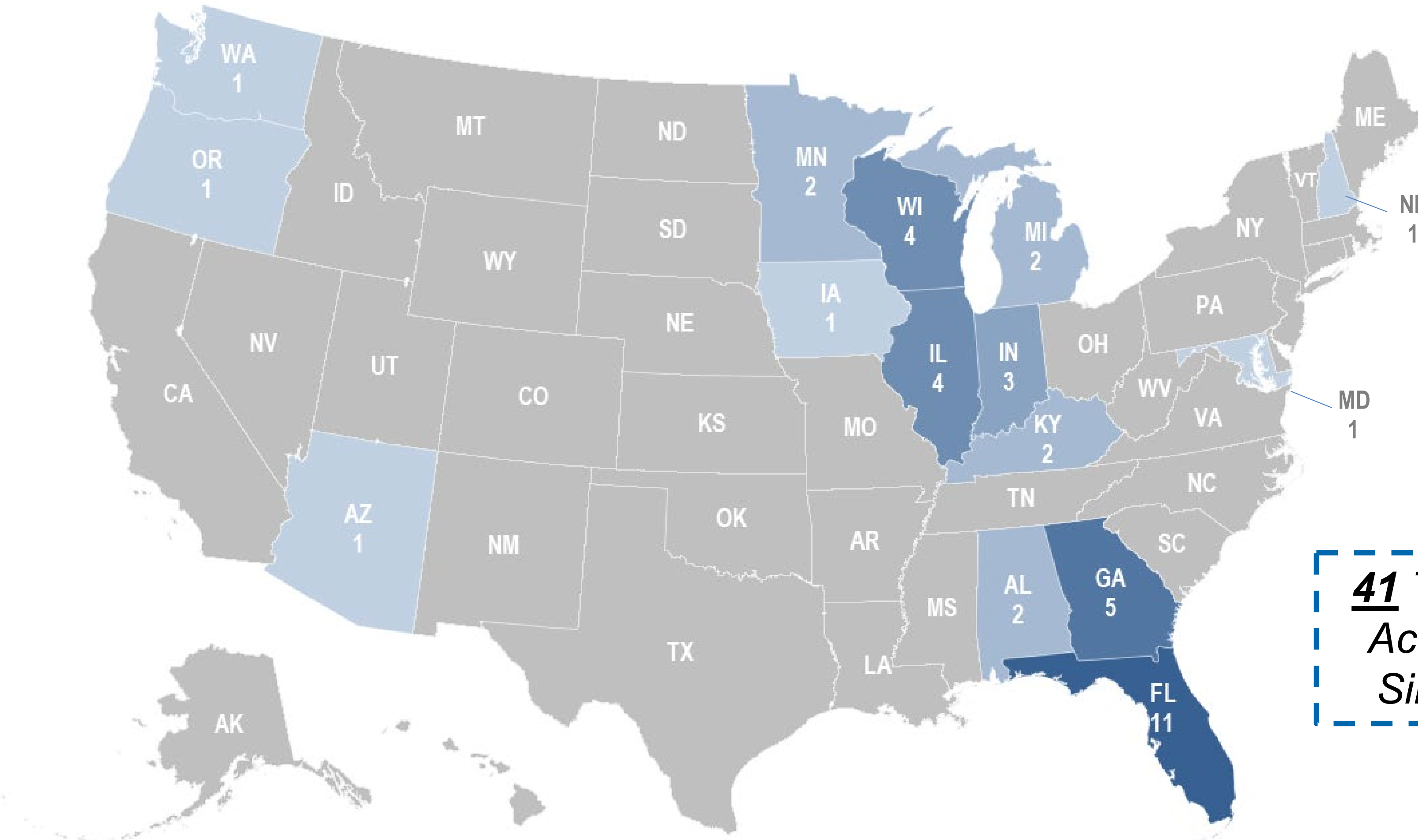


***41* Total Bank Acquisitions Since 2011**



*Source: S&P Global Market Intelligence, as of 4/27/2020*

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# What Does it Mean For Internal Audit?



- Reevaluate your 2020 plan and allocation of resources
- What changes in risks have occurred?
  - Internal: process changes mean control changes
  - External
- What are your credit union's reentry plans and post COVID-19 business model changes?

# What Does it Mean For Internal Audit?



- Consider an updated risk assessment
  - What changes have occurred?
  - What does this mean for the internal audit plan?
- How can we help management?
- Where can we start?
  - Loan portfolio performance
  - Modifications / TDRs
  - Tracking, monitoring
  - Post modification changes

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# Thank You!

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