CU LEADERSHIP
WEBINAR SERIES

DISCOVER.
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The COVID-19 Recession and its Impact on Credit Unions

Part 2 of 2

Practical Financial Strategies for CU Leaders in the "New Normal"

Featured Speaker: Timothy Harrington

Founder & President

Timothy P. Harrington, Inc. dba

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Dennis J. Sullivan, Chairman
& Host for Today’s Webinar


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Get a private backstage tour of Legends in Concert - the long-running show in Vegas! See how stars such as Elvis, Frank Sinatra, Bono, Cher & Prince are transformed before they hit the stage. Meet the performers & take home pictures with your favorite legend!
PEI

Presented by Timothy Harrington, CPA

Tim Harrington is a Certified Public Accountant who has consulted with credit unions since 1992. Since 1996, Tim is President of TEAM Resources, a firm that provides consulting, strategic planning and training to financial institutions from coast-to-coast. He is the author of the popular lending software *Lenders Tax Analyzer©* and the books *Eisenhower on Enlightened Leadership* and *A Credit Union Guide to Strategic Governance*. Tim is a faculty member of three national credit union schools on finance, governance and management, and has spoken to hundreds of thousands of directors, executive management and staff throughout North America.

Think Long!
Act Short!
Preserve Capital!

What Are Our Potential Financial Issues?

Deposits

- *A flight to safety will cause Deposits to rise*
  - *Control balances or it can hurt Ratios*
  - *Manage Net Interest Margin during this time*

Loans

- *Loan volume will drop*
- *Loan income will drop*
- *Loan losses will rise*
- *ALL: You're going to need to add, but how much and how soon?*

Net Income

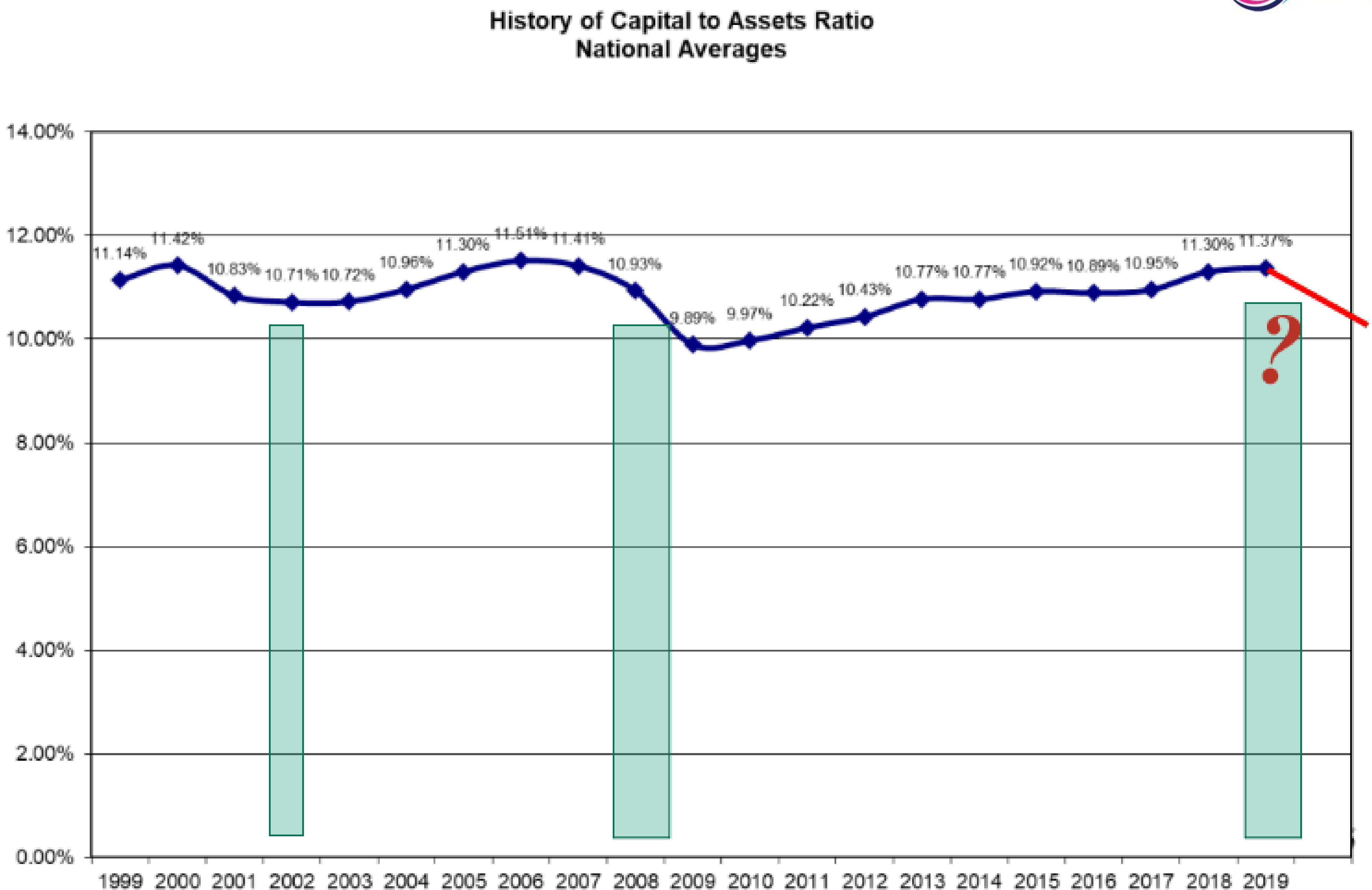
- *Pressure from low interest rates – loans and investments*
- *Lower NII*
- *Higher Provision for Loan Losses*

Preserve Capital

Per CUNA Mutual Economist's Forecast

Key Ratios	*2019*	*2020*	*2021*
Capital to Assets	11.39	10.50	9.75
Loan Quality-Misery Index	1.26	2.12	1.85
Loan to Share	84.40	76.60	73.40
Spread Analysis			
Yield on Assets	4.04	3.25	3.00
Cost of Funds	0.89	0.50	0.50
Net Interest Margin	3.15	2.75	2.50
Operating Expense	3.19	3.05	3.03
Provision for Loan Losses	0.43	0.75	0.85
Non-Interest Income	1.40	1.25	1.28
ROA	0.93	0.20	-0.10
Asset Growth	8.10	10.00	7.00
Loan Growth	6.50	2.00	3.50

Preserve Your Capital Position



Deposits

Generally, during recessions, members turn to credit unions to safeguard money.

The Flight to Safety

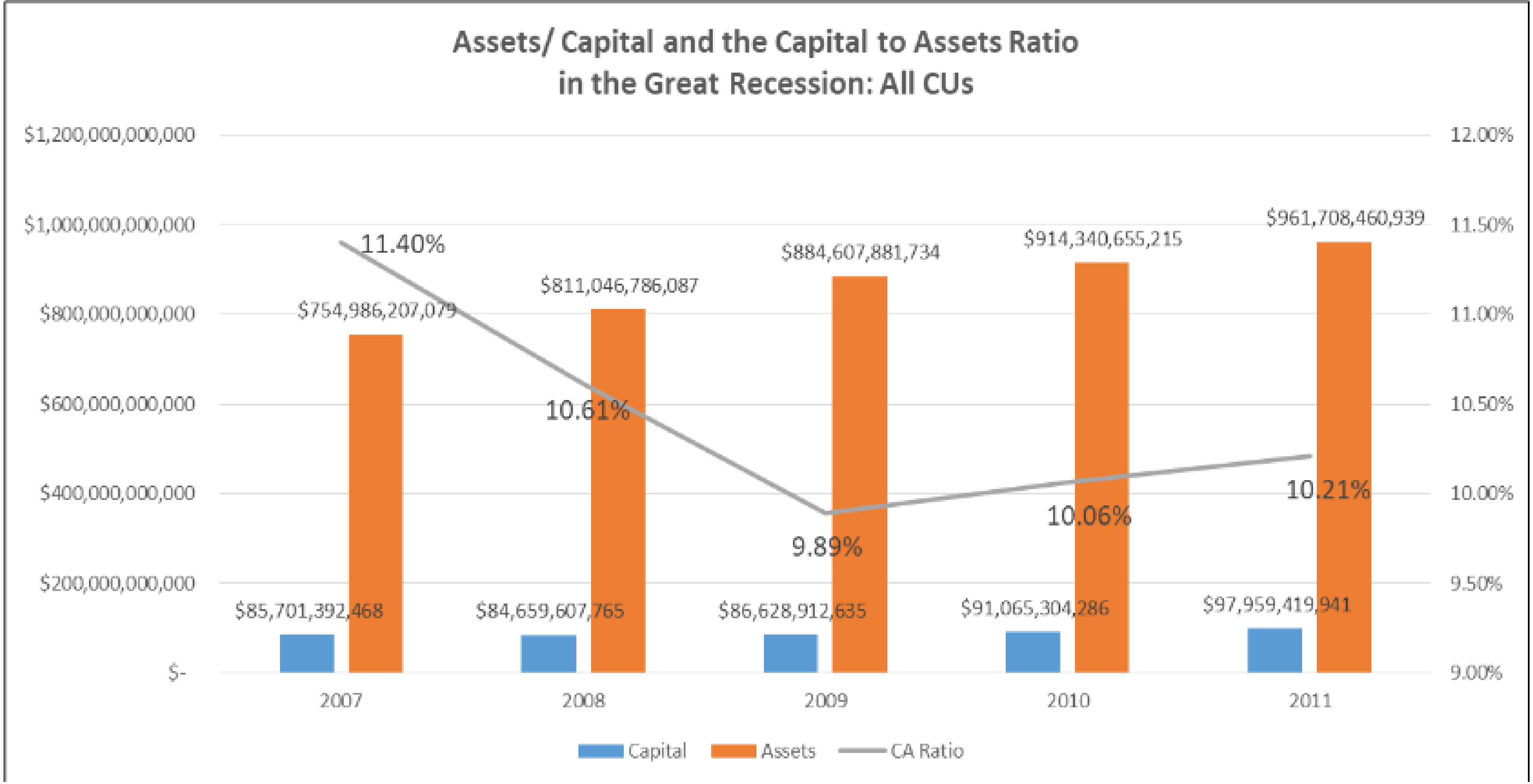
Strategies as Deposits/Assets Rise

Rising deposits, if they are unwanted and unneeded, can weaken your financial stability

- Growing Assets without growing Capital causes the Loan to Share Ratio to drop
- In a low interest rate and low loan demand environment, there's no place to put the deposits. If priced wrong, and volume's too great, profit can be challenged.

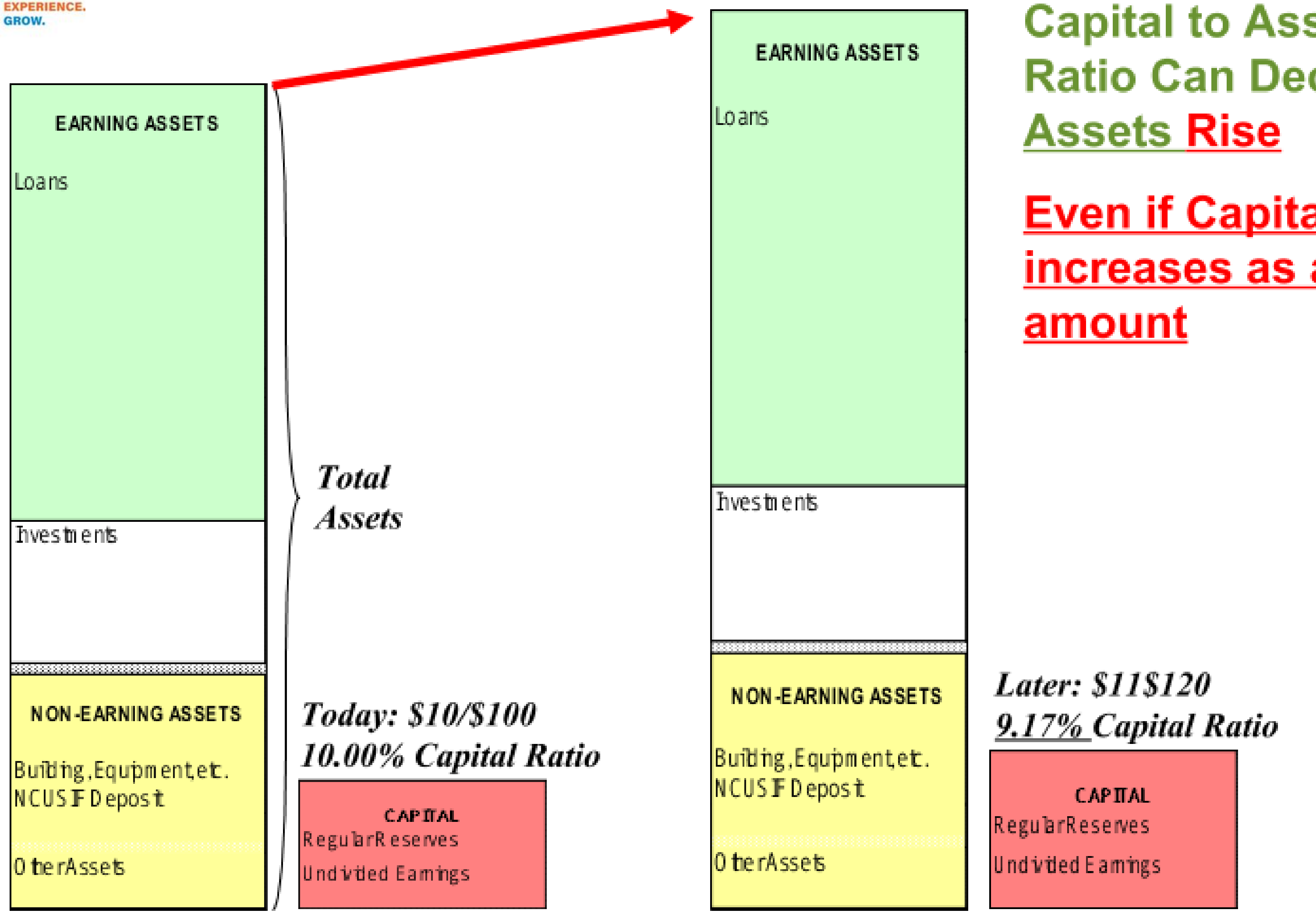
Unless you have the knowledge and capacity to leverage them with decent yield investments

If Assets Grow, and Capital Doesn't, NW Ratio Slides



Capital to Assets Ratio Can Decline if Assets Rise

Even if Capital increases as a dollar amount



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Capital Growth Calculator

Fill in white cells, do not change gray cells

Solve for Projected Capital to Assets Ratio

Five Year Projection

	12/31/2019	12/30/2020	12/30/2021
ANTICIPATED ASSET GROWTH RATE		10.00%	7.00%
ROA ANTICIPATED		0.20	0.10
TOTAL ASSETS	$ 372,727,799	$ 410,000,579	$ 438,700,619
TOTAL CAPITAL	$ 42,325,156	$ 43,107,884	$ 43,532,235
$ INCREASE IN CAPITAL (SAME AS NET PROFIT NEEDED)		$ 782,728	$ 424,351
% INCREASe IN CAPITAL		1.85%	0.98%
ACTUAL CAP/ASSETS %	11.36%		
PROJECTED CAPITAL TO ASSETS RATIO		**10.51%**	**9.92%**

Scenario Projections over the Next Several Years Will Be Helpful

What will happen to C/A Ratio under different Scenarios. Worst, Best, Likely

Today
10.5%

Net Interest Margin

Some will want deposits and can manage an increase

Others will NOT want deposits

It may be wise to *drop deposit rates soon and far*:

1. To earn a slightly larger NIM and contribute to profit or blunt losses
2. To deter unwanted deposits

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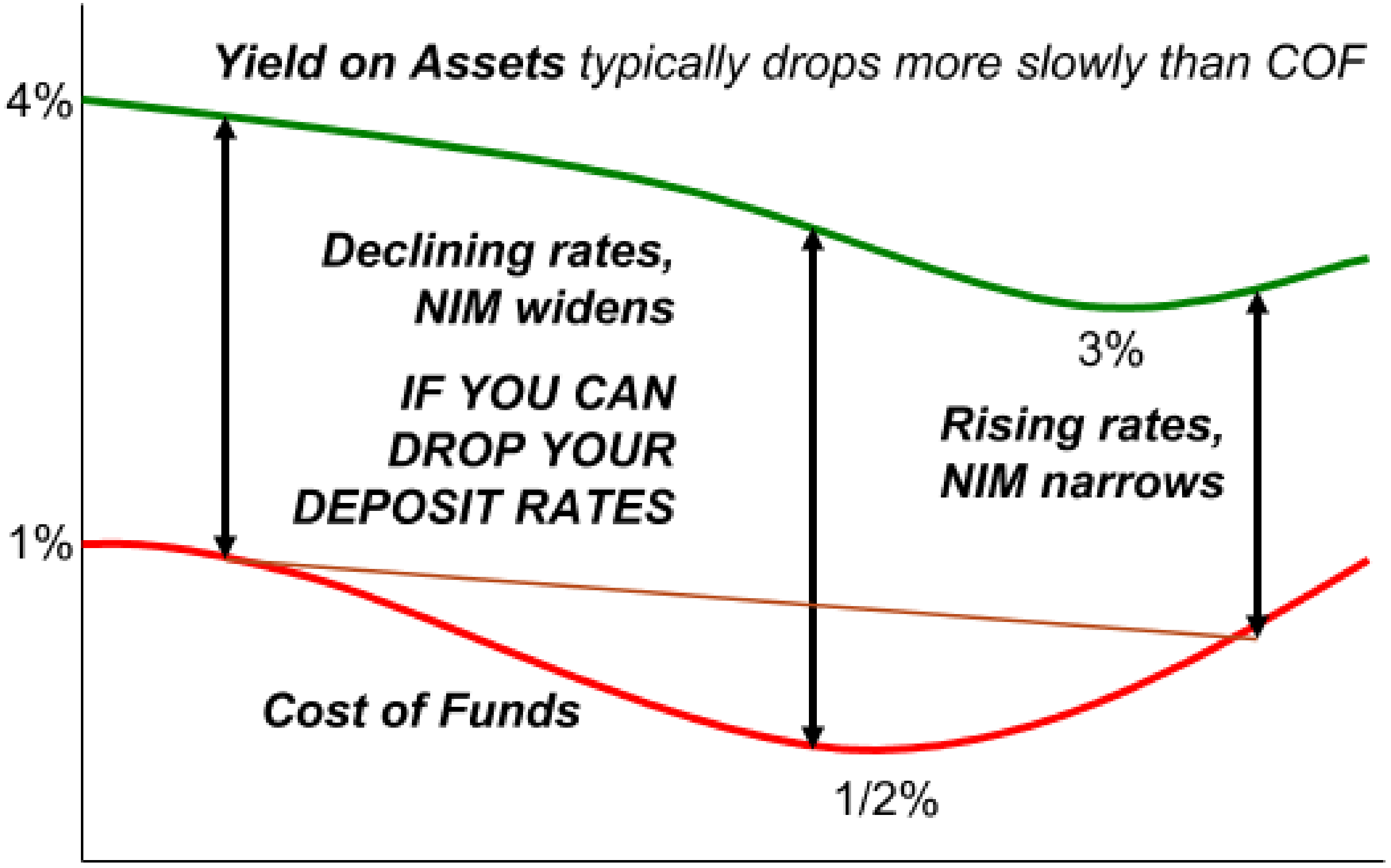
The Flow of Net Interest Margin

Negative GAP means Assets reprice faster than Liabilities



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Effect on Net Interest Margin

At time loan is made:		
Earning Asset Yield	4.04%	
Your COF at time of loan	0.89%	
Net Interest Margin	3.15%	
After rates drop:	**Poor**	**Well**
Earning Asset Yield	3.00%	3.00%
Your COF at time of loan	0.80%	0.20%
Net Interest Margin	2.20%	2.80%

What You Want to Avoid

Attracting too many deposits

At too high a rate

You end up with a double whammy

1. More deposits which increase your Assets and decrease your Capital to Assets Ratio
2. More high-priced deposits that can boost your Cost of Funds causing your Net Interest Margin to suffer

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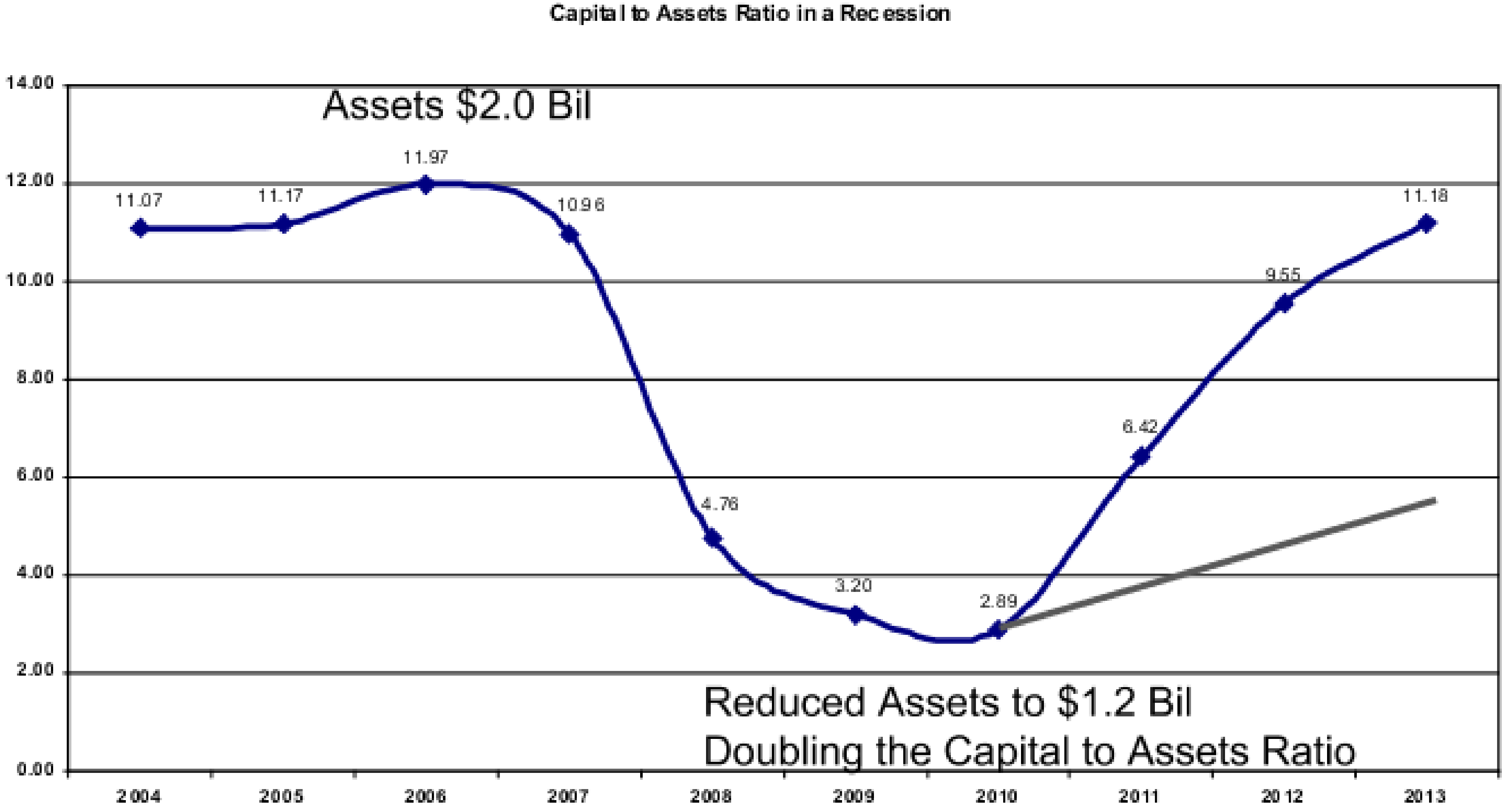
What Can You Do?

Create strategies to slow deposits if that's what you need.

1. Lower rates rapidly and significantly to make deposits less attractive
2. Establish "Action Triggers"
   A. 1st trigger: lower rates again if you have room
   B. 2nd Put a moratorium on certain deposit types, e.g.
      A. Stop selling CDs
      B. Discourage adding more to MMA accounts
   C. 3rd trigger: Find other financial institutions who may need deposits and direct your member to deposit there as a service to the member (and the CU)

Even with these strategies, you may find it challenging to reduce the inflow of deposits.

One Credit Union's Survival Method in the Great Recession When Loan Losses Caused Capital to Plummet



12/31/19 again $2 Bil and 15.00% Capital Ratio

In a Severe Circumstance, Reduce Assets

Capital Growth Calculator Fill in white cells, do not change gray cells

Solve for Projected Capital to Assets Ratio

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ROA ANTICIPATED		0.20	0.10	0.10
TOTAL ASSETS	$ 372,727,799	$ 410,000,579	$ 438,700,619	$ 416,765,588
TOTAL CAPITAL	$ 25,000,235	$ 25,782,963	$ 26,207,314	$ 26,635,047
$ INCREASE IN CAPITAL (SAME AS NET PROFIT NEEDED)		$ 782,728	$ 424,351	$ 427,733
% INCREASe IN CAPITAL		3.13%	1.65%	1.63%
ACTUAL CAP/ASSETS %	6.71%			
PROJECTED CAPITAL TO ASSETS RATIO		6.29%	5.97%	6.39%

Know What is Happening with Your Loan Portfolio

You need to know what is occurring in your loan portfolio.

Good news or bad, information is key for management and the board.

Goal is to move from being…

Reactive

to

Proactive

And be ready to 'respond'

Replace Lagging Indicators with Early Indicators

Delinquency and Charge-off ratios are of Little help.

They are Lagging Indicators

You will need ***Leading or Early Indicators***

Identifying Loan Portfolio Early Indicators

Develop a Process to Know What is Happening

- Create task forces/teams of staff members
- Develop a process to monitor Early Indicators
  - Daily, Weekly and monthly
  - Create Member Care teams to reach out and stay in touch
  - Help members as much as possible without hurting their credit union

Look for those early indicators

Early Indicator.
Late Pays

Track percent of portfolio with **Late Payments**

- Parse by loan type
- Look for emerging negative trends
- Pre-emptively contact member

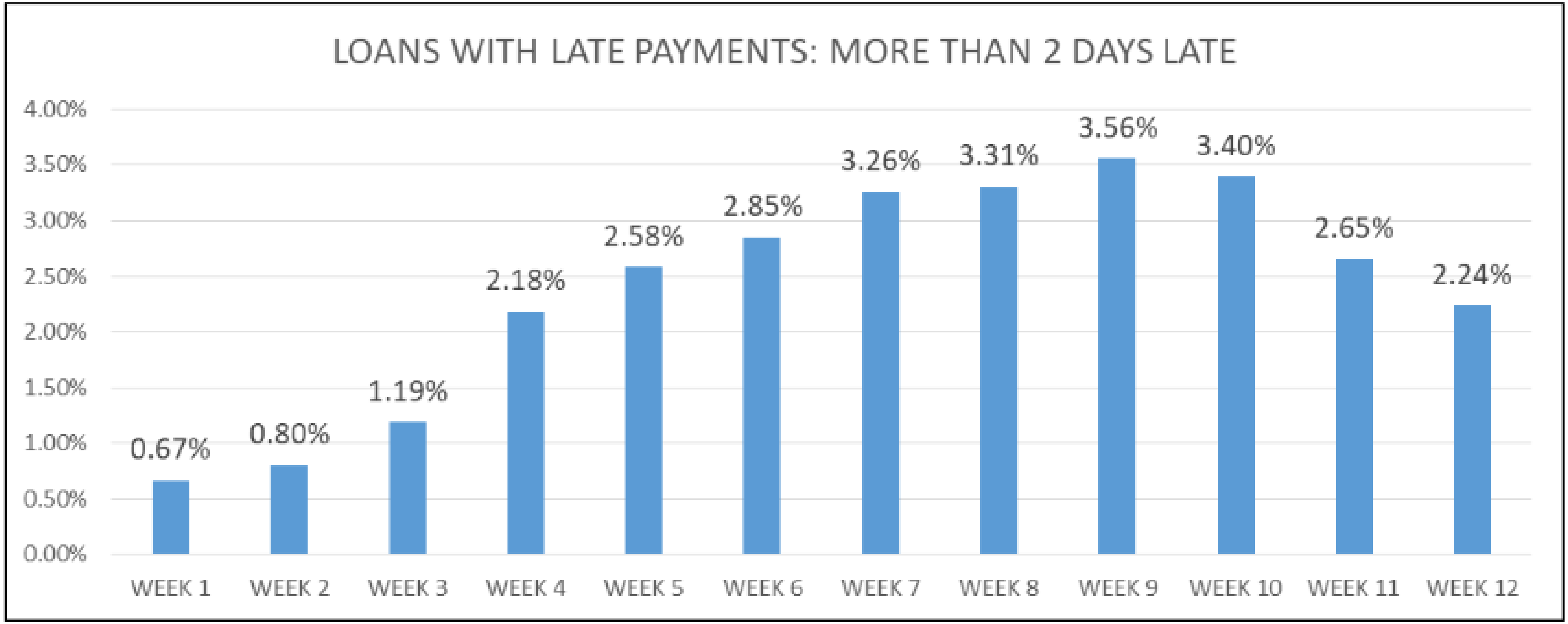
TASK FORCE CALL PROJECT

Early Indicator.
Late Pays

Work your Late Payments

- A paper: Make 'soft calls' at day 10
- C and lower: **Day 2?**

"Do you realize that if you make your payment today you can avoid a late fee? Can we transfer the funds for you?



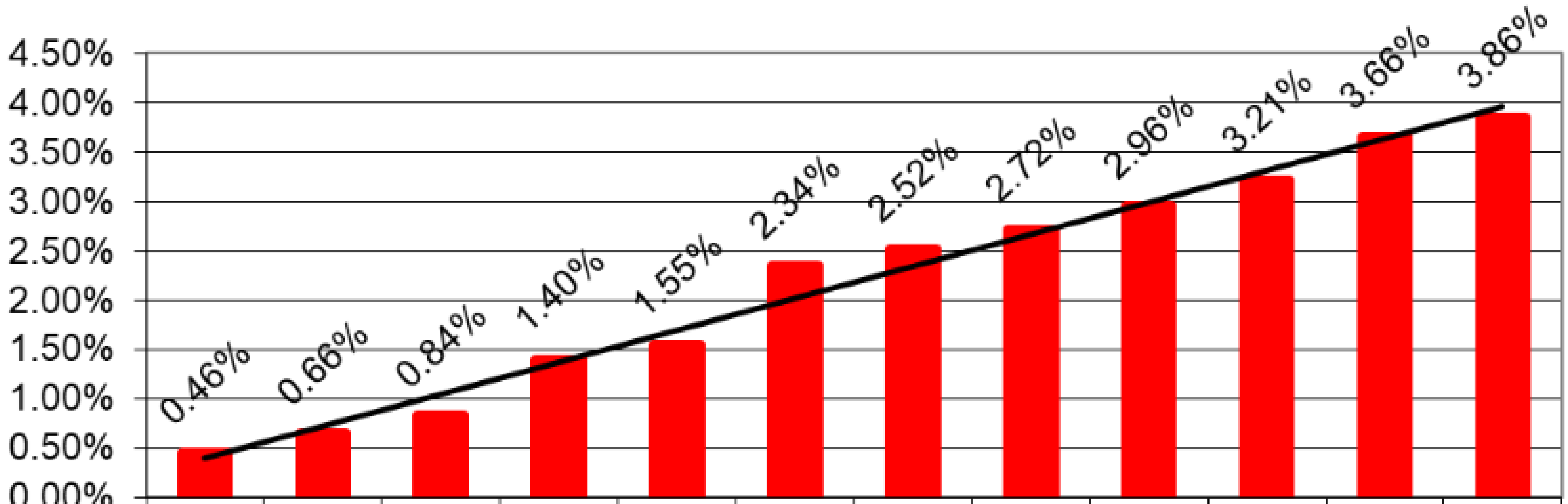
Early Indicator
Trends in Force-Placed Insurance

Track Trends in Force-Placed Insurance (CPI)

- If cash is short, where will members cut?
- If notice arrives that insurance has lapsed, what choices do you have?
  - Repossess the vehicle
  - Add force-placed insurance
  - Pre-emptively contact member

Early Indicator
Trends in Force-Placed Insurance

% of Portfolio with Force-Placed Insurance (CPI)



	jan	feb	mar	apr	may	jun	jul	aug	sep	oct	nov	dec
Series1	0.46%	0.66%	0.84%	1.40%	1.55%	2.34%	2.52%	2.72%	2.96%	3.21%	3.66%	3.86%

Early Indicator:
Change in Borrower's Payment Pattern

If your system allows:

- Monitor borrowers' **<u>payment patterns</u>**. Changes in that pattern may represent a change in a borrower's financial condition
- Eg. Borrower consistently paid by the 28th, now payments are arriving between the 2nd and 10th of the following month.
- Pre-emptively contact member

Watch List:
High Value Loans

- EG. Create report of Vehicle Secured Loans Exceeding 100% at Origination
- Set a threshold, eg. Loans > $40,000
- Use NADA or Kelly Blue Book to obtain the current values and see how 'upside-down' the loan is today
- Link to member's credit score, now and at origination
- For borrowers whose FICO has migrated downward or payment pattern has changed, put on watch list
- Pre-emptively contact member

Watch List: *At-Risk Loans*

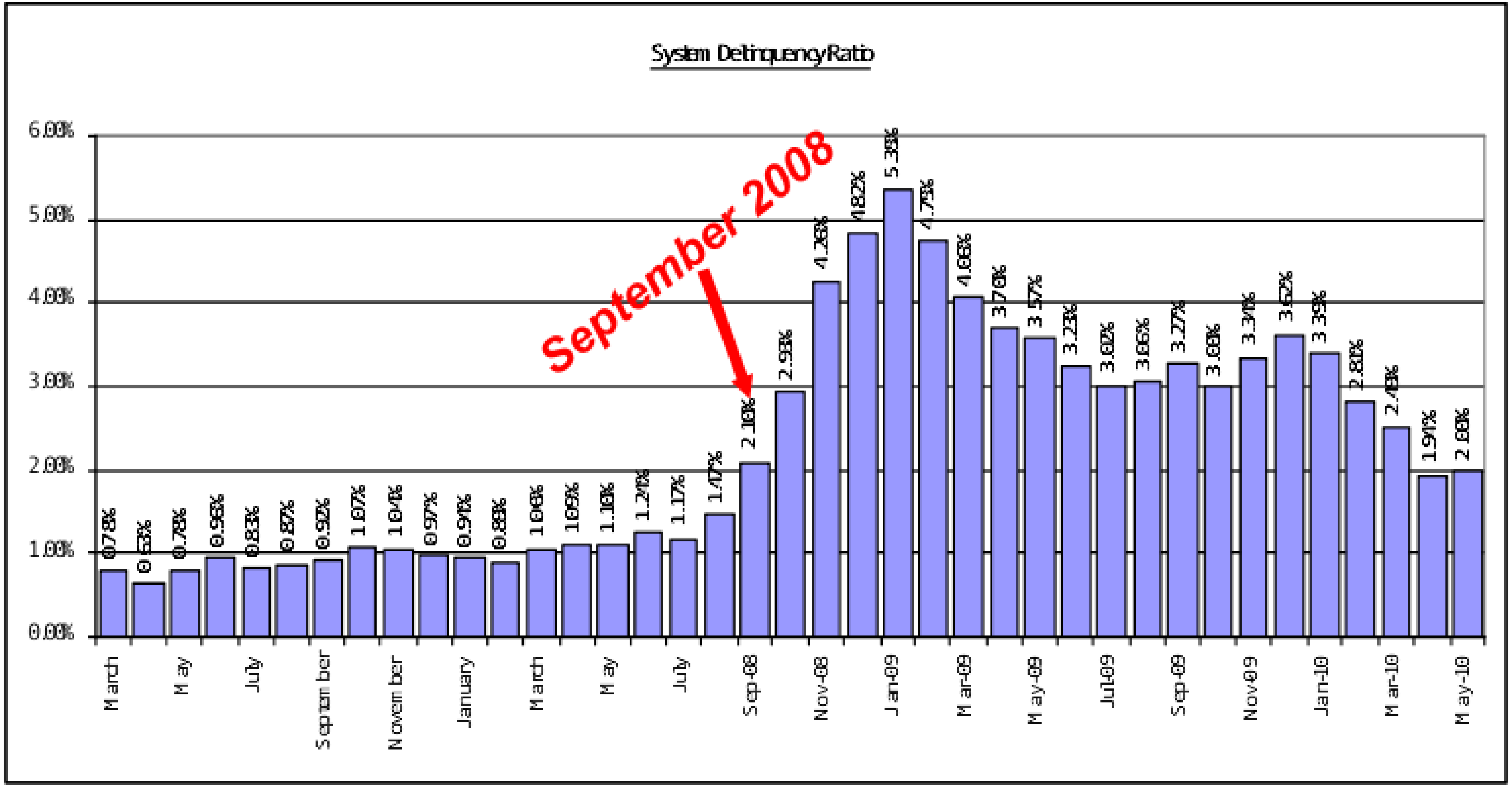
High Balance Auto Loans

Borrower	Orig Date	Orig Balance	Orig Value	Current Balance	Current Value	Orig FICO	Current FICO	FICO Migration	Orig LTV	Current LTV	Risk	Action
Rachel Green	2019	42,000	46,000	36,000	38,000	668	664	-4	91%	95%	low	none
Monica Geller	2016	39,000	35,000	30,000	29,000	714	698	-16	111%	103%	high	contact
Joey Tribbiani	2017	58,000	58,000	51,000	48,000	658	678	20	100%	106%	low	none
Chandler Bing	2018	69,000	60,000	61,000	49,000	725	707	-62	115%	124%	high	contact
Phoebe Buffay	2018	49,000	47,000	42,000	40,000	702	640	-18	104%	105%	high	contact
Ross Geller	2019	69,000	65,000	61,000	54,000	723	725	2	106%	113%	med	watch

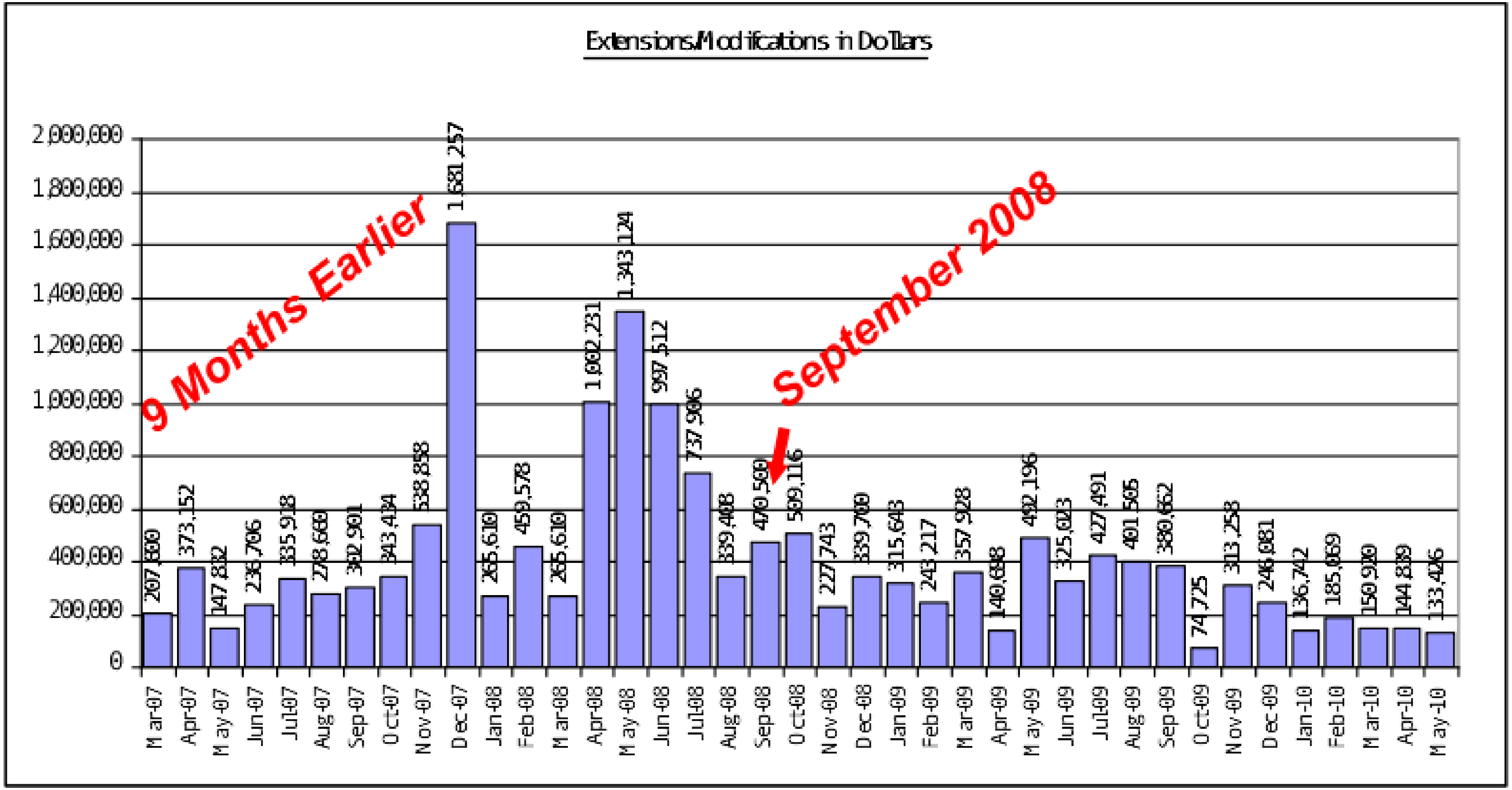
Monitoring Modifications

Track number and amount of Loan Modifications and TDRs (troubled debt restructures)… EVEN IF THE LAW DOESN'T REQUIRE IT

If delinquencies did this, was there something that predicted it?



Loan Modifications or TDR trends will often foretell coming delinquency problems



Monitoring Modifications

Loan Modifications and TDRs

Make sure all modified loans are segregated from and reported separately from the non-modified portfolio

- ***Once a loan is modified, all bets are off regarding the borrower or loan behavior***
- ***This loan is no longer just a New Car or Mortgage loan***
  - ***It is now an 'impaired' loan***
- ***The purpose is to <u>not fool yourself</u> by hiding them among all other loans***

Monitoring Real Estate Portfolio

In-house Mortgage/HELOC analysis

- Obtain current FICO score of borrowers
- Test for FICO migration from lower risk to higher
- Obtain current value of collateral
- Contact borrowers who are leaning toward greater risk. Work preemptively with them
- With HELOCs, be ready to reduce or close lines with greater risk

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Monitoring Real Estate Portfolio

Mortgage Loan/Home Equity Trends

Borrower	Orig Date	Orig Balance	Orig Value	Current Balance	Current Value	Orig FICO	Current FICO	FICO Migration	Orig LTV	Current LTV	Risk	Action
Harvey Specter	2009	125,000	165,000	68,000	110,000	668	664	-4	76%	62%	low	none
Rachel Zane	2016	325,000	350,000	275,000	280,000	714	698	-16	93%	98%	high	contact
Louis Litt	2015	87,000	110,000	55,000	95,000	658	678	20	79%	58%	low	none
Jessican Pearson	2018	225,000	275,000	213,000	220,000	725	707	-18	82%	97%	high	contact
Micheal Ross	2019	475,000	525,000	470,000	425,000	702	640	-62	90%	111%	high	contact
Donna Paulsen	2014	235,000	292,000	200,000	275,000	723	725	2	80%	73%	med	watch

May add to the ALLL due to risk identified in this report

If a member is high risk, reach out. Be sure to contact them and work with them.

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Find ways to keep borrowers in their loan

- Be proactive in helping members manage:
    - Consider a 3-month Skip-a-pay
    - Followed by 3 months of Interest Only
    - Develop solution ideas
    - Reach out to borrowers, etc.

Your **ALLL** Is Going to Rise

Most credit unions have been using historical 'Look Back" period of 12 or 24 months.

That history is suddenly irrelevant

The historical period should resemble the period you are entering – 2020 will be more like 2008-2010.

Consider using the historical data from those years to develop your ALLL

Monitoring Current Credit Card Portfolio

Look for this troubling combination:

- Increasing use of credit line
- FICO migration to lower score
- Negative change in payment pattern

Be ready to contact the member pre-emptively

Monitoring Current Credit Card Portfolio

- Look at mechanism used to establish borrower's credit limit (per card and total unsecured)?
- Is mechanism still viable in the current economic times?
- It may be important to reduce or cut-off the credit limit to protect the credit union

Generate as Much Income as Possible

1. Get crazy about mortgage refinancing
   A. Hold if you can. (interest income)
   B. Sell if you can't. Find a good outlet and sell as much as possible for as high a rate as possible (non-interest income)
2. Ask every department to suggest budget cuts of ___ %
   A. Let them know that just because something was budgeted in 2020, it doesn't mean you will get it
3. Furlough staff who will qualify for unemployment?
   A. Some CU staff are earning more furloughed than employed
4. Don't cut Marketing!!!
   A. But make every dollar count…Loans, Loans, Loans; Digital, Digital, Digital.

Generate as Much Income as Possible

1. Slightly reduce Courtesy Pay charge but increase eligibility and limits (wisely)
   A. Higher volume and income will likely ensue (non-interest income)
   B. Consider something like ***Chime***
      A. For long-term members, no fee is charged for the first $100 overdrafted. A
         I. Hall Pass on smaller overdrafts
2. Do whatever you can to encourage Debit card usage
   1. Instant issue/digital issue
   2. Cash back program?
   3. Periodic drawings on debit transactions to win $500

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Consumers will still borrow. Make sure they borrow from you!

1. Spend money to market three things…*Loans, Loans, Loans*
2. While caution is essential, loan diversity can improve yield:
   A. Broad credit quality spectrum
   B. Broad product spectrum
3. Mortgage Refi's – if you can hold mortgage in your portfolio
   A. Look at 5/1, 7/1, 10/1 or some other shorter-term options
4. HELOC and Home Equity
   A. Perhaps as consolidation loans (but understand your local market values)
5. Digital marketing, digital marketing, digital marketing

Remove every obstacle to borrowing.

1. Fast **on-line automated** approvals for qualified borrowers
2. Put APPLY FOR LOAN button on home page
3. Shorten loan application to **5-7 questions** (to conditionally qualify)
4. Follow-up with call from **incented closer**
5. Follow up on every **abandoned** loan application
   A. Ask only **name, email and phone number** on first screen.
   B. Have **incented lending salespeople** monitor and call quickly
6. Don’t ask for any document you don’t absolutely need
7. Reach out to members with pre-approvals for every loan they qualify for

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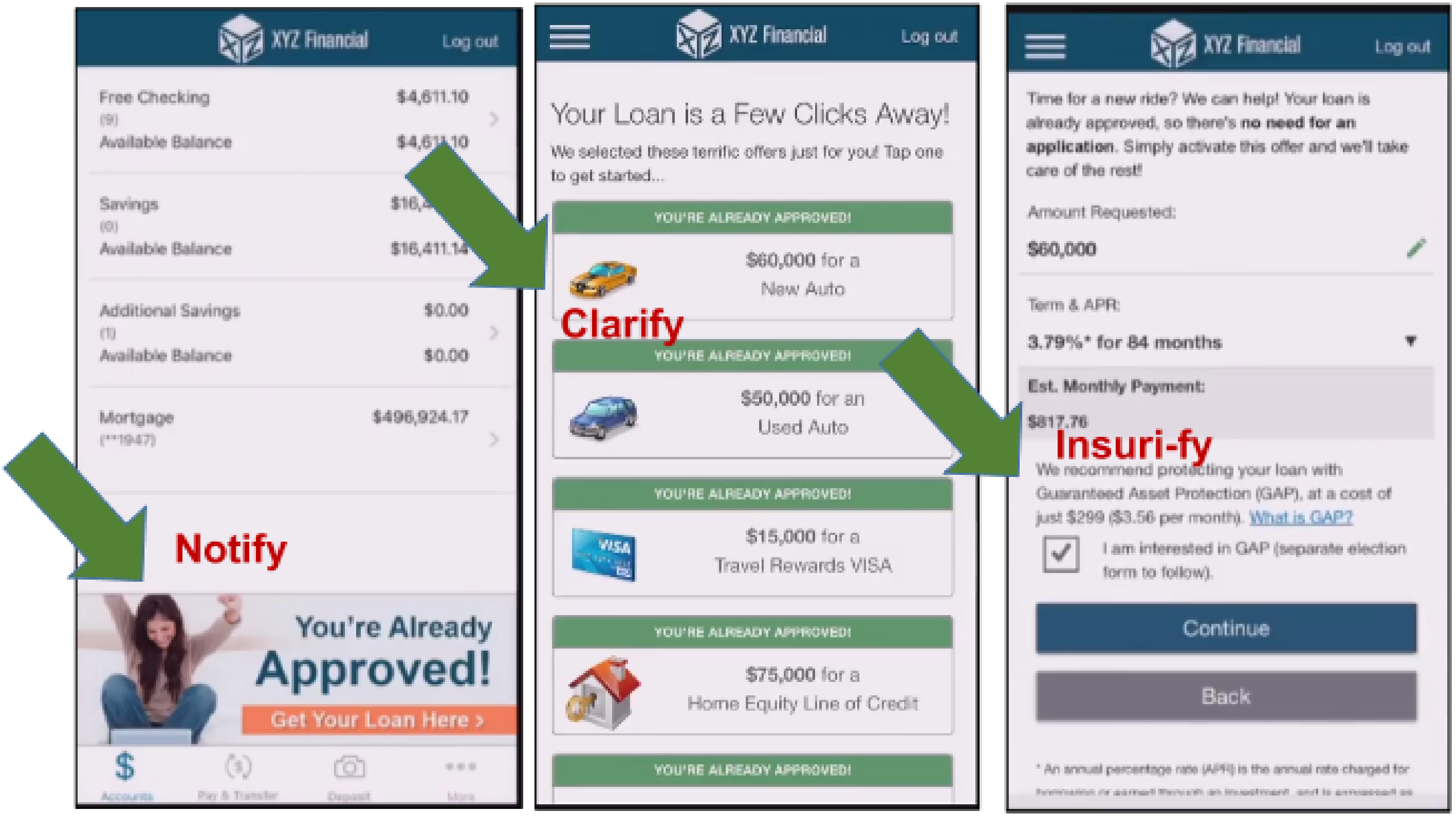
From offer to loan in 10 seconds???

cuNexus

- Great pre-screening
- Perpetual loan approval
- Approve, fund and insure in 10 seconds
- Trackable marketing



“Smooth Seas do not make good sailors.”

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Control Growth
Preserve Capital!
Hyper-focus on New Loans
Generate Revenue
Reduce Non-Essential Costs

Think Long!
Act Short!
Preserve Capital!

TIM Transform Inspire Motivate

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