OLDEN LANE

The Tides They Are A'–Changin'

What's inside:

July 2022 – A concise write-up from the team at Olden Lane.

Only when the tide goes out do you discover who's been swimming naked."

Warren Buffett

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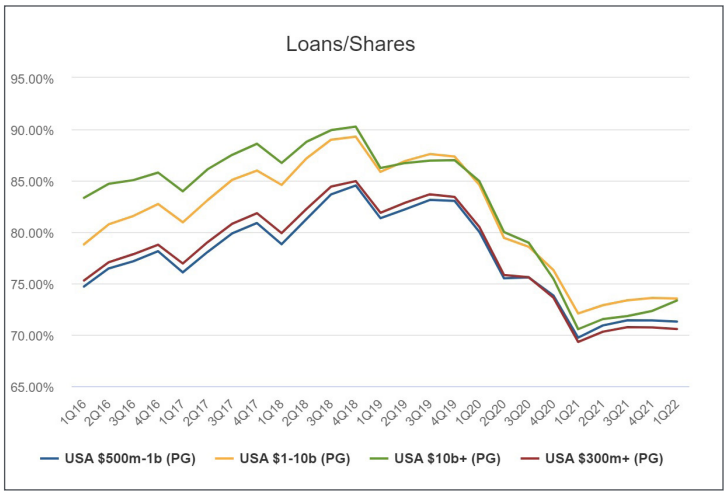
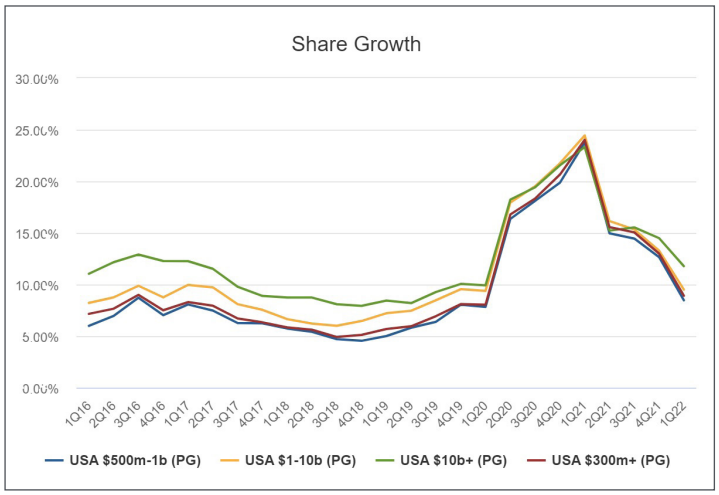
The Tides They Are A'–Changin'

Credit unions have been awash in funding for the last two years.

The combination of IRS administered stimulus checks (issued in April 2020, December 2020, and March 2021) and historically low interest rates meant credit unions were flush with shares. Moreover, accommodative Federal Reserve policies ensured that anomalously low interest payments were required for credit unions to maintain these shares.

Credit unions of all sizes enjoyed abnormally high share growth following the stimulus payments. In fact, the six quarters from Q2 2020 to Q3 2021 represented each of the top six quarters of share growth for the average credit union since the start of data in 1998. Leaving no doubt as to causation, the industry's initial uptick corresponds directly to the issuance of the first stimulus check, and the peak in 2021 Q1 corresponds to when the deposits of the latter two stimulus checks were likely processed.





All chart data from Callahan and Associates, Inc.

On the asset side of the balance sheet, the robust share growth was accompanied by flat loan growth on average. As a result, the industry saw a sharp dip in the loan-to-share ratio for all credit union peer groups, falling to a 70% average in the first quarter of 2021 from an all-time peak of 85%, in late 2018. This decline is comparable in magnitude to the drop in the same ratio following the U.S. financial crisis in 2008, despite being driven by vastly different underlying factors. This combination should have driven a compression of credit union earnings as they were unable to redeploy these new liabilities into loans, but, because rates were kept low by the Federal Reserve, credit unions were comfortable. This era is now likely at a close.

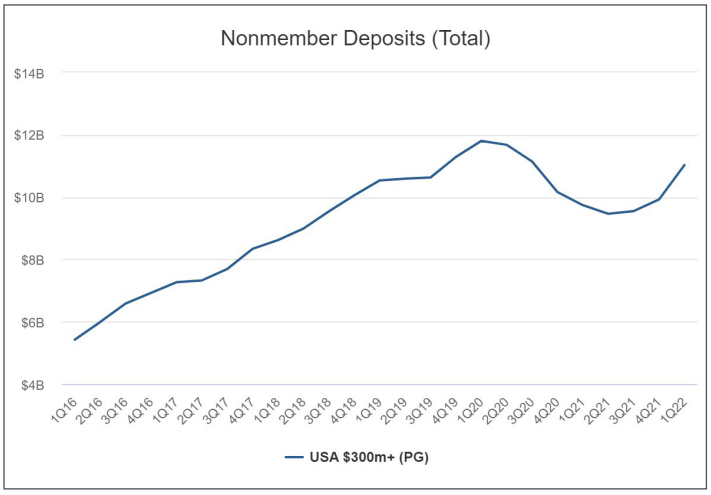
If savings rates continue to fall, however, and debt continues to rise, credit unions will quickly find themselves needing access to additional liquidity to properly serve their members.

With rising interest rates and an uncertain economic environment, ample and cheap credit union liquidity is drying up. Considering the length of the low interest rate environment and the speed of the recent interest rate reversal, many credit unions will be surprised by the pace at which their liquidity posture has changed from surplus to scarcity. The Federal Reserve has already raised its interest rate target three times this year and the futures market for the Federal Funds Rate is pricing in an additional 75 basis point increase in July.

Compounding this market change, the personal savings rate, representing the amount of disposable income each American saves, fell to 4.4% in April, the lowest level since September 2008.[1] Americans' pocketbooks are being stretched by a variety of economic factors, forcing them to save less and spend more. Most recently, inflation numbers reached a 40-year high and those Americans not able to make ends meet are taking on more debt. According to the Federal Reserve, U.S. household debt reached an all-time high in the first quarter, rising to $15.84 trillion.[2]

In the near term, credit unions will likely be able to continue to meet loan demand using the remaining excess liquidity from government stimulus. If savings rates continue to fall, however, and debt continues to rise, credit unions will quickly find themselves needing access to additional liquidity to properly serve their members.

One available source of alternative liquidity is non-member deposits, a tool for credit unions that has gained popularity over the last decade, as credit unions and the NCUA have become more comfortable with the available programs. The chart below shows total outstanding non-member deposits for all credit unions for the past six years. It demonstrates that while non-member deposits declined during the pandemic, they have already recovered to 2019 levels and are poised to rise even higher in the current interest rate and inflationary environment. Utilizing non-member deposits allows credit unions to better match the duration of their assets and liabilities while also providing the necessary liquidity to grow their loan books.

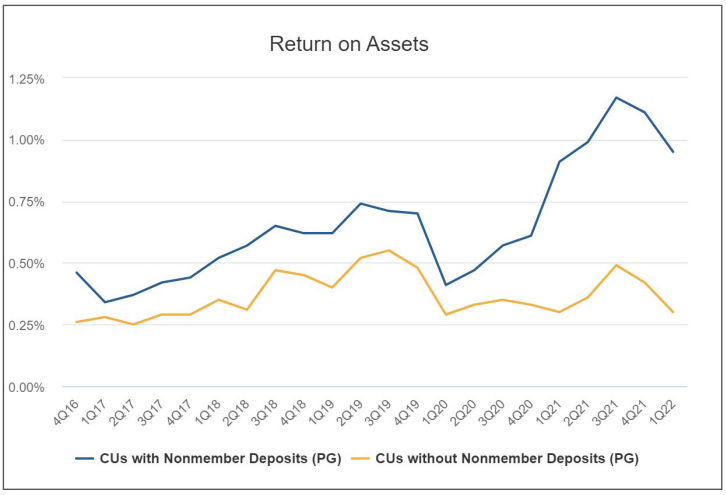


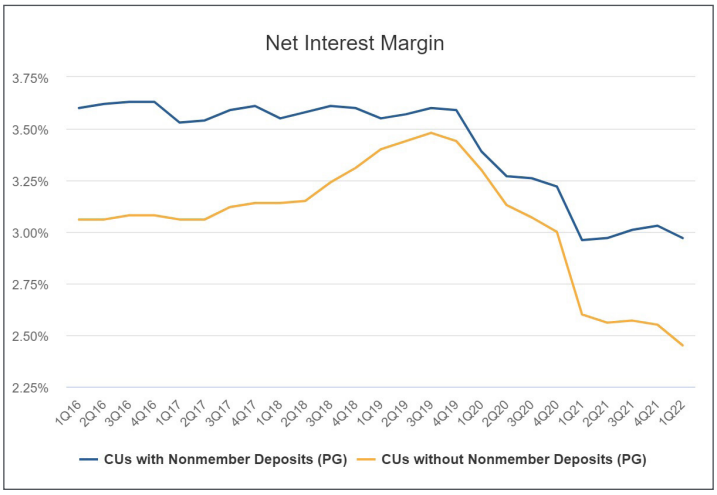
[1] https://www.bea.gov/news/2022/personal-income-and-outlays-april-2022

[2] https://www.cnbc.com/2022/05/10/household-debt-nears-16-trillion-despite-rising-rates-and-inflation.html#:~:text=Reserve%20reported%20Tuesday.-,Consumer%20debt%20and%20credit%20rose%201.7%25%20in%20the%20first%20quarter,the%20first%20quarter%20in%202021.

[3] *In October 2019, the NCUA increased the limit on non-member deposits, allowing credit unions to receive up to the greater of "50% of the net amount of paid-in and unimpaired capital and surplus less any public unit and nonmember shares, as measured at the time of acceptance of each public unit or nonmember share," or $3 million.*

Historically, credit unions that have raised non-member deposits have outperformed those who have not. For example, in every quarter since 2016, institutions that have taken on over $1m in non-member deposits have had a higher average Return on Assets (ROA) and Net Interest Margin (NIM) than those who have not used non-member deposits.





As credit unions respond to the changing economic landscape, we expect that non-member shares will again be front and center as a significant part of a holistic liquidity program. In today's environment, access to non-member deposits, coupled with a healthy plan to attract member shares and a mix of liquid, marketable securities, should serve a credit union well. At the same time, such a strategy allows for a healthy diversification of funding sources. Today, sound liquidity management requires that a credit union avoid funding source concentration, especially as liquidity pressures elevate.

In 2010, the NCUA joined federal bank regulators in issuing a call for diversified funding strategies in an "Interagency Policy Statement on Funding and Liquidity Risk Management." We suggest that this document be given renewed consideration in the current environment. And, we urge all credit unions to consult this guidance and heed its tenets:

> *"An institution should establish a funding strategy that provides effective diversification in the sources and tenor of funding. It should maintain an ongoing presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources. An institution should regularly gauge its capacity to raise funds quickly from each source. It should identify the main factors that affect its ability to raise funds and monitor those factors closely to ensure that estimates of fund-raising capacity remain valid."* [4]

[4] *See, e.g., Interagency Policy Statement on Funding and Liquidity Risk Management (Mar. 17, 2010), at 8, available at https://www.federalreserve.gov/boarddocs/srletters/2010/sr1006a1.pdf.*

At Olden Lane, our team of experienced market professionals is able to assist credit unions as they manage through changing liquidity environments. And, as markets evolve, credit union leaders will be wise to get smart on the various sources for these funds and the idiosyncrasies of each.

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