U.S. CREDIT UNIONS: WALKING THE TIGHTROPE

BALANCING GROWTH IN A RISING INTEREST RATE ENVIRONMENT

DECISIONPOINT™ by WNS

Overview

Credit unions, while being a small contributor to the U.S. financial services industry, hold significant importance for their members. They have maintained a strong loan growth over the years, with industry loans exceeding USD 1 Trillion in the second quarter of 2018.

The interest rate environment as dictated by the U.S. Federal Reserve's (Fed) policies impact the growth and performance of credit unions. There is a clear trend of increasing interest rates over the last four revisions in 2018. With indicators pointing at a slower growth in 2019, the Fed has already marked down its growth and inflation projections. Recent policy briefings signal further rate rises in the medium term.

Credit unions are feeling the impact of the rising rates. For example, auto loans, constituting approximately 35 percent of their portfolio, have witnessed a decline in the past year. Further, credit unions also experienced a flat quarter-on-quarter yield on loans in 2017-2018.

Credit unions will need to re-assess their lending and investment strategies in the current environment. They have to find ways to continue lending while maintaining adequate liquidity. Building a contingency plan for any short-term change is also recommended.

This WNS DecisionPoint™ report analyzes the growth trajectory of credit unions, in loans, assets and membership, across categories in context of the interest rate policies. It also discusses the possible options and approaches credit unions can take to deal with the situation in the near future.

- As interest rates continue to rise due to the U.S. Federal Reserve's policy, consumer lending is likely to experience further slowdown in 2019
- Credit unions now have to re-assess their lending and investment strategies, while maintaining liquidity
- A WNS DecisionPoint™ analysis shows that if policymakers allow credit unions more opportunities to partner with small businesses, it will have far-reaching implications for the industry

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In its latest policy review, the United States (U.S.) Federal Reserve (Fed) continued on its trajectory of rate hikes by raising the target range of the federal funds rate to 2.25–2.5 percent. This is the fourth rate hike in a series of three consistent rate hikes in 2018. Economic data monitored by the Fed indicates that the labor market has continued to strengthen amid strong job gains and a low unemployment rate. The Fed has indicated two rate rises ahead for 2019 in the wake of softening economic data and anticipated global growth slowdown.

A look at financing conditions in the consumer credit markets presents a mixed picture. While nurturing of growth in household spending, interest rates on consumer loans continued to rise. In the residential mortgage market, tight financing conditions persisted for borrowers with low credit scores. There was a slowdown in the growth of home-purchase mortgage originations as mortgage rates reached their highest level since 2011, and refinancing activity remained muted.[1]

Consumer lending is likely to experience further slowdown in 2019. The path of U.S. rate rises over the course of next year will determine the lending strategies of credit unions and their subsequent growth. In the coming sections, we will assess the forecasts for U.S. interest rate rises and how these will impact credit unions and their lending portfolios.

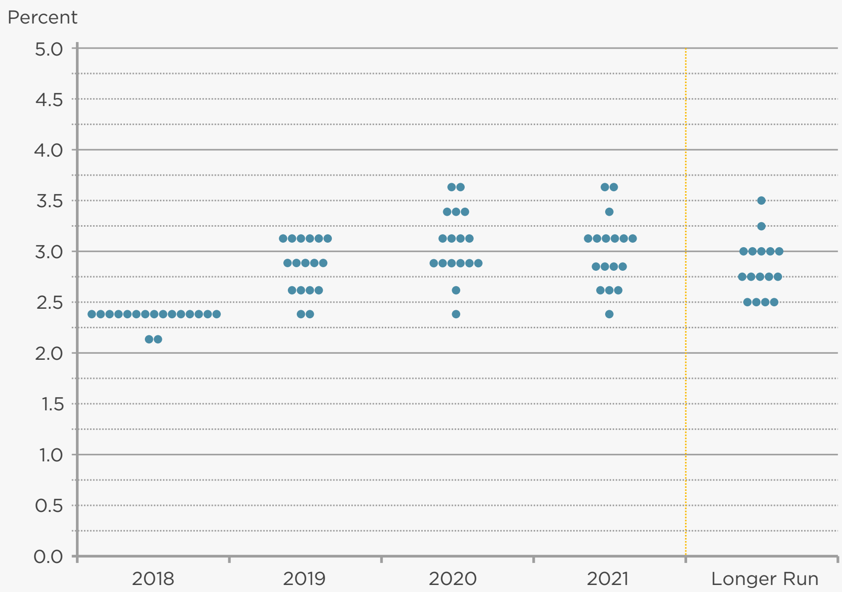
FORECAST OF U.S. INTEREST RATE TRAJECTORY

In its press conference held on December 19, 2018, the U.S. Fed singled out two important points that will differentiate the trajectory of U.S. interest rates in 2019 from that of 2018. Firstly, 2019 will witness moderate growth compared to the rising pace of growth in 2018. The additional tightening of financial conditions seen over the last couple of months combined with signs of weaker growth seen outside of the U.S., have led the Fed to mark down its growth and inflation projections.[2] Secondly, the U.S. economy continued to strengthen in 2018. Given the four rate hikes, the Fed signaled that it will be providing a smaller boost to the economy in 2019 and put the target rate for the Fed between 2.25 to 2.5 percent, at the lower end of the range of estimates provided by the Federal Open Market Committee (FOMC).[3]

1. Minutes of the Federal Open Market Committee, November 7-8, 2018
2. Transcript of Chairman Powell's Press Conference Opening Remarks, December 19, 2018
3. Ibid

Exhibit 1

FOMC Participants' Assessments of Monetary Policy: Mid-point of the Target Range of the Federal Funds Rate



Source: Federal Open Market Committee Projections, December 2018

The chart describes the policymakers' assessments of the future path of monetary policy. Each shaded circle (rounded to the nearest 1/8 percentage point) indicates an individual participant's perception of the mid-point of the target range of the federal funds rate toward the end of the year. With at least two more rate rises anticipated in 2019, U.S. interest rates are set to follow a rising course in the medium-term, with far reaching implications for the credit union industry.

CREDIT UNIONS: INDUSTRY TRENDS

Credit unions are member-owned, non-commercial cooperative financial institutions. They are run autonomously, led by directors who offer their services for free and function to serve their field of membership. In terms of size, they occupy a tiny proportion of the U.S. financial services industry, and yet they are of paramount importance to their members.

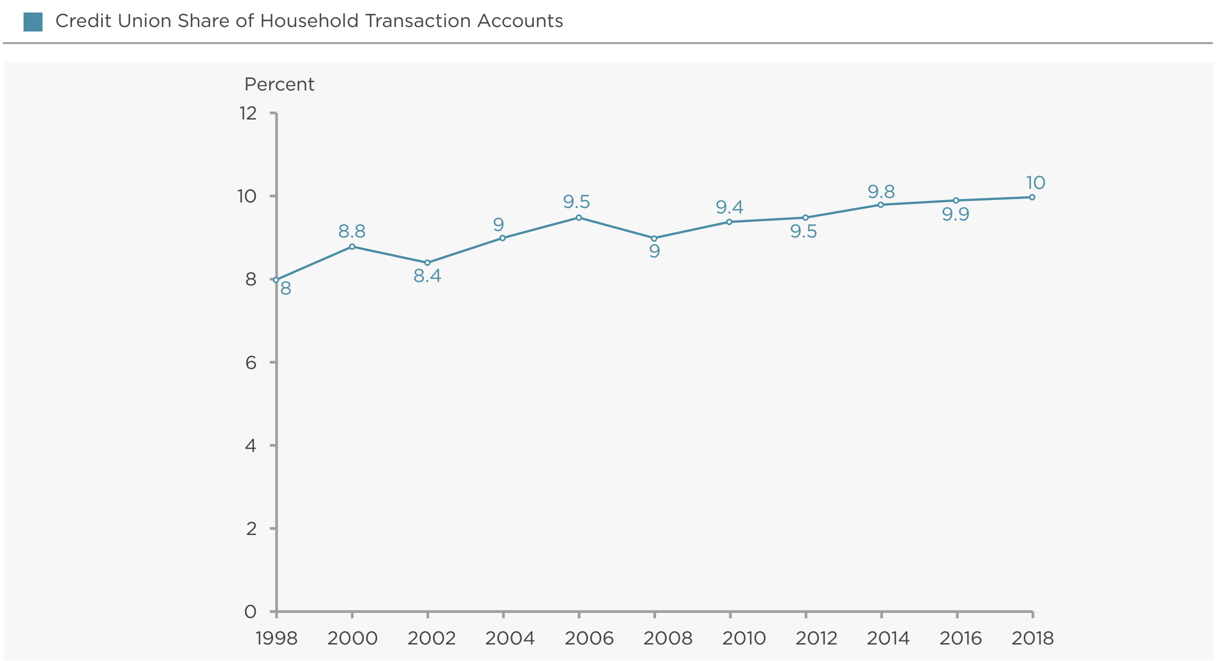
The vast majority of credit unions are small financial institutions trying to gain a footing in the highly competitive financial services industry. The median credit union manages a meagre USD 33 Million in assets and has 8 full-time employees.[4] By comparison, the median bank has more than USD 210 Million in assets and 45 full-time employees.

In addition, the credit union industry is less top-heavy than the banking industry. The top 100 banks represent 81 percent of total bank assets, whereas the top 100 credit unions only account for 44 percent of industry assets. Each of the three largest banks accounts for more assets than all 5480 credit unions combined.

4. 2018 NAFCU Report on Credit Unions, National Association of Federal Credit Unions

Exhibit 2

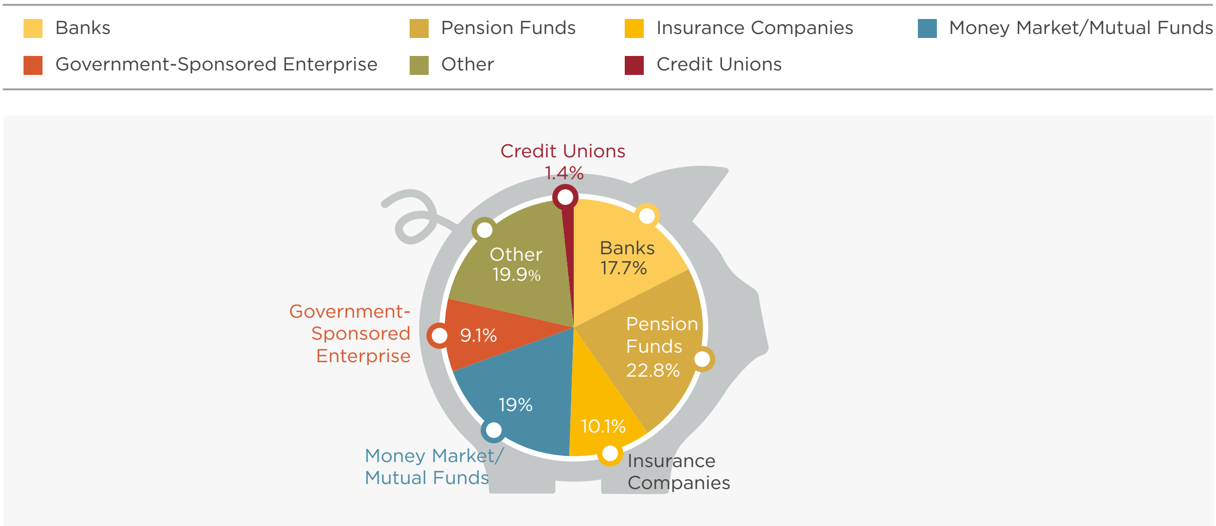
Credit Union Share of Household Transaction Accounts



Source: Financial Accounts of the United States

Exhibit 3

Share of Domestic Financial Assets in 2018



Source: Financial Accounts of the United States

Year-over-year growth in credit union membership was 4.3 percent in June 2018, its highest level in three decades.[5]

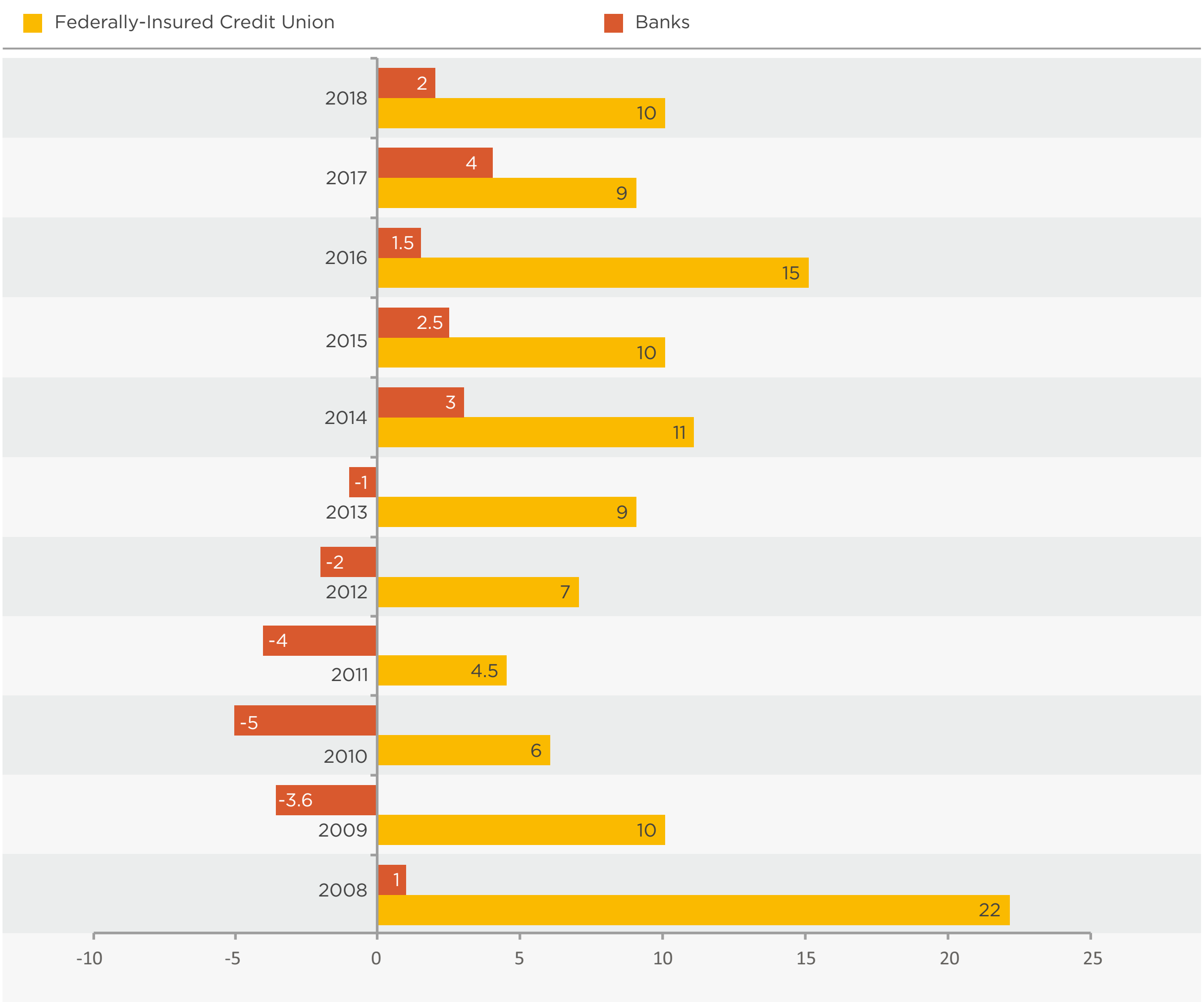
5. Ibid

HOW HAVE RISING U.S. INTEREST RATES AFFECTED CREDIT UNION LENDING?

In recent policy briefs, the Fed has indicated more rate rises in the medium- term, thereby pushing credit unions to reassess their lending and investment strategies.

Exhibit 4

Small Business Loan Growth



Source: National Credit Union Administration; Federal Deposit Insurance Corporation

An assessment of credit extension by type of institution reveals a pattern of credit unions maintaining a flow of credit to the small businesses sector. As policymakers grapple with the prospects of a slowing economy in the near-term and decline in business dynamism, they would do well to provide credit unions with more opportunities to partner with small businesses.

Exhibit 5

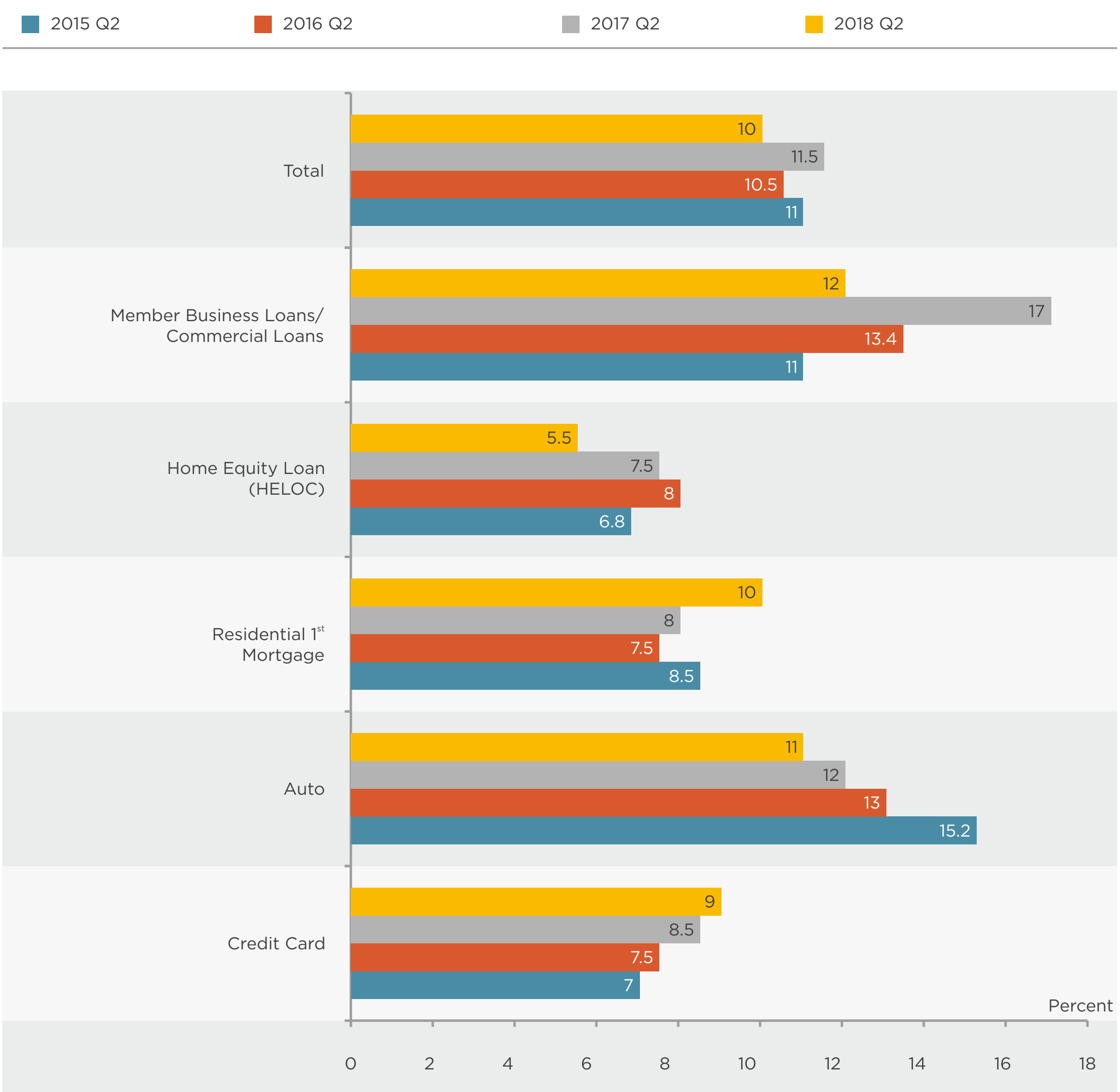
Top 10 Credit Unions as of September 2018

Credit Union	Asset Rank		Assets		Asset % change	Member Rank		Members		Member % change
	Sept -18	Dec -17	Sept -18	Dec -17		Sept -18	Dec -17	Sept -18	Dec -17	
Navy FCU	1	1	95,308,043,652	90,565,764,127	5.2	1	1	8,121,667	7,542,010	7.7
State ECU	2	2	38,577,953,375	37,318,930,375	3.4	2	2	2,363,917	2,272,944	4.0
Pentagon FCU	3	3	24,078,710,098	22,858,875,932	5.3	3	3	1,686,675	1,626,359	3.7
BECU	4	4	18,756,685,226	17,853,551,539	5.1	4	4	1,147,090	1,081,077	6.1
SchoolsFirst FCU	5	5	14,876,023,946	14,118,974,703	5.4	7	7	845,685	793,592	6.6
First Tech FCU	6	7	12,265,746,776	11,392,700,229	7.7	16	15	542,985	506,442	7.2
Golden 1 Credit Union	7	6	12,125,057,884	11,486,760,824	5.6	6	5	983,252	921,901	6.7
Alliant CU	8	8	10,965,140,012	9,696,343,968	13.1	19	20	428,427	385,302	11.2
America First FCU	9	10	10,241,482,016	9,214,916,059	11.1	5	6	998,845	905,161	10.3
Security Service FCU	10	9	9,549,770,009	9,526,054,404	0.2	12	8	774,223	750,971	3.1

Source: Credit Union National Association, December 2018.

Exhibit 6

Loan Growth by Product Line



Source: National Credit Union Administration; Federal Deposit Insurance Corporation

Credit unions have maintained strong loan growth over the years. In the second quarter of 2018, total industry loans outstanding exceeded USD 1 Trillion. More than 70 percent of that comprises first-lien residential mortgages and auto loans (35 percent each). The remainder of the loan portfolio consists of junior-lien residential loans (8 percent), commercial loans (7 percent), credit card loans (6 percent) and unsecured personal loans or lines of credit (4 percent).[6]

6. 2018 NAFCU Report on Credit Unions, National Association of Federal Credit Unions

Auto lending has been a key component of the industry lending, propelling total loan growth for years. However, auto sales have declined sharply from a year ago, primarily due to rising interest rates which have led to a fall in auto loans. As rates continue to rise, auto companies enjoy greater flexibility with regard to offering low rates on vehicles, thereby potentially gaining an advantage over credit unions and taking a small amount of business away from them. Also, consumers have been used to low interest rates for a very long time. Hence, even a slight increase in interest rates might steer consumers away from loans.

So what strategies can credit unions deploy to stay afloat in the rising interest rate tide? One of the best ways to combat the challenge is to continue to loan as much as they can, while maintaining adequate liquidity to service the members' financial needs.[7] A proper contingency plan must be in place should credit needs change in the short-term. Yields on loans have consistently declined over the last several years, but stayed flat quarter-on-quarter in 2017 and 2018 – a clear indication that credit unions are starting to feel the impact from the re-pricing of newly originated loans. Credit unions are facing increasing pressure both from consumers to increase deposit rates and from internal business, as loan growth has outpaced share growth and created a need for additional deposits to fund future loan growth. One way to meet this challenge and fight rising interest rates would be to offer more adjustable-rate products, enabling an increase in expected income as and when rates rise.[8]

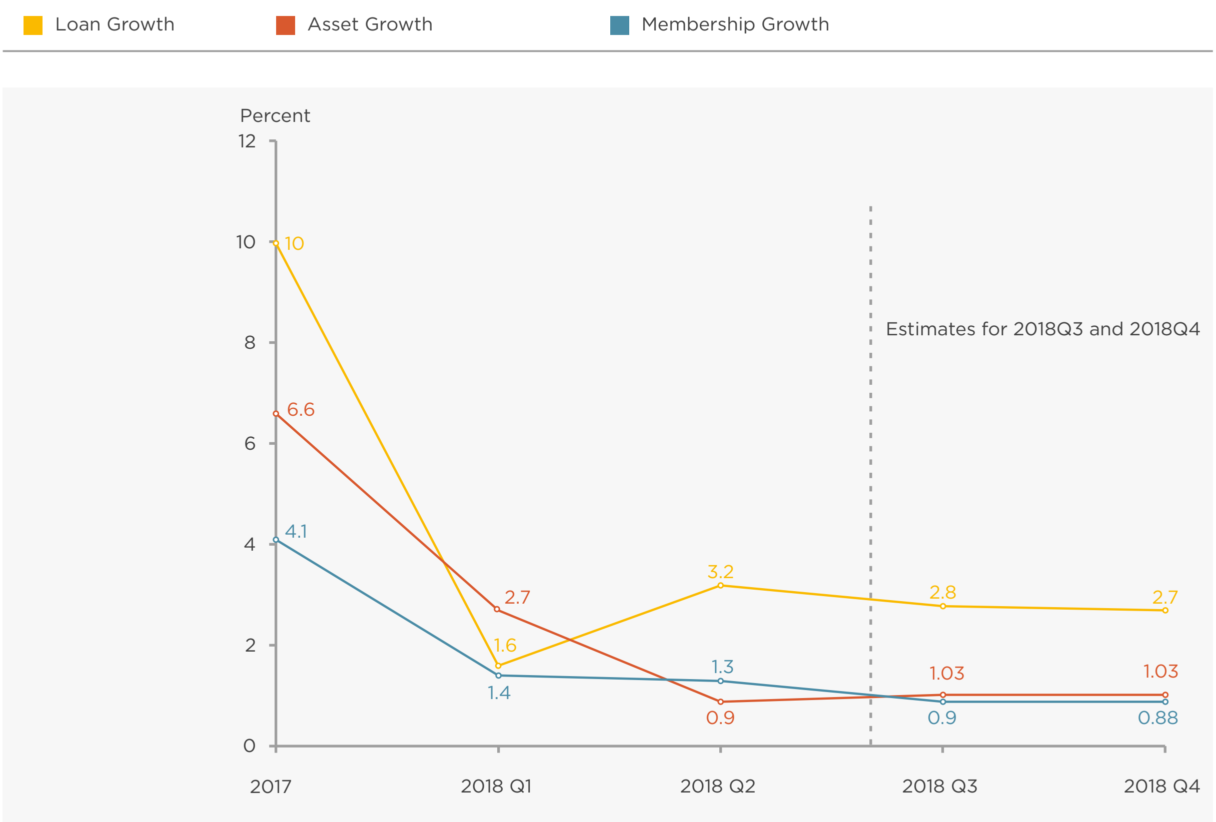
7. 'As interest rates climb, how should credit unions respond and strategize?', Credit Union Journal, March 2018
8. Ibid

OUTLOOK FOR CREDIT UNIONS

Based on actual historical data from the Credit Union National Association, WNS DecisionPoint™ has created loan growth, asset growth and membership growth estimates and forecasts of credit unions for the third and fourth quarter of 2018. Credit unions have enjoyed a period of high growth across the three categories through 2017 and the first two quarters of 2018. However, with spikes in interest rates having taken a toll on loans, assets and membership, WNS DecisionPoint™ estimates a downward trend for the remaining two quarters of 2018 and an overall decline from previous years across the three categories.

Exhibit 7

Credit Union Forecast



Source: WNS DecisionPoint™ estimates based on data from Credit Union National Association. 2018Q3 and 2018Q4 are estimates.

CONCLUSION

Rising interest rates in the U.S. in the last one year have had an adverse impact on the credit union industry as consumers steered away from loans. Key components of credit union loan growth, such as auto loans, have witnessed a slight decline as interest rates rose and consumers started to postpone their auto purchases. In order to maintain healthy levels of asset and loan growth, credit unions will have to adopt a host of strategies, ranging from creating more diverse rate-adjustable loan products in their portfolio offerings to maintaining adequate levels of liquidity to satisfy consumers' credit needs. With the Fed expected to go in for further rate rises in 2019, it would be interesting to see how credit unions balance their asset and loan growth with increasing pressures on liquidity levels in the industry.

About DecisionPoint

Making key decisions that improve business performance requires more than simple insights. It takes deep data discovery and a keen problem solving approach to think beyond the obvious. As a business leader, you ought to have access to information most relevant to you that helps you anticipate potential business headwinds and craft strategies which can turn challenges into opportunities finally leading to favorable business outcomes.

WNS DecisionPoint™, a one-of-its kind thought leadership platform tracks industry segments served by WNS and presents thought-provoking original perspectives based on rigorous data analysis and custom research studies. Coupling empirical data analysis with practical ideas around the application of analytics, disruptive technologies, next-gen customer experience, process transformation and business model innovation, WNS aims to arm you with decision support frameworks based on 'points of fact.' Drawing on our experience from working with 200+ clients around the world in key industry verticals, and knowledge collaboration with carefully selected partners including Knowledge@Wharton, each research asset comes up with actionable insights with the goal of bringing the future forward.

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