SEPTEMBER 2020

NAFCU

State of the Industry Report

BY NAFCU RESEARCH DIVISION

EXECUTIVE SUMMARY

The COVID-19 crisis is having a profound impact on the credit union industry. In the process, it is upending some long-standing trends and amplifying others. In an effort to identify and better understand the issues that concern our members, and to get a sense of how the current crisis is re-shaping their outlook on the future of the industry, NAFCU recently surveyed its members on some of these critical issues.[1] The results are summarized in this *State of the Industry* (SOTI) report.

Because of the large response rate to our survey, we were able to aggregate responses across a number of different dimensions, which allow for more granular insights. Specifically, this report assesses the pandemic's impact on different credit unions based on:

- Asset size
- Census region
- Low-income designation
- Local COVID severity

Please refer to the appendix for more detail on our survey population and methodology.

Our key findings include the following:

1. **Loan demand** is currently weak, save for residential real estate. However, credit unions expect stronger-than-average loan demand a year from now. Areas that were severely impacted by the COVID virus at the time of the survey reported weaker current loan demand than areas with a milder impact; however, COVID severity made little difference in respondents' year-ahead expectations for loan demand.

2. Credit unions are currently experiencing **delinquency rates** that are about average, largely due to widespread loan forbearance. However, they expect higher delinquencies than normal one year from now. Larger credit unions tend to have a more pessimistic outlook on delinquencies and forbearances than smaller ones.

3. The **low interest rate environment** is the biggest concern for credit unions related to their bottom line. Those concerns were particularly prominent among low-income credit unions. Policymakers should consider the intersection of low interest rates and rules and regulations such as the Current Expected Credit Losses (CECL) accounting standard. The combined effects could constrain the provision of credit to low-income populations.

4. **Remote work** has proven incredibly effective during the crisis. The vast majority of respondents report that their experience with remote work has exceeded expectations, and they generally expect to increase use of remote work even after the COVID-19 crisis has passed.

[1] NAFCU's State of the Industry survey was conducted between June 2 and June 19. NAFCU received responses from 218 credit union representatives, from credit unions which account for 19 percent of industry assets. We are thankful to these credit unions for taking the time to complete our survey.

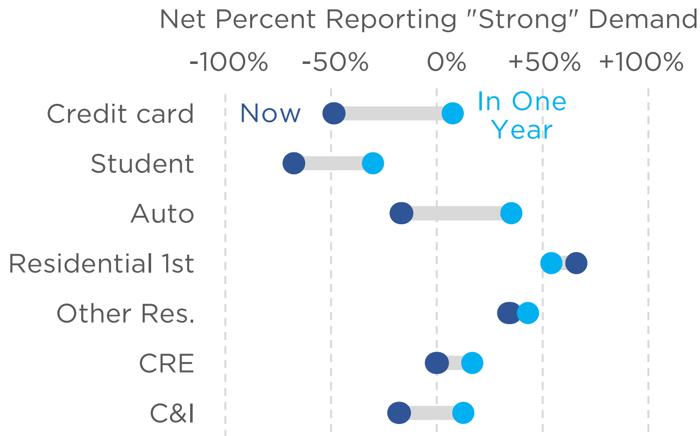
LENDING

Credit unions entered the crisis with tapering consumer loan demand even as booming mortgage refinance activity served to buoy overall loan growth. Year-over-year growth in auto loans declined from 10.1 percent at year-end 2018 to 2.5 percent by the end of 2019. In that time, overall loan growth fell from 9.1 percent to 6.2 percent. Meanwhile, loan delinquencies and charge-offs were low and stable, having achieved pre-financial crisis levels several years earlier. NAFCU's SOTI survey covered emerging challenges related to lending, including loan demand, loan competition, and delinquencies and forbearances.

Loan Demand

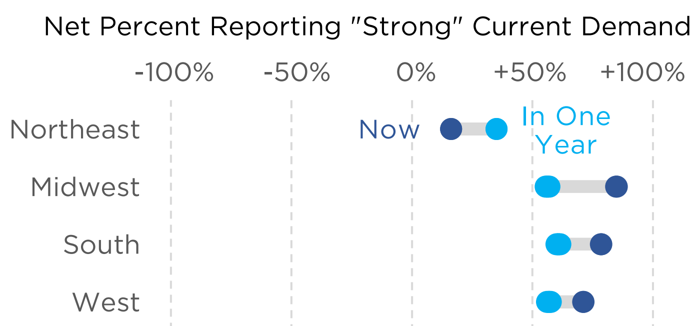
NAFCU's SOTI survey asked respondents about both current levels of loan demand and expected levels one year from now. Not surprisingly, current loan demand is weaker than average, on net, for most product segments (Chart 1).[2] The exception is real estate lending, where respondents overwhelmingly described current demand as being above average. This was particularly true for larger credit unions. While all asset classes reported relatively strong residential loan demand, credit unions with over $1 billion in assets were nearly unanimous (92 percent "strong"; 2 percent "weak"), while credit unions with under $250 million in assets were somewhat more mixed (57 percent "strong"; 19 percent "weak"). Purchase loan demand rebounded earlier and more sharply than nearly any other area of the economy following the shutdown of the economy. That development may be disproportionately benefitting larger credit unions, as they tend to do more purchase loans than smaller credit unions.[3]

Chart 1: Current and Expected Loan Demand



Source: NAFCU *State of the Industry* survey

Chart 2: Current and Expected Residential 1st Mortgage Loan Demand, by Region



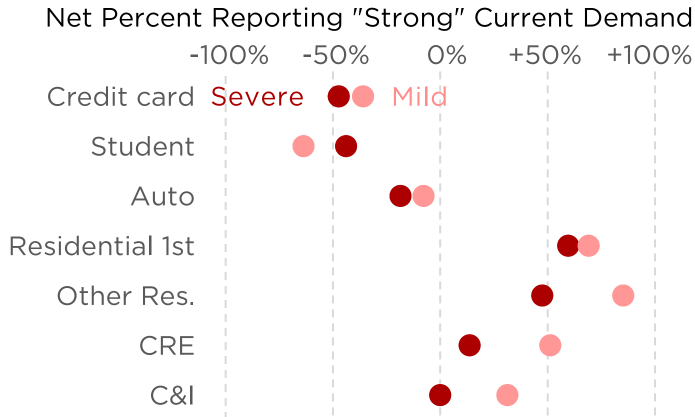
Source: NAFCU *State of the Industry* survey

NAFCU's survey also revealed some important regional distinctions in the assessment of real estate loan demand. All four Census regions reflect positive assessments of current loan demand for residential first mortgages (Chart 2). However, that sentiment was noticeably weaker in the Northeast region. This regional disparity still exists in the year-ahead expected loan demand responses, but the gap shrinks as the Northeast was the only region with a higher score for expected than current demand.

[2] The net percent reporting a certain result refers to the fraction reporting that result minus the fraction reporting the opposite result. Therefore, the net percent for a given result could range from -100 percent to +100 percent.

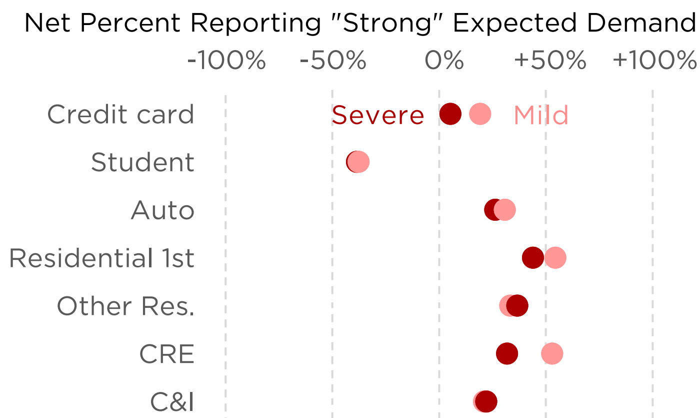
[3] NAFCU's analysis of 2019 data released under the Home Mortgage Disclosure Act indicates that, for 1- to 4-family, owner-occupied, first-lien mortgage loans, purchase loans represented 51 percent of total originations for credit unions with over $1 billion in assets, but only 37 percent for those with under $250 million in assets.

Chart 3a: Current Loan Demand, by COVID Severity



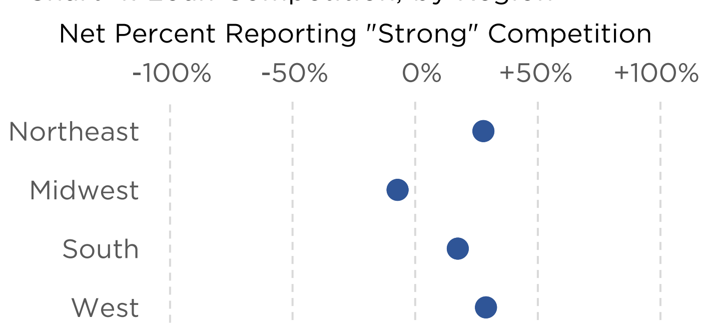
Source: NAFCU *State of the Industry* survey

Chart 3b: Expected Loan Demand, by COVID Severity



Source: NAFCU *State of the Industry* survey

Chart 4: Loan Competition, by Region



Source: NAFCU *State of the Industry* survey

We also investigated whether respondents' current and expected loan demand was impacted by the local severity of the COVID-19 virus based on respondents' branch locations. At the time the survey was conducted (early June), severely affected areas were predominantly in the Northeast region.[4] For current demand (Chart 3a), areas that were severely impacted did report weaker demand for most loan categories. This was particularly true for other real estate and business loans. However, those gaps generally narrowed or disappeared entirely for expected loan demand (Chart 3b). While this suggests that impacted areas do not expect COVID-related drags to be long-lasting, there was no indication that loan demand foregone due to the virus was expected to be recovered in the future.

Loan Competition

Despite the results on loan demand showing that demand is currently weak, survey participants reported that overall loan competition is fierce. Roughly one-third of respondents said that competition for loans is stronger than average, while only 13 percent said that it is currently weak.

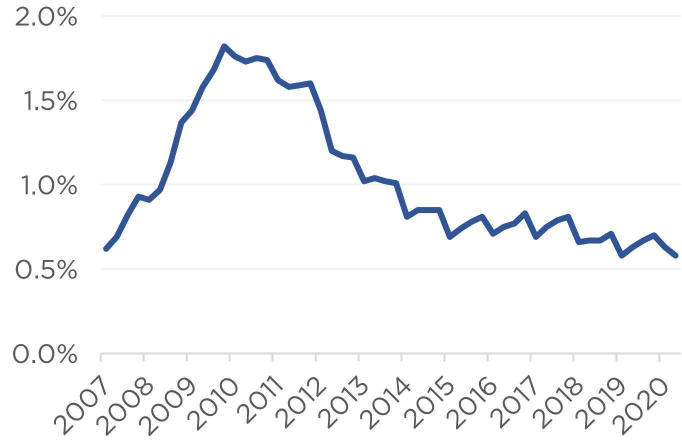
Three of the four regions reported competition that was stronger than average, on net (Chart 4). The one outlier was the Midwest region. Smaller credit unions reported stiffer loan competition than larger ones. Among credit unions with under $250 million in assets, 39 percent indicated that competition was stronger than average, compared to just 19 percent among credit unions with over $1 billion in assets. Credit unions in areas with mild rates of COVID infection also reported stronger loan competition.

[4] States and jurisdictions with more than half of the population in counties designated as "severe" as of June 2 included: CT, DC, DE, IL, LA, MD, MA, NJ, NY, and RI.

Delinquencies and Forbearances

The COVID crisis threatens what has been an extended period of stability in asset performance (Chart 5). Delinquency rates that prevailed prior to the Great Recession were achieved in the mid-2010s and have remained there since. Credit card delinquencies have been rising modestly, but that has been offset by improvements in auto and real estate loan delinquencies. Net charge-offs mostly tell a similar story; however, charge-offs at the end of 2019 (0.6 percent) were slightly higher than they were in 2015-16. While uncertainty still reigns when it comes to the impact of the virus, delinquencies, forbearances, and loan charge-offs are sure to rise.

Chart 5: Credit Union Delinquency Rate

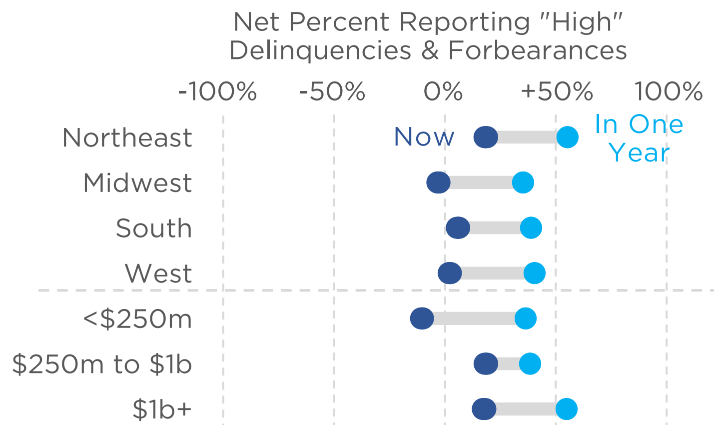


Source: NCUA 5300 data

Survey participants indicated that delinquencies are higher than average, but not yet by a wide margin. Among all respondents, 37 percent said that delinquencies and forbearances are higher than average, while 32 percent said they were lower. However, 56 percent reported that they expect delinquencies and forbearances one year from now to be higher than average, with only 15 percent expecting lower-than-average delinquencies. Delinquency rates have yet to rise in a meaningful way across the industry, thanks in large part to the breadth of loan forbearance. In a March survey of NAFCU members, every respondent said that they had extended payment accommodations such as skip-a-pays and loan deferrals.

Dissecting the responses by region, the Northeast region once again is an outlier (Chart 6). While the aggregate responses from the other three regions are centered roughly at average for current delinquencies, the Northeast reported higher than average current delinquencies, on net. This gap holds for the year-ahead expectations, as well. Each region anticipates that delinquencies will be higher than average in 12 months, but that feeling is strongest in the Northeast.

Chart 6: Current and Expected Delinquencies and Forbearances, by Region and Asset Class



Source: NAFCU *State of the Industry* survey

Reviewing the responses by asset class, mid-sized and large credit unions indicated that delinquencies and forbearances are higher than average, while credit unions with under $250 million in assets claimed lower than average delinquencies, on net.[5] Each asset class expected delinquencies to be higher than average in one year, but that sentiment was strongest for the largest credit unions. Large credit unions as a group have loan portfolios with heavier residential mortgage loan concentrations.

[5] Note that smaller credit unions in aggregate have higher average delinquency rates than larger credit unions.

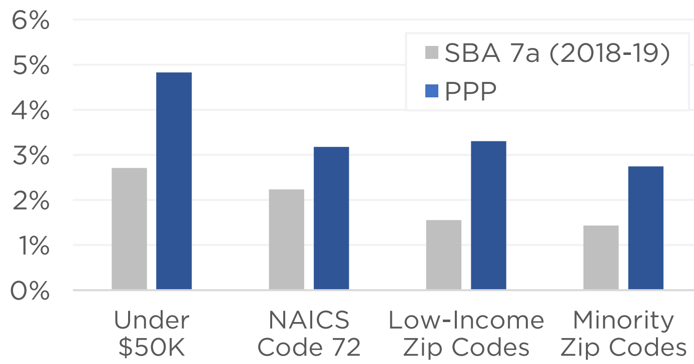
Paycheck Protection Program

Despite the challenges posed, credit unions are already going the extra mile to serve their communities. One clear example is with the Small Business Administration's (SBA's) Paycheck Protection Program (PPP). The program seeks to provide liquidity to the distressed small business sector; according to data from Yelp, over 40 percent of closures on its website since March are permanent.[6] The PPP generally provided forgivable loans of up to $10 million to businesses with 500 or fewer employees. However, there were numerous reports of delays in getting those loans to borrowers in a timely way. Despite the program's "first-come, first-served" design, large lenders in particular were accused of catering to existing customers.[7]

Traditionally, credit unions have stepped in to fill the void when larger lenders cut back on credit provision.[8] However, most credit unions do not focus on small business lending as a result of the artificial business lending cap. Furthermore, the fact that the PPP program was, by necessity, developed in such a short amount of time meant that credit unions who wanted to participate faced additional hurdles as compared to institutions with a longer history of SBA lending. Despite those challenges, NAFCU heard from countless members about the extraordinary efforts they took in order to participate in the program, familiarizing themselves with SBA's lending portal and application process, deputizing staff from other divisions to process loans applications, and working through the night to make sure that their applicants could get in line as early as possible when there were no guarantees of future rounds of funding.

The data confirm that credit unions did indeed increase their presence in the PPP relative to their SBA footprint in recent years (Chart 7). The PPP was an extension of the SBA's 7a loan program, which is the SBA's primary ongoing program to support small businesses. As compared to 7a lending from the prior two years, credit unions made a larger share of PPP loans in several critical areas. These include small-dollar loans (those under $50,000), those to borrowers with an industry NAICS code of 72 (primarily hotels and restaurants), those to borrowers in low-income zip codes, and those to primarily nonwhite zip codes.

Chart 7: Share of Loans Originated by Credit Unions, by SBA Lending Program



Note: NAICS Code 72 is primarily restaurants and hotels; Low-income zip codes are those with median annual household income below $40k; Minority zip codes are those where more than half of population is non-white

Sources: Census Bureau, SBA Loan Level Data, NAFCU calculations

Based on NAFCU's analysis, over 900 credit unions took part in the PPP. Of that amount, more than three-quarters did not make a 7a loan in the prior two years. Nearly 300 of these new SBA lending credit unions are subject to the business lending cap, yet they still took part in the program and originated over 40,000 loans. The fact that credit unions were willing to do so with limited long-term incentive stands in stark contrast to how large banks approached the PPP. Eliminating the cap altogether would these and other credit unions to provide additional small business credit to many communities as they seek to recover from the impact of the pandemic.

[6] *Yelp: Local Economic Impact Report* (updated June 25, 2020)

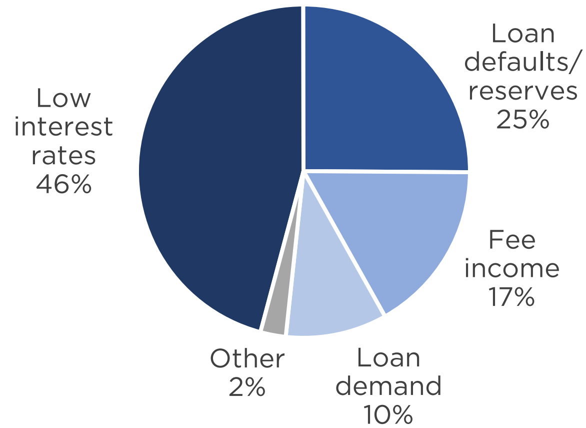
[7] *Banks Gave Riches Clients 'Concierge Treatment' for Pandemic Aid*, New York Times (April 22, 2020)

[8] Wilcox, James. "The Increasing Importance of Credit Unions in Small Business Lending." *Small Business Administration Office of Advocacy*, September 2011.

EARNINGS

Industry return on average assets (ROA) was a sturdy 93 basis points in 2019. Low charge-offs and strong real estate loan growth contributed to an environment where credit unions could succeed despite a flat yield curve which traditionally stresses financial institutions. Those solid returns helped credit unions rebuild capital following the Great Recession. The industry net worth ratio climbed to 11.4 percent at the end of 2019, which is equal to 2007. As credit unions endure the COVID-19 crisis, the impact of broader economic forces will undoubtedly weigh on earnings.

Chart 8: Greatest Challenge to Net Earnings



Source: NAFCU *State of the Industry* survey

NAFCU asked survey respondents about various challenges they face to their bottom lines. The single greatest, as identified by nearly half of respondents, is the low interest rate environment (Chart 8). Historically, smaller credit unions have relied more on net interest margins to support operations, but responses to NAFCU's survey were fairly consistent across asset classes; 43 percent of credit unions with under $250 million named the rate environment as their chief concern versus 44 percent of credit unions over $1 billion. However, there was a clear difference between low-income credit unions (LICUs) and non-LICUs. The majority of LICUs (56 percent) named the low-rate environment as their main challenge, as compared to 39 percent of non-LICUs.

This is particularly concerning as the effective date of the current expected credit loss (CECL) accounting standard draws near for credit unions, currently scheduled for 2023. Congress has noted that CECL poses risks to the provision of credit to low- and moderate-income consumers and small businesses.[9] It is important as policymakers weigh the impact of CECL on vulnerable communities that they also account for the tight margins lenders will likely face when CECL goes takes effect. In combination, this poses a considerable headwind for those communities and could hamper the recovery of the broader economy.

The second greatest concern for respondents was high loan defaults and associated reserve expenses. Call report data through March shows the early impact of loss provisioning on earnings. As compared to 2019, first quarter provision for loan loss expense as a percent of average assets reduced overall ROA by 10 basis points on an annualized basis.

The third-ranked concern was declining fee income. Generally speaking, credit unions provide low-fee financial products to their members. A recent survey found that 82 percent of credit unions offered free checking to their members, compared to just 38 percent of banks.[10] As a percent of total assets, fee income has declined each year since 2012, and is down 27 basis points since 2008.

Despite this concern, respondents are reluctant to raise fees or eliminate products or services. Just five percent of all respondents said their credit union is considering increasing fees, and even for respondents where declining fees are the chief earnings concern, only six percent are thinking or raising fees. Similarly, only six percent of respondents said that their earnings outlook has them considering about eliminating existing products or services.

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[9] *Luetkemeyer Calls for Committee Action on CECL*

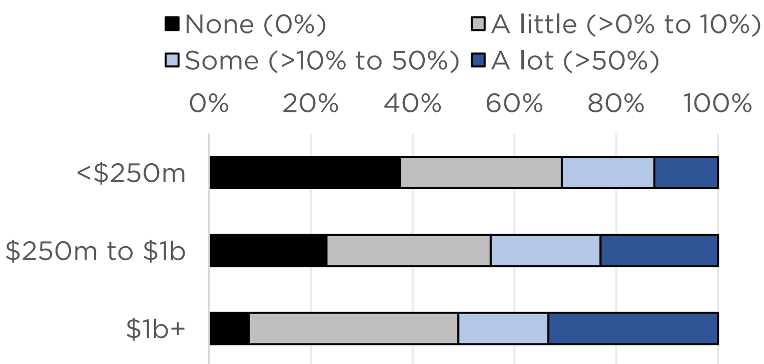
[10] https://www.bankrate.com/banking/checking/survey-free-checking-largest-credit-unions/

REMOTE WORK

The biggest challenge for many employers during COVID-19 has been the abrupt switch to full-time telework throughout the organization. Credit unions are in a unique situation in that they provide essential financial services, much of which is delivered through their physical branch networks, but also employ a substantial number of centrally-located staff, many of whom can perform their jobs remotely. NAFCU's SOTI survey explored how broadly credit unions are utilizing work from home (WFH) arrangements with non-branch staff, how those experiences are faring, and what the prospects are for wider adoption of regular WFH after the pandemic.

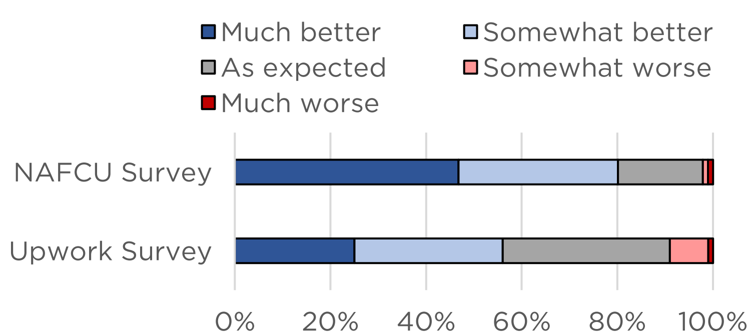
Most survey respondents had already adopted a WFH policy for non-branch staff prior to COVID-19. Among surveyed credit unions, 75 percent reported that staff were regularly teleworking. Looking at the responses by asset class, it is not surprising to see that large credit unions had implemented telework more broadly than smaller credit unions (Chart 9). Over 90 percent of credit unions with over $1 billion in assets said that at least one staff member was regularly teleworking before the pandemic, and 33 percent said that at least half of their non-branch staff was regularly teleworking. Although adoption rates were lower among smaller credit unions in our survey, more than 60 percent had some degree of regular telework in place.

Chart 9: Share of Non-Branch Staff that Regularly Teleworked prior to COVID-19, by Asset Class



Source: NAFCU *State of the Industry* survey

Chart 10: How WFH has Functioned during COVID-19, NAFCU Survey vs. Upwork Survey



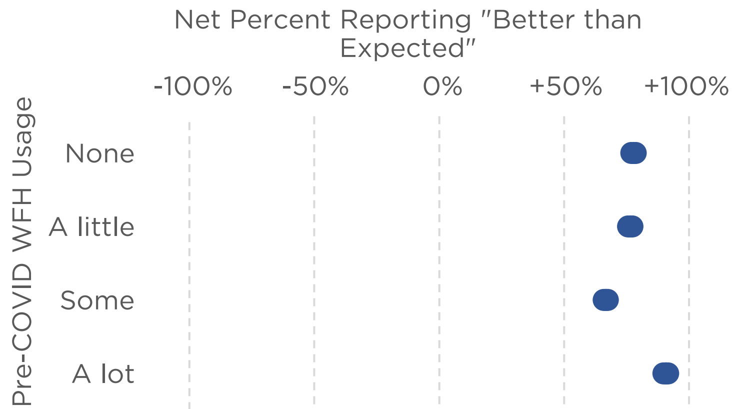
Sources: NAFCU *State of the Industry* survey, "Future of Remote Work" (Upwork)

NAFCU also asked respondents to assess how WFH is faring relative to expectations at the outset of the COVID crisis. The results were overwhelmingly positive: 74 percent said that WFH is going better than expected, while only 2 percent said the experience has been worse than anticipated. These results line up favorably in comparisons with similar surveys. Upwork, a freelancing platform, posed the same question to 500 hiring managers in April.[11] While that survey also yielded a positive experience, on net, the overall sentiment was more mixed than in NAFCU's survey (Chart 10). In the Upwork survey, the main issue that hiring managers said was going poorly was technology. It may be that because most credit unions had experience with WFH prior to the pandemic, technological hurdles posed less of a challenge than for other industries. The main benefits of WFH, according to the Upwork survey, are the elimination of commutes, fewer meetings, and the lack of office-related distractions.

[11] Ozimek, Adam. "The Future of Remote Work." *Upwork*, April 2020, http://upwork.com/press/economics/the-future-of-remote-work.

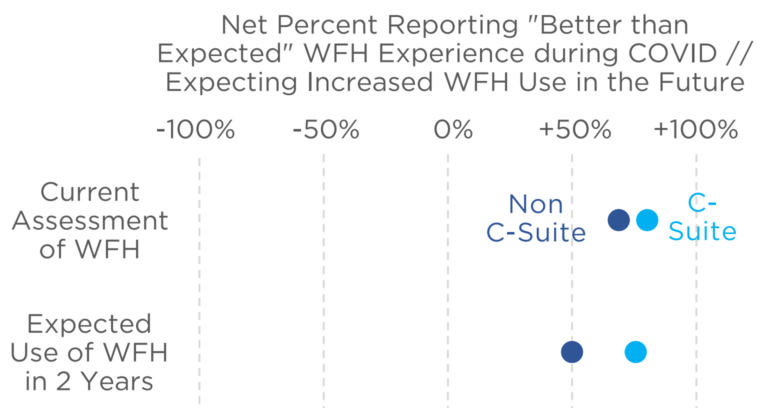
Chart 11 shows the results to this same question asking respondents to assess their current experience with WFH, according to pre-COVID utilization of WFH. Interestingly, responses were extremely positive for every pre-COVID category, even for those credit unions that did not have any non-branch staff working remotely on a regular basis. The phrasing of the question is important, as respondents were asked to judge WFH during COVID-19 against their expectations at the outset. It may be that credit unions with less experience with remote work anticipated more challenges and therefore had lower expectations. This could explain why respondents in the next two categories, those with more than zero and up to 50 percent of non-branch staff regularly teleworking, provided slightly less positive assessments of current WFH relative to expectations.

Chart 11: How WFH has Functioned during COVID-19, by pre-COVID WFH Usage



Source: NAFCU *State of the Industry* survey

Chart 12: Current WFH Assessment & Expected Future Use of WFH, C-Suite vs. Non C-Suite Staff



Source: NAFCU *State of the Industry* survey

However, our survey suggests that credit unions where "a lot" (more than half) of staff regularly teleworked prior to COVID are having the most positive results. A staggering 91 percent of such credit unions reported that WFH is going better than expected, while the other 9 percent said it was "as expected." Presumably, these credit unions should have had the most accurate expectations for how they would fare under an extended period of WFH across the organization, and yet the vast majority say that their actual experience exceeded those expectations. This suggests that the benefits of past experience may be nonlinear. Credit unions where more than half of non-branch staff work remotely on a regular basis are ones where each division is accustomed to coordinating while one or more members are out of the office, and where WFH is an ingrained part of the organizational culture. It is these credit unions which are experiencing the best outcomes with remote work during COVID-19.

Finally, respondents were asked whether they expect their credit unions to expand the availability of remote work after COVID-19. Here again the results were exceptionally positive. Overall, 75 percent of survey participants expect their credit union to utilize remote work more than it did prior to the pandemic, while only 5 percent expected to use it less. However, in both the assessment of current experience during COVID and in their outlook for future WFH adoption, C-suite respondents were somewhat more positive than staff (Chart 12). One lesson for executives who expect to increase use of WFH after the pandemic subsides may be to ensure that their staff is as eager to do so as they are.

APPENDIX: NOTES ON METHODOLOGY

NAFCU received 218 survey responses from 204 unique credit unions. For instances where multiple responses were received from one credit union, we used the response from the highest ranking official at that credit union. However, in our analysis of responses by staff level, duplicate responses per institution were counted.

The category dimensions were determined as follows:

- Asset classes were based on assets reported on the credit union's December 31, 2019 call report.
- LICU status was based on the limited income flag in the December 31, 2019 call report data.
- Region is based on the location of the credit union's headquarters using the Census regional map (see next page).
- COVID severity was based on positive cases per capita as of June 2, when the survey was released. NAFCU's analysis looked at each credit union's U.S.-based branches and assigned an average based on the county-level positive cases where those branches are located. All credit unions across the nation were then ordered from highest to lowest cases. "Severe" credit unions are those in the top quartile of per capita cases, "mild" credit unions are in the bottom quartile, and "moderate" credit unions are in between.
- NAFCU's survey was targeted at C-level staff. However, we received a fair number of responses outside of the C-suite. Therefore, we provide responses based on that distinction, as well.

Category	Nbr of Respondents
Total	204
Asset class	
<$250 million	88
$250 million to $1 billion	65
Over $1 billion	51
Low-income credit union (LICU) status	
LICU	120
Non-LICU	84
Region	
Northeast	38
Midwest	34
South	85
West	47
COVID severity	
Mild	43
Moderate	110
Severe	51
Staff level*	
C-Suite	170
Staff	36

* responses are for unique credit unions except at the staff level, where duplicate responses per institution were counted

Census Regional Map