Digging Out From the Great Recession

Special *Credit Union Times* Supplement

As the economy turns from downward plummet to gentle valley, *Credit Union Times* is here to help you prepare for what's to come. This special supplement, "Digging Out From the Great Recession," is provided as a bonus to our subscribers to help you navigate the potential pitfalls and recovery to come. Here, we delve into what economists and regulators will be looking at in 2010, as well as what a cross section of credit union executives are expecting in their shops. To complement this effort, we've also included a bonus feature found only at cutimes.com: Q&A: CPA Veteran Talks ALLL Funding. Just search the headline on our site. As always, we welcome your thoughtful and constructive feedback.

Negative Equity Increased to One in Four Mortgages at Year-End 2009

By HEATHER ANDERSON

Nearly one in four mortgages nationwide was in negative equity status as of Dec. 31, 2009, according to a report released Feb. 23 by First American CoreLogic. That represents more than 11.3 million properties.

An additional 2.3 million mortgages were approaching negative equity at the end of 2009, with less than 5% in the black. Together, negative and near-negative equity mortgages accounted for almost 29% of all mortgages nationwide.

The report called out five states where negative equity is concentrated. Nevada is alone at the top with 70% of borrowers underwater. Arizona and Florida follow at around 50%, with Michigan trailing at 39% and California with 35% rounding out the top five.

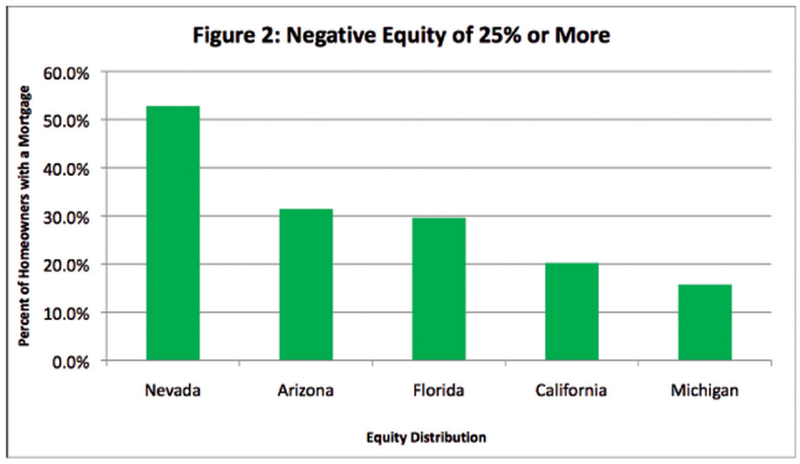
Negative equity is a significant drag on both the housing market and on economic growth.

Nevada's statewide loan-to-value ratio stands at 123%, underwater by nearly $25 billion. Arizona and Florida followed with 95% and 91% LTV respectively, and Georgia made a notable showing at 80%.

Daniel Penrod, senior industry analyst for the California and Nevada Credit Union Leagues, said Nevada's housing market has been made worse by such a high percentage of speculative buyers during the boom years. To a lesser extent, speculative buyers also hurt Arizona's market.

"Speculative investors watched home prices in California go up beyond their price range," Penrod said, and those who couldn't afford to buy an investment property in the Golden State went shopping in Las Vegas or Phoenix instead.

"So many areas had a huge run-up in home prices with nothing to sustain it once the bubble burst," he said. While Newport Beach or San Francisco have coastal geography and high paying jobs to support price increases, other areas saw price increases driven by speculators. Many were California residents who funded the purchase with equity pulled from their homes, he said.



Mortgages aren't just a little bit in the red in some states. The graph above charts the percentage of underwater mortgages that have 25% or more negative equity. (Source: First American CoreLogic)

Investment buyers look at the bottom line, he said, and will walk away more quickly.

"People didn't want to lose $20,000 today, but it was better than losing $50,000 in a few months, so homes hit the market quickly" in Las Vegas, he said.

News that California's housing market is stabilizing showed in equity numbers; compared to other high negative-equity states, California had the smallest increase during the fourth quarter at only 0.4%. Nevada, Georgia and Arizona experienced the largest increases.

"Negative equity is a significant drag on both the housing market and on economic growth. It is driving foreclosures and decreasing mobility for millions of homeowners," said Mark Fleming, chief economist with First American CoreLogic. Fleming said because he expects home prices to only increase slightly during 2010, negative equity will remain a "dominant issue" in mortgage markets for "some time."

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Smaller Recovery Expected in the Sand States for 2010

By HEATHER ANDERSON

The second-half rally forecast by economists for the entire country also holds true for the so-called sands states in 2010. However, in places like Nevada, where mortgages statewide are 123% loan-to-value, recovery is a relative term.

DHAWAN

Nevada's economy was reliant upon California weekenders, conferences and international tourism, said Daniel Penrod, senior industry analyst for the California and Nevada Credit Union Leagues. So when those markets stopped bringing discretionary income to Las Vegas, jobs and home values disappeared faster than a lost bet.

"Unemployment dropped about 1% in a month near the end of the year," Penrod said, "but according to people in the area, it was due to migration out of the state, not job creation."

On the bright side, Penrod said once Nevada's economy does regain its footing, remaining unemployed residents will have less competition. Until then, Nevada is still in survival mode, with its state government "running at a large deficit" and "trying to keep afloat." However, he said he thinks speculative buyers and entertainment spenders will return to Nevada, maybe even later this year; however, its lack of economic diversification will hamper recovery compared to other states.

Penrod described his 2010 economic forecast as "cautiously optimistic." Economic diversity is helping California, even though like Nevada, it also experienced a large residential property value bubble and has state deficit issues as well.

The technology sector has been "surprisingly resilient" in San Jose and other areas, Penrod said, and while tourism is down, global draws like Disneyland and the San Francisco Bay area are still doing decent business. News that Disneyland resurrected the late Michael Jackson's 1980s era 3-D production Captain EO last month, prompted by multiple requests from fans, shows that "even the big dogs in California are pulling out all the stops" to attract consumer spending.

More affordable homes will also help California's economy get rolling again, as companies can offer less pay because cost of living has decreased.

"When the bubble was building in the coastal regions, companies couldn't attract talent and pay them enough to buy a home nearby, so a lot of companies moved out of the state to get wage scale," Penrod said.

However, Penrod cautioned that while coastal California is recovering, inland areas are projected to experience far less job growth or consumer confidence in 2010. While the state economy is diverse, specific areas still depend upon one or two major industries, and inland jobs in transportation, warehousing and logistics are still down thanks to lower consumer spending and import demand.

The East Coast's sand state, Florida, will experience some recovery in 2010, but the University of Central Florida's fourth quarter state economic forecast called job growth "feeble." And while new housing starts are expected to rise and speculative buyers snap up affordable excess inventory, real estate will be a "fraction" of what was once a major part of the state's economy.

The report said Florida's state government business model, built upon decades of high rates of population growth, must now contend with decreasing population and much less growth for several years.

"Gaudy rates of population growth will no longer be par for the course in Florida, and thus the model for economic development must evolve, as must the tax structure," the report said.

UCF predicted a 1.8% gross domestic product growth for the state in 2010, and although unemployment is expected to peak and remain high, reduced property taxes will ease some burdens on residents in 2010. Additionally, consumer spending is expected to pick up a little bit in the second half of the year. GDP, jobs and consumer spending is forecast to improve at a faster rate in 2011.

Florida's northern neighbor Georgia is also struggling economically. The Peach State's 80% loan-to-value average is among the highest in the nation, plus Georgia has almost the same ratio of underwater properties as California.

Rajeev Dhawan, professor and director of Georgia State University's Economic Forecasting Center, said Georgia led the nation in originating interest-only mortgages due to affordability issues. Like in the Bay Area's Oakland, or Los Angeles' Inland Empire, the outlying suburbs of Atlanta have experienced significant foreclosures and decline in equity.

Unemployment dropped about 1% in a month near the end of the year, but according to people in the area, it was due to migration out of the [California], not job creation.

On top of that, since the recession Georgia has lost 7% of its job base, similar to the impact of job losses in Florida, he said.

Dhawan earned his doctorate at the University of California-Los Angeles and said he "knew all about affordability issues" and recognized the bubble burst coming in Georgia.

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2010: Consumer Spending Will Spark Modest Economic Growth

By HEATHER ANDERSON

Economists both in and outside the credit union industry agree the country probably left the worst of the recession behind with 2009, and 2010 could bring some modest economic growth. However, challenges remain in the coming year, especially in employment and the housing market, which tempered the overall optimism.

SHIERHOLZ

NAFCU Chief Economist Tun Wai said based on his conversations with the trade's members and attendees at a conference for chief financial officers he recently attended, the most worrisome balance sheet issue for credit unions isn't the economy, it's the size of this year's deposit insurance premium.

"It's a rather significant amount, especially when not very many institutions have that capacity to pay," he said. A sluggish economy exacerbates the situation, he said, because loan demand and approvals are low, making it tough to generate additional revenue. Lowering cost of funds to pay for the assessment hurts savings growth, too.

VELZ

"It's the government asking for it, and credit unions are required to pay," Wai said, "and it's a big concern, how to fund the coming assessment."

The size of the assessment depends indirectly upon the economy, as so many seized institutions suffer from real estate loan losses and modification options are limited by job losses and in some cases, severe loss of value. (*See story, page 2 of supplement*) Additionally, the performance of corporate credit unions' mortgage-backed securities depends upon the success of those modifications, as well as the housing and job markets.

Wai and Fannie Mae Senior Economist Orawin Velz have hope for 2010's economic performance, though, and the positive effect it will have on financial institutions. They predicted, respectively, a 3.5% and 3.0% growth in gross domestic product for the year, driven by an increase in consumer confidence and spending in the third and fourth quarter.

In fact, Velz cautioned credit unions to focus on consumer lending early, building relationships with members now before banks ease up on consumer lending standards. She sourced the Federal Reserve's latest survey of consumer lending officers, which she said for the "first time in many years" showed an increased willingness to lend.

Velz said Fannie Mae forecasts cautious consumers in the first half of the year, but if the labor market improves as expected, consumer loan demand will improve later in the year right as banks loosen up the supply side.

Wai was a little more cautious about loan growth because it hinges upon jobs but said, "Consumers don't borrow to just borrow. They borrow to consume." He agreed consumer spending will return, but disagreed on the timing, saying it "may come back closer to the end of the year."

"We can't forget that the home equity component of lending has disappeared," he said. Housing prices need to rise and incomes and jobs must return to more households before "people feel confident they'll have a job tomorrow" and increase debt, he said.

Velz acknowledged consumers are still leery of additional debt, saying "that's why we won't see 8% GDP growth," but rather a modest 3%. The savings rate is still increasing and consumers want to pay down debt further. But, as they increase savings, "repair their household balance sheets," and see an improvement in the labor market, they'll return to borrowing.

Velz also predicted continued improvement in residential real estate in 2010. Although she doesn't think this year will bring a quarter as strong as fourth quarter 2009, which was boosted by the first-time homebuyer tax credit, she said another credit has been expanded to repeat buyers, which will increase sales this quarter.

"By the end of the year, the labor market will be strong enough, people will stop worrying about losing their jobs, and it will create demand in home sales without government support," Velz said. She called for a strong fourth quarter 2010, and overall for the year, a 12% increase in home sales.

However, she cautioned against commercial real estate, saying that market will "continue to decline" in 2010. The labor market is still weak, creating little demand for office space, and until consumer spending returns, retail demand will also remain low.

Business borrowers will face tighter lending standards than consumers, with Velz predicting rising commercial foreclosures in 2010 but forecasting "some rebound" in 2011.

Heidi Shierholz, economist with Washington-based Economic Policy Institute, agreed with Velz and Wai that the 2010 Census couldn't have come at a better time. All three economists remarked that although the 1.2 million temporary government workers hired on this year may artificially boost employment numbers, jobs are jobs, and the good news will boost consumer confidence.

Velz said manufacturing is "coming back big time," with January bringing the first increase in manufacturing jobs in years.

However, Shierholz was less optimistic about a 2010 job market recovery. The EPI's labor market specialist said unlike after the recession of the early 1980s, this is a "jobless recovery" in which the macro economy is growing but jobs are still being shed.

Where there has been increased demand for goods and services, instead of adding overtime hours or part-time staff, employers are "merely speeding up" the pace of existing workers, and relying upon "massive productivity gains" achieved over the past few years.

Cutting hours or implementing furloughs instead of cutting jobs is another way American companies have reduced their employment costs that may not be showing up in the unemployment rate. And, instead of hiring on new workers when the economy improves, Shierholz said she thinks employers will instead restore hours to existing workers.

"If employers hadn't cut hours at the beginning of recession, we would have lost an additional 2.5 million jobs," she said, "so if employers merely restored the hours for staff they have now, it would be equivalent to 2.5 million jobs." While fatter paychecks are good for the economy, it won't help the unemployment rate.

Plus, at the average rate of population growth in America, 100,000 new jobs must be created each month to keep the unemployment rate from rising, she said. So, since the beginning of the recession in December 2007, 2.6 million jobs should have been created on top of what has been lost just to keep pace.

That means instead gaining back the 8.4 million jobs lost so far to regain pre-recession unemployment rates, the country now needs 11 million jobs. However, Shierholz conceded that immigrant flows "respond dramatically to the conditions of the U.S. labor market," and the country's population growth rate has declined since the recession began.

Because the U.S. labor market is so complicated, the unemployment rate and underemployment rate should be considered together as a "more comprehensive measure" of the market's strength, she added.

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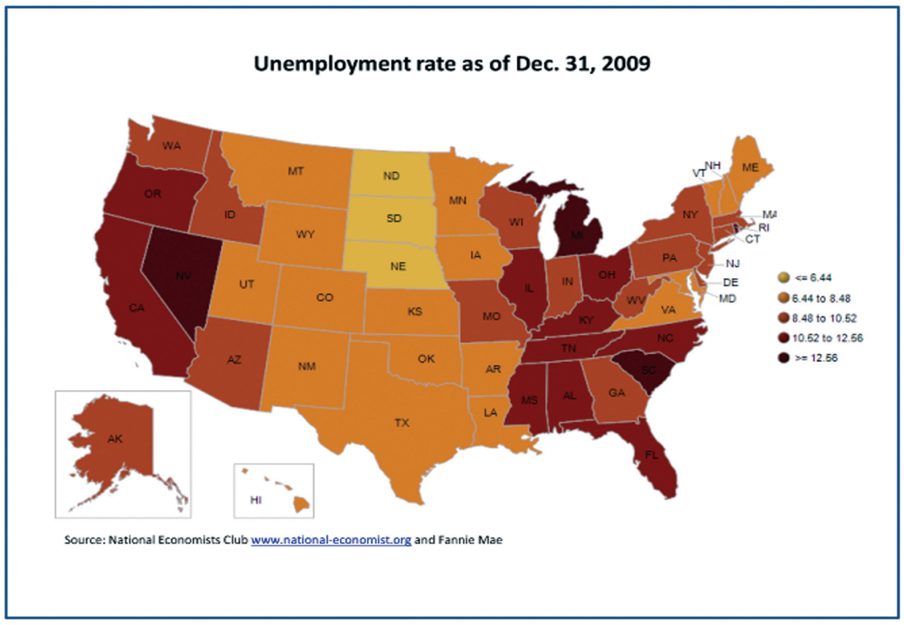
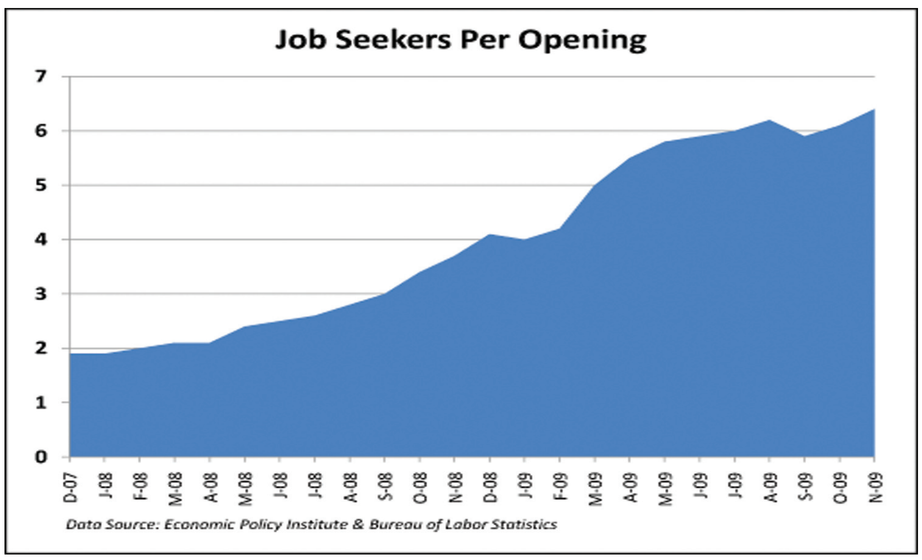


As of Dec. 31, unemployment was highest in the sands states, southeast and upper Midwest.



Competition for available job openings has increased at a far greater percentage than the unemployment rate.

Credit Unions Ready to Lend, But Are Members Biting?

The current recession is largely regional with some areas of the country suffering from both a lack of creditworthiness and borrowing demand, while other areas are performing much better. *Credit Union Times* asked: What kinds of loans will you be making to members in 2010? And, if loan volume is down, what is the overall creditworthiness of your members?

With our membership, overtime not as prevalent as once was, but underlying job security is by and large still there. We're located in a pretty conservative area, so we're thinking our loan growth will come from three sources.

First, we have low hanging fruit in the form of new members, because each new member will have loans elsewhere they can refinance. That means no additional debt load for the household, which consumers don't want now. We're just assuming existing loans.

FRASER

Secondly, we also will encourage members to switch to our credit cards, because we have very competitive rates.

And we also make student loans to members, There's always a demand there and they perform well.

Stan Fraser
President/CEO
Nebraska Energy Federal Credit Union
Columbus, Neb.
Assets: $210 million

Golden 1 is eager and well-positioned to make loans to members. With the California economy still in distress from an unsettled real estate market and a very high and rising unemployment rate (12.4% in December and expected to rise to over 13% this year), loan volume overall remains lackluster at best. However, Golden 1 continues to advertise and our members recognize we are here to lend to them to meet their financial needs.

HALLECK

The popular products we see in our markets are new and used auto loans, and fixed-rate mortgage loan applications for refinancing purposes (to lock in a low rate). When comparing and contrasting an auto loan to a fixed-rate mortgage in the context of which product offers the best risk-adjusted return to the credit union, the auto loan is clearly the superior product in this historically low interest-rate environment if your underwriting is consistently strong. The auto loan has a significantly shorter duration along with little extension risk in contrast to a 30-year, fixed-rate mortgage loan which has a substantially longer average life expectancy at the onset coupled with greater potential that the average life will be lengthened if interest rates rise sharply or if property values remain flat.

With strong underwriting criteria in place to help protect against defaults and the likelihood that interest rates will begin an upward trend in the next few years, shorter-term auto loans inherently provide better interest-rate risk protection for the credit union when sound underwriting principles are adhered to on a consistent basis. In the past, mortgage loans in California offered the benefit of rising home values which shielded lenders from loan losses in the event of default. Previously, that built-in value protection helped balance and offset some of the interest-rate risk when the product was evaluated from an asset/liability management standpoint. However, given the dramatically changed real estate environment affecting most of California and our very strong and consistent underwriting criteria for Golden 1 auto loans originated on both a direct basis and through the CUDL platform at dealerships, the auto loan currently offers the better risk versus reward for Golden 1 to meet member needs while balancing and preserving the interests of the overall membership.

Terry Halleck
President/CEO
The Golden 1 Credit Union
Sacramento, Calif.
Assets: $7.1 billion

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We're expecting the same lending products as usual and offer just about everything but business lending. We haven't found there's been an economic decline in this particular area. I think New Orleans isn't faring as poorly as the rest of the country; we probably had our hit with Katrina. The unemployment rate is much lower here. We've experienced a slight increase in

KENNELLY

loan demand so far this year. I'll emphasize it was very slight, but January and February are historically low volume months, and we're doing better than we were last year.

Connie Kennelly
President/CEO
Tulane Loyola Federal Credit Union
New Orleans
Assets: $13 million

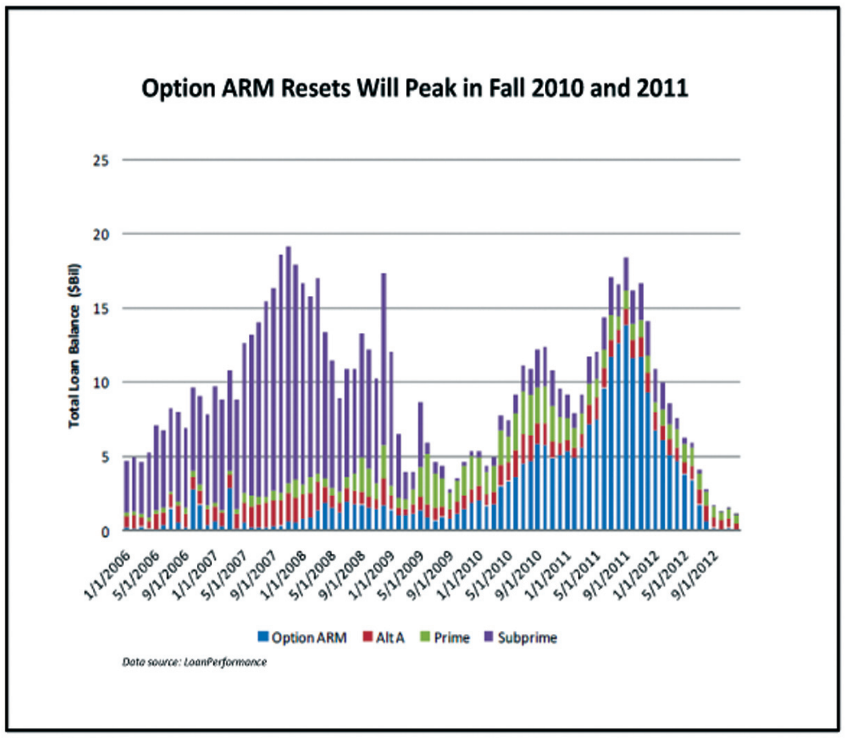
We're making the same kind of loans as usual, which are autos, credit cards and mortgages; that makes up most of it. We got sacked pretty good too, and we're wondering where is the light at end of tunnel, but we're readily available to make loans. Loans are way down, and that's part and parcel of this economy. I don't know that denials are up, I think more than anything consumers are backing off from credit and being more careful. Everybody is still kind of scared.

William Braddock
President/CEO
Florida Telco Credit Union
Jacksonville, Fla.
Assets: $455 million

Service Credit Union plans to offer our full range of loans and continues to execute our successful lending practices into 2010. We research, evaluate and determine each member's credit worthiness, discussing appropriate loan criteria and alternatives. Further, Service Credit Union loan officers make recommendations to members regarding credit union products and services that are most advantageous to their financial position. This includes the offering of loans discounts of up to 1% based on member status, with programs to support our wide range of members throughout the world.

SIMMONS

Gordon Simmons
President/CEO
Service Credit Union
Portsmouth, N.H.
Assets: $1.4 billion



Though residential home prices and jobs are expected to gain ground in 2010, will be it enough to outpace the tsunami of mortgage resets scheduled to crest in 2010 and 2011? Fannie Mae Senior Economist Orawin Velz said pending resets won't drive as many foreclosures as they did early in the recession. Ultimately, jobs determine the fate of a resetting mortgage, and improvements expected in the 2010 labor market should mean good news for home values, too.

Rising Rate Forecasts Challenge Portfolio Managers

By HEATHER ANDERSON

Credit union balance sheets have done a 180-degree turn from just a few years ago: deposits are flush, but loan demand is low.

Those tasked with credit union investments aren't having much more luck than their counterparts in the lending division, because short-term rates are low, long-term rates are better, but almost every economist in the country is predicting rates will rise between 50 and 100 basis points by the end of the year.


CHIAPPETTA

Kevin Chiappetta, senior portfolio manager at Balance Sheet Solutions, presented his firm's ideas for managing current rate risk during a webinar Feb. 24, presented by Members United Corporate Federal Credit Union.

Chiappetta said Balance Sheet Solutions doesn't like to forecast rates but said of 2010, "When you're running out of room to drop, when you see the short end of the curve at zero, the only way rates can go is up or sideways."

He said "easy spread money" is a thing of the past,

When you're running out of room to drop, when you see the short end of the curve at zero, the only way rates can go is up or sideways.

and portfolio managers must experiment with diversification to create a portfolio that will both provide a return and manage interest rate risk.

He suggested modeling how current investments will perform if rates hold flat or move up 100 basis points, and purchase new investments according to what kind of combination will allow the entire portfolio to perform above benchmarks.

"Go back to your benchmark portfolio," Chiappetta responded to a question from the audience about how far out on the yield curve he would recommend buying agency bullets. "Ask yourself, are my liabilities on the long end? Then, I would be more comfortable going out a few years and could take advantage of the yield curve. But, if my liabilities were short in nature, longer assets might put me into a dangerous situation."

Andrew McGeorge, senior portfolio manager with CNBS, LLC, said his credit union clients are purchasing mostly two- to four-year bullets in today's rate environment.

"The sweet spot for bullet investment appears to be the three-year part of the curve," McGeorge said. "The agency yield curve is at its steepest at the three-year point, and this gives an investor the most roll down and the most implicit protection against higher rates."

However, the investment adviser cautioned against loading up on three-year bullets. CNBS typically divides a portfolio into three segments: short-term investments, which consist of bullets of one-year maturity or less and overnight accounts; other bullet investments; and, investments with embedded options like callables.

"Right now, there is no reason to overweight short-term assets, but you need to have the standard amount on hand, roughly a third of the portfolio, either in overnights or short bullets," McGeorge said. "There's no reason to buy anything other than CDs (corporate or bank) to fill in the short ladder."

Mid-range investments are best placed from one to 3.5 years on the curve, spread out but concentrated around two to three years. McGeorge suggested placing investments with less than two years in CDs but longer term investments should be marketable securities.

"The risk of rates rising more than expected is particularly painful for longer-dated securities because you've locked in the low yield for longer and face more price depreciation in the short-run," he said. "The higher yields available in five-year investments are tempting, for sure, but we believe investors are better off limiting their maximum final maturity to 3.5 years right now."

Both advisers cautioned against purchasing mortgage backed securities today given what might happen to prices and spreads when the Fed removes it support from the market.

"They certainly have some things lining up against them, but other things might make it good for your balance sheet," Chiappetta said. "If you can control the risks, that's great, but as a general rule, I'd be very cautious with those right now."

McGeorge agreed callables are preferable to MBS,

The sweet spot for bullet investment appears to be the three-year part of the curve. The agency yield curve is at its steepest at the three-year point, and this gives an investor the most roll down and the most implicit protection.

saying the 10 to 30 basis points they currently offer over bullets isn't particularly great, "but if everyone's forecast of higher rates materializes then this is pure gravy."

The Fed is almost done with its purchases of agency MBS, McGeorge added, but Fannie and Freddie now have more authority to grow their balance sheets and could keep the MBS market "propped up for another few months."

"However, at some point the artificial bid in this market must subside and mortgage rates and yields on mortgage investments will likely rise 25 to 75 bps as a result," he said.

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Regulators Will Look for Post-Recessionary Modeling

By HEATHER ANDERSON

A joint letter to financial institutions released in January listed recommendations regulators are starting to ask for from credit unions, according to Balance Sheet Solutions' Darren Fago.

The senior portfolio manager told a Feb. 24 webinar audience based on feedback from credit union custom-

Examiners will ask credit unions to show the usual loan and deposit growth modeling, but will also be looking for static forecasts that show 0% growth, which could reveal embedded balance sheet risks.

ers, he expects examiners will adopt five points from the letter which all center around asset liability modeling in a post-recession era.

Examiners will ask credit unions to show the usual loan and deposit growth modeling, but will also be looking for static forecasts that show 0% growth, which could reveal embedded balance sheet risks. Net income simulations stretched out over a 24-month time frame will also be requested by examiners, which Fago said credit union executives should already be prepared to share with their regulator, as well as their volunteers and management team.

More extreme rate shock modeling is a bigger issue for banks than credit unions, Fago said, because the letter's +400 basis-point shock test recommendation is only 100 bp higher than what credit unions are already asked to perform. Commercial banks, on the other hand, usually only have to test for 200 basis point swings.

Balance Sheet Solutions is going further, suggesting clients test up to +500 basis points.

"Going back to 2004 when the Fed went through its most recent tightening phase, we saw a 420-basis-point upward movement in a short period of time," he said, "so not even a rate shock of 400 basis points would have covered our most recent rising rate environment."

Rates could also jump 200 basis points in a couple of years then jump another 300 points shortly thereafter, he added, justifying the need for +500 bps.


FAGO

Andrew McGeorge, senior portfolio manager at U.S. Central spin-off CNBS, said his firm hasn't made any ALM process changes as a result of the joint regulator letter, because they are waiting on further advice from the NCUA. However, he called it "more likely than not" that CNBS will add a +400 basis point test to its reports sometime during 2010.

The joint regulator letter also recommended modeling a flattening yield curve scenario, which Fago said he agreed with.

Finally, the letter suggested conducting a share rate sensitivity analysis on nonmaturity deposits. In the event that rates rise, credit unions will need to plan for members shopping rates, forcing the institution to either raise dividends or lose deposits.

"If your members have been sensitive to rates in the past, then you should be cautious they will be in the future," Fago said. "However, it's the same deal the other way around, if they aren't sensitive, then you have more room to exploit that."

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