Planning for Uncertainty

Credit Risk Analysis and Mitigation

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Recession Fears?

What's next?

Here's the bad news: Most economists still expect a recession to hit within the next year. A survey of 48 forecasters issued by the National Association for Business Economics found about 60% of respondents believe the U.S. economy is more likely to slide into a recession in the next 12 months than it is to avoid an economic downturn.

https://thehill.com - 3/12/23

Chances of a Recession Rise

The economy is expected to slowdown later in 2023, economists estimate.

Signs that the economy is cooling off are rising as growth in many industries has begin declining while banks will tighten lending.

The Atlanta Federal Reserve revised its estimate of growth during the first quarter to 1.7% from its previous estimate of 2.5%.

The Fed said the combination of lower construction spending and a decline in manufacturing from the Institute for Supply Management led to the revised estimate. The declines were "slightly offset by an increase in the nowcast of first-quarter real government spending growth from 1.7 percent to 2.1 percent," the Atlanta Fed said.

The U.S. will not be able to avoid a recession in 2023 since the number of loans being approved will decline during the second half of the year, impacting capital expenditures and consumer spending.

www.thestreet.com – 4/5/23

DQ and Charge-Off Forecasts for 2023

"After two years of aggressive loan growth, particularly for credit cards and personal loans, and serious delinquency rates that generally remained near pre-pandemic levels, the consumer credit market will experience more pronounced changes in 2023. TransUnion's (NYSE: TRU) [2023 Consumer Credit Forecast] projects delinquency rates for credit card and personal loans to rise to levels not seen since 2010. At the same time, demand for most lending products will remain high relative to pre-pandemic levels with the number of consumers securing auto and home equity loans increasing on an annual basis."

https://News.cuna.org – 2/28/23

"From a delinquency perspective, TransUnion forecasts serious credit card delinquencies to rise to 2.60% at the end of 2023 from 2.10% at the conclusion of 2022. Unsecured personal loan delinquency rates are expected to increase from 4.10% to 4.30% in the same timeframe. Serious auto loan delinquency rates are expected to modestly decline to 1.90% in 2023 from 1.95% in 2022."

https://Newsroom.transunion.com – 12/14/22

DQ and Charge-Off Forecasts for 2023

- Experts increasingly think there will be a mild recession in 2023.
- DQ and CO are projected to increase in 2023
- Does your credit union serve members who are being laid off (tech)? Or is your membership stable?
- Pressure to increase interest rates is causing debt ratios to increase and impacting affordability.
- Do you have variable rate loans (e.g., HELOCs and Credit Cards) with payments that are going up and impacting your members' disposable incomes?

Best Practices to prepare for higher risk

- Credit Risk Analysis and documentation
- Policies and procedures
- Coordinate with Finance on Reserves
- Loan originations vs. Credit Risk Appetite
- Loan Pricing & Rates
- Member outreach
- Reporting & Communication

Credit Risk Analysis – Credit Score Migration

- Do you run a fresh credit score on your member-borrowers throughout the year? Semi-annually? Quarterly?
- This can be a cost issue, but regulators want to see that you are reviewing your loan portfolio for changing risk.
- If this is cost-prohibitive, do you have internal metrics that you can review? Even something as simple as PTI (Payment-to-income) is better than nothing.
- Line of Credit Reviews - are you reviewing your member lines of credit (e.g., HELOCs, Credit Cards) for possible suspensions? - This is a regular item checked by examiners.
- Other analyses? LTV, DTI, 1st payment defaults?, etc.

Policies & Procedures: High Risk Delinquency

- Develop criteria from your Credit Risk Analysis to use to move up members in your queue priority. At my last two credit unions, we moved up member calls to one day DQ if they had dropped two FICO tiers or more in the last quarter.

- Do you collect on negative days DQ?

Coordinate with Finance on Reserves

- Does your credit union coordinate and communicate between Collections and Finance to review your Allowance for Loan & Lease Losses (ALLL)?
- A regular meeting will allow you to more accurately adjust your Provision for Loan Loss Expense.
- Your Finance and Accounting teams may be able to adjust their Q&E projections (Qualitative and Environmental) based on Collections' analysis.
- This will also show Regulators that your Collections efforts are integrated with credit union financial statements.

Loan Originations vs. Credit Risk Appetite

- Average FICO and Losses by Tier are no longer enough
- Examiners consider this “driving using the rear view mirror”
- Review your loan portfolio by FICO tier (or other criteria) against the new loans you made this month/quarter. Are you consistent with your past practice?
- **If you see a change, is that a conscious change in lending strategy or are your members’ credit profiles changing?**

Pricing – Do your rates cover your losses?

- Do you have reports showing your loan portfolio and new loans by Credit Tier? If not, can you slice them by another risk metric?
- Do you/Can you know the charge-off rate (current or projected) for each tier?
- What is your net yield for each tier and is that in line with your income expectations?
- Normally you want to earn a higher yield for the higher risk tiers.
- If not, do you need to increase rates on those lower tiers?

Member Outreach

- Do you inform members of your collection practices at loan origination?
- Do you have good contact information? Especially for indirect loans and loans originated outside the loan department.
- Are ACH and other automatic payments set up properly?
- Are you looking at texting and other communications?
- Those who call first get paid first.

Credit Risk Reporting – Tools for Audits/Exams

- Having a quarterly credit risk committee/team that reviews the above is essential.
- This team can interface closely with your Accounting & Finance teams to prepare the Allowance for Loan & Lease Losses (ALLL)
- **Having an agenda, the reports above, and meeting minutes will go a long way to show your auditors, examiners, and Boards that you are serious about credit risk and are managing it proactively and professionally!**

Thank you!

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