

The U.S. Mortgage Crisis

**Causes, Effects and Outlook
Including Suggested Credit Union Responses**

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Executive Summary

The U.S. sub-prime mortgage crisis spawned severe financial market dislocations. These dislocations, including the widely-reported “credit crunch”, have intensified what otherwise might have been a mild economic slowdown. The U.S. economy is now most likely in the early stages of a recession. In the best of outcomes, economic growth in the first half of 2008 will be disappointing and unemployment will be rising. Some regions of the country will experience disproportionately harsh economic conditions.

These developments will have significant financial and operational consequences for credit unions. The effects, most of which already are observable, will become more pronounced going forward and some may be seen for years to come. They include:

- Faster savings and asset growth
- Significant increases in loan delinquencies and losses
- Substantial downward pressure on net income
- Falling net worth ratios

Understandably, these sorts of trends get the attention of credit union boards and senior management. A natural reaction is to jump into action to quickly take whatever steps are necessary to reverse results like these. But, in this case we urge caution in your response. It is certainly appropriate to closely monitor this situation and evaluate the cause of any negative results in your credit union. However, for most credit unions the current and near term deterioration of financial results stemming from the mortgage crisis and the economic slowdown is best described as neither the fault of the credit union nor likely to be very long term. In many cases, the appropriate actions needed to deal with these challenges will be modest.

Most credit unions now have very strong balance sheets and near-record-high capital levels. The appropriate course of action for most credit unions is therefore to let the capital cushion do its work: temporarily let net income fall as a result of the loan losses. This will require a careful review of the credit union’s budget and financial situation and a clearly delineated plan. But it is imperative to avoid doing unnecessary harm to the credit union that would result from trying to maintain net income in the current environment. This means:

- Credit unions that have more than adequate capital should not find it necessary to penalize members of the credit union with higher loan rates, more and higher fees, lower dividend rates, service cutbacks or layoffs just to keep net income from falling for a year or two.
- Rising delinquency and loan losses require close monitoring and active collections, but they do NOT necessarily call for a tightening of credit standards.
- The best response to a decline in net income caused by rising loan losses may be to adjust your budget and then carefully let it happen.

There are often opportunities for well-positioned market participants in times of financial dislocation. With their strong capital positions and very stable balance sheets, we believe that many credit unions should consider the positive opportunities in the current situation. By keeping an even keel and letting capital absorb much of the short-term dislocation, credit unions can show both members and non-members the unique and substantial benefits of the cooperative structure.