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Analysis of credit union, challenger bank and fintech competitiveness

Insight

#13 | April 2024

High interest rates and inflation have hit credit unions hard, but not equally

Three outcomes and four lessons learned from 2023

It's no secret that 2023 was a tough year for many credit unions. After strong performance during COVID, most credit unions struggled to maintain revenue and deliver solid earnings. As credit union annual reports hit the street, three major trends have become apparent:

1. Increased rates drove up cost of borrowing, negatively impacting net interest income
2. Inflation drove up operating costs, in some cases by double digits
3. Non-interest revenue was stable, but not large enough to cover declining NII

A number of clients have reached out to ask how they performed relative to their peers. This Insight answers that question in broad terms, using three categories. A few credit unions were able to stay on track by growing top-line revenue and containing costs. They had a **"not bad"** year. Many **"battled through"**, absorbing hits to their net interest income and increased costs that resulted in lower-than-normal performance. Still others had a "**challenging**" year, where a confluence of forces resulted in breaking even or suffering a loss. This stands in sharp contrast to the big banks, where revenues and profits generally continue to rise.

To make the conversation real I've used the top three credit unions to illustrate these outcomes. Servus was "not bad", Meridian "battled through" while Vancity's year was "challenging". These results are not a reflection on the quality of management decisions or signal any existential problems. Rather, they show how systemic impacts can have different impacts on credit unions based on factors such as product mix, risk appetite and cost structure.

At the end of the analysis, I'll flag four strategic imperative that credit unions need to tackle in 2024.

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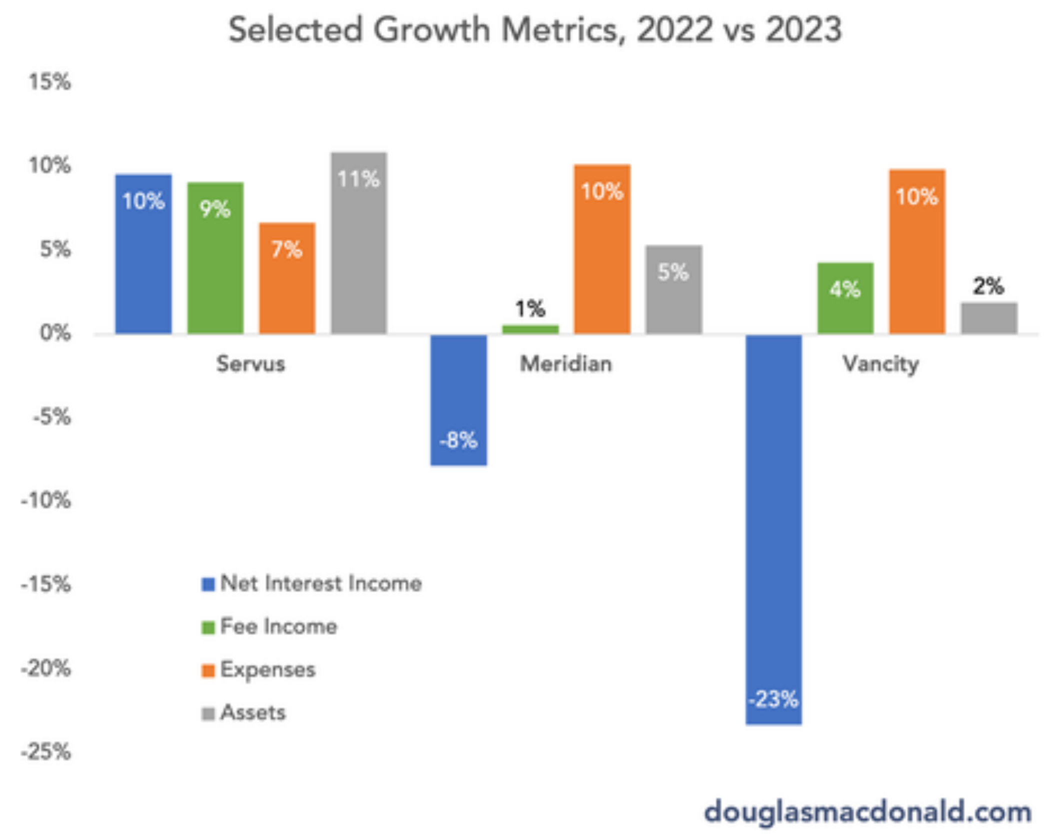


Major Impacts

After dropping to a pandemic low of 2.45%, Canada's prime rate rose dramatically in 2022 and 2023. Banks and credit unions started 2023 at 6.45%, rising to the current 7.2% in July. This uptick has resulted in mortgages crossing the 7.0% posted and 5.49% discounted level. However, the speed of this increase was rapid. Many financial institutions are still carrying a lot of five-year fixed mortgages in the 2-3% range.

Savings rates have also increased, but with shorter durations their impact has hit income statements much faster. Many credit unions have been issuing HISA teaser rates, GICs and investment shares in the 5-6% range. When short duration borrowing is higher than long-term lending, loan books can quickly get out of balance. This is particularly true in institutions that are highly reliant on five-year fixed retail mortgages for the bulk of their loan portfolio. Many credit unions have also increased allowances on their portfolios in anticipation of future defaults.

The other major impact has been inflation. The Consumer Price index rose 6.8% in 2022 and 3.9% in 2023, the two highest years since 1991. This has driven up the cost of supplies at a time when many credit unions have expanded their workforces to develop new products and drive digital transformation.

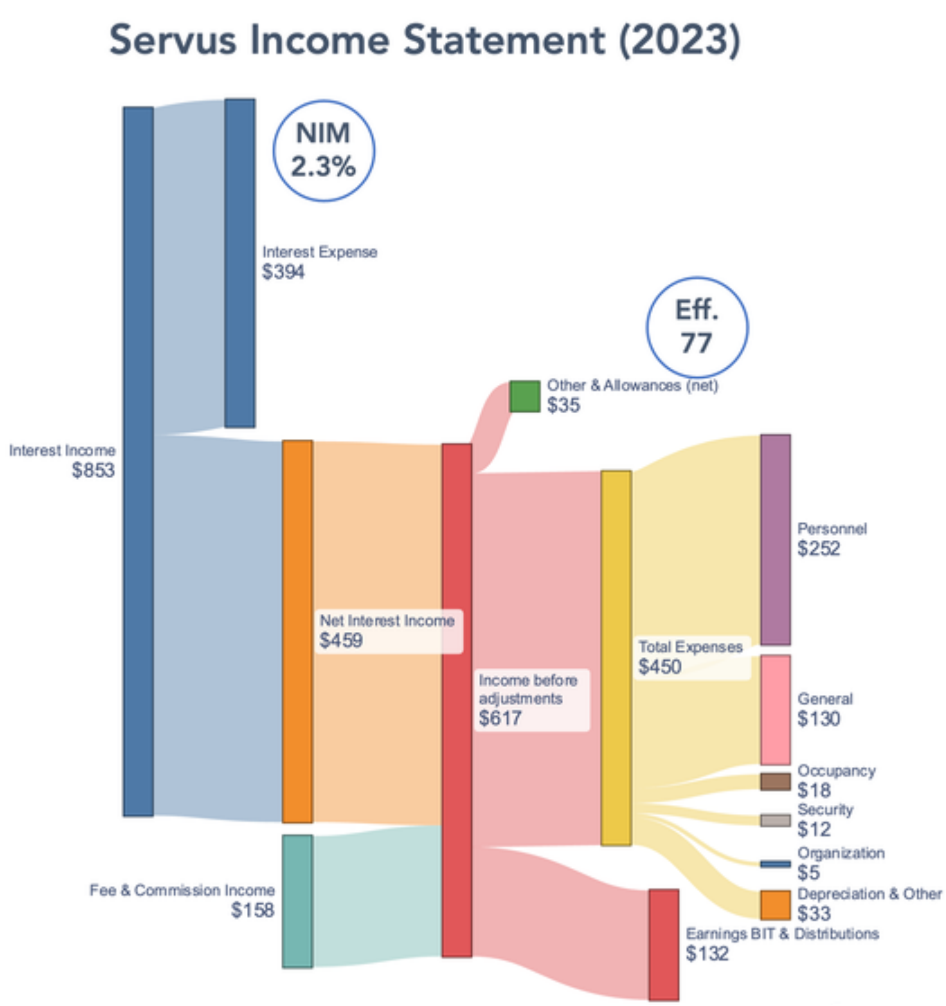
One bright spot for credit unions has been non-interest revenue from fees, commissions, advisory services and financial instruments such as securitization. In the three example credit unions shown below, non-interest revenue increased. This provided an important buffer against interest rate shock. However, most credit unions lag their bank peers in share of revenue from non-interest sources, limiting the impact.

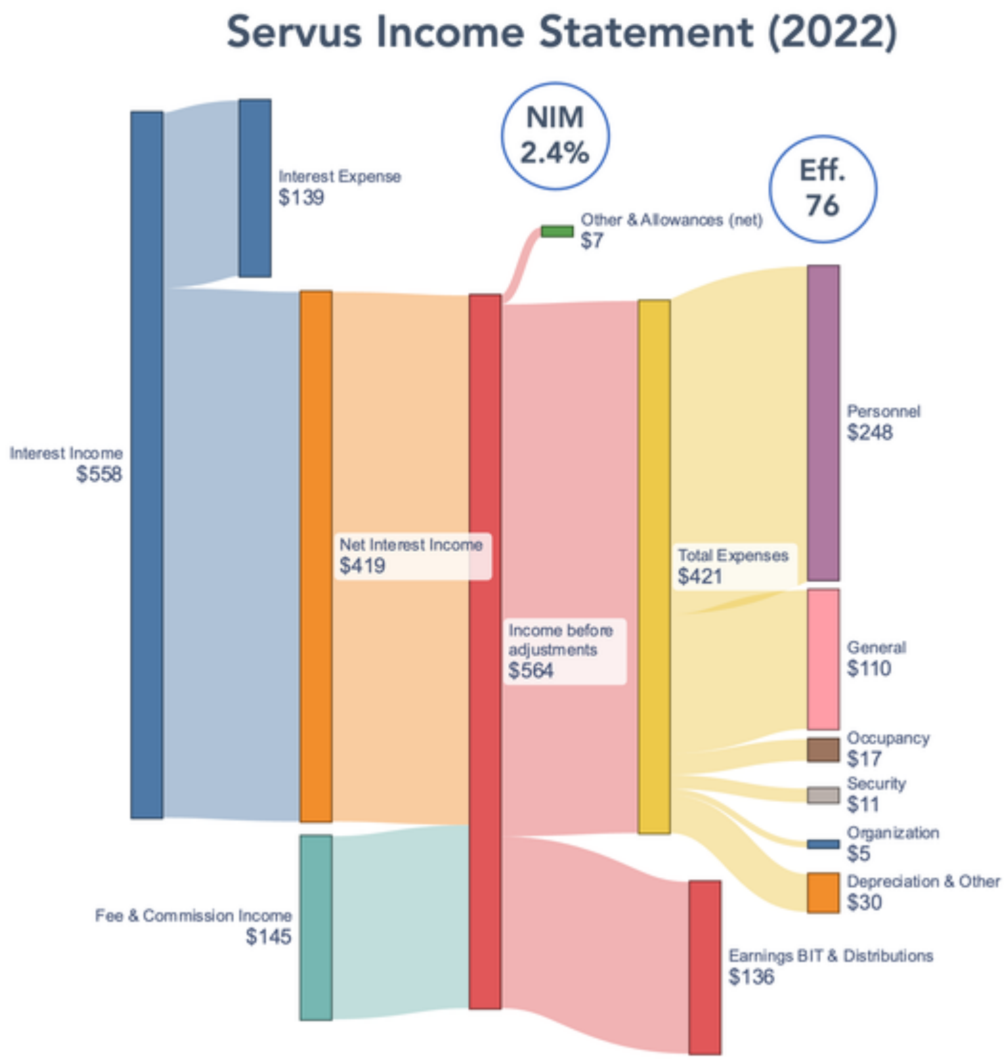
Finally, credit unions had varying success organically growing their assets and membership. Those who were able to stick to their growth strategies. despite the market disruptions tended to fare better.

Let's take a look at how this played out under the three main scenarios.

Outcome A: The "not bad" year

Some credit unions managed to stay on track in 2023. One good example is Servus Credit Union in Alberta. Total revenue grew by 4.3%, including a 9.5% increase in net interest and 9.2% increase in fee income (offset slightly by higher allowances). Expense growth was limited to 6.6%. Meanwhile assets grew by 11%. The net effect is a 2.8% drop in earnings before taxes and dividends, which was quite impressive considering everything going on.





How did Servus achieve these results? Servus took difficult steps to reduce personnel costs and find other efficiencies in 2022. These moves paid off in 2023, as Servus was able to keep costs increases below their peers. Another is that 27% of their revenue comes from non-interest sources, one of the highest in the system. This provided an important buffer to interest rates.

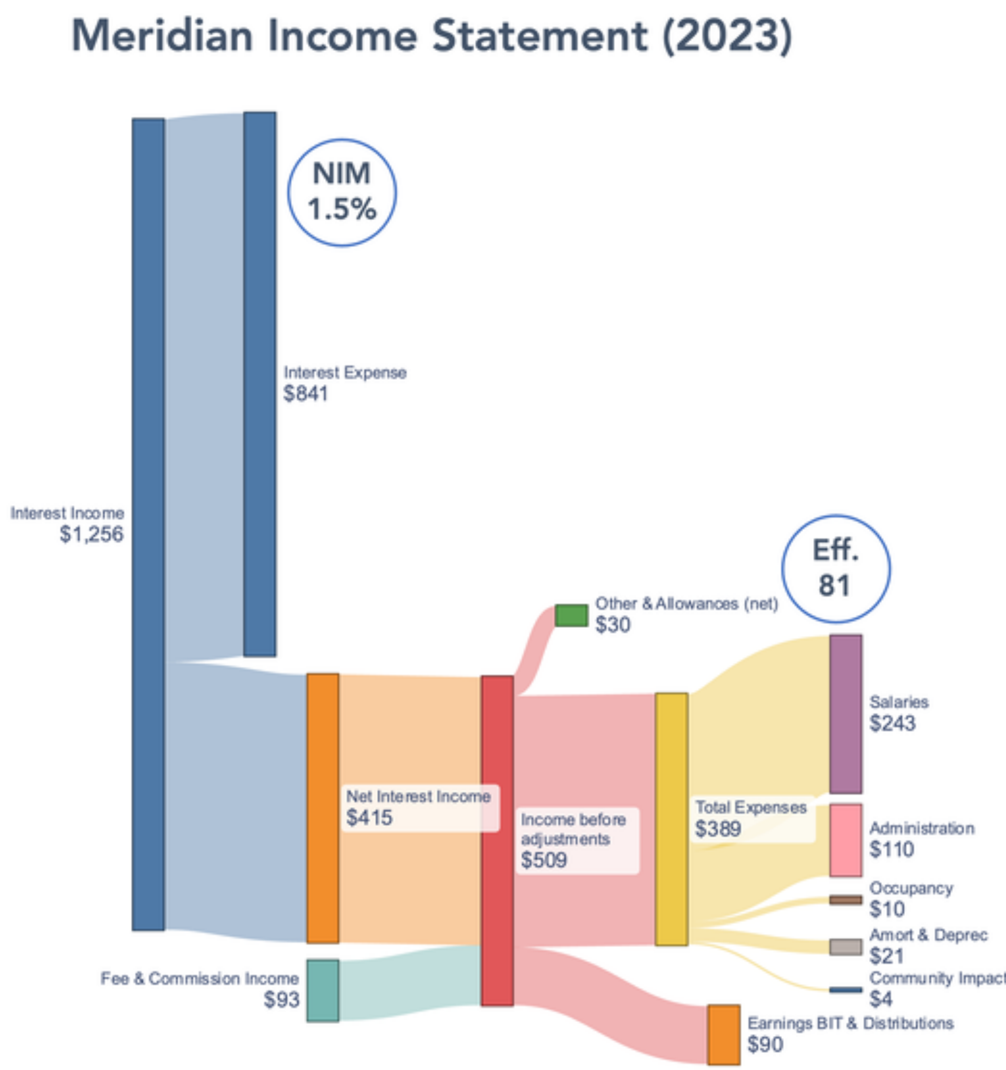
However, the most important factor was Servus' ability to manage their loan book. Servus operates a diversified portfolio of 51% residential mortgages, 42% commercial and 7% consumer lending (net of allowances). The $160M acquisition of a leasing company also helped boost numbers. NIM stayed essentially unchanged at 2.3%, while net income before allowances grew from $419M to $459M.

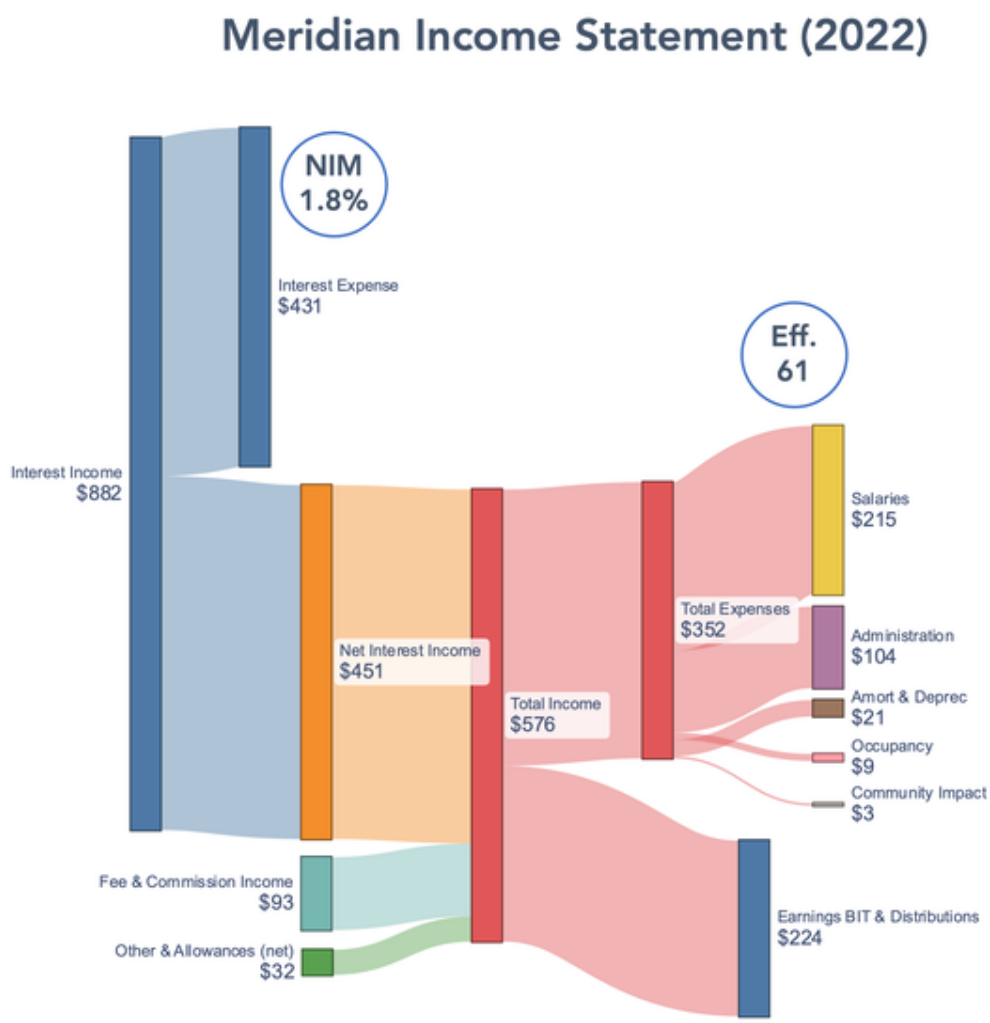
On the deposit side, member deposits increased by 9.1%, primarily via term deposits and registered plans. While term deposits are expensive, Servus did not go after rates as aggressively as some peers. Critically, $8B, or 48% of total deposits, is held in demand accounts that pay a much lower interest rate. The net result is that Servus was able to dodge the worst of the rapid rate increase.

Note that Servus has an October year end while most credit unions go with December. However, their Q1 2024 performance shows that they are still on track so timing alone does not account for Servus' strong performance.

Outcome B: The "battled through" year

Not everyone was as lucky as Servus. Most credit unions struggled to manage both rising costs and a difficult lending environment, finishing the year with reduced profit but profit nonetheless. Meridian is a good example of this cohort. After two very strong years, in 2023 Meridian saw its earnings before interest taxes and distributions drop from $224M to $90M. That drop looks big on paper but does represent a return to their 2019-2020 earnings range.





Like Servus, Meridian benefited from stable fee revenue, but at $93M this was only 19.5% of net revenue. Costs grew by 10%, with particularly large increases in salaries and administration. However, coming from a 61 efficiency in 2022 Meridian was better able to absorb the shock. Allowances and other adjustments also caused a negative variance of over $60M.

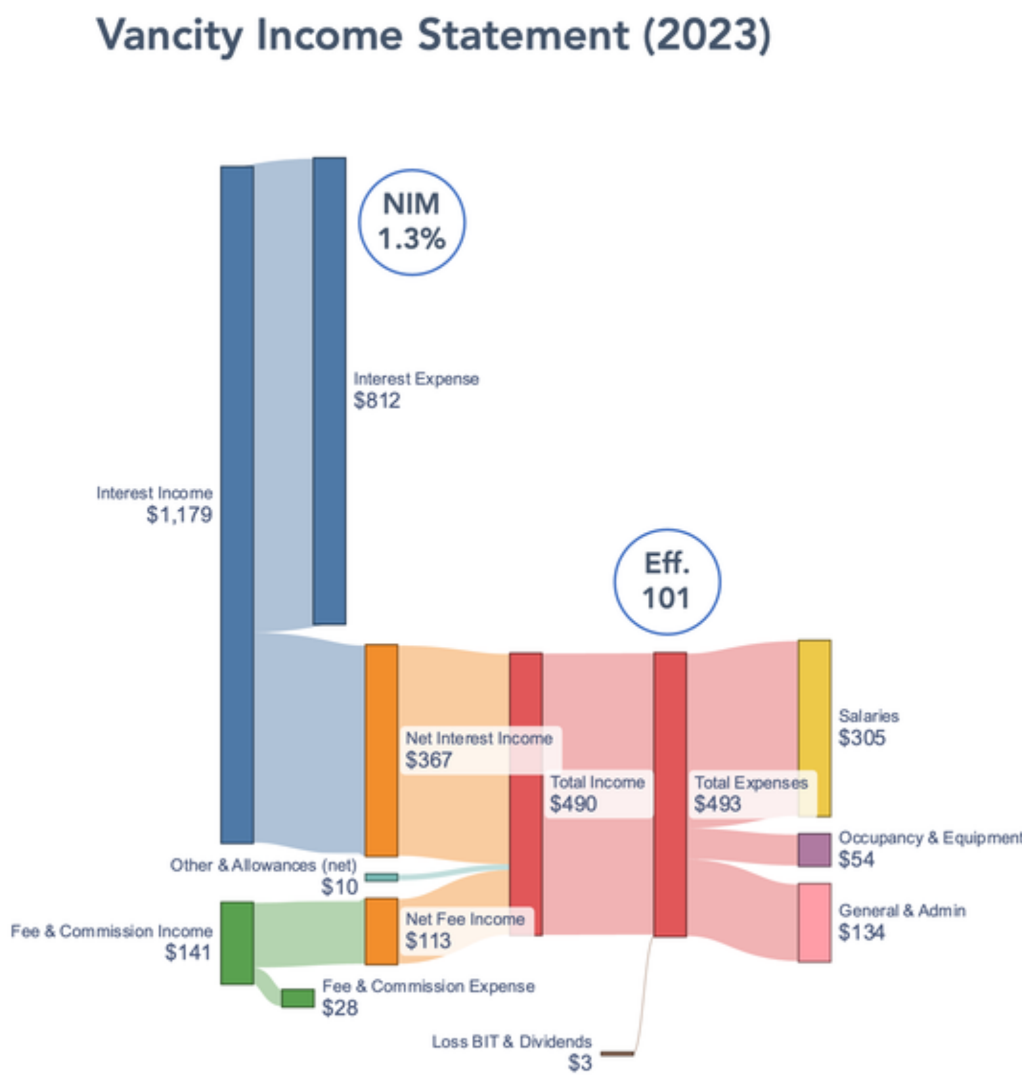
Unsurprisingly, the main difficulty was lending. Meridian's portfolio contains a slightly higher share of residential mortgages than Servus, at 57%. It also competes in the more competitive marketplace of Southern Ontario. This likely limited Meridian's ability to raise rates with the market. Meridian also had to deal with a more expensive deposit book, with 37% in term deposits and 63% in term and registered. As a result, NIM shrank from 1.8% to 1.5% and net interest revenue fell from $451M to $415M.

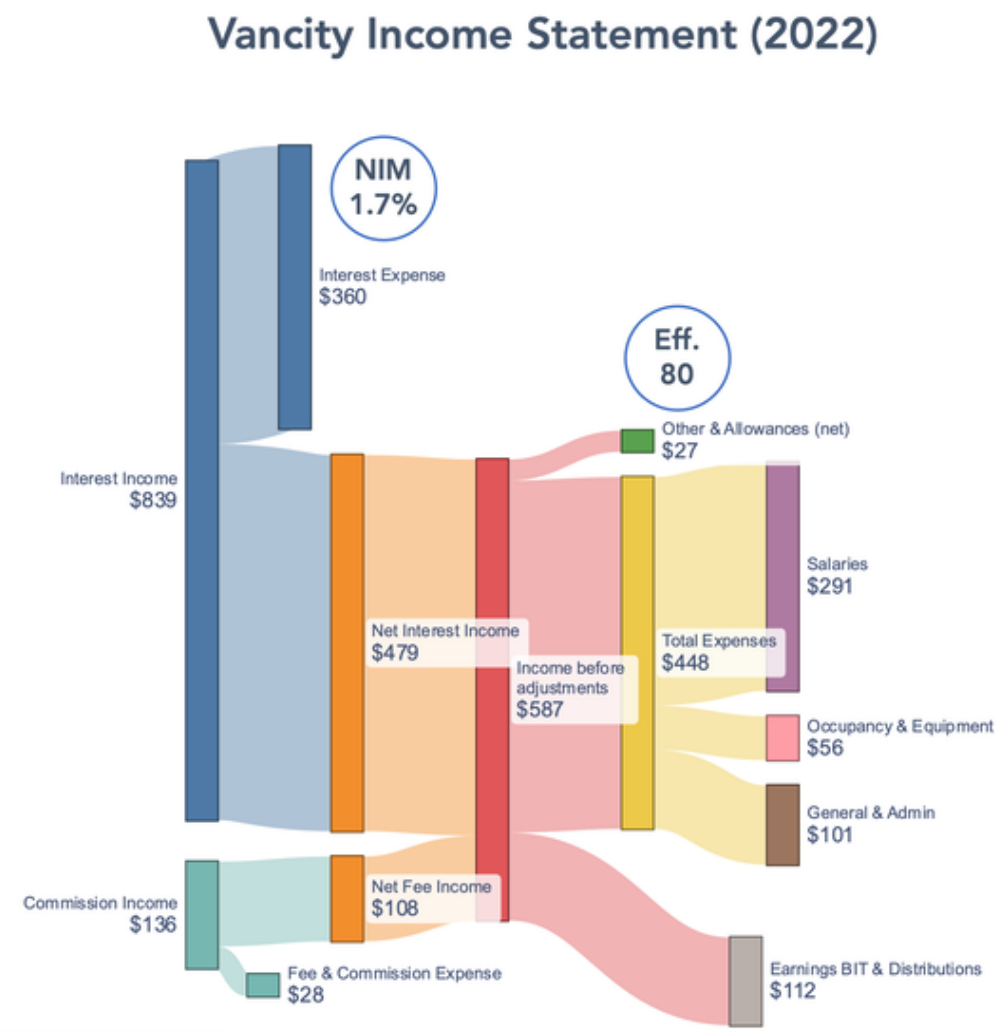
One other item to note is that Meridian has $765M of investment shares outstanding, representing 44% of Meridian's total equity. These generated $34M in dividends in 2023 ($9.9M in cash, the remainder reinvested). Meridian counts these dividends as member distributions after Net Income and not an interest expense.

Did Meridian have a great year? Not compared to 2021 and 2022. But they also stayed on track and avoided a much worse result. Previous efficiency efforts helped Meridian stay in the black. Meridian is in a good position to recover going forward.

Outcome C: The "challenging" year

Finally, let's look at the third group of credit unions - those who were hit hard by economic conditions. Vancity is an example of this category. Vancity's assets grew by 1.9%, but cost increases and shrinking interest income took their toll. Net income before interest taxes and distributions dropped from $112M to a loss of $3M. As a result, community and member distributions (which Vancity records below EBIT) dropped from $24M to $3.7M.





Vancity's experience outside of lending was similar to Meridian's. Net fee income grew slightly, but only accounted for 23% of total revenue. Expenses rose by 10%, also mainly via salaries and administration. Unfortunately, Vancity's 80 efficiency in 2022 made them more susceptible to this increase. Allowances and adjustments took a $37M unfavourable swing.

The big challenge for Vancity was the loan portfolio. Residential mortgages comprise two thirds of Vancity's loan book (65% before allowances). Vancity also operates in the highly competitive Lower mainland, requiring aggressive mortgage pricing. Vancity's business portfolio is very high quality, with only 1.1% of loans considered High Risk. The trade-off is a limited ability to extract higher rates. On the deposit side, Vancity did benefit from 43% of its book coming from demand deposit accounts.

Morningstar noted these challenges in April when they **confirmed Vancity's rating** at R-1(low) but moved the trend to Negative. "The trend change to Negative from Stable reflects Morningstar DBRS' assessment that Vancity's profitability prospects and earnings capacity to absorb potential credit losses have weakened, which poses downside risks to the credit ratings... Vancity's profitability will likely remain under pressure in 2024 and most of 2025, potentially reverting to the historical trend in 2026 as market conditions improve and loans reprice."

Vancity had a tough year, but they are going to be fine. Can the same be said for smaller credit unions in the "challenged" category with less resources and resilience? 2024 will be a critical test.

Strategic imperatives

Each credit unions is unique, and each experienced rising rates in different ways. However, there are four key take-aways that apply across the system. These strategic imperatives are:

1. Fix mismatched loan durations
2. Diversify loan books
3. Grow non-interest revenue
4. Get serious about costs

1. Fix mismatched loan durations

Credit unions need to understand the specifics of their loan books, and how they will perform in a future that could see interest rates fall or stay stable. Reduced reliance on residential mortgages is an important strategy for shortening book duration, which will be important in an era of rate instability.

2. Diversify loan books

Moving beyond residential mortgages also provides portfolio diversification, which will be critical in managing portfolio risk. Unsecured lending, managed properly, will grow net interest margin and provide a buffer on rate moves. On the flip side, credit unions need access to stable, cheap(er) funds such as demand accounts from primary banking relationships. Chasing deposits with teaser rates can be a useful short-term tool, but over-reliance will make it hard for credit unions to compete.

3. Grow non-interest revenue

If the past year has taught us anything, it's that credit unions can't rely on just interest income. Non-interest revenue from activities such as wealth advisory, insurance, agent credit cards, user fees, securitization and similar activities is a critical buffer. Most credit unions are well below the 30% non-interest revenue share of the big banks. Non-interest activities also drive membership growth and primary banking relationships, which is critical for lowering the cost of funds.

4. Get serious about costs

Credit unions who moved aggressively to control costs when times were good generally performed much better in 2023. More efficient operations were able to absorb reduced revenues, and will allow the institutions to bounce back faster as the market recovers. Credit unions cannot expect to remain long-term competive with an average efficiency ratio in the 80s vs big banks in the 40s. Credit unions are also facing significant expenses in digital banking, real-time payments and open banking. Reduced revenues will make funding these costs much more difficult.

Credit unions lacking the scale, capacity and funding to tackle these changes must consider alternate delivery models. Working together and working with partners will be critical for getting back on track and continuing to deliver excellent member services.

Let's chat!

Want to discuss credit union performance in greater detail? Start the conversation by reaching out to me via **email** or on **LinkedIn**.

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