# Small banks, credit unions warned to brace for pandemic aftershock

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## Body

Credit union and bank clients - and ultimately the financial institutions where they do business - have been propped up to some degree by federal stimulus programs during the pandemic.

But with the phaseout of government support that was designed to keep consumers, businesses and markets afloat, parts of the economy could falter and put more credit unions and banks at risk of financial losses or even failure, some experts say.

Todd Harper, the chairman of the National Credit Union Administration, warned last week that the industry should expect delinquencies and charge-offs to rise in the months ahead. He urged credit unions to pay careful attention to their capital, asset quality, earnings and liquidity.

"To protect the share insurance fund - and, ultimately, taxpayers - against losses, the NCUA needs to stay on top of these emerging risks and problems in the credit union system," he said at an agency board meeting Thursday.

Three days earlier the NCUA announced that it hadclosed Community Owned Federal Credit Unionin Charleston, South Carolina.

The NCUA has now shuttered three institutions this year. The others wereNewspapers Federal Credit Unionin Indianapolis, Indiana, andDefense Logistics Federal Credit Unionin Dover, New Jersey.

Until federal restrictions on foreclosures and evictions are fully lifted and the legal process relating to those actions are restarted, no one can predict what impact the pandemic will have on financial institutions or if liquidations will rise, said Michael Fryzel, an attorney and former chairman of the NCUA.

Regulators must be cautious and anticipate that problems may lie ahead, he said.

"The return to in-person exams may reveal that some credit unions will not be able to withstand the pressures of the environment and will close or be merged," Fryzel said. "The full impact may not be felt until well into 2022 or even 2023."

That time frame might also apply to banks, said Michael Jamesson, a principal at the bank consulting firm Jamesson Associates. He said the massive level of government stimulus injected into the economy during the pandemic - from emergency small loans to direct federal payments to households - played a vital role in warding off coronavirus-induced credit woes for small lenders.

But that stimulus has begun to wear off and, should the economy falter in the months ahead or next year, credit quality could reemerge as a concern for the industry. Ultimately, he said, at least some banks will grapple with significant losses and failures are likely to bubble up in coming years.

"When the dust settles from this pandemic, we will probably see failures again," Jamesson said. "It takes time for loans to go bad and the full extent of problems to surface, so I'd predict this is likely to be a 2023 issue."

Jon Winick, CEO of the bank advisory firm Clark Street Capital, had a similar take. The majority of government stimulus is sunsetting, but the economic damage from the pandemic could linger, he said.

The delta variant surge has increased the odds of remote-working arrangements becoming the norm - a trend that could do lasting harm to commercial landlords who traditionally have been valuable bank customers. Commercial real estate properties that are adjacent to urban office towers and rely on foot traffic generated by office workers could be hurt, too.

"If this work from home thing is durable, it could cause a lot of problems," Winick said.

He agreed with Jamesson that it could take several quarters for the true extent of pandemic-related credit issues to mount. But eventually, he said, this could lead to failures a year or two from now.

"Banks are sitting on a lot of risk right now," Winick said.

Eight banks failed in 2019 and 2020 combined, but none have been shut down this year.

The three credit union failures year to date is not a big number, and the liquidated institutions were quite small, said Dennis Dollar, a credit union consultant and a former NCUA chairman.

But, just as with community banks, there is a lot of pressure on smaller credit unions necessary to deal with the disruptive marketplace of the past 18 months.

"If the rate of one failure per quarter remains in credit union land and - although unfortunate - if they continue to be small and relatively insignificant to the share insurance fund, that is very manageable for NCUA," Dollar said.

The improving job market and quickly growing economy bode well for many institutions afloat, but the industry has little experience with pandemics, said Mike Schenk, chief economist for the Credit Union National Association.

"There are a lot of small credit unions in the United States and a number of small banks, and some of those were pretty stressed during the crisis," he said, adding that the good news is that capital levels are "quite high" at many small institutions.

There have only been four credit union failures in the past three years, and most have been very small. But there have been exceptions. For instance, the NCUAclosed the $1.2billion-asset Melrose Credit Union in 2018.

Curt Long, chief economist of the National Association of Federally-Insured Credit Unions, said credit union net worth rebounded in the second quarter and the risks posed by historically unprecedented asset growth have moderated in recent months.

Loan performance has never been stronger, and although forbearance programs are coming to an end, studies by the Federal Reserve Bank of New York confirm that borrowers had been exiting those programs quickly and ahead of schedule, said Long, who is also the association's vice president of research.

Future issues for most credit unions revolve around having too much liquidity on their balance sheet and not enough loans to generate interest income, said Jeffrey Voss, managing partner of Artisan Advisors.

Seeking to pump up growth, financial institutions in that situation often make the mistake of venturing into types of lending they're unfamiliar with or loosen credit terms too much, he said.

"We believe that failures in both banking and credit unions are inevitable, but not at the level it was during the last recession," Voss said. "We believe that such activity will likely begin mid- to late 2022, or whenever the federal programs supporting the economy have ceased and customers are forced to repay their loans as agreed."

Vincent Hui, managing director at Cornerstone Advisors, said he does not expect to see a big spike in credit union closures but rather more mergers - either voluntary or NCUA-assisted.

Net interest margins are tight, and noninterest income is harder to come by, he said. Add excess liquidity and weak loan growth to those challenges, and many credit unions are facing a "perfect storm" that they lack sufficient scale or balance sheets to ride out.

"Even the strongest need to be prudent on finances and spending.

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