SAN DIEGO BUSINESS JOURNAL

Rate Hike Reverberations Would Be Felt By Credit Unions

FINANCE: Hot High-End Market Stokes Competition

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Thursday, August 13, 2015

Possible interest rate hikes were on the minds of Perc Pineda, left, a senior economist for the Credit Union National Association (CUNA); Bill Hampel, chief economist and policy officer for CUNA; and Mike Schenk, vice president of economics and statistics for CUNA. Photo by Nevada Credit Union Leagues

Credit unions are preparing for a possible increase in Federal Reserve-controlled interest rates next month and the risk it could create for balance sheets with significant levels of long-term assets.

Members of the Credit Union National Association (CUNA) discussed a rate hike's potential effects during the trade group's annual economics and investments conference, held Aug. 10 in San Diego.

Regulators have been concerned for years that as credit unions issued more mortgages and other long-term loans during historically low interest rates, they exposed themselves to potential downside. If rates increase, credit unions will have locked themselves into low returns for decades on the mortgages while they will be pressured to pay out higher interest rates on deposit accounts.

Long-term assets make up about 33 percent of credit union assets, according to CUNA, down slightly from a record 36 percent in 2013, but still higher than pre-recession norms. Credit unions argue the increases have been modest and they know how to manage the added risk.

“It's not without any reason that (regulators) are concerned about these sorts of things,” CUNA's chief economist, Bill Hampel, said during the conference.

Federal Reserve Bank of Atlanta President Dennis Lockhart this month reaffirmed analysts' expectations of a rate hike in September, telling reporters the central bank was “close” to raising short-term interest rates above near-zero levels. Federal Reserve Chair Janet Yellen said in July rates would likely rise by the end of the year.

Here Comes the Hike

Interest rates have been near zero since December 2008 and any increase would be the first in almost a decade. Hampel predicted the federal funds rate, or the cost of banks to loan money to each other overnight, would rise from 13 basis points in the second quarter of the year to 175 basis points by next year in steady increments.

That will drive 10-year Treasury bond rates from about 2.5 percent to 3.25 percent over the same period, he said. The difference between long- and short-term rates would shrink from 2.4 percentage points to 1.5 percentage points if Hampel is right.

David Ely, an associate dean and finance professor at San Diego State University's College of Business Administration, said flattening yield curves will be uncomfortable for both banks and credit unions.

"It's something that credit union regulators have expressed concern about because, as rates have stayed low for so long, credit unions have moved into long-term assets to maintain their interest margins," Ely said. "Relative to historical norms, they're more exposed than they have been in the past."

Parked Money May Move

But Hampel warned credit unions should be even more concerned about losing their stockpiles of non-maturing deposits, such as checking accounts and money market funds.

"There's a lot of money simply there because no one else is paying anything else on those accounts either," he said. "No one is paying anything for short-term savings."

Credit unions are offering roughly 20 basis point returns on their money market accounts, compared with 10 basis points from banks, Hampel said.

But once interest rates rise, credit unions will have trouble maintaining their balance sheet as some borrowers will likely pull their large balances in search of higher returns, he said.

CUNA pegged loan growth next year at 11 percent, while deposits are only expected to grow 3 percent.

Another impact of rising rates will be far fewer consumers seeking to refinance their mortgages. Since 1988, there's been a general downward trend for 10-year Treasury bonds with five periods of all-time lows that drove refinancing booms for credit unions.

Hampel predicted those days were gone and that credit unions would need to step up efforts to capture the purchase market to grow their mortgage assets.

Todd Lane, CEO of California Coast Credit Union, agreed that the biggest risk to his institution amid rising rates was mortgage lending.

"If rates are rising across the yield curve, it means fewer consumers have the opportunity to refinance their mortgage," Lane said. "That's where we'd see the first and largest impact."