TRENDWATCH 3Q22

November 15, 2022

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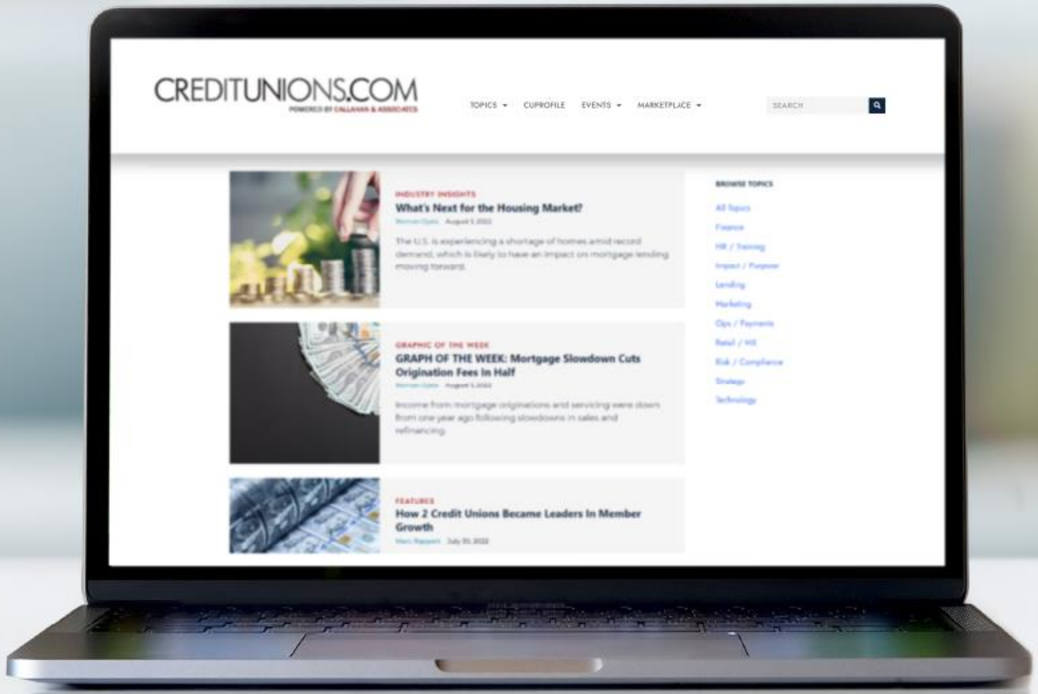

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Today's Lineup

Market Update
Jason Haley, Chief Investment Officer, Investment Management Group, ALM First

3Q 2022 Credit Union Results

Jon Jeffreys, Chief Executive Officer, Callahan & Associates

Jay Johnson, Chief Collaboration Officer, Callahan & Associates

Preparing for a Recession
Jack Biggs, Jr., Senior Vice President – Chief Financial Officer, Desert Financial Credit Union

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Callahan Quarterly Trendwatch | November 15, 2022

ALM FIRST MARKET UPDATE

Speaker

Jason Haley

Chief Investment Officer

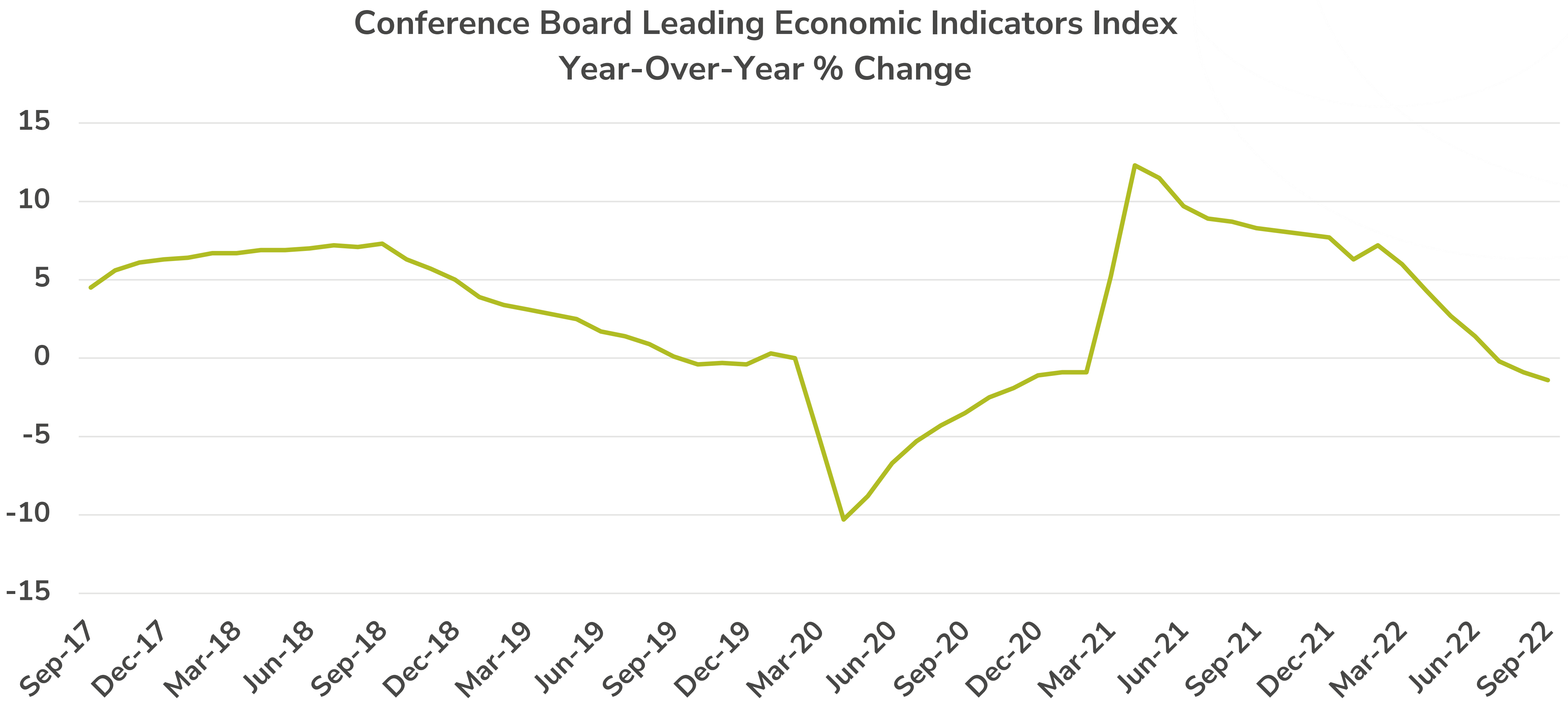
Economic Themes

- **Near-term Fed policy uncertainty still high**
  - FOMC announced 4th consecutive 75 bp rate hike at November meeting but cracked open the door for a reduced pace of hikes going forward
    - "In determining the pace of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments." - Nov. 2 FOMC official statement
  - Powell maintained a hawkish tone at the 11/2 press conference
    - Said the Fed still "has a ways to go" to reach the "sufficiently restrictive" level of rates currently envisioned
    - Also noted that the terminal fed funds rate is likely higher than previously expected (suggesting September FOMC "dots" will be revised higher at December 14 meeting)

- **Labor market still stubbornly tight**
  - Job openings unexpectedly rose to 10.72 million in September, sending the closely monitored job openings to total unemployed ratio up 20 bps to 1.9:1 (just below cycle high of 2:1)
  - October job growth more than expected (261k vs 193k), and wage growth also beat expectations at 0.4% m/m

- **Important data to come**
  - Prior to December 14 FOMC meeting, two CPI reports and the November jobs report will be released
  - Following a lower than expected October CPI report, the market is now more firmly pricing in a 50 bp hike in December

Signs of Slowdown Growing...



Source: Conference Board; Bloomberg

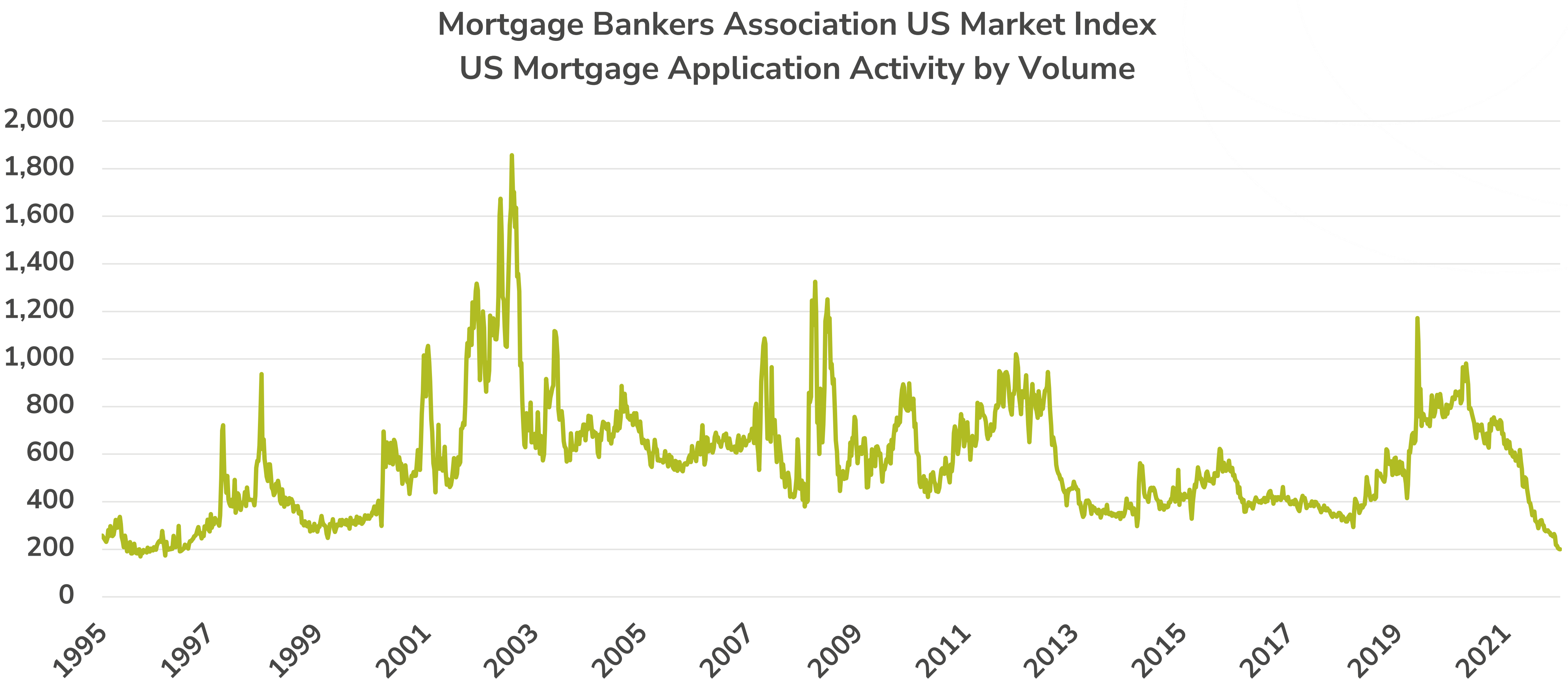
Housing Market Slowing

- **Mortgage rates up 400+ bps in a year**
  - According to Bankrate.com, national average 30yr and 15yr conforming rates are 7.32% and 6.43%, respectively, as of November 7
    - One year prior, national average 30yr and 15yr rates were 3.07% and 2.41%, respectively

- **Home prices falling**
  - The Black Knight Home Price Index fell 0.52% in September, the third consecutive monthly decline
    - Annualized appreciation slowed to 10.7%, still more than double historical norms
    - Nation's 50 largest markets remain elevated from 19% to 66% since the start of the pandemic
    - $1.3 trillion (-7.6%) of home equity was shed in Q3, the largest quarterly decline on record and the largest on a percentage basis since 2009

- **Mortgage application activity plummets**
  - Mortgage Bankers Association index now showing the lowest application volumes since 1996

Mortgage Activity Grinding to a Crawl



Source: MBA, Bloomberg

Looking Ahead

- **Signs of slowdown emerging, but labor market and inflation data still strong**
  – Fed Chair Powell has made clear that the mistakes of prematurely ending tightening cycles in the 1970s are fresh on the minds of current Fed leaders (hence ‘higher for longer’ guidance)

- **Industry loan pricing under greater scrutiny**
  – Q3 loan growth approximately 20% for CUs >$100mm total assets
    - YTD more than 18% growth
  – CU Times article last week highlighted an Experian report showing that credit union market share in the auto loan market increased to 25.81% in Q2, up from 18.32% a year prior
    - Captive autos market share declined to 22.64% from 28.47% over the same timeframe
  – Asset pricing issues can morph into liquidity issues as time passes

- **Attractive opportunities for liquidity providers in current market**
  – Bond market has repriced much more effectively this year, and current all-in yields are the highest we’ve seen in 15 years amid the sharp increase in rates and, more importantly, spreads

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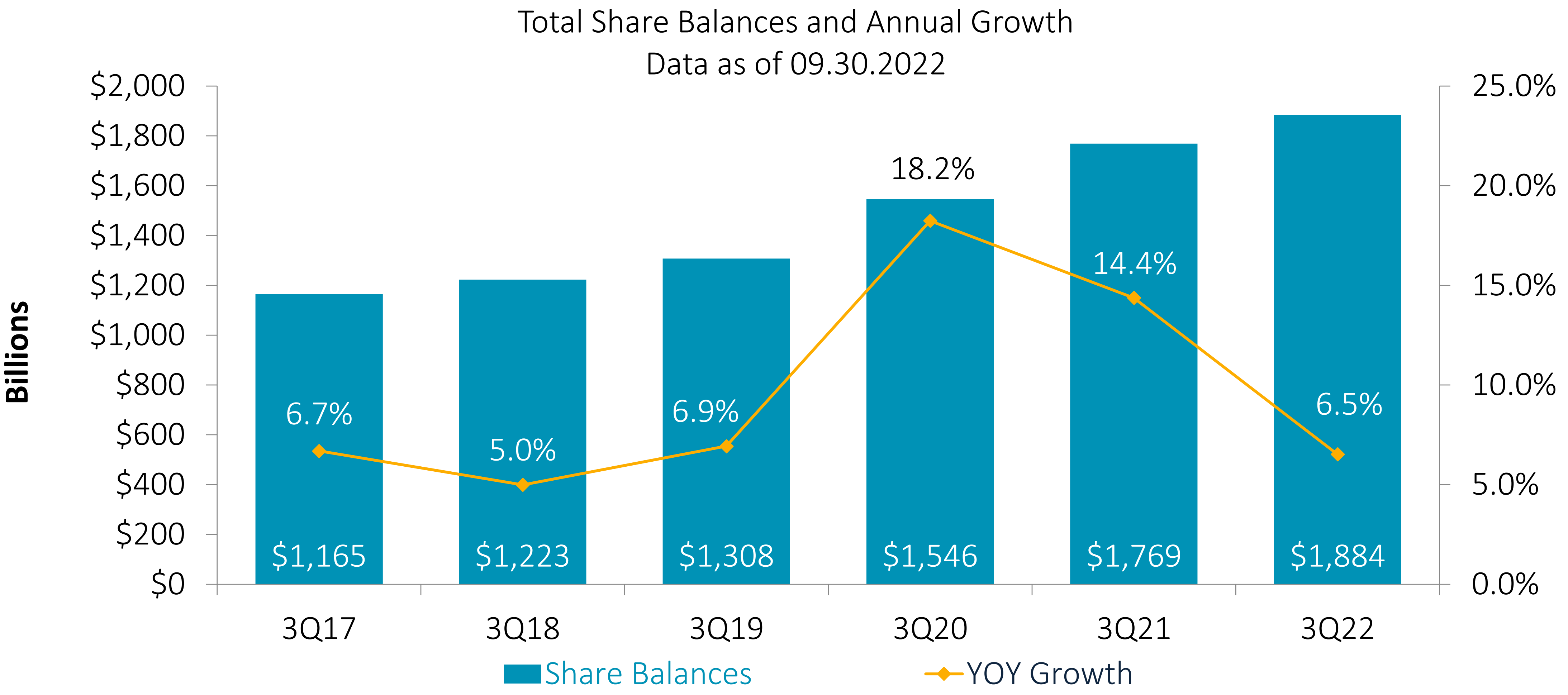
Credit union loan growth reaches its highest level ever through the third quarter

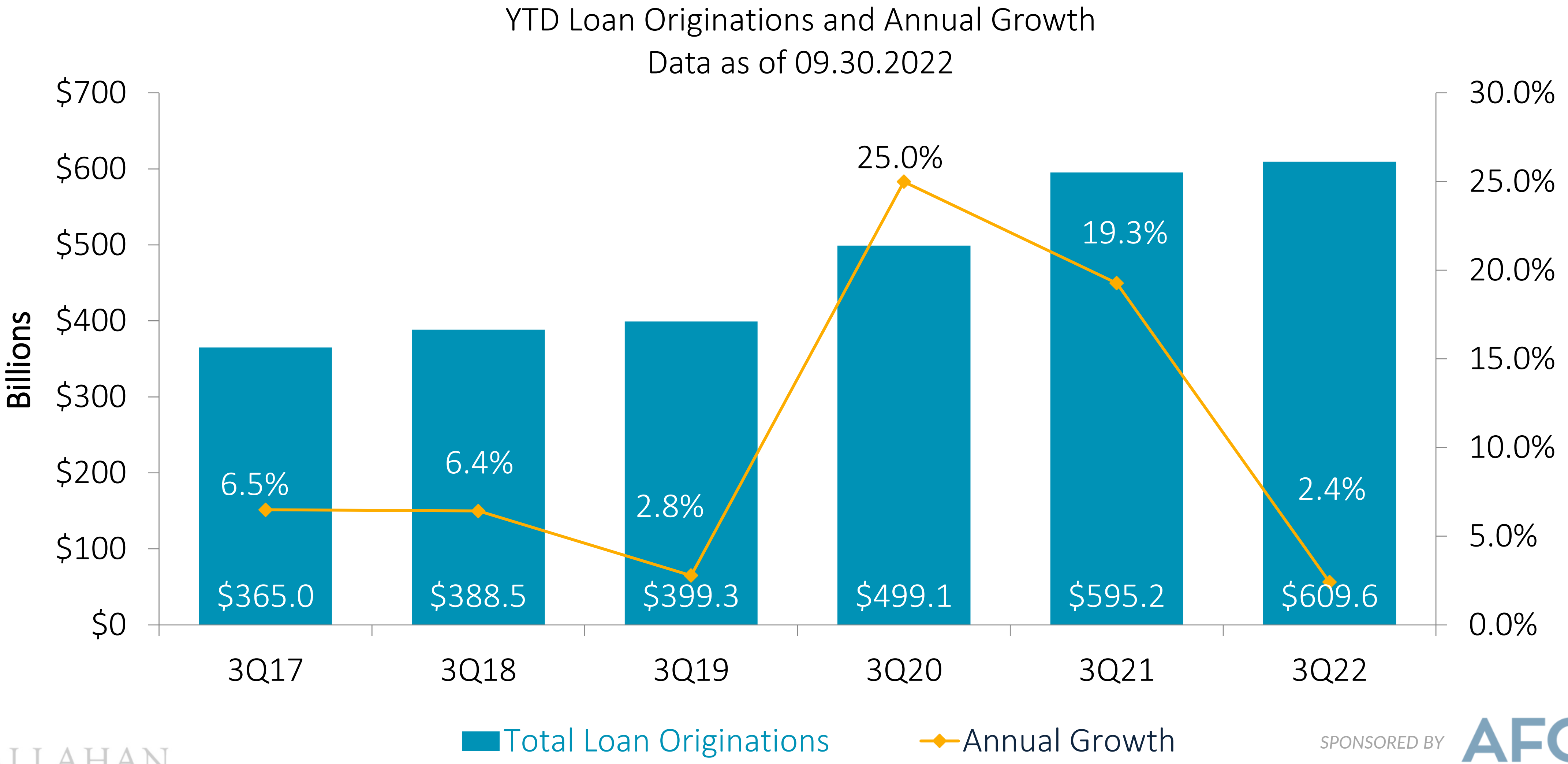
	9/30/2022	12-Mo. Growth	9/30/2021	12-Mo. Growth
Assets	$2,177.8B	6.7%	$2,040.7B	12.9%
Loans	$1,475.6B	19.4%	$1,235.6B	5.8%
Shares	$1,883.9B	6.5%	$1,768.5B	14.4%
Investments	$608.3B	-14.3%	$710.0B	28.5%
Capital	$200.7B	-7.8%	$217.7B	7.4%
Members	136.0M	4.6%	130.0M	4.0%

Source: Callahan's Peer-to-Peer Analytics

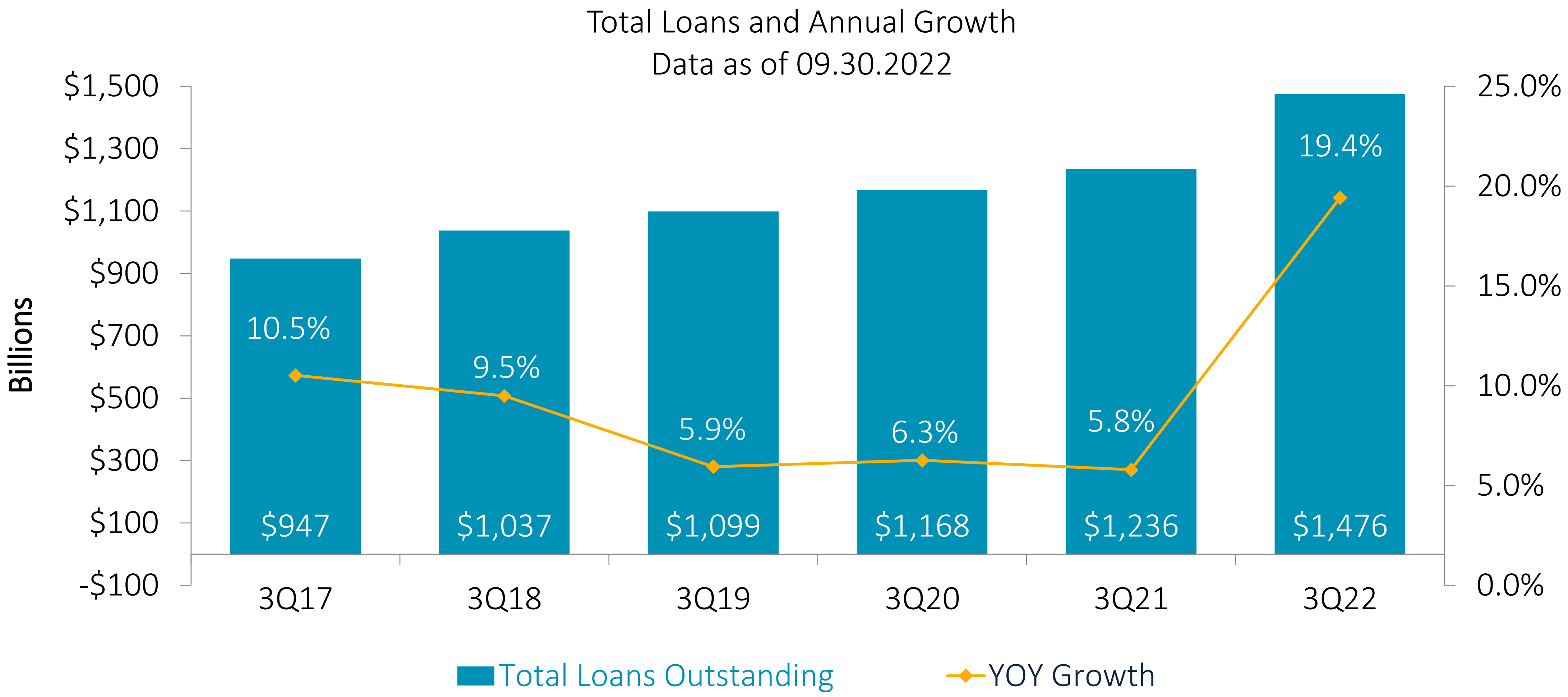
Share growth returns to pre-pandemic levels



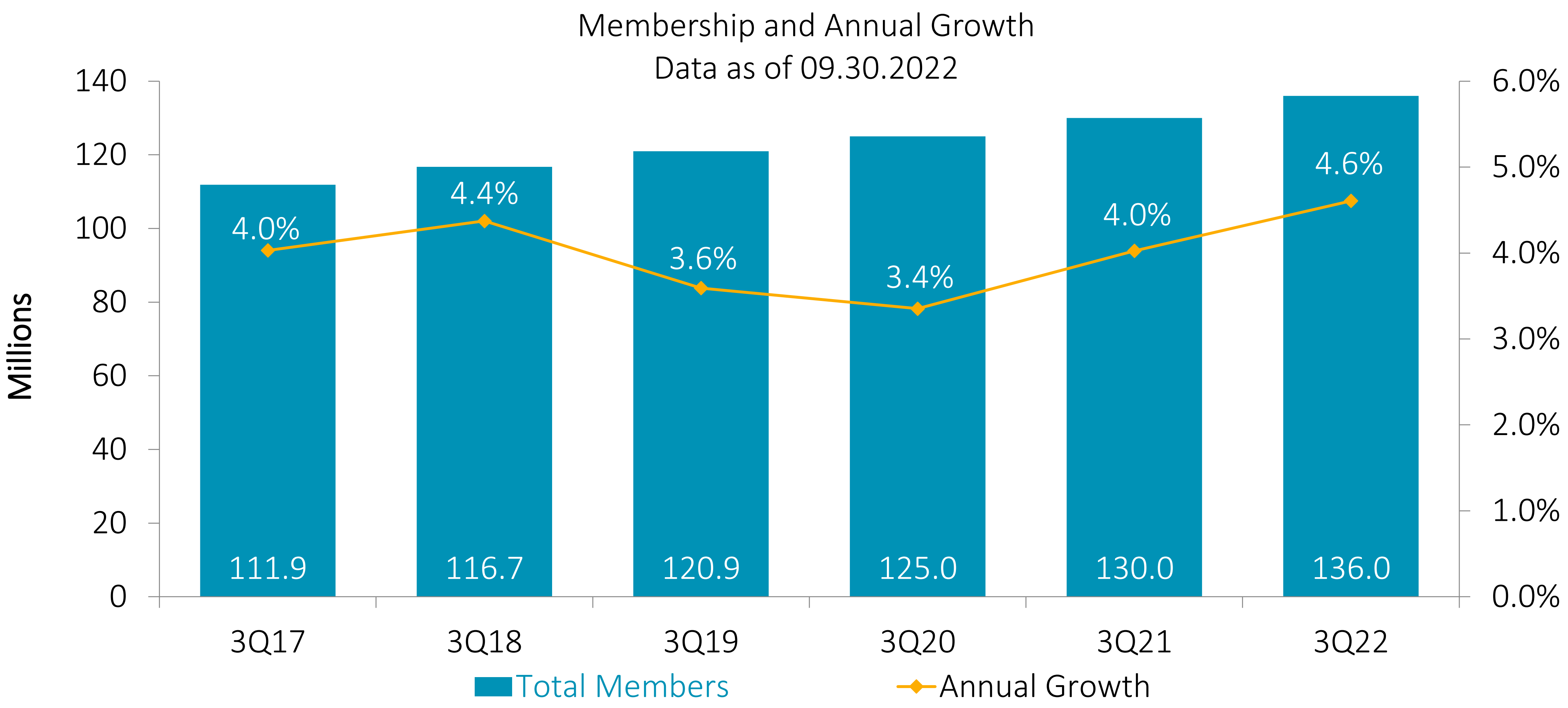
Loan originations are on a record pace in 2022



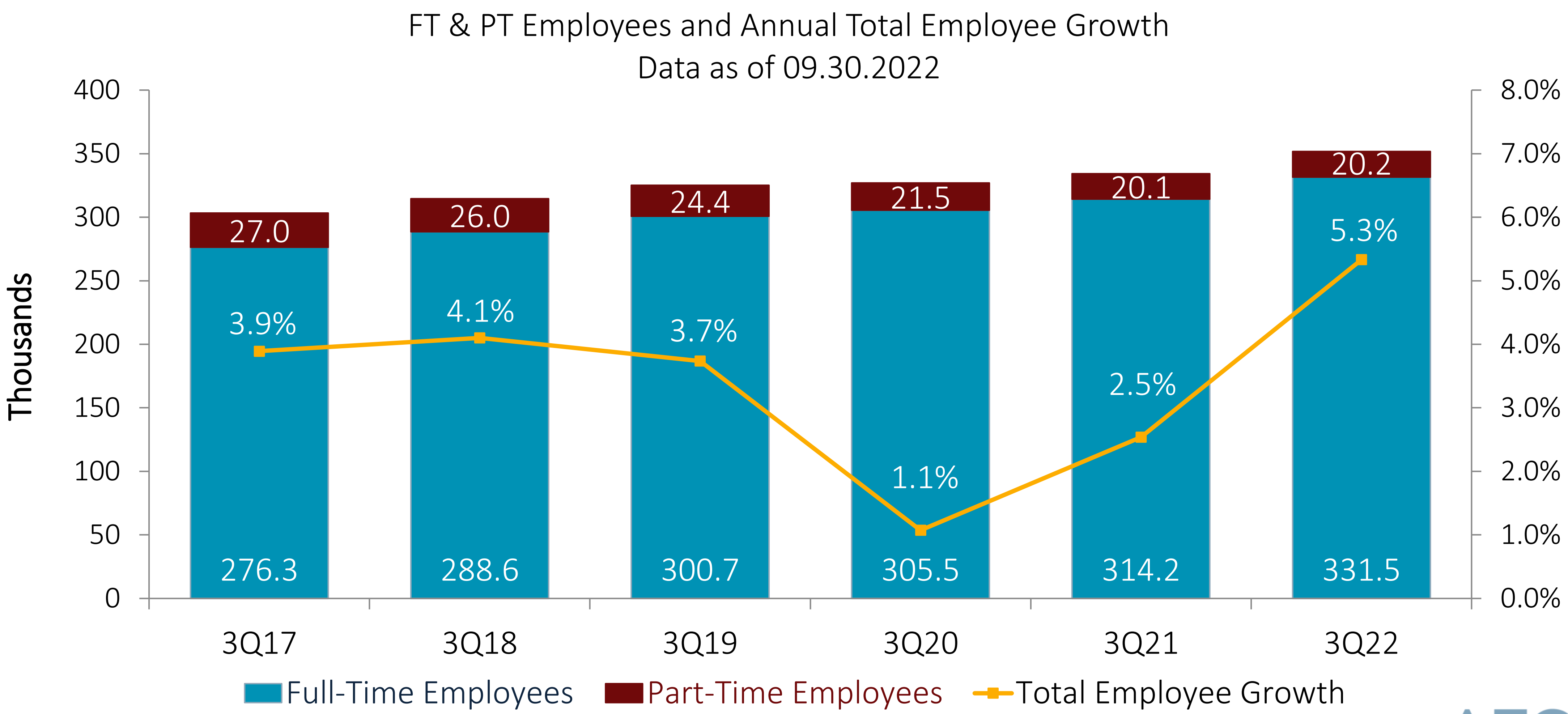
Loan growth more than triples from a year ago



A record 6 million consumers join a credit union over the past year



Credit union hiring ramps up to serve a growing membership



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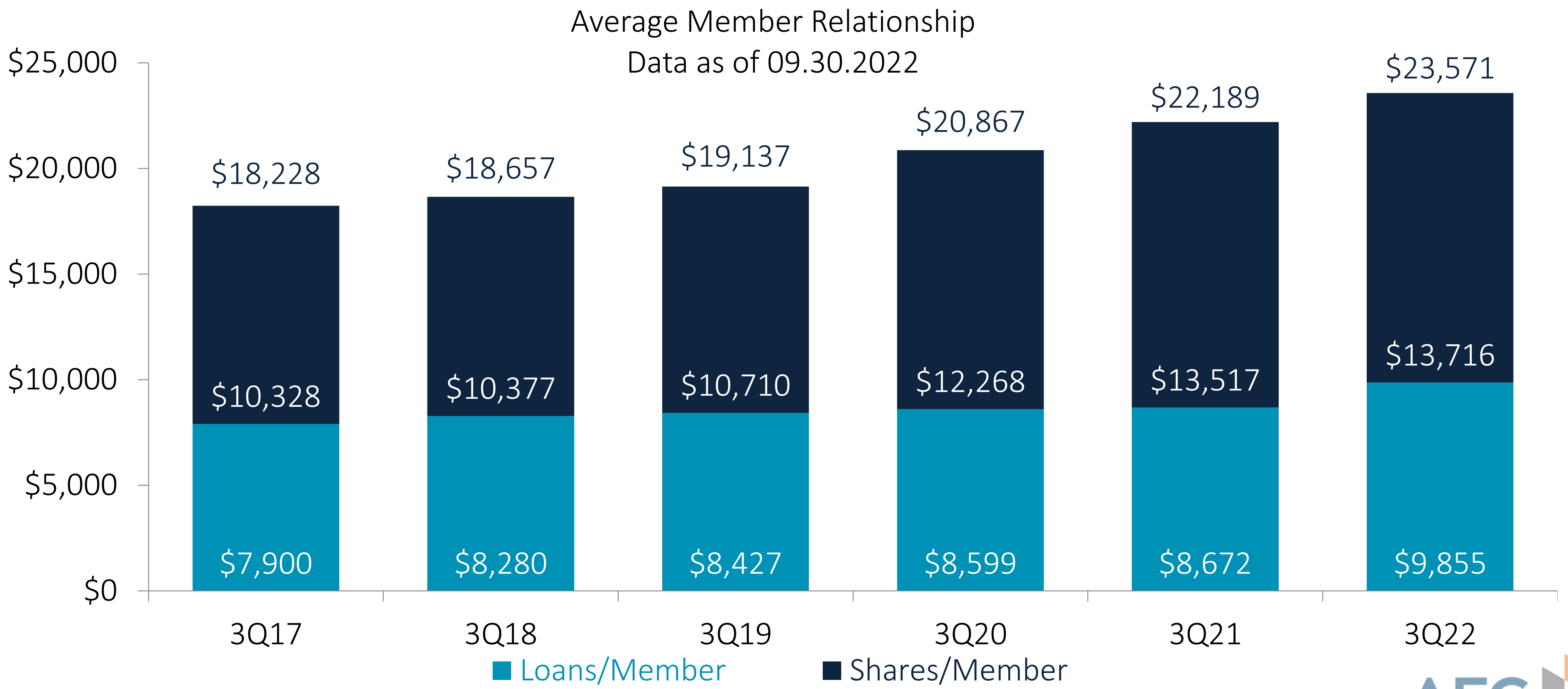
The average member relationship is at an all-time high as loan balances rise



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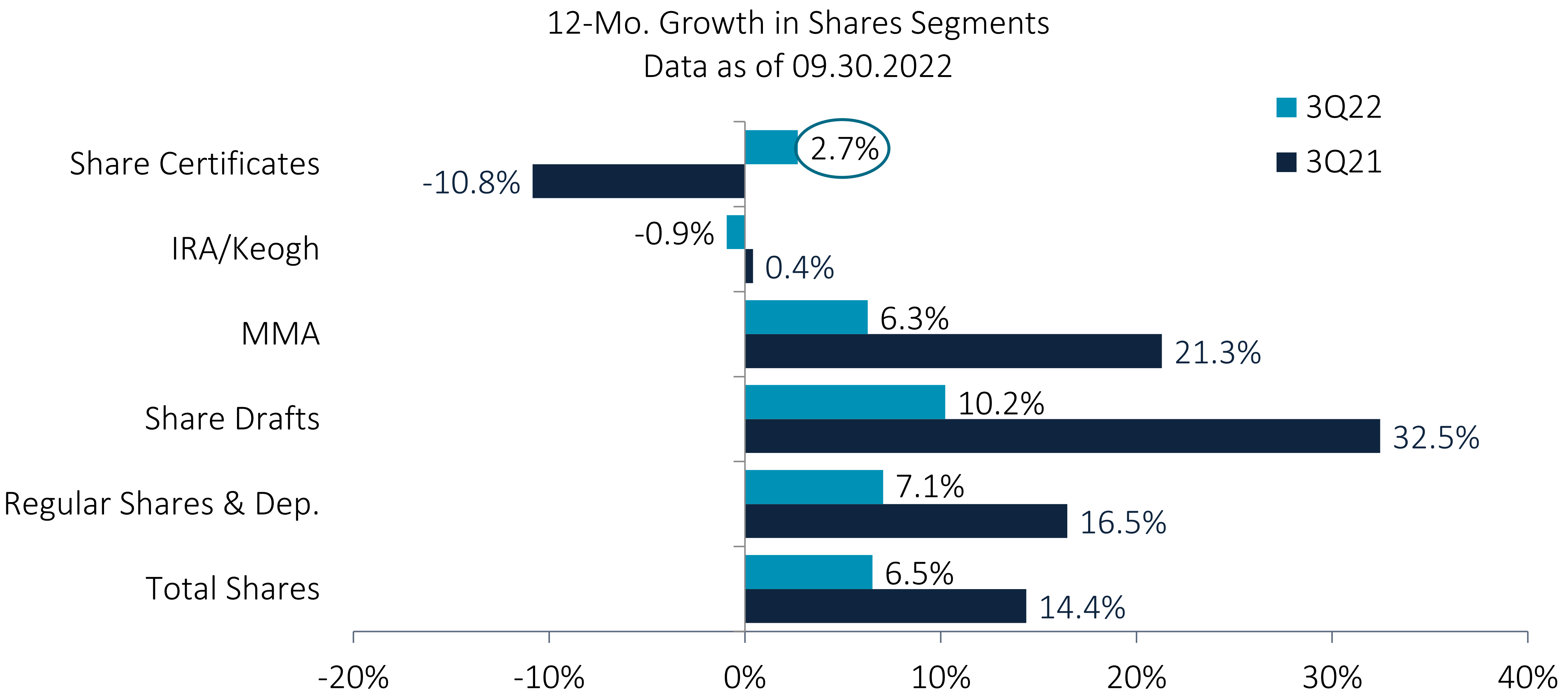
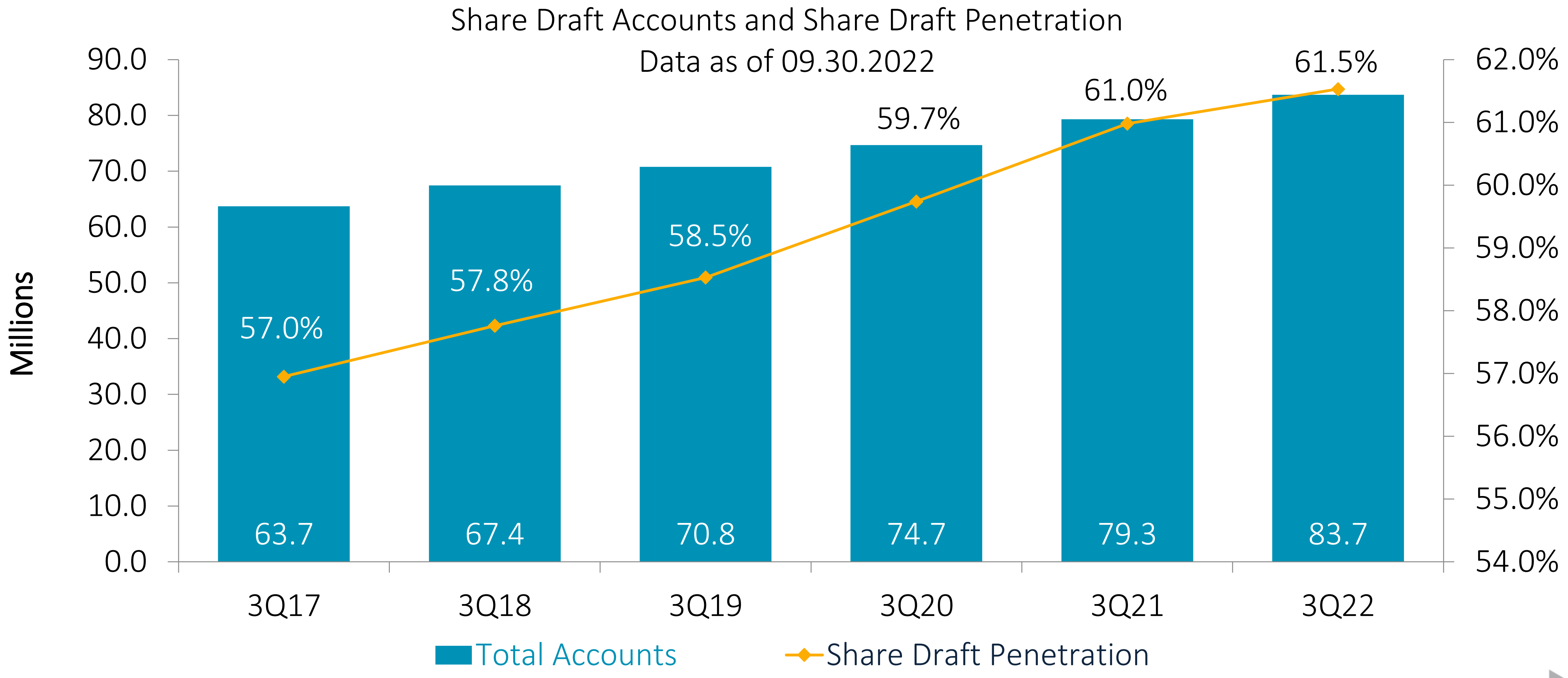
Savings

Growth is slower in every share category except certificates

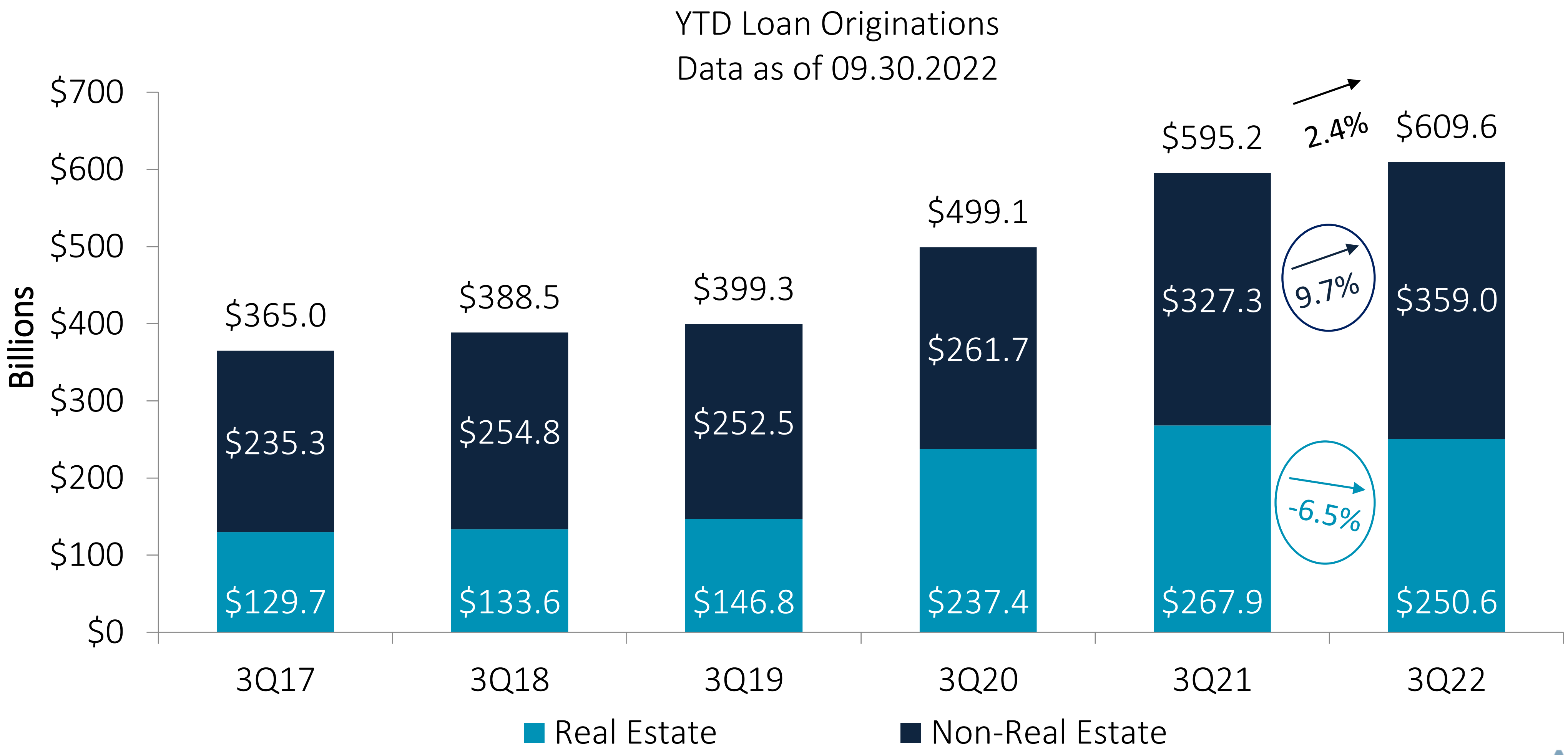


Share draft usage continues to increase among members

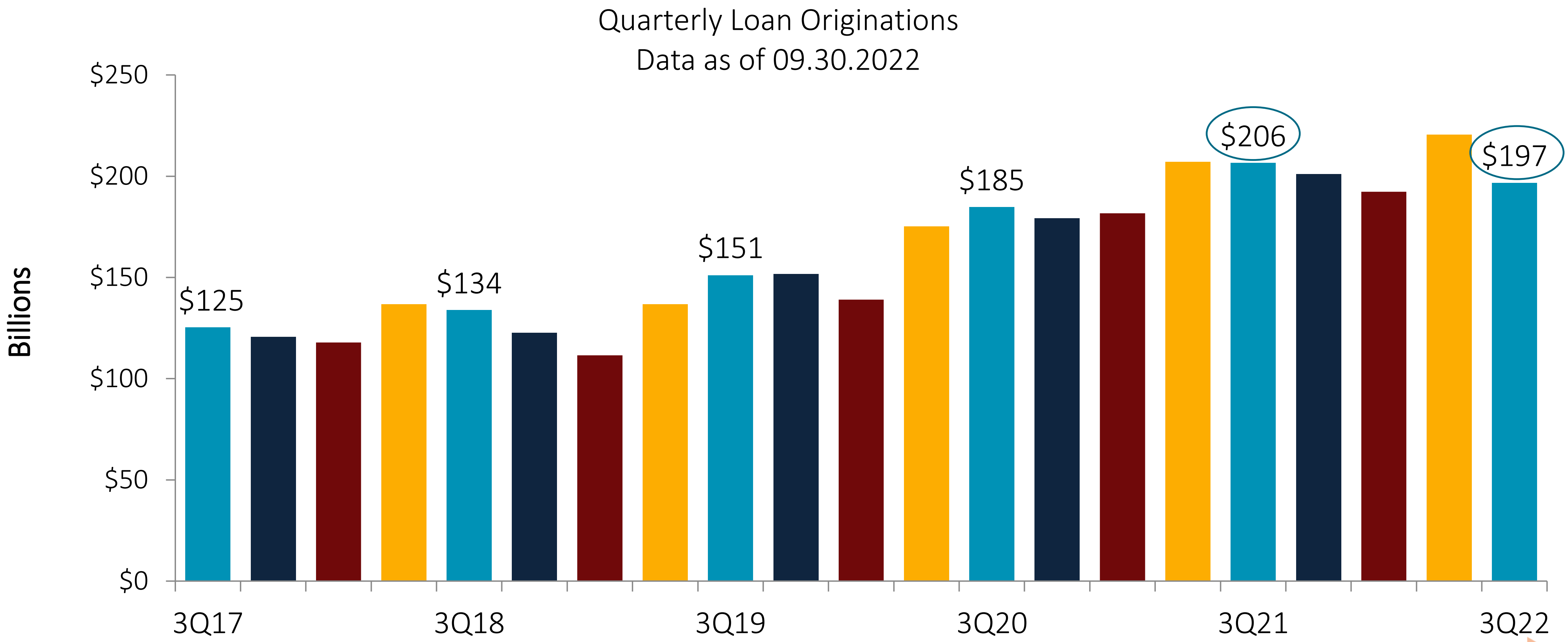


Lending

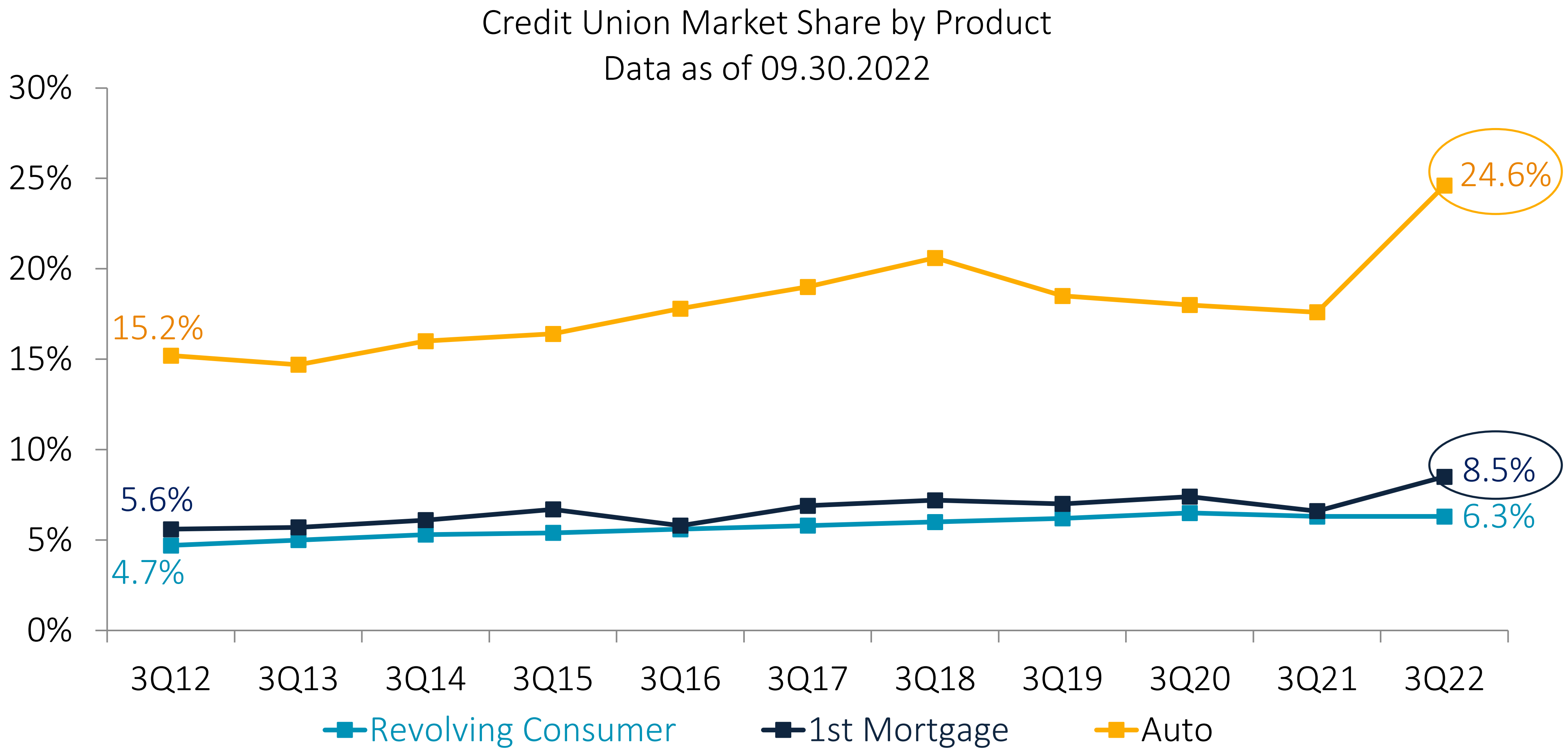
Consumer lending remains strong while real estate originations decline year-over-year



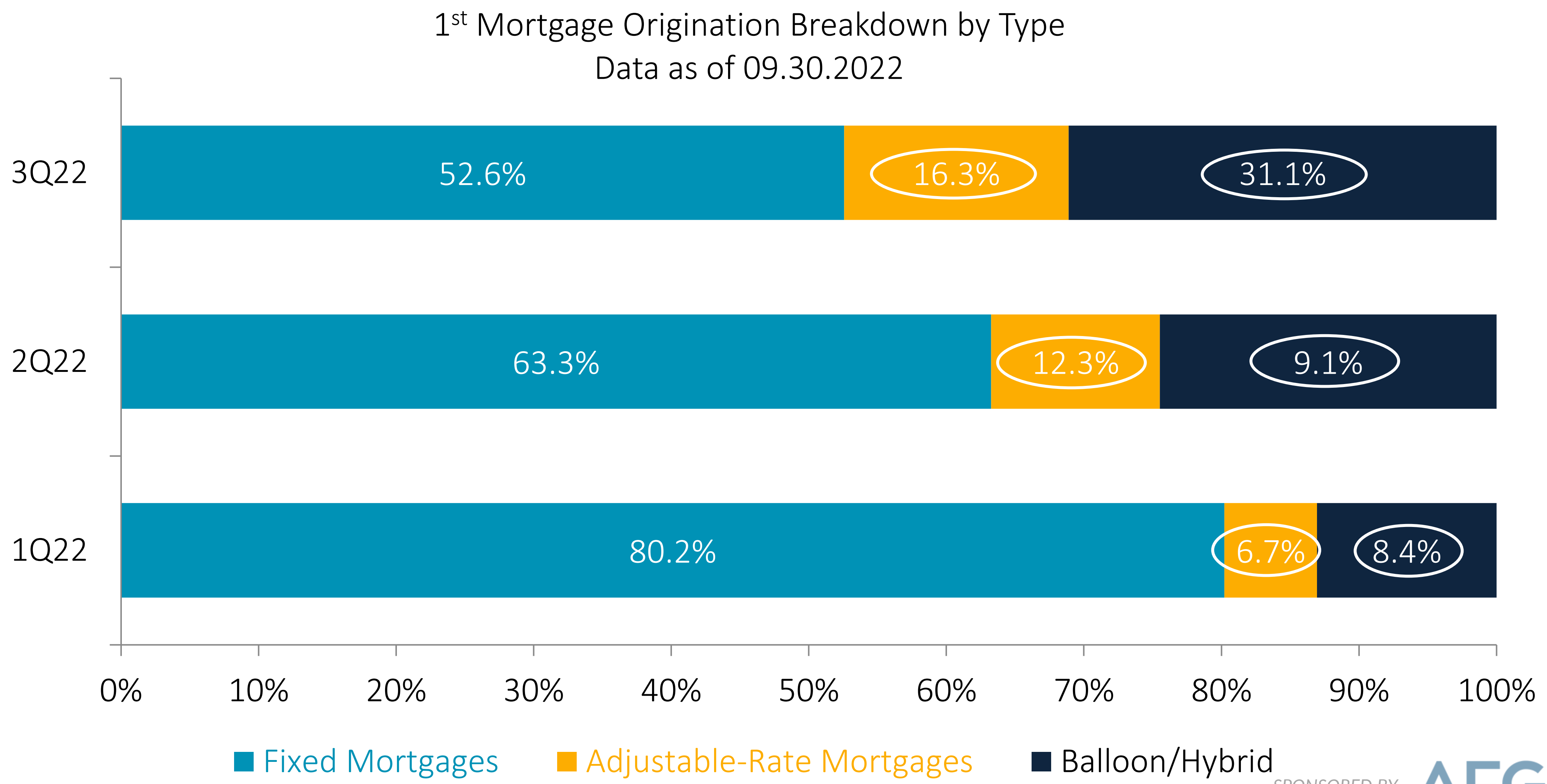
Quarterly loan originations are lower than the prior year for the first time since 1Q 2019



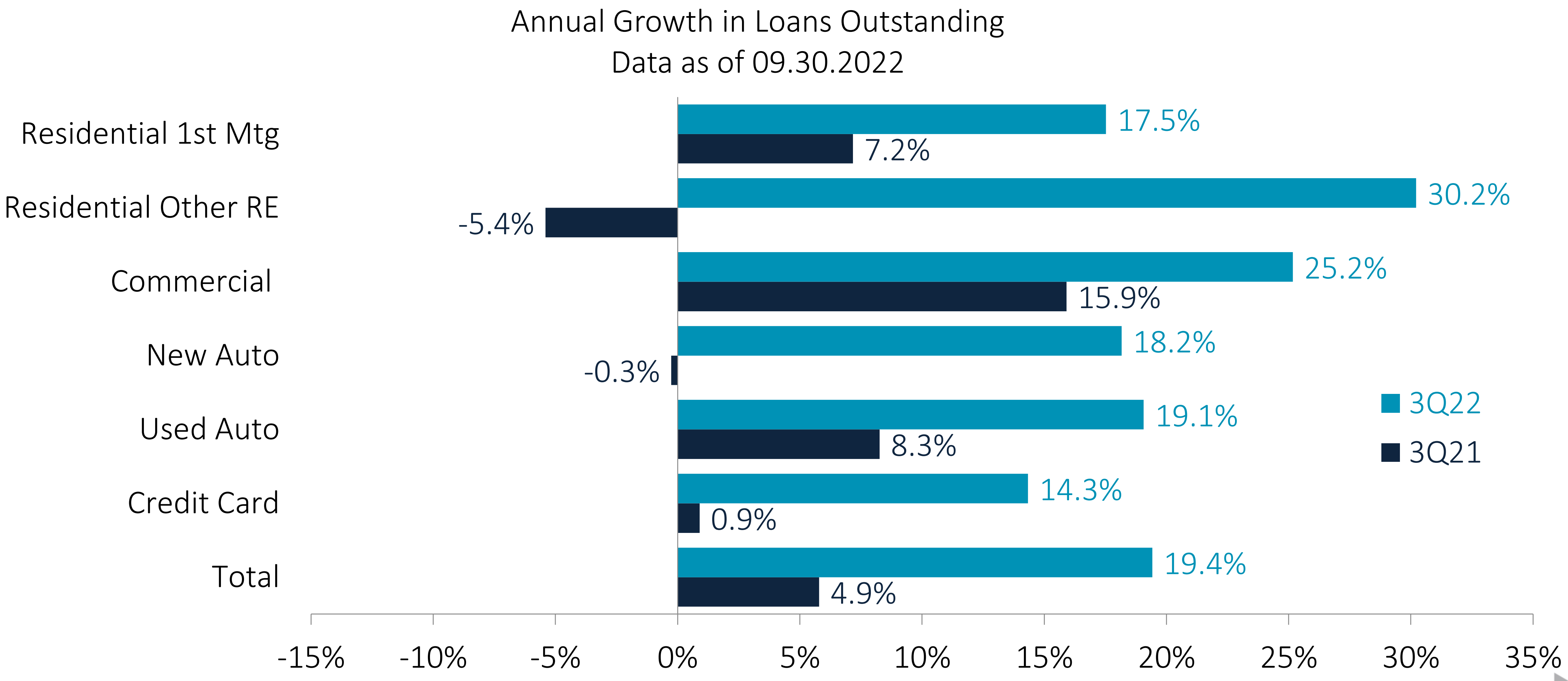
Credit unions increase market share in both auto and first mortgage loans



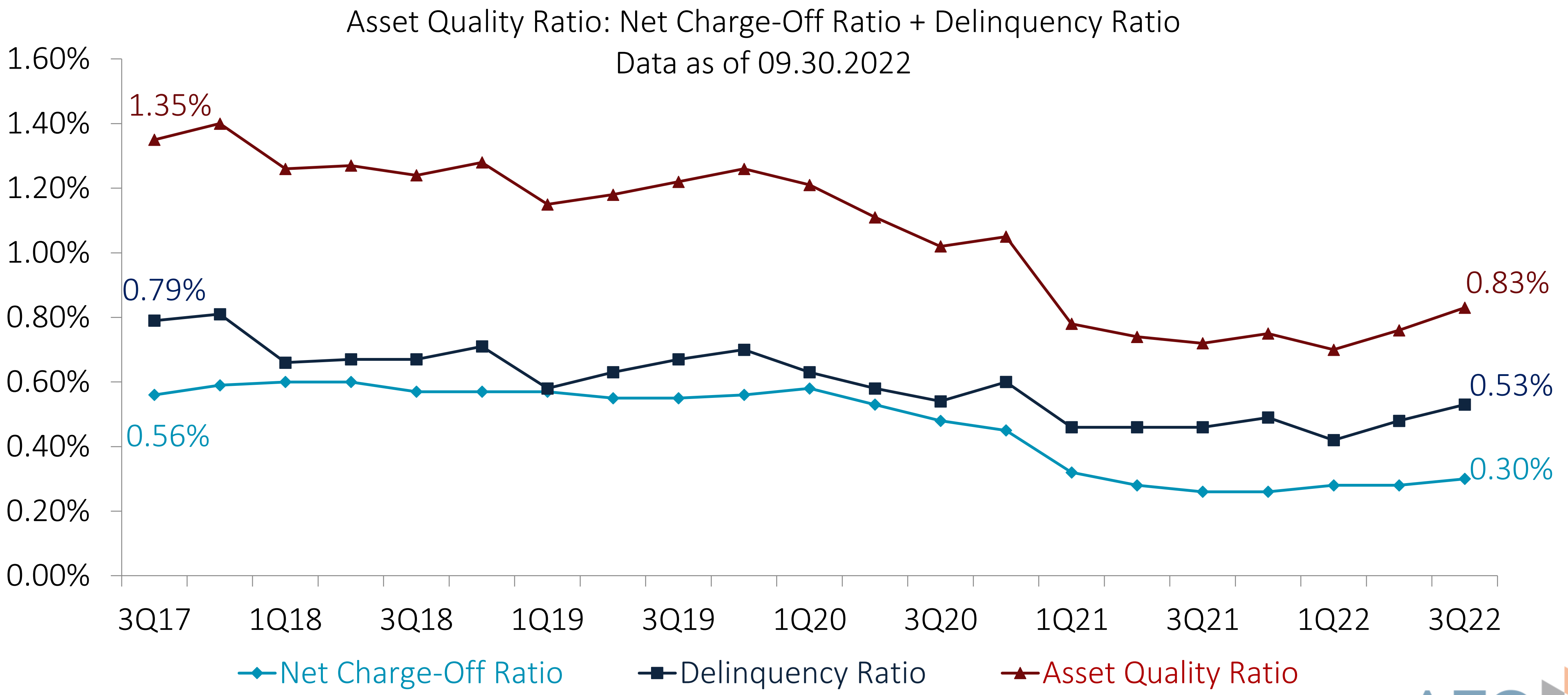
Adjustable and balloon mortgages grow in popularity as rates rise



Double-digit growth is seen across the loan portfolio



Asset quality remains strong but delinquency is rising



Credit cards and car loans are driving the increase in delinquency

Annual Change in Delinquency
Data as of 09.30.2022

Total	Residential 1st Mortgage	Auto
0.53%	0.40%	0.53%
↑0.07%	↓0.01%	↑0.18%

Residential Other RE	Credit Card	Commercial
0.34%	1.29%	0.42%
↓0.19%	↑0.44%	↓0.10%

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Jack Biggs, Jr.

Senior Vice President, Chief Financial Officer

Assets	Annual Share Growth	Annual Loan Growth	ROA
$8.29B	14.5%	40.0%	0.89%

Phoenix, AZ

51 Branches

417,710 Members

1,177 Full-Time Equivalent Employees

Background

- Located in a “sand state”, the Great Recession had a significant impact on our credit union, particularly real estate lending
- As we worked our way out of the downturn, we focused on building a “fortress balance sheet”
- We are focused on taking care of employees and members when times are challenging

Initial Steps

- We have experienced record growth over the past few years but believe we are now entering a period where growth will slow materially
- Asking our team leaders which projects we could defer. We are not saying “no”, just deferring until we have more clarity on the environment
- Modified underwriting on home equity; Pulling back on indirect lending and being disciplined on pricing
- Trying to look around the corner…are we seeing signs that delinquencies and charge-offs are moving up?

Communication is Key

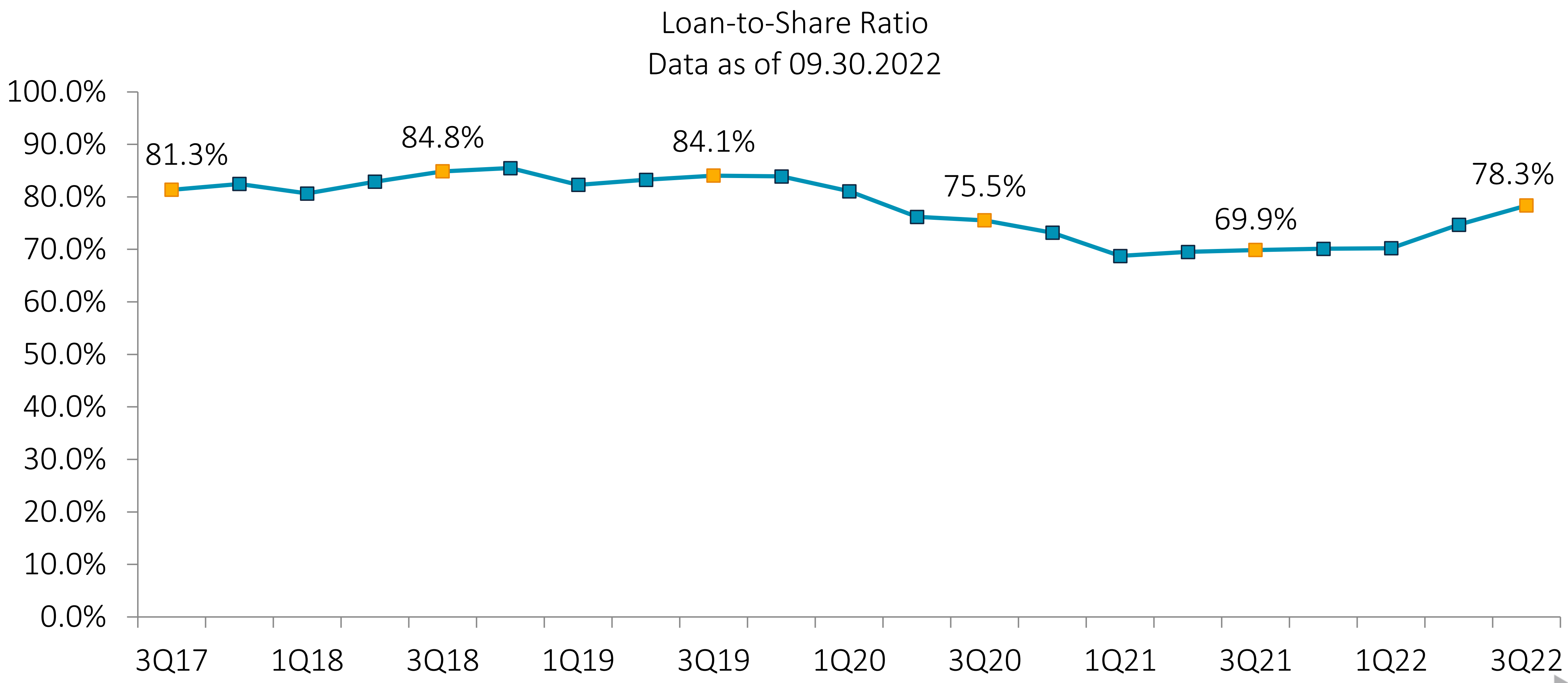
- We began communicating with our team about pending "storm clouds" in the second quarter as the Fed shifted to rapid interest rate increases
- Our senior leaders hosted a series of town halls with all ~1,200 employees to talk about the economic environment and what it could mean for DFCU; provided a forum for employees to ask questions
- Leadership meetings with all managers every 45 days
- Have shifted some roles from our mortgage CUSO to the credit union; No lay offs – the credit union has their backs

Looking Ahead: 2023 Forecast

- Budgeting for 8% deposit growth but expect it to be much more difficult to achieve
- Budgeting loan growth of 12%, with loan production down ~20%
- Headcount expansion is down significantly, especially for back office positions
- Expect to ramp up reserves as CECL is implemented; tougher economic environment, higher unemployment

Liquidity

The loan-to-share ratio is up 8 percentage points over the past two quarters



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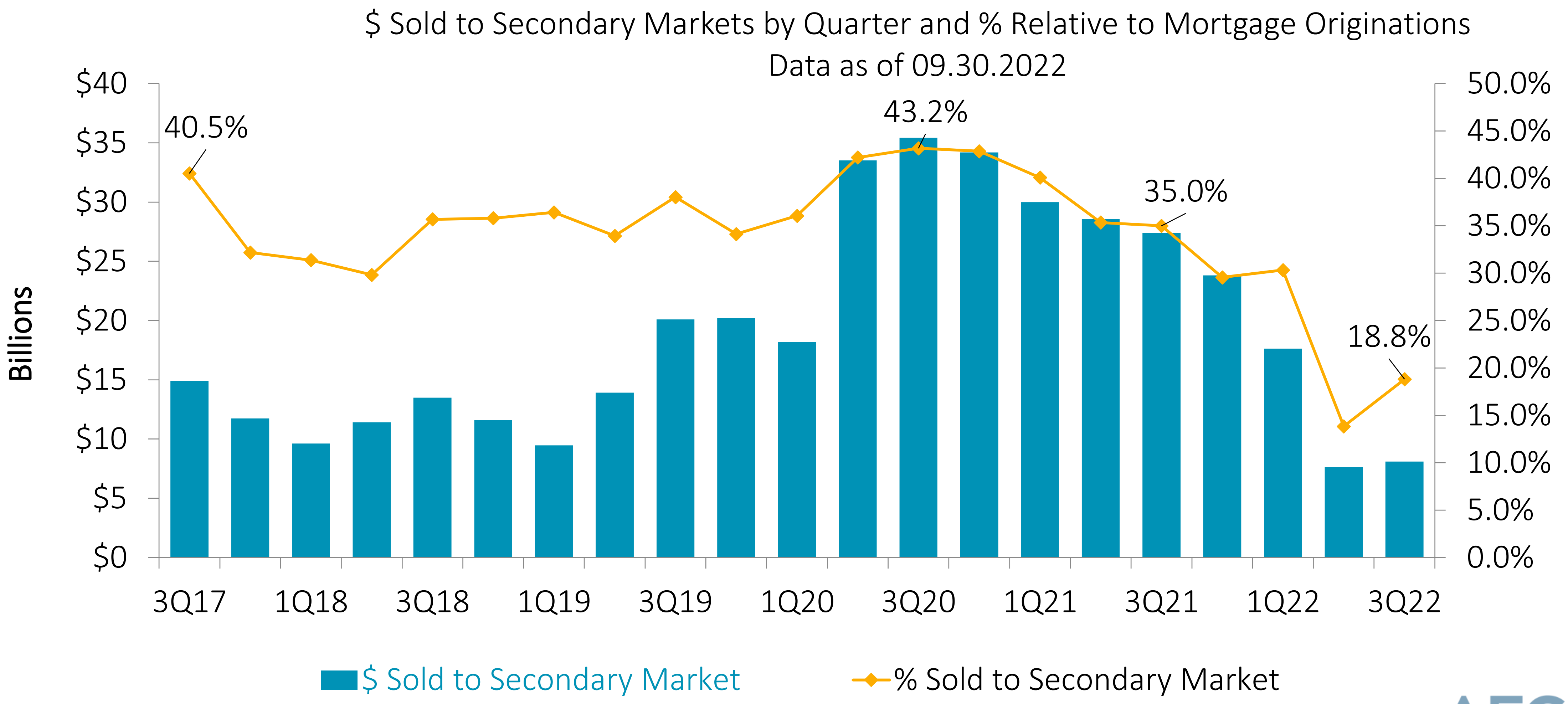
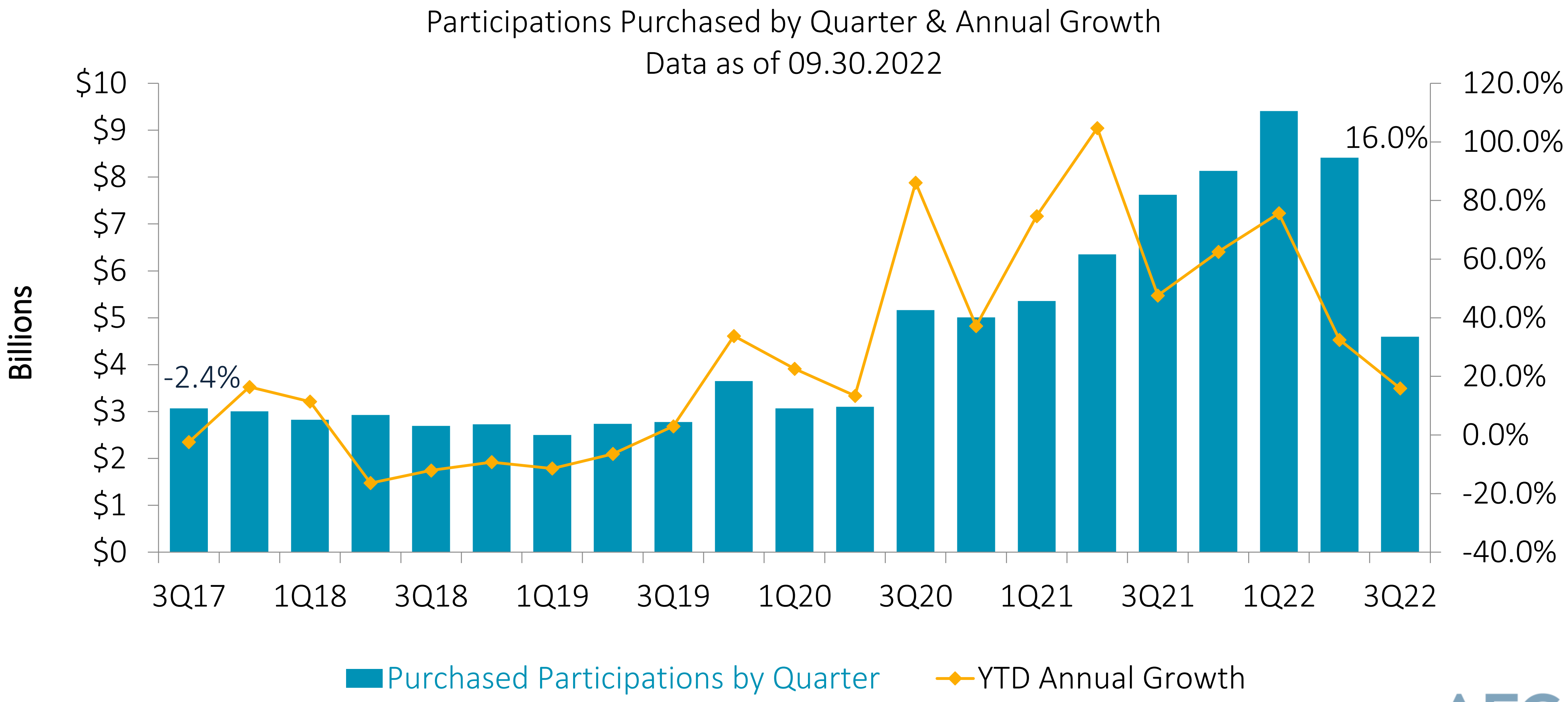
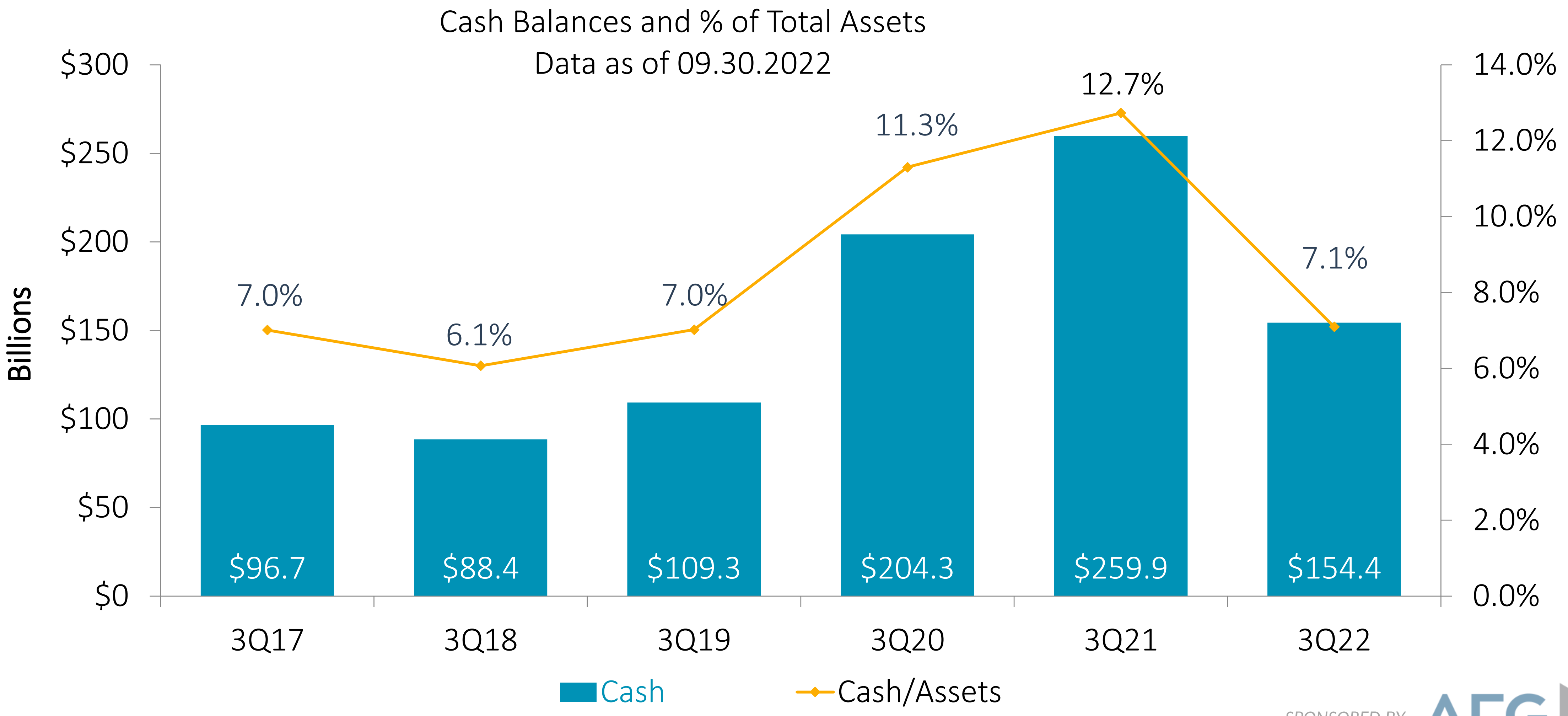
Fewer mortgages are being sold to the secondary market



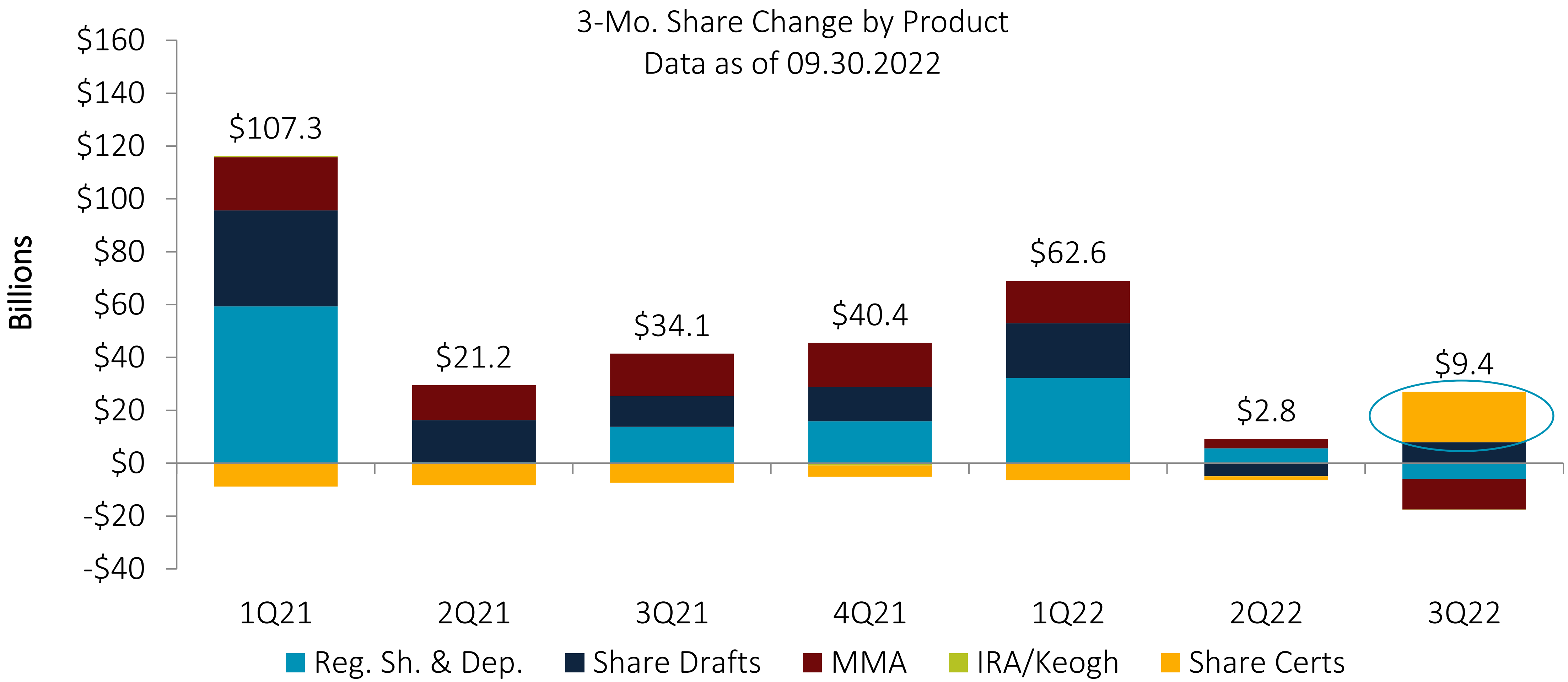
Purchases of participation loans drop to the lowest amount since the first half of 2020



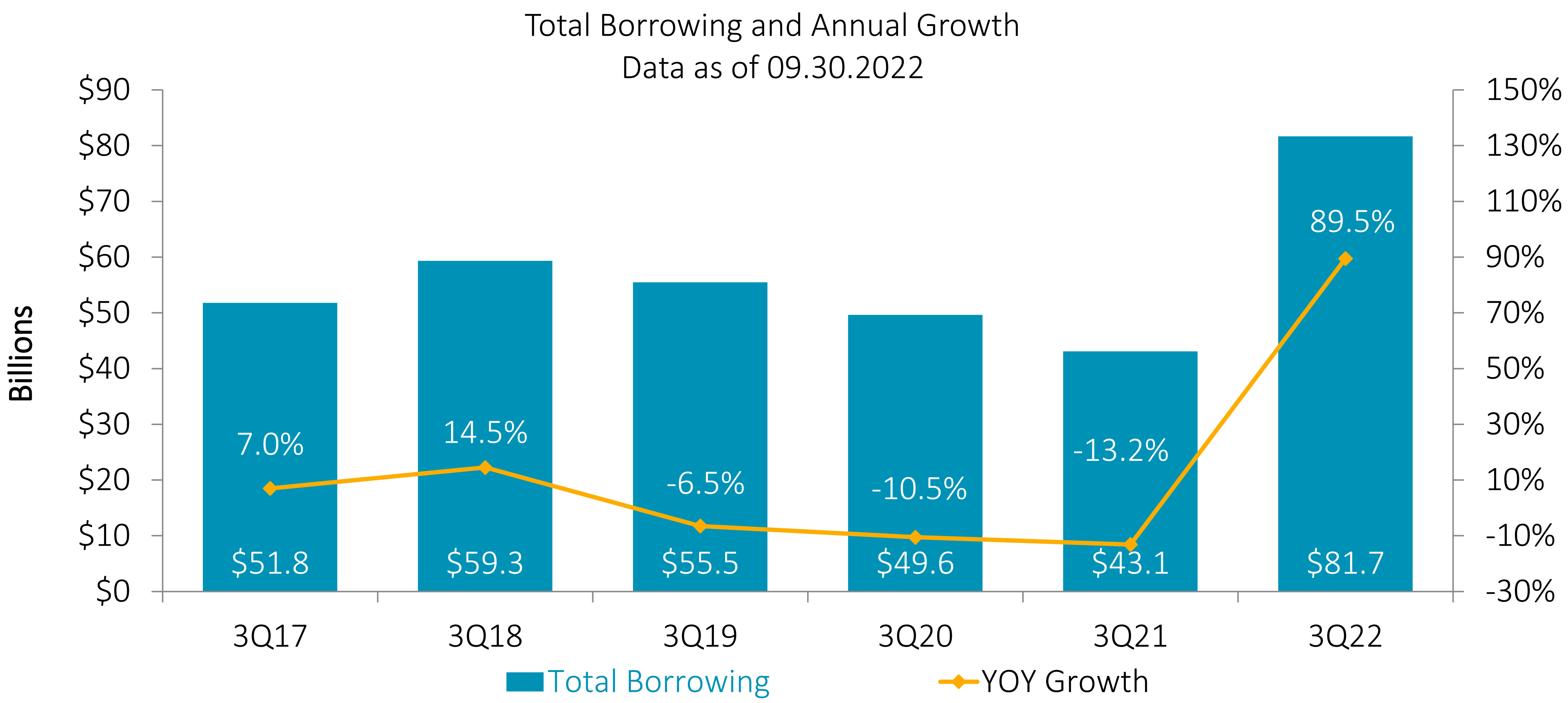
Strong lending and slower share growth leads to lower cash balances



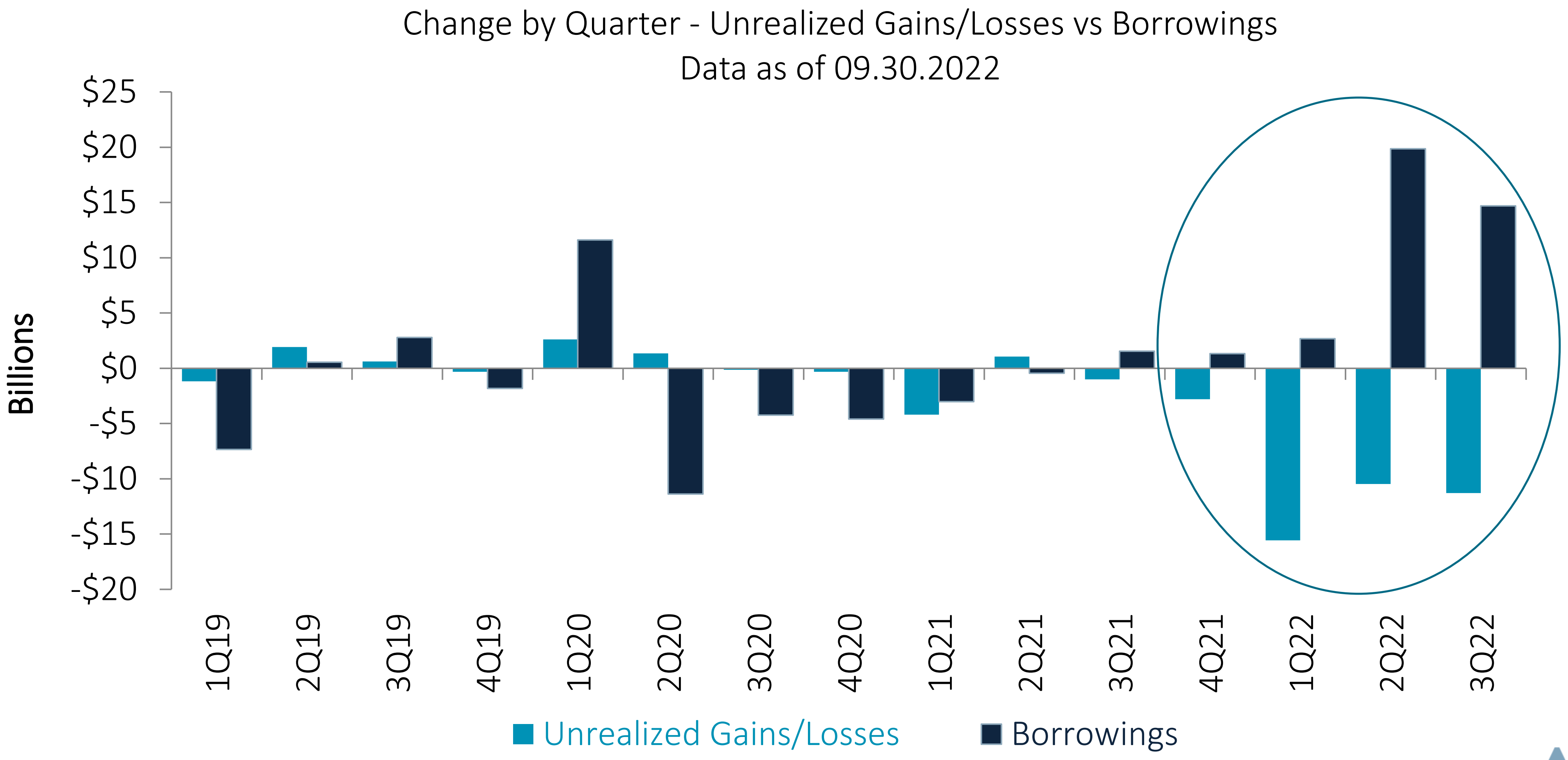
Share certificate balances jump $19 billion in the third quarter



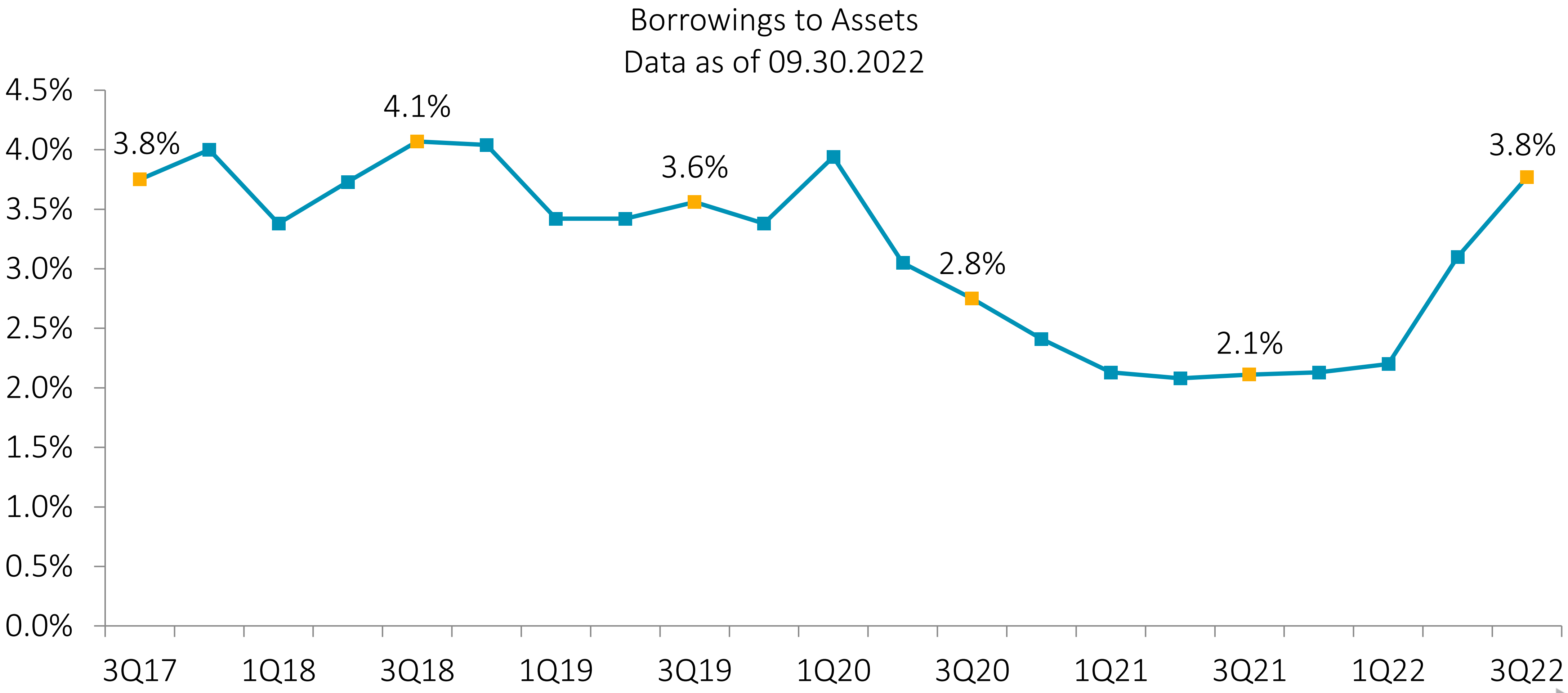
Credit unions are borrowing to help meet loan demand…



…and to avoid selling investments at a loss



Borrowings are in line with historical norms as a percentage of the balance sheet



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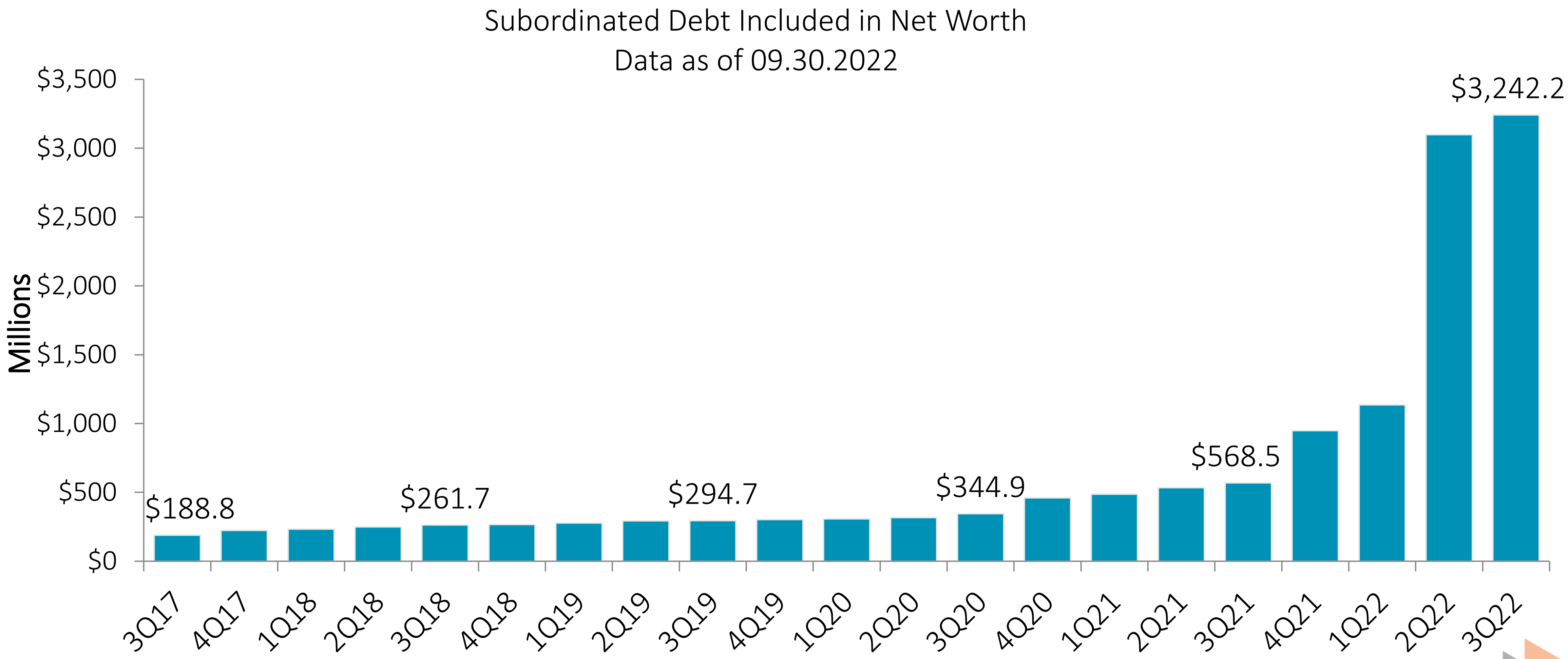
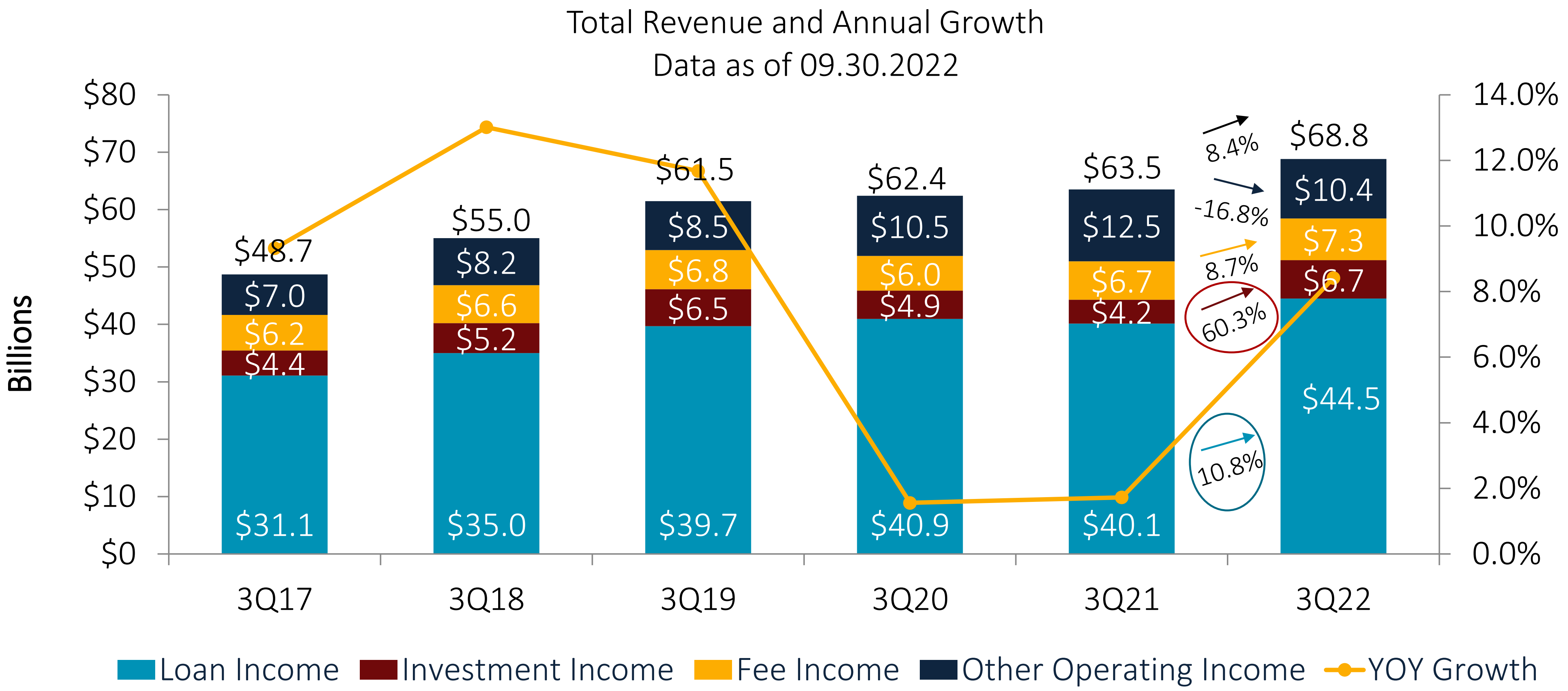
Subordinated debt is providing additional capital

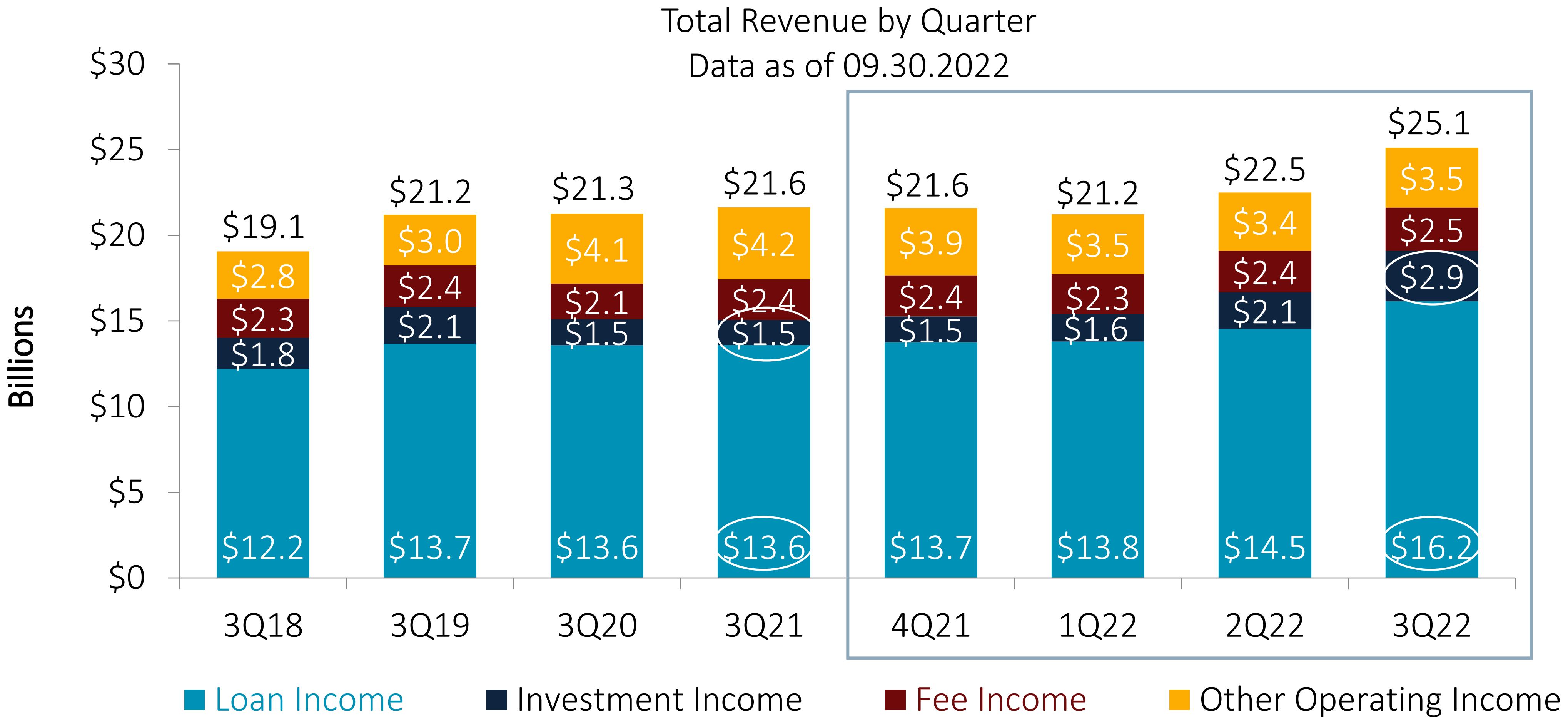


Earnings & Capital

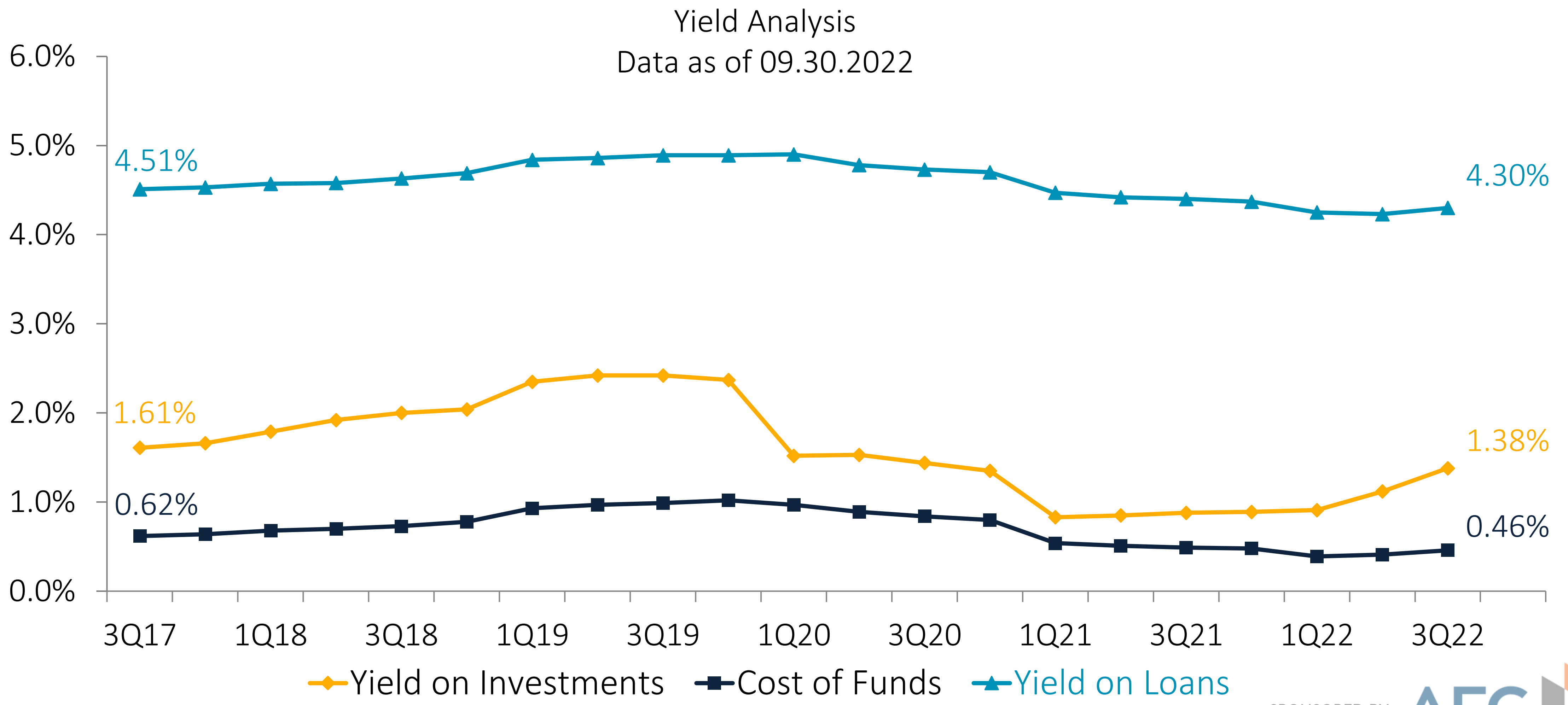
Rising rates are boosting income from loans and investments



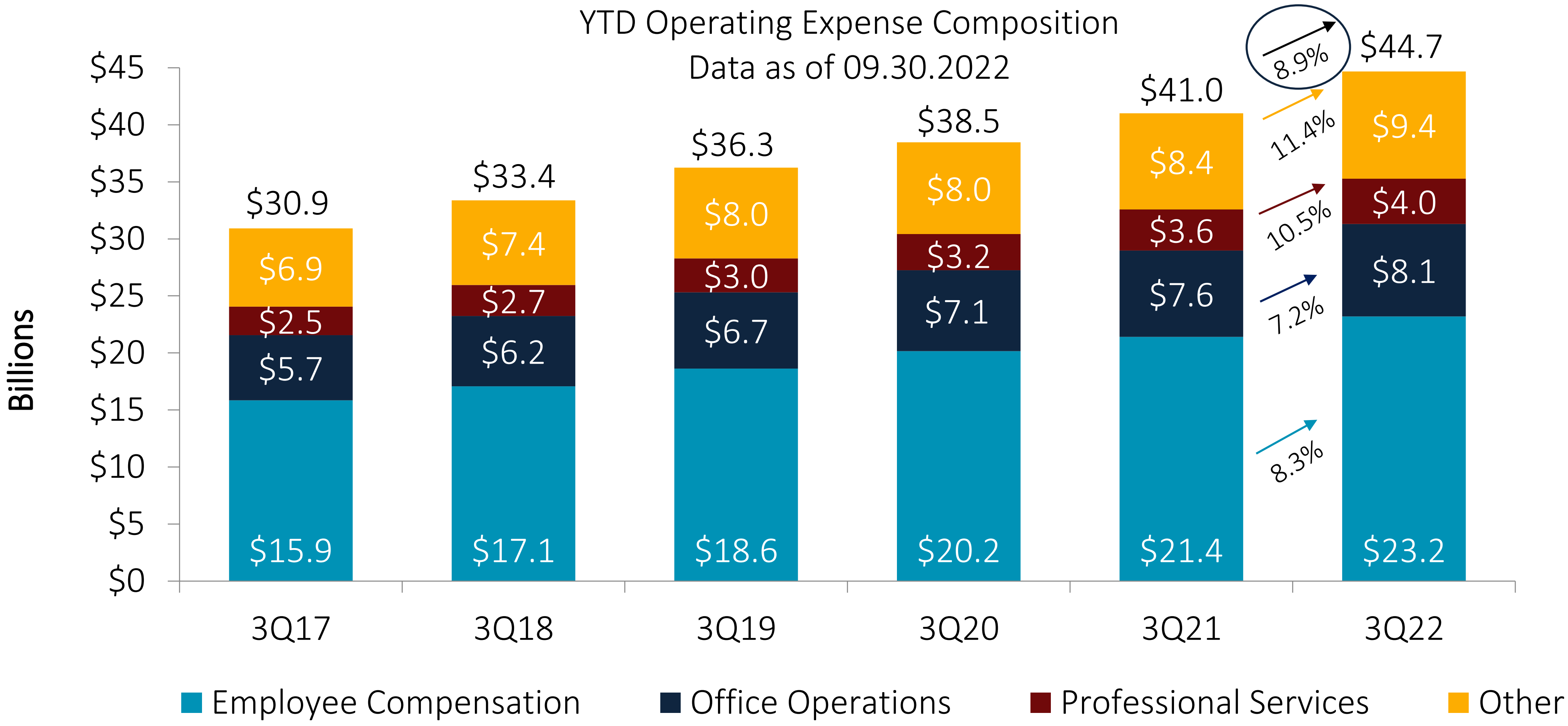
Loan income is up 19% and investment income has nearly doubled versus the third quarter of 2021



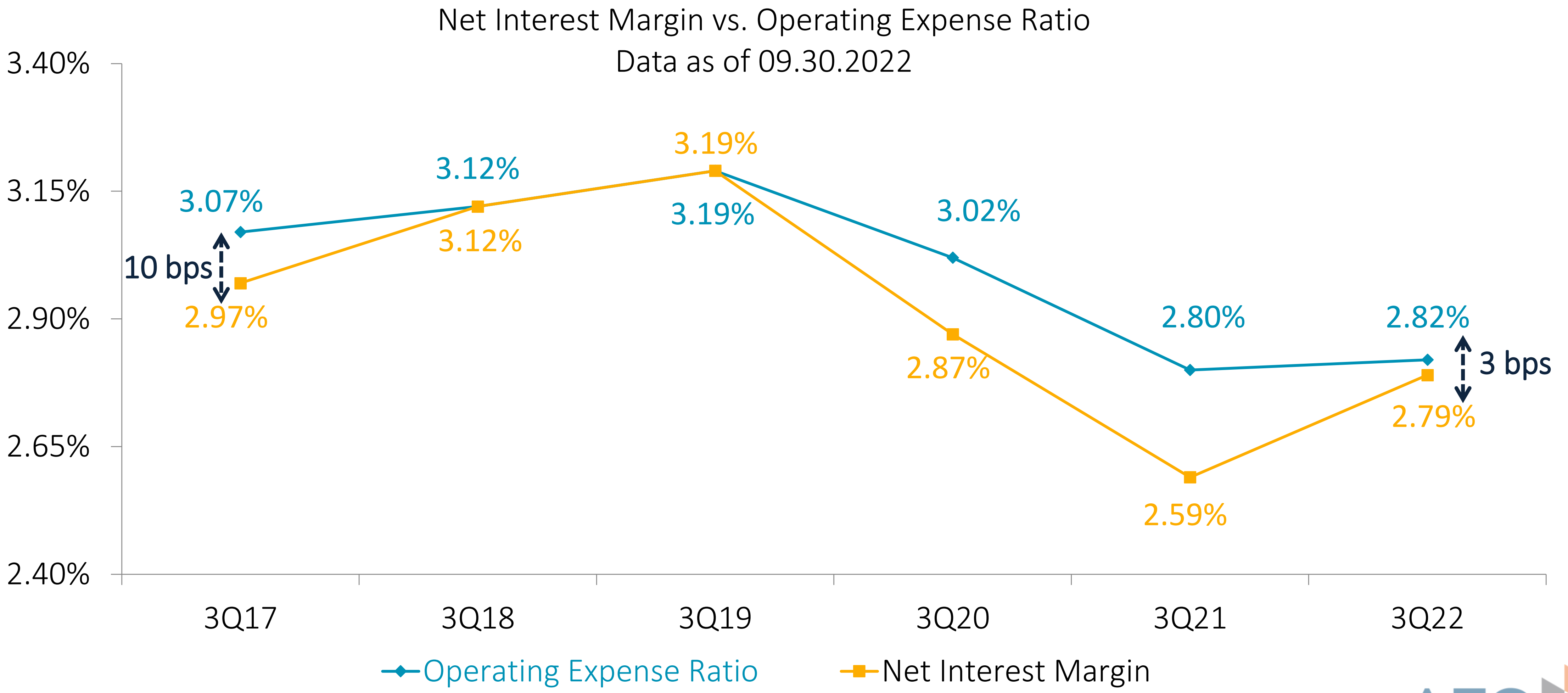
Loan yield and cost of funds rise at a single-digit pace in the third quarter



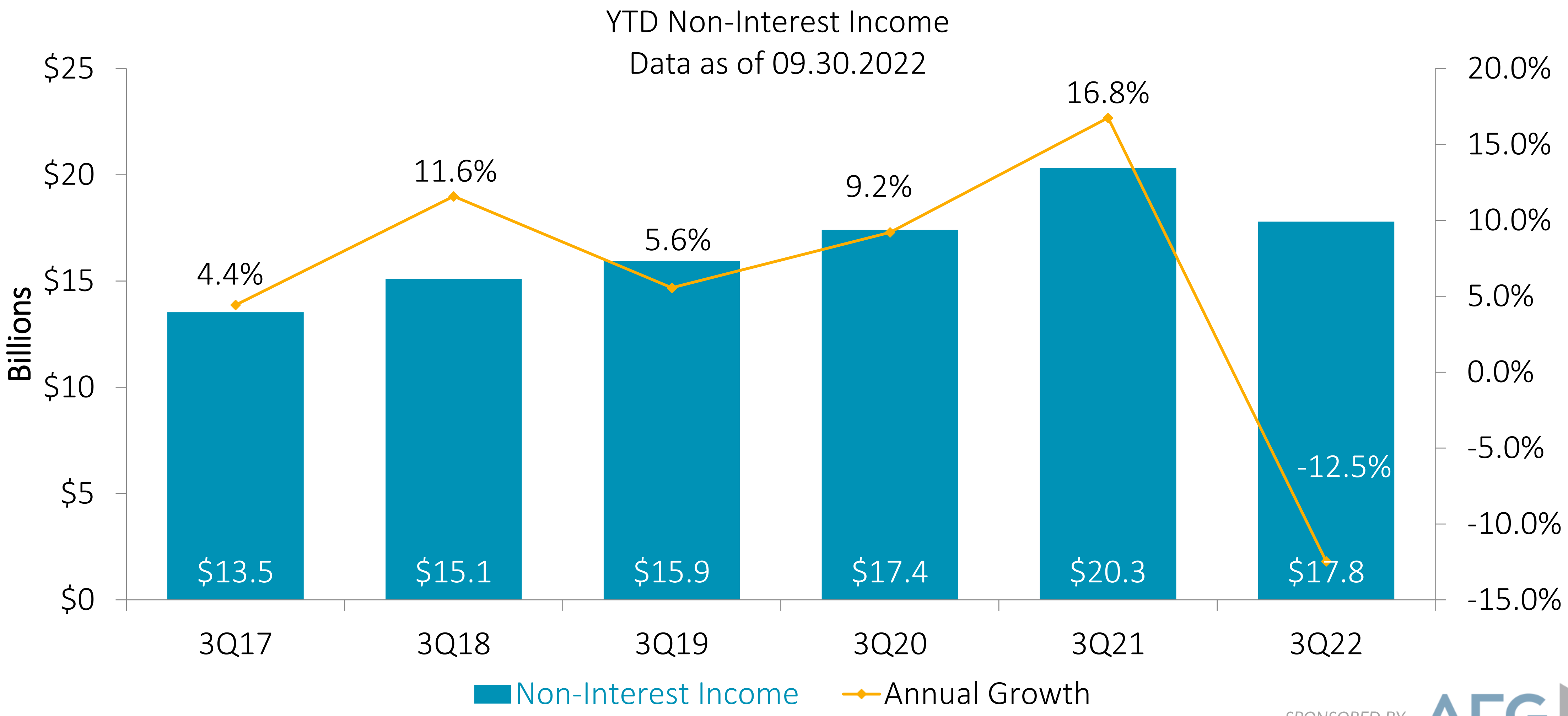
Led by compensation growth, operating expenses are rising at a slightly faster pace than income



A widening net interest margin is close to covering operating expenses



Non-interest income declines after a record year in 2021



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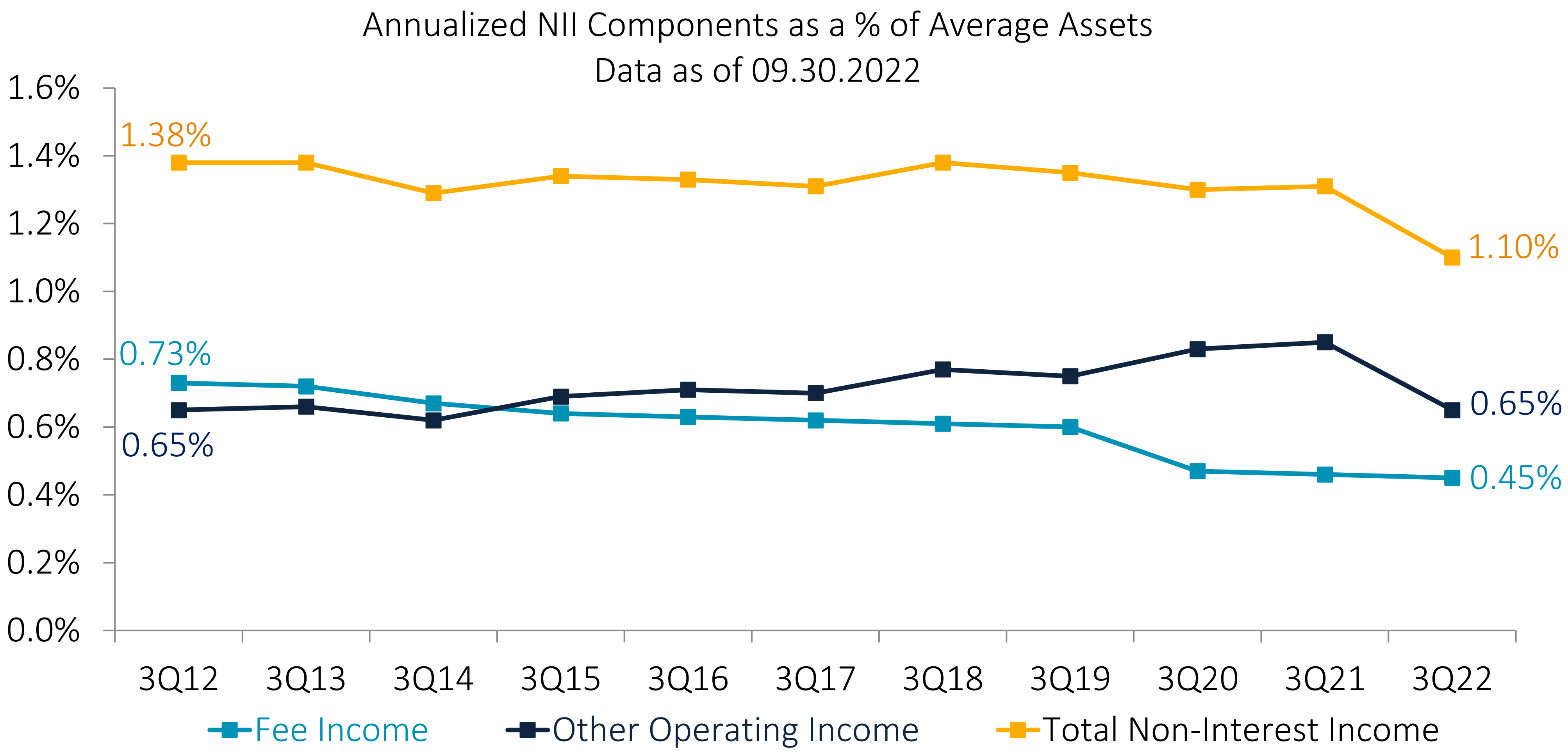
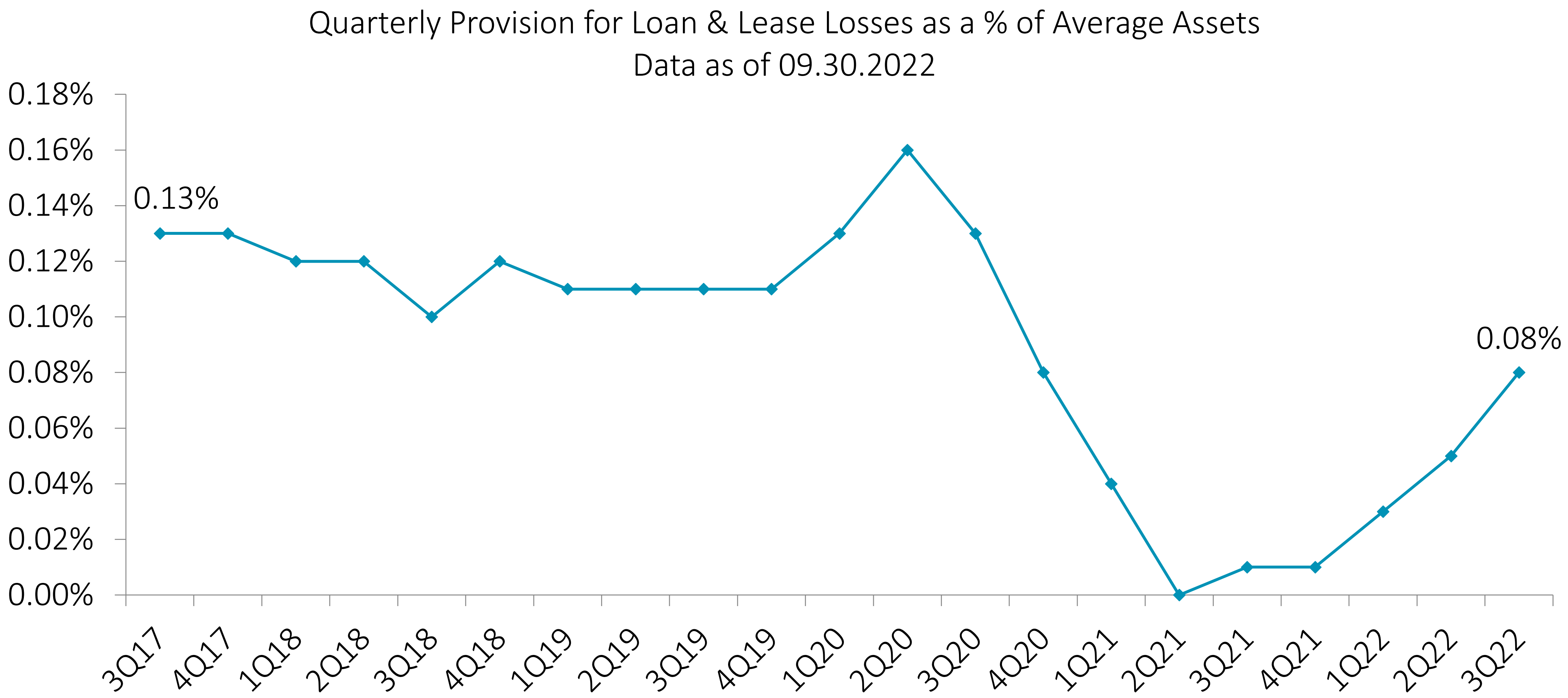
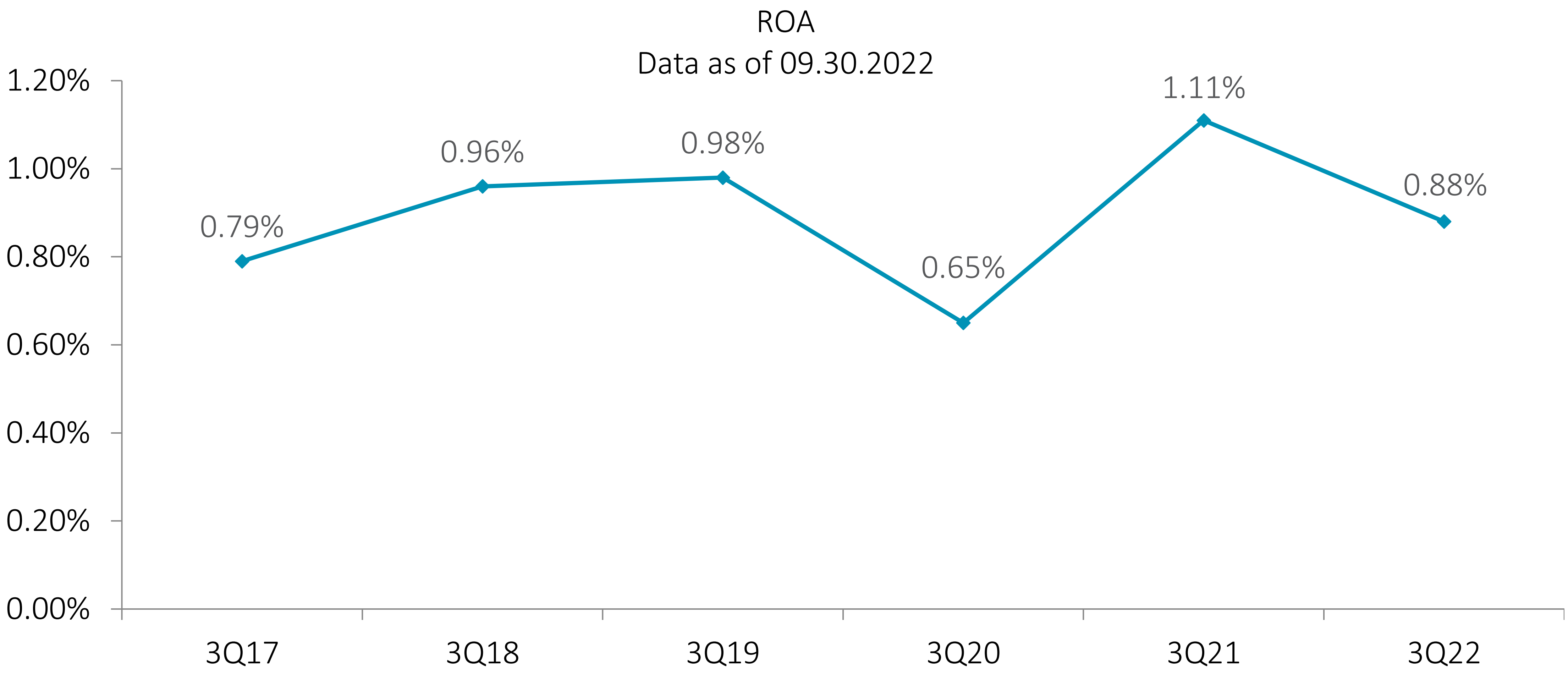
Non-interest income as a percentage of average assets is at its lowest point in a decade



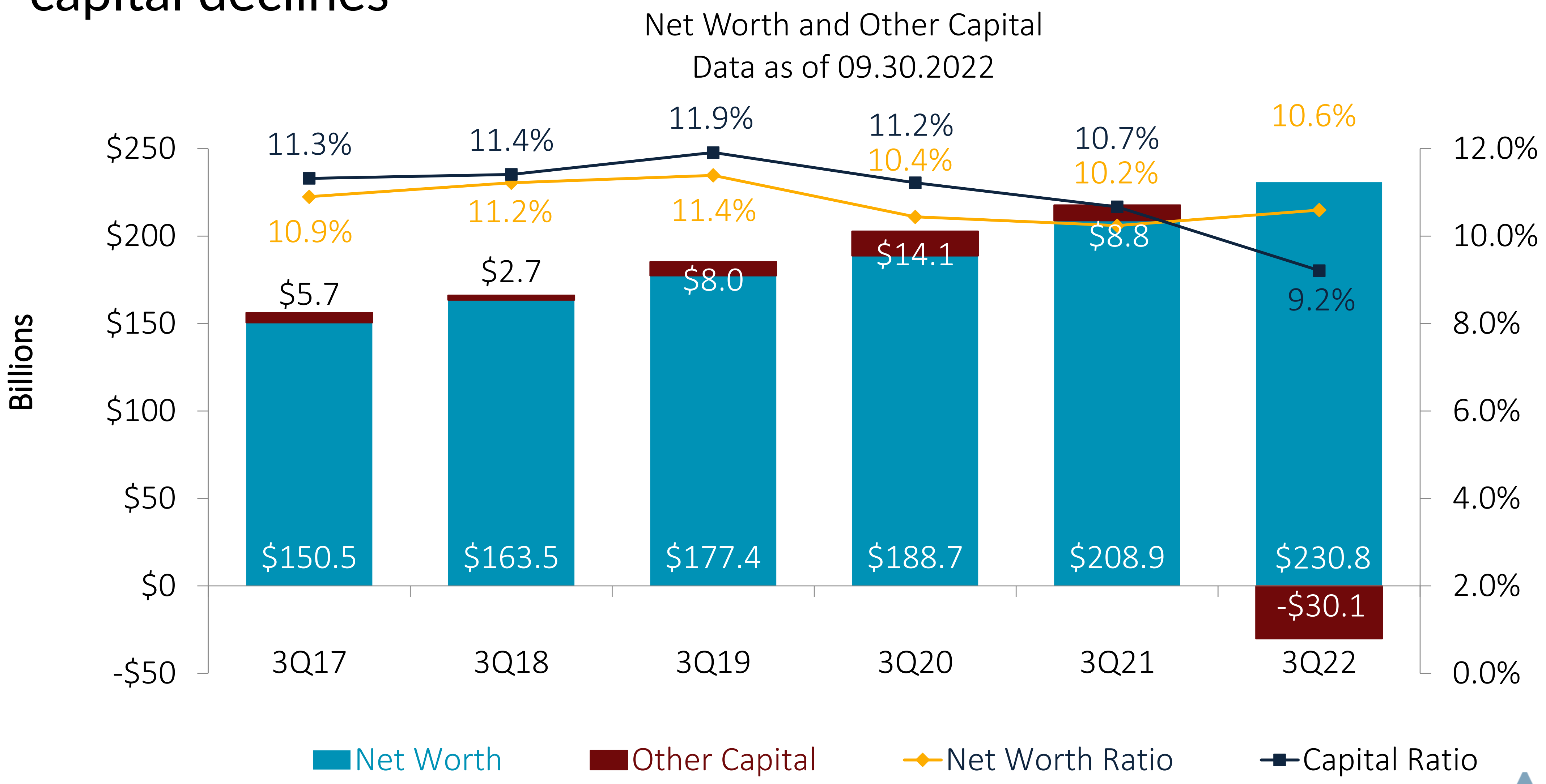
Quarterly provision for loan loss expense returns to historical norms



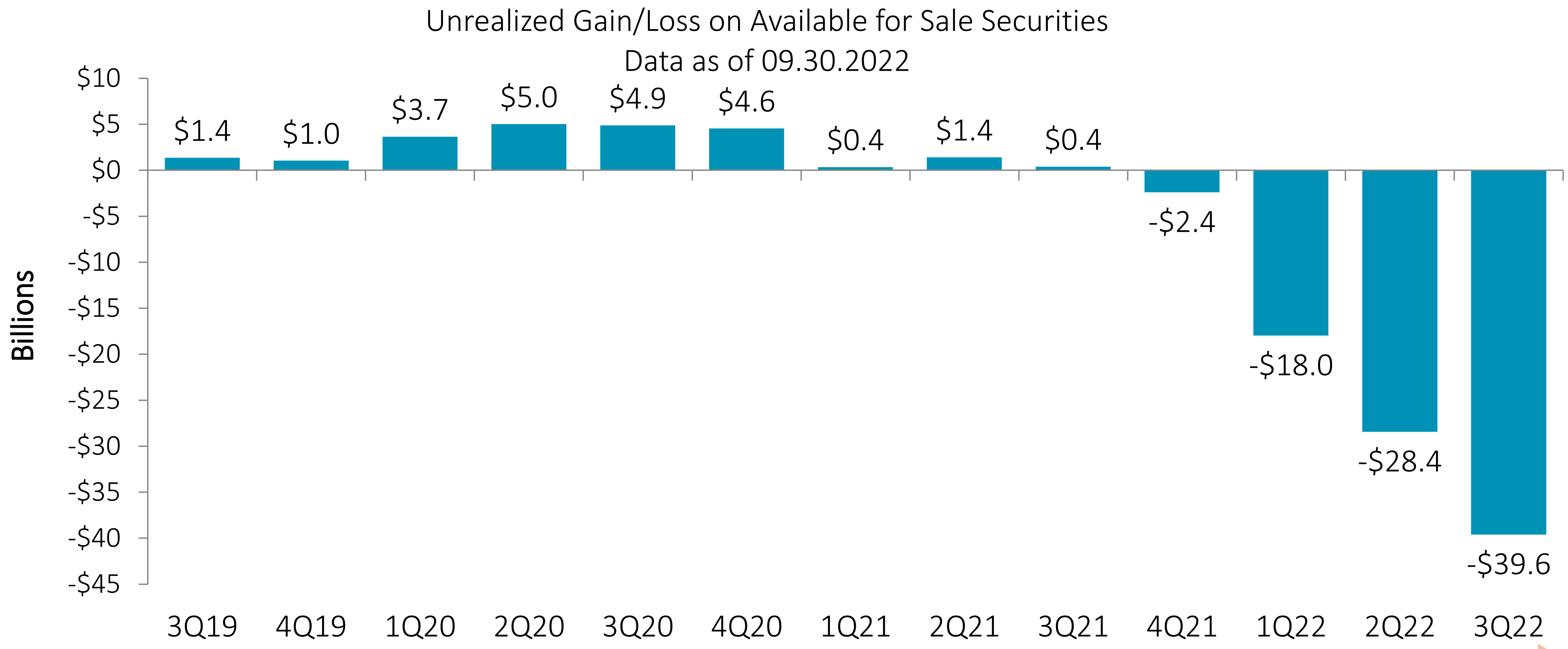
ROA is in line with pre-pandemic years



Net worth ratio rises to its highest level since 2019, even as total capital declines



As interest rates continue to rise, unrealized losses on securities increase



Lessons & Looking Forward

Navigating 2023

- The economy is likely to be weaker in 2023 as the impact of rapid interest rate increases is realized

- Credit union enter 2023 in a great position, with strong net worth and asset quality, solid earnings, and capacity to lend

- Credit unions are at their best during challenging times when members are looking for guidance and help. Member challenges provide an opportunity for the credit union difference to shine!

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