Unprecedented Times

Managing Through COVID-19

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These are Unprecedented Times

The impact of COVID-19 on the economy has been swift and extraordinary. While we don't know how long the current environment will persist – we've heard estimates from two weeks to several months – we do know that significant, unprecedented dislocation has already occurred and will persist well past the shutdown.

At Ensemblex we have managed through several economic crises: the oil shock in the early nineties; the dotcom bust at the start of the millennium; and the '08 financial crisis. **We've learned one hard and fast rule: acting quickly and prudently is often the difference between survival and failure.** Lenders who act swiftly generally emerge from crises stronger and with the opportunity to thrive in the post-recession environment. Lenders who fail to respond put their businesses at risk, and many of them may not survive this economic crisis.

The Economy is Getting Rocked

The S&P is down 33% from its February peak. Huge chunks of the economy are essentially turned off. JPMorgan Chase is estimating Q2 GDP to contract by 14%, and Goldman Sachs is estimating an even more severe contraction of 24%. During the '08 financial crisis, the largest quarterly contraction was 8.4%.

Millions of Americans have suddenly become unemployed. Last week we heard some news that was simultaneously shocking and unsurprising – Goldman Sachs is predicting that next week we are likely to see IUC (initial unemployment claims) of 2,250,000. To put this in perspective, the peak weekly IUC during the 2008 crisis was 665,000[1]. The '08 financial crisis shock to employment occurred over quarters; the current shock is happening in a matter of weeks and is evolving daily.

We have never before seen such an immediate and massive unemployment spike. If the shutdown is lifted fairly soon, it is possible that many of the people

[1] The seasonally unadjusted peak occurred shortly after the holidays at the beginning of 2009. The raw number then was 960,000, but the seasonally adjusted number was under 600,000. In March the seasonal adjustment usually increases the raw number slightly. Therefore, we believe the best comparison is a seasonally adjusted number would be on the order of 2,500,000 now vs. 665,000 in the peak of the '08 crisis.

filing now will be re-employed in the relatively near future. However, if the shutdown persists for any length of time, then there will be significant damage done and even in the best of circumstances, it will take several quarters for the impact to lenders to wash through the system. In such a scenario, government stimulus will struggle to help against the magnitude of damage done to the economy.

Consumers are Struggling

We know that a large proportion of American households have little to no cushion to help weather economic disruptions. Those consumers are generally subprime and are usually the first to suffer in a recession. There is no doubt that the current economic shutdown is absolutely ruinous for millions of households who have just lost their jobs with essentially no prospects to find other work.

In previous recessions, the more gradual displacement gave consumers time to prepare financially. Those that were displaced could often rely on employed family members for support or take lower wage jobs. The pace and depth of change in this environment has deprived consumers of any chance to prepare and families are likely finding themselves all in the same boat at the same moment leaving them unable to receive or provide financial assistance.

Prime borrowers aren't immune to the shock either. To the extent that the dislocation leads to companies dialing back employment, it is likely that "work from home" may turn into just "stay home."

Lenders Will Feel the Impact Soon

It is intuitively obvious that increases in IUC lead to increases in charge-off rates ("C/O"). In Figure 1, we show the relationship between IUC and C/O for consumer loans. As expected, the C/O curve generally follows the shape of the IUC curve.[2] Following the data from the '08 financial crisis, the peak of IUC was led to a spike in C/O about a year later.

Regardless of the duration of the shutdown, it is reasonable to assume that the jobless spike will have an immediate impact on every lender. At the very least,

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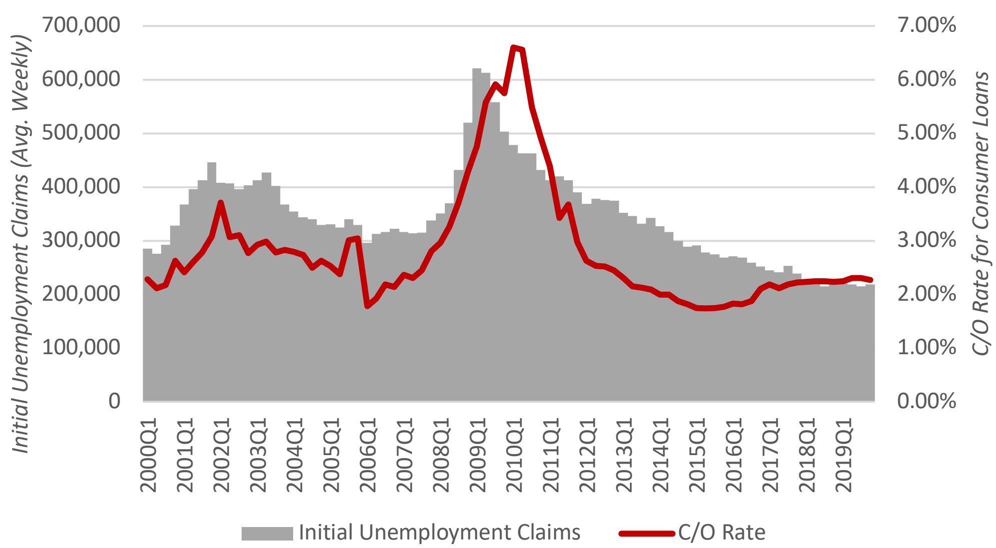
[2] It is reasonable to ask about the relationship between unemployment rates (instead of IUC) and C/O rates. The relationship is very similar, so we saw no benefit in showing that as well.

customers who were already on the edge are likely to be tipped into default. Customers already in default are less likely to be able to tread water or cure. Given what we've already seen with IUC figures, lenders should expect to see more delinquencies and minor delinquencies will turn into severe delinquencies more quickly. Demand for credit will almost certainly increase, but the quality of that new demand is highly suspect.

Figure 1 - Weekly IUC vs. Consumer Loan Charge-Off Rate



If this shut down persists for any length of time many lenders may not survive. Small business lenders appear to be most at risk followed by monoline subprime lenders with thin balance sheets.

Lenders Need to Take Action Now

We recommend being very judicious with any new credit extension. This would include originations, line increase programs, balance build initiatives and cash-out refinancing. The risk is too unknown and potentially too toxic to justify extending any more credit until lenders have more information about what risk is going to look like as this economic crisis unfolds.

Loan extension programs need to be thought through, operationalized, and analyzed to gauge impact on cash flows. Many lenders will need to review such programs with their debt funders and ratings agencies, so they really need to get going on these programs immediately.

Smaller lenders should do whatever they can to fortify their balance sheets and adopt a survival posture. These lenders should proactively reach out to their current debt funders, reinforce their relationship, and review data and covenant requirements. The last thing a small lender needs right now is to receive a call from their debt funder with the message that their note is being called.

For prime lenders, we recommend strategies that reduce overall credit line exposure. The concern is that any new utilization of unused credit line is likely to be far riskier for all populations, and marginal risk could overwhelm marginal revenue if the shutdown persists.

Call Ensemblex for Help

We've been in your shoes. We appreciate the stress and the uncertainty facing you. The good news is that we have successfully helped businesses of all sizes through incredibly challenging environments like the current crisis. We can help you, too. We have deep experience across all lending products including credit card, auto, personal loans, and small business.

We are lending experts who can help you survive the current crisis and position your business to thrive when normal returns. You can reach us at shawn@ensemblex.com or mike@ensemblex.com.