

CU-ALM REPORT

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DEPLOYING THE CREDIT UNION'S SECRET WEAPON

**PART 1 OF A 3-PART SERIES
IDENTIFYING AND TARGETING CAPITAL TO
ENHANCE MEMBER SERVICE AND FURTHER THE
CREDIT UNION'S GOALS FOR ITS MEMBERS**

Credit unions have a secret weapon which they often fail to recognize. That weapon is their strong capital/net worth. This article will be the first installment in a three-part series that will help you identify the value of the credit union's capital and develop strategies to deploy that capital to better serve your members and help your credit union grow and prosper.

First, let's distinguish credit union capital from bank capital. Banks have capital and are required to do so by law, much as credit unions are. Nevertheless, the source and nature of bank capital differs significantly from credit union capital. Bank capital is provided by investors, both individual and institutional, who invest money in the bank and put their money at risk in anticipation of a significant reward.

Bank stockholders and capital investors are rewarded in two ways. The first is the anticipation that investors will receive a dividend that yields the market rate or better on their investment. The second way that stockholders and investors are rewarded is that the value of the stock may increase. Bank stockholders may choose to sell their stock to other individuals or institutions at a significant profit for having exposed their investment to risk.

There is also the risk that bank stockholders and investors may lose all or part of their investment. Should the bank fail or become capably challenged, the common stock may be diluted or devalued completely. That's the way it is for stockholders. If you don't believe me, find someone who owned stock in Delta Airlines before their bankruptcy. The common stockholders of Delta received absolutely nothing (*continued on pg 2*)

FREE ALM TRAINING ON OUR WEBSITE

In 2002, we began providing basic introductory level ALM training to our clients. It worked well and was so popularly received we made the decision to offer it to all credit unions rather than restricting it to our clients. In some cases, we offered it directly and in states where local leagues wanted to participate, we have offered it through the leagues. We estimate that over the past five years approximately 1,000 credit union people have attended the *ALM 101 Live Seminar*.

We also videotaped the seminar and made the VHS videos available to credit unions. Recently, we sold the last of the run of videotape sets. VHS has become an obsolete technology and the format of the original video presentation did not allow for conversion to DVD format.

For all of the above boring reasons, we have made the decision to redo the *ALM 101 Seminar on Video* and make it available to credit unions free of charge on our website. We have reorganized the content of the (*con't on pg 3*)

GUEST CONTRIBUTION DEFENDING AND ENHANCING YOUR NET INTEREST SPREAD IN THESE CHALLENGING TIMES

By Lawrence E. Miele
Vice President, A.G. Edwards Institutional Sales

You may recall from your school days that the textbook definition of a recession is two consecutive quarters or more of negative GDP. While this is one measurement of a downturn, it is certainly not the only one. All you have to do is look back to our last recession in 2001 to see that the economy did not have two consecutive quarters of negative GDP. The National Bureau of Economic Research examines the rate growth of the four primary sectors of the U.S. economy. If activity in any of these measures declines for six months or more, the economy is said to be in a recession. I would advise you to start watching the (*continued on pg 3*)

DISCLOSURE—*CU-ALM REPORT* is a publication that contains opinions, articles, and insight into many facets of credit union operations. At times it offers suggestions in the decision-making process. We are not registered investment advisers and our suggestions tend to be general in nature. While we are happy to share our insights and thoughts with our readers, it is important to understand that the responsibility for implementing the ideas or strategies suggested in these pages rests solely with the credit union's management.

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IDENTIFYING AND TARGETING CAPITAL... (cont from pg 1)

when Delta was reorganized under Chapter 11. On the other hand, individuals who may have invested in more successful airlines such as Jet Blue or Southwest Airlines have seen the value of their investments increase. This is the old risk/reward ratio that we have been hearing about all of our lives. Credit union capital is different. While in fact the shareholders are the owners of the credit union, by far the vast majority of them do not see themselves as stockholders and do not have the expectations that stockholders may have. They certainly do not see their savings in the credit union as being at risk. In fact, just the opposite is the case. An agency of the Federal Government NCUA insures the majority of the credit union shares owned by credit union members in the U.S. Credit union shareholders look at their shares as savings on which they may, or may not, expect to earn interest. Few of them, if any, expect to sell their shares at a profit.

If you doubt this, examine the mergers that are taking place almost daily in the credit union industry. Many of those mergers involve well-capitalized credit unions and merger partners that are less well-capitalized. All of the capital is thrown into the pot and shared equally by the shareholders of the new credit union. This would be totally unacceptable in the for-profit world of investing.


The good news is that credit union capital has been accumulating from extremely low levels in the 1970s to the point where the average credit union is capitalized at a rate in excess of 11%. This refers to the capital/net worth ratio with which most of you are familiar.

In a bank, the stockholders would be expecting a return on this capital called return on equity (ROE). In fact, high capital ratios often mean low performance leading to take-

over offers from other banks. With credit unions, for the most part, the members don't care about return on equity. As long as they are receiving the expected dividend or level of service, they look at their shares as savings accounts without the expectation of capital gains.

The bottom line is credit union management, for the most part, has a pile of free money to play with. Most credit unions have a level of surplus capital as they face the myriad challenges that credit unions are facing. We believe that the time has come for credit unions to consider deploying their high capital for the benefit of their current and future members.

It's a bit more complicated than it sounds, because technically you can't just spend the capital. The accounting rules that all credit unions adhere to do not allow that. It will be necessary to access the capital by incurring expenses which may benefit the members and allow the credit union to better serve its members, which over the short-run may actually result in foregone earnings. Yes, you read that right—we're saying that the credit union may forego some earnings in order to provide services and increase its member base in order to succeed in the long run. This is a difficult and precarious course. It must be undertaken deliberately and very carefully.

In the next article of *CU-ALM REPORT*, we will cover this idea more in-depth and identify projects and strategies for deploying the credit union's excess capital. In the third article in this series of *CU-ALM REPORT*, we will present strategies to actually accomplish the deployment of excess credit union capital in a way which will increase membership base and encourage the long-run probability of success and prosperity for your credit union. 

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DEFENDING AND ENHANCING YOUR NET INTEREST SPREAD ... (continued from page 1)

weekly economic data releases and follow the trends, because the economy is clearly on track for a recession.


The Fed has been reacting to this slowdown with the tools of monetary policy. These include introducing large sums of liquidity into the market by lowering the target for the Fed Funds and Discount Rates as well as lowering reserve requirements. While the jury is still out on whether these tactics will help the problems of this economy or make them worse, it is not relevant to your business. Credit unions need professional investment advice on not only how to weather the storm, but how to use it to your competitive advantage and profit from it. A skilled broker should have a track record of coaching credit unions through the cycles of the economy by safely adding incremental income to their bottom lines.

The current economic cycle is presenting credit unions with the opportunity to consider proven investment strategies that differ from those traditionally employed. If the right strategy is employed, your investment portfolio can pick up the slack of slowing loan demand or tightened credit standards. By investing properly now, you can create a significant advantage for yourself over your competitors and stand out in your peer group. This advantage can be in the form of using incremental investment income to subsidize share and loan rates to gain market share or merely keeping the credit union running at a time when your competitors are sitting tight. Instead of viewing low rate environments as an obstacle, consider them an opportunity, since so few institutions know how to succeed during them.


While each institution needs to be evaluated individually, the balance sheet needs to be positioned with idle liquidity being deployed in cash flow investments that will earn much needed incremental income. Some examples include U.S. Agency issued MBS. These investments provide the cash flow from monthly principal and interest, while generating a handsome return. Keep in mind that despite the 10 and 15 year stated maturities of these investments, their true average lives are approximately 3 and 5 years respectively. These investments exhibit no credit risk and contain fully conforming mortgages. Since their average lives rest on the shorter spots of the yield curve their price risk is only moderate. Of course if you are considering a major change in your investment strategy you will want to undergo a strong due diligence effort as to the legality and appropriateness of the investments under consideration. A review of the business reputation and financial condition of your investment broker and/or advisor

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seminar into sessions that are approximately 30 to 45 minutes long. You may go to our website www.MarkHSmith.com, click on Free Training, and you will receive instructions on how to receive the seminar. There is no charge and absolutely no commitment or contingencies attached. In order for us to gauge the effectiveness of this program, we will ask that you identify yourself and your credit union and fill out a very short evaluation on the program. We will not give your e-mail address to any third-party, and we will not contact you unless you request us to do so. Session 1 is now available. Note that you will need a "high speed" connection and that it might take several minutes to download enough content for the video to begin. The technology is complicated and is not totally bug-free. If you have problems, please call us or send an e-mail describing your problems and we will get back with you as soon as possible. We can't fix the problems unless you let us know what they are.

Session 2 will be available on February 18th. We will try to add two or three sessions each month until the complete seminar is available. If the training proves popular, we will add additional topics including "Credit Union Basic Training for Volunteers and New Employees" and the *Managing in These Troubled Times Seminar* later this year. 


should also be undertaken. You will certainly want to review and maybe update your investment and related policies.

If you have read some of Mark Smith's earlier newsletters, you will recall that he points out that many credit unions have low interest rate risk. In many cases, this low risk profile is largely attributable to a short-term investment outlook. With a yield curve that is finally realigning itself to provide a worthwhile risk/return ratio, now may be the time to consider taking on some interest rate risk in the form of fixed income securities. 

Larry Miele is a graduate of Cornell University with a BS in Applied Economics. He is currently working on his MBA in Finance at State University of New York. He has over 10 progressive years' experience advising credit unions and other depository institutions. Eight of those years concluded as a senior vice president of investments at First Empire Securities. He is currently a vice president of institutional sales at AG Edwards and Sons, Inc. Larry is a competitive swimmer and enjoys SCUBA diving and cheering for the New York Yankees. Larry and his wife Jennifer have two children. You may call him at (800) 348-3420 ext. 289 or email to Lawrence.Miele@AGEdwards.com

CU-ALM REPORT TO PUBLISH BI-MONTHLY IN 2008

Last year, we promised we would publish every month. It didn't happen. We have heard from some of you about that fact and we apologize. The newsletter is very labor intensive and requires a lot of resources to maintain. Some of those resources have been were pulled away from the newsletter production to get the free *ALM 101 Seminar* ready for the website (see article above).

Again we apologize and, with a more realistic goal, hope to do better in 2008 (and we're really glad you missed us). 

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