

# CU-ALM REPORT

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## STARTING 2010

With a new year upon us, it might be a good idea to review some of the annual events associated with the ALM function at your credit union. Here are some ideas which you might want to consider as we start the new year.

### Review Your ALM Policies and Risk Guidelines.

The past two years have been very challenging and, for some, chaotic. Your ALM policies and risk guidelines should be reviewed at least annually. Additionally, if you had set your policies and guidelines based on your circumstances, let's say, two years ago, it is almost a certainty that things have changed. Not only have the dynamics of the credit union changed, but the economic environment in which the credit union operates may very well have changed. What might have been a suitable guideline two years ago could be totally unrealistic today. We suggest that you set risk guidelines which are realistic and achievable within a reasonable period of time, such as one year.

### Evaluate Your Net Worth (Capital) Position and Take Corrective Action, if Necessary.

Many credit unions have watched their net worth (capital) ratio decline over recent quarters. In some cases, the decline is due to an actual decrease in net worth due to operating losses. For others, the decline in the ratio is due to an increase in the denominator of the ratio, which is total assets. In many cases, credit unions have experienced the Perfect Storm of declining net worth due to operating losses running concurrently with an increase in total assets caused by an inflow of deposits.

It is important that capital be managed proactively. Easily said, I agree. The only source of capital, earnings, are going to be scarce for the foreseeable future. What this is going to do is limit growth opportunities. Also easily said. Nevertheless, if your net worth position is lower than you like and earnings are not likely in the immediate future, restrictions on deposit and corresponding asset growth need to be seriously considered, as noted below.

Review Your Deposit Base. Many credit unions have experienced an inflow of deposits as some members appear to have abandoned equity investments in a flight to safety. We had a similar experience in 2003 and the thought at that time was that these deposits (continued on page 2)

## WATCHING THE CORN GROW

I love to visit states like Nebraska and Iowa in the late summer. The corn is tall. It is growing so fast that you can almost see it grow. I'm told you can actually hear it grow.

Growth is constantly on the minds of credit union executives and when you mention growth the term "asset growth" almost always pops up. In my 32 years of working with credit unions I wish I had a dollar for every time I've heard the phrase "asset growth." However, the truth of the matter is: Assets don't grow. There is no way on earth that a credit union can grow its assets. It's just not going to happen.

Assets increase only as the credit union increases its liabilities or capital. If you want to increase assets, the money must come from somewhere and there are only two places that can be. The first is to increase liabilities by borrowing money. You can borrow it from your members or nonmembers in the form of shares or deposits, or borrow from a lender such as a corporate credit union or the Federal Home Loan Bank. In either event you're increasing your (continued on page 3)

## SEGMENTATION STRATEGIES—NOW IS A GOOD TIME

Some time ago, an article that we published in *CU-ALM REPORT* addressed disparity and segmentation strategies. The nomenclature of disparity and segmentation strategies depends on who is speaking. They effectively mean the same thing. We commented that such a strategy may be appropriate for some of our readers. You can review that article in the August 2007 edition of *CU-ALM REPORT*, which you can find on our website ([www.MarkHSmith.com/Newsletter/PDF%20Newsletters/8-07%20Newsletter.pdf](http://www.MarkHSmith.com/Newsletter/PDF%20Newsletters/8-07%20Newsletter.pdf)).

In the article, we mentioned that the best time to begin a segmentation strategy is when rates are low. Since writing that article, rates have declined to and remain at near-historical lows. If you have considered deploying a segmentation strategy, now is the time.

Briefly in review, the advantage of a segmentation strategy is to separate your rate-sensitive savers from (continued on pg 3)

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**STARTING 2010** (continued from page 1)

were merely temporary and would leave at a future date. In retrospect, most of the deposits stayed.

Over the last nine months, the equity markets have recovered significantly. I suspect the deposits that remain at the credit union are probably going to stay. We need to look at these and analyze them. The real question is: What impact are these deposits having on the credit union's solvency and operating ratios? If your net worth (capital) ratio is still strong, then these deposits could be beneficial to the credit union. It is important that we evaluate the impact they have on your profitability. Would your credit union be better off if these deposits were gone? In other words, what are you doing with that money? If you have taken CD money in deposits and your only alternative is to make short-term investments, it may very well be that the credit union could be better off without some of the new deposits. I realize it borders on heresy to suggest that you should run off deposits. But, sometimes the credit union's, and conversely the members', best interests might lie in doing so. I have to admit that might sound easier than it is. I recently had a conversation with a client who had experienced significant growth in deposits. I suggested the credit union would be better off if those deposits were run off while funding the runoff with low-yield, short-term investments. This strategy would allow the credit union's profitability to increase slightly and the decline in assets would allow the credit union's net worth ratio to rise a bit. The client responded that they had tried, by lowering dividend rates well below market. I found that a bit hard to believe, so I confess I went on line and to my surprise discovered that the client was absolutely correct. Their dividend rates were significantly less than their major competitors' and the money just wouldn't leave.

So, it's a tough call; but, over the long-run, the credit union cannot afford to accept deposits that come on a disadvantageous basis.

➤ **Evaluate your Investment Portfolio.** Does your credit union have excess liquidity? Excess liquidity comprises short-term investments over and above what you need for operating liquidity and anticipated loan demand. Many credit unions do have excess liquidity. Take a pragmatic view of the components of your investment portfolio and consider strategies which might enhance your yield from that excess liquidity. .

➤ **Evaluate Your Cost of Funds.** Many credit unions like to pay an above-market dividend rate. If your capital is very strong and you can afford to forego earnings, then this may be an acceptable outlook. I suggest that, if you choose to pay an above-market rate, you need to clearly specify that you are paying a bonus or special dividend from earnings. Your members need to understand that this might not continue in the future.

If your credit union's net worth ratio is less than you would like it to be, seriously consider managing your dividend policies in a way in which you do not pay greater than market rates for your funds.

➤ **Remember: The Credit Union is—First and Above All Else—a Business that Needs to be Managed and Operated in a Businesslike Manner.**

The economic landscape on which you operate is populated with predators who will gladly steal your members and watch your credit union die without a second thought. The credit union is, first and foremost, a business. If it is not aggressively managed in a businesslike way, it will fail over the long-run. This outlook is contrary to some traditional credit union thinking, but in January 2010, that's the way it is.

We at Mark H. Smith Incorporated wish you the best of success in meeting your challenges in the coming year. ➤

**CU-ALM REPORT** is a publication of Mark H. Smith Inc. 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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**WATCHING THE CORN GROW** (continued from page 1)

liabilities with borrowed money. The funds generated by the increased liabilities can then be used to acquire new assets.

The second way to increase your assets is to generate positive net income and retain that income as new capital in the credit union.

There is no other way to “grow assets.”


The assets that you own are a function of borrowed funds including shares and deposits, and accumulated net worth (capital). There is no way assets can be anything more or less. If you want to increase your assets, the only way to do so is to borrow funds, increase deposits, or retain earnings adding to your net worth (capital).

What this means to credit union management is you might want to alter your thinking when it comes to managing the balance sheet. When we use the term “managing the balance sheet,” most people immediately think asset management; i.e., lending and investment decisions. Without diminishing the importance of asset management, I would argue that managing the liabilities, deposits, and net worth of the credit union is of equal, if not greater, importance.

A net inflow of deposits will generate funds with which the credit union can purchase additional assets. An inflow of deposits can be good or bad. If you have loan demand or investment opportunities that allow you to productively engage those funds, then an inflow of funds would be good news. If you don’t have a productive use for incoming funds, then they could very well end up costing you money.

A net outflow of funds means that the credit union will have to reduce its assets. Again, this could be a good or a bad thing. If you can run off high-cost deposits and fund the runoff with low-yielding investments, the credit union may be better off. But if an outflow of funds requires you to pull back on productive lending programs, clearly that would be a negative impact.

Another factor that comes into play is that the liability side of the balance sheet is one of your major cost drivers. While your cost of funds might not be your largest expense in this low-rate environment, it is clearly a major expense. Also, if you remember from our previous newsletters, the credit union is a highly leveraged financial institution. Because of the leverage, management of cost of funds is crucial to your profitability. Small changes in cost of funds flows straight down to ROA, where they will have a significant impact.

**Bottom line:** Asset growth is a myth. All growth in the credit union comes from increasing shares and deposits, borrowing money from a lender such as Corporate, or retaining earning as new capital. It is urgent that the liability side of the balance sheet be managed in a businesslike manner at all times. 

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**SEGMENTATION STRATEGIES** (continued from page 1)

your nonrate-sensitive savers. Having done so, you might now pay a minimum rate to those savers who don’t care (in other words they are nonrate-sensitive) and manage your rate-sensitive deposits in a way that benefits your credit union and members best. If properly designed, a segmentation strategy could allow you to increase deposits without cannibalizing your own low-cost shares. When rates are low, segmentation strategies are more easily deployed because the differential between rate-sensitive and nonrate-sensitive deposits is very small and your members typically are less sensitive to that differential.

Summing up, segmentation strategies offer a businesslike approach to managing the deposit side of the balance sheet. They are very effective in controlling your cost of funds and providing additional funds for growth when needed. 