

# CU-ALM REPORT

FEBRUARY 2009

VOLUME 6, ISSUE 2

## —THE CORPORATE BAILOUT— GOOD NEWS & BAD NEWS

When presented with this scenario, many of us like to get the bad news first, so let's cover that; then we can talk about the good news. Unless you've been vacationing on Mars for the last six months, you know that the Corporate Credit Union System is facing an estimated loss of up to \$5 billion as estimated by NCUA. The key words here are "up to." The Corporate Credit Union executives argue that much of the loss will be recoverable over time as the toxic securities which they have purchased perform better than the market anticipates. For those who are religious, let's pray that they are right; if you're not religious, cross your fingers. If NCUA is wrong and in fact is underestimating the damage, the pain to be inflicted will be excruciating. Determining who is at fault here is way above the pay-grade of your humble author. I'll leave it to better informed persons than I to make that determination and take corrective action. Hopefully there will be some justice, but I'm not holding my breath.

So, the real question we have to analyze is how do we deal with this problem? The good news—and I believe the best news for credit unions to come out of all the black and ugliness that has taken place over the last year—is that the Credit Union System, comprised primarily of natural person credit unions who have been accumulating capital like crazy, remains sound. The capital of the natural person credit unions stood at \$89.9 billion for year end 2008. Losses of \$5 billion constitute only 5.6% of the capital on hand. Clearly the Credit Union System possesses the financial capacity to resolve this issue without intervention from the taxpayers. So, let's take it one step at a time.

**First:** The question pops up "Who should accept financial responsibility for saving the Corporate System?" I'm going to argue that the natural person credit unions who are the owners and members of the Corporate System should shoulder that responsibility and not seek government assistance. My reasoning is pretty simple: For years, the Treasury Department has been trying to draw NCUA and the credit union that it insures into their clutches. There the credit unions would be treated as just another entity and probably be overseen by the FDIC. Also, don't forget the Treasury Department also includes the IRS which for decades *(continued on page 2)*

## PROPER PLANNING AND PORTFOLIO CONSTRUCTION CAN HELP IN ALL ECONOMIC CYCLES



*The following guest editorial represents the opinions of its author Larry Miele. For additional information regarding the topic of this article, please contact Larry directly. His information is at the end of the article.*



The importance of proper investment portfolio construction is too often overlooked, yet the consequences of not paying the attention it deserves can be significant. In light of a sustained recession, new budgetary constraints and unforeseen, one-time (hopefully) capital calls, there has never been a better time to reevaluate the way the investment portfolio is being handled. What many industry executives often forget is that a well-built investment portfolio will stand up in all markets.

The first step of proper portfolio construction begins with an investment policy that is both realistic and accomplishes the goals of keeping the money safe, liquid and obtaining a competitive return above US Treasuries (Spread). It is important that your investment policy and portfolio are not only functional, but complement your institution's ALM profile. I cannot tell you how many institutions I have worked with over the years that had investment policies in place that actually contradicted their Asset Liability Management findings. It is important that you are able and willing to provide the right medicine the balance sheet needs when it is needed.

For many credit unions, keeping excess liquidity in an overnight account at Corporate or a correspondent institution has been a sufficient alternative to a diversified approach to investing. If you have been watching your returns over the past year then you are realizing that this no longer a viable strategy that will allow your investment portfolio to remain profitable. With the yield curve and the pricing of risk they way it currently is, an alternative, safe strategy needs to be thoughtfully deployed. Keeping excess cash overly liquid, not only provides a significant opportunity cost, it may be compounding your exposure to interest rates; it is essentially *(continued on page 3)*

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## —THE CORPORATE BAILOUT— GOOD NEWS &amp; BAD NEWS (continued from page 1)

has been trying to tax credit unions. Once a part of Treasury, it would not be many years before credit unions as we know them cease to exist. Credit unions have remained independently supervised by their state or the NCUA, primarily because they have been able to argue before Congress that they are self-supporting, solvent, have never taken tax dollars, and have earned the right to be treated differently. This argument seems to work because to this point credit unions are not part of the Treasury. By taking federal bailout money in any form, I fear that the credit union's ultimate argument for independence will be compromised and sooner than later the credit unions will be part of the Treasury Department.

**Second:** Should the credit unions admit to being a part of the overall liquidity and credit meltdown by accepting bailout money, the result is nearly certain that they will be swept up in the financial institutions reformation that is going to take

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place over the next several years. If you think you have seen regulation in the past, don't kid yourself. Financial institutions will see an onslaught of regulatory vindictiveness that will make past regulatory practices seem user friendly. The only argument credit unions have to be left out of this regulatory quagmire is that they are not part of the problem, and for that reason should be left alone to continue serving their members as they have successfully done for decades. If credit unions can solve this crisis within their own system with their own resources, not resorting to taxpayer assistance, they have a fighting chance of escaping the draconian regulatory blizzard that is fast approaching from the shores of the Potomac.

Okay, so you're still reading. **Point 3** is how to best effect the resolution of the Corporate Credit Union meltdown. I don't think we are going to have a lot of choice here. It appears that NCUA, which remains the 800-pound gorilla on the block, has made a decision and that Congress, in an effort to avoid having to appropriate tax dollars, will go along with them.

I've talked with many of you in the past few weeks. Most of you are very angry and rightly so. The events that have transpired are outrageous. For the most part, natural person

credit unions remained bystanders to the excesses and greed which have transpired in the past decade. As I said before, I'll leave it to others, hopefully more knowledgeable than I, to point fingers and level punishment.

My **Fourth Point** here is the timing of the recognition of these charges that the natural person credit unions must take appears up in the air. Some are arguing for a five-year gradual charge-off to take place. Others would make the charge-off immediately and NCUA is even suggesting that credit unions can make this charge effective for the year ended 12/31/08 behind them. If given a choice, I would argue that it would be far better to put this behind us as rapidly as possible and move forward. It's kind of like cutting off a gangrenous appendage. You know it has to be done, and you know it is going to hurt. So, do you chop it off a little bit at a time, or do you just get it over with? I vote for getting it over with. There is a caveat here, however. For those of you who have a full audit and auditor's opinion on your financial statements, I suggest you get your CPAs into the loop if you haven't already done so. I suspect they will have their own opinions as to when these losses should be recognized. This is especially true regarding the option of recognizing the losses in 2008. (con't on pg 3)

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**Fifth**, it is important that NCUA remember that long ago they declared that a 6% net worth ratio represented adequate capital. Further, NCUA, only a few short years ago, proposed that the capital requirements for credit unions be reduced to allow a ratio of 6% to be considered well-capitalized. Assuming the NCUA proposal to bailout the Corporates moves forward, there are a few credit unions who will find themselves with less-than-desirable capital. NCUA should use regulatory forbearance with these credit unions as they endeavor to rebuild the capital lost to the Corporate System bailout.

So there you have it. I'm aware that some of you have differing opinions. I respect that and understand that other arguments can be made. But it just seems to me the best approach is to get this behind us and move forward. ↪

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essentially making an expensive bet on the direction of interest rates.

Rates are low, and there is a pervasive view that rates will remain low for an extended period of time. Many executives are feeling the need to educate themselves on how to construct a well built portfolio to provide the credit union with better alternatives. It is never too late to consider alternative approaches and your attitudes towards the investing process.

The importance of diversification in your investment strategy may be the biggest factor in your portfolio's performance. This may, in fact be the most important lesson I can leave you with. The good news is that diversification is the one rule that keeps the odds in your favor in all environments. While this is not the appropriate forum for me to go in to the technical details of the benefits of diversification, we should all agree that diversification mitigates your exposure to any particular type of interest rate, sector, market or credit. What I mean by diversification is making sure that the portfolio is balanced among different asset classes; different maturities; various cash flow structures and amortization schedules. The exact proportion of any given asset should be weighed against its benefits, the relative size of the portfolio and the proportion to the rest of the balance sheet. By way of an example, an institution should not have all of their investments in a handful of bond positions nor should they have all of their dollars one asset class within the same maturity. Another important consideration is how the investment portfolio distributes cash flow. If you are an institution that needs a portfolio that throws off generous cash on a monthly basis, then you need to be looking at securities like Agency issued mortgage backed securities with shorter amortization schedules or balloon pass-throughs. You may also choose to have a ladder of Agency bullets intentionally maturing throughout the calendar year, paying particular attention to months where loan volume is higher or when Christmas Clubs begin to be drawn down. On the other hand, if you are an Asset Sensitive credit union, then

you may decide to purchase investments with more lock out or that pay little or no principal. These may include FNMA DUS Bonds or building a ladder of bullets that intentionally mature at longer maturities.

A balanced portfolio should not only have several asset classes represented but also have realistic yield targets for the various parts of the yield curve (maturity spectrum). These yield targets also have to be revisited on a regular basis depending on how often you are in the market to add securities. Being able to receive a given yield is a market driven situation and while targets are important to have they are not always achievable, but certainly not a reason to avoid the market completely. Since no one really knows when that investment rate may be available again, it could be months, so the opportunity cost of not investing can be significant.

Every credit union is unique; therefore the advice and the education provided should be customized to fit the profile of the individual credit union. Taking the time to educate yourself and plan your approach to entering the market is as important as the implementation of your plan. Since you would not attempt to take a long journey in your car to a destination you have never visited without a map or a plan, why should building and maintaining an investment portfolio be any different? I recommend a process of investment proposals and ultimately an investment plan to ensure that the investment objectives are stated, they are measurable and clear to everyone. The plan should be examined monthly or quarterly and any changes that should be made should be well thought out to ensure that the portfolio is meeting its budgetary and strategic goals. ↪

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