

CU-ALM REPORT

MARCH/APRIL 2004

VOLUME 1, ISSUES 3&4

WHEN INTEREST RATES GO UP

ALM WEBSITE ANNOUNCED

Are you prepared for a period of rising interest rates? The Federal Reserve and all of the market indicators point toward interest rates going up. There are only a few questions left. They are: "When?" "How fast?" and "How high?" The last, and probably the most important, question is: "Are you prepared strategically, financially and psychologically to manage your balance sheet when rates move up?"


Being prepared strategically and financially means:

1. You have shocked your balance sheet and have determined and allowed for the regulatory issues that will be raised if your capital should decline significantly using an NEV analysis.
2. You should have tested the sensitivity of your NII* and NI to increases in interest rates.
3. You should have a strategy in place as to the actions that you will take when rates begin to rise.

The psychological part of dealing with higher rates may be the most difficult. CUs are a business, not a charity. Sometimes CU officials forget that distinction and make poor decisions based on sympathetic

or unrealistic expectations of what the CU can do. As interest rates go up, CU officials will have to make difficult decisions about interest rates on both assets and shares.

If interest rates move up at a rate of less than 100 basis points per year, our experience at Mark H. Smith Inc., is that most CUs can effectively manage that type of a movement. If they move up at a faster pace, some CUs will start seeing their NII decline significantly with a corresponding impact on NI. Under these circumstances, it will be necessary to put off dividend increases for as long as possible, while at the same time raising loan rates as fast as the market will allow.

This mind set is difficult for some CU officials. They are normally focused on serving the members, and rightfully so. Nevertheless, during the complex financial times that CUs will experience if interest rates rise rapidly, rate-setting decisions must be made in a businesslike way that reflects the long-term financial health and well-being of the CU. Remember, the best way that CUs can serve their members is for their executives to be certain that the CU is financially strong and stable, not only today, but in future periods. 

**Abbreviated terms are defined on pg. 3.*

Mark H. Smith Inc., the publisher of *CU-ALM Report*, announces its website www.markhsmith.com. This site is dedicated to the ALM needs of small- and mid-sized CUs. Of interest to all CUs are the pages entitled "Free On-Line Training" and "Free ALM Templates & Sample Policy."

The training modules are written for nonfinancial persons such as directors and ALCO members. Each module takes about 30 minutes to complete. As we go to press, the training modules are just starting to come online. We anticipate adding two to three new subjects each week.

The Sample ALM Policy is meant to provide help in build ing an ALM policy that will suit the needs of individual CUs. Please don't just take the policy and stop publishing it.

Current and prior issues of *CU-ALM Report* will be available on the website for downloading. In the near future, the website will incorporate an open forum and chat where CU executives and volunteers can post their comments and interact with other CU officials. We hope that the forum will become a valuable resource for small- and mid-sized CUs to share ideas and current information with other CU executives in similar circumstances.

CU executives and other CU officials who may be interested in services provided by Mark H. Smith Inc., a complete catalog of services, sample reports, references, and fee information is available on the website.

Welcome to www.markhsmith.com

THE ROLE OF NEV/MARKET VALUE ANALYSIS

In the February 2004 issue of *CU-ALM Report*, we discussed the role of income simulation and its application in evaluating IRR. In this issue, we will discuss the role of NEV/market value analysis (NEV).

Let's clarify the outlook of CU managers as opposed to that of the regulators. CU executives and volunteers look at the CU as a going concern. It will continue to operate into the future. It will continue to take deposits, make loans and provide services to its members. This is called the going concern principle and is one of the foundations of GAAP. This is the reason that traditionally, even if the market value of loans falls to less than book value, the declining value can be looked at as temporary because the CU will stay the course and hold the loan to its maturity. At that time, it will receive full book value. This is a valid assumption and a correct methodology if you look at the CU as a going concern, as CU officials normally do.

Regulators, however, look at the CU much differently. When regulators get a CU tossed in their lap, it is usually a basket case. Typically the regula-

regulators are going to sell the assets and find someone to assume the liabilities. The sale may involve selling the whole CU, or it may involve the liquidation of the CU's assets piece by piece. In any event, what is important to understand is that the regulator of the CU is only going to receive the current market value for the CU's assets and liabilities. If the current market value of the CU's assets are significantly less than their book value, then someone is going to have to make up the difference. The CU's liabilities, which consist primarily of shares and deposits of members, are insured, and cannot be written down.

If the CU's capital is strong, then the capital can be used to cover the decline in market value of the assets. However, this rarely happens because, if the capital were strong, the regulators would not be liquidating the CU in the first place. CUs with strong capital are not candidates for liquidation. If they run into problems, they rely on the strength of their capital, work through the problems, and continue to serve their members.

So, most of the time if the regulators find themselves in possession of a CU, there is very little capital available to cover short-comings in the balance sheet due to declines in the market value of the (... continued on page 2)

WRITTEN AND PUBLISHED BY

MARK H. SMITH INCORPORATED
www.markhsmith.com

2860 WEST 4700 SOUTH, STE. D
(800) 268-7795 (801) 963-8470 (fax)

SALT LAKE CITY, UTAH 84118
mark@markhsmith.com

LONG-TERM RATES MOVE UPWARD— IS IT A SIGN OF THINGS TO COME?

Is it April 2004? Long-term interest rates as represented by 10-year T Bonds and 30-year mortgages have spiked up almost 100 basis points, even as the Fed continues to hold down short-term rates. What is the relationship between short-term and long-term rates? While the Fed has some control over short-term rates, long-term rates are set by supply and demand in the financial markets.

In previous interest-rate scenarios, long-term rates have been what is called a leading indicator of increases in the short-term rates. A leading indicator is simply an index that precedes another index in its movements. For example, in 1993 and again in 1998, interest rates rose by 200 to 300 basis points over a 12-month period. The rise in long-term rates in each of those periods commenced about six months before the rise in short-term rates began. Traditionally, long-term rates are a leading indicator for the direction of short-term rates.

This is not necessarily a cause and effect relationship. And, in fact, it doesn't matter. If the rooster crows,

and an hour later the sun rises, it doesn't matter that the rooster is not making the sun rise. It is sufficient to know that in the wee hours of morning when the rooster crows, there is a high probability that the sun will shortly rise.

Does this recent spike in long-term rates mean that the historically-low, short-term rates we are experiencing will go up in six months? Who knows? We here at Mark H. Smith Inc. certainly don't. But if I were managing a CU, I would be watching those long-term rates like a fat gopher watching a hungry eagle circling overhead. It is not a certainty that long-term rates will sustain themselves. They have spiked several times in recent years, and receded to previous lows or moved to even lower levels. That could happen again. But, the economy seems to be improving. The factors that may influence the Fed to begin moving rates up are converging. Overall, the conditions for increasing interest rates seem to indicate that this may be the time.

We'll follow up on this article in future issues. ☞

THE ROLE OF NEV/MARKET VALUE ANALYSIS (continued from Page 1)

... assets. Typically, when the regulator finds an entity to assume the liabilities, they are compensated by receiving a like amount of assets. If the market value of the assets has declined and doesn't cover the liabilities assumed, then the share insurer must step up and make up the difference.

This is the reason that regulators are concerned with the market value of FR loans even though the CU may be anticipating holding them to maturity. If the loans and investments get tossed into the regulator's lap, they do not have the option of holding them to maturity, but must resell them over a short period of time at their market value and make up any deficiencies.

NEV analysis is simply a methodology that allows management or regulators to estimate the current market value of the CU's assets and liabilities and determine if the CU's capital is at risk and/or is sufficient to compensate for any declines in the market value of the CU's assets. The methodology for making this analysis is beyond the scope of this article. It can be a very complex calculation if the CU's balance sheet carries a significant number of long-term assets.

Your choices for determining the market values basically boil down to: 1) purchase software where you will analyze your loan and investment portfolios and calculate market value; 2) outsource the project to a firm that specializes in providing this service; or 3) perform the calculations yourself. The NCUA

offers help on their website for those CUs which would like to perform this calculation. In a future issue of *CU-ALM Report*, we will cover the advantages and disadvantages of purchasing software, outsourcing and/or doing it yourself.

One other issue arises and that involves the duration of long-term assets. NEV analysis is the only method commonly used by CUs that captures all of the long-term IRR. If your CU has significant levels of loans or investments whose effective maturities are beyond 60 months, you should be using NEV in order to evaluate the long-term IRR. If you don't have a lot of long-term assets, you don't necessarily need to use NEV; however, that's what the regulators are going to use when they make their examination, and it's always a good idea not to be surprised by the regulators' findings. For this reason alone, most CUs should be using NEV.

In summary, NEV is a methodology for determining the market value of the CU's assets and liabilities and how they impact the CU's capital. It pertains primarily to long-lived assets and investments whose effective maturities exceed 60 months. It measures all of the IRR in the CU's balance sheet, even the risk inherent in long-lived assets. It is used by the regulators to determine their potential exposure to losses if the CU were to fall into liquidation. It should be used as a management tool by CU executives to enhance their knowledge, understanding, and management of the IRR in the CU's balance sheet. ☞

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ALM 101/201
Live Seminars

With interest rates at extremely low levels, many credit unions are taking on higher levels of **interest rate risk** in order to maintain net income and capital levels. The importance of training and building expertise in the ALM area is becoming more critical each day. It is imperative that all credit unions measure, evaluate, and manage IRR during these difficult financial times. This seminar will help you do so!

The **ALM 101/201 Seminar** is

There are 24 **ALM 101/201 Seminars** being presented nationwide in 2004. During May and June, seminars will be presented in:

Baltimore, MD;
Los Angeles, CA;
New Orleans, LA;
New York City, NY;
Boston, MA;
Dallas, TX; and
Denver, CO.

Time is running out, so act quickly to reserve your seat.

For more information:

visit our website:

www.markhsmith.com

call our toll free number:

(800) 268-7795

or e-mail us

mark@markhsmith.com

We look forward to hearing from you. ☞

WRITTEN AND PUBLISHED BY

MARK H. SMITH INCORPORATED
WWW.MARKHSMITH.COM

2860 WEST 4700 SOUTH, STE. D
(800) 268-7795 (801) 963-8470 (FAX)

SALT LAKE CITY, UTAH 84118
mark@markhsmith.com

ABBREVIATED TERMS DEFINED:

| | | | | | |
|----------|---|----------------------------------|------|---|--|
| ALM | = | Asset and Liability Management | NEV | = | Net Economic Value/Market Value Analysis |
| CU | = | Credit Union | NI | = | Net Income |
| Fed | = | Federal Reserve | NII | = | Net Interest Income |
| FR loans | = | Fixed-Rate Loans | GAP | = | A methodology for measuring IRR |
| IRR | = | Interest Rate Risk | GAAP | = | Generally Accepted Accounting Principals |
| RAP | = | Regulatory Accounting Principles | CRAP | = | What you get when you mix GAAP and RAP |

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ALM SOLUTIONS WITH *ALMPro*® !

With interest rates at near-historic lows, the specter of increasing rates and the related interest rate risk have to be of concern. *ALMPro*® is a periodic (monthly or quarterly) reporting service that analyses your balance sheet with a minimum of effort and time on your part. Our clients send their financial data to us and receive their *ALMPro*® Report two to three business days. The *ALMPro*® Report includes:

- ☞ Rates Up and Down Shocks Using Income Simulation and NEV/ Market Value Analysis;
- ☞ A Liquidity Analysis;
- ☞ A Capital Sensitivity Analysis; and
- ☞ A Net Interest Income Analysis

ALMPro® is a service rather than software. As the CEO of your busy credit union, your time is very valuable. This service will free up your time for more pressing matters which constantly arrive on your desk. Our fees are based on asset size and are very reasonable.

For further information:

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 call us at our toll free number: (800) 268-7795
 or e-mail us: mark@markhsmith.com

We look forward to hearing from you!