

CU-ALM REPORT

MAY/JUNE 2004

VOLUME 1, ISSUES 5&6

STRATEGIES FOR MANAGING INTEREST RATE RISK

As we look forward to the second half of 2004, the probability of rising interest rates is high. This leads to the question of how to manage asset and liabilities as rates increase. Typically, credit unions have a liability-sensitive balance sheet. That's just a fancy way of saying that most credit unions have short-term liabilities and shares, and have used those liabilities to fund intermediate- and long-term loans. As a result, most credit unions are subject to interest rate risk (IRR) when interest rates are rising.

However, the credit union does have options and strategies that it can implement when rates begin to rise. All of these options and strategies exist within the framework that the credit union

is a business and not a charity. Even though the credit union's reasons for existing are different, the credit union must make businesslike decisions in order to prosper. It must be there to serve its members in the future.

As interest rates rise, here are some of the things you may consider to maintain the credit union's net interest margin.

» **Increase dividends only as fast as you absolutely must.** Boards of directors love to increase dividends. It makes the members happy. But the business facts of life are that when rates are going up, you must hold back as long as possible before increasing the dividends.

(... continued on page 2)

MANAGING NET INTEREST SPREAD

Traditionally, credit unions loaned money at 12% and paid dividends or interest of 6%. That's equal to 6% or 600 basis points for the net interest margin. Some CEOs would sacrifice a key body part to have that kind of margin to work with today. However, in the absence of very unusual circumstances, the typical margin is going to be more in the 300 to 400 basis-point range—sometimes a little higher; sometimes a little lower. Management of this narrow interest margin is crucial. **In fact, it is the single most important decision process at the credit union!**

The rate-setting process has traditionally and legally been a duty of the board of directors. However, regulators and industry leaders have encouraged all but the most simple credit unions to establish an asset and liability management committee, com-

monly referred to as an ALCO. The ALCO typically consists of key members of the credit union management and representation from the board of directors. It meets regularly and has more resources and knowledge available to it than the board.

The ALCO should include representatives from key departments in the credit union. For example, if you make a decision regarding loan rates, it is very important that a loan manager or administrator be involved in that decision. Likewise, your marketing manager needs to be aware and able to input their feedback. Otherwise, the rate decision may prove to be unmarketable or unmanageable by those charged with the responsibility to implement them.

A second advantage to having an ALCO leading the rate-setting process is it is not bound by a

(... continued on page 3)

CREDIT UNIONS ARE A BUSINESS (A COMMENTARY)

Years ago, I read a book entitled *How to Swim with the Sharks Without Being Eaten Alive*. The book was okay, but the title was one of the best I have ever seen. Little did the author realize that years later, in 2004, this title would describe perfectly the plight of credit unions as they struggle to prosper and serve their members in this vast economic marketplace where there are literally thousands of competitors. Three competitors are very aggressive, some may say vicious, and many of them are as much as 1,000 times the size of your credit union. Given the chance, they will eat you for lunch and smile while doing it. If credit unions are going to survive in this market, they must be

run in a pragmatic, businesslike manner. Sometimes the management of a credit union confuses the term "nonprofit" with "charity." In fact, we all know that credit unions must be profitable. The difference between a credit union and its competitors is the credit union will use those profits for the benefit of its members and to capitalize future growth of the credit union. In fact, if there were no profits, the credit union would never be able to grow because of the lack of capital.

When it comes to profitability, there are two areas which are often problematical for credit union management:

(... continued on page 4)

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

STRATEGIES FOR MANAGING INTEREST RATE RISK

(continued from page 1)

» **Identify nonrate-sensitive shares and don't increase dividends on them at all.** Some members deposit their funds in the credit union for reasons other than dividends. Those reasons include safety and convenience. These funds will likely stay in the credit union regardless of the rate paid. The member is being served in other ways such as offering a convenient place for them to store their money.

Nonrate-sensitive shares are identified in various ways. Typically, they reside in low-balance, checking, and club accounts. It is not immoral to stop paying dividends on these accounts; it is businesslike. Your competitors will do it and the nature of the competitive economy in which we operate says that you have little choice.

» **Identify high-yield, rate-sensitive shares and let them run off rather than pay a higher dividend.** The outlook of credit union management has traditionally been that bigger was better. A growing credit union was a successful credit union. Many credit unions would be better off if they shrank their asset size by 10%, conditioned, of course, on running off the right combination of liabilities and assets. Obviously, you will want to make a thorough assessment of your liquidity position before implementing this strategy.

» **Raise loan rates as fast as possible.** Nobody likes to raise rates on loans—it makes the members unhappy. Nevertheless, this is a business and, as rates rise, it is imperative that you move your loan rates up as **rapidly as possible**. Remember, in spite of all that you can do, it is very likely that your dividend rates will increase more quickly than your asset yields. This is going to cause a squeeze on interest margins that are already at historic lows. Any loss in the interest margin will translate directly to a decrease in net income.

» **Consider selling some of the credit union's long-lived assets** now before rates increase dramatically. If you really believe interest rates are going to go up, a small loss now may very well avoid a larger loss in the coming years. If you choose to sell long-lived investments or conforming long-term real estate loans, you may soon have the opportunity to reinvest those funds at higher rates and recover the loss. Obviously, this strategy is based on a bet that interest rates are going to go up significantly in the foreseeable future. If you sell assets at a loss and rates don't go up, this strategy will have backfired.

» **Promote non-rate sensitive shares such as checking, regular shares and club accounts.** Typically these shares are deposited for reasons other than yield. By providing service, convenience and safety, the credit union can attract shares which are not rate sensitive and on which they can pay no dividend or a nominal rate.

» **Sell share CDs.** Share CDs are the only share relationship that carries a contractual rate and a fixed maturity date. As such, the credit union can lock in rates into the future. While there often is not a large demand for share CDs extending beyond 24 months, many credit unions can sell some share CDs in the 12-24 month range. By fixing these rates for a year to two years into the future, the credit union avoids paying the higher rate until such time as the shares mature. Of course, this strategy has an associated risk: If rates do not increase, the higher rates paid on the CDs will have a negative impact.

» **Borrow intermediate- or long-term funds.** If you really believe with a certainty that share rates are going up, you can lock in a fixed rate for your funds by borrowing for the intermediate- to long-term. Remember that these intermediate- and long-term loans are bullet loans that do not allow prepay-

ment. The costs typically would be high. If you locked into a loan and rates do not go up significantly, you will have just locked into a high cost liability for a significant amount of time. However, if this option appeals to you, these loans are available at the Federal Home Loan Bank and/or your corporate credit union.

» **Implement an intentional disparity within the credit union's rate structure** that allows the credit union members to choose the rate that they want, either actively or by default. With rates at historic lows, now is an ideal time to consider this strategy. Implementation of the strategy would be as follows:


Create within the credit union's share structure two share relationships that are identical or are very similar; for example, regular shares and a money market fund. The minimum balance on these accounts would be relatively low, allowing members to easily transfer money back and forth between the accounts. With rates so low at the present time, the disparity may be small. For example, you may offer regular share rates at .25% and money market share rates at .50%, a differential of 25 basis points. This would be announced in the credit union's newsletter and statements.

The members' option would be to transfer their shares to the money market fund and receive the higher rate. Those members who look at the yield on their savings as an important factor will notice the disparity and will make the transfer to the higher rate. Those members whose accounts exist for their convenience, safety, or reasons other than dividends will probably choose to leave their shares where they are. At that time in the future, when rates begin to move up and market forces require that the money market yields increase, you may do so appropriately. Do not increase the regular share dividend!

As this process repeats itself over a period of quarters or even years, a significant disparity between the regular share rate and the money market rate will take place. More and more members will take note and some will transfer their money to the higher rate. At some point down the road, when the disparity is significant, it will be obvious that the funds remaining in the regular share accounts are not rate sensitive. That money is there for reasons other than the yield.

Having identified these nonrate-sensitive funds, we are able to utilize this knowledge to the credit union's advantage in managing the credit union's NII. There is no reason to pay dividends in the future on these funds. If the members are dissatisfied with the relationship, they have the option to transfer their funds to the money market share account. Now, when we model the credit union's IRR, we know we have shares that can offset the IRR of long-lived assets.

Certainly, the amount remaining in regular shares which is now considered nonrate sensitive, may vary from credit union to credit union. As I have presented this strategy to credit union CEOs over the past two years, I have had different reactions. Some felt there would be very little left in regular shares. Others felt there would be significant funds remaining. You won't know until you try. It is completely fair to the members. It is unconventional; however, unconventional thinking may be necessary to survive in the financial services industry in the future. Traditional thinking certainly will not suffice.

The process of managing IRR is ongoing. You are never finished. You may implement a strategy, discover it is not having the effect you want, and you may have to adjust it. However, by making businesslike, pragmatic rate decisions, especially regarding nonmaturity shares, credit union management will serve its members well over the long-term. 

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

MANAGING NET INTEREST SPREAD

(continued from page 1)

traditional monthly meeting cycle. There have been time periods in recent history where it would have been necessary for an ALCO to meet almost daily in order to keep abreast and set rates competitively and in a manner that is economically feasible.

Third, the members of an ALCO typically are better trained and more experienced than the board of directors in financial matters. It is important that rates be set based on financial decisions.

Lastly, the rate-setting procedure is too important and pervasive to be administered by one person. A single executive, no matter

how superbly trained and knowledgeable, cannot have the perspective of the members of an ALCO.

The purpose of this article is not to beat up on directors. As the governing authority of the credit union, the directors bear the ultimate responsibility for all of the financial decisions made at the credit union. However, in an economic environment, where the rate-setting process has changed from mundane to dynamic, we suggest that the ALCO is in a far better position to make sound and pragmatic rate-setting decisions. We recommend that boards actively establish ALCOs and implement them into the rate-setting process.

Advertisement

ALM 101/201 Live Seminars

With interest rates at extremely low levels, many credit unions are developing 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 the perfect opportunity to obtain ALM training for you, your ALCO members and your directors. This is the only seminar that presents ALM concepts at a level geared especially for small- and mid-sized credit unions.

There are 24 *ALM 101/201 Seminars* being presented nationwide in 2004. Coming up this summer, seminars will be presented in:

Detroit, Michigan.....	July 12-13
Chicago, Illinois.....	July 15-16
Columbus, Ohio.....	July 22-23
Oakland, California.....	August 5-6
Pittsburgh, Pennsylvania	August 23-24
Philadelphia, Pennsylvania	August 26-27
Las Vegas, Nevada	September 13-14

For additional cities and dates to be presented in the fall of 2004, visit our website.

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

For more information:

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



We look forward to hearing from you.


CREDIT UNIONS ARE A BUSINESS (A COMMENTARY)

(continued from page 1)

1. Rate-setting. The setting of realistic rates, especially share and deposit rates, has bedeviled credit union management for decades. It is an extremely technical process that has become extremely complicated over the past 10 years. Interest rate deregulation and competition have decreased. The interest margin to about half of what it was as little as 20 years ago. The management of that margin has become the single most important management decision in the credit union. The necessity and importance of making pragmatic business decisions with regard to the setting of loan and share rates cannot be overemphasized. While it is always nice to give the members a high rate, the credit union can only do what is economically realistic and feasible. Remember, the members' shares are a liability to the credit union. It is imperative that, during the next 12 months, management implement realistic businesslike decisions with regard to rates.

2. Fees and other revenue. It has been a tradition with credit unions since the beginning that members should not be subjected to paying fees. In today's reality, this is an unsustainable practice. Historically, the interest spread has been sufficient to cover all of the expenses of the credit union. Now, as the interest spread narrows, credit unions find themselves hard-

pressed to continue this strategy. It is not contrary and immoral to charge members a reasonable fee for the services that they enjoy and use. In fact, the traditional way of doing things (i.e., having one group of members, such as borrowers, pay for the services of others) is imminently unfair. It seems that the more fair way would be that members pay a reasonable fee for the services that they use. That way, members who demand a great deal will pay appropriately. Likewise, members who demand very little service from the credit union are not required to contribute to the expense of serving demanding members.

Pragmatic businesslike decisions from a volunteer board, often with little financial training, seems a bit unrealistic; nevertheless, that is the result that must be achieved. To do so will require that the directors learn to be business persons first. It will also require that credit union members understand the business nature of the credit union and accept decisions of the board and management that may impact them in a negative way. In any event, a businesslike approach to managing the affairs of the credit union, especially in the rate-setting process and revenue administration area, will be crucial to the success of the credit union in future periods. 

Advertisement

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 more information

visit our website
www.marksmith.com

call toll free
(800) 268-7795

or e-mail us
mark@marksmith.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