

CU-ALM REPORT

SEPTEMBER/OCTOBER 2004

VOLUME 1, ISSUES 9 & 10

MANAGING THE INTEREST SPREAD

The objective of this article is to help you start thinking of your cost of funds as a major component of your ROA, and as an area where you might be able to improve your competitive position. If I were to tell you that your small- or mid-sized credit union should operate like Wal-Mart, your first impression might be to laugh. Cut me a little slack and hear me out. Wal-Mart is far and away the most successful retail enterprise in the history of the world. There has to be something we can learn here. So, let's examine it and see what we can find.

When people think of Wal-Mart they think of sales. However, let's look at the other side; that is, Wal-Mart as a purchaser. After all before Wal-Mart can sell anything it has to buy it. All of those shelves full of merchandise must be purchased and this process has as much impact on the profitability as the sale of merchandise. The bottom line is that it's the margin that counts, or the sales price less cost of goods sold. Wal-Mart's purchasers are famous for being tough negotiators. They are like that because they

know that they will live and die with the margin. The cost of sales is every bit as important as the sales price itself. While many things contribute to Wal-Mart's success, its legions of hardnosed purchasers, who negotiate everything to the last fraction of a penny, are a major factor in the organization's success.

So what does this have to do with your credit union? Well, if you think about it for a few minutes your credit union isn't that much different from Wal-Mart. You purchase funds from your members which you use to make loans to other members. The credit union's costs (dividends and interest) to use the funds is equivalent to Wal-Mart's cost of goods sold. At the credit union, we call it cost of funds. Now when you loan the money out you mark up the price to provide an interest margin.

We can learn something if we put ourselves in the shoes of the Wal-Mart purchaser in charge of buying toasters. Your job is to have toasters on the shelves when a customer comes in wanting to ... (cont. on page 2)

THE MAGIC OF 300 BASIS POINTS

The objective of a 300-basis-point shock to your balance sheet is to simulate a worst-case scenario. As interest rates have begun to rise, some people, including some individual regulators, have suggested that a 300-basis-point shock is not a worst-case scenario and greater shocks, such as 400 or 500 basis points, should be tested in order to thoroughly assess the credit union's NII at risk.

Where did the 300-basis-point number come from? Basically, it was handed down to us from NCUA approximately 4 years ago. Historically, there is some support for a 300-basis-point shock. In 1994, short-term rates increased 300 basis points in 12 months. In 1999-2000, short-term rates increased approximately 250 basis points in 15 months. If you look at recent history, 300 basis points would appear to be a pretty reasonable number. If you go back further into the late 1970s and early 1980s timeframe, certain economic indicators did increase far more than 300 basis points. But, if you were to track the overall cost of funds for credit unions, I believe the increase would be in the 300-basis-point range.

Other factors which enter into the decision matrix here would be:

- Credit union share portfolios are much different now than they were 20 years ago. A far greater percentage of shares and deposits are in money market funds or CD relationships which tend to be more rate sensitive than shares. On the other hand, many credit unions have a significant checking or share draft component which typically would not be rate sensitive at all.
- The 300-basis-point shock, which NCUA wants to see, is an instantaneous shock. That means that interest rates would change overnight. While this is truly a worst-case scenario, it is not likely; so, implementing an instantaneous shock will bring a far more harsh result than a ramp shock, where rate increases are phased in over a period of months or years.

We at Mark Smith Inc. were curious about how much the instantaneous aspect increased the severity of the shock. To answer the question we ran a series of tests on the *ALMPro* Income Simulation Model. While the testing was extensive, we were able to boil down the ... (cont. on page 3)

MITIGATING INTEREST RATE RISK

When talking about interest rate risk (IRR), the focus almost always goes to the sensitivity of interest rates, in particular, the sensitivity of the credit union's net interest income (NII) or interest spread to changes in rates. The primary concern for most credit unions is the effect of increasing interest rates on an NII if rates move upward rapidly. This concern is certainly justified. Nevertheless, there is another aspect to IRR that is not talked about as often, namely the revenue that the credit union receives which is not impacted by changing rates. For example, checking account fees, NSF

fees, and courtesy pay fees typically are not rate sensitive. Therefore if economic conditions cause the credit union's NII to contract, the negative effects of this event can be mitigated if the credit union has an income stream of revenue that is not impacted by changes in rates.

When I began working with credit unions 27 years ago, almost 100% of the credit unions' revenues were from interest on loans. When interest rates rose to historic highs in the late 1970s and early 1980s, ... (cont. on page 3)

S

WRITTEN AND PUBLISHED BY

MARK H. SMITH INCORPORATED
WWW.MARKHSMITH.COM

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

SALT LAKE CITY, UTAH 84118
MARK@MARKHSMITH.COM

MANAGING THE INTEREST SPREAD

(continued from page 1)

purchase one. You need a wide variety of toasters ranging from simple and cheap to deluxe and expensive. You need to have enough toasters on hand that they will be available when the customer wants one. If a customer comes in to buy a toaster and you don't have what he wants, he will go to a competitor, and he might not come back. On the other hand, if you buy too many toasters, you might not be able to sell all of them and they may become obsolete or shopworn and need to be cleared out at distressed prices.

Your first job, then, is to estimate the demand for toasters. Estimating demand is tricky; nevertheless an estimate for demand has to be made. Once you have estimated demand, you know how many toasters you can sell at a given price. Now you call the toaster salesman and inquire about volumes and discounts. You only buy the toasters if you can purchase them, mark them up, and resell them in a way that will be profitable. You don't necessarily buy all of the toasters available just because the salesman offers them to you—even if they're offered at a good price. If you are in business to make money, you will only buy the amount of toasters that you can resell profitably.

Okay, how does this apply to your credit union? We have said over and over in past issues of the *CU ALM Report* that the credit union is a business, not a charity. While you may have altruistic objectives and motives, in the end the credit union must operate in a competitive business environment with thou-

sands of competitors. Successful retail organizations like Wal-Mart place a high priority on controlling inventory costs. Credit unions traditionally have not done so. Unfortunately, many credit unions do not look at the acquisition of funds in a businesslike manner. In fact many credit union officers and officials make every effort to increase the cost of funds (that is raise the dividend) at every opportunity. That's because they don't fully understand the nature of the credit union. Even though the credit union was formed with altruistic motives, it is still a business. Members are not donating their money when they deposit shares. They expect to get it back, often with interest. It is fine for officers and directors to look at the altruistic goals of the credit union, but those goals must be accomplished within the context of a business, which the credit union is.

The level of competition dictates that any overpayment or premium paid on share dividends or interest will come directly out of your ROA. That is to say that if you overpay dividends by 50 basis points, your ROA will decline by 50 basis points. In other words, if your ROA would have been 1%, the dividend overpayment of 50 basis points will lower the ROA to .5%. Those officials at the credit union with responsibility for rate setting need to understand that over the long-run credit unions cannot pay excessive dividends and interest. **ED**

Advertisement

ALM 101 SEMINAR ON VIDEO

(An Introduction to Interest Rate Risk)

Over 600 credit union personnel have experienced the *ALM 101 Seminar* during 2003 and 2004. Their response has been universally enthusiastic and positive. This six-tape video package is an excellent way to train yourself, your staff, your ALCO, and your board on the basic principles of ALM and interest rate risk.

ALM 101 Seminar on Video is an introductory course, geared to the needs and resources of small- and mid-sized credit unions. You can view the seminar in its entirety or choose from the topics listed below to train in shorter segments, allowing vital training for your staff members and your volunteers who have other responsibilities which absorb their time.

TOPICS

The 30 to 60 minute topics addressed on the six-video set include:

- *Introduction to ALM & Interest Rate Risk (IRR)*
- *Measuring IRR Using NEV/Market Value Analysis*
- *Measuring IRR Using Income Simulation*
- *Organizing & Using an ALCO*
- *Defining & Measuring IRR Risk*
- *Measuring IRR Using GAP Analysis*
- *Options: Embedded & Otherwise*
- *Managing & Mitigating IRR*

SATISFACTION GUARANTEED!!!!!!

Your satisfaction is absolutely guaranteed. Order the videos today. If for any reason you are not 100% satisfied, return the videos within 10 days and your purchase price will be refunded.

Price: \$199, plus \$5.95 shipping*

Purchase the video and if you later become an **ALMPro® client (see info on next page), the full price of the video will be credited against your **ALMPro®** setup fee.*

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.

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

THE MAGIC OF 300 BASIS POINTS

(continued from page 1)

results to one simple statement: *The result of the regulatory 300-basis-point instantaneous shock is effectively the same as a 500-basis-point ramped shock.* In other words, the result of a 300-basis-point instantaneous shock carried forward three years is effectively equal to the result of a 500-basis-point ramped shock where the shock is ramped over the first 12 months and rates are left at the shock level for two more years.

Our conclusion is that a 300-basis-point instantaneous shock remains a good example of a worst-case scenario and can be considered as a good measurement for the worst likely circumstances that a credit union can face.

That's our opinion. If yours is different, we would be delighted to hear from you. Please e-mail me at mark@marksmith.com. 

MITIGATING INTEREST RATE RISK

(continued from page 1)

many credit unions were adversely impacted. Some actually failed. Others needed help from NCUA in order to legally pay dividends because earnings were insufficient to do so. Since that time, credit unions have diversified their base somewhat and now have a stream of fees and charges that are not rate sensitive. This stream of fees and charges mitigates the effects of IRR and can be measured. We suggest that credit unions measure the effects of fees and charges in two different ways:

1. The ratio of fees and other income to total income (fees + other income ÷ total income). This ratio will measure fees and other income as a percentage of total income. The higher the percentage, the less rate sensitive the credit union's earnings will be to IRR. Most credit unions that do this on a historical basis will discover that the percentage of fees

and other income to total revenue is increasing, thus decreasing the credit union's earnings subject to IRR.

2. The ratio of fees and other income to net income (fees + other income ÷ net income). This ratio will measure the portion of the credit union's net income that is derived from fees and is not subject to IRR.

We need to note that not all fee income is exempt from IRR. Some fees, for example loan origination fees, do have an element of IRR. Most do not, however, and that makes fee income an excellent mitigating factor with respect to IRR.

We suggest that you measure the impact of fees on earnings at risk. The two measures mentioned above will be helpful in doing so. 

Advertisement

ALM SOLUTIONS WITH *ALMPro*® !

With interest rates at near-historic lows and currently rising, interest rate risk has to be of concern to the financial industry. *ALMPro*® is a quarterly reporting service offered to credit unions 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 in 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 that allows you, the CEO of your busy credit union, to free up your time for more pressing matters which constantly arrive on your desk. The fees for this service 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