ALM NEWS

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Welcome to *ALM News*

You might be asking yourself, "Why "another newsletter?" Certainly there are numerous newsletters available–many of them intended for the credit union market. However, to the best of our knowledge, there is only one newsletter, available specifically for credit unions, that deals exclusively with ALM issues and that one costs about $350 per year–a hefty price for many small- and mid-sized small credit unions. We think free is a lot better.

In addition, our experience is that most of the information pertaining to ALM topics tends to emphasize those issues of large credit unions. The issues of small- and mid-sized credit unions are often signify-cantly different. The focus of *ALM News* will be to provide help for, and be a resource to CEOs, ALCOs, and volunteers at small- and mid-sized credit unions. It will be written in a way that hopefully will be understandable to these individuals and not leave them in the dust wondering when the stage left.

You have probably guessed by now that I am not a professional writer. In fact, I am an accountant. I practiced public accounting for over 20 years before making the decision to work in the ALM area exclusively. So, if the writing in this newsletter sounds like an audit report, I apologize. Bear with me. Hopefully it will get better.

If you like the idea of receiving this newsletter each month–absolutely free and without obligation–you don't have to do anything. It will just come automatically. If you would like to have this newsletter faxed to other members of your staff or your directors, send us a fax with their names and fax numbers and we would be glad to do it. If you would like to have this newsletter received via e-mail, send me an e-mail with the words "news-letter subscription" in the subject line and we will take you off the fax list and place you on the e-mail list. If you would like others to receive the . . . *(continued on pg 3)*

Economic outlook : Is loan growth eminent?

After years of stagnant loan demand, it may seem like a fairy tale to think that net loan growth is a possibility, let alone a reality. Nevertheless, it seems like the time may have come. Two prominent credit union economists were recently quoted in *The Credit Union Journal*. CUNA economist Bill Hample was quoted as saying that loan growth is expected to outpace savings growth in 2004. NAFCU economist Tun Wai was quoted, "The economy is growing like gang busters." Wai forecasted that saving growth would outpace loan growth in 2003, but that relationship would reverse itself in 2004.

What are the ALM and interest rate risk implications if these forecasts turn out to be correct? The answer is: it depends. If loan demand increases faster than share growth, that will mean that most credit unions will be shifting investments into loans.

The question that you need to ask yourself is: What investments am I going to sell and what types of loans will we make? If the investments sold have a shorter duration than the new loans that are made, the credit union will experience an increase in both interest rate risk and liquidity risk. Both of these factors should be taken into account.

One strategy to mitigate the effects of interest rate risk would be to endeavor to make some of the new loans of the adjustable rate variety, or with balloon payment features, in order to allow a repricing opportunity prior to maturity For many credit unions, this opportunity to make loans at the related increase in interest rate risk is an acceptable risk given the opportunity to increase the profitability of the credit union. However, if the credit union's interest rate risk is already high, you may want to think more than once about accepting additional interest rate risk. ✳

Name the Newsletter

I think we all agree that the name *ALM News* is unimaginative and unexciting. We are certain our readers can come up with something better.

We are offering a $100 American Express Gift Card to the person who submits the winning name for this newsletter. Keep in mind the following criteria:

1. The newsletter is intended for CEOs, ALCOs, and Directors of small- to mid-sized credit unions.

2. The content of the newsletter will be ALM issues in general with an emphasis on interest rate risk topics.

The rules are pretty simple:

A. Fax us your entry ((801) 963-8470) or e-mail it (mark@markhsmith.com) to us.

B. Be sure to include your name, the credit union you are affiliated with and instructions on how to reach you.

C. In case of identical entries, we will award the prize to the earliest fax or e-mail date.

D. The name chosen will become the sole property of Mark H. Smith Inc. and will be so copyrighted.

E. Entries must be received no later than February 15, 2004. ✳

Inside *ALM News*:

Coming next month:

The Role of Income Simulation
Big Bank Mergers Go For the Consumer Market
Interest Rate Decisions—Who's in the Best Position to Make Them
ALM Policy—Setting Targets and Risk Limits1

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Hedging—is now the time?

With the economy finally starting to heat up, it seems inevitable that at some point in the foreseeable future interest rates will increase. Inasmuch as almost all credit unions are liability sensitive–that is, at risk to increasing interest rates–credit union financial managers should be concerned. As interest rates rise, there is a risk that increasing interest rates will cause the credit union's cost of funds to grow at a more rapid rate than the credit union can increase its yields on assets such as loans and investments. This puts the credit union's net interest income at risk and also increases the amount of the credit union's economic capital that is at risk.

One method often used by professional financial managers to manage or mitigate interest rate risk is the implementation of a formal hedging strategy that sidesteps the credit union's ownership of medium- to long-term assets or short-term shares and deposits with a portfolio of options.

The concept of a hedge is simple. Hedging simply involves the purchase of option-type instruments that will increase in value if a certain risk comes to fruition. Typically, credit unions may own long-term, fixed-rate assets that are funded with short-term, effectively variable rate shares of deposits. Options or their equivalent can be purchased which will offset some of this risk. The problem is, hedging strategies and the instruments used to implement them are extremely complicated. In the past, we have had clients who attempted hedging strategies and the results have been universally disastrous. The result has often been an unemployed CEO and a bond claim.

Nevertheless, hedging is a valid strategy for mitigating and reducing interest rate risk if implemented correctly. The difference now versus then is that some corporate credit unions have devised a hedging strategy that they have vetted with the NCUA and apparently have received clearance. Implementing a hedging strategy under the direction of a corporate hopefully will produce better results than doing it on your own. Corporates understand the credit union system and hopefully are motivated by a desire to assist the credit unions in addition to making money.

If you are considering a hedging strategy, there are some things you must look at:

1. It will be necessary for your investment officer–which for many of you is the CEO–to become familiar with hedging principals and for your board of directors to at least understand the basics of a hedging strategy;

2. It will be necessary to modify your investment policy to allow and control the hedging activities;

3. Have your policy and intentions reviewed by the credit union's legal counsel and determine that the credit union's proposed activities are allowed by federal statutes and regs and/or state statues and the regulations of your share insurance provider;

4. The accounting for a hedging transaction is complicated. You will need to contact and work closely with your outside auditor to be certain that your hedging strategy conforms to the accounting standards in such a way that it will be accounted for as a hedge;

5. Give your regulator a heads-up on what you plan to do and how you plan to go about it; and

6. Work only through a corporate that has a prototype program approved by NCUA or your share insurance provider, and, if state-chartered, by your state regulator.

Lastly, we need to define the difference between a hedge and speculation. A hedge-type transaction effectively reduces interest rate risk and involves options that offset a position that you own, such as loans, investments or shares. A speculation is a one-sided, very high-risk transaction undertaken for profit and is totally unjustified in a credit union environment.

The purpose of this article is not to recommend a hedging strategy. However, the time may have come when some credit unions can benefit by employing such a strategy. Of course, the decision is yours. We wish you success. ✳

Credit card portfolios

If you're considering selling your credit card portfolio, it is important that you consider the ALM implications along with the other considerations that may go into this decision. The purpose of this article is to make you aware of the impact of a credit card portfolio sale with regard to interest rate risk.

Credit cards by their nature tend to have a very short duration. In our experience, we have found that typi-cally credit cards have an average portfolio maturity of 6 to 12 months. In addition, some card portfolios carry an adjustable rate feature that allows the interest rate to adjust as often as monthly.

Changes to the mix of assets on your balance sheet usually occur slowly. However, the sale of a credit card portfolio can have an instantaneous and significant impact. For some credit unions the decision to sell a card portfolio will result in an increase in interest rate risk.
This is be-cause once sold the proceeds of the sale are often loaned or invested in instruments that will reprice more slowly than the card portfolio would have. This is not neces-sarily bad, but it is important that you understand the impact of a portfolio sale from the prospective of interest rate risk before you do it. The only way to do this is to model or simulate the effects of the sale. This is a very simple . simulation. You will need to adjust your model to reflect the sale of the portfolio and to determine where the proceeds would go. Simulate both an income simulation scenario and an NEV/Market Value scenario.

For many credit unions, this analysis will forecast a benign increase of interest rate risk and you can make your decision based on other criteria. For those few credit unions who already face a high level of interest rate risk, the interest rate risk impact of a sale of the card portfolio should be a major consideration as to the sale

You can make the sale of your card portfolio neutral with respect to interest rate risk. To do so, use the proceeds of the card sale to invest in loans or instruments with pricing characteristics that are similar to those of the card portfolio being sold. For example, you could invest in adjust-able rate loans or securities that allow the rates to move with a short-term indicator such as *The Wall Street Journal* Prime. Another approach would be to invest in fixed-rate CDs or securities with maturity dates laddered out over no more than 12-18 months

Regardless of the outcome, it is important that you estimate the impacts of interest rate risk if you are considering the sale of your card portfolio. ✳

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The Role of *ALM News*

ALM News is a publication 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 insight and thoughts with our readers, it is important to understand that the ultimate response-bility for implementing ideas or strategies suggested in these pages rests solely with the credit union's management. ✳

Welcome to ALM News (Cont from pg 1)

. . . . newsletter via e-mail, send me a list of names and addresses. If do not want to receive *ALM News* at all, call us at (800) 268-7795, and we will remove you from our list. Or write the word "delete" across the cover sheet that came with this newsletter and fax it to us at (801) 963-8470.

If you have comments or suggestions, by all means we want to hear them. Same toll-free number (800) 268-7795, fax us at (801) 963-8470; or e-mail me at mark@markhsmith.com. If you have something to say in print, send it along. We are considering a guest opinion for future issues. If you disagree with us, no problem. I learned long ago that my way is not the only way.

You may be asking yourself, what's in it for Mark Smith Incorporated? We consult with credit unions and provide balance sheet and interest rate sensitivity testing on an outsourcing basis. Over the years, we have learned that we will benefit if we get out name out in front of credit union executives in a favorable light. Our advertising in this publication is clearly designated, should you be interested.

I am excited about the opportunity to serve credit unions. I have worked with credit unions in one capacity or another for over 26 years. It's not just a job for me; it is something that I believe in, especially the role of small- and mid-sized credit unions in the system. While many people will ultimately choose to transact business with a large financial institution, we believe they should have a choice. Credit unions provide that choice. ✳