Asset/Liability Management: Take five and thrive

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There's no getting around it—A/LM is a big subject, and it can be downright daunting to many. We're often asked by credit union CEOs, CFOs and board members, bleary-eyed from trying to get their arms around managing the risk and leveraging the opportunities they face, *"What are the few key things I need to remember when it comes to having a successful A/LM process?"*

With that in mind, we came up with a list of five things that credit union decision makers should keep close at hand when considering decisions that will affect their credit union's financial structure. Here they are:

1. **Decisions—not market interest rates—create risk.**
   Why do we say this? We work with hundreds of credit unions, quantifying risks to earnings and net worth. Each credit union has a unique risk profile, yet every credit union operates in the same market interest rate environment, which, over the past 18 months has seen fed funds go up 325 basis points, while the long-term rate barely moved.

   Some credit unions have risks to earnings if rates again fall to 1%, while a number of others wouldn't face significant risks until rates hit double digits. Why such a diverse range? It comes down to one word: **Decisions.**

   Decisions on target market (some credit unions try to be "all things to all people" versus carving out a slice of the market and establishing true competitive advantages)… Decisions to assume that things will always go as planned… Decisions on how fast to grow, on what types and numbers of physical locations to have… Decisions to let competitors drive strategy—we often hear, *"If we don't, our competitors will…"*

The list goes on… Decisions to maximize earnings today and potentially risk future earnings as the world changes… Alternatively, there are decisions to accept modest earnings today in exchange for more flexibility as the world changes… Decisions to build infrastructure, or to implement a sales and service culture…

All of the above are strategic decisions that can impact earnings and risks to earnings and net worth for many years to come.

Let's take this observation outside of the credit union industry for a moment and consider the auto industry, specifically GM and Toyota. A number of decisions GM made many years ago are negatively affecting sales and earnings performance today, while the decisions Toyota made are boosting their performance. Both are operating in the same fiercely competitive environment, yet one is struggling mightily and the other is thriving.

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It all comes down to this: the decisions you're making today will significantly determine your strategic flexibility in the future. Before making a major decision, test not only the short-term financial impact, but, more importantly, the *long-term* financial impact under different market interest rate conditions and yield curves.

2. **As you are making decisions, consider improbable outcomes.** While making decisions, be sure to spend the extra time to think about unlikely scenarios and prepare for them. Sure, you may face some rolling eyes, but one doesn't have to look very far back to see how the improbable and unthinkable can end up becoming reality. After all, who thought it was probable that:

   - Without fee income, many credit unions would lose money?
   - In the last 18 months (June 2004 to December 2005), short-term rates would increase 325 basis points and the long-term rate would stay about the same? So much for parallel shifts in rates.
   - In 2001, auto makers would start offering 0% financing?
   - In 2001, the Fed would drop rates almost 500 bps in 12 months?
   - In 2002, the Dow would drop over 3,300 points in less than seven months, and the NASDAQ would lose 46% in nine months?

   Keep in mind it is improbable that economic forecasts will be accurate. Statistics show that looking back over the last 20 plus years, economists have accurately forecasted the *direction* of rates less than 30% of the time. And, by the way, this statistic is for *semi-annual* forecasts.

3. **Decide on your appetite for risk and establish meaningful risk limits.** One of the principal missing components—yet one of the most important in the A/LM process—is having board and management truly agree on their appetite for risk…*before the risk is taken.*

   Oftentimes management teams are given one-year earnings goals, yet rarely does that short-term earnings goal come with guidelines on how much long-term risk is acceptable. Not clearly establishing the "rules" is unfair to all parties—management, board and membership—and can have unintended, undesirable consequences.

   To drive home this point, ask yourself if you would go to Las Vegas and gamble without first determining what you are willing to risk (lose). People concerned about their financial soundness would not. Likewise, it is critical that board and management agree on their appetite for risk and express that appetite through meaningful risk limits. Meaningful risk limits are those proverbial lines drawn in the sand, which, once encountered, signal that this is the point at which you previously agreed you're willing to take action—*today*—to reduce the risk.

   Now is probably a good time to draw the distinction between risk limits and targets and goals. Targets and goals are your plans; risk limits are your outer boundaries in case things don't go as planned.

   One more point on risk limits—don't have too many. One of many reasons

is that too many limits may result in loss of focus, and often the limits will inadvertently conflict with each other, causing confusion and possibly lead to missed opportunities.

4. **The point at which you address a problem is directly related to the number of viable options you have for solving it.**
   Rarely do things improve by ignoring them. And problems don't usually "work themselves out." More often they grow and pretty soon you're fighting fires.

   One such example is the mantra we often hear, *"After rates change we'll take action."* Stalling until after rates increase, for example, can exacerbate the cost of reducing your risk. In this situation it is most likely that if assets need to be sold it would be at a loss, and borrowing rates would be more expensive; while facing pressure to increase deposit rates in order to maintain the balances you need.

5. **Core deposit studies are not required.**
   Washington State DFI's Web site's Answers to Webinar Frequently Asked Questions says, "Core deposits are defined as those deposits that are not interest rate sensitive. In effect, this means that share accounts will stay at your credit union regardless of how dividend rates move."

   Many credit unions have recently been conducting costly core deposit studies, but such studies are not required and use of the results can lead to faulty decision making.

   Core deposit studies often take a look back at the deposit behavior over your institution's most recent five-year history. But think about it—are the past five years indicative of the next? Such a study would show that when rates fell in 2001 money came flooding into your credit union, because no matter how much you lowered your dividend, it was far better than a 30% loss in the stock market. Now rates are climbing and deposits are slowing. If you lowered your rates today, do you think your members would respond again with a big cash infusion? In addition, demographic trends—including emerging shifts in banking habits—encourage us to look forward and realize that the vision of the future may be very different than a picture of the past.

To find out more about these topics, as well as much more on developing and implementing a successful A/LM process, we invite you to attend one of our A/LM education courses. Please check out www.cmyers.com for a list of upcoming classes.

We welcome your questions and comments
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