Today's Earnings Challenges: Feeling the Squeeze

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Recent data show that the industry average ROA fell about 7 basis points, to 0.86%, in 2005, compared to 2004—a drop similar to the year before. Perhaps more enlightening is that fourth quarter 2005 earnings dropped 22 bps, to 0.62%, from the fourth quarter 2004.[i]

What's going on?

Lots. And while it would be difficult to cover everything here, a brief look at some of the key components creating this current earnings squeeze—such as type of growth, interest rate risk, effects of new business decisions, as well as liquidity and funding issues—is in order. While all of these topics are interrelated, the primary focus of this article is funding.

As we at c. myers have been watching these issues unfold, we have concluded that the earnings squeeze is likely not to be short-lived; therefore, many credit union managements and boards will need to seriously evaluate their current business model to determine if it is still viable to thrive during the rapidly changing economic and competitive landscape.

Type of growth

NCUA reported that total shares grew in 2005 at a rate of 3.8% and loans grew at 10.6%. A drill-down of the distribution of deposit growth shows that it's heavily weighted toward high cost, shorter-term CDs; in fact, regular shares and money markets actually shrank. *(See table for the components of deposit growth in 2005.[ii])* If this trend continues it will not only further compress earnings, it could add notable interest rate risk if rates continue to rise.

Type of Share Account	2004 Growth Rate	2005 Growth Rate
Share Drafts	10.9%	6.9%
Regular Shares	4.1%	-3.7%
Money Market	3.3%	-3.9%
Certificates	6.8%	20.4%

Interest Rate Risk: What was a risk is now a reality

When the components of growth noted above are combined with the fact that short-term rates rose 400 bps in about 24 months, while long-term rates barely budged, a picture begins to emerge of the squeeze on margins that many credit unions face. That image comes into sharper focus when considering these circumstances:

- Intermediate and longer-term assets booked at lower rates during 2001-2004 are still on the books and many are now starting to extend (callables turning into bullets, for example).
- The increase in non-earning assets has taken a toll over the past few years, dragging down earnings.
- Even though many credit unions have delayed raising share rates, the cost of funds is increasing while loan rates are only inching up slightly. Keep in mind, many of the one-year CDs that were put on the books two years ago at less than 2% have now rolled to a 5% rate; conversely not many loans are coming on with rates 300 bps higher to keep pace.

Still, credit unions often think that the business they're *going* to book will fix everything; but, at least in the short term, that's proven not to be the case.

New Business: No quick panacea

Simply said, for many credit unions, the new business decisions being made today are not profitable, or not profitable enough, to maintain margins and profitability *and* offset the risk they took on during 2001-2004. Additionally, operating expense ratios continue to rise for many, leaving non-interest income the final lever to pull *(see box)* to maintain earnings. And while many credit unions are increasing their non-interest income, it's just not enough to make up the difference.

Credit unions have five strategy levers to pull to affect ROA:

1. **Yield on Assets**
2. **Cost of Funds**
3. **Operating Expense**
4. **Provision for Loan Loss**
5. **Non-Interest Income**

In strategic planning sessions with our clients, we often ask them to rank the order in which they would be willing to pull the five levers. We then ask which levers they believe they have the most control over. This exercise often helps these credit unions to realize that the levers they have the most control over may be those that they're least willing to pull to increase ROA, thus making it very difficult to compensate for risks already taken.

Funding and liquidity

There are numerous liquidity and funding issues—this article focuses on two. The first deals with one that many credit unions face today; the second is a trend we're beginning to see that causes us concern.

Today's Liquidity Challenge: Will the short-term solution be a long-term problem?
The current challenge is easily summed up: loan demand exceeds deposit growth and available investments. The fix is, unfortunately, more complex. To deal with this lopsided equation, many credit unions are turning to short-term, rate-attractive CD promotions. These promotions may not only hurt today, but can actually extend liquidity challenges.

Before deciding to offer a promotional rate on CDs, ask yourself if you can afford it … and for how long. You may say you can't afford *not* to—your competitors are offering great rates, so you've got to do something to stay competitive and attract some new deposits or keep the ones you have. But sometimes the most successful CD promotions end up causing longer-term financial problems, if the marginal cost of funds is not adequately forecasted.

As an example of this potential pitfall, let's say a credit union decides to raise some cash by running a CD promotion. Its objective is to grow by $10 million by offering 9-month CDs paying 5%.

On the surface, our example credit union's results look good—they've brought in the $10 million in new funds at 5%. But then comes the news that their promo had unintended consequences: it seems their members know a better deal when they see one, and $5 million in existing shares, paying 2%, also moved into the 5% promo.

Question: What is the marginal cost of the new funds? Answer: 6.5%.

Why? To properly calculate the actual cost of the $10 million in new funds, the extra interest expense of $5 million in shares going from 2% to 5% should be added to the expense of the $10 million in growth.

Now the question becomes: Will the earnings on new loans and investments exceed 6.5% after factoring in operating expense and provision for loan losses? It's doubtful given the current economic and competitive landscape.

Setting aside the margin problems that could be encountered, it's vital to ask how long these types of CD promotions will be able to sustain your credit union's funding. After the promotional rate runs out or the CDs mature in six to nine months, then what? How will the loans you've put on be funded? What is the plan to take this potentially unprofitable business and make it profitable, while at the same time turning members into contributors to the cooperative? These questions deserve careful consideration and thoughtful debate for many credit unions.

Funding issue: Today?, Tomorrow?, Never?
Beyond the current liquidity challenges many face, a relatively new issue is developing, characterized by a situation in which the cost of funding the business structure is too high, resulting in materially depressed

earnings for an extended period of time. This funding issue could potentially require a fundamental shift in the current business model.

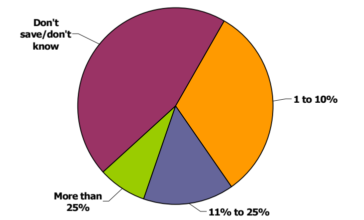
Everyone knows that most things happen in cycles, but what we don't know is how long the cycles will last. There is a potential for financial institutions to have an intermediate to long-term funding issue, due in part to reasons such as:

- The geographical lines of competition are diminishing. Traditional and non-traditional competitors are popping up everywhere in the marketplace offering great rates, and providing people what they want: more options and easier access to their money, as well as cost effective products and services; in other words, more for less. Increased competition will impact the financial performance of credit unions, as well as their overall infrastructure.
- America's age-based demographic shift is contributing to changes in consumer spending and saving behavior.
- Studies show that the savings habits of Baby Boomers (born 1946 to 1964) and the younger generations appear to be very different from the savings habits of the Silent Generation (born 1933 to 1945)—a demographic trend borne out by the recent reports in the decline of the personal saving rate.
- Despite the significant increase of community charters in the past few years—they now account for 20% of federal credit unions—overall membership in 2005 grew just 1.5% over 2004.[iii]

The (no) saving rate

As was widely reported, Americans spent more than they earned in 2005, for the first year since 1933, during the Great Depression. The personal saving rate, as calculated by the U.S. Department of Commerce Bureau of Economic Analysis, is the amount left over from disposable personal (after-tax) income after expenditures on personal consumption. Last year's saving rate was –0.4%. The rate for first quarter 2006 dipped even further, to –0.5%. Stated in dollars, that's more than $50 billion in consumer overspending for the quarter. In general, people are saving, but they're spending *more*, perhaps due in part because they feel wealthy—thanks to the tremendous run up in property values over the last several years. As pointed out earlier, this saving deficit may be at least partially caused or aggravated by the shift

How much do those 55 and over save?



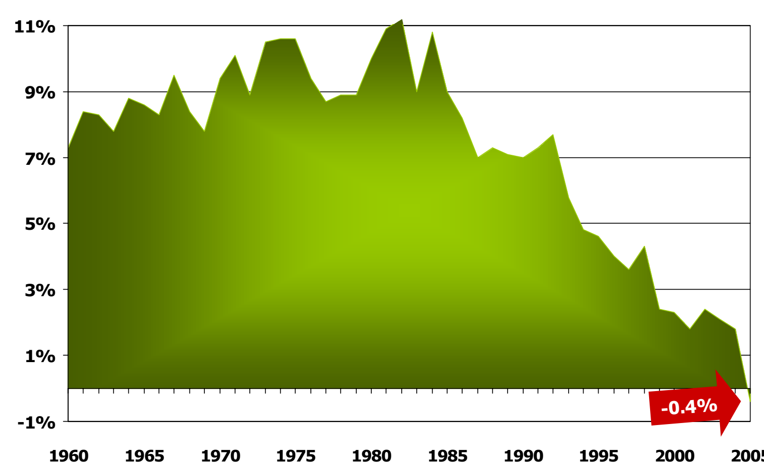
Source: Money magazine, "How Normal Are You About Money?," April 2005

in demographics. Consider, for instance, that nearly 50% of people over 55 don't save or don't know how much they save *(see pie chart)*. In addition, about one-third save only 1% to 10%.[iv] Recent figures on Generation Xers (born 1965 to 1978) indicate they have $125 billion of discretionary income, and spend $200 billion annually.[v]

What effect will these and other impending demographic shifts have on credit unions?

Contemplating questions like this keep many managements

Personal Saving Rate as a Percentage of Disposable Personal Income



Source: U.S. Dept. of Commerce BEA

strategizing and thinking "outside the box" as they figure out how to best deal with the challenges they face, such as:

- *How can we attract and maintain enough balances from younger generations to replace declining balances while the competitive environment is fierce and savings habits to date appear to be materially different from those of seniors?*
- *How can we change our operations to handle the additional members we may need without having to materially increase expenses?*
- *If the savings habits improve because people decide it's time to restructure their own personal balance sheets, what impact can that have on loan demand, and ultimately earnings?*

Parting thoughts
Even if rates don't continue to rise, many credit unions may face a sustained squeeze on earnings. What's the good news? There are many solutions to help reverse the trend of the earnings challenge. Here are just a few:

- **Face the facts.** Recognize and embrace the reality that a material shift in the current business model may be necessary for many credit unions to thrive in the future competitive landscape.
- **No sacred cows.** Be willing to use *all* strategy levers to obtain desired financial performance long term—assume that everything is fair game.
- **Make some "no" decisions.** Invest time deciding what the credit union will ***not*** do or will ***stop*** doing, so that management, staff and board can be focused on achieving objectives that are imperative for the credit union's unique situation. This point was summed up quite well during a strategic planning session we facilitated recently, when one participant observed that you have more control over what you decide *not* to do than over what you decide *to* do. Time and money are truly limited resources—use them wisely.

The bottom line is that while the current earnings squeeze may be painful to address now, delaying to do so may only make dealing with it later hurt more. And who knows? Facing these issues may just produce opportunities and competitive advantages you didn't know you had.

[i] Callahan & Associates Trendwatch, Data for December 31, 2005
[ii] NCUA Financial Trends in Federally Insured Credit Unions, January 1-December 31, 2004 and 2005
[iii] Information from Callahan & Associates
[iv] Money magazine, "How Normal Are You About Money?," April 2005
[v] "The Millennial Generation," by Madsen Pirie and Robert M. Worcester