Budgeting Lessons Learned

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Each year between late summer and early fall, listen closely and you may hear the sighs and moans of thousands. Kids going back to school? Well, that too, but we're talking here about the sounds of dread and exasperation coming from credit union CFOs and others involved in the annual ritual of budgeting.

Having spent the past 15 years helping credit unions manage financial issues, including assisting them with their annual planning process and building their budgets, we know a lot about what works and what doesn't. And while it may never become your favorite subject, there are a few lessons we can share as you tackle your financial plan for the coming year.

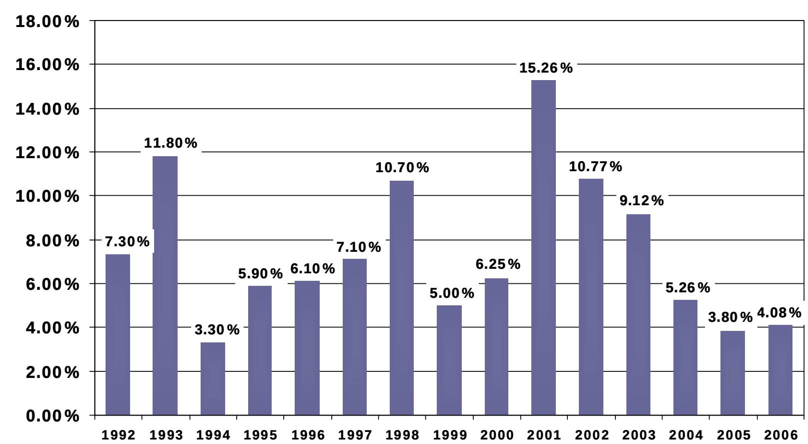
Lesson 1: History is an important subject, but so is Current Events

Many credit unions—as do most businesses—start their budgeting process by taking a look back at the past 12 months' financials and applying that history to the next 12 months. What's wrong with that? Just take a look at the chart (right) illustrating the annual deposit growth rates of credit unions to see how rarely one year's growth applies to the next. As the chart shows, deposit growth rates have bounced around over the past 15 years, from a low of 3.30% in 1994, to a high of 15.26% in 2001, as reported by NCUA.

Of course 2001's strong deposit growth can be directly correlated to that year's run from the stock market, just as the subsequent years' declining growth rates track with those years' trends. In the past few years members have been diverting their money to things like real estate investment, the recovering stock market and —put simply—spending.

Two thousand five's well-publicized deficit in the personal saving rate was due in some part to the fact that many homeowners raided the equity that seemed to appear at their doorsteps overnight. They refinanced at historically low mortgage rates and many took the cash and went on spending sprees. With the once-hot home sellers' market cooling off, this situation could be a setup for several different possibilities. (For more on the negative saving rate, download a copy of our ***c. notes*, "Today's Earnings Challenges: Feeling the Squeeze," at** www.cmyers.com/education/cnotes.html.)

Deposit Growth Annually as of 12/31



Source: NCUA

Simply "copying and pasting" the prior year's numbers without understanding the economic environment that influenced them is probably not wise. Want proof? Consider this: In 2006 (according to NCUA)—

- Regular shares declined 6.8%
- MMKTs increased 1.4%
- CDs grew 23.8%

For the first time CDs are larger than shares.

Lesson 2: Behavioral Studies

Consider what happens next with the homeowners who either bought or refinanced in the past couple of years. Imagine how differently just these two behavior patterns could affect your credit union—

- One scenario has people realizing they're not as rich as they thought they were and reacting by starting to save again. They would likely focus on paying off credit cards and HELOCs, driving their cars a little longer and putting some money away each month. **Translation: loan volume may decline.**
- Another real possibility is that your members are unwilling to change their spending habits. After all, old habits die hard. This scenario could mean reliable, low cost funding would continue to be in short supply. This may lead to challenges for reliable, affordable funding. Not to mention a sustained increase in credit risk. Strategic risk: materially higher funding costs with no end in sight. **Translation: decrease in deposits.**

THINK YOU DODGED A BULLET? DON'T BE TOO SURE.

Even if your credit union didn't make any hybrid or exotic mortgages, plenty of financial institutions did. Many of the holders of these mortgages will experience a material increase in their payments, so chances are you have a fair number of members that will find themselves in this "house of pain" scenario. Testing how your members who *do* get hit with big monthly payment increases may react (more defaults? further shrinking deposits?) and making adjustments to your budget is vital homework.

The point is that one set of circumstances can have a wide array of results when the uncertainty of human behavior is taken into account. Plan for a range of outcomes by creating not just your base case budget but also a range of alternative forecasts. Better to prepare your management and board for a range of earnings, growth and net worth, than painting yourself into a corner with just one magical number for each.

PAST DUE

Share of subprime loans outstanding that are 60 or more days in arrears, by value:

Source: First American LoanPerformance estimates as of March 2007

Lesson 3: Why testing is a good thing

Effective lessons often include a test—a way to prepare you for the future. This idea fits well in the budgeting process. Since no one knows which way interest rates, deposit growth rates, or anything else will go, testing—or "what-ifing"—your budget extensively is an essential part of the process, and it could enable you to react faster to changing opportunities.

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So, here's an example test. Let's say your credit union is planning to open a new branch in the coming year. There are four basic outcomes—

A. No growth: neither loans nor shares grow

B. Loans grow as expected, but shares don't

C. Shares grow as expected, but loans don't

D. Loans and shares both grow as expected

Question: What's the worst-case scenario—in terms of your earnings—that could result?

Most people would say that answer A—the "we built it, but they didn't come" scenario—would be the worst thing to happen, but actually, in many cases, it's not.

Answer B frequently results in lower ROAs for many credit unions that employ a strategy of growing loans with below-market pricing. Why? Many are already experiencing a shortage of low cost, reliable funding. If they grow in low-yielding loans and then turn to high-rate CD promotions to fund the loans, earnings will be pushed lower.

Our new branch test is a perfect example why "what-ifing" is so important. In fact, we recommend when building a branch you do a minimum of four "what-ifs."

Final Lesson: Always keep an eye on the long term

If there's just one more lesson we can leave you with it's this: Remember the long term. Getting caught up in short-term objectives can create a cycle of short-term thinking which can harm your credit union in the long term.

And remember, in this increasingly competitive and volatile environment:

- Don't rely strictly on the past to tell you what the future has in store.
- Manage the expectations of your board and management by discussing a range of potential financial outcomes.
- A dynamic budgeting process including lots of "what-ifs" can help you ace this project.

Questions or comments? I'd appreciate hearing from you. Call me at 800.238.7475 or email me at rjohnson@cmyers.com.