Is Reliable, Affordable Funding a Thing of the Past?

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Credit unions must prepare for a possible sustained shortage in reliable, affordable funding.

This painful reality is the result of three converging trends: consumers are saving less, they're placing less of their assets into traditional institutions like credit unions, and more and more the money they place in traditional financial institutions is in higher-yielding accounts like money markets and CDs.

These three trends have been noted by many reputable sources. Consider the following:

The Commerce Department reported that the nation's personal savings rate for all of 2006 was a negative 1 percent, the worst showing in 73 years.

In April 2007, *U.S. News & World Report* stated, "55% of young boomers—those ages 45 to 54—have saved less than $50,000 toward their retirement."

This low savings rate could cause many people to retire at a later age, leaving their funds in the market longer, reducing the opportunity for growth in traditional depository accounts.

Even when retired, will people be positioned for wealth preservation? Or, will they reach for yield in the market, in hopes of accumulating more for their retirement years?

"Total deposits as a percentage of assets on hand at the end of September at the country's more than 8,700 insured banks and thrifts reached **the lowest level** since the Federal Deposit Insurance Corp. was established in 1933."

"Consider that in 1989, U.S. households deposited 30% of their financial assets in banks, according to the Federal Reserve. By 2004, that had declined to 17%, while the amount of money in stocks, bonds, mutual funds, and retirement accounts grew to 69% from 50%."

—"Banks' Cry: Give Us Your Cash!" *Wall Street Journal*, January 12, 2007

What if this trend continues and by 2014, the percentage of household assets in banks and thrifts drops to just 8%?

Consider the options today's younger generations have for building wealth, compared to 25 years ago.

When a younger person talks to an investment advisor, how often, and how much, do advisors suggest depositing at a credit union?

Of that, what portion do they recommend putting into a regular share account?

The changing membership

We've all heard the statistics regarding the aging membership of the credit union industry.

How will this impact affordable funding and profitable, sustainable growth if the trend in aging credit union membership is combined with the trend for consumers to save less in traditional institutions?

According to NCUA and CUNA, the average growth rate of membership over the last 10 years was about 2.2%. In 2006, membership growth was only about 1.5%.

When evaluating membership growth, consider how much is coming from indirect auto lending, which for most credit unions has resulted in very little deposit growth.

The dramatic shift to CDs

In 2003, CDs as a percent of assets were about 19%; today, they represent about 27%.

What if the change in deposit mix that occurred since 2003 were to continue for the next three years, as shown in the graph? Or, what if the change since 2000 were to continue for the next three years?

Even capturing the flight to safety (of '01-'03), the change in mix of deposits indicates a potential, sustained decline in lower-cost funding.

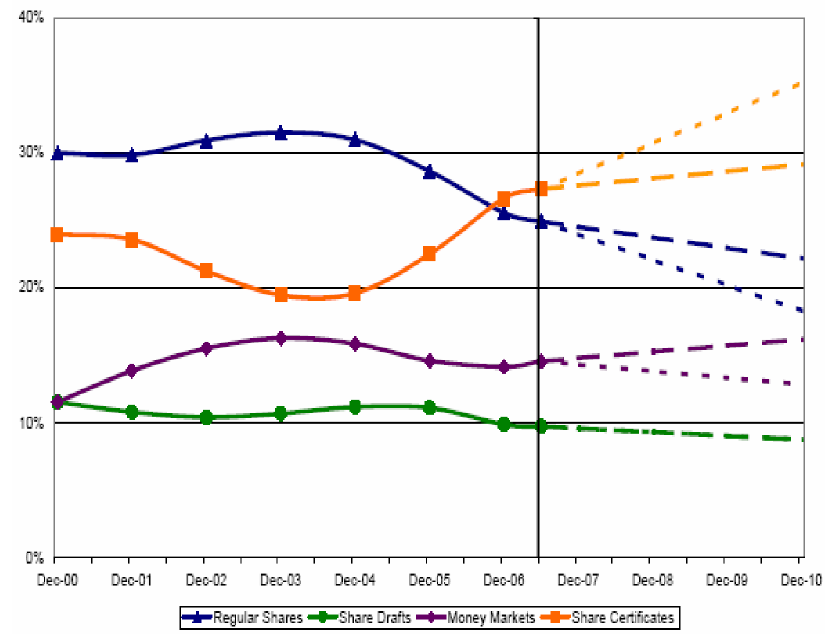
The following table illustrates the financial impact of a shift from lower-cost funding to CDs, even if the rates on CDs don't increase. The table shows the impact if the shift in CDs since 2003 were to continue for the next three years, all else being equal.

Notice how one change in deposit mix reduces ROA by 23 basis points, given the current rate environment.

What would a credit union have to do to offset the 23 basis point increase?

In this example, CD rates were not increased. Imagine the impact if rates were increased to promote growth.

Distribution of Funding as a Percentage of Assets
TWO of MANY Potential Futures



Dotted lines: changes since 2003 continue to 2010
Dashed lines: changes since 2000 continue to 2010

These trends, and more, point toward a potential shortage of reliable, affordable funding. Another flight to safety could alleviate this situation; but based on past experience, it would be wise to assume that any flight would be temporary.

If the shortage of reliable, affordable funding is here to stay, what can credit union decision-makers do to help offset this?

Components of Return on Assets (ROA)

	Current Industry Averages	What-if Changes in Mix Continue?
Yield on Assets	5.81%	5.81%
– Cost of Funds	2.68%	2.91%
Net Interest Margin	3.13%	2.90%
– Operating Expenses	3.35%	3.35%
– Provision for Loan Loss	0.34%	0.34%
+ Non-Interest Income	1.30%	1.30%
Return on Assets (ROA)	0.75%	0.52%

Cost of Funds Breakdown

	Current	What-if
Non-Maturity	56%	47%
CDs/Brw	33%	42%
Net Worth	11%	11%

What can decision-makers do?

Consider the five strategic levers that credit union decision-makers can use to influence ROA:

1. Yield on Assets
2. – Cost of Funds
Net Interest Margin
3. – Operating Expenses
4. – Provision for Loan Losses
5. + Non-interest Income
Return on Assets (ROA)

To start, we recommend that decision-makers do two things:

1. Thoroughly analyze how well the credit union is managing each lever.

As part of the analysis, rank in order how much control decision-makers have over each lever.

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If the most control is believed to be over operating expenses and the least over yield on assets, operating expenses would be ranked "1" and yield on assets would be ranked "5."

This process can help in determining the focus and priority of any actions to be taken.

2. Assume that the mix of cost of funds will continue to shift to higher-cost funding, such as CDs and money market-type accounts.

Therefore, regardless of the rate environment, the relative cost of funds will be more expensive. Explore options in other areas to offset higher-cost funding.

Evaluate each option in detail, and quantify the impact of each option individually to assist in prioritizing resource allocation.

Solutions to address the changing cost of funds typically require in-depth discussions within each credit union, taking into account its business model and strategic focus.

Using just two of the levers as examples, here are some possible options to help offset the increase in cost of funds.

Working with yield on assets

1. Analyze how loans are contributing to the credit union.

If loans, net of provision expense by paper quality, and direct costs (such as dealer fees for indirect loans, expense of collections, etc.) are not contributing on a standalone basis, then determine the true business reason for booking these loans.

This is especially critical if a credit union needs CDs to fund loans. If the true business reason for making loans at a loss is because decision-makers have decided to give back to members who take advantage of these loans, it might be helpful to quantify that give-back in terms of lost income.

Perhaps this lost income translates into lost opportunities to pursue other initiatives that could benefit a larger subset of the membership than those taking advantage of particular types of loans.

Consider sharing the information with the board so they understand how the credit union is investing its resources. There are different ways to quantify the impact of lost earnings opportunity.

One simple way is to compare it to an investment with a similar term. These days, plenty of loans, because of pricing decisions, actually return less than many investments.

If a loan analysis reveals that the loans are not standing on their own, *and this is not a conscious decision*, then a series of strategic issues must be addressed.

2. Consider that non-earning assets are a key component of yield on assets.

The biggest component of non-earning assets is **buildings**. Using industry averages, non-earning assets are reducing credit union income by about 30 basis points in today's rate environment. Many credit unions don't adequately quantify the opportunity costs of owning versus leasing.

Another area to thoroughly evaluate is cash management. It can help to determine how much cash is really needed in ATMs, teller drawers, and so on, versus how much *feels good* to have on hand.

Working with operating expenses

Operating expense ratios continue to increase in many credit unions. This means that the rate of growth in operating expenses is outpacing the rate of growth in assets.

If this trend continues, along with the increase in less reliable, higher-cost funding, **the viability of many credit unions may be threatened.**

But this is also an opportunity—and we don't mean just a one-time chance to slash expenses.

This challenge is an opportunity to consider many business options, like the following:

1. Align operating expense structure with strategy.

This can result in *sustainable* reductions in expenses. We have often observed that strategy and decisions on operating expense structure are not cohesive.

Sometimes a strategy is set, but the execution does not support the strategy. Or, there can be execution with no strategy. Both situations result in unnecessary expenses.

2. Count business every day.

Find out how many loans, deposits, transactions, and so on were facilitated, by delivery channel and/or by person. Use this information to more effectively allocate resources, marketing efforts, and staff training.

3. Decide the type of member the credit union wants to attract, and why.

Make sure the appropriate processes to measure and monitor success are in place. If the credit union is not attracting its target, find out why, and make appropriate adjustments.

Agree on how long it is acceptable to have a member, or type of member, subsidized by the cooperative (6 months, 1 year, 5 years?).

Again, this type of focus will help allocate resources more effectively.

4. Consider separating core operating expenses from new initiatives.

It is easy to miss increases in core expenses when they are routinely blended with new initiatives designed to move the credit union to the next level.

5. Target to have core operating expenses grow at a slower rate than assets.

6. Start thinking strategically about how assets under management can affect operating expense ratios.

7. Have clearly defined success measures, trigger points, and exit strategies for all new initiatives.

8. Put to rest products and/or services that are not returning enough value to the cooperative.

This can help provide the necessary resources to launch new and more relevant initiatives.

9. Promote financial discipline throughout the organization.

Keep in mind that just about any expense can be justified as a member service. But is it truly being sourced or delivered in the most cost-effective manner?

The solution is often a combination of steps

We recommend that credit unions prepare for a sustained shortage of reliable, affordable funding. Evaluating other components of the financial structure, and taking action when appropriate, will help in this preparation.

Many solutions will come from doing business differently. While this can be unsettling, it is a necessary change that must occur, soon.

Our experience shows that if change is needed, the solution is most often a combination of steps that can add up to significant improvements.

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

For a more in-depth look at the issues discussed in this article, please read our white paper, **"Managing Success in a Changing World: Best Practices of Highly Successful Credit Unions"** (http://www.cmyers.com/education/ManagingSuccessinaChangingWorld-Summer2007.pdf).