# Thriving In A World Of Shrinking Margins

*Start By Counting The Right Business Every Day*

By c. myers corporation

As interest rates have been at historic lows for a prolonged period of time, credit unions have had the benefit of lowering their cost of funds (COF) as loan and investment yields decline. Many seem to have worked through their credit issues and, at least for now, have been able to reduce their provision for loan losses (PLL)—another counter-balance to declining asset yields.

Unfortunately, for many, the COF and PLL have—or will soon—hit a floor while asset yields continue to decline. Some have turned to longer-term assets, such as mortgages, mortgage investments and callable bonds to help current earnings. However, these options add interest rate risk in a rising rate environment.

Others have found sustainable profitability by counting the right business, every day. They are looking inward at their business models and practices for opportunities to sustainably improve ROA no matter the rate environment. They recognize that, while they exist for the members, they also have to run the credit union like a business in order to improve its viability and relevance in the longer term for those very members.

To do this, they recognize that they have to break away from the conventional wisdom of focusing mostly on member growth, asset growth and products per member. They are drilling down as they ask a different set of questions in which the answers can reveal eye-opening decision information.

## Counting Your Business—Operating Expenses And Yield On Assets

There are five levers that drive earnings. As noted above, the benefits from two of them (COF and PLL ) in this rate cycle are nearly exhausted.

The balance of this article will focus on two of the remaining three levers—yield on assets and operating expenses. Following are a few examples of questions that can help a credit union count the right business every day.

**Strategy Levers**
***What Drives ROA?***

|   |   |
|---|---|
|   | Yield on Assets |
| – | Cost of Funds |
| = | Net Interest Margin |
| – | Operating Expense |
| – | Provision for Loan Loss |
| + | Fee/Other Income |
| **=** | **Return on Assets (ROA)** |

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## Yield On Assets

Credit unions that do not have the appetite for taking and managing more interest rate risk or credit risk have been focusing on questions that may help them to sustainably improve their ROA. Some of those questions include:

- What is the total number of loan applications we received in the past 12 months? How does this compare with application volume in 2007 (for example), prior to the recession?
- What are the sources and growth trends of our loan applications (e.g., branch, call center, e-branch, indirect, individual employees, etc.)? What can we learn from each?
- Of all the applications, what percentage was approved? Should we be satisfied with this ratio? How does this compare with 2007? Do approvals vary depending on the source (internet, dealer, branch, etc.) of the application?
- Of those approved, what percentage was funded, and should we be satisfied with this ratio? If not, what are 3 things we can do—or stop doing—to improve this ratio? Again, how does this compare with 2007 and vary by source?
- If we do indirect auto lending, who are our most profitable dealers? Are we including delinquency/loan losses in this measure? How are we rewarding those dealers who are consistently high performers (e.g., same day payment, bonus for low delinquency after 12 months of aging)? If we don't do indirect, what alternatives do we provide to help our members with their auto buying when our branches are closed?

**Note:** The point of comparison to 2007 is for example purposes only. Your credit union should select the point of comparison most appropriate for your situation.

## A Couple Of Things To Consider…

If your credit union is approving loans and a material portion of those loans are not funded, identifying the key reasons for this issue and fixing the issues could result in more loan volume without taking on additional credit risk. These are loans that you have already determined are within your credit risk parameters because you invested the time, energy and money in approving them.

If your approval ratio is low, determine why:

- If you are attracting consumers to whom you are not willing to lend, do you need to adjust your marketing message to attract the consumer that fits within your appetite for credit risk?
- What is the financial waste of your marketing effort as well as human resources to evaluate the applications? Equally, if not more important, what is the reputation risk of marketing to people to whom you have no intention of making a loan?
- Has your credit union "over corrected" its credit risk parameters? Or, are your employees afraid to lend because they are still scarred by huge loan losses? Has the risk tolerance of management been clearly communicated to the loan decision-makers?

If your approval and funding ratios are similar to that of 2007, but the sheer volume of applications is down materially, what can you do to beef up marketing efforts to get more of the right type of applications?

## Operating Expenses

There are an infinite number of business questions related to operating expenses. Here are a few to consider that can provide tangible opportunities for process improvement, growing member loyalty and increasing revenue:

- How long does it take for a member to apply for a loan and, if approved, receive funding? This needs to be answered from both the member's and the credit union's perspective. It is important to quantify and evaluate elapsed time as well as effort
- If we implement a proactive approach to driving members to self-service through remote or electronic channels, what are our marketing and sales strategies as we reduce the frequency of personal contact? Are we using our marketing dollars appropriately?
- What are the top 3 sources of new members segmenting by age and source?
  - What productive business are they doing with us within 3, 6, 9 and 12 months? As their membership matures beyond 12 months are they doing more, or less, business with us? Why?
- How long does it take to open a new member checking account? Should we be satisfied with this time? If not, what are the top 3 things we should do—or stop doing—to improve this time?
- Who is using our branches? What are the top 2 reasons they are using the branch? What percentage of deposits, loans and fee income do branch users have? What has happened to the average age of those who use our branches over the past 5 or 10 years?
- How much **productive** business do we get from members with products we believe to be "sticky" or relationship builders, such as bill pay, checking accounts and mortgages? Are we satisfied with the results? If not, what are the top 3 things we should do—or stop doing—to improve this time?
- What is a proxy for the **cost** of a checking account? This question intentionally deals with cost rather than net cost because sources of revenue generated by checking accounts continue to be threatened

## Not All Products And Services Are Productive (Or Created Equal)

Many credit unions have a goal of achieving a certain level of product and service penetration per member or household. However, not all products and services are created equal and, therefore, should not receive the same weighting. Some credit unions are prioritizing or weighting products and services based on contribution to revenue or efficiency to help focus marketing and sales efforts. This weighting will undoubtedly change as the environment changes. Right now the focus should be on what needs to be done to thrive within a world of shrinking margins and still remain relevant to the members that contribute to the cooperative.

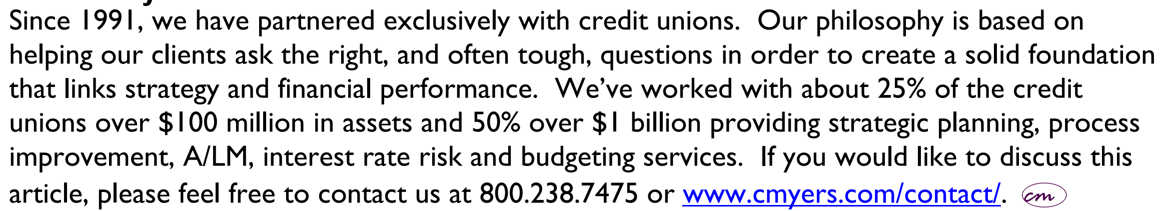
***If you consider weighting your products and services, rely first and foremost on common sense. Don't succumb to analysis paralysis.***

### Benefiting Membership By Thinking Differently

In order for credit unions to thrive, especially in a world of shrinking margins, boards and managements need to think differently about their business model. This is entirely for the benefit of the credit union membership. Relevancy is under threat as the cost to run the business goes up and sources of revenue decline.

For a more in-depth view, please read *Managing Success in a Changing World* which we wrote in the summer of 2007—just before the Great Recession hit.

### About c. myers



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