



Integrating Asset/Liability Management and Profitability

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Most financial institutions have a goal to grow in assets and grow in accounts. A lot of focus in management is given to strategies to produce more loans, attract more customers or members, open new locations or expand services through technology channels. The battle is to do all these things while maintaining a healthy balance of profits and balance sheet risk. Management has to consider the

impact of changes in the interest rate environment and their pricing decisions to control the level of interest rate risk. Funding sources and deposit growth are a challenge to the liquidity position of the institution. Loan quality standards must be examined to insure that credit risk is under control.

The Financial Planning Process

There are several key planning disciplines that make up the total financial planning process of an institution. Success first comes from a commitment to a strong planning process from management and the board of directors. Figure 1 illustrates the processes included in a comprehensive financial planning process. The focus becomes more tactical and less strategic as you move from the top to the bottom of the list.

The board plays a key role in setting long term direction and goals. Long-range planning is defined as the process of defining the institution's goals and objectives. The Board provides a strategic look ahead to the future of the business, or in other words, where the institution "wants to be" in the future. They define mission-critical business strategies, policy limits and guidelines for key performance indicators, such as those shown in Figure 2.

Key management positions make up the membership of the Asset/Liability Committee (ALCO). The ALCO has the responsibility for determining the tactical strategies that will be used to achieve the long-term goals established by the board. They make decisions regarding pricing and mix of products, investment strategies and funding strategies. These decisions determine "how they will get there." It is a process of managing action plans to achieve the institution's goals while managing the risk inherent in the strategies. ALM models help managers test strategies and measure risk, including shocking interest rates on "what-if" scenarios to test the impact on earnings and capital levels.

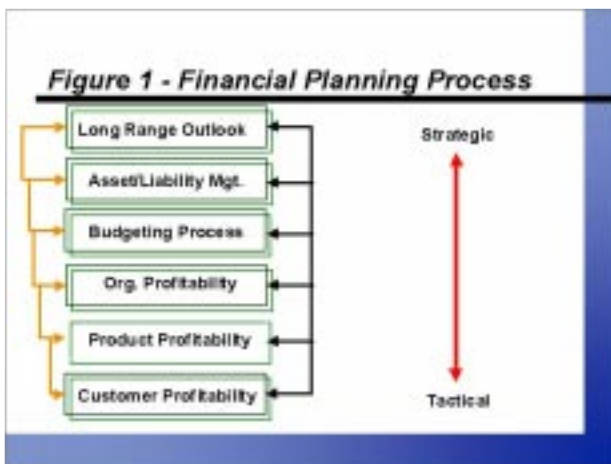


Figure 2 - Long Range Outlook - Targets

Targets:	2001	2002	2003	2004	2005
ROE	14-16%	15-17%	15-17%	15-18%	15-18%
Assets	214,000	222,000	233,000	250,000	267,000
Loans to Deposits	60-65%	62-68%	62-70%	63-74%	65-75%
Locations	3	3	4	4	5
Customers	50,000	52,000	53,000	54,000	55,000

The ALCO, along with line managers, also have the responsibility for working with the Board of Directors on the fiscal year plan or budget. This process helps to refine goals for a fiscal year and provides benchmarking throughout the year so that management can see how well it is doing compared to plan.

So far, we've defined the top three financial planning processes: long range planning, asset/liability management and budgeting. As you move down the diagram shown in Figure 1, the processes become more tactical in nature. The last three shown—Organizational, Product and Customer Profitability—deal with cost accounting and profitability management strategies. To thrive in today's competitive environment, managers need a better understanding of what makes up the profit margin. Traditional financial statements have weaknesses that prevent management from finding the answers they need. By using allocation and funds transfer pricing techniques, managers can understand which organization units, products or customers are profitable

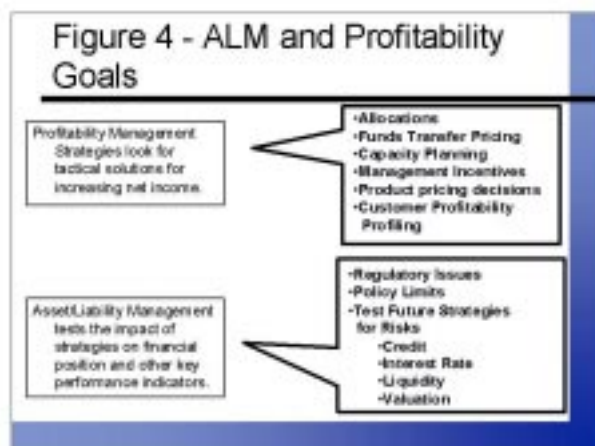
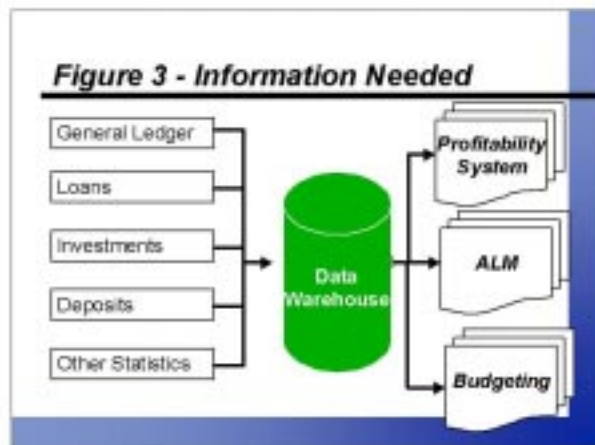
and why. Profitability accounting provides new options for management incentive programs and helps managers focus on activities that produce the greatest return. It also helps to focus attention on areas of strategic or operational weaknesses.

How Asset/Liability Management and Profitability Management Integrate

Asset/Liability Management and Profitability Management share common goals and common data sets. Figure 3 illustrates the type of information that is needed for budgeting, ALM, and profitability systems. The financial and statistical data requirements overlap a great deal between these systems. All need to have checks and balances to ensure that the financial information used ties to the General Ledger. The more the data is integrated through a shared database or shared data warehouse, the easier this system of checks and balances is to maintain.

In both ALM and Profitability Management, increased profitability is a goal (Figure 4). Using profitability analysis, management can determine new strategies for funding or pricing or products. For example, an institution may find that their Home Equity loan product is one of the most profitable types of loans it offers. This may be due to a variety of factors, including efficiencies in opening new loans, servicing loans and pricing strategies. Once management understands this, they may want to pursue a strategy to increase loan growth by focusing on this product. Asset/Liability management simply takes a strategy a step further to test the impact of the strategy on risk position. There may be other factors that prevent this from being the most profitable strategy for the institution. Increased credit risk or interest rate risk may show that too much growth in one portfolio could cause the institution to potentially earn less in the future. Examiners have placed a heavy emphasis on Asset/Liability tests, such as interest rate shocks on future strategies to ensure that profitability and capital levels do not suffer in the future.

The example in Figure 5 next page shows the results of a simple rate shock test on this loan strategy. Under certain rate conditions, Return on Assets could actually decline. Management has to decide how much risk it is willing to accept in order to achieve loan growth and profitability goals. When used together, these systems can be highly effective



at improving the performance of the financial institutions.

In closing, there are several do's and don'ts in the financial planning process.

DO:

- Use the ALCO as the main group for the financial management process.
- Have clear goals and objectives of what the financial management function does.
- Ensure that the MCIF, ALM, and Profitability Accounting systems tie back to the General Ledger.
- Keep it simple!

DONT:

- Over or underestimate the time and effort on coordinating the strategies and tactics.
- Get caught in the details. Accuracy is important; precision is not.
- Leave this process to one person.

ALM and Profitability Management are complimentary processes. They are part of the overall financial planning process for financial institutions. When integrated together, they help financial managers maximize profitability while keeping the risk profile of the institution within the institution's risk tolerance limits.



Since 1992, Karen has helped thousands of financial institution executives improve their financial management, reporting, and decision making processes. As Senior Vice President of Sales and Service, Lead Trainer and Consultant with Profitstar, Karen has helped Profitstar achieve the industry's top customer satisfaction ratings as shown on four separate surveys.

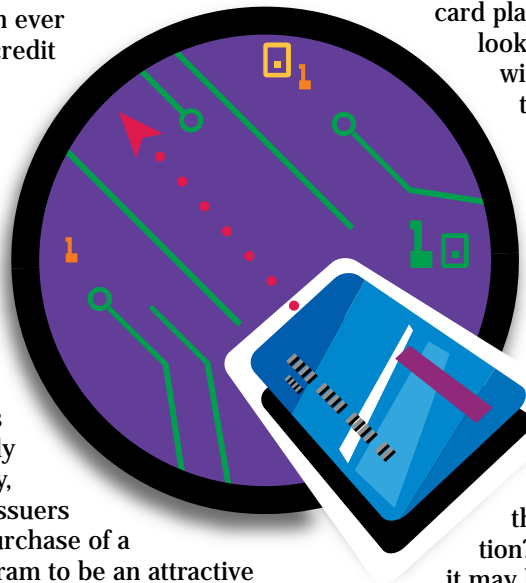
Karen's dedication to meeting client needs through service and education earned her the company's Manager of the Year Award in 1996 and 2000. Karen holds an MBA from Georgia State University and a BSBA from Shorter College. She resides in Omaha with her husband, Harrison. ♦

Should You Sell Your Credit Card Portfolio?—Part 1 of 2

By William C. Koo, Chief Executive Officer, AssetExchange.com

Has your credit union ever considered selling its credit card portfolio? Take a closer look at this option to managing your credit union's balance sheet. The benefits may be surprising to many CFOs.

Today, credit unions willing to sell a card portfolio face a wealth of opportunities that were not previously available. Until recently, buyers who are large issuers did not consider the purchase of a credit union card program to be an attractive option. But times have changed. Bigger credit



card players are now aggressively looking for credit union partners willing to enter into agent relationships, and are making compelling offers along with commitments to promote the credit union brand.

Five Good Reasons for Selling a Credit Card Portfolio

Sometimes it's wise to give your card program a checkup. Is the card program pulling its weight and contributing to the health of your organization? Here are five reasons why it may be time to consider selling:

1. Running a Card Program is Expensive

While the card products often have higher interest rates than other loans, when marketing, servicing, and technology costs are factored in, the portfolios are often not profitable. Why? First, it's very difficult to achieve economies of scale with smaller-sized credit card programs.

Next, for most credit unions, running a credit card program is not a core competency. While card portfolios make up a small percentage of assets, they can account for a large percentage of loan losses.

2. Competition Against Bigger Card Issuers is Fierce

Most of your members get flooded with direct mail from credit card issuers with enticing offers: lower APRs, higher credit limits, low interest rate balance transfer offers, and a myriad of enhancements such as air miles, product giveaways and other enticements. These offers make it less and less likely that your credit union's card will be the primary credit card for your members. Consequently, your member's credit union card is either not used or carries a low balance in comparison to other cards in the member's possession.

3. Lack of Portfolio Growth

Most credit union card portfolio balances are relatively flat. To grow your cardholder base and increase usage, it takes a large marketing budget, expertise, and people. You are competing against the bigger issuers with massive budgets and firmly entrenched marketing infrastructures. Marketing costs can easily exceed \$200 just to get one new account.

4. Adverse Selection

The bigger issuers know who your better cardholders are. Yielding to a constant bombardment of offers, many of your best customers will eventually take their offers. Over

time, this will degrade the quality of your portfolio, with the remaining cardholders representing a population of lower usage and higher charge-offs.

5. Need for Capital Infusion

Many credit unions wish to add new technology, enhance services, and offer new products to their members. This can take significant capital. The credit union holding an unproductive portfolio may be sitting on a pile of much-needed cash.

When Selling Makes Sense

Selling your credit union's card portfolio can make sense. Sometimes, the financial rewards of selling, added to a renewed ability of the credit union to focus on other core services, outweigh the benefits of keeping the credit card program. When that happens, choose to sell with confidence, knowing it's one of many ways to manage your credit union's balance sheet well. ♦

In the next issue of CFO News, learn about critical factors in the sale process and what kinds of offers you can expect.

About AssetExchange

AssetExchange (www.AssetExchange.com) is a network of 700 executives at credit unions and other financial institutions that buy and sell loan portfolios. AssetExchange allows sellers to post summary information describing loan portfolios for sale, and allows buyers to be notified when particular assets are available. With the seller's approval, members may download spreadsheets with portfolio details.

AssetExchange helps buyers and sellers efficiently find each other and manage the sale process. William C. Koo can be reached via e-mail wkoo@assetexchange.com or by phone (503) 220-0007, ext. 100.

A Fixed Income Cushion For An Economic Rebound

The recent decline in interest rates combined with expectations for an economic rebound in the latter half of the year presents an opportunity for investors to consider purchasing "cushion" bonds. Bond prices typically move inversely to interest rates; that is, as interest rates rise (fall), bond prices fall (rise). Cushion bonds help defend, or "cushion,"

against price depreciation in periods of rising interest rates. This is an important feature for investors who may wish to sell their bonds prior to maturity. Cushion bonds can be corporate, agency or municipal bonds. A cushion bond trades above par value (\$100), carries a relatively high coupon rate, and is callable within a few years (short call feature).

What Makes a Bond a “Cushion”?

Cushion bonds are a special type of premium bond. A premium bond is any bond that trades above par value (\$100). Since a bond’s coupon rate typically does not change over the life of the security, a bond becomes a premium bond when interest rates have declined. For example, Bond ABC was issued with an 8% coupon rate at par (\$100). Since then, interest rates have declined and the prevailing market rate for comparable securities (bonds with similar ratings, maturities, etc.) is 6%. The investor must now pay a “premium,” or more than par value (\$100), to buy the bond with the 8% coupon rate.

If interest rates decline dramatically, the price of a bond may rise well above par value (\$100). This is where the call feature enters into the equation. The call feature limits the price appreciation of the bond when interest rates decline. For example, Bond ABC was issued with an 8% coupon payment, 10-year maturity, and is callable at par (\$100) in three years. The bond’s price will not increase as much as a non-callable bond because of the risk the bond will be called from the investor in three years at par (\$100).

Defense Against Rising Interest Rates

Table 1 illustrates the impact of rising interest rates on bond prices. In this example, we’ve used a non-callable par bond, a premium non-callable bond, and a premium bond with a short call feature—the cushion bond. The bonds used in the illustration are A-rated cor-

porate bonds with approximately a 10-year maturity. First, note the cushion bond has a lower price than the premium non-callable bond even though it pays a higher coupon rate. Again, this is because the bond is callable in 2003, which limits the price appreciation of the bond. This illustration assumes interest rates increase 50 bps over the next year. As you can see, the price of the cushion bond declines \$1.46 (or \$14.60 per \$1000 face value of the bond). The price of the non-callable premium bond declines \$3.87, over two-and-a-half times the price decline of the cushion bond. The last row of the table shows the bonds’ total return in the event the investor sells the bond in one year. Total return takes into account coupon income received, the rate at which the coupon payments are reinvested, and the difference between the prices at which you bought and sold the bond. The total return for the cushion bond is nearly twice as high as the total return for the premium non-callable bond (6.46% vs. 3.27%) for two reasons. First, as we mentioned before, the price depreciation is less for the cushion bond. Second, the higher coupon payment (8.0% vs. 7 1/4%) means that more money is reinvested at the new, higher interest rates.

Potential For Increasing Yields

In addition to total return advantages, cushion bonds have the potential for increasing yields. Yields are quoted on a worst-case-scenario basis (assuming no credit default),

Table 1
Impact of Rising Interest Rates on Bond Prices
Assumes 1-Year Time Horizon and 50 bps Rise in Interest Rates

	Par Non-Cal	Premium Non-Call	Premium Callable (Cushion)
Coupon	6 7/8%	7 1/4%	8.0%
Maturity	01-15-11	10-01-10	02-28-10
Call Dat	—	—	02-28-03
Call Price	—	—	100
Price on 4-10-01	100	107	102
Yield to Maturity/Call	6.873 (YTM)	6.258 (YTM)	6.836 (YTC) 7.683 (YTM)
Price on 4-17-02	96.82	103.13	100.54
Price Change	-3.18	-3.87	-1.46
Total Return	3.85	3.27	6.46

For Illustrative Purposes Only. Sources: Bloomberg, L.P.; Legg Mason Fixed Income Trading

which for premium bonds is the yield-to-call. However, if interest rates rise significantly before the call date, the chance the bond will be called decreases. The yield on a cushion bond will increase as each call date passes without the bond being called. In our example, the bond is callable in 2003, '05, '07, '09 and '10. If the bond is not called in 2003, the yield increases from 6.84% to 7.39%—the yield to the 2005 call date. If interest rates remain high, the yield increases after each call date and the investor, ultimately, realizes the yield to maturity (7.68%). Typically, cushion bonds experience the greatest jump in yield if the nearest call date passes. In this example, the yield moves first from 6.84% to 7.39% (55 bps), then from 7.39% to 7.68% (29 bps). *Having said this, investors should expect to earn the lower, yield to call, but recognize the possible yield advantages should interest rates rise substantially.*

Interest Rate Expectations

Why are we talking about *rising* interest rates? Aren't interest rates moving lower? Before we answer, let's look at what we mean by "interest rates". Typically, the term "interest rate" refers to the target federal funds rate set by the Federal Open Market Committee (FOMC). In reality, bond prices respond to

changes in the interest rate, or yield, on the comparable Treasury security rather than in lockstep with the target federal funds rate. In fact, Treasury yields often move ahead of the federal funds rate and are a reflection of where investors think interest rates are headed.

Graph 1 shows the 10-year US Treasury plotted against the target federal funds rate. The arrows indicate the most recent cycles of rising interest rates.

In two instances, the yield on the 10-year Treasury moved higher several months before the rise in the target federal funds rate. For example, the 10-year Treasury began its rise in September 1993; however, the target federal funds rate did not increase until five months later, in February 1994. More recently, Treasury rates began rising in October 1998, and again, the target federal funds rate remained steady until June 1999.

Consider Cushion Bonds

Investors wary of today's relatively low interest rate environment may wish to consider cushion bonds. As outlined in the economic commentary "Treasury Curve Says Ease Now, Rebound Later," it is our opinion, and the stated belief of many Federal Reserve officials, that the economy is likely to experience moderate growth in the latter half of 2001. We believe Treasury yields are likely to increase as the market anticipates an end to the current easing cycle. For more information about cushion bonds, please contact your Financial Advisor. ♦

Graph 1
10-Year US Treasury vs.
Target Federal Funds Rate
March 1993-March 2001



Source: Bloomberg, L.P.

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Additional information is available upon request.

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