



NEWS

SEPTEMBER 1999



AN ELECTRONIC REPORT FROM THE CUNA CHIEF FINANCIAL OFFICER COUNCIL

CREDIT UNION ACCOUNTING ALERT

We have received several inquiries from credit unions regarding a recent FASB (Financial Accounting Standards Board) ruling permitting a one-time transfer of securities **out of the held-to-maturity (HTM) portfolio** into available-for-sale (AFS) or trading. As you know, SFAS 115 generally precludes this type of transfer unless very specific (and rare) criteria are met. **However, there is a provision in SFAS 133 that will allow a one-time transfer to occur.**

SFAS 133 addresses the accounting procedures to be followed for derivative instruments. This financial accounting standard is very complex, and its implementation has been postponed by one year. The standard will be effective for fiscal years beginning after June 15, 2000. At this time, we don't expect SFAS 133 to be applicable to most credit unions. However, since it is possible that a credit union could have a derivative instrument (or an embedded derivative instrument) in its portfolio, we recommend that you become familiar with this new accounting standard.

One of the provisions of SFAS 133 precludes designating a held-to-maturity security as a hedged item, and therefore, such HTM securities would not qualify for hedge accounting. Original decisions to classify securities as

HTM prior to SFAS 133 could limit the applicability of the new standard. Therefore, SFAS 133 provides a one-time opportunity to transfer any security that was originally designated as HTM to either AFS or trading. As noted in paragraph 54 of SFAS 133, "...At the date of initial application, an entity may transfer any held-to-maturity security into the available-for-sale category or the trading category."

To recap, SFAS 133 provides a one-time opportunity to transfer securities out of the held-to-maturity category. This transfer must be done upon initial adoption of SFAS 133, and specific disclosures will apply. Also, SFAS 115 provides instructions on how to account for the unrealized gains/losses that exist at the time of such transfer. It is important to note that even if your credit union does not have any derivative instruments, you may still adopt the new accounting standard and take advantage of the one-time opportunity. It should also be noted that even though SFAS 133 is not required to be implemented until after June 15, 2000, early adoption is permitted. ♦

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CURRENCY & COIN 2000

As we have seen in the past few years, the Treasury Department has rolled-out new 100-, 50-, and 20-dollar bills. However, with the government's need to allocate resources to the Y2K issue the new 10- and 5-dollar bills have been placed on hold and will not be released this year as initially scheduled. These new designs should be in circulation in the Year 2000.

To keep things interesting, the U. S. Mint

will release a new minting of the Susan B. Anthony dollar coin by August, in part due to the shortage of this coin for vending and postal needs. Since this coin will have a minting date of 1999, it will undoubtedly be a collector's item. Prepare now to stock up, as these coins may not remain in circulation too long. In fact, Treasury estimates that the supply will be depleted by early 2000.

Yet, even more interesting is the new \$1 coin

As you begin work on your credit union's budget for 2000, keep the CUNA CFO Council in mind. Membership dues remain unchanged for 2000 and our annual conference will be held in Orlando, Florida, May 21 - 24, 2000. ♦

expected to be released in early 2000. The new \$1 coin will be distinguished by its unique golden color, and will offer a convenient alternative for vending use, tipping, school lunches, and general spending. This new coin was conceived when President Clinton signed into law the United States Dollar Coin Act of 1997, perhaps one his more magnanimous acts. Following this law, Treasury Secretary Robert E. Rubin created the Dollar Coin Design Advisory Committee, which met and reviewed 17 design concepts presented by the public at large.

The Committee selected a design that represented Sacagawea, the Native American woman whose presence was essential to the success of the Lewis and Clark expedition.

Sacagawea went on to play a critical roll in the entire expedition, all the while carrying her infant son on her back for the entire 3000 miles. Without the knowledge and fortitude of Sacagawea, many historians believe the expedition would have been a failure. Indeed, one of the reasons for selecting Sacagawea was that her story embodied the richness of the symbols and values that made our nation great - peace, hard work, honesty and commitment. In fact, if you searched the boundaries of this great nation, you would find that there are more statues of Sacagawea than any other woman. Fittingly, though almost 200 years later, this woman is honored by her three-quarter profile on the new golden colored \$1 coin. ♦

WELCOME NEW MEMBERS

The CUNA CFO Council would like to welcome our new members that joined the Council during April - August 1999.

Barbara G. Wilson, First Federal CU,
Tempe, AZ

Robert Sanders, Jr., FAA Western FCU,
Los Angeles, CA

Sherri L. Jones, Philips Electronics FCU,
Fort Wayne, IN

Donald H. Killian, Lansing Automakers
FCU, Lansing, MI

Heidi Kassab, Motor Parts FCU,
Auburn Hills, MI

Betty Moran, Hudson Valley FCU,
Poughkeepsie, NY

Scott Burgess, Safeway NW Central CU,
Beaverton, OR

Marietta J. Wahl, South Carolina FCU,
N. Charleston, SC

G. Phillip Craver, EDS EFCU,
Plano, TX

Dennis F. Murray, Tooele FCU,
Tooele, UT

Trudy L. Parks, 1st Advantage FCU,
Newport News, VA

Janet M. Bley, Pentagon FCU,
Alexandria, VA

Elaine F. McConnell, North Florida
Education CU, Tallahassee, FL

Donna Leist, Texas Dow ECU,
Lake Jackson, TX

Judy Joly, SEFCU, Albany, NY

James J. Miller, Provident Central CU,
Redwood City, CA

Helen R. Maeias, Colorado FCU,
Grand Junction, CO

Sheri Hopwood, Colorado FCU,
Grand Junction, CO

Marie E. Peet, Bay Pines FCU,
Bay Pines, FL

Natalie J. Woomer, Municipal ECU of
Baltimore, Baltimore, MD

Christine A. Decarlo, Penfield FCU,
Rochester, NY

Pat D. Force, Wood Products CU,
Eugene, OR

Jim Sikra, Norton Community CU,
San Bernardino, CA

Robert C. Trumble, Communications
Family CU, Saginaw, MI

Michael F. Calandrillo, Paragon FCU,
Westwood, NJ



SPECIAL REPORT

AN ELECTRONIC REPORT FROM THE CUNA CHIEF FINANCIAL OFFICER COUNCIL

Due to the importance of this topic in the marketplace, we are including a special report with this newsletter on Real Estate Lending and Risk Management

REAL ESTATE LENDING AND RISK MANAGEMENT

By Frank D. Vassallo, Financial Management Services, CUNA Mutual Group

NCUA's recent release of Letter No. 99-CU-12 entitled *Real Estate Lending and Balance Sheet Risk Management* has sparked a lot of discussion regarding fixed rate real estate loans as they pertain to the credit union's loan portfolio. The increase in credit union real estate loan volume in recent years has been phenomenal. From 1996-1998 alone, credit unions originated \$64.8 billion in mortgage loans. This can be attributed to a variety of factors. High consumer confidence levels, low interest rate levels, and unprecedented economic growth all lead to new building, refinancings, and first time home buyers looking for credit. It is important to understand, however, that this growth does not come without its own distinct problems, as real estate loans tend to change the appearance of an institution's balance sheet dramatically.

Characteristics of Mortgage Loans

Like other types of loans, real estate loans come with a degree of risk. Some of these risks, such as credit risk, are not new for credit unions. However, there are other types of risk that credit unions may not be used to measuring and managing. The most significant of these is interest rate risk.

Mortgage loans contain embedded options that the credit union cannot ignore when originating these types of products. The first item that credit unions must consider is the prepayment option that the borrower has. The borrower can prepay their loan at any time without penalty, and unfortunately they tend to exercise this option at the least beneficial time to the lender. As rates are falling, the borrower will exercise their option and prepay the loan, which leaves the lender with a large amount of cash

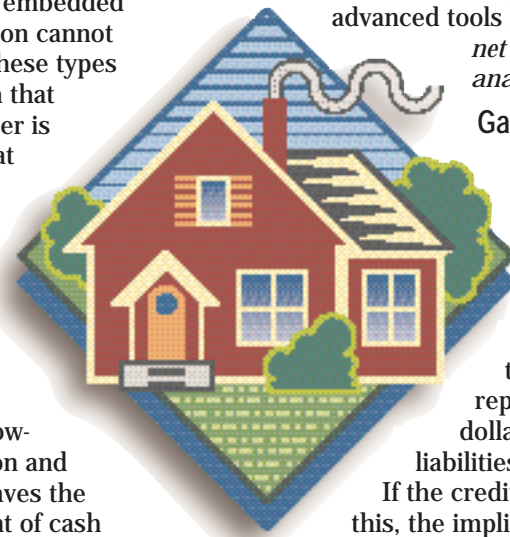
that must be re-invested at lower rates. As rates are rising, the borrower will opt not to exercise their option and they will hold the mortgage, which reduces the credit union's cash flow when rates are higher, which is exactly the time that you want to see cash come in.

Mortgage loans also have a tendency to lose their value when rates fall too much. This is known as negative convexity and can be directly attributed to the prepayment option that the borrower is holding. The traditional price/yield relationship that exists with fixed-income products is that as yields go down, prices go up, however, with mortgage loans, this does not hold true. As rates go down, the borrower has a tendency to prepay, which makes the product less desirable from a fixed-income point of view. This will place a "cap" on how high the market value of these products can actually go. This unique feature also makes risk measurement with mortgage loans more difficult than more traditional products.

Because of these characteristics, traditional interest rate risk measurements like gap analysis are not appropriate for analyzing mortgage loans, so credit unions need to move to the next level and use more advanced tools like *income simulation and net economic value (NEV) analysis*.

Gap analysis

Credit unions have traditionally relied on gap analysis to determine the degree of interest rate risk that their balance sheet contains. The goal was to match the dollar amount of repricing assets with the dollar amount of repricing liabilities in a given time period. If the credit union could accomplish this, the implication was that they were



insulated from changes in market rates because they will have an equal amount of assets and liabilities responding to the changing marketplace. Unfortunately this approach assumes that the repricing assets and liabilities will react to the market in a similar fashion. This is just not the case with mortgage loans.

Gap is not sophisticated enough to handle the complexities of mortgage lending because it does not account for option risk. Gap is a static tool that assumes a fixed stream of cash flows or fixed repricing frequencies for each rate related item on the balance sheet. This characteristic applies to most of the shorter term consumer loans that credit unions specialize in, but does not hold true for mortgage loans. The cash flows increase or decrease dramatically when rates change. This can affect the credit union dramatically, and gap simply cannot handle this type of dynamic analysis. The end result is that a credit union relying solely on gap analysis may think that they are adequately protected from interest rate risk, when in fact they may actually be over-exposed to rate movements in the marketplace.

Income Simulation

A better tool for analyzing mortgage portfolios is income simulation. This will allow you to determine what the credit union's income statement and balance sheet will look like in the future under different interest rate forecasts, more commonly referred to as rate shock analysis. It will also allow the user to get a picture of which direction important measurement tools like ROA, ROE, and equity levels are headed in the future.

If you are using an Asset Liability Management (ALM) model to perform income simulation, it should be able to accommodate changing cash flows for the real estate portfolio under different interest rate forecasts. This will overcome a big weakness of gap analysis, as it will allow the credit union to take the prepayment tendencies of mortgage related products into account when analyzing their risk profile. If your ALM tool cannot properly model the cash flows when performing the shock analysis, it is ignoring a major risk in the real estate portfolio, and will generate invalid results.

Another factor that must be considered when using income simulation models is the time horizon of the forecast. Many credit unions only perform income simulation for

one or two years, which can hide potential problems. The past two or three years have seen credit unions take on a significant amount of both mortgage loans and callable investments (which is another matter altogether). An income simulation that only looks ahead 12-24 months may not even be taking the call options into account as they may be four or five years into the future. By ignoring these options in the analysis, the user may be overlooking major sources of risk in the balance sheet. In order to accommodate for this, credit unions that are making large amounts of mortgage loans should be performing income simulation that is at least five years in length.

Net Economic Value (NEV)

In order for credit unions to more accurately assess their overall interest rate risk exposure with regards to mortgage loans, they must use more advanced tools that take the options into account. NEV can do this as it is based around the current market value of the balance sheet. Simply stated, NEV measures the market value and interest rate risk position of a credit union's capital. This is more of a solvency measure as it looks at the current market value of the credit union's assets and deducts the current market value of the credit union's liabilities. Whatever is left over is considered to be the credit union's net economic value.

The major strength of the NEV measurement is that it accounts for the options that are embedded in the mortgage loans when the calculations are performed. Market values of the assets and liabilities are calculated by taking into account all cash flows from the individual items on the balance sheet. Therefore, changes in cash flows due to prepayments and calls will be reflected when the calculations are performed. This fact alone makes the NEV analysis a more valuable tool than either the gap analysis or the net income simulation when assessing the credit union's overall risk position.

The credit union should ultimately strive to manage their risk position by this NEV figure. Major declines in the credit union's NEV under different rate forecasts can indicate a degree of weakness in the overall balance sheet.

Credit unions should also put some type of risk management policy into place with regards to NEV. This will allow them to effectively define and limit the amount of interest

rate risk that they are willing to accept. Common guidelines are to determine a degree of loss in NEV the credit union is willing to sustain under rate shocks of 100, 200, and 300 basis points up and down. This degree should be expressed as a percent of the current NEV. Absolute dollar limits will become restricting and obsolete as the credit union's asset size and capital base grow over time.

Is NEV Alone the Answer?

One thing that must be considered when performing the NEV analysis however is that it is a reflection of the current balance sheet. It provides very useful information to the management team, but the information may already be too late. The items that are creating an adverse risk profile are already part of the credit union's book of business, so the management team must be reactive to this and work to make changes in the future to correct the problems that exist.

A better approach would be to combine the income simulation and NEV analysis. The first step is for the credit union to forecast their balance sheet to a particular point in time in the future, taking into account any strategic plans that they may have. The NEV analysis should then be performed on that forecasted balance sheet. This will allow the credit union to stay proactive in their risk management as the management team can see what the potential effects of a strategic decision will be before it is implemented.

All of this analysis may seem overwhelming, but remember, real estate lending in credit unions is relatively new, and presents some additional risks that were not previously considered when managing a credit union. Because of this, these more advanced analytical tools are necessary. A good ALM program should be able to perform both the income simulation and NEV analyses. If your ALM program cannot do these types of analyses, your credit union should consider upgrading the ALM software before beginning any type of long-term fixed rate mortgage lending.

Conclusions

Mortgage Lending has become a large part of many credit unions' balance sheets. However, these types of loans contain risks that credit unions have not previously worried about due to the relatively short nature of the consumer loans that have been their core group of products for many years. The NCUA is closely looking at many credit unions as a result of this dramatic growth in real estate lending. The first reaction to this increased scrutiny may be to avoid these risks altogether. Unfortunately, if the credit union avoids risk they will incur profitability problems in the future. The solution is not to ignore these risks, but instead to make sure that you understand them and have the necessary tools in place to adequately measure and manage their impact on your overall balance sheet. ♦



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