CUNA CFO COUNCIL

NEWS

SEPTEMBER 2004

AN ELECTRONIC REPORT FROM THE CUNA CHIEF FINANCIAL OFFICER COUNCIL

MESSAGE FROM THE CHAIR

I'm pleased to report that the Tenth Annual CUNA CFO Council Conference, held in San Diego in May, set an all-time record for attendance—nearly 260 chief financial officers participated. I hope everyone had a great time, enjoyed the presentations, and took advantage of the many opportunities to network with their peers.

I'd also like to thank the many attendees who took the time to fill out surveys that dealt with compensation issues and their satisfaction with the actions of the council. A wealth of good comments was received. A gap analysis revealed the areas where improvements can be made to better meet your needs. Plans are underway to improve the structure and focus of the organization accordingly as we plan for the upcoming year.

This was the first time in the history of the annual conference that we recognized ten-year members. Five-year members also received awards. We value the commitment that these long-term members have made to the CUNA CFO Council through the years.

Christina Brown, Frank Vassallo, and I are tenured executive committee members who will be reaching their maximum terms and will need to be replaced in 2005: The election process will begin in early 2005. As part of the succession planning process we have made some rotations in officers, moving Brian McVeigh to vice chair and Mike Lord to secretary/treasurer.

It's gratifying that the CUNA CFO Council set an all-time high in August for membership, with a total of 578 members. That's up from 512 at the end of 2003, or a growth rate of more than 10% over the first eight months of 2004. Since 2001 we have grown more than any other council, adding 196 members for an increase of 51%! We are also the second largest of the six CUNA councils. Our growth is a reflection of the fact that we're the premier association in the country for credit union CFOs and continue to add value to the services we provide our members.

One of these added values is the recent decision to create a professional development subcommittee. Many of you have expressed interest in more support for professional development. We are currently writing a specific charter for this subcommittee that will clarify its role in developing products that will assist with professional development, including breakout sessions at future conferences.

Finally, please keep in mind that the Eleventh Annual CUNA CFO Council Conference and Roundtable will be held in Washington, D.C. at the Capital Hilton, May 15-18, 2005. As you create your budgets for next year, I hope that all of you will add enough to attend the conference and help us set another new attendance record. ♦

Scott M. Waite,
Sr. VP-CFO
Patelco Credit Union

Member Input Sought

Want more information on a particular topic? See something you didn't like? Have an idea for a new feature? Or would you like to contribute an article? The CFO Council Website has a Suggestion Box at *www.cunacfocouncil.org/site_suggestions.html.* Click on the link and let us know! ♦

In This Issue

ROUNDTABLE PREVIEW

A Practitioner's Guide to ALM

Asset liability management in credit unions is as important as ever, especially when it is more likely interest rates are moving up than down. Chief financial officers across the country are scurrying to make sure their ALM policies and procedures are up-to-date and practical in this relatively new environment. More recently, increased regulatory scrutiny and the debate on certain aspects of ALM, namely core deposits, have taken center stage. Many more issues are certain to arise, so it is critical for credit unions to take the necessary steps to be better prepared to manage the inherent risks of ALM.

ALM starts with a comprehensive ALM policy, which describes the composition of an Asset Liability Committee (ALCO), along with the group's required responsibilities. An ALCO typically consists of senior management, usually the CEO, CFO, and CLO. It also helps to have some board members on ALCO as well.

It is prudent to have ALCO meet on a regular basis. At TruMark we meet informally every week, and more formally once a month. Our monthly meetings generally include presentations and minutes are kept. We have found that the minutes are usually of strong interest to regulators and examiners as part of their annual review.

ALCO receives periodic reports that aid us in managing ALM. More frequent reports center on pricing and production. Monthly and quarterly reports focus on risk assessment and management.

Critical to managing the ALM process is a strong analytical model. TruMark utilizes CUNA Mutual's Model Management Program, which is a full cash flow basis forecasting and risk assessment tool. We run a rolling 12-month forecast each month, with particular focus on net interest margin and liquidity. On a quarterly basis, we provide a full assessment on net interest rate risk, with scenario analysis on net income, net interest income, and net economic value. To assist in the evaluation, we have established guidelines for each scenario and variable.

On an annual basis, we utilize an independent assessment to validate our model's assumptions. This typically involves providing key data and assumptions to the independent assessor and having them utilize their proprietary software and analysis to provide the assessment. We use the assessment's results to compare and contrast with our model's output.

Finally, it's becoming more important to document assumptions, especially as it relates to prepayment speeds and decay rates; two variables that have a dramatic impact on risk assessment. Documentation memorializes what you were thinking at a particular time about ALM, and also provides justification for your ALM practices.

We have found that having a comprehensive ALM policy, an active ALCO with board participation, a strong analytical model, relevant and timely reports, an independent assessment, and good documentation greatly assist in managing ALM. Conveying your knowledge of these crucial aspects goes a great distance to proving to your regulator and examiner that ALM is a focus of your credit union. ♦

Vince Market, CFO
TruMark Financial Credit Union

A preview of Vince's presentation for the CUNA CFO Council 2004 Regional Roundtable in Orlando on September 24.

Business Services: More than Just Loans

Credit unions taking aim at serving the member business segment may be tempted to believe that the target is difficult to miss. Yet expanding from consumer to business services is rarely as simple as it sounds. Credit unions that aim to provide business services must invest in experienced staff and monitor risk on an ongoing basis. They must also design complementary business services that are superior to the competition and still yield fair rewards for the credit union's time and resources.

The first step? Define the potential business market—first within the existing membership, and then among potential members within the overall field of membership. The Tower Group estimates that there are more than 10 million small businesses in the U.S. Given the size of this market, it's likely that a substantial number of small businesses already make up a significant portion of a credit union's potential business market.

Once a credit union decides to pursue member business services, it must assess its capabilities. Hiring experienced business staff and creating the infrastructure to support business services is crucial. Obtaining the right technology is often challenging, since credit unions' core processing vendors are still developing full-fledged business solutions.

Credit unions often begin their involvement in member business services with loan participations and gradually expand into other services. While offering loans is essential to the business market, deposit services can deliver two or more times the return of business lending. In high demand are deposit accounts, cash management services, and retirement planning.

Bank mergers often move authority for business-lending decisions to regional offices, which lead to dissatisfied customers and creates a need for local services that credit unions can fill. Long-term relationships with business members will lead to greater rewards on both sides of the relationship. ♦

Executive summary from The CFO Council white paper, "Taking Aim at Business Services."

Read this white paper and others at *www.cunacfocouncil.org/research.html*

OPERATIONS & COMPLIANCE

Core Deposits Studies

Core deposit behaviors continue to be contentious balance sheet inputs for credit unions. Many current problems, though, are largely caused by miscommunication. Exploring three issues will shed a good deal of light on the debate.

Three Types of Behavior

Three types of core-deposit behavior are relevant to balance sheet performance and risk: total balances supplied, rate paid, and retained balances.

Total balances supplied are your G/L balances. Rate paid is self-explanatory. Combining total balances supplied and rates paid produces interest expense, from which income at risk IRR arises. Total balances supplied are also an indicator of the liquidity dimensions of core deposits. This last point is more than a footnote! In my experience, after all of the IRR discussions are finished, examiners will always come back to this issue: Can you really count on core deposits to fund the credit union?

Retained balances are the aggregated balances from a set of member accounts chosen at a defined historic point and followed through time (no new accounts added). Analyzing retained balances is the only way to determine how long members keep balances in the credit union—i.e., what is the average life of a category?

Some consultants claim that reviews of total balances supplied can be used to estimate average lives. This is simply not possible because the multiple influences on total balances supplied (marketing events, seasonality, new accounts, etc.) hopelessly confound the picture. To find out how long core deposits stay in you credit union, you must study retained balances.

It's Duration, Not Average Life

Average lives are also an emotional debate point. People have strong feelings about what is "too long," despite typically having no firm frame of reference. Interestingly, average lives are only a portion of what determines NEV IRR hedging for core deposits. The other driver is repricing. The two together define duration, the change in the value of core deposits as interest rates change. Duration is what determines the ability of core deposits to support long-term assets, not average life.

An example: For most traditional credit-union core deposits, it's not uncommon to statistically estimate long average lives (and stable total balances supplied), despite a low rate paid that does not change much as interest rates fluctuate. Service and relationship, not rate paid, are driving the behavior of these categories. Valuing such categories finds long durations: they are "funding bonds" with long average life and a stable "coupon" (rate paid), with associated large swings in value as interest rates change.

Let's switch to an indexed (or quasi-indexed) type – say, high-tier MMDAs. Although it may seem counterintuitive, long average lives can be found for these categories (because you are paying a high rate paid that is floated with interest rates, why would members leave?). Valuing such categories leaves us with a pocket full of nothing – these balances will not support long-term assets. This is because while the long average life defines a long-term funding bond, the indexed repricing turns it into a variable rate one, which brings duration down to near zero values.

What Causes the Behavior?

Advanced statistical analyses of credit union core deposits often find favorable IRR-related behaviors. However, these results tend to be over-applied to core deposit balances in two major ways:

1. If the history of total balances supplied is very volatile, then you have, in fact, two types of core deposits within one category. Segment the portion of current total balances supplied that is below some measure of the lowest level of supply. Apply statistical estimates of average life duration to only these balances, treating the remaining volatile portion of the category as short-term funding.
2. If you have witnessed a large increase in core-deposit balances since early 2001, a portion of current total balances supplied may be a "surge balance." The motivations of your members in bringing you this funding (for example, stock market crash or declining interest rates) are

almost certainly different than the traditional supply reasons. Because surge balances have great uncertainty attached to them, they need to be identified and separated out in their own subcategory. Apply statistical estimates of average life duration to only traditional balances, treating the surge portion of the category as short-term funding.

Once you separate volatile and surge balances, and start thinking about duration instead of average lives, statistically estimated behavior values often look more reasonable than at first pass. These are the insights you need to build into your IRR modeling and provide your examiners when they review your work. ♦

William J. McGuire
President and CEO
McGuire Performance Solutions, Inc.
480-556-6771
info@mpsaz.com

Easing the Pain of Lost Debit Interchange Fees

S.C. Federal Credit Union projected a loss of up to $1 million — 11% of its 2003 net income — in the year since Visa and MasterCard cut the debit interchange fee as part of a settlement of a lawsuit by Wal-Mart and other retailers. Many CUs feel the same pain, made worse because non-interest income has held the industry's ROA above water for the last few years.

But S.C. Federal, of North Charleston, offset the shortfall by delving into its EFT relationships, and by increasing its debit card penetration and use.

Each network has a different pricing structure, and transactions can be routed at the merchant's discretion. Many merchants automatically route transactions through the network that charges them the smallest fee. According to Janece Van Wart, VP of electronic services for S.C. Federal, after analyzing the net interchange (the interchange fee minus the point-of-sale switch fee charged by the network) generated by the EFT networks, the credit union chose to continue its relationship with those most favorable to the credit union.

The change has helped the credit union recover much of the lost income. To further counteract the fee reduction, S.C. Federal ($991 million assets, 136,726 members) is promoting its debit cards with marketing campaigns.

This appears to be a good time to do that, as debit volume has been growing nationwide by an average of 27% for the last five years. It will continue growing at about 20% per year for the foreseeable future, according to Navigating the New Payments Landscape: What Credit Unions Need to Know, a white paper by Dove Consulting, sponsored by the CO-OP Network, the California Credit Union League, and WesCorp.

S.C. Federal has increased debit card penetration by 9% since first quarter 2003, and signature-based transactions by 18% since 2002. Van Wart attributes the debit card portfolio's solid performance to the credit union's marketing promotions, member awareness campaigns, and increased cross-selling efforts in its branches and call center.

Van Wart sees potential for further growth because 48% of the credit union's total debit cards still have four or fewer uses per month.

Visa and MasterCard increased debit interchange rates again this year, as allowed by the settlement. But the dust hasn't settled, and credit unions shouldn't expect debit interchange revenues to go back to where they were. Instead, grow card portfolios to increase debit transactions, and look for efficiencies in EFT network configurations. ♦

Judy Tharp
VP Solutions Development
Cuna Mutual Group

Find this and other stories in **Added Dimensions,** CUNA Mutual Group's weekly on-line publication at *www.cunamutual.com,* click on the "Resources" tab

Freddie Mac Alliances

The recent slowdown of refinance activity has credit unions and other lenders looking for new solutions to grow their mortgage businesses and retain members as the market begins to shift to purchase transactions. One strategy for mortgage originations would be utilizing Freddie Mac alliances, such as the Freddie Mac/CUNA Alliance, Prime Alliance, Freddie Mac's MoneyLine, Nexstar, and LenderLive. These alliances provide offerings that help with mortgage products and portfolio strategy options, including:

- Streamlined refinance options
- Construction to permanent mortgages
- Modified and converted mortgage solutions
- Seasoned mortgage sale

Branding and controlling your own consumer-based website

As interest rates gradually rise this year, mortgage portfolio strategies and sale solutions can help assess your portfolio and what you should sell into the secondary market, depending on your own market situation.

The market is constantly shifting, but mortgage portfolio risks and rewards remain all year. Various alliance portfolio options can help position your portfolio for future growth throughout the year and maximize your profitability. Visit *www.freddiemac.com/single family/cuna.html* for details on CUNA's alliance. ♦

EYE ON WASHINGTON

FASB Mergers Project Nears Proposal Stage

Since 2001, the Financial Accounting Standards Board (FASB) has been working on a business combinations project that would change the way credit unions and other mutual enterprises account for mergers on their books. The new rule, which is expected out for public comment in the fourth quarter of this year, will eliminate the pooling-of-interests method of accounting for business combinations (simple combination of the balance sheets of the merging entities), the approach used in the majority of credit union mergers. Instead, the new rule would require the use of the purchase method of accounting, meaning the fair (market) valuing of assets and liabilities of the acquired entity. The new rule would impose an additional cost burden on a credit union that undertakes a merger and would be particularly detrimental for two like-size credit unions because all of the net worth of the combined credit union would not count for purposes of Prompt Corrective Action (PCA).

FASB staff has posted a marked-up version of Statement 141 (business combinations) based on the Board's tentative decisions so far. The document has been posted on FASB's website—essentially a preview of what the formal exposure draft will look like, which will be out for public comment in the fourth quarter this year. To view the changes, read the marked-up version at *www.fasb.org/project/summary_ tent_decisions_bcpm.pdf.*

FASB will conduct interviews/field tests in late September/early October with eight mutual enterprises that have recently completed business combinations. Through CUNA CFO Council Chairman Scott Waite's direct involvement with the FASB, CUNA has nominated a credit union to be a field test subject. Several FASB and Board members will visit the credit union's premises to conduct a short interview as to how the proposed merger rule would have impacted the merger the credit union recently went through and how the new rule would likely impact future mergers. Upon the completion of the field visits, the staff will compile the results and present its findings to the Board.

More information regarding FASB's business combinations project is available at *www.cuna.org/reg_advocacy/member/hot_topic/fasb_mergersproject.html.* ♦

Catherine Orr
CUNA senior regulatory counsel

Status of the FASB Loan Participations Project

FASB is working on a project to amend Financial Accounting Statement (FAS) 140 (Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities), which sets requirements a transfer in a loan participation must meet to be considered a sale under Generally Accepted Accounting Principles (GAAP). The board is considering amending FAS 140 to disallow sales treatment for loan participations marked by rights of setoff. Instead, the transaction would be reflected on the originating credit union's financial statements as a secured borrowing. CUNA is concerned that under this type of treatment, more assets would have to be recorded on the originating credit union's financial statement, possibly triggering a need to increase net worth in order to meet prompt corrective action standards and, in the case of member business loans (MBLs), pushing the originating credit union closer to the statutory MBL cap.

In May and June, FASB held two public roundtables on this issue to gather information before issuing a proposal for public comment. In July FASB discussed information provided by participants at the roundtable discussions on legal isolation, setoff rights, and loan participations and consider the impact of this information on sale accounting under FAS 140. The Board considered four alternatives to clarify the definition of isolation in Statement 140, including alternatives that would permit transfers of financial assets that contain setoff rights to continue to be accounted for and reported as sales. Visit *www.cun.org/newsnow/04/wash081004-5.html* for more information.

At the Board meeting on August 11, FASB again discussed the loan participations project. The Board directed staff to "do yet a little more work" on the project. FASB chairman Robert Herz admitted trepidation, saying "I'm willing to have one more go to see if maybe we've got something that's better and workable – [but] I'm skeptical." It seems the immediate goal is to better articulate the characteristics of a participation that should lead to a true sale opinion and, therefore, isolation under FAS 140. Here is the link to the most recent Board deliberations: *www.fasb.org/board_meeting_minutes/08-11-04_qspe.pdf.*

FASB expects to issue for public comment proposed amendments to FAS 140 in the first quarter of 2005. More information on the loan participations project is available on CUNA's website at *www.cuna.org/reg_advocacy/member/hot_topic/fasb.html,* as well as in the project update section of FASB's website at *www/fasb.org/project/qualifying_spe.shtml*.

Catherine Orr
CUNA senior regulatory counsel

CURRENT AFFAIRS

Partnership to Promote Strategic Training

CUNA, CUNA Mutual Group, and the American Association of CU Leagues (AACUL) recently announced a new partnership to motivate and train credit unions in key strategies that will enhance growth, member satisfaction, and level of service.

The partnership will help address less-than-desirable net income levels prevalent at many credit unions. Although the nation's 9,554 credit unions ended 2003 with an average return on assets of 98 basis point (0.98%), more than half had an ROA of less than 70 basis points. Of greater concern, over one-third had an ROA of less than 40 basis points, and 1,211 had a negative ROA.

"Many credit unions today have ROA levels lower than they would like to see, and rising interest rates will only make matters worse," says CUNA president/CEO Dan Mica. "Our new partnership will leverage the respective strengths of CUNA, CUNA Mutual, and the leagues to help credit unions improve their performance."

Strategies such as cross sales, sale of lending-related ancillary products; best practices; and case studies of successful lending activities, including risk-based lending; will be presented through league and chapter meetings, related training materials, and programming. The partnership will also reach out to the CUNA Councils for input and support.

Mortgage Loan Growth Solid

In the second quarter of 2004, mortgage loan growth was at a rate of 4.4%, outpacing the first quarter's loan growth of 1%. This is attributed to a drop in mortgage rates in March. Credit unions in Callahan & Associates' First Look program grew their mortgage balances by 5.6% during the second quarter. The additional mortgage applications for March translate into more origination dollars—the primary catalyst for a 50% increase in dollar originations for first to second quarter. The loan-to-share ratio for the credit unions survey continued growing, to 74.%. For the quarter, share growth was at 2%.

Equity Ratios Remain Low

According to NCUA's report, the National CU Share Insurance Fund's equity ratio for year-end 2004 is project to be 1.25%, indicating that a dividend based on the year 2004 fund equity level is highly unlikely. A dividend can only be paid to federally insured credit unions when, at the end of the calendar year, the equity level exceeds the fund's normal operating level, which is currently set at 1.3%. So far there have been 13 credit union failures in 2004 and only 251 credit unions now have CAMEL ratings of 4 or 5. ♦

MEETINGS AND CONFERENCES

CFO Council Roundtable – Orlando

It's not to late to catch the 2004 Regional CUNA CFO Council Roundtable in Orlando, Florida. Held at the Portofino Bay Hotel at Universal Studios on **Friday, September 24,** the roundtable will feature presentations by Marvin Garland, Don Robb, Lee Noack, and Vince Market. Topics include asset liability management, utilization of capital, best practices on investment portfolios, and best practice sharing on ALM. Cost is $49 per person and council membership is not required to attend. See *www.cunacfocouncil.org* for all the details. ♦

Executive Boot Camp

CUNA CFO Council members may wish to attend the Executive Boot Camp, **October 17-20, 2004.** The camp consists of three days of high-intensity leadership training at Resort Semiahmoo in Blaine, WA. Attendees work in teams as they carry out experiential and motivational exercises geared toward change management, competitive analysis, teambuilding, and the effective use of the media.

For details, call 800-356-9655 ext. 4123 or email dverdecchia@cuna.coop. ♦

HEARD IT ON THE LISTSERV

Hot topics on the Listserv over the last month include callable agencies, new branch growth, allowance for loan loss calculation, budgeting, systems, changing from bi-weekly to bi-monthly payroll, and broker/dealer approvals. The Listserv is available on our website *(www.cunacfocouncil.org)* 24 hours a day. If you haven't yet explored the new version, it's worth a look! ♦

NEW MEMBERS

Allen Arvizu
Controller
Financial 21 Community CU
San Diego, CA

William El Birnie
VP-Financial/Risk Management
Pacific Marine CU
Camp Pendleton, CA

Donna Camp
VP-Finance
First Service CU
Houston, TX

John Carson
EVP/CFO
USE CU
San Diego, CA

George J. Charette, III
SVP/CFO
Pawtucket CU
Pawtucket, RI

Nathan Ciurzynski
Manager-Accounting
Financial 21 Community CU
San Diego, CA

Mary K. Dalfrey
VP-Finance
Apple FCU
Fairfax, VA

K. Verline Davis
President
Wyo Central FCU
Casper, WY

Syed E. Dinar, CUCE
VP/CFO
Texas Bay Area CU
Pasadena, TX

Mary Doyle
CFO/VP-Information Systems
City-County FCU
Brooklyn Center, MN

Nancy Falkenham
VP-Finance/CFO
Pacific Community CU
Fullerton, CA

Constance c. Forbes
Controller
1st Advantage FCU
Newport News, VA

Cris Garcia
VP/Controller
ILWU CU
Wilmington, CA

Jose L. Garcia
Chief Financial Officer
Illiana Financial CU
Calumet City, IL

Mark A. Harris
Chief Financial Officer
High Desert FCU
Apple Valley, CA

Brad Heap
VP-Finance
Arsenal CU
Arnold, MO

Jon R. Hehli
Chief Financial Officer
Royal Credit Union
Eau Claire, WI

Daniel Kern
Chief Executive Officer
Holy Rosary Regional CU
Rochester, NH

Jennifer E. Kutcher
Controller
Whatcom Educational CU
Bellingham, WA

Robert E. Leist
VP-Finance
Grafton Suburban CU
North Grafton, MA

Linda L. Love
Vice President/ Controller
HealthAmerica Credit Union
Jacksonville, FL

A. Scott MacKnight
Controller
Triangle CU
Nashua, NH

Tracey Madar
Manager-Accounting
FAA Eastern Region FCU
Clark, NJ

Kirk D. Mills
Chief Financial Officer
St. Louis Community CU
Saint Louis, MO

Bill Miner
VP/CFO
Lacamas Community CU
Camas, WA

Daniel J. O'Brien
SVP/CFO
Credit Union Central Falls
Central Falls, RI

Chin Ping Sun
Manager-Accounting
Dept of Commerce FCU
Washington, DC

John Pawlowski
VP-Finance/Investments
Consumers Cooperative CU
Round Lake Beach, IL

Valerie Silverman
SVP-Finance/CFO
Alliant CU
Chicago, IL

Thomas J. Pisano
Chief Financial Officer
U-Mass Five College FCU
Hadley, MA

Larry D. Wagenknecht
Controller
The Telephone CU Inc
Cleveland, OH

James W. Smart
EVP/CFO
Colorado State ECU
Denver, CO

CFO News is a web-based newsletter published bimonthly by the CUNA CFO Council. Send news and CFO Council information to Scott Waite, SVP/CFO, Patelco CU, San Francisco, CA, phone (415) 442-7158; fax (415) 442-7193 or Mike Lord, SVP/Comptroller, State Employees CU, Raleigh, NC, phone (919) 839-5084; fax (919) 839-5100.
For council membership and administration information, call Cheryl Sorenson, manager of CUNA Council Administration, at 1-800-356-9655, extension 4393 or e-mail her at csorenson@cuna.coop.