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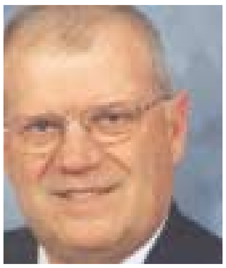
In Response to Rising Rates

JOHN FRANKLIN



SUCCESS IN any phase of life is a process, not an event. Once you attain it, you must work hard to maintain it.

Successfully managing a credit union is no exception. A year of solid growth, low delinquency, healthy loans, smooth operations, service excellence, and a strong bottom line is no assurance the next year won't bring challenges. Rising interest rates, plant closings, fraud, robbery, or natural disasters can create serious problems. When this happens, credit union leadership must start over to regain success.

A current situation concerns me. Through June 30, 2004, the 9,401 U.S. credit unions had a weighted return on assets (ROA) of 92 basis points (bp). If you eliminate the 246 credit unions with assets exceeding $500 million, the weighted average ROA for the remaining credit unions drops to 80 bp. And 5,445 credit unions have an ROA of less than 70 bp; 3,548, less than 40 bp; and 1,410, a negative ROA. These income levels are a concern, even with a weighted average capital-to-asset ratio of 10.7%.

Of more concern is the likelihood this problem will worsen. Credit unions' cost of funds was at historically low levels for nearly three years. In the past six months or so, market interest rates have climbed and likely will continue to do so.

Credit union share portfolios are heavily weighted in favor of short-term, low-cost deposits, which will reprice quickly. Loan portfolios are heavily weighted toward relatively long-term loans yielding low rates of return. As of June 30, 2004, the average net interest margin was a record low 331 bp. This margin could get even tighter as rates rise, short-term deposits quickly reprice upward, and longer-term loans reprice upward more slowly.

The result: even smaller bottom lines. Credit union leaders can't control the economy, competition, and demographic changes. Yet, these leaders will be held responsible for the credit union's performance and for leading it back to acceptable profitability.

Credit union leadership can reshape asset and liability portfolios over time and maximize noninterest revenues. On the asset side, changing the mix of the loan portfolio and maximizing revenues from ancillary, loan-related products and services can provide relief from problems associated with a declining interest margin.

Mid-2004, credit unions had:

▶ **32%** of loans in first mortgages. Most are fixed rate and will reprice slowly;

▶ **14%** in home equity loans and second mortgages. Many are at variable rates and will reprice fairly quickly;

▶ **About 38%** in new- and used-auto loans. These will reprice during the next few years but at generally low rates due to competition; and

▶ **Only 10%** in unsecured loans, including credit cards.

To reshape your loan portfolio, instill an aggressive marketing and training effort to make more unsecured debt, which carries higher interest margins than secured debt. Specifically:

▶ **Implement** a risk-based lending program. Credit unions can make more loans and achieve a higher yield even after accounting for any increased losses.

▶ **Adopt** a rate-change model that quickly reacts to Federal Reserve and competitive rate-change increases.

▶ **Consider** a lending incentive program rewarding staff for making "second" loans to members applying for a loan.

▶ **Create** a sales culture to cross-sell credit union products and ancillary products such as credit insurance.

From an interest margin standpoint, share drafts are a low-cost source of funds. Some successful share draft programs pay no dividend on the basic share account and don't charge basic fees. Material revenues from fees and check sales are natural byproducts of share drafts, which are an effective segue to cross-sell other products and services.

Working together, management, board, and staff can weather rapid rate increases. Like most things worth doing, it'll take time and hard work.

JOHN FRANKLIN *is executive vice president and chief operating officer for the Credit Union National Association. Contact him at 608-231-4266 or at* jfranklin@cuna.com.

Editor's note: *Project LEAP is a CUNA initiative to enhance credit union operations by focusing educational and informational products and programs on three critical success factors: consumer loan growth, asset/liability management, and sales and service cultures. The initiative is supported by CUNA Mutual Group and the American Association of Credit Union Leagues.*