

ARIZONA CREDIT UNION LEAGUE & AFFILIATES

2009

ALM, Investments, and the Credit Union Industry

Understanding ALM Strategies to address the current environment and prepare for a better future

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Arizona Credit Union League & Affiliates

CUNA Credit Union National Association

Agenda

- Economic Environment
- Investments
- Setting Your Risk Tolerance
- Risk versus Reward

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What Happened?

- "The Catch": Long Period of Growth/Stability...
- Strong Credit Environment
- Global Growth & Wealth Creation
- Easy Money
- ... Led to Super-Sized Leverage
- "The Storm": Systems Converged
- Slowing Economy & Housing Market
- FASB/SEC -Fair Value Accounting
- Liquidity Crunch
- Loss of Confidence



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Ramifications of Being WRONG are HUGE

- Financial
 - Ineffective ALCO / Risk Management
 - Bad decisions / pool financial performance
 - Restatements
 - Credit downgrades
- Regulatory
 - Prescriptive / one size fits all
 - Over regulation



Risk versus Reward

“There are risks and costs to any program of action. But those risks are far less than the long range risks and costs of comfortable inaction.”

John F. Kennedy

“Risk comes from not knowing what you’re doing”

Warren Buffett



Risk versus Reward

“Yesterday's failures are today's seeds That must be diligently planted to be able to abundantly harvest tomorrow's success.”

Navigating Through the Current Environment
Requires...

...not letting greed overcome fear!

Hope is not a strategy



Projections

- This cycle will end.....the credit union industry will survive
- Increased Regulation and Supervision
- Increased Capital Requirements
- Increased Cost of Liquidity
- Increased Cost of Capital
- Consolidations



Projections

- Great Opportunities for Credit Unions that have
 - Strong Capital
 - Good Liquidity
 - The RIGHT PEOPLE



What to Do

- Determine Your Risk Tolerance
- Build Your Team
- Price Risk Appropriately
- Build Slow, But Don't Get in and out of the Game!!
- Educate.....Educate.....Educate.....




Interest Rate Risk

- Did you know that:
 - There are financial institutions that have failed just months after having positive earnings.
 - Two main ALM tests to ensure financial stability
 - Net Interest Income Simulation
 - Net Economic Value Analysis

BOTH ARE IMPORTANT

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What is Your Interest Rate Risk Tolerance?

LOW

MODERATE

HIGH

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Your Interest Rate Risk


↓

LOW

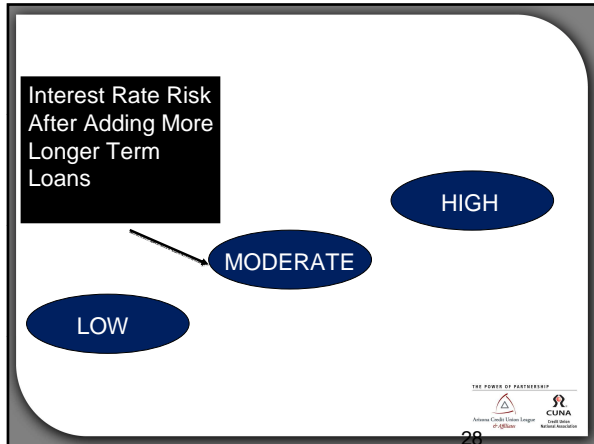
MODERATE

HIGH

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Interest Rate Risk

- Modeling of additional loans shows that the credit union moves to the “moderate” interest rate risk category from “low” and ROA is enhanced by 20 basis points.
- Is this within your risk tolerance?
- If yes, then IT IS OK!!
- If no, then you might need to lower your ROA goals for your CEO.

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Loan Pricing DISCIPLINE

- Wider Credit Spreads – PERIOD
- Lenders Market – set the tone
- DO YOUR HOMEWORK


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- Lending
 - According to 2006 Experian figures, the average rate for a credit union auto loan was 8.12%. In comparison, banks averaged 9.89% a 1.77% difference.

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- Indirect Lending
 - Many financial institutions are earning negative yields and don't even know it!!
 - Dealer fees can grossly impact yields

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Loan Analysis

| Loan Type | Spread to FHLB Offering Rates |
|------------|-------------------------------|
| New Auto P | -1.17% |
| New Auto A | -1.39% |
| New Auto B | 0.29% |
| New Auto C | 3.14% |

| | |
|--------------------|--------|
| Coupon | 7.56% |
| Fees | 6.59% |
| Servicing | 5.97% |
| Delinquency | 5.32% |
| Actual Losses | 5.14% |
| Projected Losses | 3.82% |
| Spread to the FHLB | -0.25% |

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Leverage Opportunities Embedding a Cap in a Borrowing Structure

- A Cap is a derivative which protects the buyer from interest rates rising. A Cap's payout is based upon the strike of the Cap (a rate agreed upon at the inception of the agreement, i.e., 4.0%) relative to an underlying index. If the underlying index exceeds the Cap strike, the buyer of a Cap receives a payment equal to the index minus the Cap strike rate times the notional amount of the Cap.

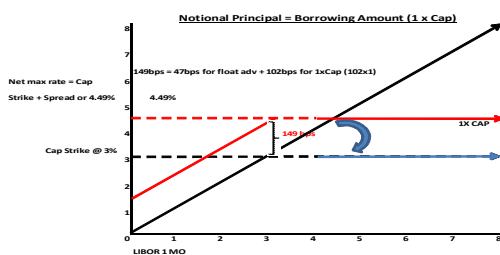


Embedding a Cap in a Borrowing Structure

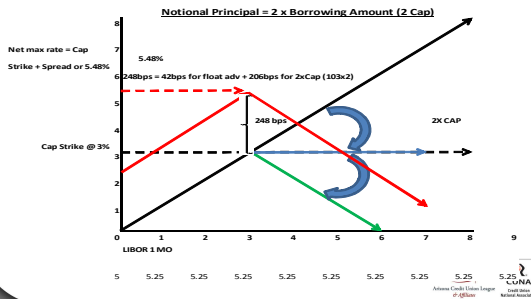
- The following is an example:
- Cap Strike = 4.0%
- Index Rate = 3.5%
- Borrowing Amount = \$10,000,000
- Cap Notional Amount = \$10,000,000
- Cap Cost = 100bps or 1%
- Cap Payout = $(5.5\% - 4.0\%) = 1.5\% \times \$10,000,000 = \$150,000$
- Borrowing Rate = $(5.5\% + 1.0\% - 1.5\%) = 5.0\%$



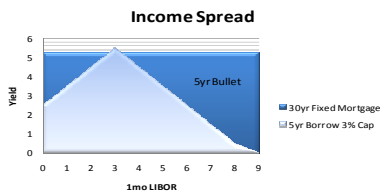
Embedding a Cap in a Borrowing Structure



Embedding a Cap in a Borrowing Structure



Embedding a Cap in a Borrowing Structure



Proactive Balance Sheet Management

- Decrease Risk
- Take on Risk to add income
- Determine effect of different strategies
 - Adding loans
 - CD specials, etc.

Risk Reduction Strategies

- Assets
 - Adjust Investment Portfolio – shorten duration
 - Sell Mortgage Loans
- Liabilities
 - Certificate Promotion – attract longer term funding to offset asset duration
 - Hedge – borrow longer term funding to offset asset duration



Conclusion

- This Cycle Will End
- Great Opportunity for Some Credit Unions
- Build Your Team
- Educate.....Educate.....Educate....