

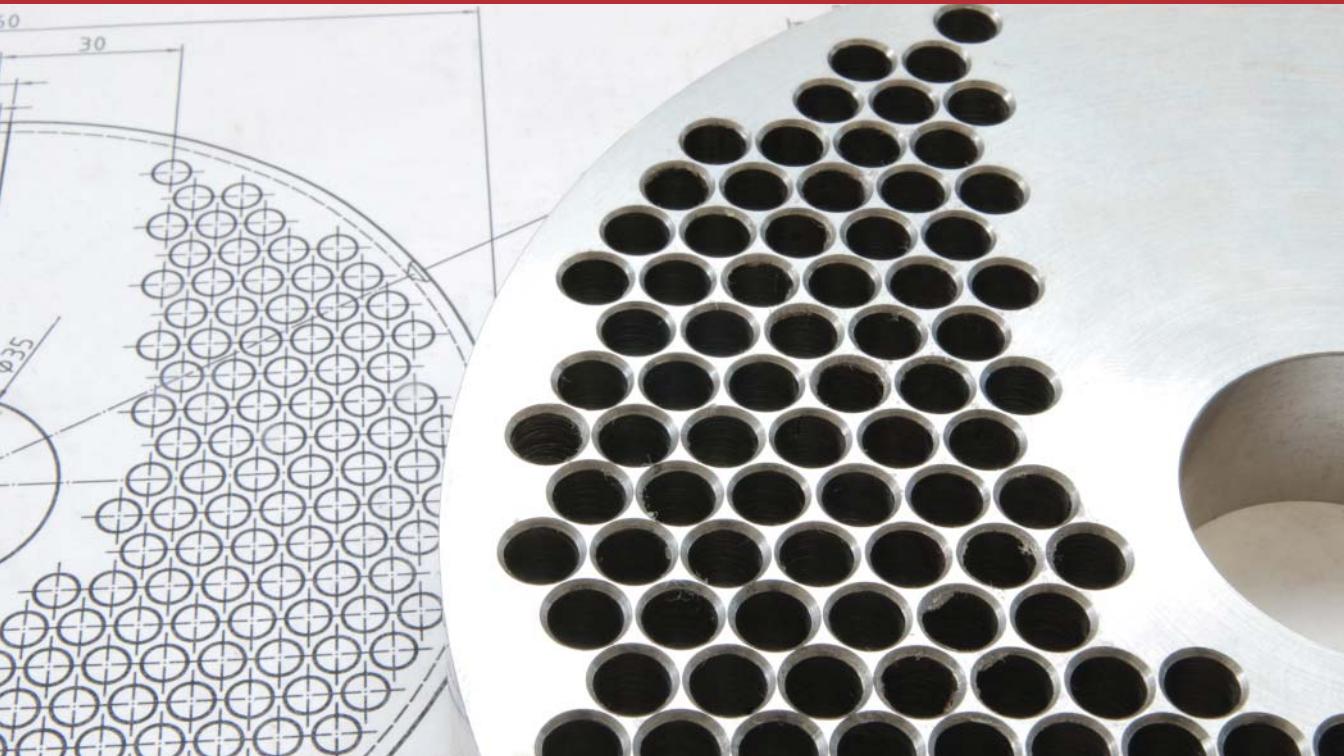
Credit Union Strategic Growth and Budgeting

Mike Higgins, Jr.

Partner, Mike Higgins & Associates

filene

RESEARCH INSTITUTE





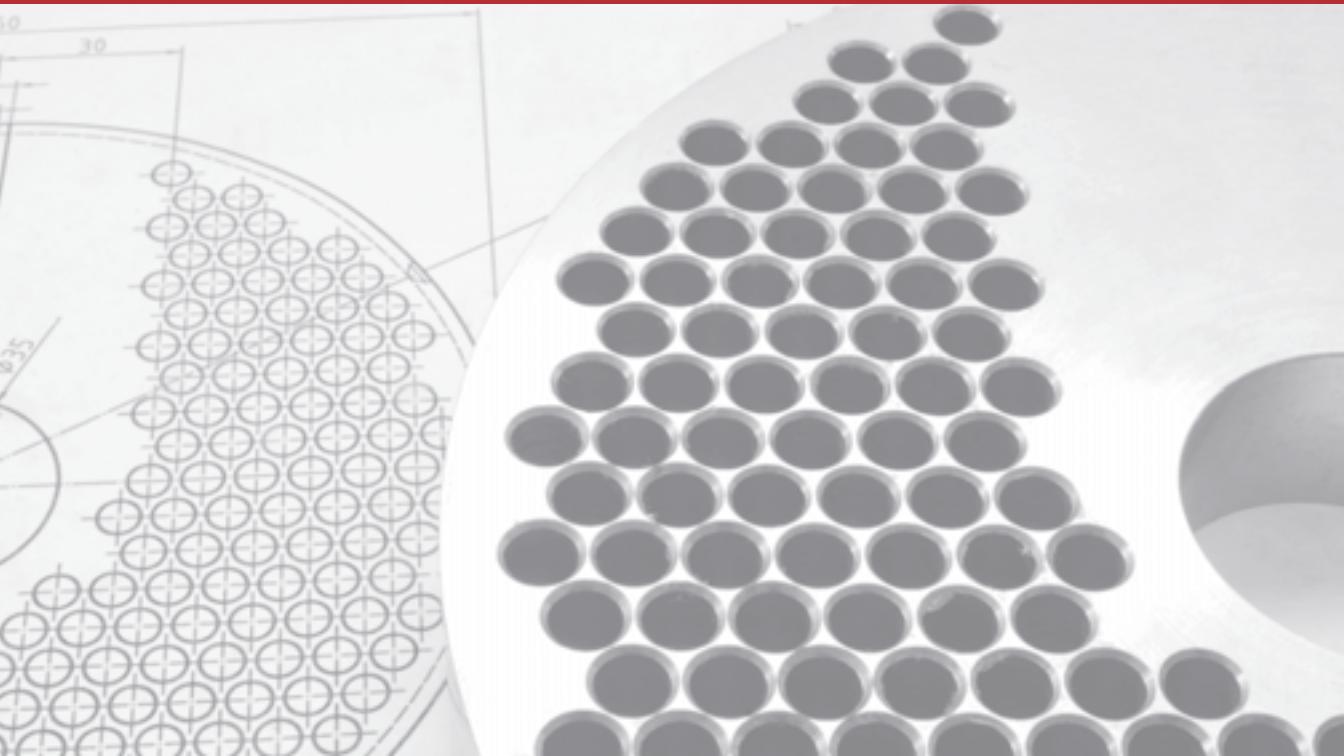
Credit Union Strategic Growth and Budgeting

Mike Higgins, Jr.

Partner, Mike Higgins & Associates

filene

RESEARCH INSTITUTE





Progress is the constant replacing of the best there is with something still better!

— ***Edward A. Filene***

Deeply embedded in the credit union tradition is an ongoing search for better ways to understand and serve credit union members. Open inquiry, the free flow of ideas, and debate are essential parts of the true democratic process.

The Filene Research Institute is a 501(c)(3) not-for-profit research organization dedicated to scientific and thoughtful analysis about issues affecting the future of consumer finance. Through independent research and innovation programs the Institute examines issues vital to the future of credit unions.

Ideas grow through thoughtful and scientific analysis of top-priority consumer, public policy, and credit union competitive issues. Researchers are given considerable latitude in their exploration and studies of these high-priority issues.

The Institute is governed by an Administrative Board made up of the credit union industry's top leaders. Research topics and priorities are set by the Research Council, a select group of credit union CEOs, and the Filene Research Fellows, a blue ribbon panel of academic experts. Innovation programs are developed in part by Filene i³, an assembly of credit union executives screened for entrepreneurial competencies.

The name of the Institute honors Edward A. Filene, the “father of the US credit union movement.” Filene was an innovative leader who relied on insightful research and analysis when encouraging credit union development.

Since its founding in 1989, the Institute has worked with over one hundred academic institutions and published hundreds of research studies. The entire research library is available online at www.filene.org.

During our journey through life, there are a number of people who provide insight, perspective, and opportunity that ultimately influence who we become and what we make out of our career. I would like to recognize and thank the following:

- Dr. F. Neil Baker, Nebraska Wesleyan University, who first introduced me to the world of finance and taught me how to convert indiscriminate data into practical information for decision making and enterprise management.
- Dr. Dennis F. Karney, University of Kansas School of Business, who introduced me to the “14 Principles” of W. Edwards Deming and the concept of continuous process improvement.
- Dr. Steve Hilmer, University of Kansas School of Business, who constantly reinforced “understand the process, understand the process, understand the process; don’t cure the symptoms, find and fix the root problem.”
- Deloitte Consulting, where I learned how to apply academic concepts in the results-driven world of business. Not a day goes by that I don’t leverage my years of consulting experience gained while working there.
- The Filene Research Institute for providing me with a forum to share my knowledge obtained over the last 19 years with others (and for making my writing skills appear much better than they really are).

	Executive Summary and Commentary	vi
	About the Author	viii
	Introduction	ix
Chapter 1	What Matters and How a Credit Union Really Operates	1
Chapter 2	Things Your Financial Statements Don't Tell You	22
Chapter 3	An Incremental Approach to Managing Performance	46
Chapter 4	Conclusion	53

by Ben Rogers,
Research Director

“Net income ROA is a worthless measure,” writes researcher Mike Higgins in this report. And that’s not the only sacred cow that comes under fire. Interest rates are just noise, he adds. And if that’s not enough, try this: “The number most important to your ongoing existence is not even reported on your income statement.” From the first page, you’ll realize this is not just a warmed-over analysis of credit union strategy or budgeting. Higgins is on to something.

The bombs are all well aimed. He attacks the outdated way credit union boards think about ROA (return on assets) targets and the budgeting hoops that managers (often willingly) jump through to reach them. Growth is good, but the *type* of asset growth is what matters most. Credit unions must focus on responsible revenue growth to compensate for the inevitable creep of operating expenses. Staying ahead of that gap is the only way a credit union can hope to be profitable and sustainable and to flourish in the long run.

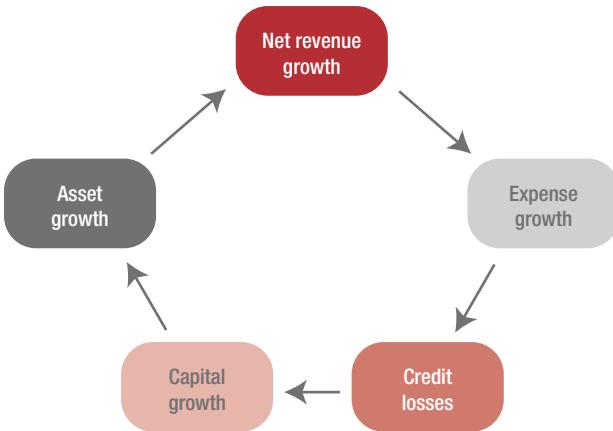
What Is the Research About?

This research grew out of the frustrations Filene has heard from credit unions that, too often, strategic budgeting is anything but strategic and instead hews painfully to processes of last year. But breaking old habits is hard, and the pull of regulatory accounting, with its emphasis on net income ROA, is strong. So any research that reframes the question must be thorough.

Higgins’s analysis is that. Among the most trenchant analyses are:

- **Operating expenses do not equal member service.** When the operating expense ratio gets smaller, members are being served more efficiently; when it grows, members are being served less efficiently.
- **Noninterest income should be a strategic priority.** Because noninterest income is not asset dependent and exerts no pull on capital, it is pure oxygen to the credit union. You should not, of course, maximize it ruthlessly, but it keeps credit unions buoyant without constraining growth.
- **Measuring a product’s “marginal contribution” is more important than cost accounting.** In rank order, noninterest income has the highest marginal contribution, followed by loans, regular and draft shares, money markets, and certificates.
- **Product diversification (not just rate changes) can improve net interest margins.** Net interest margin is the combination of interest rates and product mix. A considered move away from low-margin accounts like certificates toward more profitable,

Figure 1: The Circle of Life



longer-duration accounts like share drafts will improve margins.

Some of these points may not be groundbreaking individually, but taken together they represent a promising shift toward more rigorous budgeting and more realistic planning.

What Are the Credit Union Implications?

Strategic budgeting sessions are often either disappointing or unrealistic, and they are often both. That's not because of a dearth of good intentions from the board or a lack of budgeting expertise from managers. They are often disappointing because they work from

a dangerous initial premise: The credit union ought to earn what it used to earn. Credit unions that break free from this historical loop are on the path to improvement.

As with several recent Filene reports, this one preaches the value of measuring and managing to return on equity (ROE), because it is a much better indicator of sustainable growth than ROA, which is subject to the whims of a shifty denominator (total assets). ROE, on the other hand, can only improve with disciplined management of operational expenses, superior underwriting, and, most important, a focus on top-line revenue growth. None of these need come at the expense of the credit union's members. To the contrary, done correctly, each aspect represents a deepening commitment to serve all members well.

The author may take aim at sacred cows, but he does so with sound logic and a model that individual credit unions can use to turn the strategic budgeting process from the same-old into an exercise that promotes realistic goals and good strategic thinking.



Mike Higgins, Jr.

Mike Higgins, Jr., is a partner in the firm of Mike Higgins & Associates (MHA). His consultants work with clients in the financial services industry. His primary areas of focus are performance management, compensation, and strategy. Mike's firm works with executive management teams and board members to develop a balanced scorecard of objectives and then creates a self-funding compensation plan relative to actual value created for members or stockholders.

Since 1998, Mike has worked with over 300 community-sized credit unions and banks. Mike has presented his contemporary approach to managing performance to numerous state and national associations. He coauthored the book *Performance Compensation for Stakeholders: 14 Prerequisites for Success*.

Prior to joining MHA, Mike was a consultant at Deloitte. His areas of focus were business process design and information technology. During his tenure at Deloitte, Mike worked with clients in the financial services, retail, manufacturing, logistics, aerospace and defense, and state government sectors.

Mike received an MBA from the University of Kansas and an undergraduate degree in finance from Nebraska Wesleyan University (NWU). While at NWU, Mike was an Academic All-American and was inducted into the NWU Athletic Hall of Fame.

He can be contacted at the following address:

Mike Higgins & Associates, Inc.
8080 Ward Parkway, Suite 100
Kansas City, MO 64114
mhigginsjr@mhastakeholders.com

The indicator of a successful executive team is *not* the return on assets (ROA) it produces. The indicator of a successful executive team is its ability to do two things:

- Identify change as it is occurring.
- Direct incremental improvement in performance within the organization in order to *achieve* and *sustain* competitive advantage.

An executive team that cannot identify change and direct incremental improvement cannot influence the outcome of its organization; that is a very dangerous proposition, indeed.

To better equip management teams to be successful, this report will address three specific areas:

- A baseline of knowledge: What matters and how a credit union really operates.
- How to monitor change: Things your financial statements don't tell you.
- What to do about it: An incremental approach to managing performance.

The Parable of the Boiling Frog

Picture a pot of water on a stovetop, hot to the touch. Now imagine placing a live, healthy frog in the heated water. No surprise—the frog, recognizing the immediate danger and the threat to its survival, leaps out of the pot.

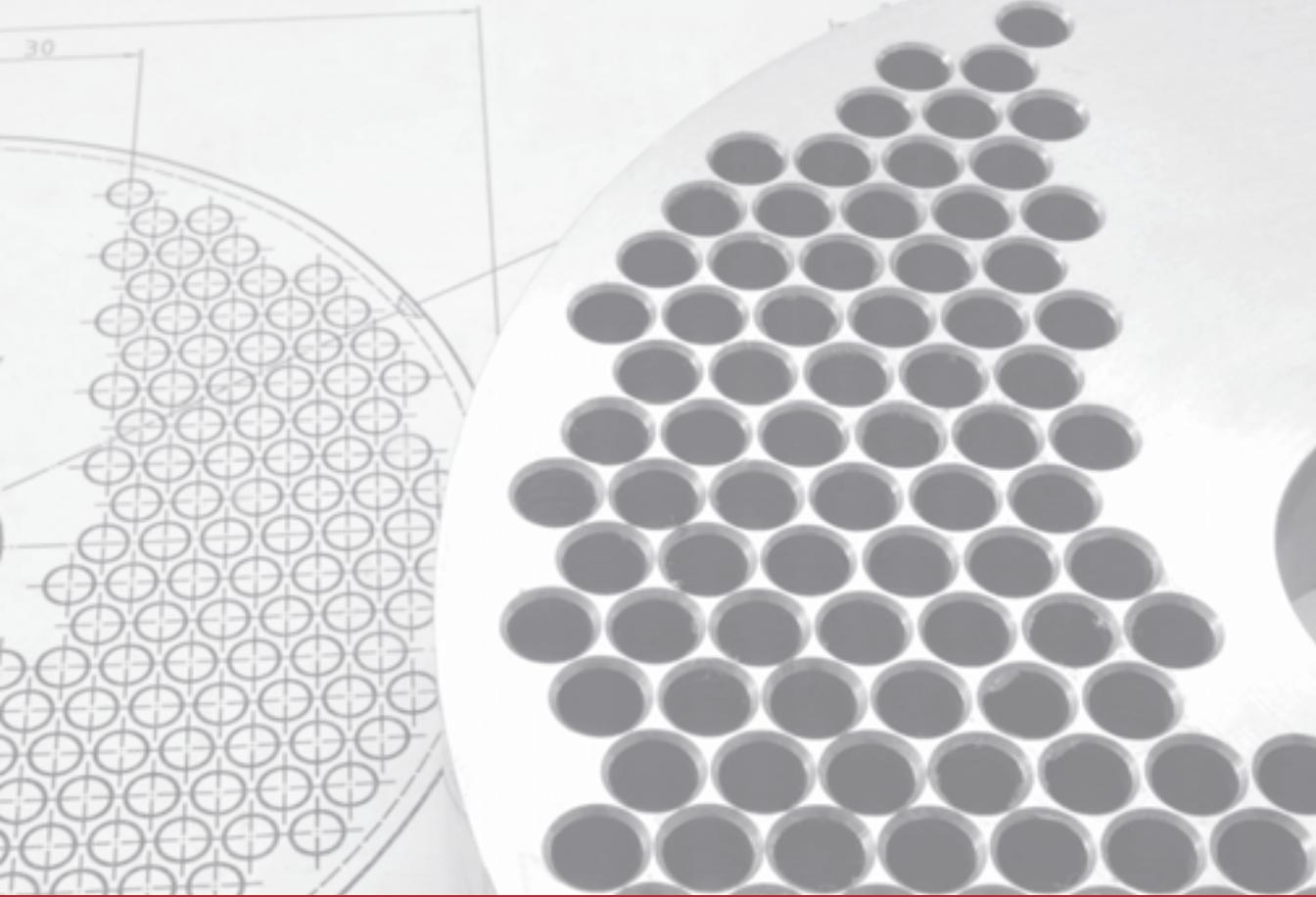
Now, imagine placing a similar frog into a pot of room-temperature water. Let the frog settle in. Then, very gradually, start turning up the heat, starting from a very low temperature setting. Feeling complacent and comfortable, the frog won't realize the water is gradually getting hotter. It gets more and more groggy, less and less conscious, and it is unaware of the impending threat to its survival until it is too late; it dies.

While not quite scientific, the parable is useful. Do you ever wonder why the financial services industry is so regulated and becoming ever more so? There are a number of reasons. At or near the top of the list is risk mitigation—in other words, to make sure organizations do not fail or engage in excessive amounts of risk that will harm consumers. So much focus is put on failure that little attention is directed to success. I would argue that the fastest path to risk mitigation is building a safe, sound, and successful operation. A well-run entity does not have to engage in elevated levels of risk, because it is not desperate for survival.

In addition, because credit unions are not investor owned, demands for *excessive* rates of return (greed) are kept in check. It's not that profit (surplus) does not matter; it does matter. Regardless of tax status, all organizations must generate a rate of return large enough to support their ongoing existence.

Much like the parable of the boiling frog, a number of factors prevent credit unions from being successful because the management team and board of directors are not aware of them until it is too late. At that point, damage occurs that members end up paying for directly, or worse, the credit union fails. Charge-offs don't cause the credit union to fail. Credit losses are the straw that breaks the camel's back. The inability to replenish capital due to credit losses is what ultimately leads to failure.

In this report, we will look at a series of items that management teams and board members not only must understand but must be constantly aware of and *proactively* manage; if these items are *reactively* managed, it will be too late, and the damage will already be done. We will then take theory and turn it into practice. A process of continuous strategic budgeting will be presented that focuses on *incremental* changes in performance (in other words, keeping the heat turned down on the pot of water).

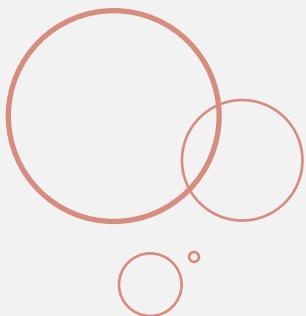


CHAPTER 1

What Matters and How a Credit Union Really Operates



Using the bottom line as a benchmark for success or as a tool for evaluating performance demonstrates ignorance, shortsightedness, and lack of general business acumen. The bottom line is not the bottom line.





The Bottom Line Is Not the Bottom Line

A credit union does not operate like a mom-and-pop soda shop; rather, it is a complex entity. At the strategic level are five primary functions contained within three separate areas:

- Day-to-day operations.
 - Retail (loans, deposits, noninterest income, and retail expense).
 - Service and support (back-office and overhead expense).
 - Interest rate management and investment portfolio management.
- Credit administration.
 - Underwriting policy/standards and credit losses.
- Noise.
 - Extraordinary and/or nonoperating income and expense.

If you draw conclusions by looking at the bottom line, you have no basis for understanding how well each function is performing. For example:

- A credit union is failing in retail operations, service and support, interest rate management, *and* credit risk mitigation, but because of a huge windfall (gain on disposition of assets, gain on sale of securities, etc.), all of the sudden it looks like the management team is doing a great job running the credit union. Furthermore, based on the bottom line, it looks like the organization is poised for a long-term run of success.
- Retail did a very good job over the course of the year. It was able to grow draft and regular shares by 15% (picking up market share in the process) without sacrificing rate (currently 0.25%). Loan demand is very weak. Retail did a great job by replacing loans

paid off but could not grow loan balance. Because the overnight rate on investments (0.15%) is less than the cost of draft and regular shares, the credit union made less money than the year before. A bottom-line assessment would lead one to conclude that the management team is floundering, despite the acquisition of strategic, high-value members.

- Retail operations managed to grow low-cost shares by 10% and noninterest income by 15%. Service and back-office support identified \$500,000 of cost savings that were fully realized. Because of some hedging and foresight, interest rate management has slowed the rate of deterioration in the investment portfolio dramatically without incurring increased risk. However, because numerous loans made years ago were charged off during the current year, the credit union lost money. Using a bottom-line assessment, one would assume the management team did a horrible job in the current year.

In these examples, a bottom-line assessment leads to conclusions that could not be further from the truth. The only way to understand a credit union is to understand its parts. An overall assessment of performance can be made only after an assessment of the parts is done.

Lastly, here is my favorite example of ineptitude as a result of bottom-line focus:

In the good old days, the credit union used to make an ROA of X%. We no longer make that ROA. I just can't understand why [first sign of ineptitude]. In the upcoming budget, we should plan on making what we used to make [second sign of ineptitude].

The good old days are irrelevant. The shape and slope of the yield curve was different. National Credit Union Administration (NCUA) assessments did not exist. Deposit/share insurance cost less. Compliance costs were lower. Loan loss reserve requirements were lower. Credit unions did not compete with banks as aggressively as they do today. Just because you “used to” make an ROA in a certain range in days of yore does not mean it is tactically possible to return to those days in the next 12 months.

Does it mean you should accept mediocrity? Absolutely not!

Credit union members are not second-class citizens; the management team of a credit union should not be allowed to hold itself accountable to second-class standards. However, budget suggestions from left field and potshots about days long past demonstrate lack of awareness, and that borders on negligence.

Death and Taxes

Death and taxes are the only two things you can count on in life. And credit losses and increases in operating expense are the only two things you can count on in credit unions.

The first thing one must recognize is that almost all costs in a credit union are downward fixed (i.e., they go up, but they rarely go down).

Personnel costs, about 50% of total operating expenses, are downward fixed. When was the last time you asked people to take a pay cut? If you did, how well was it received, and what did it do for morale? If they took a cut, did benefits expense also decrease?

Premise expense, about 27% of total operating expenses, is also downward fixed. When was the last time your utility bills, insurance premiums, property taxes, or lease payment actually declined?

A significant amount of all other expenses, about 23% of total operating expenses, is downward fixed too. Furthermore, if you eliminate all discretionary spending, then 100% of other operating expenses is downward fixed.

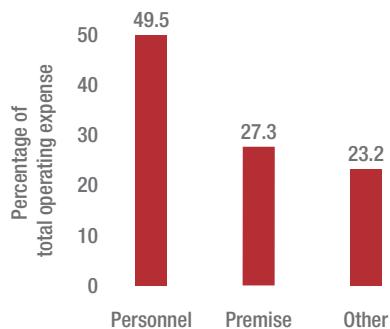
Regardless of minor differences among credit unions, it is safe to say that somewhere between 85% and 95% of all expenses in the credit union are downward fixed.

In the past decade, credit union operating costs have escalated at an average rate of about 6.9% per year. Do you know the rate of expense escalation (cost to serve members) in your credit union over the past 1, 5, and 10 years? If not, then like the frog, you are unaware of the change simmering in your organization.

Prior to the real estate crisis that struck in earnest in 2008, the average rate of credit losses was about 0.50% of loans. Since that time, credit unions have suffered severe losses. In fact, in both 2009 and 2010, the dollar amount of net charge-offs exceeded the dollar amount of net income for the industry as a whole.

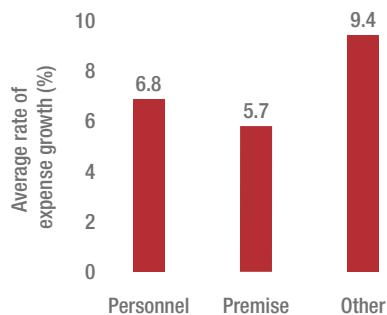
Operating expenses and credit losses deplete capital. For this reason alone, credit unions *must* produce income in excess of expenses and credit losses in order to survive to serve their members and provide job security to the employees who serve them.

Figure 2: Operating Expense Breakout



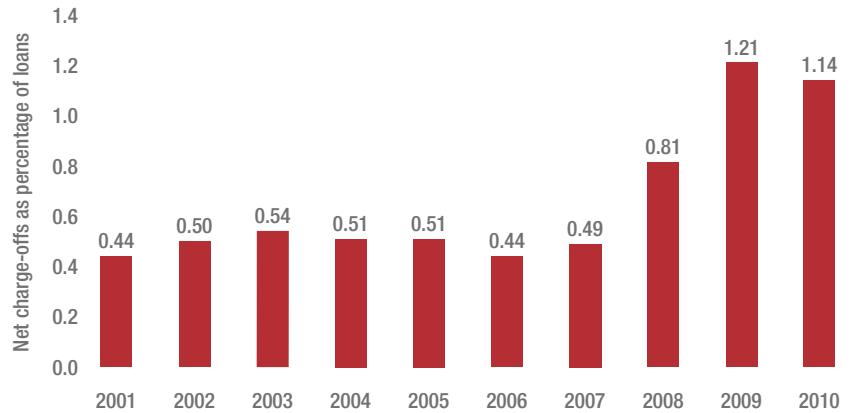
Source: NCUA 5300 Data 2001–2010.

Figure 3: Annual Operating Expense Growth Rate



Source: NCUA 5300 Data 2001–2010.

Figure 4: Annual Net Charge-Offs (% Loan Balance)



Source: NCUA 5300 Data 2001–2010.

Death, Taxes, and Capital

In most industries, the cure-all for inadequate profits is more sales. In the credit union system, however, there is a cap on how much asset-based sales you are allowed to have. It's the limitation of your capital. It can literally prevent you from being able to grow your way out of your problems.

All credit unions have a hard cap on how large they can become. The hard cap is the minimum capital ratio your regulator will allow you to maintain.

The harsh reality of operating in this industry is that about 70% of total net revenue comes from asset-based, capital-*dependent* sources (net interest income), and 30% comes from non-asset-based, capital-*independent* sources (noninterest income). One could argue that an even *larger* percentage of income comes from asset-based sources because transaction accounts and loans drive a significant amount of noninterest income.

Bottom line: Assets drive net revenue. If assets don't grow, net revenue does not grow.

Axiom of Growth

The axiom of growth states that if capital grows by some percentage, assets can grow by up to that same percentage without depleting the capital ratio. For example:

- If capital grows 5% and assets grow 5%, the capital ratio is maintained.
- If capital grows 3% and assets grow 5%, the capital ratio is depleted.
- If capital grows 5% and assets grow 3%, the capital ratio is accreted.

Axiom of Death

If you are currently at your minimum capital ratio and need to grow assets by 5% to offset increases in operating expenses and credit losses, but the income produced does not grow capital by 5%, you are dead. You cannot grow your way out of your problems.

This is why measuring return on equity (ROE) is so important for a credit union. ROE is the axiom of growth. If ROE is 5% and asset growth is 5% or less, then the capital ratio is maintained or accreted. If ROE is 3% and asset growth is 5%, then the capital ratio is depleted.

Do you know the ROE in your credit union? Is it adequate to fuel the asset growth that is necessary to offset increases in operating expenses and credit losses? If not, then like the frog, you are unaware of the change occurring in your organization.

Capital Constraint Chart

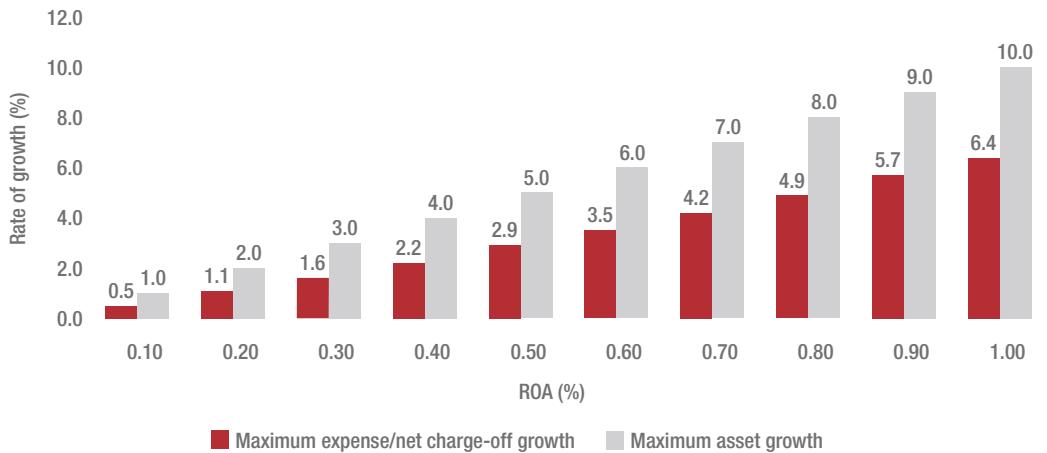
The capital constraint chart in Figure 5 illustrates the concept of the limitation on asset growth using a target capital-to-assets ratio of 10% and a net revenue ROA of 4.50% (both industry averages).

ROA produced by the credit union is on the horizontal axis. Rate of growth is on the vertical axis. On the chart are plots for maximum annual increases in operating expenses/net charge-offs and asset growth.

An example will help explain the chart. Let's look at a credit union that produces 0.80% ROA on the horizontal axis.

- If this credit union incurred an operating expense and credit loss growth of 4.9%, it would need to grow assets by 8.0% to offset those increases and sustain its current capital ratio of 10%.
- If this credit union planned for only 3.5% operating expense and credit loss growth, it would have ample capacity to grow assets to

Figure 5: Capital Constraint Chart at 10% Capital Ratio



offset the increases because the 3.5% growth rate is less than the 4.9% maximum allowed. It would be able to accrete capital.

- If this credit union planned for 6.5% operating expense and credit loss growth, it would not have the capacity to grow assets to offset the increases, because the 6.5% growth rate is more than the 4.9% maximum allowed. Growth in assets beyond 8.0% would start to deplete the capital ratio. The only way it could cover the increase in expenses and credit losses and not deplete capital would be to generate some of the income required from non-asset-based (capital independent) revenue sources.

Things get very difficult for the low-ROA credit unions along the left side of the horizontal axis. Asset growth is constrained because the low ROA does not accrete much capital. In turn, this limits the amount of annual increases in operating expenses and credit losses that can be incurred.

Because they are constrained on asset growth, the only way credit unions along the left side of the axis can survive is by some combination of the following:

- Minimal increases in annual operating expense.
- Minimal levels of credit losses.
- Improvement in asset and liability mix without growing assets.
- More profitable interest rates (higher asset yields and/or lower funding rates).

Conversely, credit unions on the right-hand side of the horizontal axis pretty much get to do whatever they want. They are not

constrained. They have the capacity to invest in people, facilities, technology, etc., should they so desire. They are at a clear, competitive advantage.

The Circle of Life (or Spiral of Death)

Like the predictability of the change in seasons, so goes the circle of life in a credit union.

The circle of life starts with net revenue growth.

Net revenue growth is necessary because . . .

Operating expenses grow every year, and . . .

Credit losses occur every year, and . . .

Capital must grow every year to allow for asset growth because . . .

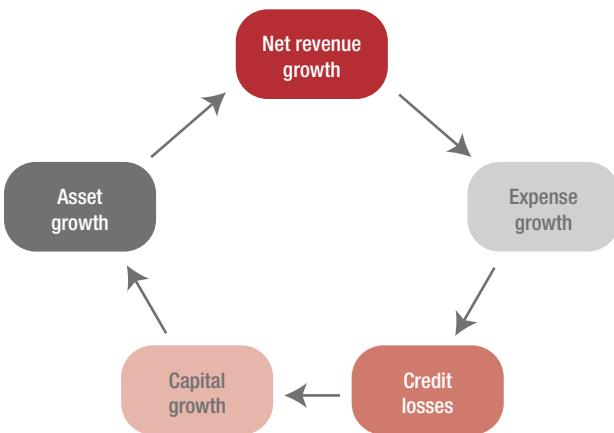
Assets drive a majority of a credit union's net revenue, and . . .

If assets don't grow, then net revenue does not grow. Net revenue growth is required because . . .

The cycle of operating expense growth and credit losses never ceases.

Net revenue is the "engine" that drives the ongoing existence of the credit union. The more powerful the engine, the less effort needed to keep the credit union moving along. The less powerful the engine, the more effort needed (or the lighter the load must be) to keep the credit union moving along.

Figure 6: The Circle of Life



The Top Line Is the New Bottom Line

The number most important to your ongoing existence is not even reported on your income statement.

All businesses, no matter how big or how small, whether motivated by profit or not, regardless of industry focus or business model, *are all exactly the same*. Their ongoing existence is determined by the difference between their revenues and expenses. Credit unions are not exempt from this reality.

Let's take a moment to recap:

- Credit union operating expenses, which are downward fixed, increase at a rate of about 6.9% every year.

- Net charge-offs are a fact of life; they average about 0.50% of loan balance in “normal” times. In the last decade, loan balance has grown at a rate of about 6.5% per year. Therefore, if loans are growing by 6.5% per year in periods of *normal* credit losses, net charge-offs are growing by 6.5% per year as well.
- Organizations that incur more expenses than revenue produced cease to exist once capital is depleted.
- The single most important number that determines whether a credit union thrives, survives, or dies is called *net revenue*.
- Credit unions must *right-size* operating expenses and credit losses relative to the amount of net revenue produced.

Net revenue is interest income minus interest/dividend expense plus noninterest income. Think of net revenue as gross profit, a number that every other industry in the world focuses on.

If you don't report on, and manage to, net revenue, you are unaware of the change occurring in your environment, and that is a threat to the survival of the credit union, the well-being of its membership, and the job security of its employees.

Income Statement Overhaul

If you can't see it, you can't manage it.

The first thing I would do is restructure the income statement illustrated in Figure 7.

On the funding side, include a minimum of three sources: transaction balance (regular and draft shares), limited transaction balance (money markets), and time-based balance (certificates and IRAs). Each category has a different cost structure and different consumer characteristics as well. Analyzing total shares

When the operating expense ratio gets smaller, members are being served more efficiently; when it grows, members are being served less efficiently.

provides a credit union with no information whatsoever; you need more visibility.

In addition, break out noninterest income into a handful of categories or logical groupings. Any single general-ledger account that generates 10% or more of total noninterest income gets its own category. Why? You need visibility on the most valuable sources of income. If there is volatility in performance on the large income sources, then there will be volatility in surplus (profit) as well.

Figure 7: Sample Income Statement

	Income(Expense)	Rate
Loans	\$4,200	6.00%
Investments	\$600	2.00%
Interest income	\$4,800	4.80%
Regular and draft shares	\$50	0.25%
Money markets	\$150	0.50%
Certificates	\$900	1.80%
Interest expense	\$1,100	1.10%
Noninterest income	\$1,000	
Net revenue	\$4,700	
Net revenue ROA	4.70%	
Operating expense	\$3,500	
Operating expense ratio	74.5%	
Profit before provision	\$1,200	
ROA	1.20%	
Provision expense	\$500	
Profit after provision	\$700	
ROA	0.70%	
Extraordinary income(expense)	\$50	
Net income	\$750	
ROA	0.75%	
ROE	7.50%	

Focusing on net revenue is critical because net revenue must *grow* every year for the reasons just discussed. Furthermore, an organization that fails to show net revenue growth is sending a signal that systemic problems may exist within the organization (e.g., it does not have a sales culture and/or management team that is capable of producing net revenue growth).

Also include the operating expense ratio (operating expenses as a percentage of net revenue). This is the cost to serve members. When this number gets smaller, members are being served more efficiently; when it grows, members are being served less efficiently.

Include ROA before *and* after provision expenses, as it illuminates operating excellence (or lack thereof) and then how much ROA is being consumed by credit losses.

Finally, nothing creates confusion, misunderstanding, and distraction faster than allowing an extraordinary item to become part of ordinary reporting. Extraordinary

items lead to illogical and irrational conclusions about performance, cover up hidden problems, and distort trend analysis. Because of this, extraordinary income must be excluded from net revenue. For example, gain/loss on sale of investments, gain/loss on disposition of assets, and nonoperating income would be excluded from net revenue and placed into the extraordinary income/expense section at the bottom of the income statement with a footnote.

Understanding Balance Sheet Contracts

Credit unions do not make sales; they make contractual obligations.

When a credit union enters into a relationship with a member, it is consummating a series of one or more financial contracts.

Loans are financial contracts. The member agrees to return the principal, plus interest, to the credit union, according to an amortization schedule. Some loan contracts are long term (mortgages), while

others are short term (credit lines). Some contracts have a fixed rate of interest, and others have a variable rate. When interest rates are rising, consumers want fixed-rate contracts while credit unions want variable-rate contracts (i.e., interest rate conflict) and vice versa.

Shares are financial contracts as well. The credit union agrees to pay the member a rate for using the member's funds. Some contracts have a very low interest rate (share draft accounts), while other contracts have a higher interest rate (certificates).

Furthermore, each share contract represents consumer interests. For example, a member who purchases a certificate is rate sensitive (fickle). When interest rates are low, the average life of a typical certificate contract is very short, usually less than one year. When the contract expires, the certificate member will shop around for the best rate. If the rate is with a competitor, the member will threaten to leave if the credit union doesn't match the rate. Too often the credit union acquiesces and succumbs to the terms demanded by the member. As a sidebar, organizations desperate for funds tend to have the most favorable rates. So, when you match the rate of a desperate competitor, you too are behaving in a desperate manner. And don't forget that you have to pay deposit insurance on top of the long-term, high-interest-rate contract you just signed with the member.

A money market contract represents a rate-sensitive consumer who desires a limited amount of transaction capability on the account in exchange for a somewhat lower rate. The average life of a money market account is three to five years or less (the lower the rate, the shorter the life).

A regular or share draft contract represents a consumer who is more interested in transaction convenience and features than rate. The average life of this type of contract is currently 8–10 years.

Shares that are not loaned out are converted into investment contracts. Like loan contracts, investment contracts can be short or long term in nature.

The good news about contractual relationships (e.g., loan and share balance) is that you never start the year out with zero sales, as you would in other industries. In many cases, even before the year has started, 60%–80% of net interest income for the upcoming year is already under contract. That's great news if you have a bunch of good contracts.

The bad news about contractual relationships is that if you have engaged in a series of low-margin contracts, it will take time to unwind and renegotiate your contracts.

Introduction to Marginal Contribution

Success or failure is determined on a marginal basis, one transaction at a time.

Recall the discussion around operating expenses. They are downward fixed. Obviously, minimizing the rate of expense growth is paramount to the success of a credit union; however, eventually one must turn to net revenue growth as the offset to expense growth. Even if a credit union can find ways to reduce expenses, such opportunities will eventually be exhausted.

Also recall the discussion around balance sheet contracts. A majority of net interest income is locked in before the year starts. The only real areas you can influence are the marginal contracts that expire (or by changing rates on non-time shares). You can choose to renew contracts, or focus on replacing them with new or different contracts.

It's all a game of *leveraging* your cost structure and making good marginal decisions on the revenue side. You cannot successfully manage the credit union by looking *only* at ROA and net interest margin. You must manage things on a more granular level. To get to that level of granularity, you must understand the concept of marginal contribution.

Let's start with a very simple example. If noninterest income increases by \$100, with no *variable* expenses incurred, then net revenue increases by \$100. In this example, the marginal contribution is 100%.

Question: What is the ROA on noninterest income?

Answer: Infinity. It can't be computed. Noninterest income not directly tied to an asset is pure oxygen to the well-being of the credit union. It goes straight to the bottom line and does not harm the capital ratio; it enhances it. This is why noninterest income is so vital to credit unions.

What happens when a deposit account is opened? The balance of deposits *and* investments grows. The marginal increase in net revenue is the difference between the deposit cost and the investment yield.

What happens when a loan is made? The loan balance increases and the investment balance decreases. The marginal increase in net revenue is the difference between the investment yield and the loan yield.

This is not some form of fuzzy math or fancy accounting; it is credit union reality. It is how things work from an income and expense perspective. The sum of the marginal increases (or decreases) in net revenue and expenses is what really happens on the income statement.

The ability to see and understand things from a marginal contribution basis sheds a tremendous amount of light on how net revenue is generated, how each product contributes to net revenue, and where you should place your focus.

Marginal Profitability

To further illustrate the concept of marginal profitability, let's look at both a traditional income statement and a marginal contribution statement (see Figure 8).

Looking at the traditional income statement, one would surmise that loans, investments, and noninterest income are good (they increase income) and all shares are bad (they decrease income). It is also not

possible to gain any insight into the profitability of each product.

When looking at the same information from a marginal contribution perspective (which

produces the same net revenue figure), one is able to gain much insight into which products make the largest marginal contribution.

I am constantly told that without doing a full cost accounting analysis, you will never know the "true" profitability of a product. To that argument, I say hogwash.

Figure 8: Traditional Income Statement vs. Marginal Contribution Statement

	Traditional Income Statement		
	Balance	Rate	Income(Expense)
Loans	\$70,000	6.00%	\$4,200
Investments	\$30,000	2.00%	\$600
Regular and draft shares	\$20,000	0.25%	(\$50)
Money markets	\$30,000	0.50%	(\$150)
Certificates	\$50,000	1.80%	(\$900)
Noninterest income	\$1,000		\$1,000
Net revenue			\$4,700
Net revenue ROA			4.70%

	Marginal Contribution Statement		
	Balance	Profit margin	Profit
Loans	\$70,000	4.00%	\$2,800
Investments	\$30,000	0.00%	—
Regular and draft shares	\$20,000	1.75%	\$350
Money markets	\$30,000	1.50%	\$450
Certificates	\$50,000	0.20%	\$100
Noninterest income	\$100,000	100.00%	\$1,000
Net revenue			\$4,700
Net revenue ROA			4.70%

In rank order, noninterest income has the highest marginal contribution, followed by loans, regular and draft shares, money markets, and certificates.

I am constantly told that without doing a full cost accounting analysis, you will never know the “true” profitability of a product. To that argument, I say hogwash.

I have also been told by CFOs that their analysis *proves* regular and draft share accounts are unprofitable because of the high cost to service the accounts. To that line of thinking, I say fancy accounting and allocations are trumping both common sense and reality.

If your strategy is to have branches and transaction accounts to begin with, then your objective is to leverage your cost structure to its fullest extent. Following the logic of the CFO who proclaims you can't make money on share and draft accounts would lead you down the

ILLUSTRATION OF NET REVENUE ENGINE

What does a net revenue engine look like? Is it possible to create a chart or plot characteristics of a net revenue engine? Absolutely! Let's take a moment to think about it.

A powerful net revenue engine produces a lot of noninterest income, has a strong loan-to-asset ratio, and has a majority of its funding in longer duration, lower-cost shares and less of its funding in shorter duration, time-based shares and borrowings.

Figure 9 illustrates this concept.

In this example, data for a credit union have been plotted against data from a peer group. As you can see from the column chart on the right-hand side, net revenue for this credit union as a percentage of assets is 4.10%. The peer group average is 4.97%. Therefore, the credit union's net revenue engine is weaker than the peer group's. In fact, the average net revenue engine for the peer credit union is about 20% more powerful.

The chart on the left illustrates the differences in terms of product mix (i.e., the sales curve). On a marginal contribution basis, the least profitable item is on the left-hand side of the chart (time-based funding), and the most profitable item is on the right-hand side of the chart (noninterest income). In other words, product mix is arranged in ascending order of marginal contribution from left to right.

The credit union highlighted has about the same mix of time-based funding as its peer. The credit union has more money market funding but less regular, draft, and other share funding, fewer loans, and less noninterest income.

By creating a picture, it becomes obvious where this credit union's shortcomings exist from a net revenue perspective. Each deficiency can be either rationalized (toleration of mediocrity) or targeted in order to develop strategies and tactics to improve performance. If this credit union has the

path of closing all branch locations to improve earnings. That simply is flawed thinking.

The fact of the matter is that credit union costs are downward fixed, and the only way to offset these ever-increasing costs is with marginal net revenue. End of discussion.

Net Revenue Engine

Question: Which is best?

- A very powerful and efficient net revenue engine (*think freight train locomotive*).
- A moderately powerful and efficient net revenue engine (*think semi-tractor trailer truck*).
- A weak and inefficient net revenue engine (*think old pickup truck*).

Answer: It depends on how you run the credit union.

ILLUSTRATION OF NET REVENUE ENGINE (CONTINUED)

same product mix as its peer group, it will have the same net revenue ROA.

This leads to a question about whether interest rates impact the net revenue engine. The answer is they do. They have a

huge impact on it. However, interest rates create noise. If you are not able to silence the noise, you may move down a path of irrational and illogical decision making. We will start to address the impact of interest rates in the next section.

Figure 9: Product Mix Sales Curve

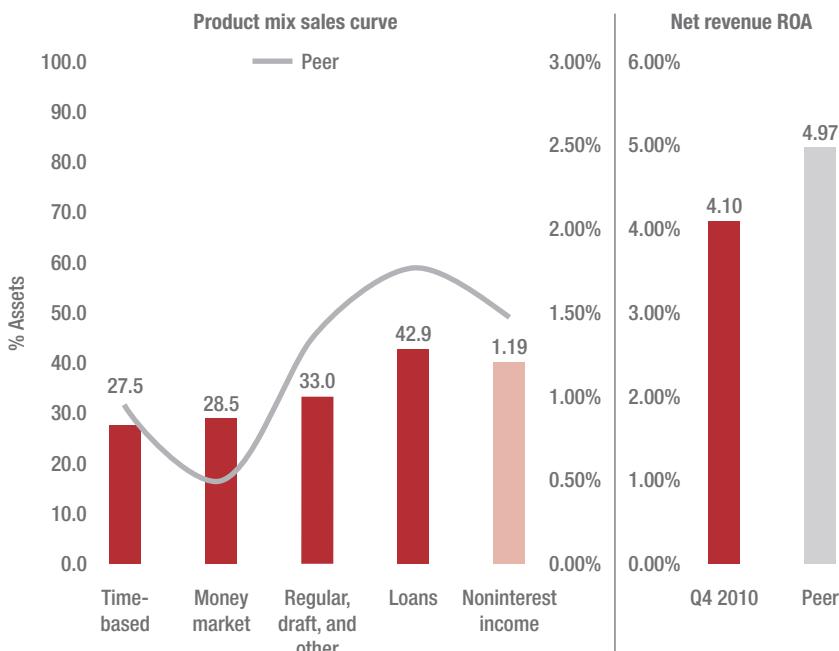
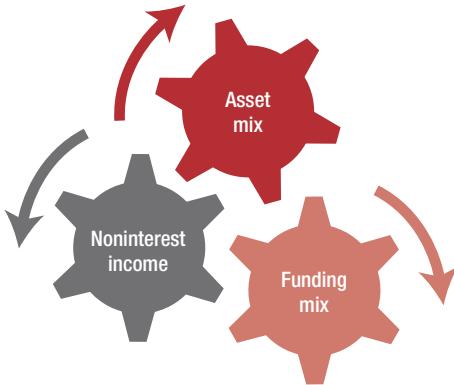


Figure 10: Net Revenue Engine



If the credit union is very lean on the expense side, rarely has credit losses, has plenty of capital, and has no ambitions to extend its market reach, then the old pickup truck will probably suffice. In fact, this is the only set of circumstances where the old pickup truck would be adequate. The pickup truck is fully capable of pulling the very light expense burden and still has room for the occasional loss. It serves its purpose very well.

If the credit union is a 50th percentile performer (meaning it is in the lower half of all credit unions), then a semi will be required; the pickup truck won't do. The peer average credit union has a larger expense load, is not overly productive, and has the average amount of credit losses. Because of this, it needs annual net revenue growth, which requires asset growth, which requires capital growth. A moderately powerful net revenue engine is necessary for survival.

If the credit union has aspirations for growth or is extremely inefficient and laden with a very heavy expense load and a large amount of credit losses, then a freight train locomotive is required; neither a semi nor an old pickup truck will do. The need for the locomotive for the expense-laden, inefficient, high net charge-off organization should be fairly obvious; it has a lot of load to pull.

On the other hand, the need for the locomotive for the credit union with growth aspirations might not be so obvious. Growth requires capital and investment. Capital is required to support larger amounts of assets. Investment (i.e., incurring more expenses) always results in a period of operating loss until revenues ramp up and exceed expenses. During this time, capital is depleted (because expenses exceed revenue). This creates a larger burden. For this reason, the net revenue engine needs to produce enough surplus (profit) to cover losses in the areas of emerging investment or expansion.

Regardless of the situation or the strategy of the credit union, it is fairly safe to conclude that as long as asset quality is not being sacrificed and elevated levels of interest rate risk are not incurred, the more powerful the net revenue engine, the better off the credit union and its members are.

In fact, a credit union with a weak net revenue engine, coupled with the demands of a heavy expense burden and/or credit losses and/or an inability to grow due to inadequate capital, may be compelled to engage in elevated levels of risk in order to survive (i.e., it may become desperate).

Understanding Why Interest Rates Must Be Separated from Product Mix

I always thought net interest margin meant rates. Are you telling me I am wrong?

Net interest margin is the most understood number on a financial statement. It is possible to *improve* net interest margin by *lowering* loan yields. It is also possible to *improve* net interest margin by *increasing* rates on shares. How can this be? If you don't already know the answer, then you don't understand net interest margin, and making decisions on the basis of something you don't understand is dangerous.

Net interest margin is the combination of interest rates *and* product mix. It is a "one size fits all" number that fits no purpose. The key is to separate interest rates from product mix. Let's take a look at an example.

A credit union's loan-to-asset ratio is currently 40% (which is sub-par). The average offer rate on loans is 6.50%, a full 50 basis points (bps) higher than the market in which the credit union competes. So, the credit union's rate is higher than the market rate, and the credit union's loan volume is much lower than that of its peer. The credit union's high

Certificates have no financial nutritional value. They are iceberg lettuce to the income statement. You need protein to survive.

rate on loans makes it unattractive to customers. If the credit union lowered its loan yield to match the market, it could pick up more market share, improve its loan-to-asset ratio, and improve net interest margin. Cutting the rate, as in this example, improves margin.

See how obvious the course of action becomes when you eliminate the noise by separating the rate from the product mix?

In addition, strong product mix always has strategic value regardless of the shape or slope of the yield curve. In fact, traditional accounting analysis might lead you to draw the wrong conclusions. Let me give you two specific examples:

- The current overnight rate on investments is about 15 bps. The current rate on draft/regular shares is about 25 bps. Loan demand is weak. The credit union is struggling to hold loan balance at its current level. Consolidating these facts into an analysis would lead one to conclude that increasing the balance of draft/regular shares is a bad idea because they will be invested at a loss because they can't be loaned out.

Strategy would dictate otherwise (and be right). The reason you want draft/regular shares is because they represent relationships that have an average life of 8–10 years, lead to cross-sell opportunities, and are a source of noninterest income.

Economics would dictate otherwise as well (and be right). Go out and try to buy a branch with a bunch of low-rate deposit accounts—you will pay a huge premium.

Marginal contribution would dictate otherwise as well (and be right). The more low-cost share balance you have, the less high-cost balance you need.

Because of these facts, I always place a strategic value on regular/draft accounts (at 25 bps interest rate) of at least 200 bps.

- Currently, there is a lot of discussion about extending the duration on funding by tempting consumers with slightly higher rates on longer-term certificates, under the presumption that rates are going to go up.

While this is sound asset-liability management strategy, it must be implemented very carefully for the following reasons:

- If certificate balance increases and those funds are not immediately loaned out, the credit union loses a lot of money quickly. Paying 1.50% for a certificate and investing it at 15 bps is a losing proposition.
- An often overlooked expense accompanies certificate growth: NCUA assessments and deposit insurance are based on share balance.
- Certificate balance is a very low profit margin product to begin with. Concentrating sales volume in certificate balance lowers net revenue ROA. A smaller net revenue ROA means capital is being leveraged less efficiently, and that moves you closer to the constraint of capital.
- The customer always owns the option call on a certificate and can cancel the contract at any time.
- All of your competitors are trying to beat the yield curve using the same strategy. Good luck winning here.
- The average life of a certificate, even at its extended duration, is still the shortest-lived relationship.
- Finally, you are hedging against the yield curve; if it does not move, you lose.

You would be so much better served trying to attract draft/regular share and money market customers.

Because of this, I always assign an economic value to certificates of 10–50 bps. Certificates have no financial nutritional value. They are iceberg lettuce to the income statement. You need protein to survive.

Am I saying asset-liability management strategy is a waste of time? Absolutely not! What I am saying is that good, old-fashioned hard work and focus make asset-liability management strategy less vital to your success. A credit union with a strong balance sheet and efficient operations does not need a complex, high-maintenance asset-liability management strategy.

Interest Rate Differential

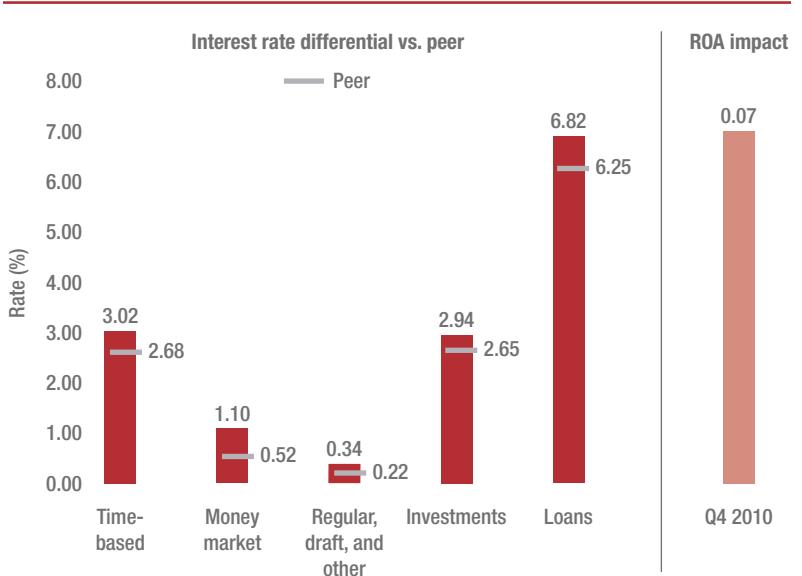
It's hard to beat the market on rate, but is sure is easy to mess it up.

Net interest income accounts for about 70% of total net revenue. Since this is such a large number, it is important to price your products accordingly in the marketplace. A mispriced product will not only cost you market share but hurt the bottom line (and therefore your ability to offset annual increases in operating expenses and credit losses).

The back-test to product pricing is called interest rate differential. Simply stated, if you are maintaining market rates on your contracts (loans and shares, investments and borrowings), you should have rates on your balances that are similar to those of other credit unions in your marketplace.

A simple picture of this is illustrated in Figure 11.

Figure 11: Sample Interest Rate Differential



By cross-referencing this information with the sales curve, the following commentary can be made:

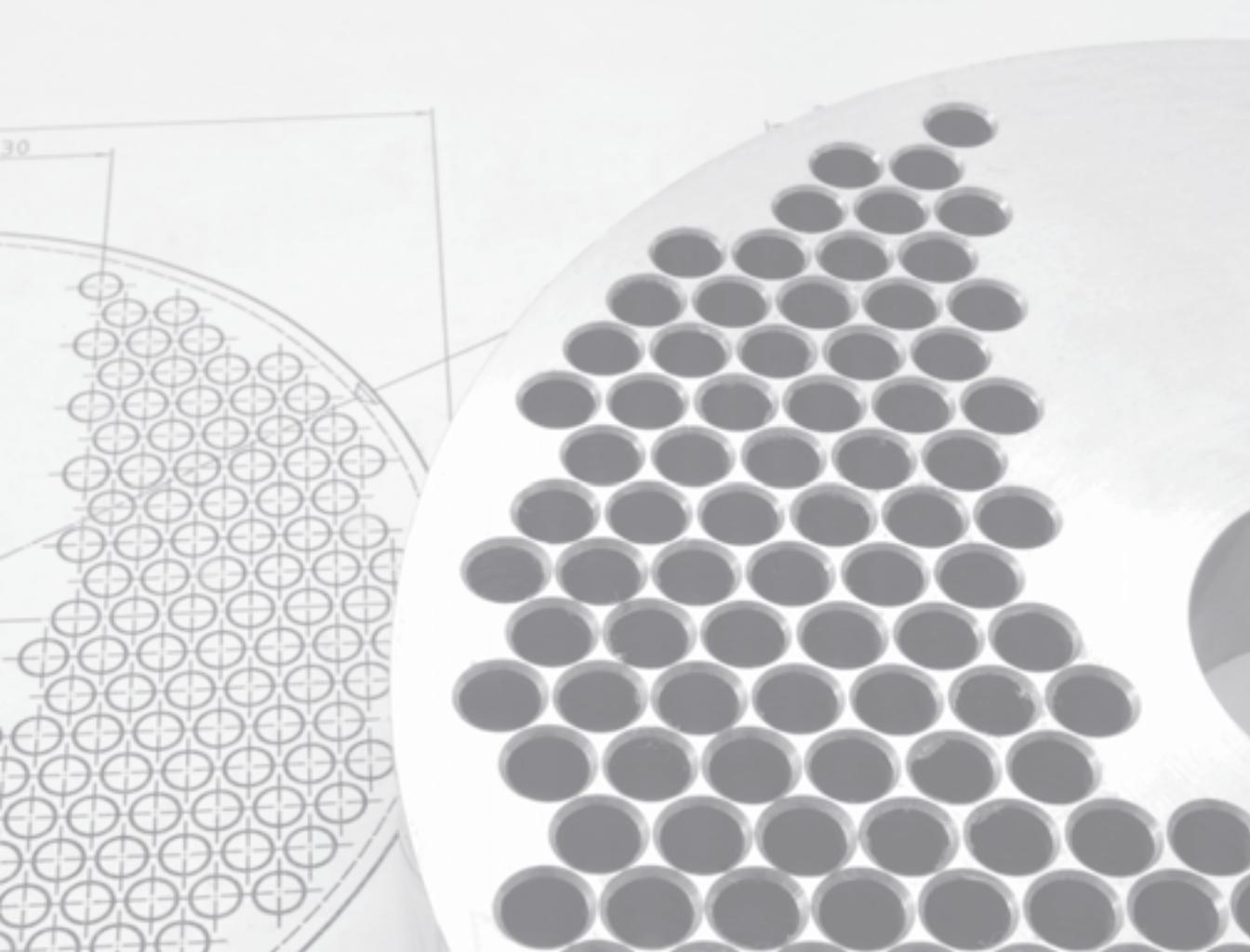
- Time-based funding: The credit union's balance-sheet mix is similar to that of its peer, but the cost of CDs is 34 bps higher. Why is that? Are we not paying close enough attention to pricing? Are we paying up for CD balance?
- Money market funding: The credit union's balance-sheet mix far exceeds that of its peer; the credit union's rate is 58 bps higher than its peer's rate. The higher rate could be driving more market share. If that advantage is maintained, larger balances of money markets could be used to reduce the need for certificate balance.
- Regular, draft, and other funding: The credit union's balance-sheet mix is less than that of its peer, yet the credit union's rate is 12 bps higher than its peer's rate. A more favorable rate is not leading to more market share.
- Investments: The credit union's yield on investments is better than that of its peer.
- Loans: The credit union's balance-sheet mix of loans is far less than that of its peer, but the credit union's rate is 57 bps higher than its peer's rate. Is the credit union pricing itself out of the market in this area?

Recap: A Baseline of Knowledge

Executives and board members make bad decisions when they don't understand the dynamics of their industry. Here is a recap of the concepts just covered:

- ROA is *not* the bottom line. It does not provide you with enough information to make a qualified assessment of performance.
- Operating costs increase every year. Credit losses occur every year. Both of these items deplete capital.
- You are subject to the constraints of capital. It is possible that you might not be able to grow assets fast enough to cover increases in operating expenses and credit losses.
- Net revenue is arguably the number most important to your ongoing existence, yet it is not reported on your financial statements. If net revenue does not grow faster than increases in operating expenses and credit losses, you will not accrete capital to fuel asset growth.
- The traditional formatting of financial statements is woefully inadequate. Numerous data are provided, but very little information. An overhaul is necessary.

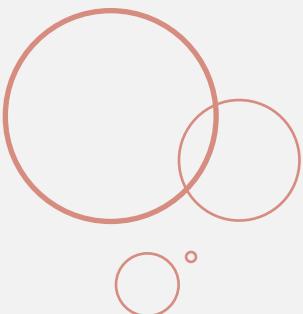
- The balance sheet represents the summation of each financial contract made with members. A credit union does not start the year out with zero sales; 60%–80% of net interest income is already under contract. This is very good news if you have negotiated a series of winning contracts. It is very bad news if you have a bunch of losing contracts. Writing good contracts is paramount to success.
- Due to the downward fixed-cost structure in a credit union, understanding the concept of marginal contribution is critical. Traditional cost accounting methodologies often lead to illogical conclusions. Leveraging your fixed-cost structure to its fullest extent is how you create value for members. Leverage is created on a marginal basis, one transaction at a time.
- Every credit union has a net revenue engine. The more powerful the engine, the less hard it has to work to offset increases in operating expenses and credit losses and to accrete capital. Credit unions with a weak net revenue engine are at a strategic disadvantage; to overcome this, they may be tempted into excessive levels of risk.
- Five major product lines make up the net revenue engine:
 - Noninterest income (highest marginal contribution rate; highest ROA).
 - Loans (high-yield, high-risk investments).
 - Transaction funding (draft and regular share accounts).
 - Semi-transaction funding (money market accounts).
 - Time-based and other funding (lowest marginal contribution rate; lowest ROA).
- Interest rates are a major component of the net revenue engine. Analysis of interest rates must be separate from analysis of product mix in order to gain insight about performance.



CHAPTER 2

Things Your Financial Statements Don't Tell You

Start by selecting a representative peer group, and then set up a variety of report cards to track your changes, point by point. Comparisons of expense ratios, product mix ROA, and asset growth should all be on the list. Quarterly tracking of these and other ratios against the peer group will keep you on track.





Just like the boiling frog, an organization must be able to *detect* change as it is occurring.

As a CEO or board member, I would have a specific checklist (report card) of items that I would like to review on a quarterly basis, preferably against a representative peer group. At a minimum, the checklist would include the following items:

Day-to-Day Operations

- Net revenue ROA and the components that drive it.
 - Loan, share, and asset growth.
 - Product mix.
 - Interest rate differential.
- Operating expense ratio and the components that drive it.
 - Personnel, premises, and other expenses.
 - Product mix personnel expense ratio.
- Profit before provision.

Credit Administration

- Provision for loan loss expense and the components that drive it.
 - Loan loss reserve.
 - Net charge-offs.
 - Delinquencies.
- Profit after provision.

Capital Adequacy/Bottom Line

- Capital ratio.
- ROA/Equity.
- Extraordinary income/expense.

Is this it? Should I be ignoring everything else? Of course not! For starters, there is a whole list of regulatory items that must be monitored; a periodic market assessment is useful as well. However, by

developing an operating plan, focusing on these three major areas, and watching the trends within, you will get a pretty good idea of what is going on and what needs to improve. You don't need an exhaustive list of ratios and comparative metrics.

Selecting a Representative Peer Group

Don't let perfect be the enemy of good; seek relevance over precision.

There is no such thing as a perfect peer group. The goal is to select a representative group in order to make rational and logical comparisons.

The main objective of selecting a peer group is not to rationalize mediocre performance but to develop internal standards of performance and make sure they stay relevant by reviewing trends occurring within the industry.

That being said, all credit unions make money the *same* way, measure the *same* things, and report information quarterly using the *same* standardized format. If there ever was an industry where benchmarking is a valid tool, it is this one.

There are a number of ways to select a peer group. Here are some criteria to consider:

- *Operational peer group.* This peer group is determined based on asset size. For example, credit unions with \$25 million (M) in assets would not have the same operating structure as credit unions with \$250M in assets.
- *Geographic peer group.* This peer group is based on geography. It could be within the same standard metropolitan statistical area, state, or region of the country.
- *Charter-based peer group.* An SEG-based credit union with a national presence might have a hard time making sense out of a geographic peer group; comparing itself with other national SEG-based credit unions might make more sense.
- *Custom peer group.* A representative group of peers selected based on criteria that best fit your credit union.
- *Ugly duckling peer group.* A group of low-performing credit unions hand-selected in order to make yourself look better. You may laugh at this, but it happens (and I don't recommend it; you will lose credibility over it).

Sitting in the director's chair, I encourage a bias toward operational peer groups, regardless of geography. The overriding objective of any credit union is to create value for its members. Operational excellence knows no geographic boundary.

Performance Report Card

Effort without result is meaningless.

Six outcomes determine the success of the credit union: growth, product mix, interest rates, operating expenses, credit losses, and capital adequacy. That's it. There are a number of ways to get to those outcomes, but if you don't deliver those *results* for your membership, then you are failing as a management team to create value for your members.

Developing a one-page report card to focus on those six outcomes is a great way to track performance. On that report card, you need a balance of summary and granularity; enough detail must be present to provide some insight and direction for further investigation as to *why* performance is where it is. The report card should be supplemented with "drill down" information to allow for that investigation.

Advances in report-writer, database, and spreadsheet technology have made it easier to present results. Gone are the "green-bar" reports; color coding and highlighting are in. Directional icons and graphs in a report help the reader assess performance and spot trends.

Over the past two decades, I have seen literally hundreds of reports and formats, some good and some bad. What's important is that the reader be able to understand the information and use the report to make the *correct* assessment.

Figure 12 shows a best-practices report card. Categories of performance are located in the left column. The gray circles indicate areas where the credit union is performing better than its peer, and the red circles indicate areas where the peer is performing better than the credit union. In the center columns are current quarter performance and a peer comparison. The right columns include directional arrows to indicate a trend over a longer period of time, and the percentage of time that the credit union has beat its peer over that time period.

Reading the Report Card

I am not a fan of "pet" or singularly focused metrics. However, if pressed, I would have to say that the most important number on the

Figure 12: Sample Quarterly Performance Report Card

Status vs. peer (prior four quarters unless noted)	Credit union	Peer group	Variance	12-quarter trend	Winning % vs. peer
● Net revenue ROA	4.29%	4.81%	-0.52%	↘	25.0%
● Asset growth	4.69%	1.92%	+2.77%	↗	
● Loans	-10.72%	-0.89%	-9.83%	↘	
● Draft and regular shares	3.79%	6.09%	-2.30%	↗	
● Money markets	19.20%	4.47%	+14.73%	↗	
● Time-based and other funding	-8.74%	-4.35%	-4.38%	↗	
● Product mix ROA	4.22%	5.07%	-0.85%	↘	
● Noninterest income	1.22%	1.42%	-0.20%	↘	
● Loans	42.9%	59.7%	-16.8%	↘	
● Draft and regular shares	33.0%	40.0%	-6.9%	↘	
● Money markets	28.5%	17.0%	+11.4%	↗	
● Time-based and other funding	27.5%	32.2%	-4.7%	↘	
● Surplus funds (investments)	45.6%	26.7%	+18.9%	↗	
● Interest rate differential (current)	-0.04%	0.00%	-0.04%	↘	
● Loans	6.68%	6.10%	+0.58%	↘	
● Draft and regular shares	0.34%	0.18%	+0.16%	↘	
● Money markets	1.10%	0.50%	+0.60%	↘	
● Time-based and other funding	2.61%	2.21%	+0.40%	↘	
● Surplus funds (investments)	2.56%	2.46%	+0.10%	↘	
● Operating expense ratio	89.90%	77.60%	+12.31%	↗	8.3%
● Operating expense growth	2.94%	1.52%	+1.42%	↗	
● Net revenue growth	-0.25%	2.12%	-2.37%	↗	
● Product mix personnel expense	48.7%	36.1%	+12.5%	↗	
● Profit before provision ROA	0.43%	1.08%	-0.65%	↘	8.3%
● Provision expense (% assets)	0.31%	0.83%	-0.51%	↗	75.0%
● Net charge-offs (% loans)	1.12%	1.21%	-0.09%	↗	
● Loan loss reserve (current)	1.83%	1.45%	+0.37%	↗	
● Past due 0-59 days (current)	0.62%	1.89%	-1.26%	↗	
● Past due 60+ days (current)	0.80%	1.08%	-0.28%	↗	
● Profit after provision ROA	0.12%	0.25%	-0.13%	↘	41.7%
● Capital ratio (current)	10.14%	9.90%	+0.24%	↘	25.0%

report card is the expense ratio. I would begin my assessment of performance there. Naturally, this raises the question, If it is so important, why is it not at the top of the report card? The rationale of the report card is to create a logical flow of information:

- Top-line net revenue and how it is being created (growth, mix, and rates).

- Expenses necessary to support revenue production.
- Impact of credit losses on earnings.
- Capital adequacy.

Placing the expense ratio at the top of the report card is too radical due to the “traditional method” executives and board members have been taught to read financial statements.

Report Card: Expense Ratio

The expense ratio is a very simple and very powerful number. It is operating expenses as a percentage of net revenue—the lower the number, the better. A credit union with a low expense ratio has a lot left over to cover credit losses and accrete capital. A credit union with a high expense ratio is at risk; it has very little left over to cover credit losses and accrete capital.

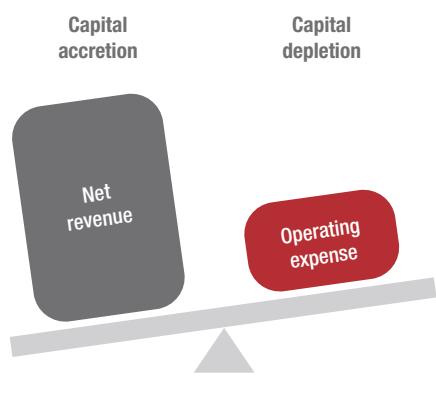
Looking at the expense ratio trend, you get a clear picture of what is growing faster, expenses or net revenue. If expenses and net revenue are growing at the same rate, the expense ratio will not change. If expenses are growing faster than net revenue, the ratio will get larger. If net revenue is growing faster than expenses, the ratio will get smaller.

Every credit union should have a target expense ratio. It is a dollar-on-dollar measure of productivity. It is not susceptible to the flaws of volume-based metrics (like assets per employee). It is easy to run up asset-based volume metrics: Start giving money away without regard to rate and credit risk. That is no way to run a credit union, yet many hold such measures in high reverence.

As a point of reference, here are some guidelines that can be used to develop a target expense ratio within your credit union:

Expense ratio > 100%	Failure is imminent. The credit union can't generate enough net revenue to cover its day-to-day operating expenses. A <i>target</i> efficiency ratio exceeding 100% is tolerable only if the organization has surplus capital and is growing rapidly (e.g., a startup).
----------------------	---

Figure 13: Effect on Capital



Expense ratio 90%–100%	Slow death. Credit unions with <i>recurring</i> expense ratios in this range will not create enough income to cover traditional levels of credit losses (40–50 bps). Capital will be steadily depleted, and it will not be able to grow to offset annual increases in operating expenses. An economic downturn will only speed up the credit union’s demise.
Expense ratio 80%–90%	Skating on thin ice. Credit unions with <i>recurring</i> expense ratios in this range will generate enough income to offset traditional levels of credit losses but not enough retained earnings to fuel asset growth (less than 5%) to offset annual increases in operating expenses. ROA will be in the 0.20%–0.40% range. A credit union must have superior asset quality in order to survive with an expense ratio in this range.
Expense ratio 75%–80%	Surviving. Credit unions with <i>recurring</i> expense ratios in this range will generate enough income to offset traditional levels of credit losses and create enough retained earnings to fuel moderate asset growth (5%–7%). This credit union will find it difficult to achieve an ROA exceeding 0.70%; however, this credit union is probably providing value to members in the form of competitive rates (a component of net revenue).
Expense ratio 70%–75%	Thriving. Credit unions with <i>recurring</i> expense ratios in this range will generate enough income to offset occasional elevated levels of credit losses and still create enough retained earnings to fuel tangible asset growth (up to 10%). This credit union will produce an ROA in the 0.75%–1.00% range, assuming traditional levels of credit losses, and could easily weather a downturn in the economy.

Expense ratio 65%–70%	Highly productive. Credit unions with <i>recurring</i> expense ratios in this range will generate enough income to offset occasional elevated levels of credit losses and still create enough retained earnings to fuel <i>significant</i> asset growth (up to 12%). This credit union will produce an ROA in the 1.00%–1.20% range, assuming traditional levels of credit losses, and could weather a <i>prolonged</i> downturn in the economy.
Expense ratio < 65%	Approaching greedy. Credit unions with <i>recurring</i> expense ratios in this range are bordering on greedy (e.g., they could be providing more benefit to members in the form of rate, which will lower net revenue, but allow them to capture more market share). An <i>extremely</i> productive credit union would operate in this range and could support asset growth of up to 15%. This credit union will produce an ROA of 1.20% assuming traditional levels of credit losses.

Once a target expense ratio is identified, a clear sense of direction can be developed:

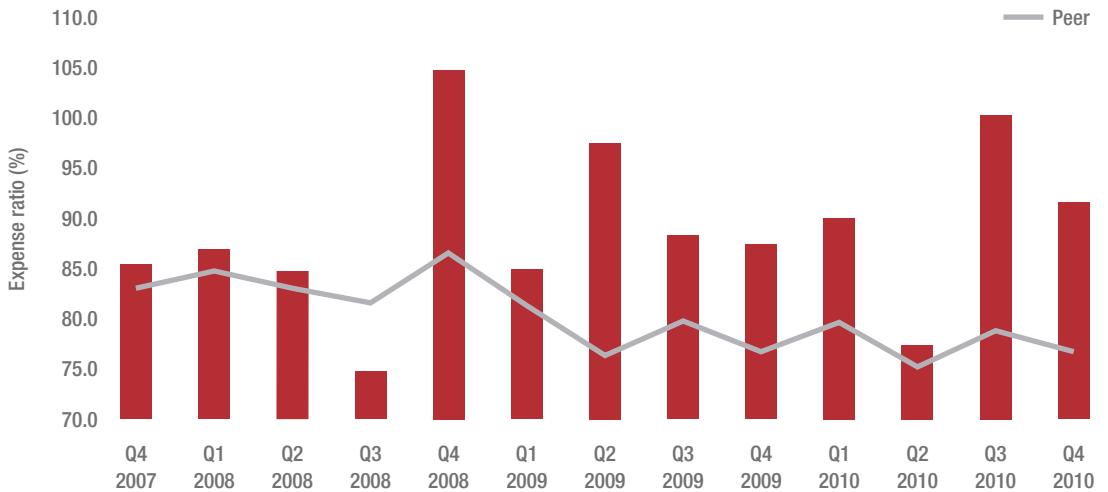
- If the expense ratio is at or better than target, then value for members is being created (e.g., the cost to operate the credit union is in an acceptable range). Discussion and strategy should focus on sustainability of the expense ratio.
- If the expense ratio is worse than target but improving, then value for members is being created (e.g., improvements in productivity are being realized). Discussion and strategy should focus on ongoing incremental improvements.
- If the expense ratio is worse than target and not improving or deteriorating, then member value is being destroyed (e.g., the cost to operate the credit union is too high and getting costlier each quarter). Discussion and strategy should focus on not only ongoing incremental improvements but also the ability of the executive team to exact change in the organization.

Figures 14–16 illustrate the concept of trending the expense ratio and its components.

Figure 14 is a simple plot of the expense ratio of the credit union versus the peer group it has selected. Note the two periods where the expense ratio is greater than 100%. This means that before credit losses and extraordinary expenses, the credit union failed to generate enough net revenue to cover its day-to-day operating costs. Also note that expenses are growing at an average annualized rate of 3.7%, but net revenue is only growing at a 1.5% rate. This is *not* a long-term strategy for success; it is a recipe for failure.

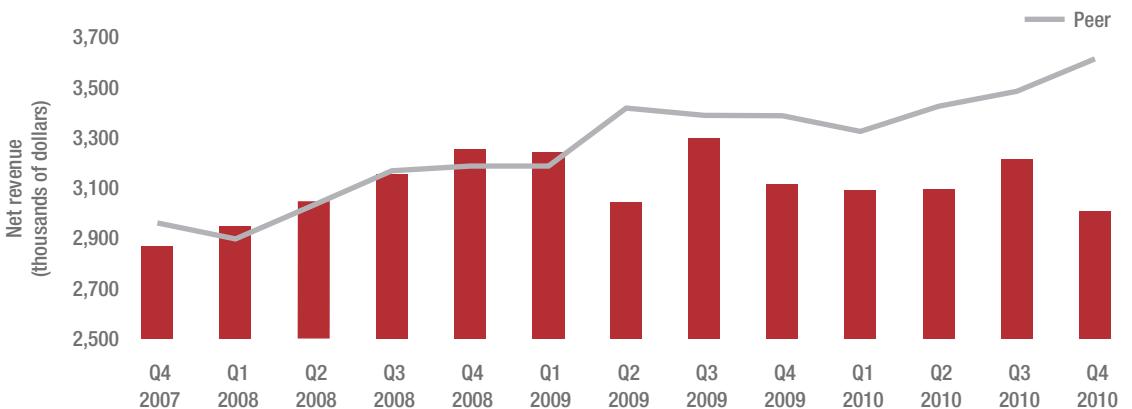
Figure 15 plots actual net revenue produced by the credit union against what a peer credit union with the same asset size would have produced. A “hard dollar” comparison gives real meaning to what

Figure 14: Sample Expense Ratio Analysis



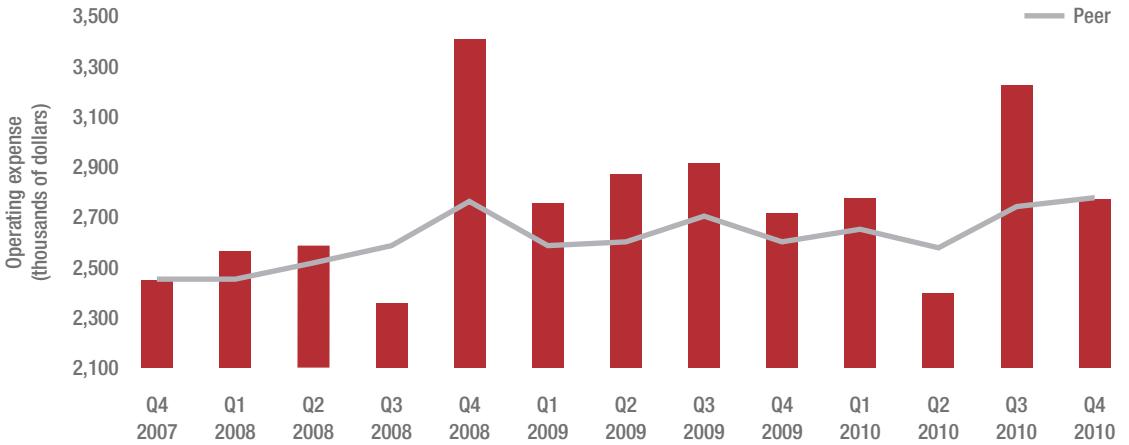
Annualized expense growth rate: 3.7%; annualized net revenue growth rate: 1.5%.

Figure 15: Sample Quarterly Net Revenue Analysis



Annualized growth rate: 1.5%; peer annualized growth rate: 6.5%.

Figure 16: Sample Quarterly Operating Expense Analysis



Annualized growth rate: 3.7%; peer annualized growth rate: 3.0%.

the credit union is leaving on the table each quarter compared to the peer.

Figure 16 plots actual operating expenses of the credit union in serving its members on a day-to-day basis versus a peer credit union with the same asset size. As with net revenue, a “hard dollar” comparison versus the peer gives real meaning to the degree of efficiency or inefficiency as compared to the peer.

The expense ratio is a strategic measure. It does not provide enough insight as to *why* performance is where it is. We’ll dig into the components of net revenue included in the expense ratio next.

Report Card: Net Revenue ROA

Net revenue ROA is a measure of the power of the credit union’s earnings engine. A powerful net revenue engine produces a lot more income to offset operating costs and credit losses and provide capital accretion than a weak net revenue engine. Recall the discussion on capital constraints: A credit union with a weak net revenue engine and a high expense ratio, and/or high levels of credit losses, might be constrained from growing assets fast enough to correct its expense and credit loss problems.

Stated another way, the net revenue ROA is a measure of how effectively member capital is being deployed on the “sales” side of the income statement. Credit unions with higher net revenue ROA figures are utilizing member capital efficiently (much like a mutual fund manager would allocate investor capital); conversely, credit unions with low net revenue ROA figures are squandering member capital.

Figure 17: Sample Net Revenue ROA Analysis

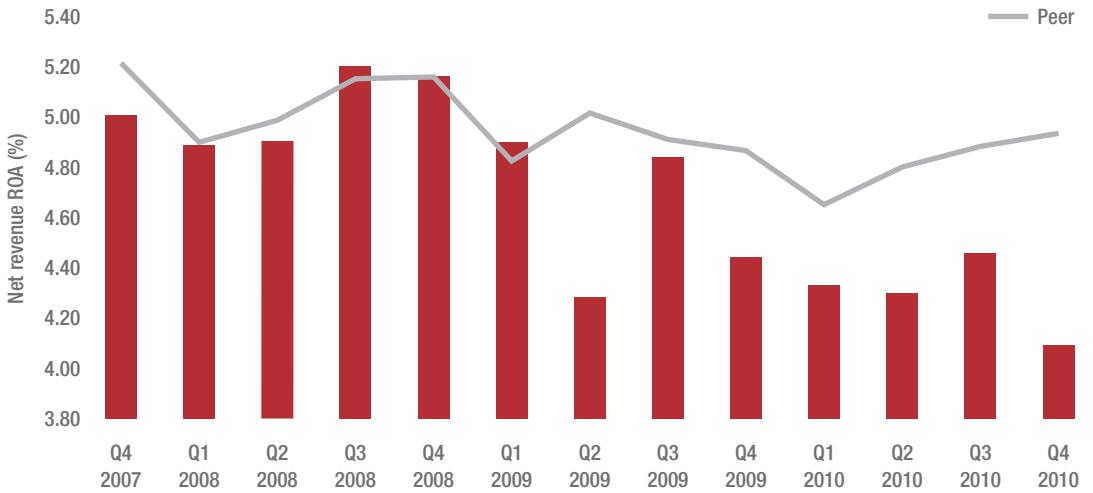


Figure 17 illustrates the concept of trending net revenue ROA.

Like the expense ratio, net revenue is a strategic measure, but it does not provide enough insight as to *why* performance is where it is. Three components determine the power of the net revenue engine: volume of balance, mix of sales, and interest rates. Each of these will be discussed next.

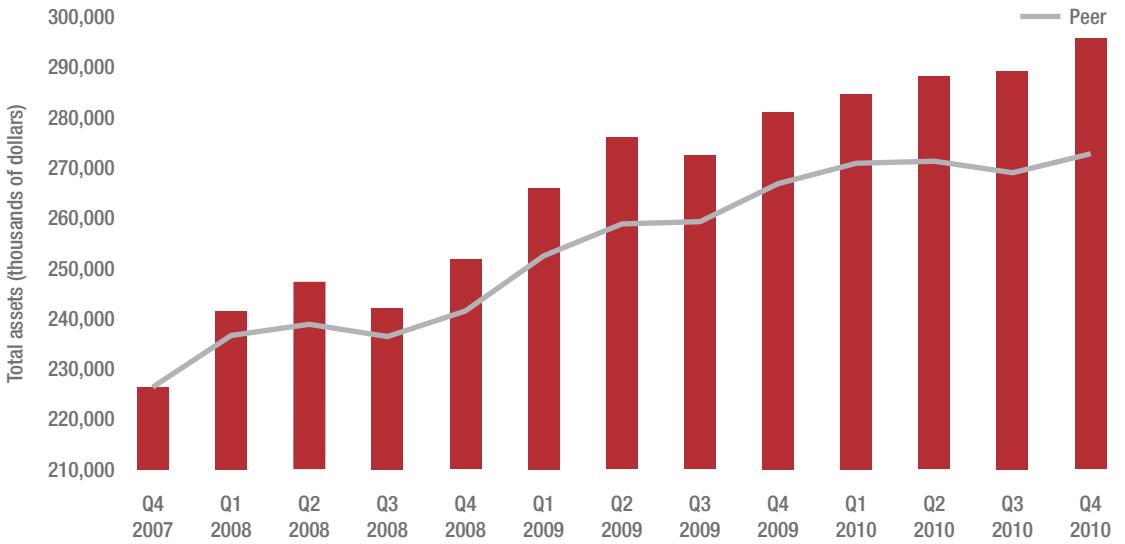
Report Card: Asset Growth

Frankly speaking, asset growth does not tell you very much. However, it is such a commonly used assessment of performance that it would create too much discomfort to ignore it. What matters is *how* the assets grow, not just the fact that they grow. Growing assets by increasing certificate balance 15% at rates 25 bps above market is not very healthy for the long-term existence of the credit union; however, it does look impressive on a chart. I would much rather shrink assets by 5% and improve product mix by 10%; doing so makes the net revenue engine more powerful, accretes capital faster, and reduces strain on the current capital ratio.

There is such a stigma attached to shrinking assets that it leads management teams and board members down a path of logic that fails to consider it as a viable option. Rare is the instance where the earnings of a credit union cannot be improved by shrinking the balance sheet a little (by eliminating unprofitable relationships and improving product mix).

About the only value of trending asset growth is to compare credit union growth against a peer's growth. This is very easily

Figure 18: Sample Asset Growth Comparative Analysis



Average annualized growth rate: 8.5%; peer average growth rate: 6.4%.

accomplished. One would simply plot credit union growth on a chart. The peer would be plotted using the starting credit union asset balance and then applying the peer growth rate each quarter. Figure 18 illustrates the concept of trending asset growth.

Report Card: Product Mix ROA

Product mix looks at the *composition* of the balance sheet, not the *size* of the balance sheet, along with the amount of noninterest income generated. To accomplish this, interest rates are eliminated from the equation. In their place, standardized, strategic profit margins that are held constant over the time period are used in the trend analysis (i.e., marginal contribution). Why? Because it is the only way to know if product mix is improving or deteriorating (and where it stands relative to the peer’s mix).

If you hold profit margins constant, the *only* way to improve net revenue ROA is to *improve* mix (and vice versa).

Please note, I am not saying that interest rates don’t count or are not important. In fact, the exact opposite is true. One needs to *isolate* rate from product mix in order to *understand* what drives net revenue: rate, mix, or both.

For example, let’s take an asset-sensitive credit union during a rates-down economic cycle (e.g., a credit union whose assets are sensitive to rate fluctuations). When rates go down, assets reprice faster than liabilities, and as a result, the margin compresses. One would observe

a trend of deterioration in net revenue and conclude that management is doing a poor job. But the exact opposite might be occurring. If mix is improving, then management is doing a good job; however, it is being masked by the fact that the balance sheet is asset sensitive.

Conversely, let's take the same asset-sensitive credit union in a rates-up environment. When rates go up, assets reprice faster than liabilities, and the margin widens. One would observe a trend of improvement in net revenue and conclude that management is doing a great job. But as we saw earlier, the exact opposite may be occurring. In fact, the rate might even be masking fundamental shortcomings in product mix.

For these reasons, it is necessary to eliminate the noise that rate brings to the analysis.

Figure 19 illustrates the concept of trending product mix by using the product mix ROA, which includes standardized profit margins.

Report Card: Interest Rate Differential

When looking at interest rate differential, interest rates are isolated and their impact on net revenue ROA is evaluated. This is important because it effectively back-tests your ALCO effectiveness against the market. It is important to use current quarter rates when performing this analysis. Last year's rates are irrelevant; the only thing that matters is the current rate.

Figure 20 illustrates the concept of trending interest rate differential along with the differential by major product category so the reader can see *where* significant variances exist.

Figure 19: Sample Product Mix ROA Analysis

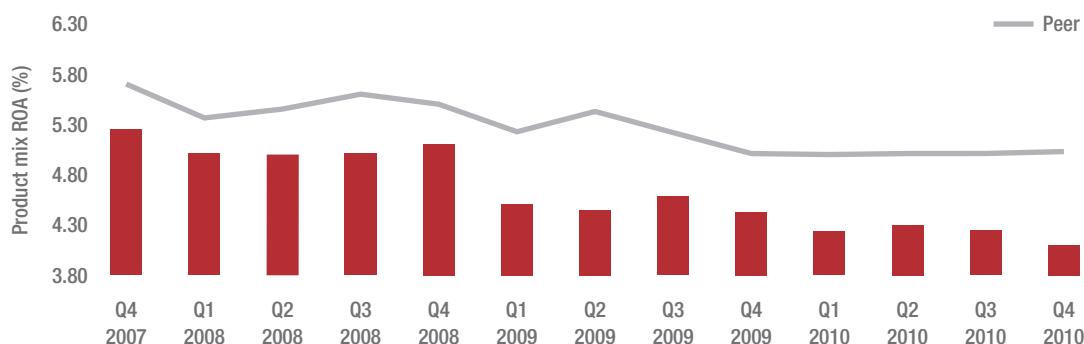
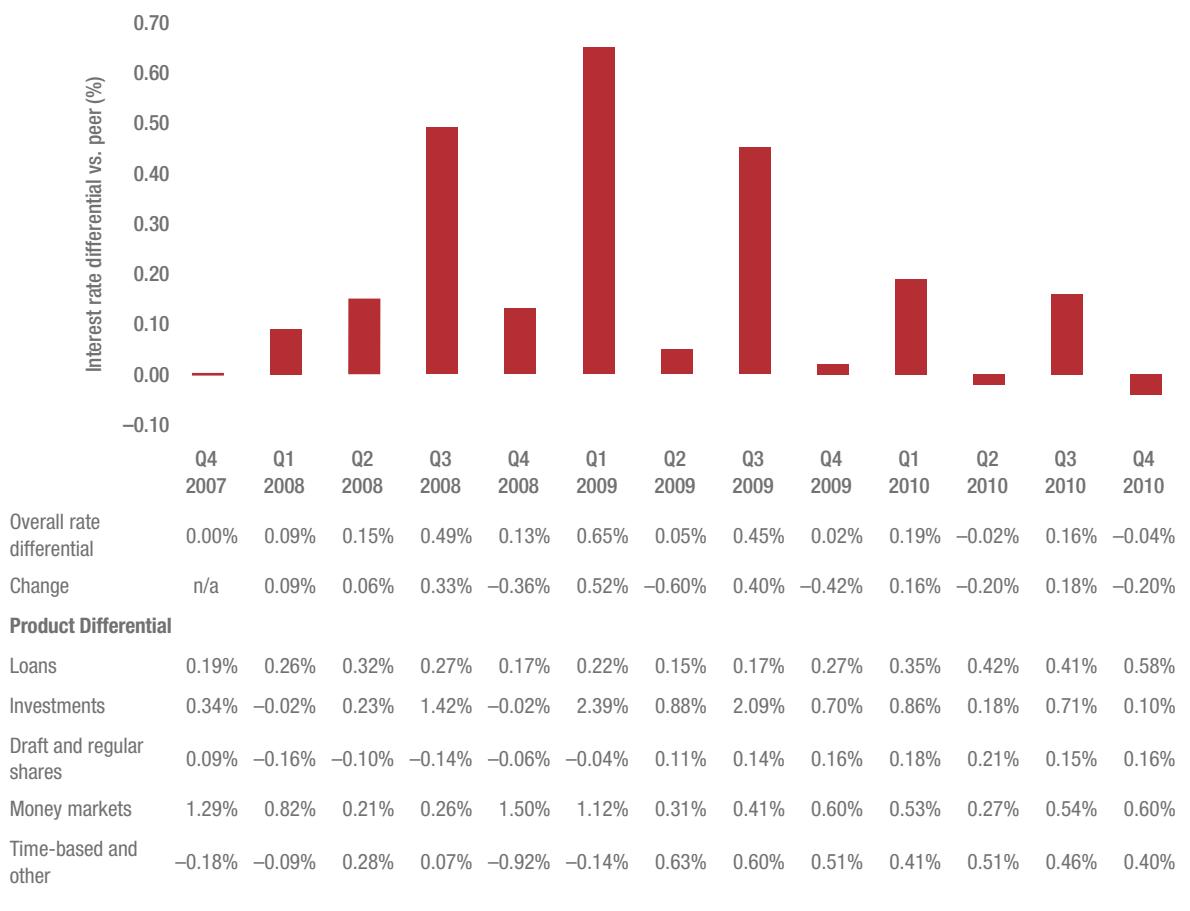


Figure 20: Sample Interest Rate Differential Analysis



Report Card: Product Mix Personnel Expense Ratio

Building leases, depreciation schedules, utility bills, and compliance costs don't create and sustain relationships. People do. Furthermore, 90% of your staff doesn't make decisions that impact your expense structure with any measure of materiality. However, 100% of your staff can favorably impact net revenue, some via direct sales and interaction with members, others in service and support roles.

How each staff member invests his or her eight hours each work-day determines how much net revenue the credit union produces. If invested wisely, it produces a high net revenue ROA (and low expense ratio); if invested poorly or wastefully, it leads to a low net revenue ROA (and high expense ratio).

Because compensation expense is the largest expense category and has the greatest impact on net revenue, it should be monitored

relative to net revenue (thus the personnel expense ratio). For the same reasons covered in the section on product mix, interest rates are taken out of the denominator in this ratio, and standardized, strategic profit margins are used instead. I want to know how much compensation expense is growing relative to net revenue and how strategically employees are investing their eight hours each day.

Figure 21 illustrates the concept of trending the compensation expense ratio.

Report Card: Product Detail

Another major shortcoming of traditional financial reporting is the lack of product focus. A credit union sells and manages products. Why balance is located on one page (balance sheet), interest income/expense is located on another page (income statement), and rate is located on yet another page baffles me. Flipping through pages to get relevant information is no way to manage an enterprise.

Figures 22–24 provide insight into balance, mix, and interest rates on a single page. A good balance of summary versus detail would include one-page reports for the following:

- **Loans:** Loans are simply investments that carry a higher yield due to risk of default. At a summary level, total gross loans is adequate. However, a more detailed breakout may be required based on the offerings the credit union provides to its members.
- **Draft and regular shares:** These represent transactional relationships with a long life. This is a major product line that should be reported on independently of other balances.
- **Money markets:** Money markets are certificates with transactional capability. Because of their unique characteristics (i.e., they are

Figure 21: Sample Personnel Expense Ratio Analysis

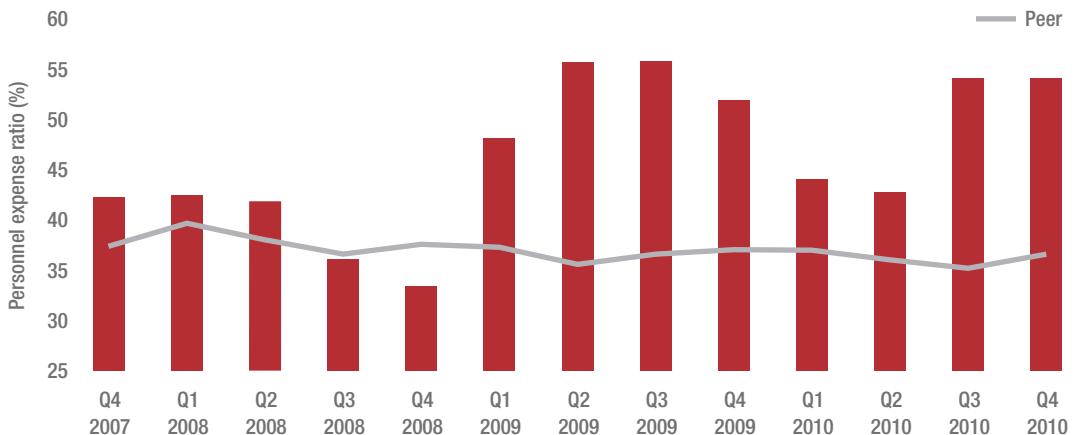
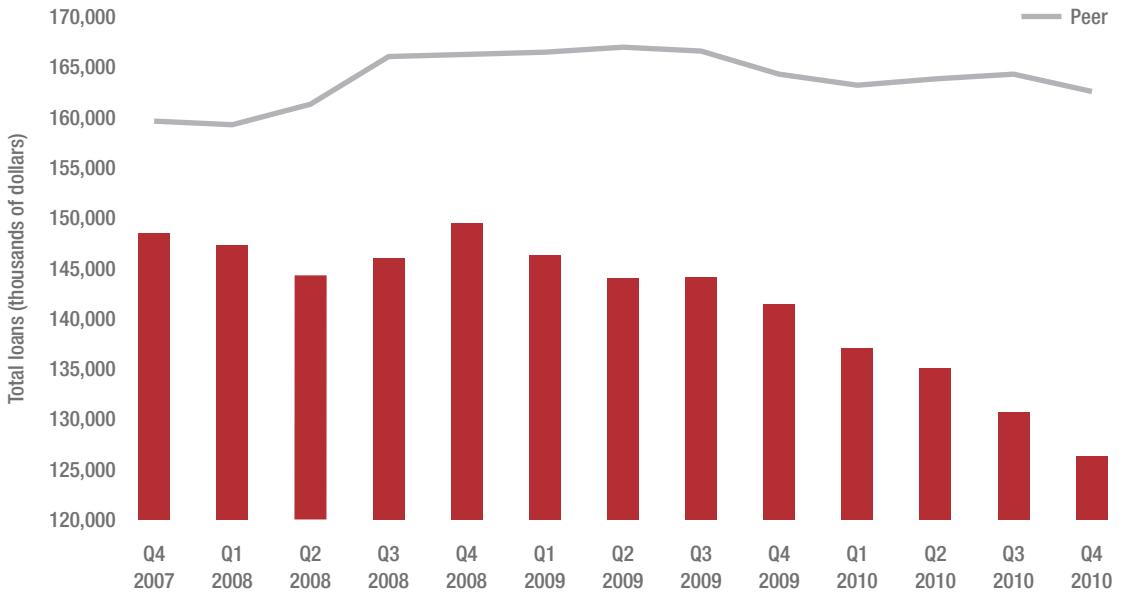


Figure 22: Sample Total Loan Peer Comparison



Average annualized growth rate: -4.6%; peer average growth rate: 0.7%.

Figure 23: Sample Product Mix Peer Comparison

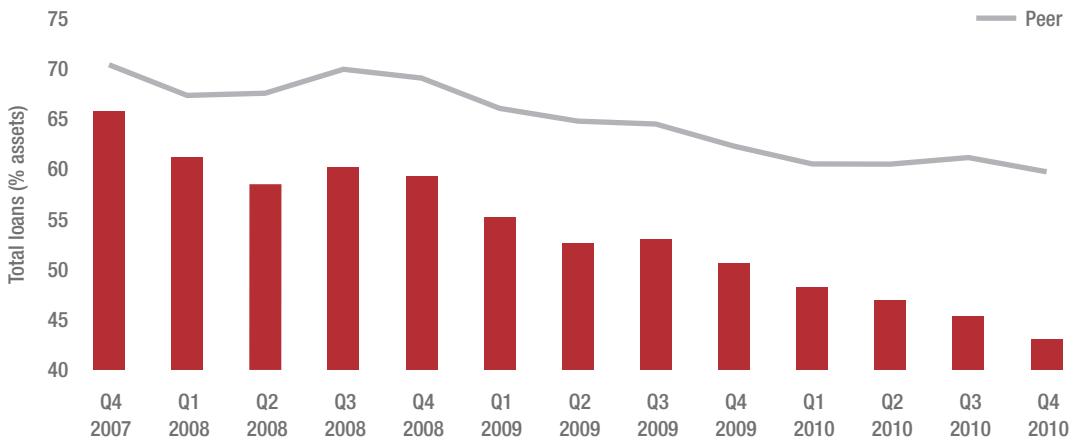
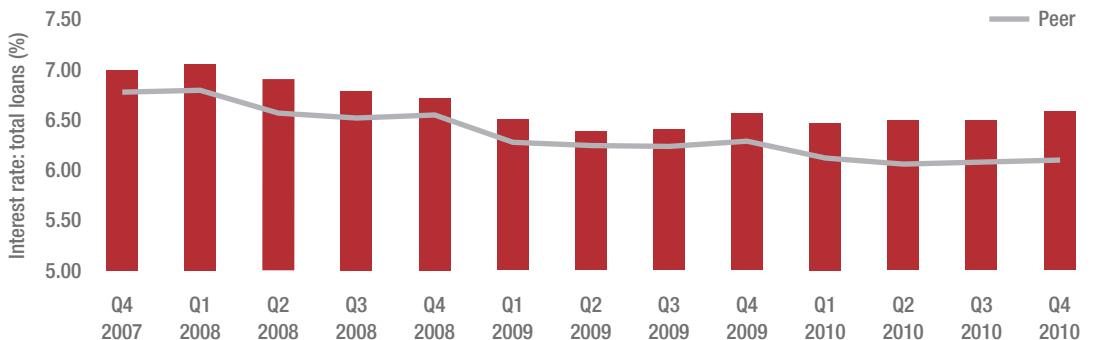


Figure 24: Sample Interest Rate Comparison



not a *true* transactional relationship and not a certificate), they should be reported on independently so as not to distort the analysis of transaction and time-based funding.

- Certificates and other funding: This category of funding carries the highest rate, shortest average life, and least loyal group of members who are constantly shopping for a better rate. This category of funding should never be summarized with draft and regular shares or money markets.
- Surplus funds (investments): Surplus funds are share balances that are not loaned out, and therefore they generate a lower rate of return residing in the investment portfolio. This is a number that has not been traditionally managed to. The current shape and slope of the yield curve demands its attention. It is a silent killer. A credit union with a low loan-to-asset ratio and a high money market and/or certificate product mix has its long-term survival at risk. The current spread between the cost of funds on those products and the investment yield is too thin to generate an acceptable ROA to offset annual increases in operating expenses. In many instances, the spread is upside-down (i.e., the cost of funds exceeds the rate at which they are invested).
- Noninterest income: As mentioned earlier in this report, noninterest income should be reported based on major product category; any single general-ledger item that represents 10% or more of total noninterest income should be reported on separately.

Report Card: Profit before Provision and Profit after Provision

Profit *before* provision is just that: core, day-to-day earnings *before* credit administration is factored into the equation. If the credit union does not perform well at this level, its only hope of survival is very small amounts of credit losses.

Profit *after* provision tells you whether capital will be accreted or depleted (prior to extraordinary income or expense). Effectively, this is a fully loaded measure of *operational* performance.

It is a mistake to not report on both at the same time. Misleading conclusions about operational performance are the result of not separating the two.

Report Card: Loan Loss Reserve

Loan loss reserve is self-insurance for potential loan losses in the future. The key is to keep the insurance fund adequately reserved. It is important because the size of the reserve has obvious implications on earnings:

Figure 25: Profit before Provision ROA

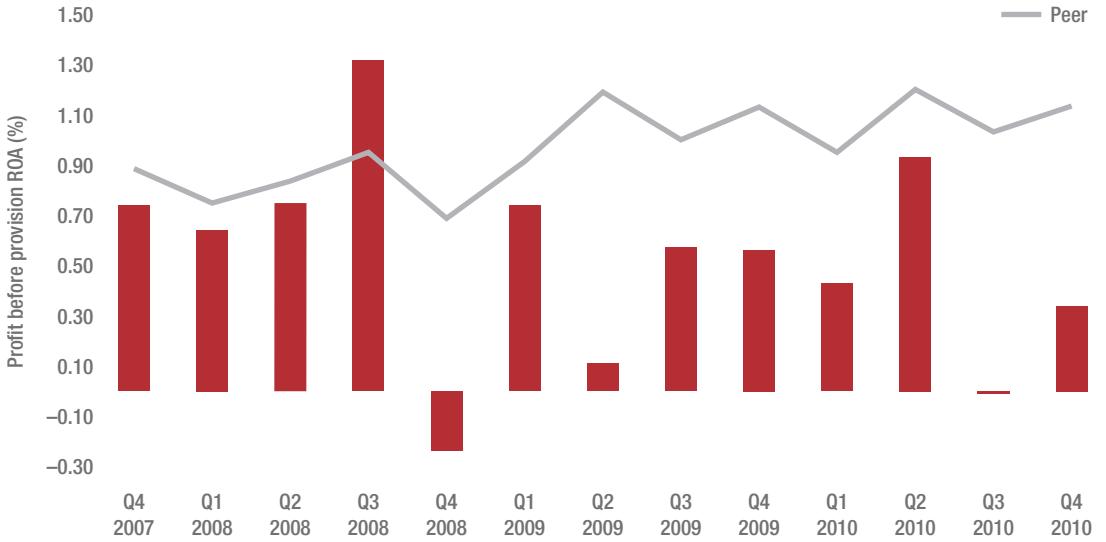
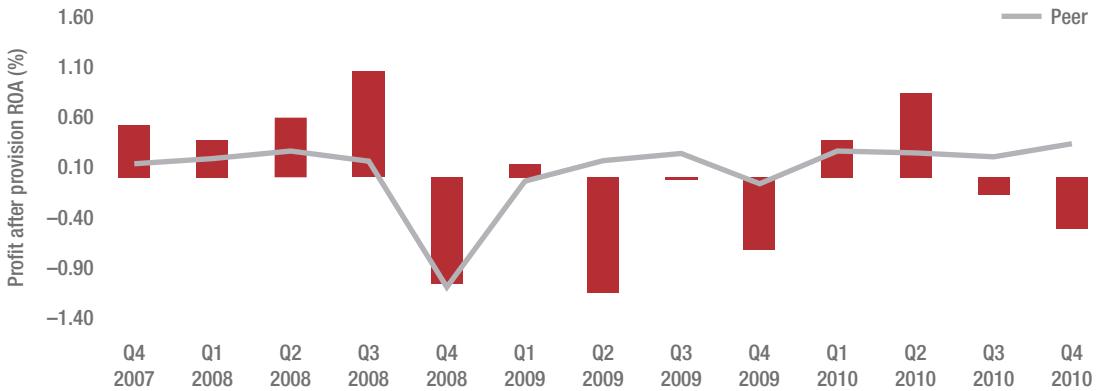


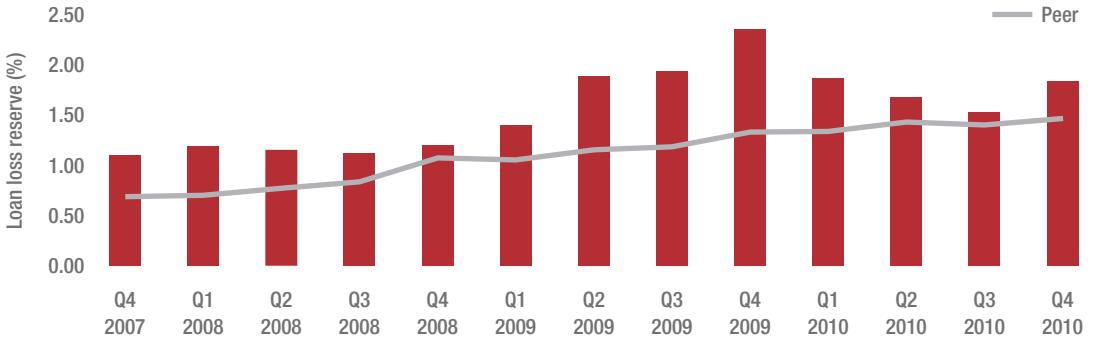
Figure 26: Profit after Provision ROA



- Credit unions whose reserves are larger than the reserves of their peers either have more risk of loan loss in their portfolio and have taken charges to earnings in prior quarters to build up the reserve balance or are overreserved and will be able to take smaller charges to earnings in future quarters.
- Credit unions whose reserves are smaller than the reserves of their peers either have less risk of loan loss in their portfolio or are inadequately funding their reserve account; they will have to take charges in future quarters to build up the reserve account.

Figure 27 illustrates the concept of trending loan loss reserve as a percentage of loans.

Figure 27: Sample Loan Loss Reserve Trends



Report Card: Past Dues

Immediately following loan loss reserve, one needs to understand what might be in the pipeline of future losses. There are a number of very good indicators of potential loan losses in the future; unfortunately, NCUA 5300 peer data are limited to delinquencies. Because of this, plotting a trend of delinquencies against those of a peer is the best available indicator of performance for comparison purposes.

The 30–59 days warning report is the first sign of possible problems. The 60+ days report is a more serious indicator of problems.

Report Card: Net Charge-Offs and Provision for Loan Loss Expense

Net charge-offs are realized losses. Provision for loan loss expense is the charge to earnings taken in advance of anticipated losses in the future (i.e., unrealized or prepaid loss expense). Over a period of time, net charge-offs and provision expense should cancel each other

Figure 28: Sample Past-Due Warning Report (30–59 Days)

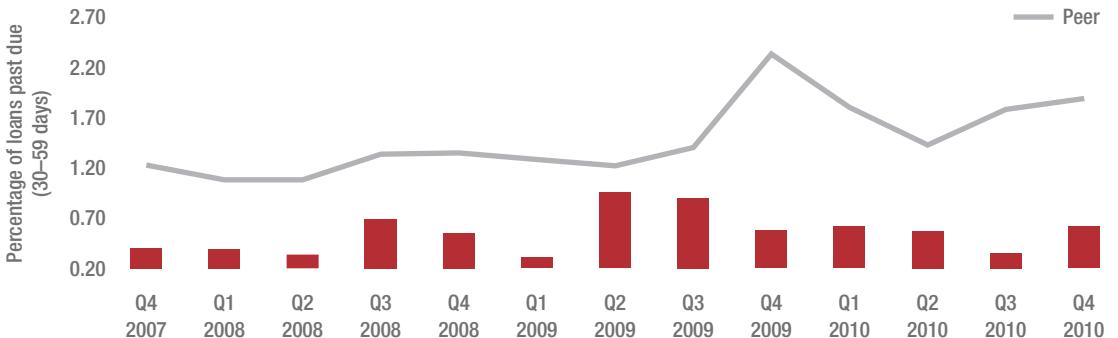
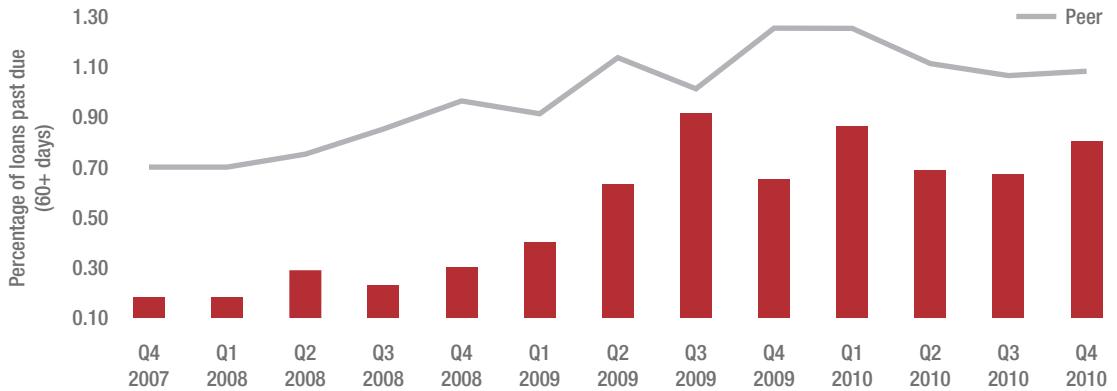


Figure 29: Sample Past-Due Warning Report (60+ Days)



out, or else you end up with a loan loss reserve balance that is either too large or too small. Trending both of these gives you a visual to see the degree to which the two are tracking against each other.

Report Card: Capital Ratio

There are three or four major derivations on the capital ratio. For the sake of simplicity and peer comparison, the capital ratio is defined as total net worth as a percentage of total assets. The credit union should have a target total capital ratio.

Figure 30: Sample Comparison for Provision for Loan Loss Expense

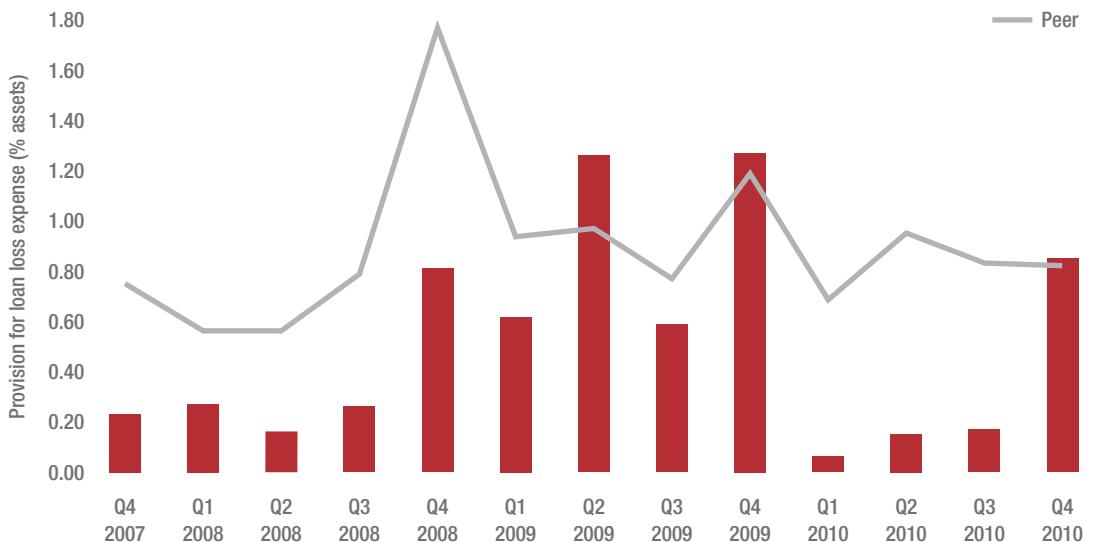
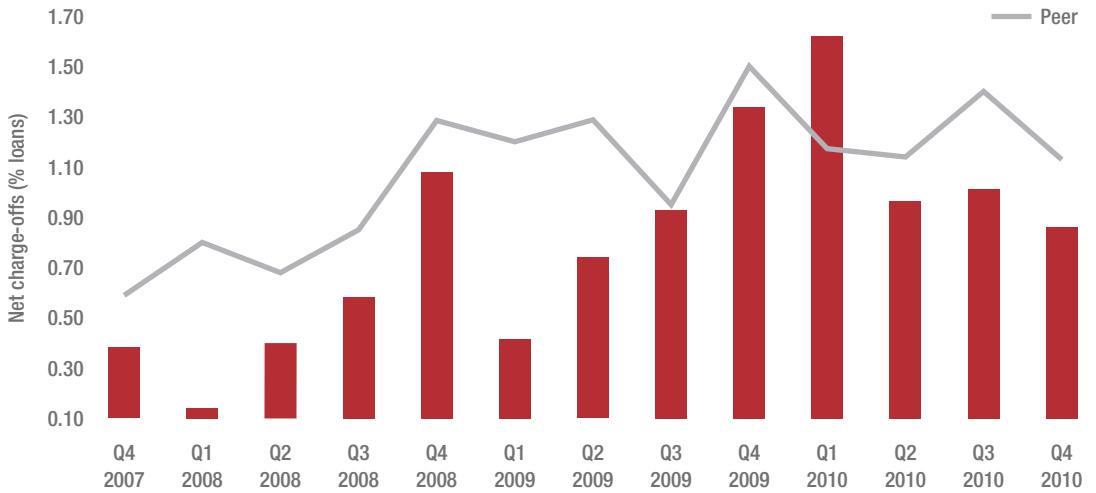


Figure 31: Sample Peer Charge-Off Comparison



Capital is like oxygen to a credit union. If there is too little capital, the credit union will no longer be able to breathe (hypoxia). If there is too much capital, the credit union is hoarding it rather than returning it in the form of dividends. A strong capital ratio is a big safety net, but too much capital can lead to performance complacency (hyperoxia).

The capital *ratio* trend tells us which is growing faster, capital or assets. Recall the discussion about capital constraints. If assets grow faster than capital for an extended period of time, the capital ratio will deteriorate, possibly to a point of hypoxia where the credit union cannot grow to offset annual increases in operating expenses.

Figure 32 illustrates the concept of trending the capital ratio.

Missing from Report Card: Extraordinary Income/Expense

Extraordinary income/expense is pure noise and needs to be called out separately. It makes unhealthy organizations suddenly appear fit, and healthy organizations suddenly appear unfit. In each quarter, a footnote should document the source of extraordinary income/expense and its impact on ROA and ROE.

Figure 33 illustrates the concept of trending extraordinary income/expense. Pay particular attention to the “lift” in ROA that extraordinary income provided this credit union in each quarter of 2009.

Missing from Report Card: Net Income ROA

Much like asset growth, net income ROA is a worthless measure. That’s right. I just said the bottom line is a worthless measure of

Figure 32: Sample Capital Ratio Comparison

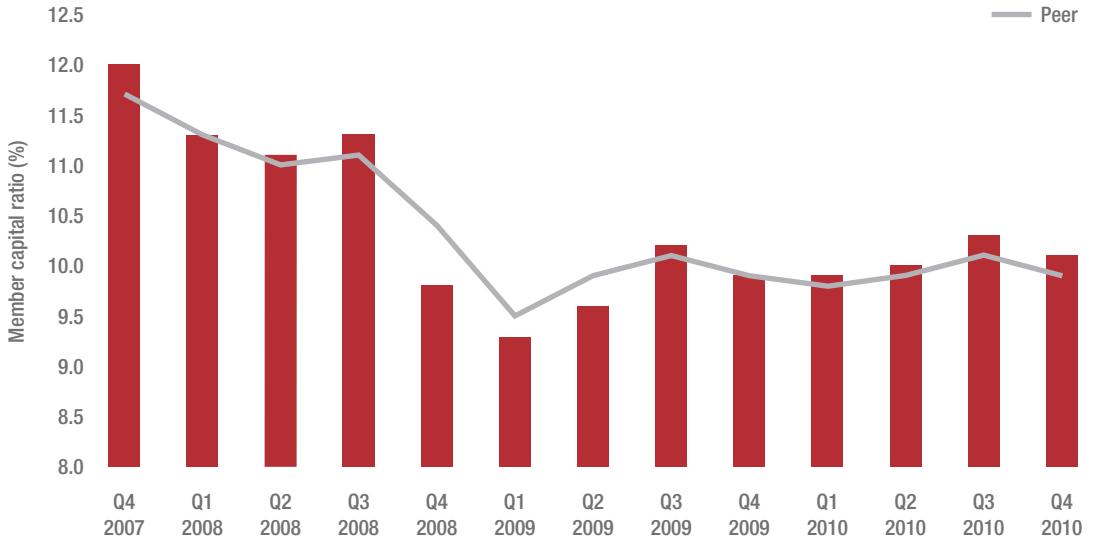
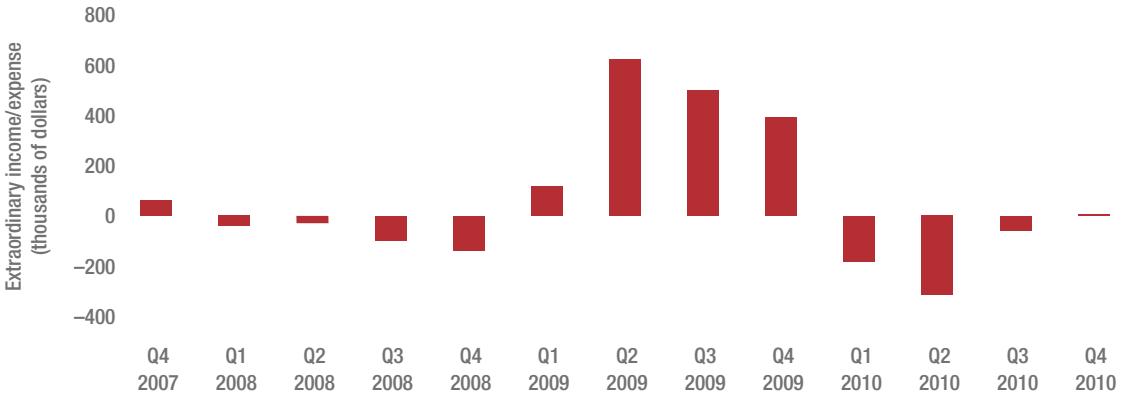


Figure 33: Sample Extraordinary Income/Expense Report

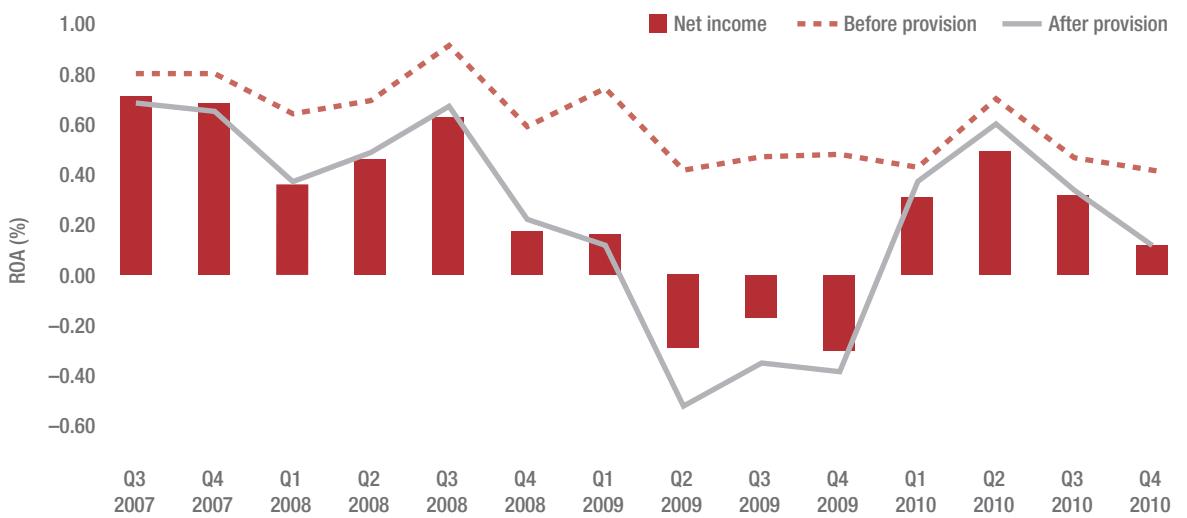


performance. Why? Because it includes the noise associated with extraordinary income/expense. Furthermore, benchmarking net income ROA is worthless for the same reason.

The only value that net income provides is a measure of capital accretion or depletion. Other than that, you cannot draw any meaningful or rational conclusions by looking at the bottom line.

I would still want to see a trend on net income, but on the same chart include return before provision expense and after provision expense, as illustrated in Figure 34.

Figure 34: Sample ROA Trend Report

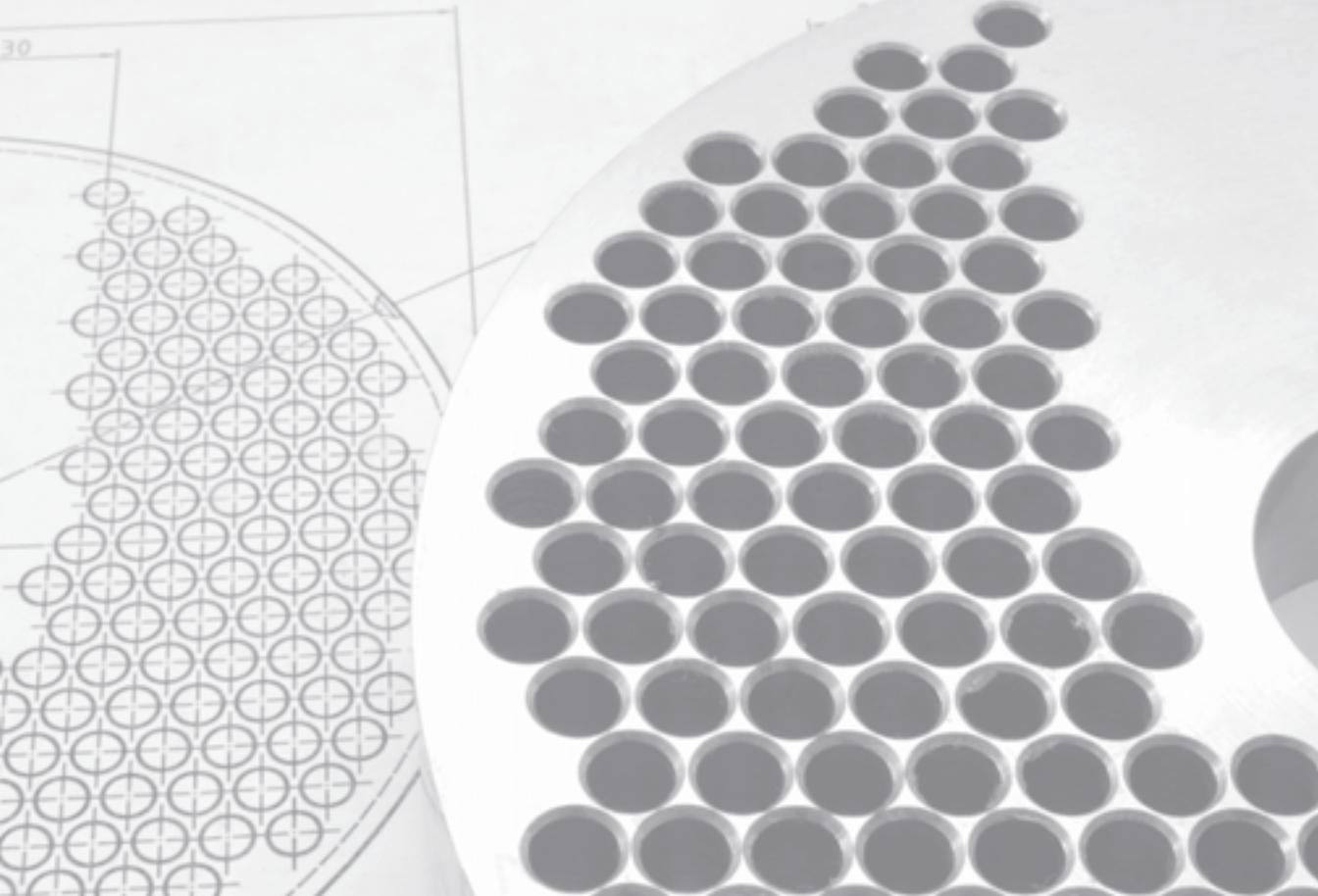


Recap: Monitoring Change

The best way to monitor change is by looking at a trend analysis and, while not 100% perfect, making comparisons to a relevant peer group. Here is a recap of the concepts just covered that you can use to develop an effective framework for reporting in your credit union:

- Create a standard report card. It serves as a common “language” for evaluating performance, spotting trends, and making peer comparisons.
- The report card needs to have a balance of summary and detail. Too much information and you become mired in data; too little information and you have no basis for making a qualified assessment of performance.
- The report card should focus on the major operational components of the credit union. Specifically:
 - Day-to-day operations.
 - Top-line net revenue.
 - Balance growth.
 - Product mix.
 - Interest rate differences vs. market.
 - Operating expense ratio (cost to serve members).
 - Credit administration.
 - Adequacy of loan loss reserve.
 - Potential for upcoming losses in future.

- Capital adequacy.
 - Capital ratio.
 - ROE.
- Reporting should include details on major product categories/ areas:
 - Noninterest income.
 - Loans.
 - Draft and regular shares.
 - Money markets.
 - Certificates and other funding.
 - Surplus funds invested.
- Use graphs, color coding, and directional icons to help readers interpret information (but don't overload users with too much color and graphic information; the key is to present the information efficiently and accurately to facilitate the *correct* assessment of performance).

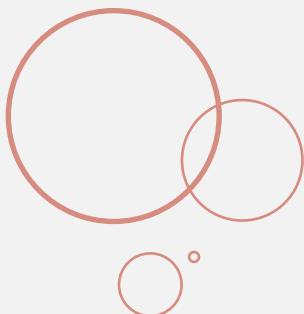


CHAPTER 3

An Incremental Approach to Managing Performance



Managing performance well is a function of identifying the appropriate goals and maintaining a tracking system to reach those goals. Too often, credit unions are missing one or both of these. This chapter helps you see how using both can earn the kind of gradual solid growth a credit union needs.





A Traditional (Waste of Time) Approach to Budgeting

Too often the budgeting and planning process for most organizations goes something like this:

Board Chair: What is the current year ROA running at? Well, that's not very good. We used to make an ROA of X.

Other Board Members: Grumble, mumble, groan. We agree with the Board Chair.

After a thoughtful bit of discussion (which might actually last about two minutes), the board comes to a consensus that the CEO needs to develop a budget that produces ROA of X%, just like in the good old days.

CEO to CFO: Well, how much asset growth will it take to reach an ROA of X?

CFO to CEO and Executive Team: It will take asset growth of Y to reach ROA of X.

Retail: We can't do that unless we have more staffing.

Operations: We'll need more back-office personnel and equipment.

Marketing: We'll need a bigger marketing budget.

Credit Administration: We'll need to lower underwriting standards. They are too tight.

CFO: I heard rates will most likely go up soon. That will help out. I'll put that in the budget to offset all of the growth in expenses that we will need.

The executive team presents the budget to the board. The board sees that the budget is for the ROA made in the good old days and quickly approves the budget so they can move on to more important things, namely, the location of the annual board retreat.

During the year, the following usually happens: Retail and operations staff up. Marketing develops an expensive marketing campaign

that includes lower rates on loans and higher rates on shares. Credit administration approves questionable credits. Finance blames the “Fed” when rates don’t improve as planned.

At the end of the year, the cost to operate the credit union has gone up by 7% but revenues have gone up by only 3%. The credit union shows no improvement in ROA; in fact, it has gotten worse.

Board Chair: What is the current year ROA running at? Well, that’s not very good. We used to make an ROA of X.

Here we go again . . .

A better approach to planning and budgeting would break the cycle of mediocrity.

A Better Approach to Strategic Budgeting

The first priority of any strategic plan is to provide for the ongoing existence of the entity.

The true test of the effectiveness of an executive team is its ability to bring about incremental change within the organization. This is the stuff of big boys and big girls—grown-ups who can make things happen for the benefit of the members they serve and the employees whose job security they are responsible for.

Budgets and strategic plans are a dime a dozen. Budgets that make strategic sense and emphasize risk-averse, *incremental* improvements in performance are worth their weight in gold. They are reasonable and attainable, and they provide an objective basis for management team accountability.

I cannot stress enough the importance of agreed-upon standards and accountability. The marketplace is flooded with silver-bullet solutions and whiz-bang benchmarks. But the truly useful objectives are not that difficult to grasp:

- The credit union must **grow net revenue** every year to offset annual increases in operating expenses and replace capital due to credit losses. Is it possible a year may pass with no net revenue growth? Of course. However, a trend of net revenue decline is the first sign that a credit union is on a path to failure. It sends a very strong and very clear message about its inability to produce an adequate amount of top-line net revenue.
- The credit union must **rationalize day-to-day operating expenses** relative to the net revenue it produces. It must develop a target expense ratio and make strides toward that target and/

or manage itself to within a reasonable variance of that target expense ratio.

- The credit union must **not extend credit to members who present a high repayment risk**. A credit union does not have a mandate to grow itself to the bounds of its capital ratio. A credit union does have a mandate to protect the members it serves; extending credit to unworthy members damages their credit history and unfairly burdens the members who do not have credit extended or who repay their loans.

As a quick aside, I know of credit unions whose board members do not participate in the development and administration of underwriting standards and policy. This is a *huge* mistake. The job of a board member is to metaphorically have “skin in the game,” just like an investor would in a profit-based entity. As I stated earlier in this report, credit union members are not second-class citizens; the credit union should not be operated in a second-class manner.

- The credit union must maintain an **adequate level of capital** to support its ongoing existence.
- The credit union must have an **executive team that can exact incremental change** within the organization.

Sitting in the director’s chair, compare these two budgets:

- Credit Union A: Our budget is to make an ROA of 1.00% this year (we made 0.40% last year). We expect to grow assets by 7%, increase operating expenses by 5%, and have about the same amount of credit losses this year as we had last year. We expect ROA to be helped significantly by an anticipated 75 bps rate hike occurring in the second quarter of the year.
- Credit Union B: Our budgeting and planning process has identified a series of incremental improvements in performance that will be accomplished over the next 12 quarters, which will reduce our expense ratio from 89.9% to 83.8% (peer is 77.6%).
 - The 12-quarter expense plan includes the following:
 - Limiting annual increases in personnel expense to 3.00% or less.
 - Limiting annual increases in premises expense to 1.00% or less.
 - Limiting annual increases in other expenses to 1.00% or less.
 - The 12-quarter credit administration plan includes maintaining a loan loss reserve of 1.50% and anticipates annual net charge-offs of 1.00%, 0.80%, and 0.60% of loans over the next three years.

- To offset operating expense increases and credit losses, the following net revenue plan has been developed:
 - The 12-quarter asset growth budget is 0.00%. The credit union has a large amount of surplus funds (over 50% of assets), and with the current shape of the yield curve, it would not make economic sense to attempt to grow the credit union. Instead, focus will be placed on improving *sustainable* product mix.
 - The 12-quarter product mix and interest rate plan is as follows:
 - Improve noninterest income as a percentage of assets from 1.22% to 1.40% (peer is 1.42%). This is a change of 0.02% per quarter.
 - Improve loans as a percentage of assets from 42.9% to 50.0% (peer is 59.7%). This is an improvement of 0.59% per quarter and would require annualized balance growth of 5.14%. To help facilitate growth, offer rates will be implemented that are more in line with those of the peer.
 - Improve draft and regular shares as a percentage of assets from 33.0% to 40.4% (peer is 40.0%). This is an improvement of 0.61% per quarter and would require annualized balance growth of 6.75%. The current offer rate is 0.34% (peer is 0.18%). To help facilitate growth, the offer rate will remain higher than the peer's but will decline to 0.25%.
 - Improve money markets as a percentage of assets from 28.5% to 30.6% (peer is 17.0%). This is an improvement of 0.18% per quarter and would require annualized balance growth of 2.42%. The current offer rate is 1.10%, which is significantly higher than the peer's, at 0.50%. The offer rate will remain higher than the peer's but will be reduced to 0.70%.

- Reduce certificates and other funding as a percentage of assets from 27.5% to 18.0% (peer is 32.2%). The credit union has a number of high-rate CDs maturing this year that will not be renewed.

Full realization of the plan will produce a run-rate ROA of 0.46% (ROA was 0.12% last year) and improve the capital ratio from 10.14% to 10.75%.

We will review our forward-looking 12-quarter plan at the end of each quarter to see if the desired improvements in performance are being realized and to make any necessary adjustments as the environment around us changes.

I like the chances of Credit Union B over Credit Union A. Credit Union B has a very thoughtful and quantifiable approach to meeting specific objectives. Credit Union A's plan is loaded with wishful asset growth, a significant increase in operating expenses, and the presumption of an interest rate hike. All of this culminates in an unreasonable ROA.

As a board member, I would have a lot of distrust in the executive team of Credit Union A and in its plan for such a dramatic improvement in ROA. I would be concerned about elevated levels of risk to make it happen (not only this year, but actions taken now whose full impact won't be felt for years).

As a board member, I would place more trust in the executive team of Credit Union B. Team members have laid out a series of specific outcomes they are trying to reach. In fact, I would even be sympathetic to failed attempts at improvement. With failed attempts comes a degree of wisdom. As long as the failures came with a lesson learned, and overall improvements in performance outpaced failures, my confidence level in the executive team would grow.

Figure 35 shows an example of using the report card (covered in the last chapter) to develop a plan for Credit Union B.

Figure 35: Sample Strategic Budgeting Report Card

Strategic priorities

	Peer	Credit union prior 4 quarters	Credit union +12 quarters	12-quarter change	Per-quarter change
Operating expense ratio	77.6%	89.9%	83.8%	-6.1%	-0.5%
Net revenue ROA	4.81%	4.29%	4.70%	+0.40%	+0.03%
Profit before provision	1.08%	0.43%	0.76%	+0.33%	+0.03%
Provision expense	0.83%	0.31%	0.31%	0.00%	0.00%
Profit after provision	0.25%	0.12%	0.46%	+0.33%	+0.03%
Capital ratio	9.90%	10.14%	10.75%	+0.60%	+0.05%

Tactical objectives

Operating expenses	Peer prior 4 quarters	Credit union prior 4 quarters	Expense		
			Qtr 1-4	Qtr 5-8	Qtr 9-12
Personnel expense	\$4.725M	\$5.939M	\$5.939M	\$6.118M	\$6.301M
Premises expense	\$2.789M	\$2.819M	\$2.819M	\$2.847M	\$2.875M
Other expenses	\$2.120M	\$2.405M	\$2.405M	\$2.429M	\$2.454M
Total expenses	\$9.635M	\$11.163M	\$11.163M	\$11.394M	\$11.630M

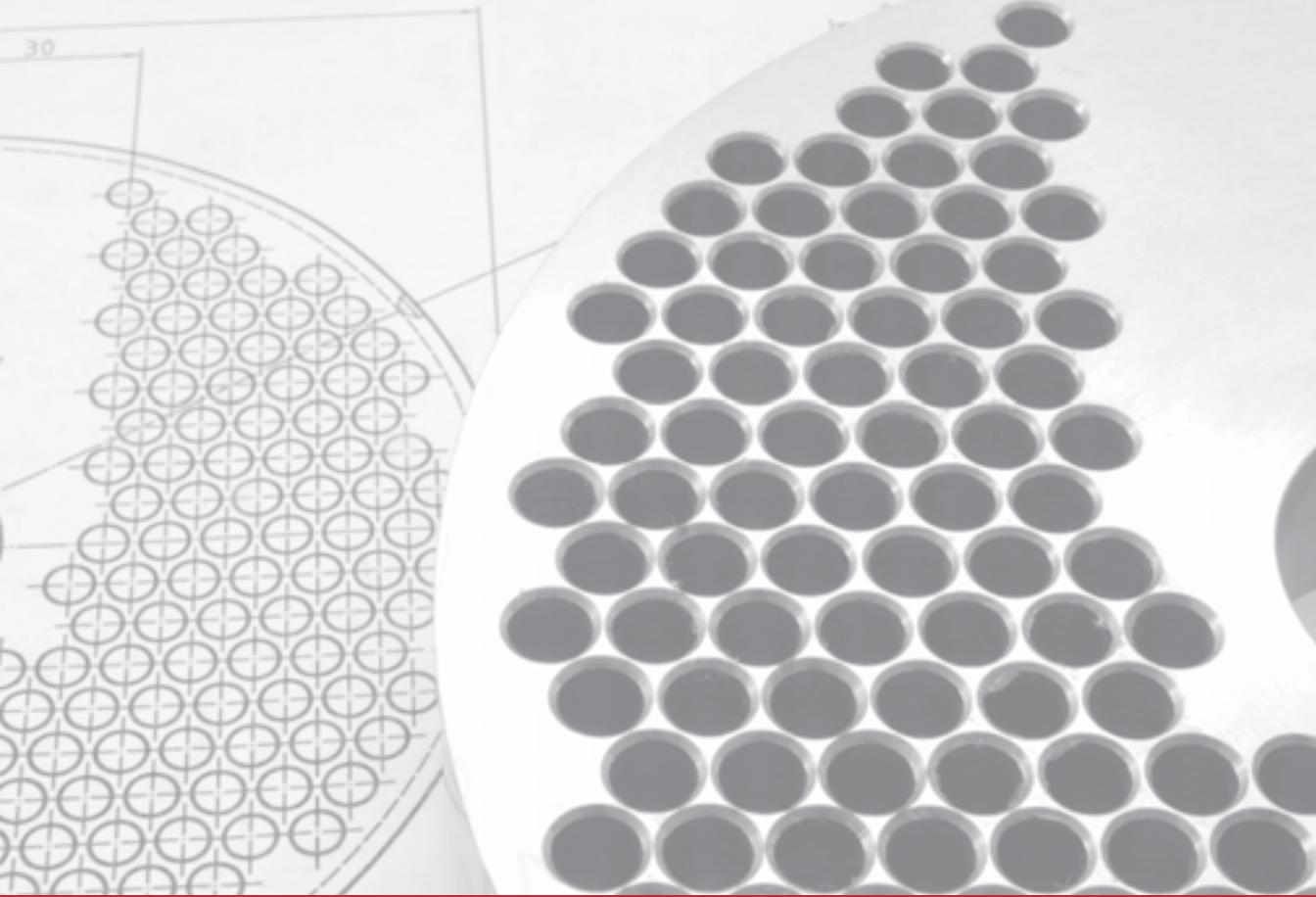
Credit administration	Peer	Credit union	Growth		
			Qtr 1-4	Qtr 5-8	Qtr 9-12
Loan loss reserve	1.45%	1.83%	1.50%	1.50%	1.50%
Net charge-offs	1.21%	1.12%	1.00%	0.80%	0.60%

Growth	Peer balance	Credit union balance	+12 quarters balance	Quarterly growth	Growth rate
Assets	\$295.706M	\$295.706M	\$295.706M	\$0.000M	0.00%
Loans	\$176.450M	\$126.845M	\$147.853M	\$1.751M	5.14%
Draft and regular shares	\$118.181M	\$97.717M	\$119,459M	\$1.812M	6.75%
Money markets	\$50.381M	\$84.150M	\$90.474M	\$0.527M	2.42%
Time-based and other	\$95.196M	\$81.293M	\$53.227M	(\$2.339M)	-13.81%

Product mix	Peer % assets	Credit union % assets	+12 quarters % assets	Change per quarter	Growth rate
Noninterest income	1.42%	1.22%	1.40%	0.02%	4.59%

Balance sheet mix	Peer % assets	Credit union % assets	+12 quarters % assets	Change	Change per quarter
Loans	59.7%	42.9%	50.0%	7.10%	0.59%
Draft and regular shares	40.0%	33.0%	40.4%	7.35%	0.61%
Money markets	17.0%	28.5%	30.6%	2.14%	0.18%
Time-based and other	32.2%	27.5%	18.0%	-9.49%	-0.79%

Interest rates	Peer rate	Credit union rate	+12 quarters rate	Quarterly change
Loans	6.10%	6.68%	6.10%	-0.048%
Draft and regular shares	0.18%	0.34%	0.25%	-0.008%
Money markets	0.50%	1.10%	0.70%	-0.033%
Time-based and other	2.21%	2.61%	1.25%	-0.113%
Investments	2.46%	2.56%	2.05%	-0.043%



CHAPTER 4

Conclusion

Strategic budgeting should be a proactive process, not a reactive one. By constantly focusing on where they want to be with respect to net revenue ROA, expense ratio, credit loss tolerance, and capital adequacy, credit unions are planning for, and constantly working toward, success and long-term prosperity.



Be quick, but don't hurry.
—John Wooden

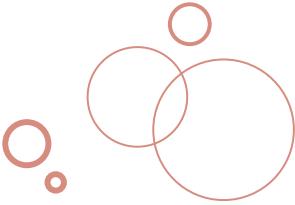
By combining peer data (for reference and relevance) with a product focus, it becomes much easier to build a plan for success. Budgeting and planning does not have to be an overly cumbersome exercise, but it should not be performed with a cavalier attitude, either. It simply needs to be a thoughtful process.

Furthermore, budgeting and planning should not be an annual exercise; it should be an ongoing exercise that is evaluated and revisited on a quarterly basis.

By developing a framework centered on the key elements of success, it is possible to maintain a strategic focus, but with enough tactical detail to create actions plans. The key focal points should include:

- Net revenue ROA.
 - Balance growth.
 - Product mix.
 - Interest rates.
- Operating expense ratio.
 - Personnel expense.
 - Premises expense.
 - Other expenses.
- Credit administration.
 - Maintenance of loan loss reserve.
 - Management of credit losses relative to growth needs.
- Capital adequacy.
 - Maintaining adequate capital reserves.
 - Accreting capital to fuel future asset growth.

In the end, managing an enterprise is not that difficult if you know and understand the de facto metrics of success. The key is to not become mired in information overload. If you can manage the de facto drivers, you will be successful by default.



ideas grow here

PO Box 2998
Madison, WI 53701-2998
Phone (608) 231-8550

www.filene.org

PUBLICATION #246 (7/11)

filene
RESEARCH INSTITUTE

