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End of 2018 May Put Credit Union (CU) Earnings at Substantial Risk

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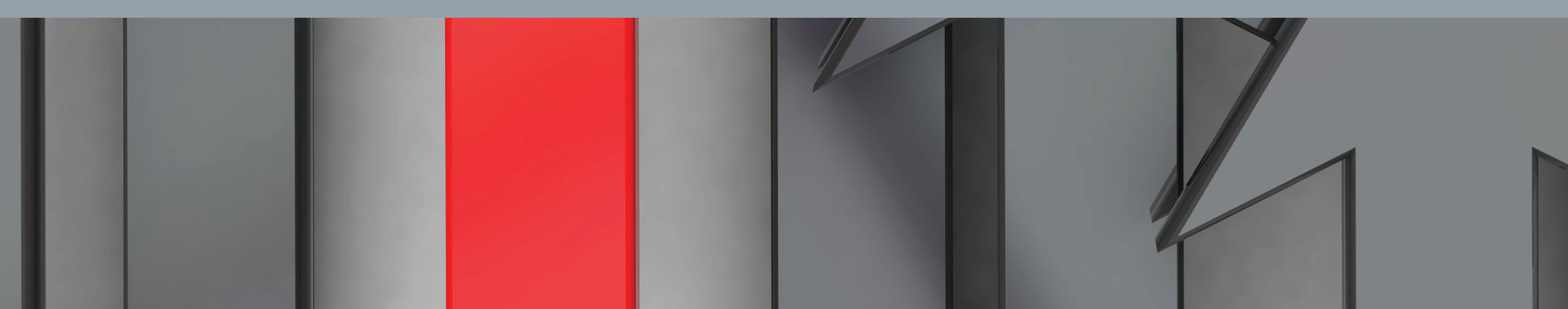
The Problem

There is a **False Sense of Security** in 1Q 2018 which could be masking a substantial risk to earnings by the end of 4Q 2018 caused by 3-4 potential short term rate increases this year.

What to do now?



In this piece, we will discuss...

1. **Why a "false sense of security?" – Its background and why it's here now.**

2. **If profitability/NIM seems to be better short term, how can I protect my margin (NIM) in light of the FOMC raising rates 3-4 times potentially in 2018?**

3. **Why in 2018 as much as 80-90% of CU's investment portfolios could underperform, in this expected rising rate environment in 2018.**

1 Why a "False Sense of Security?" - Its background and why it's here now.

The Background

Remember 2007-08 the so-called "Great Recession?" As an industry, CU's withstood the failure of U.S. Central CU and Wescorp FCU – But it was put on the backs of natural person CU's to "bail out"/fund the failure of these two one-time iconic institutions.

2007-08 saw the FOMC move into a "zero interest rate policy" – keeping its fed funds target rate at 0-0.25% - from Dec. 2008 until Dec. 2015 when it finally raised the rate initially by 25 BPS. The result of this was to affect the entire rate structure – not just short term rates.

How did this affect CU's? We saw a great shift downwards in rates on the asset side of our balance sheet. As older assets (loans and investments) came off the books, we reinvested them at lower and lower rates – which led to unwanted margin compression and earnings challenges. Meanwhile, other legislative measures such as Dodd-Frank cut into a CU's ability to earn fee income.

Some margin relief came in the form of paying less and less to our savers until our overall share rate structure "mimicked" the fed's zero interest rate policy.

But overall, margin compression had become a reality…so where are we now?

Now, we've seen that the FOMC has been raising the Fed Funds rate since Dec. 2015. It has gone from 0%-0.25% to 1.50%-1.75% as of late March 2018.

As a result of this, most recently, CU's have been able to see a lift in earning power on the **asset** side of the balance sheet:

- **Short term cash** is higher.
- **Maturing investments** have been rolled over into higher rate bonds and/or loans as the 10 year also climbed from 2.07% in Sept. 2017 to almost 3.00% in late Feb. 2018.
- **Loan Dollars** have rolled off and have been replaced at higher yields.

This has/will create a temporary false sense of security

Why? Because the share/deposit side of our balance sheet has yet to reprice and we are moving into a headwind of 3-4 more rate increases in 2018. Why should this cause concern if the FOMC raises rates 3 times in 2018?

Answer: Because the real level of short term money market rates could exceed 2% by the end of 2018 – and liquidity may become tighter for CU's as CU depositors awaken from their 0% interest rate slumber and begin to shop for higher savings rates from ***money market funds*** (think Schwab and Fidelity), ***Banks and even other CU's*** in your local market.

This, of course is known as disintermediation – it hasn't been an issue in a long time for CU's as most CU's have been awash with liquidity during 2008-2015/16. This will be a significant issue by 4Q 2018 after the FOMC has raised rates 3-4 times.

But what about now? CU's should experience a temporary earnings lift (relief/euphoria?) and possibly come to the mistaken conclusion that: "we do better (profitability/NIM) in a rising rate environment." While this will be true in the short term, it will not be the case by the end of 2018.

2 If profitability/NIM seems to be better short term, how can I protect my margin (NIM) in light of the FOMC Raising rates 3-4 times potentially in 2018?

It is a classic ALM/Net Interest Income (NII) happenstance which provides a "false positive" (false sense of security earnings-wise)

Stage 1

As rates rise, short term assets reprice immediately, thereby driving interest income higher – these are ***both market driven*** (investments) and ***administered rates*** (loans). This is temporary!

Stage 2

As this is occurring, a CU's deposit rates are left virtually untouched, except for CD rates. Deposits rates are administered– not market driven and have to be manually changed – usually by ALCO or its delegated authority.

Stage 3

As a result, NIM increases and profitability ***temporarily*** increases. But the aforementioned headwind of rising rates eventually must be addressed on the deposit side.

Conclusion:

This scenario has a strong likelihood of playing out in 2018 so that if no alternative measures are taken – CU earnings in 4Q 2018 could be at **substantial risk** because rates must be raised on our most rate sensitive deposits… and if the 80%/20% Rule follows where 80% of the deposits are controlled by 20% of the members, then things will be challenging at best in 4Q 2018. Even a small increase on a large amount of deposit dollars will squeeze NIM.

How Can I Protect My Margin (NIM) in 2018?

We must protect/maintain (increase?) NIM - And there are 3 primary ways to do that as pressures mount:

1) **Lower my cost of funds (COF)** – clearly **not** an option when rates are rising, plus most CU's already have their structure of rates (shares/share drafts/ MMA's/CD's) in the "zero interest rate" framework; i.e., set as low as possible
2) **Change my asset mix**
    a. **Lengthen assets/earn higher yield** – not a great alternative for all CU's depending on liquidity, IRR/ NEV and certainly capital dependent (strong/weak?)
    b. **Change to floating rate assets** (investments and loans or loan participations). I would submit that this is – most likely – one of the best options a CU can consider in 2018
3) **Grow the Balance Sheet**
    a. **Decrease reliance on non-core funding dependency –** shift from chasing retail deposits ("CD specials")
    b. **Wholesale funding/FHLB Funding or issue CD's through broker or CD Network**
    c. **Wholesale funding result in cheaper COF for more rate sensitive or volatile liabilities**

NOTE: We suggest discussing alternatives in detail on a monthly strategy call, as we do with all clients of our group.

3 Why in 2018, as much as 80-90% of CU's investment portfolios will underperform in this expected rising rate environment in 2018?

The reason for this statistic is very simple: Most CU portfolios contain 80-90% fixed rate investments. In a rising rate environment, not only do these assets not reprice but they become a drag on earnings as rates increase and they are stuck at increasingly unattractive lower rates. What could make this even worse? Fixed rate investments quickly fall away from their book value as rates rise and cannot be liquidated without a substantial loss.

Our clients have been re-allocating their investments towards floating rate coupons since 2013-14. We will continue to be proactive with these floating rate strategies throughout 2018 in light of 3-4 expected FOMC rate hikes. It is not too late to reallocate your investment mix from fixed to a meaningful floating rate percentage.

The results of this strategy which our clients have been reporting, has indeed been gratifying and will benefit by 75BPS-100BPS more this calendar year, as floating rate holdings reset. It still does not make financial sense to buy a fixed rate bond at this juncture, when the comparative yields are as good/better than what can be acquired on a floating basis. So if we are – on the date of purchase – as good/ better than what can be acquired in a fixed rate MBS/CMO, we will be better off with further short term rate increases during 2018.

CAVEAT: Agency arm MBS which reprice as little as one year and as long as five years, will not get the job done in this rate environment.

What to do now?

First and foremost, we need to think differently, because market conditions (i.e., rising rates) demand it.

Margins should temporarily improve, but depending on the number, magnitude and pace of 3-4 rate increases–margins will should come under pressure, possibly under siege by 1Q 2019.

We recommend looking at both asset (floating rate investments and loans/loan participations) and liability strategies (such as wholesale funding through FHLB or brokered CD's vs chasing retail deposits). This can be done through "what-ifs" on most ALM models.

We will touch on these ideas during our clients' monthly scheduled strategy calls, as well as upcoming webinars and educational forums available to all CUs.

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Conclusion: There is definitely a "false sense of security" that is emerging or will emerge with respect to CU earnings in 1Q 2018. Until the real market effects of 3-4 rate increases begin to kick in and the deposit rates of CU's come under pressure in 4Q 2018, this false sense of security will continue!

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