DCU BULLETIN

Division of Credit Unions

Washington State Department of Financial Institutions

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October 3, 2001 No. B-01-16

Earnings Weakness

While individual credit unions may have demonstrated results contrary to the trend, the return on assets for all state chartered credit unions further declined 9 basis points to .63% annualized for the six month ending June 30, 2001. One of the key factors in that decline was the erosion of net interest margin. Over 70 credit unions reflected a decline in the net interest margin.

Many credit unions have not yet implemented an effective process to control the impact of interest rate changes despite the increased attention by examiners to asset / liability management (ALM) issues. Examiners are finding that policies, training, and committees are beginning to be implemented. However, the erosion of net interest margin noted above indicates that many credit unions have not yet been effective with the ALM process.

In some cases, the recent decline in interest rates has led to lower returns on assets, but many credit unions simply have not adjusted liability rates to maintain the net interest margin. A number of credit unions do not have a process in place to quickly adjust the liability rates when the market indicates the need for a decrease. Any number of alternatives are open to boards of directors. For example, they could:

- Delegate full authority to senior management or an appropriate committee to make rate changes,
- Establish bands within which senior management or a committee has the authority to adjust rates, or
- Meet more frequently and <u>take action</u> to adjust rates.

In part, this situation has been the result of the 13% growth in assets as members increase shares or certificates of deposit rapidly but without loan growth keeping pace. In many cases the failure to earn a positive spread on the new liabilities has eroded the net interest margin. Should this condition continue, credit unions may be tempted into higher risk assets with inadequate controls. Careful attention should be given to the types of assets obtained and to avoid inappropriate or uncontrolled risks.   For further discussion of managing highly rate sensitive and volatile funding sources, see NCUA Letter to Federally Insured Credit Unions 01-CU-08.

Credit unions that find themselves with a deteriorating net interest margin may also find that examiners will be giving them lower ratings in the "L" (asset / **L**iability) component of the CAMEL rating. The rating will depend upon circumstances in each credit union. One mitigating factor may be the level of net worth for the credit union. Credit unions with higher net worth ratios may have the strength to see them through an extended adjustment process.

A number of credit unions have taken appropriate action to correct the adverse impact on earnings discussed in this Bulletin. Those who have not taken action should give immediate attention to the impact on the earnings of their credit union.

Should you wish to discuss these conditions further, please contact Linda Jekel, Program Manager, (360) 902-8753.