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Opinion How funds transfer pricing analysis can help reshape your margins

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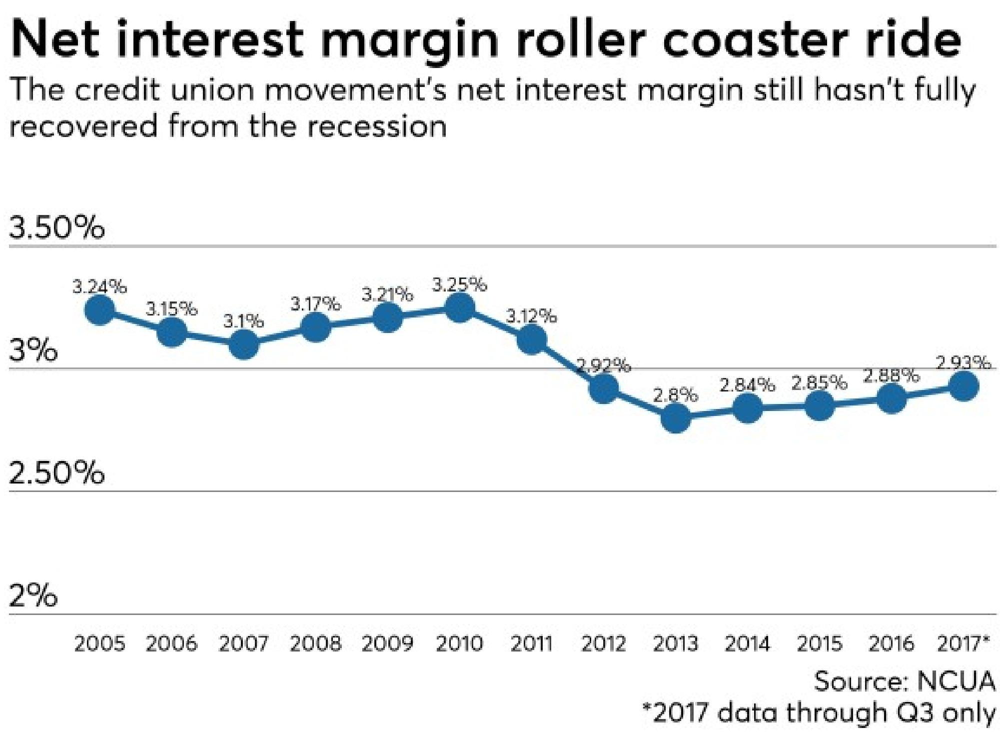
Financial institutions have watched their net interest margins (NIMs) shrink for more than 20 years in response to many factors, including an historically low interest rate environment, a flattening of the yield curve, and a shift in balance sheet structures.

While interest rates are slowly beginning to climb, and margins appear to be increasing slightly, analysts do not expect significant NIM improvements any time soon. This margin compression has been the norm for so long that many credit unions simply resign themselves to it; and fewer still take proactive measures to ensure that they are optimizing margins.



Although a credit union’s first responsibility is to its members, viable performance metrics are nonetheless important to the institution. By better understanding and analyzing the contributors to (or drivers of) profitability, institution leaders will have more effective methods to manage margins. In a 2017 study conducted by Kaufman Hall and the Association for Management Information in Financial Services, financial institution leaders confirmed the need to optimize margins through deeper analyses. More than 100 CFOs and other senior finance professionals of banks and credit unions responded to the survey. Only 17 percent said they have a clear understanding of the profitability of their products and members. A full three-quarters of respondents reported gaps in their understanding, but have efforts underway to improve profitability at their institutions.

These statistics are concerning. If an institution does not understand its profitability drivers — including which branches, products, and even members are truly profitable — it is difficult to make informed decisions on where to invest resources. To have a complete picture of these profitability drivers, successful institutions start with the largest component of profitability, that is, the calculation of funds transfer pricing (FTP) and its effect on their overall margin management strategy.

So how can finance leaders harness the components of FTP to benefit their institutions? As with any financial measurement process, the ultimate goal for using FTP should be to support better analysis and decision making.

To gain insight into the power of FTP analysis, credit union leadership should look at the planning process holistically. They should focus on each stage of the enterprise management lifecycle **—** analyze and measure, strategize, plan, and monitor **—** to gain more insights into what drives margin growth. Considerations for each stage are described below.

Analyze and Measure
Some finance professionals question the importance of historical performance analysis, doubting the value it adds to performance forecasts. However, using FTP to better understand the net interest margin and profit contribution of each branch, product, member, officer, channel, etc., allows leaders to better identify areas of underperformance and potential opportunities for pricing improvement.

Strategize
Once potential opportunities for performance improvement have been identified

through historical analysis, finance teams can evaluate various strategies using "what-if" scenario analysis. Examples of possible scenarios include:

- Growth strategies for particular product segments
- Modifications in pricing strategies to improve spreads
- Strategies to drive existing and/or new members to more profitable channels and/or products

Forecasting FTP as part of the scenario modeling and evaluation processes enables finance professionals to predict specific metrics (including net interest margin for each segment) to best define and drive a strategy that optimizes financial performance.

Plan
A detailed budgeting and forecasting process should be created to help credit unions develop, implement, and execute a tactical plan that enables achievement of agreed-upon strategies. Typical budgeting and forecasting processes focus on volumes, rates, and non-interest income/expense items. By adding forecasted FTP, the budgets (and subsequent forecasts) can also include NIM for each segment. This approach enables leaders to better plan, track, and evaluate whether performance is aligned with goals.

Monitor
By monitoring profitability drivers on a monthly cadence and distributing timely information to stakeholders across the institution, leaders and managers can seize opportunities and identify potential problems in the early stages. Reporting should be appropriate to the audience, such as summary dashboards for senior management and more detailed reports for frontline managers, with the ability to drill down in the data for deeper insights on specific profitability drivers.

As credit unions continue to face the constraints of tight margins, their leaders should be looking for every opportunity to increase spreads. Now is the time to leverage FTP to its fullest capabilities. By using funds transfer pricing as a key tool throughout the EPM cycle, finance leaders can gain a deeper understanding of what drives profitability for informed decision making.

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