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CFO Focus: Leveraging Funds Transfer Pricing to Maximize Margin

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Finance teams need an accurate and consistent methodology to analyze profitability and performance.

Credit unions continue to experience tight margins due to many factors, including low interest rates, a flattening of the yield curve, growth of share accounts, shrinking loan portfolios and a shift in balance sheet structures. Even with a recent uptick in net interest margin for the overall credit union industry (**up to 3 percent for Q1 2017 (https://www.ncua.gov/newsroom/Pages/news-2017-june-ncua-releases-q1-credit-union-system-performance-data.aspx)**), credit unions continue to operate in a historically low NIM environment. As net interest margin typically represents 50 to 85 percent of an institution's bottom-line income, finance teams need an accurate and consistent methodology for calculating and analyzing NIM to truly measure profitability and performance. Although credit union mission statements are geared toward serving members, profitability is nonetheless an important factor in determining institutional health and viability and needs to be considered strategically in your organization.

In an environment of tight margins, employing matched-term funds transfer pricing as a tool for proactive margin management provides an opportunity to improve bottom-line results. Funds transfer pricing is an internal management information system designed to allocate NIM across all segments of the credit union, including branches, products and members. FTP is often used for historical analysis and measurement, but should also be an integral part of strategic planning, budgeting and forecasting to ensure alignment with organizational goals and strategies. Let's examine the use of FTP throughout the enterprise performance management cycle.

Identify Opportunities: Historical Analysis

In a historical analysis, it's important to understand the NIM and profit contribution of each segment (e.g., branch, product, member, officer and channel). Using FTP as part of this analysis can reveal areas of underperformance. Finance professionals should measure NIM at the individual record level, then roll it up and analyze that margin across every segment of the institution to identify where opportunities exist to improve margins.

Specific ways to use FTP and profitability metrics in historical analyses include the following:

- **Peer analysis:** Comparing your results to those of similar credit unions can help you to gain insights as to how your institution's NIM is performing overall.
- **Pricing analysis:** Understanding pricing decisions and their effect on your margin by drilling down into detail data is useful when comparing margins in particular segments (e.g., products, members, etc.) to overall performance. For example, you might find that the NIM, or FTP spread, on mortgage loans is considerably lower than the spread on other interest-bearing assets. To understand why, consider conducting risk-based pricing analysis that measures the relationship of such factors as internal risk ratings or FICO scores to FTP spreads to determine whether loan margins are being generated in accordance with the risk the credit union is taking.
- **Ranking, comparative and trend analysis:** Taking the examination a step further, you might rank mortgage loans against other loan products to determine where you want to focus strategic, marketing and other new business development efforts. For example, while the growth of mortgage loan volumes may be significant, you may find that consumer loans are actually providing a higher NIM. Increasing loan originations for higher-spread products can improve margins for the credit union overall.

Evaluate Opportunities: Strategic Planning

Based on your historical analysis, it's useful to perform "what-if" scenario analyses to evaluate various strategies, using forecasted FTP to determine which opportunities will generate the best results.
Have certain branches underperformed, or have branches in one area been particularly profitable? Analyzing NIM at the branch level may guide plans to open or close branches in those markets.

On another dimension, projecting NIM at the product level enables credit unions to drive business by focusing efforts on the highest-performing products and assessing the impact of pricing improvements for lower performing products. For example, according to a **survey published by Insureon (http://www.insureon.com/resources/research/2017-predictions)**, 82 percent of small businesses expect to grow in 2017. Given the current interest rate environment, your small business loan volumes may likewise be increasing. Is that growth driving commensurate profitability? By analyzing the NIM of your business loan products under various pricing scenarios, you can make informed decisions on pricing guidelines for each loan type to improve spreads.

Execute on Opportunities: Budgeting and Forecasting

To better plan, track and evaluate performance objectives that align with the overall goals of the credit union, it's critical to bring the process down to a tactical level, folding identified opportunities and evaluated strategies into the budgeting and forecasting process.

Typical budgeting and forecasting processes focus on volumes, rates and non-interest income/expense items. By also forecasting FTP as part of the budgeting process, institutions are better able to assess future performance, including the expected NIM (spread) and income (dollars) by initiative and segment.

Adding FTP to the equation can help your finance team:

- evaluate the relative value of strategic initiative options,
- create a standard measure across markets and between teams,
- remove the impact of the interest rate environment from goal setting, and
- provide an account pricing tool, with very tactical applications.

Make It a Cohesive Process

Throughout the performance management cycle, credit unions must tie these identification, planning and execution activities together into a cohesive process. By using historical analysis to identify opportunities, strategic analysis to quantify and evaluate possible improvements, budgeting to bring strategic initiatives to the tactical level, and NIM as a target and variance metric to measure and drive performance, credit unions can improve margins and make the most of the current economic climate.

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