

# Stakeholders: Measure, Monitor and Manage Performance

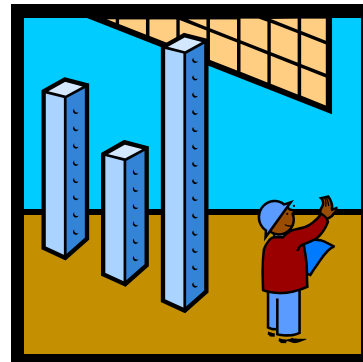
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## Setting the “Budget” Bar...

At or near the top of every credit union’s priorities is the following statement:

**“We exist to create value for members.”**

The fundamental question becomes, how do you define value? Is it service quality? Is it convenience? Is it product offering? Is it favorable rates? Most likely, it is a combination of these factors and a few others; however, **if you cannot do the items just listed in a cost effective or productive manner then you are not creating value for members.**



One universal measure of cost effectiveness or productivity is operating expense as a percentage of net revenue. This metric is often referred to as an “expense” or “efficiency” ratio. **The smaller the ratio, the more cost effective or efficient the organization is.** Let’s dig into this important measure of value a little deeper.

**Expense Ratio = Operating Expense / Net Revenue**

**Operating Expense** is defined as **all expense necessary to run the credit union on a day to day basis.** It includes compensation and benefits (by far the largest expense), occupancy, operating and servicing expense, professional and outside services expense, education and promotion, etc. Basically, all non-interest expense, excluding provision for loan loss expense, which is a function of loan balance, underwriting standards, economic conditions and whatever your auditor tells you to use.

**Net Revenue** is defined as **interest income** minus **interest (dividend) expense** plus **non-interest (fee and other operating) income.** Net revenue is really gross profit (sales minus cost of goods sold). Enough net revenue must be produced to cover operating expense, credit losses and provide a reasonable rate of return. *In every other industry gross profit is reported on the income statement. It is not in our industry ... I have never understood why.* **Arguably, net revenue is the most important number. If you miss your “top line” net revenue figures, you will miss your bottom line figures as well.** Why, because you are in a fixed cost industry. You have virtually no variable expense to speak of; even utility expense is fixed ... you have to open the doors, light, heat and cool your buildings for a certain number of hours each day.

So, how does the expense ratio come into play when setting the “bar” on your budget? It’s simple:

**Every credit union should have an expense ratio target.**

Operating the credit union in a cost effective manner creates value for your members. **Managing a credit union is just like managing a mutual fund.** The lower the “expense ratio” on the mutual fund, the more value that is left over for the mutual fund owners ... its members. On the next page, I provide some guidance that you can use to establish an expense ratio target in 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 expense. A target expense ratio exceeding 100% would only be tolerable if the organization has surplus capital and is growing rapidly (e.g., a startup).
- Expense Ratio 90-100%** **Slow Death.** Credit unions with recurring expense ratios in this range will not create enough income to cover traditional levels of credit losses (40-50bp). Capital will be steadily depleted and it will not be able to grow to offset annual increases in operating expense. An economic downturn will speed up its demise.
- Expense Ratio 80-90%** **Skating on Thin Ice.** Credit unions with recurring 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 expense. ROA will be in the 0.20% to 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 recurring 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 favorable interest rates (which reduces ROA).
- Expense Ratio 70-75%** **Thriving.** Credit unions with recurring 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% to 1.00% range, assuming traditional levels of credit losses. It could easily weather a downturn in the economy.
- Expense Ratio 65-70%** **Highly Productive.** Credit unions with recurring 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 significant asset growth (up to 12%). This credit union will produce an ROA in the 1.00% to 1.20% range, assuming traditional levels of credit losses and could weather a prolonged downturn in the economy.
- Expense Ratio <65%** **Getting Greedy.** Credit unions with recurring expense ratios in this range are bordering on greedy (e.g., they should be providing more benefit to members in the form of rate, which will reduce ROA, but allow them to capture more market share). An extremely productive credit union would operate in this range and could support asset growth of up to 15%. This credit union will produce an ROA exceeding 1.20% assuming traditional levels of credit losses.

If I am CEO, what is my target? Probably something in the 70-80% range; some years it will be closer to 70%, other years it will be closer to 80%. The 70-80% range provides a good balance of productivity and value for members. Regardless of my opinion, **using an expense ratio as a budgetary target is a great idea. It eliminates noise associated with volatile items (provision, NCUA assessments, OTTI) that show up in bottom line ROA.** What are your thoughts? Please reach out to me and I would be happy to discuss this approach with you.

