

# CU-ALM REPORT

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## LIQUIDITY RISK MANAGEMENT IS COMING TO THE FOREFRONT

**I**n the early 1980s, the Savings and Loan Industry was devastated and ultimately failed because of its severe exposure to the mismatch variety of interest rate risk (IRR). Out of this fiasco came the concept that financial institutions should measure and manage IRR. Having witnessed severe losses due to IRR in the 1980s, federal and state regulators began requiring financial institutions to measure and manage rate risk. Over the last 30 years, the tools to manage IRR evolved from simple static gap analysis to very sophisticated models. Of course, in 1980 the horse was already out of the barn, when regulators finally responded to the crises. It is difficult to get people revved up over an impending crisis. Government usually acts after a crisis hits, and then it deploys preventive measures after the fact.

Beginning in approximately 2005 and carrying forward through 2010, the fact of liquidity risk emerged as a crisis. By the spring of 2008, the crisis had progressed to the point where the government bailed out one of the major investment banks, Bear Stearns, as they became illiquid. Later in the year, the same government chose to allow Lehman Brothers to fail. Along the way, several huge retail banks, including Washington Mutual and Wachovia, were rescued and merged with government assistance. Presiding over the recent rash of bank failures, FDIC chairperson Sheila Bair is on record that the primary culprit responsible for two-thirds of the bank failures in recent years is not rate or credit risk, but liquidity risk. The near-failure of the whole banking system was caused, primarily by liquidity risk.

In the end, it took government intervention to the tune of over \$1 Trillion to pull the banking system out of its crisis. As a result, the banking system—of which credit unions represent a miniscule part—will see over the next decade multiple rules, regulations, and government mandates to prevent another liquidity crisis like the one experienced over the last several years.

Although a tiny fraction of the market, credit unions will be caught up and be required to comply with a plethora of new regulations as the government chases the liquidity horse that left the barn long before they closed the door.

This article is the first in a series. How many articles in the series, I don't know yet—at least *(continued on page 2)*

## IS PEER-GROUP ANALYSIS VALID?

**S**ince the day I became associated with credit unions 33 years ago financial analysts and regulators have trotted out peer group averages as an effective benchmark of operating efficiencies and reasonableness. In this article, we will examine the reasons why all peer-group comparisons should be used with caution. We will then review the conditions which may allow some to be used cautiously and with some level of effectiveness.

The term peer group, we all know, means things in common. If we were able to compare our credit union's operations to the operations of other credit unions exactly like ours, we might conclude there is value from the information obtained in this comparison. In reality, peer groups are rarely defined sufficiently narrow to allow meaningful comparison. The most common peer groups used, based on my experience, are NCUA groups based on asset size. NCUA peer groups classified by assets employ a huge range of credit unions. For example, one group includes all credit unions from \$10 Million to \$50 Million in asset size. It is not hard to imagine the unlimited number of differences that exist among the nearly 3,000 credit unions that fit into this category.

Let's talk about some of the criteria to consider in a peer group if you are thinking you want to use it as a benchmark for guidance. Having just dissed the concept of asset size, I would argue that it is one of many significant criteria. It makes no sense to compare a \$10 Million credit union with one five times its size at \$50 Million. Even if all the other variables match up, the economies of scale at \$50 Million are significantly different than at \$10 Million. Credit unions between \$10 Million and \$20 Million certainly would have more in common. But \$20 Million is double \$10 Million and that significance is still huge. For small credit unions the asset size spread needs to be very small. For larger one it may not be as critical.

Another factor that comes into play would be the service level that the credit union chooses to offer its members. We have a \$200 Million client in a rural area that offers limited services. Their net operating expense to assets ratio is very low at approximately 25% of the peer group average. Another similar client who offers a greater range of services experiences an expense ratio of almost double. *(continued on page 3)*

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## LIQUIDITY RISK MANAGEMENT IS COMING TO THE FOREFRONT *(continued from page 1)*

three or four. In this article, we will talk about basic liquidity issues and the first government effort at regulating liquidity risk. Follow-up articles will address core funding issues, wholesale funding issues, liquidity risk measurement tools, and management strategies.

There are several good reasons why most natural person credit unions did not experience their own liquidity crises over the last three years. Here is a quick summary.

Credit union assets typically include a core group of installment-type loans almost all of which require monthly payments. The payment covers all of the interest due and makes a contribution towards paying off principal. Credit union loan portfolios roll over in 25 to 35 months, due to prepayments. Among our client-base of 300 small- and mid-sized credit unions, the average loan portfolio turn-over rate is approximately 30 months. This figure has not changed significantly over the past 10 years. This phenomenon has a huge mitigating effect on liquidity risk.

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Also, many credit unions have excess liquidity which is invested in 1 to 3 year low-risk instruments such as jumbo CDs, US agencies, and, in some cases, US treasuries. This excess liquidity also mitigates liquidity risk.

On the liability side, where the demands for liquidity often originate, almost all credit unions have a base of core deposits which historically and, even over the most recent two years, have proved to be stable and, in many cases, not rate sensitive. This base of core deposits is a huge mitigating factor in controlling demands on the credit union's liquidity resources. For the most part, credit unions have avoided the daily liquidity demands which caused so much distress to the financial system in 2008 and 2009. *(continued on page 3)*

**CU-ALM REPORT** is a publication of Mark H. Smith Inc. that contains opinions, articles, and insight into many facets of credit union operations. At times it offers suggestions in the decision-making process. We are not registered investment advisers and our suggestions tend to be general in nature. While we are happy to share our insights and thoughts with our readers, it is important to understand that the responsibility for implementing the ideas or strategies suggested in these pages rests solely with the credit union's management.

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(cont from pg 2)

**IS PEER-GROUP ANALYSIS VALID?** (cont from pg 1)

In March of 2009, the Federal Financial Institutions Examination Council (FFIEC), of which NCUA is a part, issued updated guidance for liquidity and funds management. Here is a summary of what that guidance requires.

1. The good news first: Financial institutions are required to manage liquidity risk using processes and systems that are commensurate with the institution's risk profile and scope of operations. Clearly, the risk profile and complexity of credit unions is light-years removed from that of the large investment and commercial banks. Additionally within the credit-union system there is a huge disparity between the complexity and risk profile of large credit unions versus small ones. The guidance appears to allow for these variations to be considered and for credit unions to adopt processes and systems appropriate to their specific circumstances.

2. The guidance reiterates the importance to appropriately identify, measure, monitor, and control funding and liquidity risk.

3. The tools to accomplish this process include cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets and a formal, well-developed contingency funding plan. Traditional static liquidity ratios will not suffice except for the smallest and very simple organizations.

4. The liquidity processes and plans should be well-documented and available for supervisory review.

5. It is noted that failure to maintain an adequate liquidity-risk management process will be considered an unsafe and unsound practice.

To be continued . . . 

On the leverage front, while credit unions are leveraged (typically around 10 to 1), their leverage ratio is significantly less than the investment banks or large commercial banks which were often above 40 to 1 in 2009, and many remain so today. Additionally, a significant portion of the leverage employed by credit unions comes in the form of the core deposits mentioned previously. For the peer group. I would consider both clients to have well-controlled operating expenses. To a large extent, the difference between the two is the level breadth of service. But, geography and demographics also play a large role. It is not realistic that a credit union operating in a rural area would have operating ratios that would compare to an urban counterpart. Another primary consideration would be the demographics of the field of membership served. Many FOMs are based on religion or ethnicity. Some are community-defined, narrowly or broadly, while others remain oriented on a common group of employees. The differences among these unique groups of members have a potential to cause significant differences in the operating ratios of their respective credit unions.

Although there are many issues that could be raised here, I am going to add only one more, and that is the demographic of age. If your FOM is mature, your operating ratios may be significantly different from a credit union perhaps in your same community, made up of younger, working, singles or families.

Clearly the challenge, if you want to use peer groups as a benchmark measure, is defining what your peer group is and obtaining the data from a reliable source that can be used in your comparison. Our outlook is that none of the NCUA asset-based peer groups offers a significantly narrow group to allow for reliable comparisons. Some of the alphabet groups (like CUNA and NAFCU) offer comparisons which, in our opinion, are also way too broad. Credit union leagues or other local associations may offer peer group information that is more narrowly defined and may be useful. Additionally, there are private vendors which can supply reliable information.

What we suggest is that you consider doing it yourself or identifying and joining forces with other credit unions in your local area which you see as being viable peers. Such a narrowly defined group is much more likely to yield meaningful information. All of the financial information you need is available free from call reports on the NCUA website for NCUA-insured credit unions.

If you are going to collaborate with the peers, designate one of the group to actually do the analysis and be compensated for the expenses by the members of the group who use the information. A second approach might be to engage a CPA or other financial firm to provide the analysis for a reasonable fee and share the info and fee with the group. If you choose not to collaborate, you are on your own as to defining the group and generating the numbers. Going it alone may be a good choice if the competition among the selected peers is strong. In summary, peers groups that are broadly defined often provide misleading information, and decisions based on these broadly defined peer groups may very well turn out to be erroneous. If you can obtain narrowly defined peer group information and are certain that the definition of the group is consistent with your level of operations, your FOM, your asset size, your demographics, and other important criteria, a peer group comparison might have value if used cautiously. 