

Liquidity: 9 “What-ifs” Worth Exploring

By c. myers corporation

Liquidity is growing in importance as the economy and financial institutions continue to struggle. As such, institutions need to explore and evaluate their liquidity position in various situations and environments. In our article, [Determining And Monitoring Strategic Net Worth Requirements](#), there are three levels of liquidity that should be analyzed:

- **Level 1—Sources and uses of liquidity from the financial structure**

This analysis should include one time uses of cash, such as cash outlays for branches, technology, bonus payouts, etc. in addition to sources and uses of liquidity from loans, investments, deposits, expenses and non-interest income.

Level 1 does not rely on LOCs, which could be shut off from the credit union.

- **Level 2—Sources and uses of liquidity including available LOCs**

Executives should understand if their LOCs are actually guaranteed, which likely comes at a higher cost. Most LOCs that credit unions have are not guaranteed.

- **Level 3—Sources and uses of liquidity including available LOCs and unfunded commitments**

This analysis should help executives understand the percentage of unfunded commitments (e.g., credit cards, LOCs and HELOCs) the credit union could cover.

The following are “what-ifs” worth exploring when the question of liquidity is raised. The series is based on the three levels of liquidity identified and should be conducted after determining base liquidity needs.

Level 1 “What-ifs” To Explore

1 *What if the retention of our CDs is materially less than in the past?*

Why?

Many credit unions are finding that their retention rate on CDs is diminishing. In days gone by retention rates on CDs would typically be 80% or higher. Now many are experiencing retention rates as low as 55%.

They believe this is caused by competitors who are pricing

deposits irrationally. The irrational pricing could be for several reasons. The two most common reasons are:

- The competitor is in desperate need of liquidity
- The competitor is taking advantage of current economic turmoil to gain market share

Regardless of the reason, the consequences of the reduction in retention rates need to be understood and, if necessary, proactively addressed.

2 *What if the replacement cost of our maturing CDs is significantly higher, especially in months where large amounts of CDs mature?*

Why?

Recently, many institutions ran similar CD promotions (7 mo., 9 mo., etc.) within the same geographic area resulting in a multitude of CDs maturing. This could result in many institutions needing a disproportionately large amount of money at the same time—causing the cost of money to increase beyond expectations due to heightened competition.

3 *What if the bonds we were expecting to be called are not called?*

Why?

Due to the credit crunch, issuers may not be able to get replacement funds at rates lower than the bond the credit union may be holding.

4 *What if we begin to experience higher than expected runoff in our non-maturity deposits?*

Why?

Several banks now have relatively inexpensive access to capital enabling them to aggressively grow market share should they choose to do so.

Additionally, as consumers are no longer able to use their houses as ATMs and as unemployment rises or access to bonuses and overtime diminishes, they may need to use savings for day-to-day living.

5 *What if prepayments on our loans are slower than expected, even if rates don't change?*

Why?

Members may decide to build up their own sources of liquidity and only pay the minimum payment. This may be advantageous from a yield on loans perspective, but it can cause additional liquidity pressure.

Level 2
"What-ifs" To Explore

The following can be built on "what-ifs" tested in **Level 1**, or, tested independently.

6 *What if access to our lines of credit is reduced, eliminated or the cost increases substantially?*

Why?

Many financial institutions are currently experiencing this, particularly those with deteriorating financial performance. Furthermore, the decrease in the value of collateral is resulting in a reduction in available borrowing capacity for providers of liquidity.

7 *What if access to our lines of credit is reduced such that we cannot meet our liquidity obligations? What options are available and financially best in the long run?*

How much would we need to raise CD rates to attract the money we need? How sustainable is this option?

How much of our investment portfolio would we need to sell, and at what price? Is this a better alternative than attracting high-cost funds?

How much would we need to shrink our loan portfolio, if we decided this was the best course of action? Would we do this by increasing loan rates, immediately selling mortgages as they are made or selling loans from the portfolio?

Why?

It is important for executives to understand their options if access to lines were reduced or eliminated. In evaluating these options, it is also helpful to understand which alternatives are controlled and which are merely influenced by executive decisions and actions.

Level 3
"What-ifs" To Explore

The following can be built on "what-ifs" tested in **Levels 1** and **2**, or, tested independently.

8 *What if members begin to draw on lines materially more than expected?*

Why?

Many financial institutions have already experienced this to some extent. The consumer may view drawing on lines as an option to relieve financial pressure—even if it is only a band-aid. Actively reviewing lines open to members is critical from both a credit and liquidity risk position.

9 *What is our worst-case liquidity scenario? How would we respond? Do we need to put plans in place now such that we are prepared should this scenario materialize?*

Why?

Lack of adequate and timely access to liquidity has been the demise of many businesses.

Conclusion

The quantity and gravity of the “what-ifs” articulated in this article may seem like overkill. However, keep in mind that the government continues to allocate enormous financial resources to attenuate the economic crisis – with no real solution in sight.

If you would like to discuss specific issues that relate to your credit union’s liquidity situation, feel free to contact one of our consultants at: **800-238-7475**.

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About c. myers

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For the last 18 years, hundreds of credit unions, including 25% of those over \$100 million in assets and 50% over \$1 billion, have found value in our proven and practical approach to addressing emerging and complex business issues. 