LIQUIDITY: SHIFTING GEARS

In our numerous daily conversations with credit unions nationwide, key decision-makers are starting to note the liquidity pressure they're feeling. While not all are subject to it yet, the effects will ripple to every credit union.

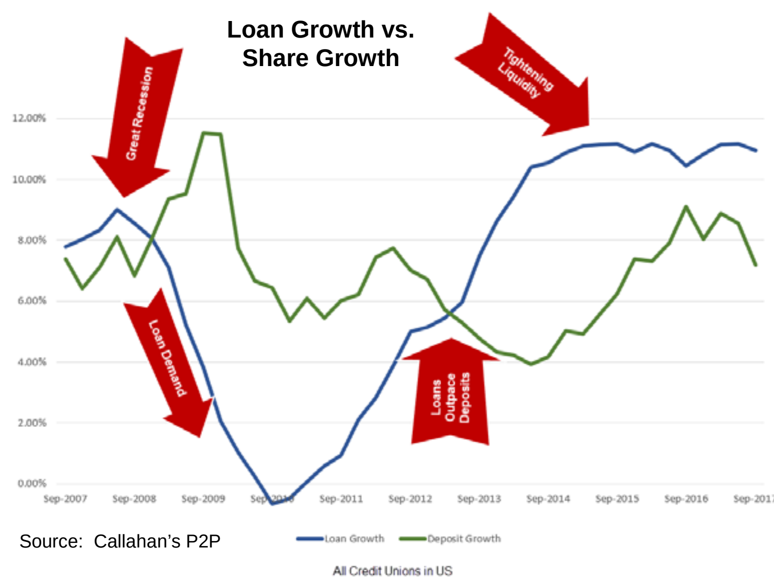
Liquidity as an industry issue took a long hiatus. Now that it's back, it is clear that the situation and methods to manage it will be different than they were in the mid-2000s. Liquidity which used to act like a faucet that you could turn on and off with rates may not work that way this time around.

Now is the time to shift gears to: proactively strengthen your deposit acquisition strategy, think through the levers you'll be willing to pull for additional liquidity, and test the impact of those decisions.

Changes that are occurring in the liquidity landscape are likely to affect credit unions in varying ways, from subtle shifts in profitability to existential threats to the business model. But they can also mean new and exciting opportunities for those forward-thinking enough to identify and seize them.

SIGNALS OF CHANGE

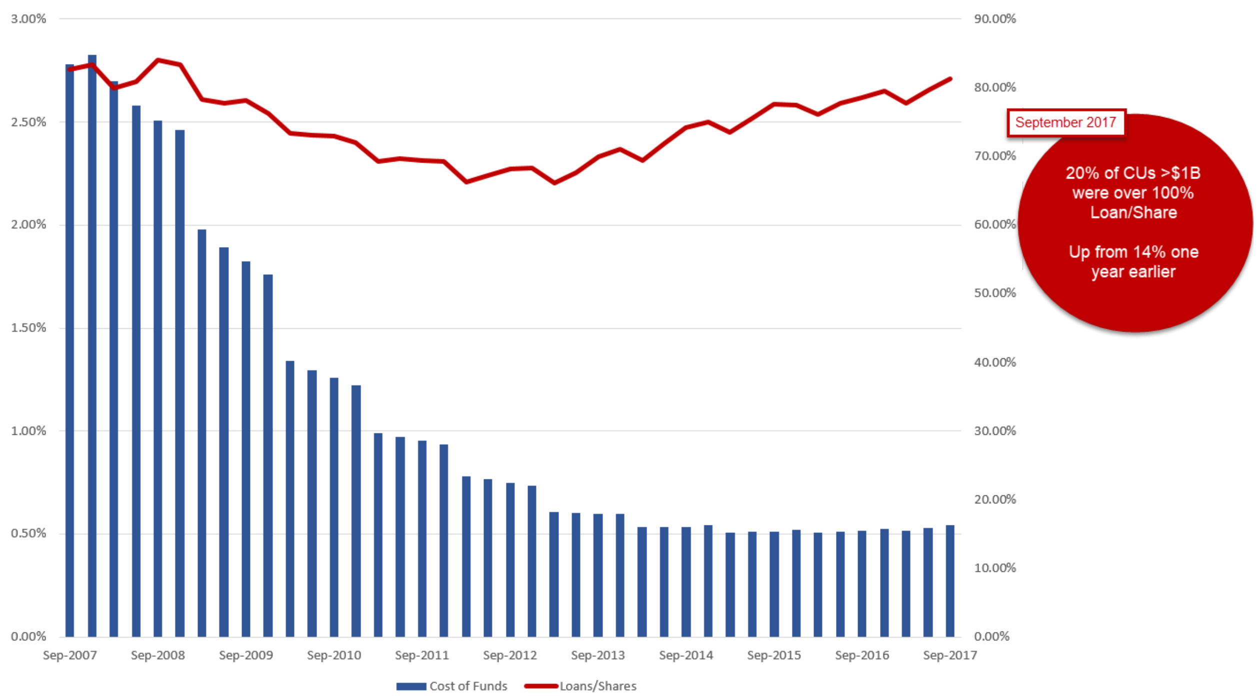
We're all familiar with the story: the Great Recession hit in 2008, loan demand plummeted, and historically low interest rates came hand in hand with an influx of deposits. The industry has spent nearly a decade soaking up the liquidity that resulted from those events.



Source: Callahan's P2P

It took a long time, but in September 2017, loan-to-share ratios finally topped 80% for the first time since 2008; for credit unions with over $1 billion in assets, it topped 85%. These trends closely mirror the number of banks with loan-to-deposit ratios exceeding 100%.

Loans/Shares vs. Cost of Funds



Source: Callahan's P2P

All Credit Unions in US

Throughout this time, the cost of funds has barely moved, even with steady increases in short-term market rates since 2015.

Most credit unions have adopted a "wait and see" approach to increasing deposit rates, preferring to lag the market as long as possible as they wait out their competitors and the economic landscape.

The wait may be over.

IT'S DIFFERENT THIS TIME

Higher average share balances, new competitors, and advancing technology have created a liquidity environment that hasn't been experienced before.

As the economy has continued its expansion over the past few years, share balances have continued to increase. Average share balances have increased nearly $3K to $11.2K since the start of the Great Recession.

Percentage of Total Growth Since 2007 – All Credit Unions

Growth	Regular Shares	Money Markets	Share Drafts
Number of Accounts	20%	9%	46%
Average Balance per Account	80%	91%	54%

Source: NCUA and Callahan's P2P

If members revert to pre-recession behaviors, significant funding could flow out of credit unions. This could be brought about by a declining savings rate, which has reached a 12-year low, better opportunities to maximize yield elsewhere, or other customer benefits from competitors that seem to emerge daily. Think through how your credit union's growth compares to the industry's growth above, and how this might make you more or less prone to balance shifts. This can play into deposit strategy and risk management decisions moving forward.

NOTE:
The lion's share of growth has been the result of larger average balances, not growth in accounts.

Many new competitors for liquidity are offering more than just rates. At the same time, technology makes it incredibly easy to access and engage with both traditional and nontraditional competitors. Deposits can move in and out of your credit union with ease and efficiency that simply wasn't possible a decade ago.

As consumers have become familiar with nontraditional financial tools and their ease of use, like Venmo, Apple Pay® Cash, Zelle®, and Amazon Pay, the risk these present to low-cost funds should be top of mind. Some of the **new hooks** that competitors are offering include **rewards**, **higher interest rates in exchange for watching ad content**, the ability to **set and track financial goals**, and the gamification of all of the above to generate a fun**,** engaging experience.

New technologies have made this changed landscape possible. Though there have been many technological advances that have taken place since the last liquidity crunch in the mid-2000s – e.g., the iPhone® itself is just over 10 years old – a few of those that are defining today's consumer banking and finance experience are:

1. The ability to open accounts on any device and move funds between *both* accounts *and* institutions with the swipe of a finger
2. Nontraditional competitors entering the marketplace, streamlining the consumer experience, and driving the change of consumer expectations through technology
3. The ability for everyone, including the average consumer, to not only shop competitive rates with relative ease, but also complete the majority of their transactions, in the moment, from their device of choice

Things today that we consider fairly normal, e.g., paying friends through apps with the swipe of a finger, opening accounts online, price shopping with anonymity, and using Amazon were not an economic habit back during the mid-2000s.

Of course tight liquidity isn't a new phenomenon and many of the challenges that have always existed are still around. Irrational pricing by competitors, who respond with knee-jerk reactions to changes in their balance sheets or economic conditions, offer a form of disruption that is not only hard to anticipate, but equally difficult to plan for. Layering on the new habits of the American people and new competition complicates the low cost funding business model as a potential fight for deposits is brewing. Even if your credit union doesn't have liquidity issues, you may have to respond to the market just to keep the deposits you have.

CREATIVE DEPOSIT ACQUISITION

Among the many possible sources of liquidity, member deposits are king for most credit union business models. They are a way to serve members, and represent a generally low-cost source of funds. As competitors and new technologies have upped the deposit game, it's time to start thinking differently and more creatively about deposit acquisition.

The first question is, ***Do you have a strategy focused on deposit acquisition and growth?*** As the industry as a whole shifts its focus from loans to deposits, each credit union needs to establish a clear value proposition for deposits. ***What is the reason members should choose to deposit their money with the credit union instead of another institution?*** Without a strong value proposition, you will be forced to compete on rate alone. Unless that is your business model, having to pay top of market rates during a liquidity crunch could create a profitability crunch.

As the strategy is rebalanced toward deposits, it may be necessary to re-evaluate measures of success or KPIs to ensure they're appropriately tuned to the updated strategy and measuring the desired kinds of deposit growth.

Engaging members through this side of the business offers a myriad of opportunities to build relevance. Even if you have "kept up" with technology offerings, ask yourself, ***have we truly engaged our members through the technology?***

Consider marketing differently – certainly beyond rate – and repackaging products to appeal to member needs. Use the data you already have on members, brainstorm, and borrow ideas freely from outside the industry to generate creative ways to appeal to members.

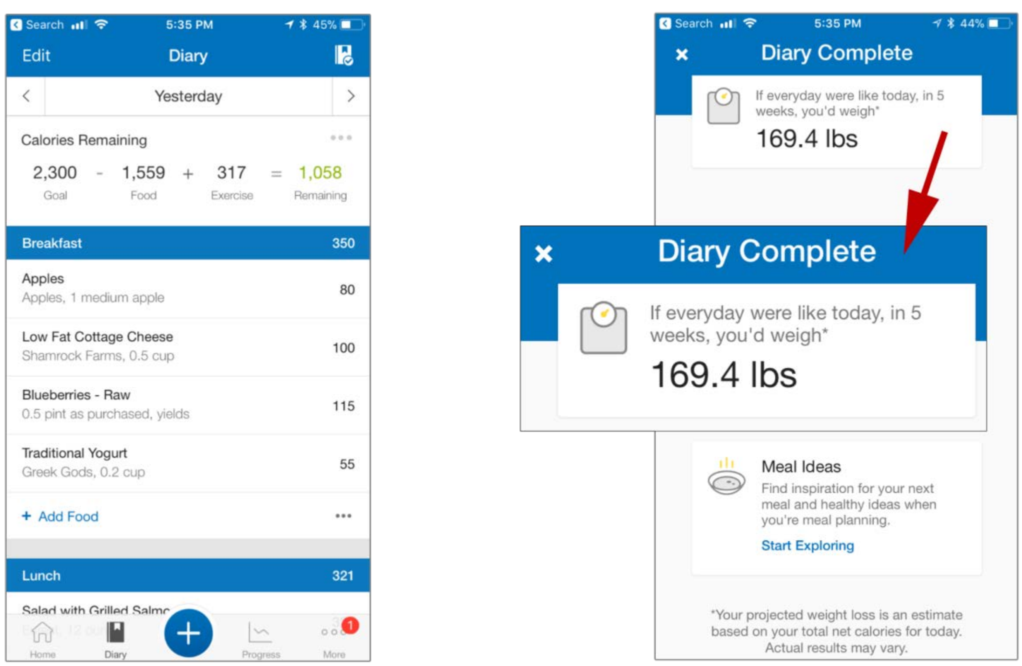
gam·i·fi·ca·tion

noun | gāmifəˈkāSHən

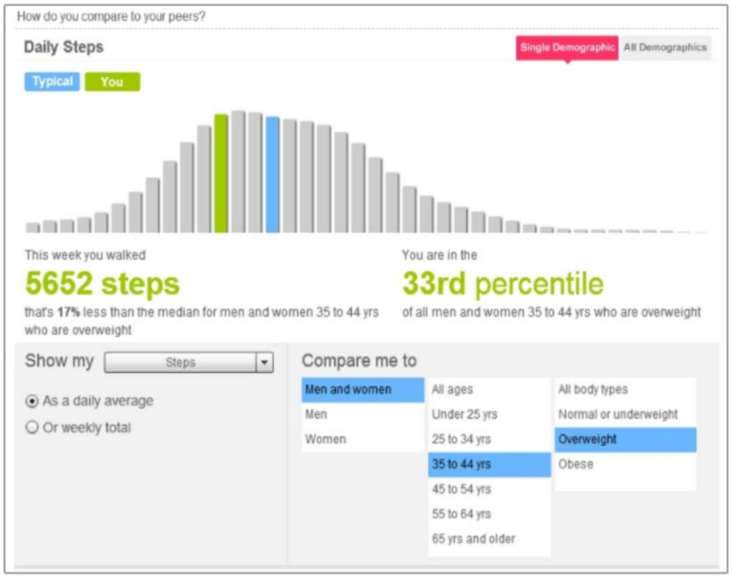
The process of adding games or gamelike elements to something (such as a task) so as to encourage participation.

Gamification has proven to be a successful approach to engaging customers in various industries. Deposit accounts may seem like a pretty dry subject, but so is walking. How many people are wearing fitness trackers who never before cared how many steps they took each day?

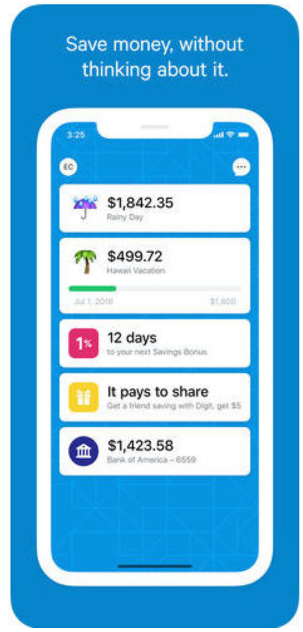
Consider these examples that engage customers through a variety of methods, including goal setting and tracking, visualization, peer competition, and making things easy:



MyFitnessPal uses goal setting and tracking, along with creative motivational messaging



Fitbit uses peer comparisons to promote engagement



Digit makes saving easy by automatically determining how much the customer can afford to save, and transferring those funds to savings

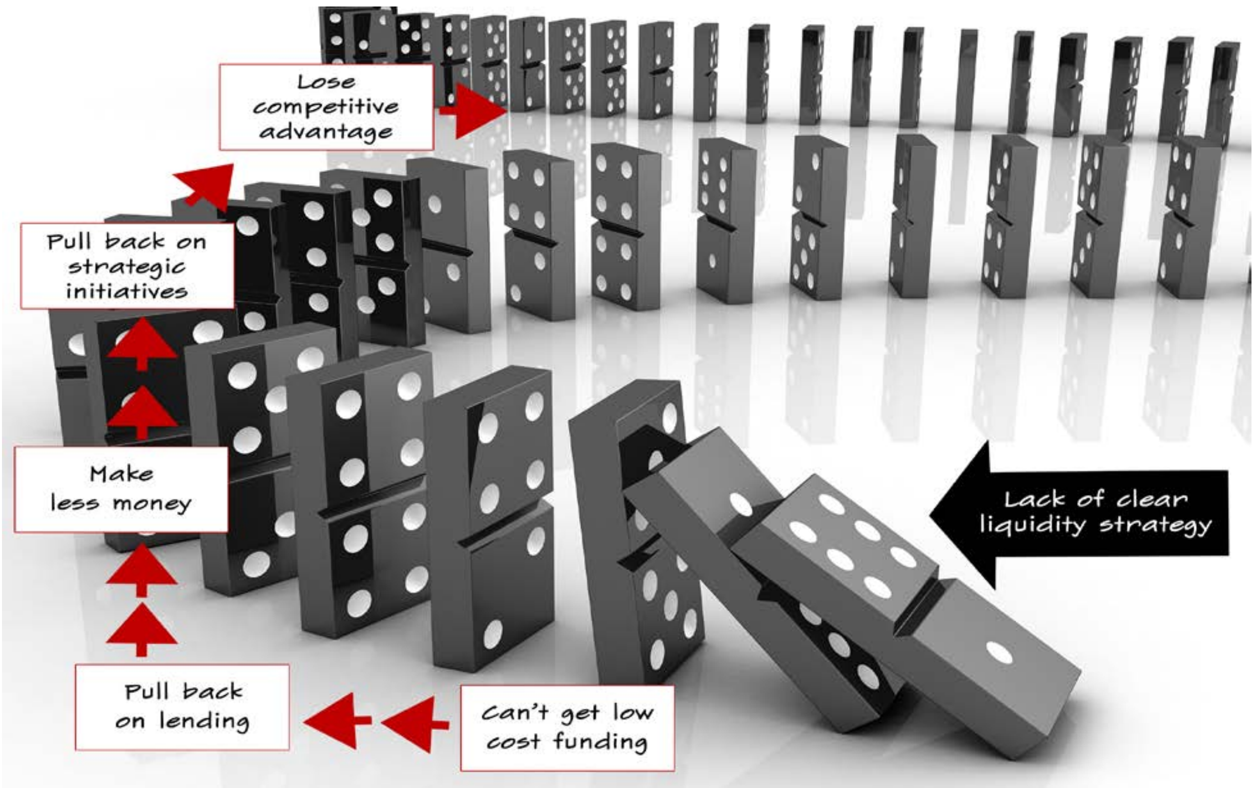
Taking another tack, could you offer an account that features digital ads from companies that may be a good fit for your membership? Could you share ad revenue with members in the form of higher interest rates?

The deposits area offers exciting possibilities for building relevance and financial sustainability for those who are willing to try creative new ideas. One caution is to be sure to define a timeframe and measures for success and be willing to pull the plug if an idea doesn't work. This frees up resources to take what you've learned and try something else.

YOUR BUSINESS MODEL AND TIGHTENING LIQUIDITY

Taking the time to think strategically about tightening liquidity for the industry and for your credit union allows for conscious decision making, better outcomes, and not having to react to a situation that could have been prevented or planned for ahead of time. It's been so long since the last liquidity challenge that many in management will not have experience with an industry-wide liquidity challenge, at least not in their current positions, so spending time to think through what tightening liquidity means to your institution's unique strategy will be invaluable.

Distinct from planning for a liquidity crisis, this is about ensuring the business model is viable in this environment. Clarify your concerns and vulnerabilities. Some credit unions need additional liquidity, while others are more concerned about market pricing and bottom line profitability. For those who have been taking a "wait and see" approach to deposit pricing, the wait may be over and plans to lag the market on pricing could evaporate. Think through the levers you can pull – higher pricing on deposits, CD promos, selling investments, borrowing, and pulling back on lending. Which levers fit with the business model? Which ones are you willing to pull? Note that some levers, such as purchasing non-member deposits or selling participations, could be far less attractive during a liquidity crunch due to pricing pressures.



In analyzing liquidity plans, the bottom line is that credit unions are faced with either continuing their growth or pulling back. As boards and executive teams have grown accustomed to year-over-year growth, the decision to pull back is one that may be unpalatable, especially when metrics are in place to reward growth. This is one key reason why discussions on the subject are so critical.

Integral to this analysis is understanding where your credit union's growth is coming from and how essential it is. On the loan side of the equation, some growth is likely consistent with the business model. For example, for a credit union that is primarily a mortgage lender, making mortgage loans is foundational to the business model. Other growth may be less essential. For example, indirect lending was put into place in some cases simply to get more loans on the books, rather than as a way to better serve members. Reaching clarity on these nuances will inform strategic decisions that may need to be made down the road.

On the deposit side of the equation, an analysis of average balances and account growth along with the sources of deposit growth is equally important. In reviewing our clients' demographic data, we have seen that on average about 60% of deposits are held by members who are 60 and over, while 30% are held by those 70 and up. In considering how well that bodes for the future, also take into account that younger members don't generally hold much in deposits because they simply don't have much saved yet, so these opposing realities need to be balanced.

There are multiple levers a credit union could utilize as it considers strategic responses. The following questions are just a handful of the many questions that can help chart a path for stakeholders:

1. If the proactive choice is to remain a bystander while other financial institutions chase higher priced deposits, how comfortable are you in consciously allowing a drawdown of asset size? What and where are the decision points for reentry and what is the impact to the bottom line?

2. Are you willing to pull back on lending as a response to tight liquidity? If so, how much are you willing to pull back, in which categories, and why?

3. If members are presented with the opportunity to earn higher rates elsewhere and if deposits flow out the door in a meaningful way, is there enough liquidity available to seize opportunities and continue to remain a competitive force down the road?

The emphasis on having proactive and regular discussions for your specific business model is to get all decision-makers to understand the tradeoffs for various responses. Being on the same page ahead of time and understanding the potential hits to profitability for each decision helps all stakeholders remain steadfast to the strategy if the expected earnings squeeze is realized in the future.

TEST YOUR OPTIONS

Testing goes beyond a mere exploration of ideas to diving into the nitty-gritty details, analyzing trends, researching liquidity outlets and their costs, and then testing those details on your credit union's unique structure. What's best for one credit union may not be appropriate for another, which is why testing options is so important.

To set the stage, consider the impact of a reversal of growth in average balances for the whole industry since the Great Recession. Take the following example for just money markets:

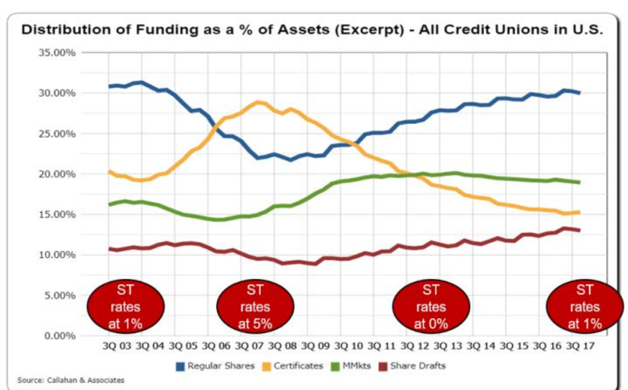
Time Period	Money Markets
4Q, 2007	$19,217
3Q, 2017	$36,393

2% Inflation would = $23,368

Source: NCUA and Callahan's P2P

Did You Know that **$130 million** could flow out of a credit union that has **10,000 accounts** if the average balance goes from **$36,000** to **$23,000?**

Another consideration is a change in deposit mix. Most members have yet to see an opportunity to lock money in at better rates that cover inflation. As CD rates approach 3%, members will be faced with the opportunity to act in their best interests – moving funds out of lower paying deposit products to lock in at attractive rates. This is what has happened in the past, so be sure to factor this in when testing scenarios that include better CD rates for members.



Also consider testing a material change in the opportunity to borrow. If many other institutions are experiencing liquidity strain, this could dry up liquidity across the board, making it more difficult to borrow. Institutions have found that lines of credit are sometimes reduced during times of tight liquidity. When testing borrowings, keep in mind that taking on borrowings can limit the institution's ability to respond to additional stresses in the future.

Based on your strategic discussions, test multiple ideas to quantify the impacts on return on assets (ROA) today and interest rate risk. Remember that each idea has trade-offs and some methodologies will not show those trade-offs.

Some what-if ideas:

- More aggressive deposit pricing: factor in cannibalization and marginal cost of funds
- CD promotions: Test different lengths
- Borrowings: Test different lengths
- Pricing money markets to LIBOR, hedge with Derivatives*
- Selling investments
- Slowing lending

** There are several factors to consider on this option. If you would like to discuss, please contact us.*

LIQUIDITY CHALLENGES AND OPPORTUNITIES TO RESPOND STRATEGICALLY

Change has arrived in the liquidity environment – and it is different this time around. Growth from higher average balances as well as competitors that are using technology in innovative ways could make some traditional tactics, like deposit rate increases, less effective.

Use this moment as an opportunity to clarify and strengthen your deposit acquisition strategy. Focus on creative methods designed to deeply engage members in fresh, new ways. It is this search for better alternatives, than rates alone, that will move credit unions forward in long-term relevancy.

Go beyond deposit acquisition to formulate strategic responses to potential liquidity challenges. Credit unions that explore and test potential decisions are much more likely to understand the costs and benefits of each decision than credit unions that do not.

Well thought-out, conscious decision making is the surest path to sound decision making and allows credit unions to identify effective responses well in advance of competitors employing knee-jerk reactions. Those decision-makers who seize these opportunities to be better positioned than competitors will find it easier to respond with agility as actual events unfold in and around your credit union.

About c. myers

We have partnered with credit unions since 1991. Our philosophy is based on helping clients ask the right, and often tough, questions in order to create a solid foundation that links strategy and desired financial performance.

We have the experience of working with over 550 credit unions, including 50% of those over $1 billion in assets and about 25% over $100 million. We help credit unions *think to differentiate* and *drive better decisions* through real-time ALM decision information, liquidity services, CECL consulting, financial forecasting and consulting, strategic planning, strategic leadership development, process improvement, and project management.