PEARLS

A Tool for Financial Stabilisation, Monitoring and Evaluation

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*PEARLS is a system of 39 financial ratios which the World Council of Credit Unions (WOCCU) employs to provide a detailed picture of credit union operations. Standing for **Protection, Effective Financial Structure, Asset Quality, Rates of Return, Liquidity, and Signs of Growth**, the PEARLS system was originally designed and implemented with Guatemalan credit unions in the late 1980s. WOCCU now uses it worldwide to monitor the performance of credit unions, to create a universal language that each credit union can speak and understand, to generate comparative credit union rankings, and to provide the framework for a supervisory unit at the second tier. Also, PEARLS presents financial variables upon which credit unions can base their business planning.*

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Background

Initially, WOCCU staff tried to adapt the US CAMEL ranking system to the credit unions in Guatemala, but found that several modifications were needed. CAMEL is a supervisory tool; in the US, its ratios intend to protect the solvency of institutions and the safety of member deposits. Beyond supervision, WOCCU was looking for a tool that would evaluate the financial structure of the balance sheet, critical to Guatemalan credit unions undergoing a major restructuring of assets, liabilities and capital. In addition, credit union mangers needed to monitor growth of total assets, seen as key to addressing the problems resulting from monetary devaluations and runaway inflation. In essence, PEARLS was designed first as a management tool, and later became an effective supervisory mechanism.

Drawing on the results of using PEARLS in Guatemala, WOCCU adopted a new approach to credit union development in 1994. In the ***new model credit union***, market pricing for products and services facilitates local savings mobilisation. With PEARLS, WOCCU has set international financial standards for credit union performance. Key ratios within the PEARLS are summarised below.

P = Protection (5 ratios)

Protection is measured by comparing the adequacy of the provisions for loan losses against the amount of delinquent loans. The Protection category also includes loan charge-offs and loan recovery rates.

E = Effective Financial Structures (8 ratios)

The financial structure of the credit union is the most important factor in determining growth potential, earnings capacity, and overall financial strength. Ratios in this category measure assets, liabilities and capital, and their associated targets constitute an *ideal* structure for credit unions. Two ratios are of note here: The capital ratio that measures the relationship of capital to assets should govern the institution's growth – when its gets too low, management should change its pricing to slow growth and protect its reserves. In the saving-led credit union movement, where demand for loans should be met through savings mobilisation, fuelling growth with borrowed capital is discouraged, hence a target of zero percent for borrowed capital to asset ratio in Table 1 Minimum Standards (see below).

A = Asset Quality (3 ratios)

The indicators in this section measure the impact of assets which do not generate income such as delinquent loans, and non-productive assets (Traditionally, credit unions have used member share capital to finance fixed assets. Under the new model, the goal is to finance a 100 percent of all non-productive assets with the credit union's institutional capital, or with other liabilities that have no explicit financial cost.)

R = Rates of Return and Costs (12 ratios)

Unlike other systems, which calculate yields on the basis of average assets, PEARLS calculates yields on the basis of actual investments outstanding. The PEARLS system also disaggregates the essential components of net earnings (distinguishing return on the loan portfolio, liquid investments, financial and non-financial investments) to help management calculate investment yields and evaluate operating expenses. The results more clearly indicate whether the credit union is earning and paying market rates on its assets, liabilities, and capital.

The "R" category also measures operational costs including financial costs paid on deposit savings, share-savings, and external loans. The target recommended by the PEARLS system is to maintain operating expenses between 3 to 10 percent of average total assets.

PEARLS separates the costs of creating provisions for loan losses from other administrative costs. By isolating this expense from the other administrative costs, one gets a clearer picture of the effect of weak credit administration on a credit union.

L = Liquidity (4 ratios)

The liquidity indicators reveal if the credit union is administering its cash to meet deposit withdrawal requests and liquidity reserve requirements while, at the same time, minimising the amount of idle funds. The *"ideal"* target is to maintain a minimum of 20 percent of deposit savings in liquid accounts, after paying all immediate obligations under 30-days. The idle liquid funds ratio should be as close to zero percent as possible.

S = Signs of Growth (7 ratios)

In this section of PEARLS, the indicators measure both financial and membership growth. Total assets growth is one of the most important ratios. By comparing the growth in total assets to other key areas, it is possible to detect changes in the balance sheet structure, which could have a positive or negative impact on earnings. If loan growth keeps pace with growth in total assets, there is a likelihood that profitability will be maintained. Because savings deposits are the cornerstone of credit union growth, savings deposit growth largely governs the change in total assets. Because share growth is de-emphasised in the *model credit union*, excessive growth rates in this area usually signal a credit union's failure to promote deposits over shares. Institutional capital growth is the best indicator of profitability within the credit union. Sustained growth of institutional capital that exceeds the growth of total assets is a strong indicator of credit union success.

Table 1 below shows key ratios and target goals that WOCCU has selected as the minimum standards for measuring credit union performance. To date, Latin American credit unions come closest to meeting these targets.

Table 1: Minimum Standards

Indicator	Standard (Target or Goal)
Protection	
Loan loss provision for loans delinquent > 12 months/Outstanding balance of these loans	100%
Loan loss provision for loans delinquent < 12 months/Outstanding balance of these loans	Minimum of 35% of delinquent loans from 2 to 12 months
Effective Financial Structure	
Assets: Net loans/Total assets	60 to 80% (country specific)
Liquid investments/Total assets	Maximum = 20%
Fixed (unproductive) assets/Total assets	Maximum = 5%
Liabilities: Savings & deposits (excluding shares)/Total assets	Country specific target 70 to 80%
External borrowing/Total assets	Minimised with a goal toward 0%
Capital: Reserves & retained earnings/Total assets	Minimum of 8% of total assets
Share Mix: Withdrawable shares/Total assets	Country specific
Asset Quality	
Outstanding balance of delinquent loans > 30 days/Total loans (*****)	Goal is < or = 5%; Maximum 10% of outstanding loans
Non-earning assets/Total assets (*****)	Maximum of 7%
Rates of Return & Costs	
Operating expenses/Average assets (*****)	< or = 10%
Net income/Average assets	Sufficient to maintain capital ratio of > 8%
Return to members on share	> inflation rate
Liquidity	
Liquidity Reserve/Withdrawable savings & deposits	10% minimum
Signs of Growth	
Annual net change in total assets/Total assets of previous year	Country specific > or = population growth rate
Annual net change in loans/Total loans of previous year	Country specific > or = inflation rate
Annual net change in withdrawable shares, savings and deposits/Total savings and deposits	Country specific > or = inflation rate

(*****) *Note that standards of excellence required of a model credit union is 15%; minimum standard for prudential purposes is 10%*

Further Information

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