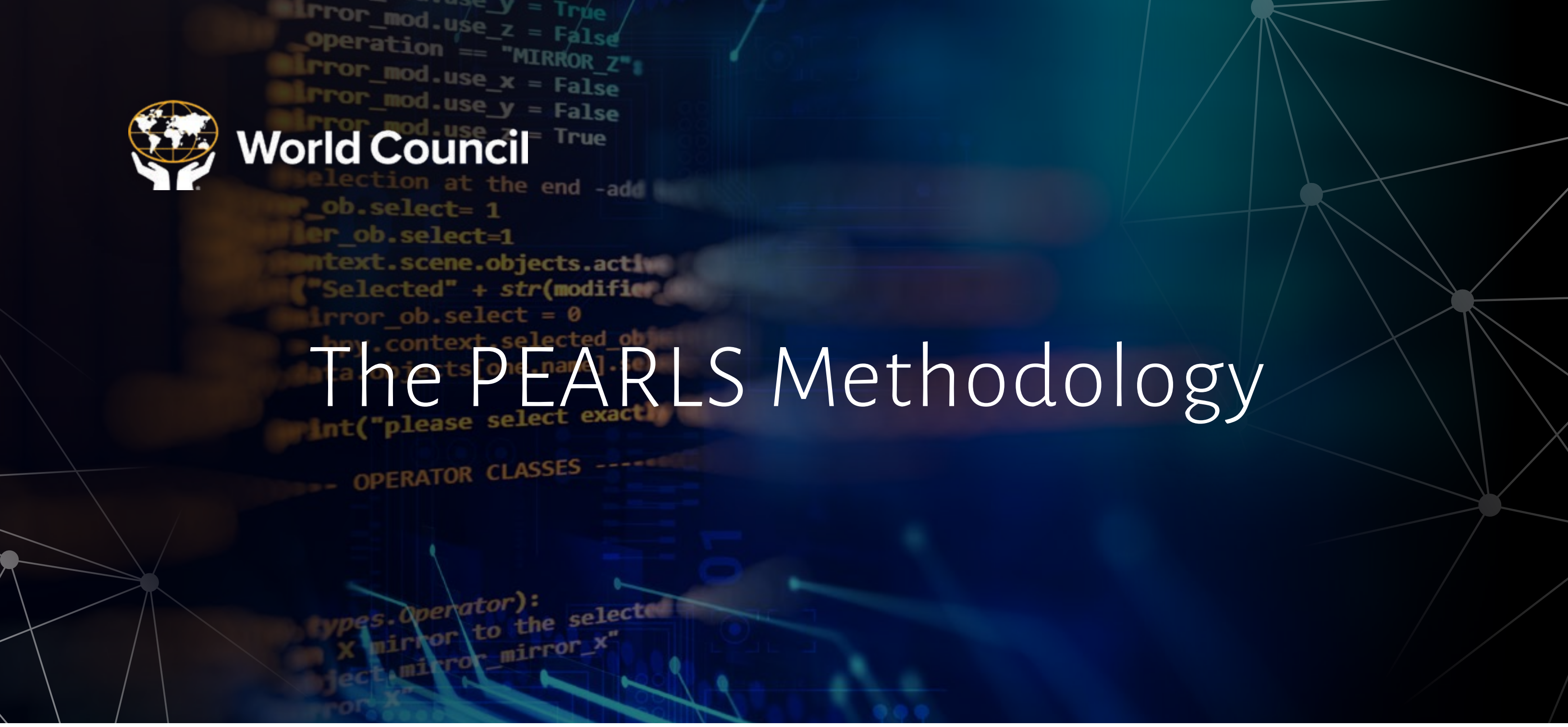

World Council

The PEARLS Methodology

PEARLS is a standardized and comprehensive tool to measure the financial health of credit unions, using a set of 45 financial ratios to measure performance in key areas and set a path to improvement. Since WOCCU created this tool in the 1980s, the growth of the credit union movement is underpinned without the financial discipline instilled by PEARLS.

PEARLS is a "living" methodology which has evolved considerably and continues to transform:

- A **management tool** with objective and quantitative diagnoses of any credit union's financial health. It can swiftly and precisely pinpoint any specific problem area(s). Having numerous data points (45 ratios) it also makes any inconsistencies in the credit unions data readily apparent. Based on this information, **actionable recommendations** can be made on specific operational functions of credit unions.
- **Addresses issues within an underperforming institution**, which can be a confusing and fraught process. Because PEARLS is an **objective and solution oriented tool**, focused on identifying root causes of problems based solely off of quantitative information from the balance sheet, it helps avoid uncertainties, needless finger pointing and helps credit unions address their problems more swiftly.
- PEARLS **tracks growth** (see Signs of growth). Unique to PEARLS this is an important indicator of financial health in the challenging macro-economic environments of developing countries (high inflation, monetary devaluation etc...).
- **Standardizes metrics for all credit unions**, to evaluate individual credit unions and cross-compare their performance.
- A **flexible tool** that can be used both in mature and developing economies as well as for new and more established credit unions.

PEARLS provides the foundation of WOCCU's broader Model Credit Union Building (MCUB) methodology (see MCUB tool).

PEARLS' Innovations

PEARLS is based on 6 key concepts:

P ROTECTION (6 ratios):

Financial institutions should have adequate liquidity to protect themselves against losses from bad loans separate from their capital reserves. Doing so gives a much more accurate picture of a financial institution's health and helps better protect depositors' funds. PEARLS recommends having sufficient dedicated funds against 35% of loan losses for delinquent loans in the next 1-12 month and 100% for 12+ months.

E FFECTIVE FINANCIAL STRUCTURE: assets, liabilities and capital (9 ratios):

- PEARLS recommends 95% of assets be income generating such as loans or liquid investments and the remaining 5% be unproductive such as equipment, land or buildings.
- **Liabilities** should primarily (70-80%) be comprised of client deposits. Attracting savings from the public is the cornerstone of healthy credit union growth and indicative of a credit union's ability to offer attractive services.
- **Capital** structure should be comprised of 10-20% owner share capital, (i.e. shares purchased by members that are separate from deposits), and ~ 10% institutional capital. Institutional capital is essentially retained earnings that helps improve profitability because, unlike deposits, it is interest free. Retaining and using institutional capital for other income generating activities helps ensure the long term profitability and stability of credit unions.

A SSET QUALITY (3 ratios)

No more than 5% of their loans in delinquency and of credit unions' assets be non-earning.

R ATES OF RETURN AND COST (13 ratios)

4 primary ratios track Profitability of specific assets, not just an overall average yield:

- Loan portfolio
- Liquid investments
- Financial investments (i.e. government securities/bonds)
- Other non-financial investments, such as real estate development, businesses etc...

Another 9 ratios are used to examine cost items to align with a credit union's assets, which fall intro these categories (for all ratios, please download the full PEARLS Methodology).

- Financial intermediation costs: interest paid on deposits and loans, returns to owner shares.
- Administrative and overhead costs: PEARLS recommends these to be 3-10% of total assets. (This is often a challenging area for smaller credit unions. They do not benefit from the same administrative economies of scale as commercial banks. For example, they tend to manage smaller loan sizes which require essentially the same administrative resources as larger ones, but yield fewer returns)
- Provisions for loan loss. In addition to the protection benefits of implementing this, it is important to isolate the provisions from administrative costs. This way it avoids signaling misleading information on what the drivers of overhead costs are.

LIQUIDITY (3 RATIOS)

Liquidity is defined as keeping enough cash on hand for customer withdrawals, separate from funds that are available to lend.

- PEARLS recommends ~15-20% of deposits and other withdrawable liabilities be maintained as liquidity reserves. Keeping excessive idle liquid funds (20%+) represents an opportunity cost and should be avoided.

SIGNS OF GROWTH (11 RATIOS)

For many credit unions, especially those operating in challenging macro-economic contexts (high inflation, monetary devaluation etc...), fairly aggressive growth is necessary just to maintain the current value of their assets, let alone increase them. PEARLS emphasizes the importance **real positive growth** (net growth after inflation) and does so by analyzing 5 key areas:

- Total assets
- Loans
- Savings
- Owner shares
- nstitutional capital

Impact Snapshot

Guatemala

After decades of civil war that ravaged the country, Guatemalan credit unions suffered from high loan delinquency and insolvency rates. From 1986-1994 WOCCU partnered with Guatemala's National Credit Union Association (FENACOAC) provided technical and financial support to credit unions. By the end of the program, the widespread application of PEARLS had stabilized the credit union's systemic issues and yielded significant inflation adjusted growth on several key metrics:

+125%
increased in assets

+98%
in loans

+504%
savings mobilized

+443%
in capital reserves

Through the continued application of PEARLS, Guatemala is now considered a best in class example for credit union management in Central America.