NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA

DATE: **July 2001** **LETTER NO.: 01-CU-08**

TO: **Federally Insured Credit Unions**

SUBJ: **Liability Management – Highly Rate-Sensitive & Volatile Funding Sources**

DEAR BOARD OF DIRECTORS:

This is the third letter on the topic of risk management to provide guidance on balance sheet risk. It follows Letters to Credit Unions Nos. 99-CU-12 and 00-CU-13. This letter further emphasizes the importance of managing risk within a total balance sheet perspective. It focuses on the funding side of asset-liability management.

BACKGROUND. Letter to Credit Unions No. 00-CU-13, issued in December 2000, discussed liquidity and balance sheet risk management in broad terms. The letter:

- defined liquidity risk,
- provided current financial trends in the credit union industry, and
- provided an example of a liquidity forecasting tool to help you project liquidity needs over a 12-month horizon.

In May of this year, the federal bank and thrift regulatory agencies issued a *"Joint Agency Advisory on Brokered and Rate-Sensitive Deposits"* (*Advisory*). The *Advisory* warned banks and thrifts that excessive reliance on these types of funding products, without proper risk management safeguards, had the potential to weaken an institution's financial condition. Historically, credit unions have relied on member shares as their primary funding source. While credit unions rely less on brokered sources of funds than banks, nonetheless, you must be aware of the risks of rate-sensitive or volatile deposits. These deposits require additional monitoring and control mechanisms to properly manage. We agree with the risk management guidelines the other regulators set forth in their *Advisory* and include a modified version under the "risk management guidelines" section of this letter.

Economic data shows that the recent increase in rate sensitive shares at credit unions has been the result of reduced investment in the equities markets. Beginning in the fourth quarter of last year, investors shifted their preference toward traditionally stable investments like deposits and short-term money market accounts. In March of this year, there was a record outflow from mutual funds of $20.6 billion. This trend may be reversing, however, as $21 billion flowed back into mutual funds in April, and the inflows continued in May. There are serious potential ramifications from over-pricing these types of shares. You should be wary of seeking to retain increased share balances through above-market pricing on rate-sensitive deposits.

What are the sources of highly rate-sensitive and volatile shares/deposits?
There are several sources of deposits that may be substantially more rate-sensitive than the typical "core deposits"[1]. For credit unions, highly rate-sensitive and volatile deposits may include:

- money market shares;
- uninsured shares;
- non-member shares (for low-income designated credit unions);
- above-market share certificates;
- deposits by other credit unions; and
- brokered shares/deposits.

These funds provide less stable funding, as they are generally attracted to yield and tend to be less permanent in nature. If market conditions change or more attractive returns become available, as evidenced by recent trends, these funds may be rapidly transferred to other institutions or investments. There are numerous near-deposit substitutes to choose from and it is easier than ever before for investors/savers to move their money.

What risk management guidelines should you follow?
We expect management to implement risk management systems commensurate in complexity with the liquidity and funding risks undertaken. Such systems should incorporate the following principles:

- **Prudent pricing practices.** Pricing decisions should be based on a range of net margin expectations established in the business plan. The expected net margin should give adequate consideration to capital needs and growth objectives and opportunities.

- **Proper funds management policies.** A sound policy generally provides for forward planning, establishes an appropriate cost structure, and sets realistic limitations and business strategies. It clearly conveys the board's risk tolerance and should not be

[1] Regular shares and share drafts are examples of core deposits.

ambiguous about who holds responsibility for funds management decisions.

- **Adequate due diligence when assessing deposit brokers.** Management should implement adequate due diligence procedures before entering any business relationship with a deposit broker. While this is a useful and valid service, deposit brokers are not regulated by bank, thrift, or credit union regulators.

- **Due diligence in assessing the potential risk to earnings and capital associated with brokered or other rate-sensitive deposits, and prudent strategies for their use.** Credit unions should manage highly sensitive and volatile funding sources carefully, avoiding excessive reliance on funds that may be only temporarily available or which may require premium rates to retain.

- **Reasonable control structures to limit funding concentrations.** When placing policy limitations on concentrations of share types or other funding sources, you should consider typical behavioral patterns of your members. Controls should be designed to reduce excessive reliance on any significant source(s) or types of funding. This includes brokered funds, and other rate-sensitive, or volatile deposits obtained through Internet or other types of advertising.

- **Management information systems (MIS) that clearly identify non-relationship or higher-cost funding programs and allow management to track performance, manage funding gaps, and monitor compliance with concentration and other risk limits.** Ideally, MIS should include a listing of funds obtained through each significant program, rates paid on each instrument and an average per program, information on maturity of the instruments, and concentration or other limit monitoring and reporting.

- **Contingency funding plans that address the risk that these deposits may not "roll over" and provide a reasonable alternative funding strategy.** Contingency funding plans should factor in the potential for changes in market acceptance if reduced rates are offered on rate-sensitive or volatile deposits.

- **Audit and/or independent review.** Internal controls should be established to ensure the credit union is complying with established policies and procedures. The scope of the audit should be sufficient to determine the credit union is reasonably measuring its liquidity risk.

EXAMINATION PROCEDURES. The regional capital markets specialists are currently testing improved examination procedures to better evaluate a credit union's liquidity and funds management process. These procedures include evaluating your funding strategies. Using a risk-based approach, an examiner will establish the scope of the review. Certain quantitative and qualitative information will be reviewed to establish an initial scope. The Liquidity Questionnaire will work in a manner similar to the Asset Liability Management (ALM) Questionnaire with the scope expanding as red flags are raised. As with the ALM Questionnaire, once the Liquidity Questionnaire has been finalized, it will be made available publicly through the NCUA web site at: www.ncua.gov. We are targeting January 2002 for implementation of the Liquidity Questionnaire.

***SUMMARY*.** You should analyze objectives before making decisions about how to deploy the recent inflow of funds. It is risky to make asset decisions without proper analysis of liability considerations. Instead, you should focus on balance sheet management by balancing yield expectations with share and deposit pricing decisions.

In a recent speech to the Independent Community Bankers of America, Alan Greenspan, Chairman of the Federal Reserve Board, stated:

> Still, many of these liquidity pressures are likely to remain in one form or another, and banks will almost certainly continue to explore non-deposit liabilities to fund asset expansion. While this is not new to community banks, the growing volume, variety, and complexity of non-deposit funds creates new issues. To meet this challenge, community banks must strive to fully comprehend the implication of relying on these types of funds from both liquidity and earnings perspectives.

Greenspan further stated: "But both the changes in financial markets and your success in credit markets suggest another important area of risk management that requires increasing attention from community bankers: maintaining enough capital and reserves so that your organization can absorb the losses that inevitably occur as part of risk-taking in a strong economy." Chairman Greenspan's comments are as relevant to credit unions as they are to community banks.

If you have any questions on liquidity, please contact your examiner, NCUA regional office, or in the case of state-chartered credit unions, your state supervisory authority.

/s/

Dennis Dollar
Acting Chairman