NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA

DATE: December 2000 **LETTER NO.:** 00-CU-14

TO: Federally Insured Credit Unions

SUBJ: Liquidity and Balance Sheet Risk Management

ENCL: Liquidity Forecast Template

This is the second in a series of letters providing guidance on balance sheet risk management, following letter 99-CU-12 which addressed real estate lending.

Credit unions have been highly successful in accomplishing their mission of providing service to their members. Increased loan volumes have occurred in the context of steady earnings and improved capital positions. The purpose of this letter is to assist credit unions in sustaining past levels of success by ensuring that the means to providing member service are in place and well managed.

Liquidity risk is a widely acknowledged current issue worthy of scrutiny. This letter emphasizes the importance of liquidity risk management and offers guidance on forecasting liquidity needs.

What is *liquidity risk*?

Liquidity risk is the funding risk that, due to a lack of sufficient stable sources of funds, a credit union will be unable to continue meeting member demands for share withdrawals and/or new loans.

What are the main sources of liquidity?

Sources of liquidity are found primarily in core deposits and, secondarily, in investments that can be readily sold without significant delay or market loss. Alternative sources of liquidity are found in borrowing arrangements, such as repurchase agreements and committed lines of credit. The alternative sources of funds are less permanent in nature, and so do not provide a continuous basis for funding loan demand or share withdrawals.

Why is NCUA concerned about liquidity risk?

Credit union liquidity is decreasing and has been reduced to the lowest level in over a decade. This situation may persist for some time. When there is an adequate surplus of funds available, the risk of illiquidity is of little concern. However, when liquid funds are depleted, the risk of illiquidity moves to the forefront of concern. Inadequate liquidity can cause potential disruptions in service to a credit union's members and thereby diminish public confidence. It can also increase an institution's vulnerability to

other market and operational risks.
Liquidity problems or special needs often emerge as a symptom of other problems. For example, the good economic conditions that currently benefit credit unions and their members may change. Members could become financially overextended resulting in higher delinquency, reduced principal repayments, and increased share withdrawals thus reducing sources of funds that the credit union may have relied upon to ensure "business as usual" stability.

Credit unions have successfully managed high loan-to-share ratios in the past. After many years of excess or adequate liquidity levels, credit unions are once again faced with the challenge of managing in a tighter liquidity situation, while continuing to meet members' needs. Credit unions should take care now to address the potential liquidity demands that have resulted from the robust demand for credit.

Are liquidity pressures emerging?
Presently, a number of key indicators exist that warrant immediate attention to liquidity risk management. Loan growth has caused a notable decline in liquid assets. For the period of June 30, 1999 to June 30, 2000, the 12.7 percent increase in loans has been funded by a decline in investments and increases in rate-sensitive money market shares and share certificates (see Chart 1 – Call Report Data). Loans are less liquid than investments since they are less marketable. Share drafts are easily withdrawn, and could produce further pressures on liquidity if this occurs. Rate sensitive shares (money markets and certificates) put pressure on profitability by increasing the cost of funds in rising rate environments. All of these factors pose risks to the credit union's profitability and capital.

Natural Person Credit Union Call Report (5300) Data (in $ Millions)

	6/30/99	**12/31/99**	**6/30/00**	**Change +(-) 6/99 to 6/00**
Total Loans	**$254,993**	**$271,547**	**$287,447**	**12.7%**
New Auto	48,673	52,454	56,568	16.2%
Used Auto	51,698	54,536	58,404	13.0%
1st Mortgage RE	67,061	70,906	74,622	11.3%
Other RE	30,167	33,084	36,841	22.1%
Credit Cards	18,471	20,120	19,648	6.4%
Unsecured Loans	21,848	22,308	21,995	0.7%
All Other Loans	17,075	18,139	19,369	13.4%
Total Investments + Cash	**$138,695**	**$126,518**	**$127,559**	**(8.0%)**
Total Shares	**$356,633**	**$356,921**	**$370,599**	**3.9%**
Share Drafts	42,562	44,824	49,850	17.1%
Regular Shares	139,015	134,032	137,685	(1.0%)
Money Market Shares	45,782	47,379	48,771	6.5%
Share Certificates	87,611	89,665	92,668	5.8%
IRA/KEOGH & Other	41,663	41,021	41,625	(0.1%)

Chart 1

What are the key indicators of tightening liquidity?

- **High loans to shares:** Loan growth has exceeded share growth for six of the past seven years. As a result, the loan to share ratio has steadily increased to 77.6 percent, the highest level in many years (see Chart 2).

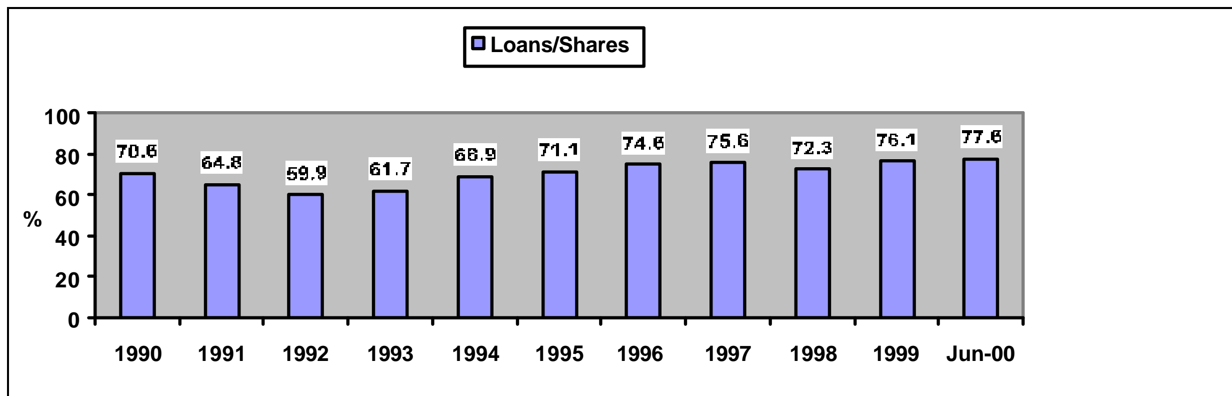

Chart 2

One indicator of potential future illiquidity is the ratio of unused commitments to cash and short-term investments. This represents the amount of additional member loans that the credit union has committed to fund in the future. This ratio has risen from 80 percent in 1998 to over 110 percent as of June 2000, indicating that liquidity pressures could further increase.

- **Declining investments and cash equivalents:** The emerging liquidity pressures facing credit unions are a result of loan growth exceeding share growth. As a result, credit union investment portfolios and cash equivalents have shrunk.

- **Corporates – overnight deposits decline while loans to credit unions increase:** Overnight deposits have declined as loans to members have increased reinforcing the observation that credit unions are cashing in investments to fund loans. As natural person credit unions seek to serve their members' needs, corporate credit union trends reflect the draw on liquidity.

  These trends further emphasize the need to focus attention on liquidity risk management.

Corporate Call Report (5310) Data (in $ Millions)

	June 1999	**December 1999**	**June 2000**	**Change +(-) 6/99 to 6/00**
Total Loans	**$238,952**	**$1,278,630**	**$1,207,724**	**405.4%**
Guaranteed Lines	106	80,203	40,162	37,789%
Loans to Members	211,786	1,170,644	1,083,276	411.5%
Other Loans	27,060	27,783	84,286	211.5%
Total Investments & Cash & Bal. Due	**$45,480,380**	**$37,502,496**	**$36,056,012**	**(20.7%)**
Total Shares	**$39,624,265**	**$32,768,407**	**$32,505,803**	**(18.0%)**
Member Daily Shares	22,773,337	17,503,054	16,104,314	(29.3%)
Other Shares	16,850,928	15,265,353	16,401,489	(2.7%)

Chart 3

- **Extended asset maturities:** Net long-term assets have steadily increased over time and now account for 25.4 percent of total credit union assets. Credit unions that offer real estate loans need to consider the variability of mortgage cash flows and the corresponding impact on their balance sheets (prepayment risk). When interest rates fall, mortgage cash flows increase. Conversely, as interest rates rise, as they have done, mortgage cash flows decline (extension risk). The result has been to extend the lives of these assets, which may result in increased interest rate risk for the issuing credit unions.

What forecasting tools can be used to anticipate liquidity needs?

Credit unions should periodically report, document, and analyze their liquidity positions as part of a sound funds management program. Proper forecasting and planning help anticipate needs before they arise and provide considerations for potential solutions. Good planning, monitoring, and controls are necessary to ensure that when liquidity pressures emerge or increase, appropriate actions can be taken to minimize the impact.

One example of a liquidity-forecasting tool is a projection of net sources and uses of funds, and the resulting forecasted level of cash and short-term investments (see Attachment). Such a tool could be used by a credit union to project liquidity needs over a 12-month horizon.

What are some possible solutions to liquidity pressures?
Credit union officials may wish to consider actions such as, but not limited to, the following:

- Update marketing plans to initiate appropriate changes to share and loan programs (consider pricing, terms, products, etc.);
- Develop new and/or alternative funding sources as allowed by regulations (for example, credit unions may consider establishing borrowing repurchase agreements, committed lines-of-credit, or other borrowing arrangements);
- Establish loan participation arrangements; or
- Analyze the impact of selling or securitizing specific assets or portfolios.

Summary: To successfully sustain the growth in lending and service to members, credit union officials and senior management must consider how a liquidity problem would be resolved. Now is an excellent time to revisit or, if need be, develop liquidity risk management policies, procedures, and practices. Each credit union's liquidity management process should be appropriate for the overall level of risk incurred considering asset size, capital adequacy, and products or services offered.

In order to establish a reasonable capacity to respond to liquidity needs, I encourage you, at a minimum, to take the following actions as part of your credit union's liquidity management processes:

- Periodically prepare, review, and document liquidity positions and forecasting (cash flow modeling, sources and uses of funds, ratios, etc.);
- Develop (or enhance) funds management plans; and,
- Consider what courses of action may be taken in response to liquidity needs, under normal business conditions, successively deteriorating liquidity scenarios, and emergencies.

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

Sincerely,

__________/s/____________________
Norman E. D'Amours
Chairman
National Credit Union Administration Board

Enclosure

Liquidity Forecast – 1 Year	Net Cash Flow ($ Thousands)					
	Month 1	**Month 2**	**Month 3**	**Quarter 2**	**Quarter 3**	**Quarter 4**
SOURCES:						
NET SOURCES OF FUNDS	**12**	**12**	**12**	**35**	**35**	**35**
USES:						
NET USES OF FUNDS	**22**	**22**	**22**	**65**	**65**	**65**
ENDING NET CASH FLOW = Net Sources minus Net Uses	**-10**	**-10**	**-10**	**-30**	**-30**	**-30**
CUMULATIVE NET CASH FLOW	**-10**	**-20**	**-30**	**-60**	**-90**	**-120**
BEGINNING CASH & CASH EQ	**110**					
FORECASTED CASH & CASH EQ	**100**	**90**	**80**	**50**	**20**	**-10**

CASH FLOW DEFINITIONS:

Sources of Funds: *Increases in shares and liabilities or decreases in assets*

Uses of Funds: *Increases in assets or decreases in shares and liabilities*

Liquidity Forecast Template Explanation:

"Net" Sources and Uses of Funds result from aggregating cash inflows or outflows within different classes of assets and liabilities.

For example: assets consist of loans and investments. Total loans include various categories such as consumer loans and mortgages. Consumer loans consist of credit cards, auto loans, real estate loans, unsecured personal loans, and other loans. Total shares include share drafts, regular shares, money market shares, share certificates, IRA/KEOGH accounts, and all other savings.

To perform a reasonable cash flow forecast, the cash flows within each balance sheet category must be considered, since each will be different. These then can be aggregated into various sub-categories such as "Total Consumer Loans." The combined totals result in a net cash flow forecast for all assets and liabilities.

"Ending Net Cash Flow" includes both inflows, or sources of funds (for example loan payments received from members, members' share deposits, sale of loans or investments, and borrowed funds) and outflows, or uses of funds (for example: new loans granted to members, members' share withdrawals, purchase of investments or other assets, and repayment of borrowed funds).

The **"Cumulative Net Cash Flow"** in the example reflects the collective impact of all flows in all categories, over a one-year period. The first quarter is broken down into months on the assumption that near-term changes will be known with greatest precision.

The **"Forecasted Cash & Cash Equivalents"** reflects the projected liquidity position for each period end after applying projected cash flows to the balance in "**Beginning Cash & Cash Equivalents.**"