NATIONAL CREDIT UNION ADNUNISTRATION
NATIONAL CREDIT UNION SHARE INSURANCE FUND
LETTER TO CREDIT UNIONS

LETTER NO. 130 DATE: February 1992

DEAR BOARD OF DIRECTORS:

For the first time in over 25 years, financial institutions must deal with a surplus of funds in an interest rate environment that has moved down rapidly. This is a tough market and we are all in it. (The NCUSIF will earn about $40 million less this year just because of the interest rate change.)

For many credit unions, margins will be tight during this transition period. Income will decline much more rapidly than the adjustment of expenses or dividends. Low interest rates and low loan demand are likely to continue for the short term; thus, both investment yield and interest on loans will continue to decline. With bankruptcies at an all time high (and seemingly out of control) and with layoffs and an uncertain economy ahead, it is important that we all work together to meet these challenges. Although the current economic situation is difficult, the economy has always gone through similar cycles and probably always will. It is important that we not overreact in this cycle and make decisions that will penalize us in the next.

The purpose of this letter is to advise you that NCUA examinations will be focusing on how credit unions are responding to the changed interest rates and market that currently exist. This letter provides some basic advice and guidance, but for the most part is a reminder that both NCUA and credit unions have to think and be flexible during the current economic transition.

Tremendous pressures exist to increase yield and continue producing a high net income. Yield can only be increased by increasing risk. Higher risk loans start to look attractive. Investments with longer maturities or more risk will seem very appetizing. All types of investments that offer high yields will be offered by almost everyone. Most of the investments use various concoctions of mortgage-backed instruments (GNMAs, FNMAs, CMOs, REMICs) with an unlimited array of internal variations.

This funding of longer-term assets with short-term liabilities can create credit unions that look and behave like a savings and loan. A credit union's deposit base is primarily short term. Almost 95 percent of a credit union's funds are in passbooks, share drafts, or certificates under 1 year. Yet, the credit union asset base is becoming longer, particularly if the funds that are not being loaned to members are being invested in mortgage-backed securities. In simple terms, some credit unions are borrowing short and lending or investing long and are developing a fairly significant interest rate exposure.

We offer this advice.

a. Adjust dividend rates to reflect the market: This is the hardest single item to do after so many years of paying passbook and share draft rates of 5, 6, 7 percent or higher. To even think about 4

percent or lower is difficult, but with consumer loan demand off, it is impossible to earn sufficient rates on investments without incurring additional risk.

b. Keep trying to make consumer loans. The opportunity is there or will be there for those credit unions that continue to market strongly.

c. Take a hard look at operating expenses and try to reduce or at least hold the line. most credit unions have done pretty well here but another look won't hurt.

d. Do not get over-extended and concentrated in long-term investments. The temptation here is going to be enormous as it provides an easy short-term fix. Sellers of such products are masterful at disguising shorter-term CMOs and REMICs as "no lose" propositions. Make sure that the investments you buy are suitable for your deposit base and your asset liability management policy. our examiners will look very carefully at investments outside of short-term U.S. Governments. Concentrations in other investment areas will be carefully reviewed to determine your credit union's analysis of credit quality and interest rate risk.

In addition to this advice to credit unions, we are also advising our examiners to consider the effect of these economic changes when rating the Earnings component of CAMEL. For those credit unions who have demonstrated that they are adjusting to the market by following the above advice, the Earnings component may be adjusted flexibly to recognize those efforts.

Credit unions have done extremely well as providers of consumer lending and deposit services. We hope that this current economic stress will cycle out soon and that-a more normal economic-situation will evolve. In any event, with your usual prudent management, I am sure we will continue as leaders in financial services.

For the National Credit Union
Administration Board,

Roger W. Jepsen
Chairman