NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

NCUA LETTER NO. 54 DATE: March 26, 1981

TO: THE BOARD OF DIRECTORS OF THE FEDERAL CREDIT UNION ADDRESSED:

On February 25, 1981, the National Credit Union Administration authorized Federal credit unions to engage in Federal Funds market transactions. These transactions, which generally receive a higher return than repurchase transactions, represent unsecured deposits in a bank, normally the credit union's local correspondent bank. The deposits are loaned to other banks in the Federal Reserve System which need funds to meet their reserves. Although the NCUA Board has authorized these deposits, it cautions that care should be taken by credit union officials in making such investments.

With interest rates fluctuating as they have over the last year, many credit unions are now matching the maturities of assets to liabilities and equity. The most common method is to match oney market certificates (MMCs) offered to members against other short-term investments such as certificates of deposit offered by savings and loan associations (S&Ls) or banks, common trust accou~nts, and corporate centrals. The obvious reason is to remain liquid while ~guarantying a favorable spread or positive arbitrage.

On the surface this practice appears to be a. easy and safe task; a credit union only needs to pick a positive rate and forward the funds. But how safe is this investment? Federally insured banks, S&Ls and credit unions are insured up to $100,000; state institutions may vary and trust funds have no insurance. Investments above insured amounts represent a real credit risk just like a loan to a natural person member. If the institution being invested in goes into bankruptcy, the investors stand not only to lose interest but also principal on their investments.

Now, consider that those institutions that are willing to pay higher rates for funds than the going MMCs rate must survive in the same competitive environment as every other institution. How do they do it when so many credit unions themselves cannot? Some can because of more efficient operations, better management, more knowledge of the competitive environment and volume of activity. But the fact is many cannot and are surviving either on prior or <u>future</u> years earnings.

Unfortunately, the continued use of prior years' earnings or the mortgaging of future years' earnings increases the risk to an astute investor. And, as in other markets, the higher the risks, the higher the return (interest rate) necessary to attract capital. Thus, those institutions which offer excessively lucrative rates of return generally represent a greater risk (although the opposite is not always true).

How can credit unions protect themselves from undue investment credit risks?

First, they can analyze the financial condition of institutions or funds they intend to invest in. This can only be done by obtaining a copy of the institutions' financial statements, and where possible, ratings from national ratings firms such as Moody's or the Dow Jones Industrial Index.

If credit unions are unskillled in analyzing these alternative, the credit union's local bank, investment banker, corporate central, league, trade association, or other independent source may be able to assist. If none of these sources are helpful, serious consideration should be given to limiting the investment to insured amounts.

Second, they can diversify investments. Thus, in the event of default, the loss could be absorbed by available retained earnings and excess reserves, or where the investment is recoverable but only through receiveship proceedings, it would not represent so large a non-income producing asset that dividends would be impacted during the receivership.

The National Credit Union Administration is concerned that some credit unions may be purchasing certificates of deposit from savings and loan associations and banks throug brokers without proper analysis. This not only compromises the safety and soundness processes for purchasing these investments as recommended above, but may also be in violation of Section 703.1 of the NCUA Rules and Regulations. In accordance with that regulation, a credit union "itself" must make the investment. NCUA has determined that this means properly authorized credit union officials must negotiate the terms, approve the investment and place the funds into the terms, approve the investment and place the funds into the money broker to purchase non-negotiable certificates of deposit (Negotiable certificates of deposit may be purchased from the broker's portfolio.) even if the fundss are mailed directly to the financial institution. NCUA has no objection when a credit union uses an investment advisor to obtain services such as rates on various permissible investments.

The National Credit Union Administration is also concerned because of rumors that some brokers negotiating certificates of deposit have been linked with firms previously involved in the municipal security and government security scandals. Credit union officials should be wary of people offering high yield investments. Every effort should be made to deal with well established and financially sound brokerage firms.

Should credit union officials be approached by persons with suspicious offerings, the Regional Office of the National Credit Union Administration should be contacted.

Sincerely,

LAWRENCE CONNELL
Chairman