NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

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TO: THE BOARD OF DIRECTORS OF THE FEDERALLY INSURED CREDIT UNION ADDRESSED:

The current interest rate environment places a great deal of pressure on the management of credit unions to seek the highest possible yield on investment portfolios to accommodate the dividend rates necessary to remain competitive in the marketplace for members' funds. The National Credit Union Administration urges that credit unions fully evaluate the risk factors associated with the higher yields.

The dangers of failing to do so are underlined by the recent failure of a large thrift institution. Investors, including a number of credit unions, that had funds invested or deposited in excess of the insured limit ($100,000) stand to lose substantial amounts. A financial analysis of that institution, coupled with diversification of the investor's portfolio, could have resulted in limiting the potential loss as well as red~ucing the overall risk exposure inherent in the investment portfolio.

A credit union should have written investment policies; a "management plan" to effectively meet its responsibility in managing the investment portfolios of the credit union. There are certain key factors which must be considered when integrating investment policy into overall goals and objectives. These factors are safety, liquidity, and yield. As a result of the liquidity pressures placed on financial institutions in recent years, credit unions should move to more efficient funds management techniques to match asset and liability maturities to effectively manage their liquidity position. Safety and yield, the other two key elements that must be addressed in the written investment policies, should be evaluated jointly. Very often investments with higher risk factors and greater price volatility command the greater yields.

One important method utilized to lower the investment risk factor is diversification in the investmet portfolio. This practice effectively reduces the credit risk (the risk one takes in recovering the principal at maturity plus a reliable income stream over the life of the investment) by reducing the possibility of incurring a catastrophic loss from the failure of a single or a few institutions or the default of a single or a few obligations.

The National Credit Union Administration realizes that it is customary in the credit union industry to maintain a significant portion of the investment portfolio in one or a small number of financial institutions. If the officials of a credit union choose to concentrate investments in one institution, this should be addressed in the written investment policies under the diversification issue. Procedures should be established to review at least on a quarterly basis, the financial condition of the institution in hich the credit union concentrates its investments. In fact, where large concentrations of investments are concerned, onthly evaluations are encouraged. The credit union should also inquire about the investment policies of such a financial institution to satisfy itself that the institution has appropriately diversified its portfolio.

The issue of investment risk is being raised because the National Credit Union Administration wishes to make credit unions aware of potential problem areas arising from the increasingly competitive nature in the financial marketplace resulting from recent legislation as well as the current economic condition.

LAWRENCE CONNELL

Chairman