NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION

NATIONAL CREDIT UNION SHARE INSURANCE FUND

LETTER NO. 170

DATE: May 1995

DEAR BOARD OF DIRECTORS:

Many credit unions use third party institutions to provide item processing, automated clearinghouse, and money order services. Most of these third party institutions require credit unions to pre-fund processing activities by placing and maintaining a deposit at the institution. The required deposit is related to the credit union's average daily processing activity and varies from institution to institution but could represent a substantial portion of the credit union's assets. In cases where the contractual agreement requires that a settlement account balance be maintained at the third party institution, there is potential for risk of loss of the amount of the credit union's required deposit that exceeds the insurable limit if the institution fails. To minimize this potential risk, credit unions are advised to exercise due diligence before entering into a contract and periodically throughout the relationship with the institution. At a minimum credit unions should follow these guidelines:

* Contact several processors. Review the financial statements and the most recent audit report and the accompanying management letter so that an assessment of the financial and operational condition of each institution can be made prior to entering into a contract.

* Review contract terms and conditions. The terms and conditions of each institution's contract should be carefully reviewed by the credit union and its own legal counsel.

* Periodically assess the financial condition of the institution. Review the financial statements and the institution's peer group ratios and rankings at least once per year. Pay particular attention to capital and profitability ratios. Review audit reports annually.

* Change processors if necessary. If the financial stability of the institution becomes questionable, consider changing to another institution. The cost of changing processors, and the terms of the contract, are some issues that must be considered. The cost of changing processors could be greatly reduced if credit unions consider using their own routing and transit number on share drafts (payable-at method) versus using the routing and transit number of the payable-through bank (payable-through method). If a credit union has its own routing and transit number and decides to change processors, it is not necessary to reissue new share drafts. Before selecting this option, however, it is imperative that officials discuss this issue with individual processors, as the terms, conditions, and the level of credit union responsibility for a routing and transit program will vary from processor to processor.

The failure of a third party institution processor not only puts your credit union's funds on deposit at risk, but may also damage your relationship with your members when items are not processed. To minimize the risk of loss of assets and promote the preservation of your relationship with your members, I urge all credit unions to enter into this type of relationship prudently.

For the National Credit Union Administration Board,

Norman E. D'Amours
Chairman