NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: **October 2013** **LETTER NO.: 13-CU-10**

TO: **Federally Insured Credit Unions**

SUBJ: **Guidance on How to Comply with NCUA Regulation §741.12 Liquidity and Contingency Funding Plans**

ENCL:
(1) Appendix: How to Establish Access to the Federal Reserve Discount Window and Central Liquidity Facility
(2) §741.12 Liquidity and Contingency Funding Plans
(3) Interagency Policy Statement on Funding and Liquidity Risk Management

Dear Board of Directors and Chief Executive Officer:

The NCUA Board adopted a final rule on liquidity and contingency funding plans on October 24, 2013. NCUA adopted this rule to ensure all credit unions conduct sound liquidity planning, and large credit unions establish access to at least one federal source of contingent liquidity: the Federal Reserve Discount Window (Discount Window) and/or Central Liquidity Facility (CLF). As we learned during the financial crisis, sound liquidity planning and access to federal liquidity sources are vital to the safety and soundness of the credit union system.

The effective date of the rule is March 31, 2014. The purpose of this letter is to advise you of your responsibilities under the liquidity rule, explain the impetus for the rule, and provide guidance on certain liquidity planning expectations and provisions of the rule.

Which credit unions are subject to the rule?

Section 741.12, *Liquidity and Contingency Funding Plans* (the "liquidity rule"), is applicable to all federally insured credit unions (FICUs), but does not apply to corporate credit unions.

The rule establishes a three-tiered framework for credit unions as follows:

Credit Union Asset Size[1]	Requirement
Under $50 million	FICUs with less than $50 million in assets must maintain a basic written liquidity policy. The policy must provide a credit union board-approved framework for managing liquidity and a list of contingent liquidity sources that can be employed under adverse circumstances.
$50 million or more	In addition to a written liquidity policy, FICUs with assets of $50 million or more must have a contingency funding plan (CFP) that clearly sets out strategies for addressing liquidity shortfalls in emergencies.
$250 million or more	In addition to a written liquidity policy and contingency funding plan, FICUs with assets of $250 million or more must establish access to at least one contingent federal liquidity source: the Discount Window and/or CLF.

What does my credit union need to do and when?

Table 1 summarizes the rule's key action steps and compliance dates.

Table 1: Timeframes for Compliance

FICUs with Total Assets:	Actions Required by March 31, 2014	Actions Required by December 31, 2014
Under $50 million	Have a basic written liquidity policy for managing liquidity in accordance with §741.12(a).	
$50 million or more	Establish and document a contingency funding plan in accordance with §741.12(b) and (d).	
$250 million or more	Apply for access to at least one contingent federal liquidity source in accordance with §741.12(c).	Conduct advance planning and a test of contingent funding sources in accordance with §741.12(c).

What steps are necessary for my credit union to take prior to and after the effective date of the rule?

Table 2 provides suggested timing for necessary action steps.

[1] For the second and third tier requirements, certain credit unions are subject to the higher requirements when total assets exceed the applicable threshold for two consecutive Call Reports.

Table 2: Recommended Timetable for Compliance Action Steps

Regulatory Requirement	Recommended Timetable for Monthly Action Steps			
	Nov 2013	Dec 2013	Jan 2014	February-March 2014
Have a basic written liquidity policy for managing liquidity in accordance with §741.12(a).	Review NCUA guidance and conduct due diligence.	Complete due diligence. Assess current policy revisions, if any.	Finalize draft changes to policy, and present to credit union board.	Take credit union board action to affirm/adopt written liquidity policy.
Establish and document a contingency funding plan in accordance with §741.12(b) and (d).	Review NCUA guidance and conduct due diligence.	Complete due diligence. Assess current plan revisions, if any.	Finalize draft changes to plan, and present to credit union board.	Take credit union board action to affirm/adopt contingency funding plan.
Apply for access to at least one contingent federal liquidity source in accordance with §741.12(c).	Contact CLF and/or Federal Reserve Bank to coordinate process for establishing relations and receive instructions.	Complete review of necessary CLF membership and/or Fed agreements and resolutions.	Work with CLF and Reserve Banks to resolve any issues, and present to credit union board.	Take credit union board action to complete and file necessary CLF membership requirements and documents and/or file necessary lending agreements and corporate resolutions to obtain credit from a Federal Reserve Bank.
Regulatory Requirement	**Between March 31, 2014 and December 31, 2014**			
Conduct advance planning and a test of contingent funding sources in accordance with §741.12(c).	For CLF: Conduct a test of funds-delivery process in accordance with CLF instructions. For Discount Window: Identify unencumbered assets to pledge, pre-position collateral, resolve potential subordination agreements, and conduct a test transaction.			

Why did NCUA issue the liquidity rule?

A major impetus for the liquidity rule is the failure of U.S. Central Federal Credit Union and the associated wind-down of its temporary successor, U.S. Central Bridge Federal Credit Union (U.S. Central). U.S. Central played a pivotal role as an agent of CLF by purchasing CLF stock and thereby extending contingent liquidity protection to consumer credit union members of U.S. Central's member corporate credit unions. This provided federal liquidity coverage to almost the entire credit union system.

U.S. Central Bridge was liquidated in October 2012 as part of its planned resolution. With this closure, CLF redeemed U.S. Central's CLF stock and paid out the cash proceeds to U.S. Central Bridge. When this redemption took place, the agent group arrangement was terminated. As a result, the roughly 6,000 consumer credit unions that had CLF access through their corporate credit unions lost that coverage. Since that time, most of the affected consumer credit unions have not taken action to restore this loss of contingent liquidity.

The recent financial crisis demonstrated the importance of good liquidity risk management to the safety and soundness of financial institutions. Many institutions experienced significant financial stress because they did not manage their liquidity in a prudent manner. In some cases, these institutions had difficulty meeting their obligations as they became due because sources of funding were severely restricted. In the financial crisis, even institutions that were healthy used emergency federal liquidity facilities when funding costs became prohibitively high.

The rapid reversal in market conditions and limited availability of liquidity during the crisis illustrated how quickly illiquidity can become a problem. This illiquidity can last for an extended period, leading to an institution's inability to meet its financial obligations and possibly its insolvency. Many of the liquidity-related difficulties experienced by financial institutions were due to lapses in basic principles of liquidity risk management.

NCUA remains concerned about the largely diminished liquidity protection for the credit union system. Thus, this rule builds on lessons learned and is designed to strengthen credit union liquidity risk management. The liquidity rule is designed to restore liquidity access, individually and system-wide, to a more prudential level. This is vital to maintain a strong and resilient credit union system going forward.

What are the key sources of liquidity NCUA looks for in credit union plans?

There are three categories of liquidity sources that apply to liquidity planning. Each of these sources is relevant to the underlying safety and soundness of a credit union's liquidity management program. Essentially, these sources act as layers of liquidity protection and function similar to a series of financial firewalls. The three categories are:

1. **On-balance-sheet liquidity**. Maintaining a balance-sheet cushion of highly liquid assets is your first line of protection. It is essential for credit unions of all sizes to hold an adequate safeguard of cash and cash equivalents (such as short-term deposits and short-maturity Treasuries). A simple rule of thumb is to identify the largest liquidity outflow your credit union has ever experienced and how long it persisted. Then set your on-balance-sheet liquidity target based on that experience. This liquidity cushion will buy you some time to avoid service disruptions and enter external funding arrangements if they become necessary.

2. **Access to market sources of funds**. Your second line of protection is to be in a position to borrow from market counterparties. You can build borrowing relationships with a corporate credit union, a correspondent bank, a Federal Home Loan Bank, or with repurchase agreement counterparties (or all of these), to name a few. You need to keep in mind your credit union's ability to borrow from market funding sources will require unencumbered assets acceptable to lenders, which can be readily pledged against your loan. Larger credit unions with greater potential funding needs should have multiple stable borrowing sources and a clear understanding of which assets can be pledged.

3. **Contingent federal liquidity providers**. The third line of protection is access to a contingent federal liquidity provider such as the Discount Window or CLF. **The Discount Window and CLF exist to provide backup liquidity in circumstances where on-balance-sheet liquidity and market funding sources prove inadequate.** While sparingly used, the Discount Window and CLF have proven to be dependable sources of liquidity in times of crisis or unexpected events. Like the funding sources, the Discount Window and CLF are both collateral-based lending facilities. All loans must be fully secured with a first priority security interest.

Generally, a credit union responding to liquidity demands will work through these sources in the above order. Your credit union needs to specify in its plan which sources it can access and the priority of steps to follow. NCUA recognizes liquidity resources may have changed for many credit unions because of the recent financial crisis. This means you may need to establish *new* relationships with market counterparties and contingent federal liquidity facilities.

For most credit unions, the first two sources of liquidity are already integrated into their day-to-day operations. However, because emergency liquidity is not an everyday need, most credit unions have not yet chosen to establish relations with a contingent federal liquidity source. Of the credit unions that are now required to access a contingent federal liquidity source, slightly more than half have already established relations with the Discount Window and/or CLF.

What should a written liquidity policy address?

All credit unions need to have a written liquidity policy. The liquidity policy can be part of an existing policy such as an Asset-Liability Management (ALM) or funds management policy. Typically it is coordinated with a credit union's strategic planning efforts.

Your liquidity policy will govern how your credit union manages its daily operating cash needs, how it meets forecasted liquidity shortfalls, and how it responds to unforeseen contingencies. At a minimum, NCUA requires the liquidity policy to include a board-approved framework for managing liquidity on an ongoing basis as well as a list of identified liquidity sources that can be tapped during contingency circumstances.

Your liquidity policy should be tailored to the size and complexity of your credit union. If your credit union has a high reliance on market-sensitive funds (e.g., money market shares) and assets with more dynamic cash flows (e.g., mortgage loans), you would need to analyze prepayments and conduct a comprehensive forecast for your sources and uses of funds. Conversely, if you hold a large percentage of liquid assets, have strong core deposits, and do not make mortgage loans, your liquidity risk is likely to be less dynamic and your plan may be more basic. As your size increases, liquidity risk typically increases in amount and complexity.

For credit unions under $50 million in total assets, the policy does not need to be elaborate, but it must cover certain basic elements that are fundamental to all depository institutions. Core elements of a basic liquidity policy include the following:

1. ***Purpose and goals of liquidity management*** – The policy should establish the purpose, objectives, and goals of liquidity management. You can begin with a definition of *liquidity risk* and why it is important to manage. Liquidity risk is the risk that a credit union:

   - Does not have sufficient access to funds to maintain a "business as usual" posture at all times; or

   - Does not have the ability to raise or borrow funds at a reasonable cost at all times.

   The policy should acknowledge that a failure to manage liquidity can result in an inability to meet operating cash needs and commitments such as member withdrawals. This understanding is highly important because an inability to meet operating cash needs and/or fund member withdrawals could be extremely damaging to a credit union. Consumer confidence erodes rapidly when a financial institution is unable to process drafts, dispense currency, or meet loan commitments. Thus, managing liquidity risk is critically important to the wellbeing of the credit union.

2. ***Thresholds or limits for liquidity measures and reporting requirements*** – The policy should convey the credit union board's tolerance for liquidity risk. The evaluation process should include identification of the appropriate ratios that can signal changing liquidity conditions,[2] preparation of periodic cash flow projections, and establishment of a minimum cash-on-hand target to which you manage. You should set forth required minimum balances for short-term and overnight funds that are sufficient to maintain a business-as-usual posture and allowing for unexpected stresses in normal funding needs that may arise.

   Your liquidity plan should require procedures for when and how the credit union will evaluate and report its liquidity levels relative to the board-approved limits. The policy should specify the reporting requirements, including the nature and frequency of management reporting. This includes clearly defining roles and responsibilities for all aspects of the liquidity management function so the credit union's board can ensure accountability. Also, the policy should address under what conditions designated staff should begin implementing contingency plans.

3. ***Primary and secondary sources of liquidity*** – It is important for the policy to specify what sources you can tap and the priority of steps to follow. Primary sources of liquidity may include share deposit growth and income from loans and investments. Secondary sources may include securities available for sale and lines of credit.

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[2] Ratios that can signal changing liquidity conditions may include the loan-to-share ratio, cash and cash-equivalents to total assets ratio, funding coverage ratio, and liquid and unencumbered securities to deposits.

4. ***Tools for liquidity risk management*** – The risk management tools should be consistent with the size and complexity of the credit union. For example, a bucketed sources and uses of funds template[3] or maturity gap template can be utilized where appropriate. This review should be based on an understanding of how your assets and liabilities behave in response to changes in market conditions. Generating a forecast of sources and uses of funds is a fundamental activity for any financial institution. Tools that are more sophisticated are needed when the credit union's cash flows are complex and susceptible to high volatility. Capturing the effects of changing market rates or varying assumptions about growth of deposits and loans can highlight potential liquidity shortfalls. Understanding sources of volatility in cash flows will help you anticipate shortfalls and plan for contingencies.

5. ***Periodic review and revisions as needed*** – As with any major policy, your liquidity policy should set forth a requirement to periodically review and revise, if necessary, the policies and plans to reflect the credit union's current tolerance for risk, balance sheet composition, liquidity strategy, and organizational structure. The frequency of review can be annually but should be reassessed whenever the credit union experiences a significant change.

What should a contingency funding plan (CFP) address?

Credit unions with $50 million or more in total assets are required to have a more comprehensive liquidity policy that incorporates a CFP. A CFP includes policies, procedures, projection reports, and action plans designed to ensure your credit union's sources of liquidity are sufficient to fund operating requirements under contingent liquidity events. A CFP needs to:

- ***Include a process to forecast and assess whether the credit union's liquidity sources are adequate to meet normal and contingent needs.*** The CFP should identify plausible stress events and quantitatively evaluate those stress events under different levels of severity.

- ***Identify specific contingency sources.*** The CFP should identify any backup facilities (lines of credit), the conditions related to their use and the circumstances where the credit union might use them. Management should understand the various conditions, such as notice periods, that could affect access to backup lines and test the credit union's ability to borrow from established backup facilities.

- ***Specify how the credit union will manage a range of liquidity-stress events.*** Contingent events arise from both unexpected circumstances and ongoing adverse business conditions. Credit union specific events are usually the result of the unique credit, market, operational, or strategic risks that occur because of a credit union's business activities. External events may be systematic financial market occurrences, such as changes in the price volatility of securities, changes in

[3] Letter to Credit Unions 00-CU-13, "Liquidity and Balance Sheet Risk Management", contains a sample liquidity forecast template as an enclosure.

economic conditions, or dislocations in financial markets. The CFP should include an asset tracking system that monitors which assets are immediately available for pledging or sale and how much a cash sale of these assets will generate.

- ***Identify the lines of authority within the credit union responsible for managing liquidity events.*** A clear description of roles and responsibilities is a critical component of the credit union's CFP. The CFP should provide for a comprehensive crisis management team with clearly defined roles. Action plans, and the assignment of responsibility for carrying them out, should be realistic and formalized in writing. The credit union should integrate the CFP with other contingent planning activities such as continuity of business planning. It should provide for frequent communication among the crisis team, the board of directors, management, and other interested parties.

- ***Outline the management processes the credit union will follow when responding to liquidity events.*** To ensure the effective and timely implementation of the CFP, credit unions should develop a process for identifying a potential liquidity event before it becomes a crisis. This can be accomplished through the use of early warning indicators and event triggers that are readily observable during a credit union's normal reporting process.

- ***Specify the frequency that the credit union will test its plan and make any necessary updates.*** Credit unions should test components of their contingency funding plan in order to assess their reliability under times of stress. Identified actions such as loan sales, repurchasing securities, and borrowing arrangements should be periodically tested to ensure that they function as envisioned. As conditions and circumstances change, CFP plans should be revised accordingly.

Credit unions under $250 million in total assets are *not required* to establish access to a contingent federal liquidity source. However, NCUA encourages *all* credit unions to do so *if* their contingency funding analysis identifies liquidity events pose a *real threat* to the credit union. Credit unions can benefit from conducting some level of liquidity-risk scenario analysis and establishing access to a contingent federal liquidity source to protect against unforeseen circumstances. A credit union's actions to enhance the liquidity strength of the credit union will reflect favorably in the Liquidity ("L") and Management ("M") components in its CAMEL rating.

How do I establish access to a federal contingency liquidity source?

Any federally insured credit union with assets of $250 million or more must establish access to at least one contingent federal liquidity source for use in times of financial emergency and distressed economic circumstances. Credit unions subject to this requirement may demonstrate access to a contingent federal liquidity source by:

1. Maintaining membership in the CLF; and/or

2. Establishing a relationship at the Discount Window by filing the necessary lending agreements and corporate resolutions to obtain credit from a Federal Reserve Bank (pursuant to 12 CFR §201).

Which federal contingency liquidity source is right for my credit union?

The decision about which federal contingent liquidity source to choose – the Discount Window or CLF – is an individual business decision that certain credit unions must make. If evaluating the two sources, one dimension you should carefully consider is how quickly your credit union may need to access emergency liquidity and how long you may need it.

As shown in Table 3, the Discount Window and CLF lending terms have similarities and differences; and the differences are important. The key differences are in the timing and duration of loans. Specifically:

- The Discount Window is designed to handle *sudden* emergencies or operational issues that require *same-day* access to contingent federal liquidity.

- The CLF is designed to handle *sustained* emergencies or operational issues that require contingent federal liquidity for a few days up to *several months*.

Table 3: Key Similarities and Differences in Lending Terms

	DISCOUNT WINDOW	**CLF**
Similarities	Both the Discount Window and CLF function as safety valves to relieve liquidity pressure on individual depository institutions and to stabilize broader liquidity systems.	
	Both are fully secured collateral-based lenders.	
	Both met emergency liquidity needs for individual institutions and for entire systems during the latest financial crisis.	
Differences	The Discount Window is able to advance *same-day funds* to qualifying credit unions (subject to collateral requirements).	CLF funding may take *1-10 business days* depending on the requested dollar amount (also subject to collateral requirements).
	The Discount Window's *overnight loans* may be renewable, but any series of rollovers is expected to be *brief* in duration.	The CLF makes *loans up to 90 days*, and these 90-day loans may be *renewed for an additional term* under certain circumstances.
For more information	www.frbdiscountwindow.org/started.cfm	www.ncua.gov/Resources/CLF

For further details on how to establish access to the Discount Window and/or CLF, see the Appendix to this letter.

Can my credit union access both the Discount Window and CLF?

Yes. **The combination of both the Discount Window and CLF would provide the greatest protection for your credit union in the event of a sudden and sustained liquidity emergency.** For example, in a liquidity crisis where balance sheet and market sources are not enough, your credit union would have the ability to immediately tap large amounts of federal backup liquidity through the Discount Window. In addition, if emergency liquidity needs persist for more than a few days, you would have the flexibility to maintain federal backup liquidity through CLF for up to several months at a time. Credit unions with dynamic contingent liquidity demands would be well served to establish access to both facilities.

How do I conduct advance planning and periodic testing to ensure my contingent federal liquidity source is readily available when needed?

Initially, all credit unions subject to §741.12(c) will have until December 31, 2014, to comply with the provision to "conduct advance planning and periodic testing to ensure that contingent funding sources are readily available when needed." This period will allow sufficient time for those credit unions opting to use the Discount Window to assess and position eligible collateral necessary to enable a test loan transaction; and for those opting to join CLF to learn and execute the new CLF testing procedure. After 2014, credit unions subject to the testing requirement will be expected to conduct such advance planning and periodic tests no less frequently than annually. The testing procedures for the Discount Window and CLF are different due to differences in their respective operational structures and funding sources.

Testing at the Discount Window

For the Discount Window, a credit union with eligible collateral in place may contact their respective Federal Reserve Bank Discount Window personnel by telephone and conduct an overnight (one business day) test-borrowing transaction. You will need to take steps ahead of time to identify your credit union's unencumbered eligible collateral. You will also need to take steps to pre-pledge all or some portion of your eligible collateral at the Discount Window *before* you will be able to conduct either a test or other borrowing transaction.

Testing at CLF

CLF will be releasing final test procedures by March 31, 2014. For CLF, a credit union is not permitted to conduct a test *loan* transaction.[4] However, CLF can conduct a test transfer of funds between itself and members to verify the correctness of the delivery instructions of record – the same wire instructions used for actual liquidity advance requests. For credit unions that choose CLF as their contingent federal liquidity source, such tests will satisfy the regulatory requirement for "periodic testing to ensure contingent funding sources are readily available as needed" pursuant to §741.12(c).

[4] CLF match-funds all of its liquidity advances with loans from Treasury's Federal Financing Bank (FFB). Under the terms of this arrangement, CLF is only authorized to seek an advance from FFB when the underlying CLF advance is for an actual liquidity need as set forth in Title III the Federal Credit Union Act.

The NCUA Board believes it is essential for every credit union to have a sound process for identifying, measuring, monitoring, and controlling liquidity risk that is commensurate with each credit union's needs. And for larger credit unions, it is essential to have established access to a federal liquidity source. When a large credit union experiences unexpected or severe liquidity pressures, it is more likely to have a material impact on the credit union system, consumers, and the National Credit Union Share Insurance Fund.

This new rule will strengthen credit unions' resilience in liquidity events – both at the individual credit union level and throughout the entire system. The rule strikes an appropriate balance between a responsible regulatory framework and liquidity management expectations that are scaled to the size and complexity of individual credit unions.

If you have questions related to the liquidity rule or this letter, please contact your NCUA regional office, district examiner, or state supervisory authority.

Sincerely,

/s/

Debbie Matz
Chairman

Enclosures