

Memo

To: North Dakota State Chartered Credit Unions
From: North Dakota Department of Financial Institutions
Date: 3/27/2015
Re: Liquidity

Much has been said and written about liquidity over the past few years. This memo is not intended to restate that analysis, rather direct you to some of the more relevant guidance letters, and to highlight trends that have been developing. This memo is also to help explain how liquidity is monitored by regulators, and how it is assessed as part of the examination process.

How Regulators Measure and Track Liquidity

The DFI uses a liquidity ratio which is calculated as follows: the sum of cash, cash on deposit, and investments divided by the sum of member and non-member shares, certificates of deposit, and liabilities. The assumption with this ratio is that investments are liquid, or stated another way they can be sold at a reasonable price and within a reasonable time period. When this ratio falls below 15% or there is reason to question the liquidity of investments due to extreme maturities or pledging agreements, we will look more closely and consider other liquidity measurements.

The DFI also uses a liquidity ratio which includes available lines of credit. The calculation of this ratio is the same as above, but also adds in the unused lines of credit to both the numerator and denominator. A trigger point for concern is when this number falls below 20%. Here again, the assumption is that investments are liquid. Factors such as pledged investments or lines of credit with terms that do not match the nature of the funding needs could impact this ratio.

Other common ratios used to measure and track liquidity are noted on NCUA's Financial Performance Report. They include, in part, the loans to shares ratio and cash and short term investments divided by assets ratio. These ratios can be compared to peer group averages.

It is important to note that the ratios, trigger points, and peer averages are the starting point of analysis. Liquidity risk may be greater or less than indicated by the ratios. This will be assessed during examinations and following call report submissions as discussed below.

Trends

While there is still a supply of relatively inexpensive cash in the market, liquidity positions have tightened. State chartered credit unions have a weighted average liquidity ratio of 27.30%, down from 31.00% two years earlier. The ratio including available lines of credit is 33.48%, down from 35.60% two years earlier. If your institution is an outlier, because your liquidity ratios which have fallen faster or are lower than the averages, it may be a cause for concern.

While many things are impacting this trend, one of the main drivers appears to be the softening of the agricultural economy. Many farmers have seen their working capital depleted resulting in an increased demand for loans coupled with the reduced deposits to fund the larger demand. While there has always been seasonal demand related to the agricultural cycle, funds available throughout the cycle are low, and the peak of this seasonal demand appears to be resulting in lower liquidity positions than in years past. The pace in which seasonal demands are subsiding also appears to be slowing. This is impacting credit unions' liquidity.

Another likely factor is the softening of the oil economy. While we have not yet seen a large decline of funds from the oil impacted region, even a gradual slowdown will likely impact the level of cash within the economy. This is a risk that should be monitored.

Regulators' Expectation

Much has been written on how to manage liquidity, but it probably can be summed up by saying you need to have cash or multiple committed funding sources available. Make sure you have taken the step to have liquid assets and multiple committed lines of credit tested and available to keep your liquidity position within a reasonable level. If you fall below a reasonable level, your liquidity risks will be elevated, and this will be point of discussion during the examination process or following a call report submission.

As noted in other guidance, regulators will be reviewing your policies, models, and contingency funding plans. Make sure they are sound and conform to the existing guidance; however, also make sure they are practical. Do not plan to use all committed sources to fund normal and cyclical demand. Sound planning involves multiple committed options. If you have a greater demand for funds than originally planned, be proactive in attracting more deposits or obtaining larger lines of credit. Within your asset liability management / interest rate risk model, it is not rational to base sensitivity on the assumption that funds will always be available at low cost. At a minimum, run a second modeling of the data assuming funds reprice quickly, including core deposits. This will give you an understanding of risk and allow you to add flexibility into your balance sheet to reduce the risk in a stressed environment.

Existing Guidance

NCUA and the FFIEC have both published guidance on managing liquidity. NCUA made changes to their rule which required a contingency funding plan, and a federal source of liquidity for larger credit unions. The FFIEC published guidance which, in part, discusses the importance of testing lines, establishing extra committed sources of liquidity, and having a cushion of liquid assets. Below is a partial list of useful guidance that has been published:

- Interagency Policy Statement on Funding and Liquidity Risk Management
<http://www.federalreserve.gov/boarddocs/srletters/2010/sr1006a1.pdf>
- Part 741.12 – Liquidity and Contingency Funding Plans
<http://www.ncua.gov/Legal/Documents/Regulations/FIR20131024LiquidityContingencyFunding.pdf>
- Letter to Credit Unions 13-CU-10
<http://www.ncua.gov/Resources/Pages/LCU2013-10.aspx>
- Letter to Credit Unions 03-CU-04
<http://www.ncua.gov/Resources/Documents/LCU2003-04.pdf>
- Letter to Credit Unions 03-CU-11
<http://www.ncua.gov/Resources/Documents/LCU2003-11.pdf>
- Letter to Credit Unions 10-CU-06
<http://www.ncua.gov/Resources/Pages/LCU2010-06.aspx>
- Supervisory Letter 14-03
<http://www.ncua.gov/Resources/Documents/SupervisoryLetter-Liquidity-and-ContingencyFundingPlans.pdf>