I. PURPOSE

1. Examiners must ensure management has established sound controls to manage liquidity risks. These controls should include identifying the existence of cash flow demands and measuring the extent of those demands, processes to identify emerging liquidity demands and ensuring corrective measures are in place to minimize liquidity risk and disruption of member services

II. PRIMARY REFERENCES/REGULATIONS

1. Michigan Credit Union Act:
   a. Section 342(4)(k): borrowing money
   b. Section 401(2)(j): borrow funds
2. NCUA Rules and Regulations, Part 741.12: Liquidity and contingency funding plans
3. NCUA Letter 01-CU-08: Liability Management – Highly Rate-Sensitive and Volatile Funding Sources
4. NCUA Letter 10-CU-14: Strengthening Funding and Liquidity Risk Management
5. NCUA Letter 13-CU-10 Guidance on How to Comply with Liquidity and Contingency Funding Plan Requirements
6. Credit Union Bylaws, Article X

III. MINIMUM PROCEDURES

1. Review the liquidity policy to ensure it is tailored to the size and complexity of the balance sheet and susceptibility to cash flow volatility; this policy may be incorporated in the ALM and/or investment policies and must, at a minimum, address the following issues:
   a. **Purpose and goals of liquidity management.** The policy should establish the purpose, objectives, and goals of liquidity management. It should include a definition of liquidity risk and why it is important to manage. The policy should acknowledge 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.

b. **Thresholds or limits for liquidity measures and reporting requirements.** The policy should convey the Board of Directors' tolerance for liquidity risk. The evaluation process should include identification of the appropriate ratios which can signal changing liquidity conditions, preparation of periodic cash flow projections, and establishment of a minimum cash-on-hand target. The policy should establish required minimum balances for short-term and overnight funds which are sufficient to maintain daily operations and allow for unexpected stresses in normal funding needs that may arise. The liquidity plan should require procedures for when and how management 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 Board can ensure accountability. Also, the policy should address under what conditions designated staff should begin implementing contingency plans.

c. **Primary and secondary sources of liquidity.** It is important for the policy to specify what sources are available 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.

d. **Maturity structure of assets and liabilities**. Cash flow projections must anticipate cash needs by estimating loan demand and repayments, share and deposit inflows and withdrawals, operating expenses, and earnings. The maturities of liabilities should be considered in establishing the maturity structure of assets.

e. **Volatility of shares, deposits, and liabilities.** In determining liquidity needs, the credit union should consider the sources and flow of funds, e.g., shares, deposits, borrowings, promissory notes, and the volatility of these accounts. Local economic and employment conditions will also affect the volatility of liabilities, e.g., strikes, layoffs, etc.

f. **Interest Rate Spread**. Establish a desirable relationship between the interest rates paid on members' deposits and on borrowings (notes payable) and the interest rate earned on loans. Sufficient earnings must be generated to meet operating expenses and to provide a reasonable return to members.

g. **Extent of and purpose for which the credit union will use borrowed funds.** State a permissible level of borrowings, in aggregate and by individual lenders, and the purposes for which borrowings will be used.

Reverse repurchase agreements shall be considered as borrowings for purposes of this item.

h. **The maximum allowable ratio of loans to member shares and deposits.** Establish the maximum allowable ratio of loans to member shares and deposits and an appropriate business plan and controls to define and monitor liquidity risk.

i. **Tools for liquidity risk management** – The risk management tools should be consistent with the size and complexity of the credit union. 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 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 assists management to anticipate shortfalls and plan for contingencies.

j. **Periodic review and revisions as needed**. The policy should set forth a requirement to periodically review and revise, if necessary, the policies and plans to reflect the 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.

2. Determine if management recognizes the overall significance of liquidity risks and ensure management implements initial and on-going risk-mitigating processes.

3. Review the overall operations, business plan, management strategies, and resulting cash flows.

4. For purposes of quantitative analysis, several ratios can assist in assessing the level of liquidity risk; they include:
   a. **Loans/Assets.** A loan to asset ratio should be sufficient to meet member loan demand and still meet other liquidity needs. A high loan to assets ratio (e.g., in excess of 80 percent) may indicate stressed liquidity, especially if:
      i. There are limited alternative funding sources;
      ii. Existing funding is heavily reliant on volatile sources (e.g., non-member shares); and/or
      iii. The credit union has minimal short-term investments.

b. **(Borrowings and Non-member Deposits)/ (Total Shares and Liabilities).** Borrowings and non-member deposits may indicate the credit union cannot meet its liquidity needs through member shares. Because these funds generally incur a higher cost and possess more volatility than member shares, they generally require a higher level of oversight.

c. **(Cash and Short-term Investments)/Total Assets.** This ratio provides an indicator of how much available cash the credit union has to meet share withdrawals or additional loan demand. A low or rapidly declining ratio may indicate the credit union may become unable to meet its current obligations. Management should consider the trend in this ratio and determine whether the current level of cash and short-term investments are sufficient or should be increased.

d. **(Regular Shares and Share Drafts)/ (Total Shares and Borrowings).** This ratio reflects the level of stable deposits a credit union has on its balance sheet (as opposed to the level of volatile funding, which the Borrowings and Non-member Deposits ratio indicates). A credit union can reasonably depend on the availability of these stable funds to meet liquidity demands.

5. In addition to quantitative measures, qualitative elements may signal immediate liquidity concerns. Examples include:
   a. The loan, investment, or share structures have changed significantly, or significant changes will likely occur in the near future;
   b. The investment portfolio consists of a significant amount of assets or liabilities with principle cash flows subject to prepayment or extension risk;
   c. The credit union has attracted shares or non-member deposits by paying above market rates; or
   d. The credit union has experienced turnover in key management positions that relate to liquidity risk management.

IV. BORROWINGS

Institutions should have access to alternative sources of funding by establishing means for generating cash or funding liquidity needs outside of normal operations. All borrowings must be approved by the Board of Directors.

1. Typically, a credit union will establish a line of credit with its corporate credit union or another lender (e.g., FHLB). A line of credit provides a source to

cover temporary shortages in meeting member share and loan demand, and internal operating needs.

   a. Federally Insured State-Chartered Credit Unions (FISCUs) must comply with the liquidity and contingency funding plan requirements of NCUA Rules and Regulations, Part 741.12.

   b. Federally Insured State-Chartered Credit Unions (FISCUs) must comply with the maximum borrowing authority limit of NCUA Rules and Regulations, Part 741.2.

2. Share and loan demands that are not met promptly presents reputation risk. At the same time, short-term borrowings are highly volatile sources of funds, and increase costs. Frequent borrowing may suggest management is not maintaining sufficient liquidity, and warrants an expanded review of liquidity.

3. Brokers are sometimes used to locate additional funding sources in the form of non-member deposits. If management is using a broker to locate funds, examiners should expand their analysis to determine if management is:

a. Controlling share growth;

b. Pricing dividends at market rates; and

c. Matching share and loan maturities appropriately.

4. Management sometimes uses planned (longer-term) borrowings for a specific purpose. Examiners should ensure the following exists:

a. Management understands all terms of the borrowings, including call features, prepayment penalties, and debt covenants.

b. Borrowings are properly structured to reduce IRR and/or liquidity risk (such as borrowing on a long-term basis to fund real estate loans).

c. The cost of borrowings is appropriate.

V. CONTINGENCY FUNDING PLAN REQUIREMENTS

Examiners must ensure compliance with liquidity and contingency funding plan requirements, as required by NCUA Rules and Regulations, Part 741.12.

1. Institutions with assets less than $50 million must maintain basic written policies which provide a Board approved framework for managing liquidity and a list of contingent liquidity sources which can be employed under adverse circumstances.

2. Institutions with assets of $50 million or more must establish and document a contingency funding plan (CFP) which commensurate with its complexity, risk profile, and scope of operations that sets out strategies for addressing liquidity shortfalls in emergency situations. The CFP may be a separate policy or may be incorporated into an existing policy such as an asset/liability policy, a funds management policy, or a business continuity policy. The CFP must address, at a minimum, the following:
    - **a.** The sufficiency of the institution's liquidity sources to meet normal operating requirements as well as contingent events;
    - **b.** The identification of contingent liquidity sources;
    - **c.** Policies to manage a range of stress environments, identification of some possible stress events, and identification of likely liquidity responses to such events;
    - **d.** Lines of responsibility within the institution to respond to liquidity events;
    - **e.** Management processes that include clear implementation and escalation procedures for liquidity events; and
    - **f.** The frequency that the institution will test and update the plan.

3. Institutions with assets of $250 million or more must establish and document access to at least one contingent federal liquidity source for use in times of financial emergency and distressed economic circumstances. These credit unions must conduct advance planning and periodic testing to ensure that contingent funding sources are readily available when needed. An institution subject to this requirement may demonstrate access to a contingent federal liquidity source by:
    - **a.** Maintaining regular membership in the Central Liquidity Facility;
    - **b.** Maintaining membership in the Facility through an Agent;
    - **c.** Establishing borrowing access at the Federal Reserve Discount Window by filing the necessary lending agreements and corporate resolutions to obtain credit from a Federal Reserve Bank pursuant to 12 CFR part 201.