

October 18, 1979

Title 12 - Banks and Banking

CHAPTER VII - NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 742 - Liquidity Reserves

Interpretative Ruling and Policy Statement Liquidity Reserve

AGENCY: National Credit Union Administration ACTION: Interpretative Ruling and Policy Statement SUMMARY: The purpose of this document is to (1) provide the Administration's position on certain provisions of 12 C.F.R. 742 published August 31, 1979; (2) provide procedures for calculating and disclosing the liquidity reserve; and (3) publish extension request guidelines for additional time to meet the liquidity reserve.

EFFECTIVE DATE: Upon publication

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SUPPLEMENTARY INFORMATION: On August 31, 1979, the Administration published 12 C.F.R. 742. Since that time, several questions have been raised about the meaning of certain terms and provisions of Part 742. Also, commenters have asked about the need to prepare a workpaper to document the calculation of the liquidity reserve. In addition, the Administration stated in the preamble to the final regulation that guidelines would be issued concerning the general standards it will apply for extension requests. This Interpretative Ruling will address these areas.

Interpretative Ruling No. 79-7

a. The following is the Administration's position on certain terms and phrases of Part 742.

(1) "742.1(a)(1) have assets of \$2,000,000 or more."

The regulation would apply the first month-end a credit union's assets exceeds \$2,000,000. However, if at a subsequent month-end the assets decrease below \$2,000,000, the regulation would not apply for that following month.

(2) "742.1(a)(2) operate share draft..."

The phrase means the regulation would apply the month-end of the month during which the credit union cleared one share draft. The regulation would continue to apply until the credit union terminated its share draft program.

(3) "742.2(a) Liquid Assets' means the following unpledged assets" The word

"unpledged" is interpreted to mean that for the purposes of this regulation assets designated as "generally pledged" assets are considered unpledged. Only assets, such as a credit union's shares or deposits in a central credit union, that are specifically pledged as collateral on a loan, are considered pledged assets.

(4) "742.2(a)(1) cash on hand"

Any negative book balance existing in cash accounts as of month-end will be added to the credit union's liability base. A negative book balance in a cash account is considered an unrecorded account payable for the purposes of this' regulation.

(5) "742.2(b) Central Credit Union' means a credit union operated primarily to serve other credit unions and in which the total dollar amount of shares and deposits received from other credit unions plus loans to other credit unions exceeds 50 percent of the total dollar amount of all shares and deposits plus loans."

Any credit union which includes share accounts in state central credit unions that are not agents of the Central Liquidity Facility as part of its liquidity reserve must provide documentation that the respective state central credit union satisfies the "50 percent" requirement.

Some central credit unions maintain separate records for their corporate and natural person divisions. For the purposes of this regulation, a loan from one division to the other is not considered a "loan to another credit union" because each division is not recognized as a separate legal entity.

(6) "742.2(c)(2) notes payable with remaining maturities in excess of one year."

Any demand note payable held by a credit union must be included in computation of the liability base, regardless of the amortization schedule, because the note can be called at any time.

(7) "742.3(b) the liquidity reserve shall be determined on a monthly basis, not later than the tenth day of each month, and shall be based on the insured credit union's liability base as of the last day of business of the previous month."

A credit union has up to 10 calendar days after month-end to calculate the liability base as of month-end and determine if liquid assets as of month-end are sufficient to equal or exceed 5 percent of the total dollar value of the credit union's liability base.

If the credit union does not meet the liquidity requirement at month-end, but meets it during the first 10 days of the following month, the credit union will be considered to be in compliance with the regulation.

(8) "742.4(a) The liquidity reserve may be depleted below the level required by this Part only to meet outflows of shares and deposits."

The Administration does not intend that a credit union cease operations when the only alternative is to utilize part of the liquidity reserve to pay operating expenses and accounts payable. Accordingly, the Administration does not intend to take action against a credit union that depletes its liquidity reserves to pay necessary operating expenses and accounts payable. The credit union must notify the appropriate

supervisory authority when the reserve is depleted below 5 percent.

If a credit union determines as of October 31, 1979 (effective date of the regulation), that it has insufficient liquid assets to satisfy the 5 percent requirement, then it should notify its appropriate supervisory authority. During the next 60 days the credit union may continue normal operations. However, if the credit union cannot increase its liquid assets to 5 percent of its liability base within 60 days after notification, then the credit union must request an extension of time to replenish the liquidity reserve. At this time, the credit union's plan for replenishment of the liquidity reserve would control the type of business it could conduct.

The Administration does not intend that a credit union borrow funds solely to meet the 5 percent liquidity reserve requirement, especially if the borrowing would adversely impact the credit union's financial condition. Furthermore, repeated borrowing of funds on the last day of the month and repayment on the following day will be viewed by the Administration as a circumvention of the regulation's intent.

In the above circumstances, credit unions should notify the appropriate supervisory authority that their liquidity reserve has been depleted and after 60 days, submit plans regarding how the reserve will be replenished over a period of time. The Administration will be receptive to extension requests and will assist credit unions develop viable liquidity management programs.

(9) "742.4(b)(1) a Federal credit union shall immediately notify the appropriate National Credit Union Administration Regional Director and shall replenish the reserve within 60 days unless an extension is approved by the Regional Director; 742.4(b)(2) a federally-insured state chartered credit union shall immediately notify its state supervisory authority and shall replenish the reserve within 60 days unless an extension is approved hZ the state supervisory authority."

Both of these subsections require the credit union to notify the appropriate supervisory authority not later than the tenth calendar day after a month-end if the credit union does not have sufficient liquid assets to meet the liquidity reserve requirement. This notification should include the amount of the credit union's liability base and the amount of its current liquid assets as defined in Section 742.2(a).

Upon notification to the appropriate supervisory authority, the credit union has until the tenth calendar day following the second month-end after notification to bring the liquidity reserve up to the required level. For example if the credit union provided notification on November 10, it will have until January 10 to bring the reserve up to the required level. If on or before January 10 the credit union has projected that it cannot bring the reserve up to the required level, then it must apply to the appropriate supervisory authority for an extension. Extension guidelines will be discussed in Section c. of this Interpretative Ruling.

b. Procedures For Calculation of and Disclosure of the Liquidity Reserve. Principles of sound internal control dictate that a credit union should prepare a workpaper to document the calculation of its liability base and liquid assets. The amount of the credit union's liquidity reserve must be footnoted on its monthly Statement of Financial Condition to provide "Full and Fair Disclosure."

The following format is suggested as one possibility for the preparation of the

workpaper.

Liquidity Reserve Computation - 11/30/79

		Amount
Member accounts	\$3,000,000	
Notes Payable	<u>250,000</u>	\$3,250,000
Less: Share certificates and equivalent member accounts with remaining maturities in excess of one year (1)	\$300,000	
Notes payable with remaining maturities in excess of one year (1)	50,000	
Member accounts that have been provided in a specific amount as security on a loan, up to the amount of the loan balance (2)	100,000	\$ 450,000
Liability base		\$ 2,800,000 =====
Required Liquidity Reserve 5% x \$2,800,000 =		\$ 140,000 =====
<u>Liquid Assets</u>		
Cash on hand		\$ 50,000
Shares and share certificates in central credit union (3)		100,000
Common trust investment (net of deferred loss)		<u>50,000</u>
		\$ 200,000 =====

Credit union has sufficient liquid assets to satisfy liquidity reserve requirement.

(1) Credit union should support any deductions with an EDP report, hand-prepared workpaper or other document which identifies share certificates and notes payable with remaining maturities in excess of one year from the computation date.

(2) Shares must be specifically pledged (dollar amount identified) on a note to qualify for this deduction. The statutory lien mentioned in many notes does not qualify as a specific pledge'. Also, any deductions must be supported by documentation.

(3) The central credit union must satisfy the 50 percent test mentioned in Section 742.2(b). Any share certificates must have a remaining maturity of less than one year from the computation date.

c. Extension Guidelines For Replenishment of the Liquidity Reserve.

If a credit union cannot increase the level of its liquid assets to 5 percent of its liability base within 0 days after notification to the appropriate supervisory authority,

it must request an extension of time for replenishment of the liquidity reserve. Any request for extension should include the following:

- (1) Most recent Statement of Financial Condition.
- (2) Workpaper outlining calculation of liquidity reserve requirement.
- (3) Steps credit union plans to take to replenish the liquidity reserve. These steps must be specific regarding what action the credit union plans to take; i.e., reducing loan maturities to increase cash flow; decreasing the amount of funds available for loans; placing future inflows of cash into short-term investments that qualify as liquid assets, etc.
- (4) Time period requested for extension. Extensions may be granted for a period up to one year.

Normally, an extension request will be approved if the credit union indicates it is taking steps to meet the liquidity reserve requirement within one year. Only in cases where it is obvious the credit union is illiquid, and not taking corrective action to remedy the situation, will a request for extension be disapproved. Additional extension requests beyond the initial extension period will normally not be granted unless the credit union is prevented from meeting the liquidity reserve requirement due to factors beyond its control.

An extension is considered approved when a credit union receives written notification of the approval from the appropriate supervisory authority. Federal credit unions will submit notifications of depletion below 5 percent and

extension requests to the appropriate regional director. Federally-insured state chartered credit unions will submit notification and extension requests to their state supervisor, unless notified otherwise.

ROSEMARY BRADY
Secretary to the Board