CONTINGENCY QUESTIONS

EXPLORING FUNDING ALTERNATIVES FOR CREDIT UNIONS

From lowering their cost of funds (without cannibalizing existing shares) to extending CD durations to regulatory pressure, Tim Peacock says there are a number of reasons why credit unions today may be interested in exploring funding alternatives. And they have options.

The Senior Vice President of Multi-Bank Securities says that when he thinks of funding alternatives, four major possibilities stand out, each with its own pros and cons:

- FHLB advances
- DTC funding
- Borrowing from one's corporate credit union
- Listing services

Peacock says that in evaluating which of these four strategies may be the right choice for one's specific institution and situation, it's important to consider the differences in the sources of the funding, the diversity of the funding and the settlement processes.

"The source of the liquidity is huge because it ties in closely to how reliable and how accessible the funding is over time – what we call cyclicality," he explains. "Five years ago, the cyclicality of liquidity (provided by other credit unions) was really high, but as it heads back down the other way, a lot of those same institutions are now looking for their own deposits to fund loan growth.

ASKING THE RIGHT QUESTIONS

The key, Peacock says, is to determine the funding source or combination of sources that best addresses the specific needs of the institution. That means asking some very pointed questions before making a decision about things that might affect your line of credit or your ability to find liquidity through any one particular vendor over the next, including:

- Is collateral required; and what assets can be pledged?
- Are they any reoccurring costs?
- Are there limits to what you can borrow?

"The idea is to understand if there's anything that can happen that could affect the availability of that liquidity," he notes. "The other two equally important things to know are what terms and

structures are available. There are certain programs that are more geared to short-end borrowing versus long-end borrowing, and thus have different strengths in that regard. Understanding what terms are available and what types of structures are available by any one particular vendor is another factor to consider."

It may seem like a lot of questions to consider, but Peacock believes asking the right questions in advance can help alleviate problems down the line.

"I really believe that asking questions and doing your homework up front goes so far later on," he says. "I tell my clients I'd rather you ask a hundred questions today then one question that didn't get answered the day after you did it. So institutions should be asking not only the broker or whoever's providing the service, but reaching out to other credit unions and their regulators as well."

This type of research not only helps build a solid contingency funding plan, but bolsters compliance and regulatory knowledge as well – growing areas of concern, Peacock says. In particular, credit unions should be aware of the regulatory guidance surrounding non-member shares and federal regulations that cap the non-member portion of outstanding shares at 20%, or $3 million, whichever is greater.

OTHER CONSIDERATIONS

But there's more at stake than just potential regulatory issues when it comes to contingency funding discussions. There are also risks that come with an economic environment in which rates are going up.

"I think one of the biggest things in a rate environment where rates may move upward is to understand what early withdrawal risk the credit union has on any share certificates," Peacock notes. "A traditional share CD might carry a six-month early withdrawal penalty, and if rates on a five-year CD go from 2% where they are now to 4% a year from now, the credit union may run the risk of the depositor taking the early withdrawal penalty and leaving the credit union to replace it at a higher rate." He further noted that DTC funding and advances specifically limit this risk and, as such, can be the preferred method for those looking to lock in shares two to five plus years.

While funding programs have evolved to be able to support even very small institutions, Peacock says it's more common to find credit unions asking what their limitations are as they merge and grow larger. For the remaining small credit unions, the questions surrounding contingency funding may be slightly different.

"I think what we find most often is really small credit unions pulling that liquidity off of their balance sheets," he says. "If they're just looking for $100,000, they're probably going to run a local CD special for a day to grab it, or maybe sell a bond or CD to get there. But once they get into an effort to bring in new liquidity, I think all of these programs can be seen as possibilities."