United States General Accounting Office
Washington, D.C. 20548

General Government Division

B-285159

May 23, 2000

The Honorable James A. Leach
Chairman
Committee on Banking and Financial Services
House of Representatives

The Honorable John L. LaFalce
Ranking Minority Member
Committee on Banking and Financial Services
House of Representatives

The Honorable Marge Roukema
Chair
Subcommittee on Financial Institutions and Consumer Credit
House of Representatives

Subject: National Credit Union Central Liquidity Facility Lending Before the Year 2000 Date Change

This letter responds to your request that we review the lending activity of the National Credit Union Central Liquidity Facility (CLF) during October through December 1999, prior to the Year 2000 date change. CLF is part of the National Credit Union Administration (NCUA). It was established in 1979 to ensure that credit unions would be able to borrow funds for liquidity needs. After Congress removed CLF's $600 million lending cap in anticipation of potential Year 2000 liquidity demands, there was a sudden increase in CLF lending to credit unions. You were interested in finding out why such an increase in lending occurred and the nature of the lending. You also asked us to look at the availability and cost of other sources of liquidity for credit unions during this period—in particular, credit union borrowing from the Federal Reserve's discount window. As agreed with your offices, the objectives of this letter are to (1) summarize CLF's lending during this period and (2) describe credit union borrowing from the discount window and compare credit unions' cost of borrowing from CLF to the cost of alternative sources of liquidity.

Results in Brief

CLF lending increased during the last 3 months of 1999. Because of the prospect of problems related to the Year 2000 date change, CLF set up expedited procedures for lending in order to meet Year 2000-related liquidity demands. As a result, any credit union qualifying for access with a stated liquidity need was eligible to obtain loans from CLF. However, of the approximately 10,000 credit unions in the United States, less than 1 percent (38 in total) of all credit unions obtained loans from CLF during the October through December, 1999, time frame. Although the total amount that CLF loaned was about $666 million, the largest value of loans outstanding on any given day was about $159 million. In most cases, the determination regarding whether a credit union would obtain a loan from CLF was made by the credit union's corporate credit union.[1] When a credit union notified its corporate credit union of a need to borrow liquidity, the corporate credit union decided whether to make a loan to the credit union itself or to go to CLF on behalf of the credit union.

During this same period, 25 credit unions also borrowed from the Federal Reserve's discount window. By law, use of the discount window requires that all borrowers, including credit unions, maintain reservable transaction accounts or nonpersonal time deposits. Nearly two-thirds of all credit unions qualify for access to the discount window, including most of the largest. Of the two types of discount window credit most used by credit unions during this period, one—adjustment credit—had an interest rate somewhat lower than the rate charged by CLF. The rate on the other widely used discount window loan—the Special Liquidity Facility (SLF), which was a special credit available in advance of the Year 2000—was considerably higher than the CLF rate.[2] Under ordinary circumstances, corporate credit union officials said that most credit unions would look first to their corporate credit union to satisfy liquidity needs. The rates that two corporate credit unions charged their members for non-CLF loans were also higher than the rate CLF charged. However, because the corporate credit unions increased the rate they charged on CLF loans to cover expenses before passing CLF credit on to their member credit unions, the actual rate paid by members of the two corporate credit unions for CLF loans was closer to the rates charged for non-CLF liquidity loans.

Background

The CLF operates out of the offices of NCUA. The staff consists of four people, two of whom devote part of their time to their CLF activities. The two senior CLF staff, the President and Vice President, also serve NCUA as the Deputy Director, Office of Examination and Insurance, and the Director of Risk Management, Office of Examination and Insurance, respectively. According to CLF officials, CLF has successfully functioned with this level of resources for at least two reasons. First, since it was established in 1979, CLF has experienced long dormant periods, in some cases lasting years, when it made no loans.

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[1] Corporate credit unions are cooperatively owned by their member credit unions and serve their members by either lending to them or investing their excess funds.

[2] During this period, the Federal Reserve lent $462.3 million to credit unions as adjustment credit and $309.3 million as SLF credit. Two credit unions borrowed $42 million in seasonal credit during this same period. These seasonal loans were not included in the analysis. Moreover, in the data provided to us, the Federal Reserve did not include information on loans that it identified as "test loans," which are defined as very short-term loans in amounts between approximately $1,000 and $10,000.

Second, when CLF does become active, employees of the corporate credit unions and U.S. Central Credit Union do much of the staff work.[3]

During the months leading up to the Year 2000 date change, there was a great deal of uncertainty regarding the amount of liquidity that might be needed as a result of both expected and unforeseen problems that could arise. Most financial institutions were preparing for an unprecedented, yet unknown, Year 2000 event. Federal agencies responsible for financial institutions were asked to develop contingency plans to meet possible Year 2000 problems because of the concern that Year 2000 problems might adversely affect financial institutions' ability to use their computer systems. Even if real systems problems did not arise, there was concern that depositors would withdraw substantial amounts of money for safekeeping. To instill confidence in the credit union system, CLF undertook several initiatives to calm the fears of both credit unions and their members that adequate liquidity might not be available when needed. In part, this was accomplished by CLF having a substantial amount of cash on hand and mechanisms in place to expedite the delivery of funds to credit unions with liquidity needs.

In anticipation of potential demand for liquidity due to the Year 2000 date change, Congress removed the appropriations cap on CLF borrowings.[4] Before that removal, the limit on CLF borrowing for the purposes of making new loans to credit unions had been $600 million. The borrowing cap was removed so that CLF could provide more backup liquidity to credit unions, if such a need arose. In preparation for the Year 2000, CLF borrowed $1 billion from the Federal Financing Bank (FFB).[5] FFB is an entity within the U.S. Department of the Treasury that is charged with lending Treasury funds to certain agencies of the federal government. Although CLF funded the majority of its loans with its own cash on hand, between December 27 and 29, 1999, it used $49.1 million of the funds borrowed from FFB. After borrowing $1 billion from FFB, CLF had the authority to borrow an additional $20 billion (approximately) to fund loans to credit unions, if it had become necessary.[6]

CLF and NCUA implemented expedited Year 2000 lending procedures in order to respond to any potential Year 2000 liquidity demand. The procedural changes included (1) delegating lending authority to the CLF President without previous approval from the NCUA Board; (2)

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[3] U.S. Central is a corporate credit union that is owned jointly by all of the other corporate credit unions. Along with other services that it provides its owners, U.S. Central is the CLF agent group representative for most corporate credit unions and obtains loans from CLF on their behalf.

[4] When a CLF member has a liquidity need due to unanticipated cash flows, it may seek a loan from CLF. Under the National Credit Union Central Liquidity Facility Act, CLF is authorized to borrow from any source 12 times its subscribed capital stock and surplus, which according to NCUA is currently $21 billion.

[5] On November 12, 1999, CLF borrowed $200 million from FFB. Between November 12 and December 1, 1999, CLF borrowed an additional $200 million four times, thereby reaching a total of $1 billion in borrowed funds. These loans were rolled over weekly until paid off in early January 2000. CLF officials stated that FFB was not set up to easily provide significant amounts of funding on a short-term basis, which would have prevented CLF from obtaining overnight loans to meet potential liquidity demands. As a result, CLF decided to borrow $1 billion from FFB and roll the amount over until after the Year 2000 date change to maintain a store of cash on hand.

[6] At year-end 1999, CLF had paid-in capital stock of $881 million. This constituted one-half of the subscribed capital stock of CLF. The remainder of the capital stock was held in callable accounts at the member credit unions or their agents (the corporates). With total capital stock of approximately $1.76 billion, the CLF's statutory limit on total borrowing would be about $21 billion.

limiting the loan period to 1 business day or overnight and allowing the borrower to roll over the loan amount for as many days as needed; and (3) determining that, during the months preceding the Year 2000 date change, any healthy, solvent credit union with a liquidity need would be eligible for a loan from CLF. CLF stated that the procedures were designed to enhance CLF's ability to effectively respond to credit unions' liquidity demands resulting from anticipated or real effects of the Year 2000 date change. The procedures remained in effect until March 31, 2000.

Scope and Methodology

To analyze CLF lending, we reviewed CLF's loan activity from October through December, 1999. Specifically, we reviewed liquidity need loan applications (LNLA), agents' (corporate credit unions) request for funds, and CLF's loan confirmations. We interviewed officials from NCUA, CLF, U.S. Central Credit Union, the Association of Corporate Credit Unions, the Credit Union National Association, the National Association of State Credit Union Supervisors, and the National Association of Federal Credit Unions. We also interviewed officials from the 2 corporate credit unions that obtained 127 loans on behalf of their credit unions—First Carolina Corporate Credit Union and Northwest Corporate Credit Union. To obtain information on credit unions' access to the Federal Reserve's discount window, we interviewed Federal Reserve officials and relied on data they provided on discount window borrowing from October 1999 to March 2000.

We requested comments on a draft of this letter from NCUA. Its comments are discussed near the end of this letter. We did our work in Washington, D.C., and Overland Park, KS, between April 2000 and May 2000 in accordance with generally accepted government auditing standards.

Overview of CLF Lending and Credit Unions' Demand for Loans Before the Year 2000 Date Change

Credit unions' demand for liquidity increased from October through December, 1999. Credit unions needed additional liquidity for various reasons. However, in most cases the corporates, not credit unions, made the decision about whether to borrow from CLF.

CLF Loans

There were 157 CLF loans made to credit unions during the October through December, 1999, Year 2000 preparation period.[7] Of the loans made, 149 were made directly from CLF to U.S. Central—the agent group representative. U.S. Central then lent the money to corporate credit unions, acting as agents for their member credit unions, which, in turn, lent the money to member credit unions. Eight of the 157 loans were made to underlying borrowers (credit unions) without going through U.S. Central. Five of those loans were made directly through

[7] The 157 loans were loans involving CLF-provided funds. CLF made 34 loans to U.S. Central, 3 loans to a regular member credit union, and 2 loans directly to a corporate credit union—all of which were for 157 underlying borrowers or credit unions.

one corporate credit union, and three of the loans were made by CLF to a credit union that was a direct member of CLF, rather than through a corporate credit union.[8] Of the 154 loans made through corporate credit unions, 127, or 82 percent, were made by the 2 corporates that were the heaviest users—76 loans by First Carolina Corporate Credit Union and 51 loans by Northwest Corporate Credit Union.

Ninety-six percent of the 157 loans (151 in total) were borrowed on an overnight basis. Four percent of the loans were for a longer duration, ranging from 14 days to 118 days.[9] Those longer term loans were the ones that CLF either lent directly to a corporate credit union (without going through U.S. Central) or directly to the credit union member. CLF officials said that the longer term loans were approved on a case-by-case basis and for specific reasons. For instance, CLF officials said that the corporate credit union that received the longest term loan requested such a loan because that corporate was (1) smaller than some of its members and (2) wanted to ensure that it had adequate liquidity to meet its members' needs without having to continuously roll the loan over each business day for a 3-month period.

Although the aggregate amount of CLF lending totaled about $666 million, the largest amount outstanding on any given day during this period was about $159 million. There were a few days in November when the amount outstanding reached $71 million, but most of the time the amount outstanding was no higher than $41 million, $40 million of which consisted of one large long-term loan. The days with the highest dollar amounts outstanding occurred between December 27 and 29, 1999. For detailed information on CLF's daily loans outstanding, see enclosure 1.

Nature of the Loans

Corporate credit union officials told us that corporate credit unions, not member credit unions, made the decision to access CLF on the basis of their own internal needs.[10] Of the 35 corporate credit unions that currently exist, 14 obtained CLF loans on behalf of their members, although some of these corporate credit union officials said they could have funded the liquidity demands of their members out of their own balances or by borrowing from U.S. Central. Officials from corporate credit unions that did not obtain loans from CLF told their trade association that (1) they chose not to because they thought they could fund member loans from their own liquidity or (2) they did not see enough of a loan demand from their members to warrant accessing CLF. Corporate credit unions that did obtain CLF loans did so for various reasons. For instance, officials from one corporate credit union said it obtained a CLF loan to run a test to ensure that everything ran smoothly through U.S. Central.

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[8] Most credit unions access CLF through their corporate credit union, which acts as an agent for its members. However, some credit unions, referred to as regular member credit unions, have joined CLF directly and have direct access to CLF lending when necessary.

[9] Four of the corporate credit unions' loans were for 87 days, and one loan was for 118 days. One of the loans to the regular member credit union was for 14 days, and the other two were overnight loans.

[10] Corporate credit unions did not make the decision on behalf of the credit union that borrowed directly from CLF.

Another corporate credit union planned to fund large credit union loan needs of members that requested secured demand loans through CLF, but not those with preexisting committed or guaranteed lines of credit.[11] Other reasons given by corporate credit union officials for accessing CLF included (1) a desire to maintain liquidity reserves internally to cover any higher-than-normal settlement activity during that period and (2) a decision to fund loans that were longer term in nature with CLF borrowings.

Corporate credit unions obtained loans on behalf of 37 credit unions between October 1 and December 31, 1999. Corporate credit union officials that we talked to, substantiated by the LNLAs and other documents that we reviewed, indicated that CLF funds were accessed to meet credit unions' liquidity needs relating to (1) heavy mortgage lending earlier in the year that put a credit union in a tight liquidity situation throughout the second half of the year, (2) an anticipated drop in member deposits, (3) heavy year-end outflows of cash related to business activity, and (4) withdrawals relating to Year 2000 or other emergency situations.

There were two credit unions that each obtained a loan in the amount of $40 million. One credit union was a member of the corporate credit union that obtained loans directly from CLF to ensure that its member's forecasted liquidity needs did not overwhelm the corporate credit union. This loan was for 118 days and because of its long term was the primary reason that the daily amount of loans outstanding was mostly around $41 million throughout the October through December time frame.[12] The other credit union that obtained a $40 million loan did so on an overnight basis. Corporate credit union officials said that this credit union needed to increase cash in the branch vaults and fund mortgage lending. The credit union normally would have sold U.S. Treasury securities to generate funds, but with the sharp increase in rates during that time, it was not cost-effective to do so.

CLF is not permitted by law to make loans to credit unions for the purposes of expanding their portfolios. CLF officials said that all of the lending that took place preparing for 2000 was solely for liquidity purposes and was not used by credit unions to expand their portfolios. However, documents and interviews showed that some liquidity needs met by CLF loans existed because of previous business expansion. For example, U.S. Central and corporate credit union officials told us that some credit unions experienced liquidity needs that were met by CLF loans because they had successfully completed a "loan sale" or other expansion in lending activity. We did not see any indication, however, that a credit union borrowed from

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[11] Corporate credit union officials told us that most loans made by corporate credit unions to their members are to be secured, although corporate credit unions do, in some cases, offer unsecured loans to their members. Committed or guaranteed lines of credit are lines of credit that are set up in advance and operate similar to an overdraft line of credit for an individual. A secured (or demand) loan refers to a situation in which a credit union approaches its corporate credit union for a loan without having a previously approved borrowing arrangement.

[12] This same credit union received a second $40 million loan for liquidity needs from funds loaned by CLF to its corporate credit union. This loan took place after the expiration of the expedited procedures used during the Year 2000 date change period. On May 16, 2000, CLF made a loan of $40 million to the corporate on behalf of the member credit union. Of this amount, just over $30 million was to repay loans previously made by the corporate to the credit union, and the remainder went to the credit union to fund ongoing liquidity needs. The term of the loan was 90 days.

CLF for the purpose of subsequently investing relatively cheap CLF-provided funds in a higher earning asset.[13]

Other Sources of Liquidity and the Cost of Borrowing

Credit unions' primary source of short-term liquidity is their corporate credit union. Under ordinary circumstances, a corporate credit union that did not have sufficient liquidity to meet the needs of its member credit unions would look first to U.S. Central as a source for borrowing. Other routine sources of liquidity also exist for some credit unions, often with their corporate's assistance. For example, some credit unions enter into arrangements to sell a portion of their own assets with an agreement to repurchase them at a specified date in the future. During this period, NCUA provided information to credit unions about the increased availability of CLF to inform them about CLF as they formulated plans to deal with Year 2000-related liquidity needs. However, corporate credit unions and CLF were not the only sources of liquidity for some credit unions. Both the Federal Reserve's discount window and Federal Home Loan Bank advances (loans) are available to credit unions that meet certain eligibility requirements.[14]

Some Credit Unions Borrowed From the Federal Reserve's Discount Window

Since 1980, the Federal Reserve's discount window has been available to all depository institutions, including credit unions, that maintain reservable transaction accounts or nonpersonal time deposits (as defined by the Federal Reserve's Regulation D). All such institutions are entitled to the same discount window borrowing privileges as Federal Reserve member banks. According to NCUA, as of March 27, 2000, 61 percent of credit unions, holding more than 96 percent of total industry assets, are eligible to borrow from the discount window. This is up from about 58 percent in February 1999. However, credit unions as a whole generally do not use the discount window extensively.

Industry and regulatory officials said that they believe there are several reasons why credit unions might not make use of the discount window. These reasons include (1) the perception of credit union officials that the Federal Reserve does not want large numbers of credit unions coming to the discount window, (2) their understanding that financial institutions are legally required to provide checking accounts in order to be eligible to borrow, (3) the increased level of comfort that some credit unions feel when obtaining liquidity within their own credit union community, and (4) a belief that the cost of borrowing from the discount window is higher than through other sources.

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[13] CLF officials told us that they are very alert for this sort of arbitrage activity. In their opinion, the most likely situation in which this activity might be found would be in longer term loans made by CLF. As a result, they told us that all longer term loans during this period received close and ongoing scrutiny.

[14] In the time available to us, we were unable to determine the extent to which credit unions used the Federal Home Loan Banks as a source of liquidity funding during this period. However, we received information that suggested such borrowing was growing. Credit unions' ability to borrow from the Federal Home Loan Banks increased with the passage of the Gramm, Leach, Bliley Act (P.L. 106-102) in 1999.

Overall, 25 credit unions borrowed from the Federal Reserve's discount window between October and December, 1999.[15] Three credit unions obtained loans both from CLF and the Federal Reserve's discount window. The aggregate dollar value of the discount window loans was about $771.6 million, and the highest single-day total outstanding was about $36 million. (See enc. 2.) While it would appear that this exceeds the aggregate total of CLF lending during the period, the two figures are not comparable because of procedural and methodological differences in how they are calculated. If all CLF loans had been overnight loans, rolled over for as many days as the loans were outstanding, aggregate lending for CLF would have exceeded the comparable figure for discount window borrowing.[16]

The discount window could be accessed indirectly by those credit unions that are not now eligible, even the smallest. Corporate credit unions could borrow from the discount window on behalf of their members just as they now access CLF. Corporate credit union officials said that to obtain access to the discount window they would have to (1) give up their banker's bank exemption and (2) maintain reserves, which they said could be costly.[17] However, the largest corporate credit union, which has given up its banker's bank exemption for business reasons unrelated to the discount window, told us that its cost of maintaining reserves was between $0.5 to $1.5 million annually between 1997 and 1999.[18] If, as has been proposed in HR 4209, the Federal Reserve were to pay interest on deposited reserves, it would become less expensive for corporate credit unions to give up their bankers' bank exemption.

The Cost of Borrowing From CLF Compared to Other Available Sources

The interest rate that CLF charged on its loans ranged between 5.24 and 5.68 percent. Before November 12, 1999, when CLF received its first loan from the Federal Financing Bank, this rate was determined by CLF's cost of funds.[19] From November 12th, the CLF rate was equal to the average rate charged by FFB on its outstanding loans to CLF.[20] Enclosure 3 shows that

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[15] The Federal Reserve's discount window offered several categories of short-term credit, including adjustment credit; seasonal credit; and SLF credit, a special category used in advance of the Year 2000. These 25 credit unions borrowed either adjustment credit or SLF credit, or both. Two other credit unions had arranged to borrow seasonal credit during this same period.

[16] The Federal Reserve discount window only makes overnight loans. Thus, every loan is counted every day both for the purposes of aggregating the total lending over the period and for calculating the daily loan balance outstanding. Most, but not all of CLF's loans were overnight. A few were for periods extending from 14 to 118 days. While these longer term loans counted every day toward the CLF's daily loan balance outstanding, they only counted once toward the aggregate amount of CLF lending.

[17] Banker's banks are owned by financial institutions with which they do business and do not engage in business with the public. These institutions are not required to maintain reserves under Regulation D and do not have access to the discount window. However, federal reserve officials said that the Board of Governors of the Federal Reserve has determined that a banker's bank may obtain access to the discount window if it voluntarily undertakes to maintain reserves.

[18] We have no information on what it might cost other corporate credit unions to give up their bankers' bank exemptions.

[19] CLF officials told us that CLF's cost of funds before November 12 was set at the rate paid to CLF on its transactions account at U.S. Central.

[20] CLF's borrowing agreement with FFB requires that, in addition to the interest charged on CLF's borrowing, CLF must also remit to FFB any additional interest earned by lending FFB's funds. CLF's rate on borrowings from FFB equals the 91-day Treasury rate plus one-quarter of 1 percent. In light of the FFB requirement, CLF set its rate on liquidity loans at exactly the rate charged by FFB.

between October and December, 1999, this rate was comparable to the federal funds rate, that is, the rate banks charge other banks for overnight liquidity. However, the enclosure also shows that the rate charged by the Federal Reserve discount window on adjustment credit loans was lower than the CLF rate throughout the period.[21] The rate for SLF credit loans, however, was higher than the CLF rate.

The rate charged by CLF might not be the rate paid by the credit union that ultimately receives the loan. In most cases, the CLF loan is obtained through the credit union's corporate credit union. The corporate consolidates the loan requests from its members and sends an Agent's Request for Funds (ARF) to U.S. Central. U.S. Central then makes a single application to CLF that consolidates all of the ARFs received from corporates that day. Once approved, CLF makes a single loan to U.S. Central, which then makes loans to each of the corporate credit unions that submitted an ARF. The corporate credit unions then make a loan to each of its members in the amounts previously determined. An official at U.S. Central told us that the rate they charged the corporate credit unions was exactly equal to the rate they were charged by CLF. However, the corporate credit unions may increase the rate to cover their administrative expenses.

Because every corporate credit union establishes its own criteria for setting the rates that it charges its members for loans, rates are likely to vary among them. First Carolina Corporate Credit Union and Northwest Corporate Credit Union each normally have a variety of rates available for ordinary overnight loans used by their members, depending on certain factors, such as the type of collateral and whether a preapproved line of credit had been established. During October through December, 1999, both corporates also established a rate to be charged on CLF loans that they provided to their members.[22]

Enclosures 4 and 5 compare the rate charged by CLF with two rates charged by each of the two corporate credit unions—first, with the rate charged to credit unions that received CLF loans and, second, with the next lowest overnight rate charged to non-CLF borrowers. The same general pattern emerges from both corporate credit unions. The rate charged by CLF was generally lower than either of the rates charged by the corporates.[23] The rate charged to non-CLF borrowers was generally between one-half and nine-tenths of 1 percent higher than the CLF rate. Moreover, the rate charged to those receiving CLF loans was usually somewhat lower than the rate available to non-CLF borrowers. Although the spread (or difference) between these two rates varied, it was generally small—about one-quarter of 1 percent.

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[21] Although the majority of the funds borrowed by credit unions during this period were adjustment credits, and thus paid the lowest available rate, it should be pointed out that adjustment credit is an administered borrowing program, with a requirement that the borrower first look to other sources of funds, and has restrictions on the use of the proceeds. As a result, it is not as freely available as other types of discount window loans.

[22] The information presented about rates charged by First Carolina and Northwest may not be representative of all corporate credit unions that used CLF to provide liquidity to their members during the period.

[23] Both First Carolina rates dipped below the CLF rate in the last few days of December 1999. This is probably attributable to First Carolina's practice of basing its rates on its overall cost of funds, of which fed funds is a major component. During the last few days of December, the fed funds rate fell from about 5.5 percent to less than 4.0 percent.

Conclusions

Concerns about potential liquidity crises at financial institutions related to the Year 2000 date change were widespread. Although the potential negative consequences were not realized, there was an increase in CLF lending from October through December,1999. According to CLF officials, CLF loans were made to solvent credit unions that needed liquidity. Moreover, they said the lending was done without any financial stress to CLF. It is reasonable to assume that the availability of CLF credit did provide a measure of calm to the credit union system amidst Year 2000 uncertainty. In retrospect, however, whether the CLF lending that actually took place provided liquidity unavailable elsewhere is questionable. Although corporate credit union officials said they were glad CLF lending was available, some officials said that they could have funded all of the lending during that time either out of their own balances or by borrowing from U.S. Central.

CLF officials said that, in accordance with the statute, all CLF loans were done for the purpose of meeting credit unions' liquidity needs and not for the purpose of expanding credit unions' portfolios. We found no indication in our work or in the documents we reviewed that any credit union receiving CLF funds borrowed those funds for the purpose of engaging in arbitrage either to increase earnings or expand new business. However, it is more difficult to identify whether a liquidity need resulted from unexpected events that were outside the control of the credit union or as a result of normal business decisions and needs, including business growth. Credit unions grow to provide more and better services to their members. By doing so, they may experience short-term liquidity needs. When this happened to an eligible credit union during the October-to-December period, CLF was willing to provide a loan. Whatever the specific purpose for which money is borrowed, it may, in effect, enable a credit union to expand its business.

Some credit unions borrowed from the Federal Reserve's discount window. Those that used the normal type of discount window credit, adjustment credit, actually paid a lower rate than the rate available from CLF. This differential was even larger when the discount window rate is compared with the rates charged credit unions by their corporate credit unions for CLF loans.

Agency Comments

We requested comments on a draft of this letter from the Chairman, NCUA. NCUA provided written comments that are included in enclosure 6.[24] NCUA disagreed with our draft conclusions. We had previously stated that it was difficult to determine whether CLF lending filled an important gap during the period before the Year 2000 date change. NCUA disagreed with that point and stated that it had filled an important gap both before and during the Year 2000 date change, in part because of the calming effect that CLF and other measures

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[24] In addition to the letter from NCUA, which is included in its entirety in enclosure 6, NCUA attached a copy of a letter sent to Chairman Leach on February 23, 1999, responding to points raised by Treasury Secretary Rubin in a letter to Chairman Leach dated January 11, 1999. Because of its length, we are not including the February letter in this letter. A copy of the letter can be obtained by contacting NCUA.

undertaken by NCUA had on depositor confidence. We have added information to the letter and to our conclusion that elaborated on the circumstances leading up to the Year 2000 event and CLF's role during that time. It is reasonable to believe that the role played by NCUA and CLF did serve to strengthen public confidence in credit unions' ability to respond to potential Year-2000 problems. However, in retrospect, it is not apparent that the liquidity actually provided to the system by CLF would have been unavailable elsewhere.

NCUA disagreed with our conclusion that CLF borrowing by credit unions before the Year 2000 date change, in some cases, facilitated the expansion of their portfolios. We had previously stated that it was difficult to know whether a liquidity need resulted from unexpected events that were outside the control of the credit union or as a result of normal business decisions and needs, including business growth. We understand NCUA's position that none of CLF's loans during that period were subsequently used by credit unions for expansion purposes, as defined by NCUA. NCUA guidance on this point says "…that the liquidity loan cannot be used to fund new investments or new loan product offerings." Our point was that some credit unions had liquidity needs because they had previously expanded their businesses, for instance, by increasing loans to their members, which resulted in them having a need for liquidity that was satisfied by a loan from CLF during this period. Additionally, to the extent that CLF makes long-term loans (either multi-day loans or one-day loans rolled over for several days), it becomes more difficult to monitor the precise use of the funds. In response to NCUA's comments, we have stated clearly in the letter and in our conclusion that we identified no case where CLF loan proceeds were used to expand business within the narrow definition used by NCUA. However, from a broader perspective, money was clearly lent to meet liquidity needs in some credit unions that resulted from a previous expansion of business activity.

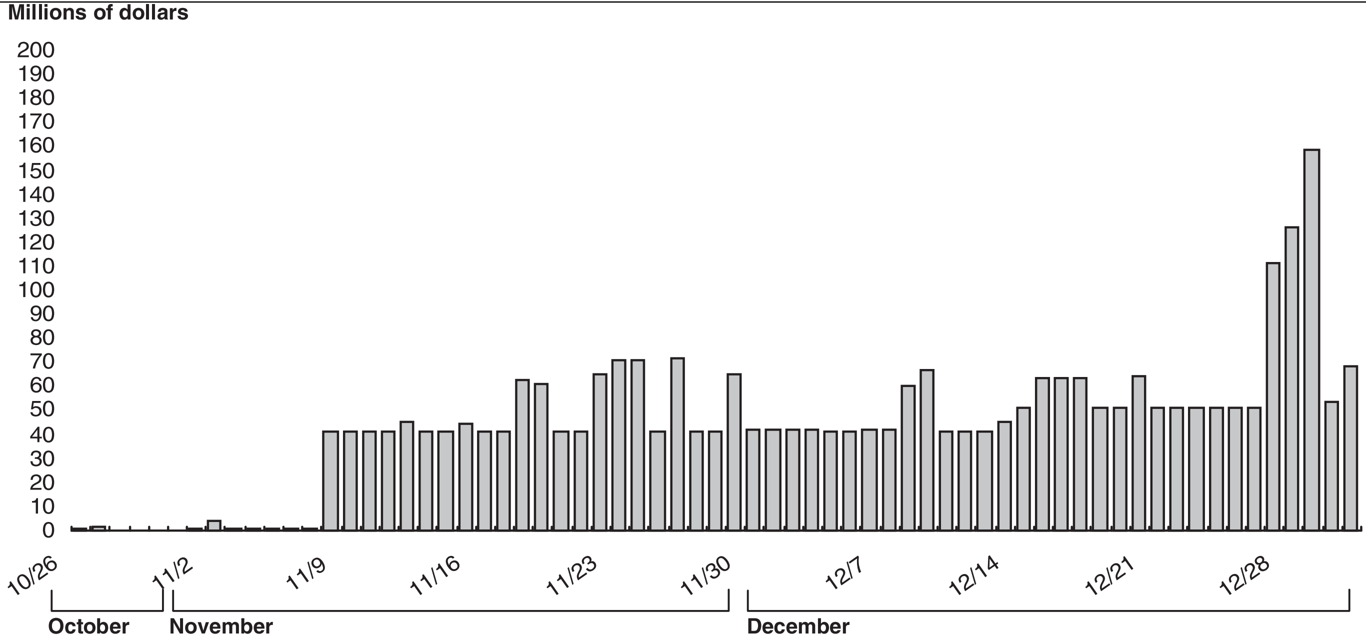
NCUA also expressed concern with an implication that they drew from our third conclusion. We observed that credit unions borrowing from the Federal Reserve's discount window paid a lower rate than the rate available from CLF. This was a factual statement of the relationship between rates from CLF and the discount window during this period. At another time, that relationship may not hold true. We recognized that CLF does not control the rate it charges for loans. The point of our discussion was that some credit unions had alternatives to borrowing from CLF, and that, in at least one case during this period, the alternative was cheaper. As a result, credit unions that are eligible to borrow from other sources such as the discount window or FHLB, may find it useful to compare available rates when they have liquidity needs.

We will send copies of this letter to Representative James Walsh, Chairman, and Representative Alan Mollohan, Ranking Minority Member, House Committee on Veterans Affairs, HUD, and Independent Agencies; Representative Bruce Vento, Ranking Minority Member, House Committee on Financial Institutions and Consumer Credit; and the Honorable Norman E. D'Amours, Chairman, NCUA. We will also make copies available to others upon request.

Please contact me or Lawrence D. Cluff on (202) 512-8678 if you or your staff have any questions. Tamara Cross was a major contributor to this letter.

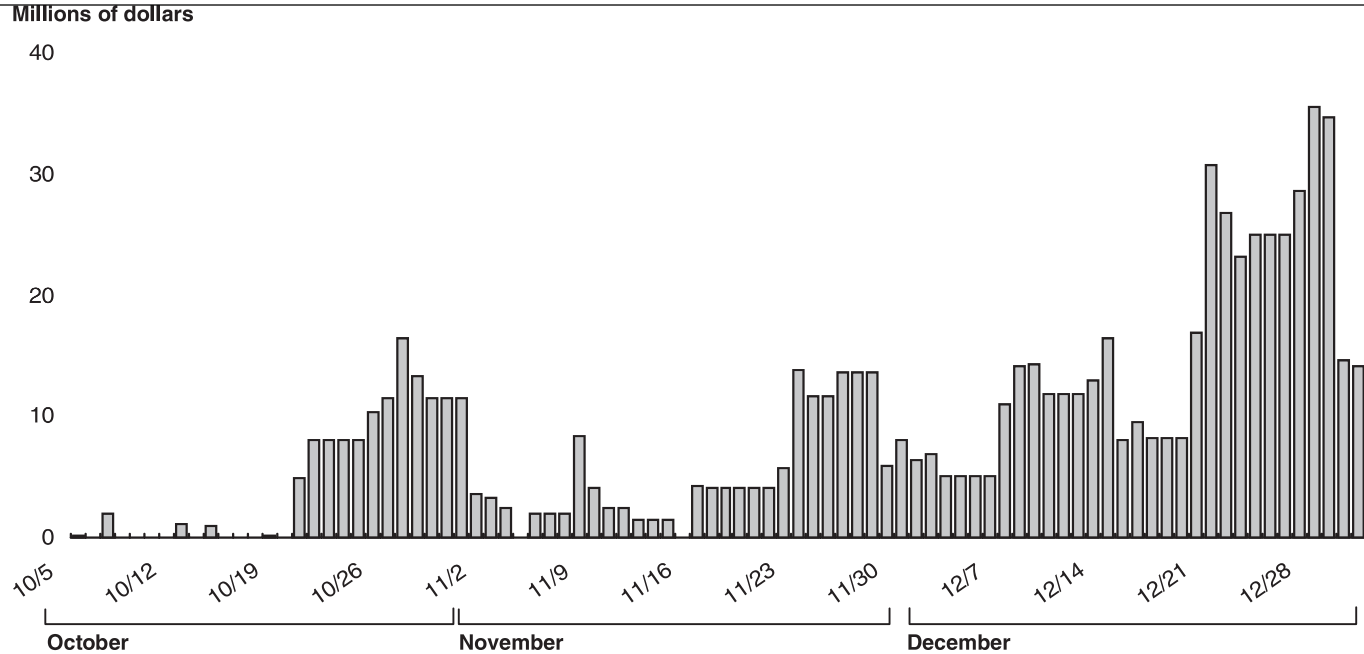
Thomas J. McCool
Director, Financial Institutions
and Markets Issues

Total Daily CLF Loans Outstanding



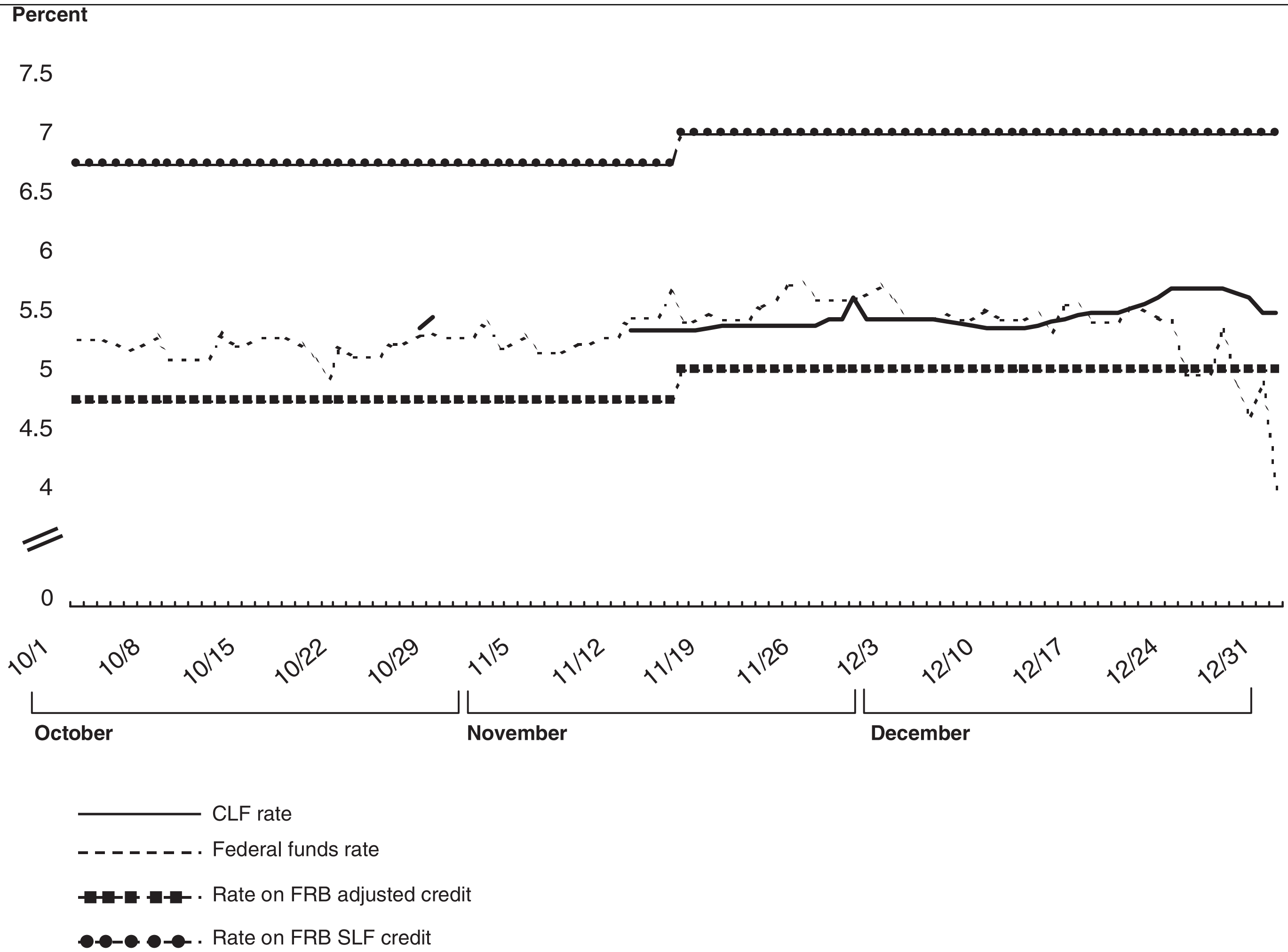
Source: GAO analysis of CLF data.

Total Daily Discount Window Loans Outstanding to Credit Unions



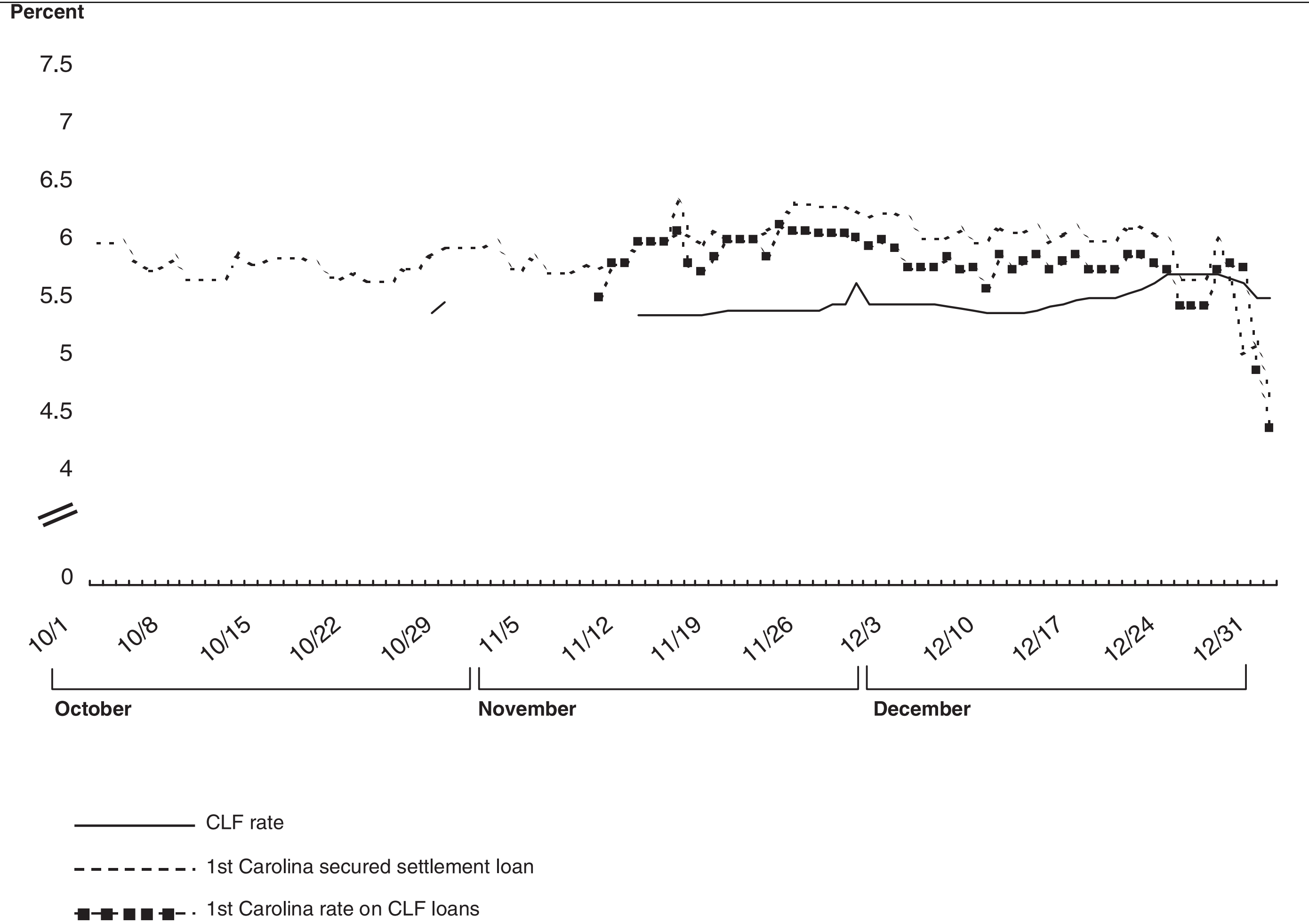
Source: GAO analysis of Federal Reserve Board data.

Rate Comparison CLF, Federal Funds, and FRB Discount Window Rates



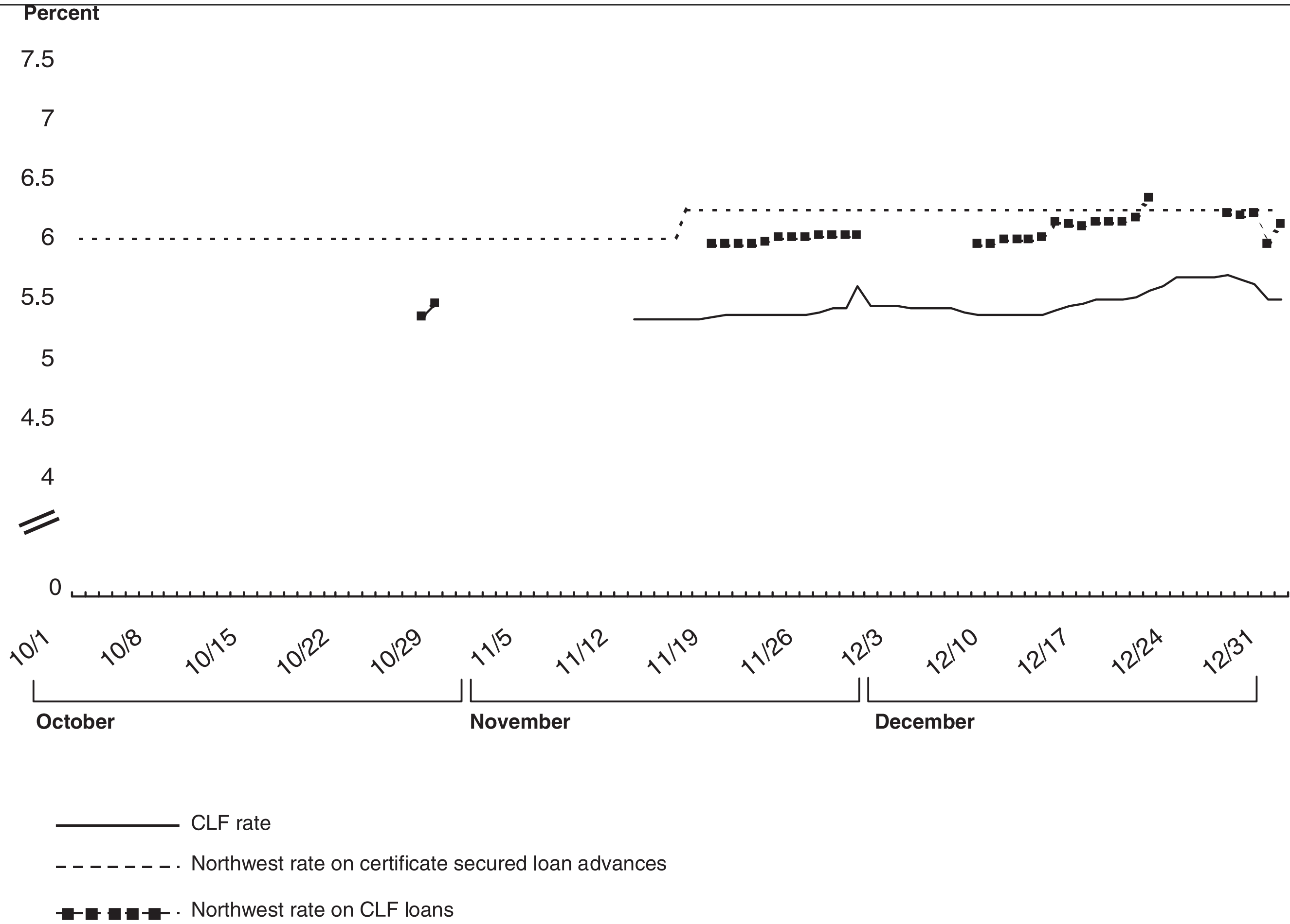
Source: The Federal Reserve Board and CLF

Rate Comparison--First Carolina Corporate and CLF



Source: First Carolina Corporate Credit Union and CLF

Rate Comparison--Northwest Corporate and CLF



Source: Northwest Corporate Credit Union and CLF

Comments from NCUA

National Credit Union Administration

May 19, 2000

Office of the Chairman

Thomas J. McCool
Director, Financial Institutions
And Markets Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. McCool:

I have reviewed the GAO report on the Central Liquidity Facility Lending To Credit Unions Prior to the Year 2000 Date Change and I appreciate both the work that your staff conducted in such a short timeframe and the opportunity to provide comments.

The report includes several conclusions that I believe may be misleading without the additional background information I have provided below. The report conclusions were that:

1. There was an increase in CLF lending during the months of October to December 1999 but whether the Central Liquidity Facility (CLF) lending filled an important gap is difficult to ascertain;
2. CLF officials said that all loans were done for the purpose of meeting credit union liquidity needs and not for the purpose of expanding portfolios but it is difficult to identify whether a liquidity need results from unexpected events that are outside the control of the credit union or as a result of normal business decisions and needs; and,
3. Some credit unions were able to borrow from the Federal Reserve's discount window. Those that obtained the adjustment credit actually paid a lower rate than the rate available from CLF.

I. NCUA Central Liquidity Facility Fills An Important Gap

Let me first emphasize that regardless of the Year 2000 century date conversion, the NCUA CLF fills an important gap for credit unions and has done so since it's creation by Congress in 1979. It continues to play a vital role as a contingency funding resource for thousands of credit unions. Many credit unions do not meet the Federal Reserve's definition of a depository institution (under Regulation A[1]) because they do not offer reservable transaction accounts. As of March 27, 2000, our numbers indicate that out of 10,721 credit unions, 6,578 maintained transactional accounts. Conversely, 4,143 credit unions did not (approximately 37%). Only 5.4% of credit unions reported being approved for Federal Reserve discount window approval as of December 31, 2000. The benefit of CLF is not the level of its activity but rather its existence as an insurance policy for credit unions *whatever* the circumstances. I addressed this very issue in a letter to Congressman James A. Leach, Chairman of the Committee on Banking and Financial Services dated February 23, 1999. My letter presented a number of points of

[1] See 12 C.F.R. § 201.2(c)(1) regarding definitions of depository institutions.

1775 Duke Street - Alexandria, VA 22314-3428 - 703-518-6300 clarification raised in response to a letter sent to Chairman Leach from Treasury Secretary Rubin, dated January 11, 2000, regarding the Treasury Department's views on credit union liquidity needs related to the Year 2000 computer problem and the lending limit imposed by Congress on the CLF. I have attached a copy for your review.

CLF Lending And The Century Date Conversion Period

The CLF did fill an important gap during the period preceding the century date conversion by instilling an important measure of public confidence into the credit union system.

For the first time in its history, the CLF was widely anticipated to make liquidity loans to the entire credit union system, at a set point in time, for an indeterminable amount, and for an unknown period. There was a remote, but potentially catastrophic, possibility that a Y2K-prompted systemic liquidity emergency would abruptly escalate through the U.S. financial system. This compelled all Federal agencies that oversee depository and financial services institutions to establish response plans for this extraordinary contingency. NCUA's expedited procedures were designed to enhance the CLF's ability to respond timely and effectively to any unforeseeable liquidity demand.[2] CLF's procedures neither forsook the NCUA's rigorous safety and soundness standards nor the established creditworthiness and liquidity-need requirements imposed upon credit unions which request CLF-provided funds. The expedited procedures did, however, remove uncertainty and accelerate the funds delivery process.

A particularly complex component of NCUA's contingency plan was its implicit role as a maintainer of public confidence. While NCUA firmly advised credit unions that borrowers must meet the "liquidity need" requirements[3] set forth in Title III of the Federal Credit Union Act (12 U.S.C. §302), it also had an equal responsibility to convey appropriate measures of confidence and willingness to respond to the needs of credit unions during this unprecedented and unpredictable ordeal. NCUA was careful not to imply that borrowing was "off limits" or that *any* use of CLF would be viewed in a harsh supervisory light. This was done to avoid undermining the confidence of credit unions that this important resource was truly available to meet immediate liquidity needs. Many credit unions were previously uncertain about how CLF worked and the circumstances under which it could be utilized. NCUA issued two operating circulars in addition to numerous letters to credit unions explaining CLF's function and lending process including the attendant statutory, regulatory and supervisory issues.

CLF also faced challenging procedural obstacles in its efforts to confront possible Y2K demands. Before the CLF's longstanding $600 million borrowing cap was lifted, the CLF was only a minor liquidity resource for the credit union system as a whole. Even after the cap was lifted, giving CLF access to a potential $20.7 Billion, the borrowing terms established in the CLF's funding arrangement with the Federal Financing Bank (FFB) presented a significant delay-of-funds risk to CLF and its members. The FFB's notice requirements range from three to ten business days (maximum) depending on the

[2] See NCUA Letter To Credit Unions CU-99-18: The NCUA Central Liquidity Facility Expedited Y2K Procedures.
[3] See Operating Circular 99-1: Agent Lending Process; Operating Circular 99-2: Regular Member Facility Advances; and, NCUA Letter To Credit Unions CU-99-18: The NCUA Central Liquidity Facility Expedited Y2K Procedures.

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amount requested with the notice period increasing at certain increased dollar thresholds (up to $500 Million, $500 Million to $2 Billion, and greater than $2 Billion)[4]. Advances can be requested only at times and in amounts necessary to meet immediate disbursing needs. FFB made a limited exception to the immediate disbursing need requirement for requesting advances for the century date change period. This allowed CLF to borrow funds on a one-time anticipatory basis to bolster its cash on hand somewhat. The pre-funding option had risk however; as any gain associated with the investment of pre-funded advances had to be remitted to FFB while any losses would be absorbed by CLF. These cumbersome conditions had a negative effect on the CLF members' perception of "immediate access to liquidity" and they compelled the CLF to keep its pre-funding advances very short-term to avoid excessive interest rate risk.

It also should be noted that the strong economy of 1999 was driving an increase in credit union share and loan growth. The Y2K issue aside, federally insured credit unions experienced strong demand for credit throughout the year and there was an incidental decline in liquidity as the average loan-to-share ratio increased from 72.3%[5] at yearend 1998 to 76.1%[6] at yearend 1999 (due to loan growth $25.8 Billion). As part of its National Liquidity Response Plan, NCUA tracked weekly the liquidity trends in five of the largest corporate credit unions during the fourth quarter of 1999 to remain vigilant for any signs of extraordinary demand for funds. During this period, the consolidated amount of loans to members (natural person credit unions) did run significantly higher than in preceding years and roughly doubled in the month of December. This further reinforced NCUA's heightened sensitivity towards possible liquidity demand. Thus, unlike NCUA's normal expectation for activity, the potential for Y2K-related liquidity needs coupled with a coincidentally strong demand for credit, created a higher anticipation of need for large-scale lending by CLF in the months preceding the century date change.

Finally, published poll results conducted during the second half of 1999 indicated that a significant portion of the public intended to make extraordinary cash withdrawals[7] in anticipation of Y2K disruptions. This further underscored NCUA's conviction that a heightened sensitivity to liquidity needs during that period was appropriate. Ultimately (and thankfully), the cash withdrawals did not materialize as public confidence in credit unions and other financial service providers remained stable right up to- and through-the date conversion weekend. However, this was not an outcome that CLF had the luxury of assuming.

This background is provided so that the reader can gain an appreciation for the unusual and unpredictable environment in which CLF and its members were poised to respond. NCUA strongly believes its Y2K response efforts and CLF lending activities were responsible, effective and appropriate. Such actions by NCUA and others helped reinforce a strong public confidence that credit unions were ready for Y2K and this may have actually obviated the need for extra liquidity. **NCUA concludes that the successful implementation of its overall Y2K-response plan, including CLF**

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[4] "Note Purchase Agreement between Federal Financing Bank and National Credit Union Administration dated as of July 1, 1999", section 6.4.3.
[5] NCUA Publication 8060: 1998 Yearend Statistics For Federally Insured Credit Unions, Table 8.
[6] NCUA Publication 8060: 1999 Yearend Statistics For Federally Insured Credit Unions, Table 8.
[7] See Joint Press Release issued by Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation on November 18, 1999, "Consumer Confidence in Banking Y2K Preparation Rises Sharply, Gallup Poll Reports".

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lending procedures, provided necessary strength and helped fill an important gap in the credit union industry's contingency funding needs.

II. CLF Lending to Meet Credit Union Liquidity Needs

You have noted that CLF is not permitted by law to make loans to credit unions for the purposes of expanding their portfolios. Your conclusion that "it is difficult to identify whether a liquidity need results from unexpected events that are outside the control of the credit union or as a result of normal business decisions and needs" implies that the loans made during the Y2K period may have been used to expand portfolios.

While I would agree that both the dynamic nature of a depository institution's balance sheet and the fungible nature of money make it difficult to say what an incremental dollar of borrowed funds is specifically used for, I would not agree that CLF's lending process effectively allows for funding of portfolio growth. The vast majority of loans were made to credit unions for one business day. It is extremely hard to imagine how a one-day loan would be strategically utilized to expand a portfolio (e.g., mortgage loans, car loans, and Treasury Notes, etc.). Rather, liquidity loans were more likely used by credit unions that had temporary liquidity deficits because of a structural balance sheet mismatch. There were also a small number of term loans made for 118, 87, and 14 days respectively. In all cases, CLF carefully (and independently) reviewed the creditworthiness and liquidity profiles of the underlying borrowers. In a few instances with overnight requests, the liquidity-need circumstances of underlying borrowers submitted on Agent Request For Funds applications were challenged by the CLF when they failed to pass the loan screening criteria established for "liquidity need". These requests were subsequently withdrawn.

Title III of the Federal Credit Union Act (CLF Act) spells out three types of liquidity need. These are essentially "short-term", "seasonal" (medium-term), and "protracted" (longer term unusual need). The statute does not address the circumstances leading up to a liquidity need nor does it address any requirements that a credit union must obtain liquidity from a source other than the CLF prior to requesting an advance. NCUA interprets this to mean that a creditworthy credit union with a current liquidity deficit, may obtain a CLF advance. Unlike extensions of adjustment credit by Federal Reserve Banks (under Regulation A), Title III does not require that "reasonable alternative sources of funds have been fully used, including credit from special industry lenders such as Federal Home Loan Banks, the National Credit Union Administration's Central Liquidity Facility, and corporate credit unions".[8] But, as stated in § 306(a)(1) of the FCU Act, the Board shall not approve an application for credit the intent of which is to expand credit union portfolios. We believe this means, for example, that the liquidity loan cannot be used to fund new investments or new loan product offerings.[9]

During the period leading up to the Y2K date conversion, CLF utilized a comprehensive financial database of key liquidity and creditworthiness indicators to assess the reasonableness of the requests. Additionally, credit unions were specifically advised in Letter To Credit Unions 99-CU-18 that:

[8] See 12 C.F.R. §201.3(A) regarding availability and terms for adjustment credit.
[9] See Operating Circular 99-2: Regular Member Facility Advances, Chapter Four, *Liquidity Need Justification*, page 5.

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"The liquidity need circumstances of each member natural person credit union would be evaluated by the CLF to assure that loans are made consistent with the requirements set forth in 12 U.S.C. § 302 of the FCU Act and 12 C.F.R. § 725.2 of NCUA's Rules and Regulations. All liquidity-need loans funded by the CLF must include a specification of the liquidity need "type" (form completed by the CLF Agent). In order to fund a member natural person credit union loan request with CLF-based funding, the agent needs to be assured that the borrower has a current liquidity need and is not borrowing to expand its portfolios...After the century date change, the CLF will require a liquidity restoration plan from any credit union with outstanding CLF balances beyond a reasonable time (generally 90 days). The liquidity restoration plan will need to detail the credit union's ability and means for restoring its business-as-usual profile to a non-CLF reliant condition."

This now is a standard part of our normal operating procedures and it underscores the unfeasibility of a credit union borrowing funds for more than a short period of time and/or using the CLF as a means for expanding its portfolios. The CLF is careful to work with the supervisory authorities within NCUA to address balance sheet structural imbalances that might be the result of uncontrolled asset growth, inadequate liquidity planning, or overall poor asset/liability management. Such problems will not preclude a CLF loan from being made but they will be immediately addressed through the supervision and/or examination process so that corrective actions can be undertaken. Such coordination ensures that access to CLF is not misconstrued by credit unions as a potential means to expand their balance sheets. **NCUA concludes that its coordination between CLF and the NCUA supervisory authorities make it unfeasible for a credit union to obtain a loan from the CLF for more than a reasonable period of time (borrow with the intent of expanding portfolios).**

III. Credit Unions Obtain Loans From Federal Reserve Discount Window Cheaper Than CLF

The CLF, to the extent that it borrows from FFB, does not control the cost of its liquidity loans. Under the Note Purchase Agreement between NCUA and FFB, any interest charged in excess of interest owed on the FFB advance must be remitted back to the FFB. Thus, if CLF charges a loan rate below its cost (the FFB advance rate) it loses money. If CLF charges more than its cost, it remits the excess directly to FFB. Charging a premium above CLF's cost would be tantamount to transferring credit union capital to the U.S. Treasury and would serve no useful function. Advance rates from the FFB are priced off of the most recently auctioned Treasury securities with the same relative maturity (the shortest reference rate being the most recently auctioned 13 week T-Bill). Unless Treasury securities are trading in the marketplace with Bond Equivalent Yields that are lower than the overnight Federal Funds Rate, a CLF advance is likely to be more expensive than a regular adjustment credit from the Federal Reserve's discount window (approximately .50% below the target rate for Overnight Federal Funds). However, current relationships between different market rates will change and no definitive conclusion should be made regarding what the relative cost differential between CLF and the Federal Reserve's discount window will be in the future.

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Thank you again for the opportunity to comment on your report on the Central Liquidity Facility Lending To Credit Unions Prior to the Year 2000 Date Change.

Sincerely,

Norm D'Amours

Norman E. D'Amours
Chairman

Enclosure

c.c. Dan Kampen, CEO, U.S. Central Credit Union

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