NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: **September 2010** **LETTER NO.: 10-CU-18**

TO: **Federally Insured Credit Unions**

SUBJ: **Investment Due Diligence**

Dear Board of Directors:

NCUA has long emphasized the need for credit unions to have appropriate risk management processes in place that are commensurate with the nature, scope, and complexity of investment activities. Performing due diligence before investing is even more important today as credit unions struggle to enhance net interest margins and seek strategies to boost profitability. While investments can provide an opportunity to contribute to the bottom line, they must always be part of a well thought-out risk management plan.

Risk management of investments should include adequate due diligence, reasonable exposure limits, accurate risk measurement, an understanding of the investment's structure, knowledge of the collateral performance (when applicable), and a determination of investment suitability.

It is of utmost importance that your management team fully understands the characteristics of the instruments held in your credit union's investment portfolio. Knowing what questions to ask and which documents to review is the foundation of a solid due diligence process.

Prior to purchasing an investment, your credit union must evaluate and document fundamental elements including:

- **Basic Nature** – Is the instrument a U.S. Treasury bond, Federal Agency Security, Mortgage-Backed Security (MBS), etc?

- **Federal Guarantees** – Is the instrument backed by any government agency which offers an implicit or explicit federal guarantee?

- **Collateralization** – Is the investment backed by any collateral? If so, what is the collateral and how does that collateral affect the price and cash flow of the instrument?

- **Interest Rate** – What is the interest rate structure? Is it a fixed rate or a floating rate? If a floating rate, what is that rate tied to? (For example, an instrument may promise to pay a certain number of basis points above the London Inter-Bank Overnight Rate, or LIBOR, which is the benchmark international interest rate.) How does the interest rate structure fit within your credit union's own strategies?

- **Size** – Is the size (dollar amount) of the specific instrument significant in relation to the investment portfolio or asset size of your credit union? Does the instrument's mere size pose any undue risk?

- **Maturity** – What is the maturity of the instrument? Is it fixed or does repayment of principal and/or interest vary based on market conditions?

- **Policy Compliance** – Does the instrument fit within your credit union's investment policy and asset-liability management (ALM) constraints?

Management must consistently demonstrate a comprehensive understanding of the investments purchased and ensure that these instruments fit within both the policies and business strategies of your credit union.

While your credit union's investment portfolio can provide supplemental income when loan demand is low, strong due diligence practices should always be a key element in your investment decision process.

If you have any questions related to this letter, you should contact your NCUA regional office, district examiner, or state supervisory authority.

Sincerely,

/s/

Debbie Matz
Chairman