Lines of credit are not created equally. We have been answering many questions from members regarding their line of credit with Alloya. We have also noted that many credit unions who are still considering whether to capitalize Alloya or who have decided to move elsewhere are unclear about their options and what other solutions may be available. We will review the three most common choices for liquidity that exist for credit unions outside Alloya: a line at a Federal Reserve Bank (Fed), a line with a Federal Home Loan Bank (FHLB) and a line with a commercial bank.

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How does the line of credit work? This can be the most important issue for many credit unions. Approximately 1/2 of all Alloya members utilized their line of credit in the past 12 months. Over 98% of these advances are what we would call an "overdraft" or "settlement" advance, most of which were unplanned. At Alloya, these advances are done automatically as items are cleared and there are insufficient funds available to cover the items. No prior action is required – at most others providers, that is not the case.

The Fed and FHLB[5] require advance notice of funding; you must request an advance prior to needing the funds. If you are clearing through the Fed, they do not allow overnight overdrafts and very closely monitor "daylight" overdrafts. As detailed in the Fed's Operating Circular No. 1 "an accountholder does not have a right to incur an overnight overdraft in its account".[1] Further, as discussed in their Account Management Guide, daylight overdrafts are measured "at the end of each minute during the business day" and if you exceed daylight overdraft limits, the Reserve Bank may "protect themselves from the risk of loss by unilaterally reducing net debit caps, imposing collateralization or balance requirements, rejecting or delaying certain transactions that would cause or increase an institution's daylight overdraft, or in extreme cases, prohibiting an institution from using Fedwire." Further, "if cap violations continue to occur… the Reserve Bank may assign the institution a zero cap. An institution could also face account activity restrictions, such as rejection of Fedwire funds transfers, National Settlement Service entries or ACH credit originations, if the institution's account contains insufficient funds. Reserve Banks will also keep institutions' primary regulator apprised of any recurring overdraft problems."[2]

For commercial bank lines of credit, credit unions can expect that all funding requests will also have to be made in advance unless you are clearing through that bank.

The conclusion is that lines of credit from these other sources cannot be used to cover unexpected liquidity issues, internal processing mistakes or for convenience. You must manage funding very closely and possibly be overfunded most of the time to avoid the risk of items being returned, and having the ability to wire funds or process ACH items be suspended. If utilizing these sources as your primary line of credit, we recommend a dedicated cash manager be assigned to avoid any funding shortages. The Fed provides a reconcilement worksheet reflecting the daylight overdraft posting rules that can help manage both intraday and end-of-day overdrafts.[3]

How do line of credit qualifications differ? Capitalized members of Alloya receive a generous line of credit that is a multiple of their capital contribution. At the Fed, as detailed on their website and in Operating Circular 10[4], primary credit eligibility is limited to "adequately or well capitalized institutions." In addition, "the Federal Reserve expects that institutions will not rely on the Discount Window as a regular source of funding" and "is to be used on a very short term basis."

At the FHLBs, as detailed on their various websites[5], credit unions must originate or purchase first lien one-to-four family residential loans or other type real estate loans with a maturity of at least five years. You must maintain positive net income in 4 of the most recent 6 quarters with maximum levels of non-performing loans and minimum levels of loan loss reserves. Capital is required in an amount of 0.20% of the mortgage assets held by the member recalculated each March. You must also purchase activity-based stock currently in an amount equal to 4.5% of the amount of outstanding advances.

Commercial banks maintain highly varied requirements for lines of credit that may include use fees, non-use fees, deposit requirements or commitment fees. Historically, bank lines have been the most unreliable source of funding due to market conditions, changing product and industry concentrations and changes in strategic direction, with many banks revoking lines of credit with little advance notice. Many money center banks have decided to either restrict their business dealings with credit unions to those with assets of $1 billion or higher, or have decided to not serve credit unions at all. Many local and regional banks will either not serve credit unions or require very high fees – rightly considering this service to be aiding a competitor.

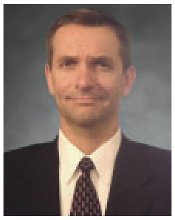
The majority of Alloya credit unions' lines are secured by an "all asset pledge." It is this pledge, and the comfort that it provides, that allows Alloya to be more flexible than other providers which are limited in the collateral that they can or will take to secure your line of credit.

What about term lending? At Alloya, your line of credit is available for term lending. The Fed does not offer term lending. If qualified, the FHLBs offer long term, fixed rate term loans at attractive rates. Commercial banks have been very reluctant to offer term lending in the past to credit unions.

We've never used our line. So why do we even need one? All regulators require that financial institutions maintain a liquidity plan. This plan can include maintaining minimum levels of cash deposits, the ability to obtain deposits through certificate issuance and most likely includes a line of credit. It is in every financial institution's best interest to have back-up liquidity sources available, not only for when there is a high level of liquidity in the system like now, but in the future when liquidity may be tight. The best time to secure a line of credit is when you do not need one. You should choose a reliable funding partner who understands the industry, has proven reliability through prior economic downturns and whose best interests are tied to your best interests.

Footnotes

1. Operating circulars can be found here:
   www.frbservices.org/regulations/operating_circulars.html
2. Account Management Guide can be found here (several sections can be found in the Reserve Maintenance Manual, also below):
   www.frbservices.org/files/regulations/pdf/amg.pdf
   www.frbservices.org/files/regulations/pdf/rmm.pdf
3. The Fed's six-page Reconcilement Worksheet can be found here on pages V10 through V17.
   www.frbservices.org/files/regulations/pdf/amg.pdf
4. The Fed's Operating Circular 10 referencing Lending can be found here:
   www.frbservices.org/files/regulations/pdf/operating_circular_10.pdf
5. Information on Federal Home Loan Banks can be found starting here and then going to your own FHLB depending on location.
   www.fhlbanks.com



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