



# **“S”** in the CAMEL(**S**) Rating System And The NEV Supervisory Test

Presented by: Frank Santucci - Managing Director ALM Services

In November 2015, the NCUA Office of the Inspector General made the following recommendations to the NCUA Board:

1. **Modify NCUA’s CAMEL Rating System by developing an “S” rating to better capture a credit union’s sensitivity to market risk and to improve interest rate risk clarity and transparency.**
2. **Revise the current “L” in NCUA’s CAMEL Rating System to reflect only liquidity factors.”**

### **NCUA agreed with both recommendations.**

“NCUA management is committed to submitting a proposal for regulatory change to the NCUA Board by the end of September 2016.

Because the process involves regulation changes, reprogramming of multiple data systems, and revisions to examination policies and procedures, management anticipates **final implementation by the end of 2018.**

Management also indicated that implementation of recommendation 2 above will track with the addition of an “S” rating (recommendation 1 above) , which will require revisions to the guidance for assigning the “L” component to remove IRR references.”

Source: <https://www.ncua.gov/About/leadership/Documents/OIG/OIG201511ReviewNCUAsIRRProgram.pdf#search=CAMEL%20Sensitivity>

**At the NCUA Board meeting in June 2016**, J. Owen Cole, Director of the Division of Capital and Credit Markets and Larry Fazio, Director of the Office of Examinations and Insurance, made the formal proposal to the NCUA Board to modify the CAMEL rating system and add the “S” component for sensitivity to interest rate risk and to isolate the “L” as liquidity management.

**Full implementation of this change will not be completed until 2018.**

**In addition, the NCUA will be updating the examination procedures for Interest Rate Risk Management and Liquidity Risk Management starting in the fourth quarter 2016.**

Source: <https://www.ncua.gov/About/leadership/Documents/OIG/OIG201511ReviewNCUAsIRRProgram.pdf#search=CAMEL%20Sensitivity>

- **What is the CAMEL(S) Rating System?**
- **What changes are being made to the examination procedures now?**

SECTION

1

What is the CAMEL(S)  
Rating System?

NCUA Letter to Credit Unions 2007-CU-12 states:

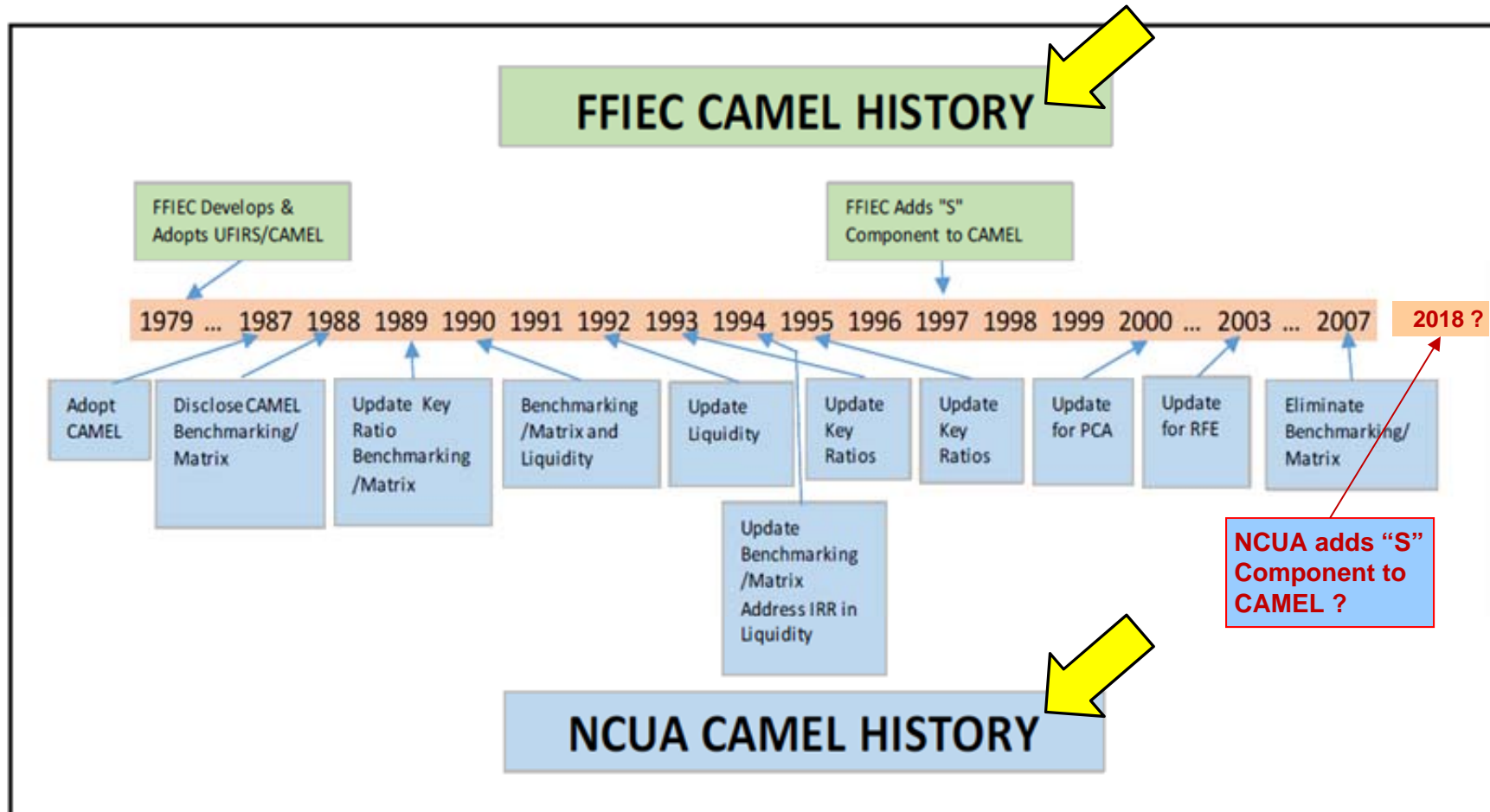
CAMEL is based on the Federal Financial Institutions Examination Council’s (FFIEC) Uniform Financial Institutions Rating System (UFIRS) commonly referred to as “CAMEL.” NCUA adopted CAMEL in October 1987.

**NCUA CAMEL is an internal rating system used for:**

- **Evaluating the soundness of credit unions on a uniform basis**
- **Evaluating the degree of risk to the National Credit Union Share Insurance Fund**
- **Identifying those credit unions requiring special supervisory attention or concern**

NCUA periodically modifies CAMEL to respond to changes in the financial services industry and supervisory policies and procedures.

# Developments in the CAMEL System



**Currently, the CAMEL rating system is based upon an evaluation of five critical elements of a credit union's operations:**

**C = Capital Adequacy**

**A = Asset Quality**

**M = Management**

**E = Earnings**

**L = Liquidity and /Asset-Liability Management**

**Once the proposed change is fully implemented in 2018:**

**L = Liquidity Management**

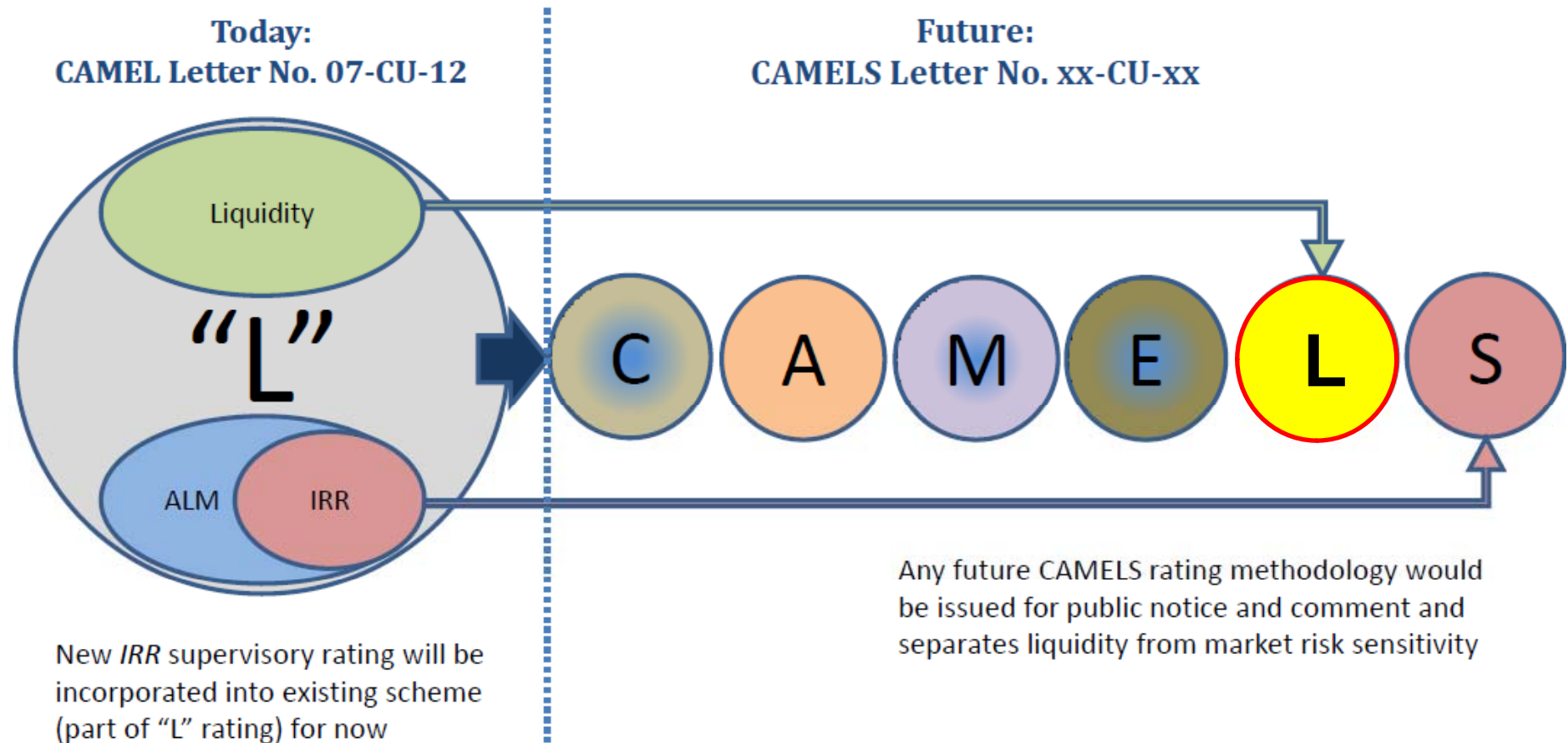
**S = Sensitivity to Market/Interest Rate Risk**

**And the CAMEL Rating System will become CAMELS.**

Source: NCUA letter to Credit Unions 2007-CU-12 Appendix A

Source: <https://www.ncua.gov/About/leadership/Documents/OIG/OIG201511ReviewNCUAsIRRProgram.pdf#search=CAMEL%20Sensitivity>

## How will we transition to an "S" Rating?



Each of the five (soon to be six) CAMEL(S) components are assigned a rating from 1 to 5 (1 being best, 5 worst) and the credit union is also given an over-all composite rating.

### CAMEL COMPOSITE RATINGS

**Rating 1** - Credit unions in this group are sound in every respect and generally have components rated 1 and 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management.

**Rating 2** – Credit unions in this group are fundamentally sound. For a credit union to receive this rating, generally no component rating should be more severe than a 3.

**Rating 3** - Credit unions in this group exhibit some degree of supervisory concern in one or more of the component areas. These credit unions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4.

**Rating 4** - Credit unions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance.

**Rating 5** – Credit unions in this group exhibit extremely unsafe and unsound practices and conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the credit union’s size, complexity, and risk profile; and are of the greatest supervisory concern.

SECTION

2

What changes are being made to the examination procedures?

At the June 2016 NCUA Board meeting, the Office of Examinations and Insurance detailed eight steps being taken this year to start implementing the change in the CAMEL(S) rating system:

- 1. Updating the NCUA Examiners Guide**
- 2. Updating the AIREs Questionnaires (scope and exam procedures)**
- 3. Eliminating the net long-term asset ratio, the SIRRT ratio, and the “17-4 Test” as risk assessment metrics**
- 4. Introducing a new “proxy NEV calculation” NCUA will run for all credit unions < \$50 Million in Total Assets**
- 5. Introducing a new “pre-examination” metric called the “NEV Supervisory Test” for all credit unions > \$50 million in total assets.**
- 6. Updating NEV risk assessment matrix**
- 7. Training examiners on the new procedures**
- 8. Issuing a Letter to Credit Unions and FAQ detailing all of the above**

In addition, on August 18<sup>th</sup> of this year NCUA hosted a webinar for credit unions to begin introducing these changes:

<http://event.on24.com/r.htm?e=1224545&s=1&k=5CFC8BEDBE4190F0791D7E549DC9C3E1>

### Replacing the Net Long-Term Asset Ratio, SIRRT Ratio and 17-4 Test

Currently, NCUA examiners use several ratios calculated from the call report to assess the potential interest rate risk of each credit union.

The pre-examination ratios used in this process have included the:

- Net Long-term Asset to Total Asset Ratio (NLTA) ,
- Supervisory Interest rate Risk Threshold (SIRRT) Ratio
- “17-4 Test”

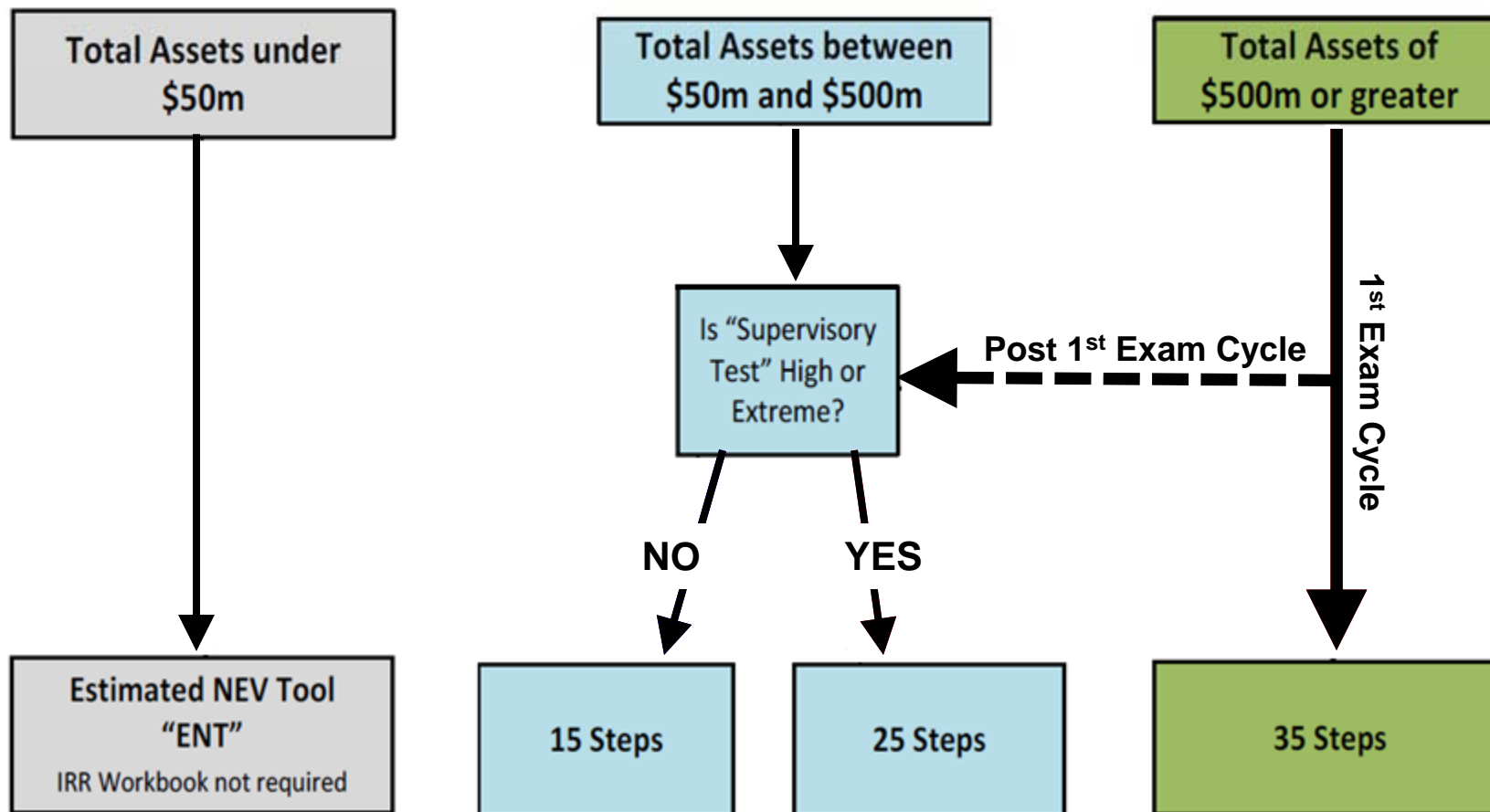
With this new guidance NCUA is looking to replace these three “pre-examination” scoping tools with a new calculation:

### The Net Economic Value (“NEV”) Supervisory Test

- Each CU will submit their latest NEV analysis to the NCUA
- Using a standardized valuation for all non-maturity deposits, NCUA will then calculate the NEV Supervisory Test results
- The results will determine the “scope” of the exam
- The higher the risk to NEV, the more detailed the IRR portion of the exam
- In some extreme cases, the results may be used to mandate risk reduction

***“NCUA is looking for outliers.”***

## IRR Supervision Scope (March 2016 Data)



NCUA Rules and Regulations Part 741, Appendix A, defines Net Economic Value as “the market value of assets minus the market value of liabilities.”

The question is: What is the maturity of a “non-maturity deposit?”

The “decay rate” is the assumed amount of non-maturity deposit withdrawals.

### **Federal Financial Institutions Examination Council - *Interagency Advisory on Interest Rate Risk Management - Frequently Asked Questions (Jan. 2012)***

**Question 11:**

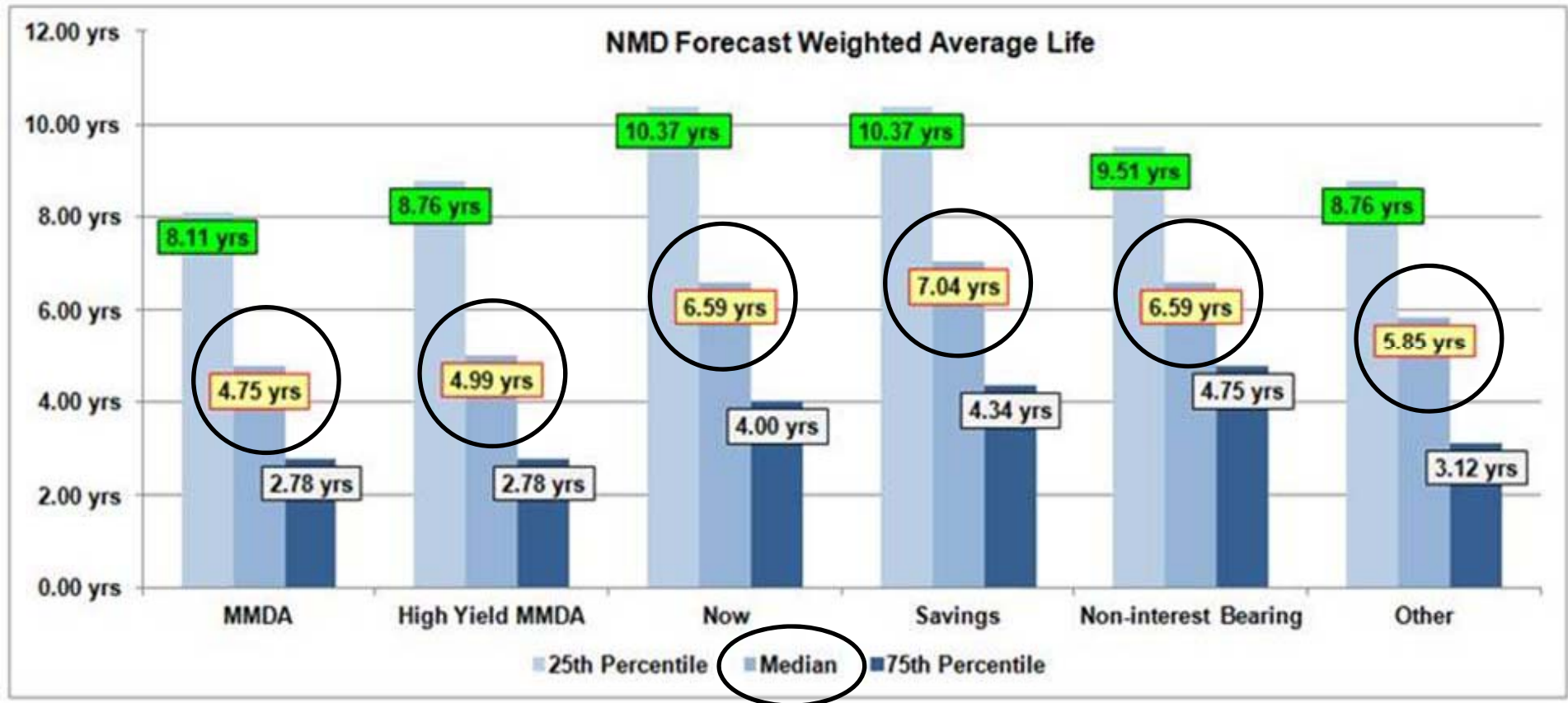
**Can an institution use industry estimates for non-maturity-deposit (NMD) decay rates?**

***Answer:* “Institutions should use assumptions that reflect the institution’s profile and activities and generally avoid reliance on industry estimates or default vendor assumptions”.**

Source: FFIEC Interagency Advisory on IRR Management FAQ (January 2012) <http://www.ncua.gov/News/Press/NW20120112FFIEC-Encl1.pdf>

- The more rate sensitive the NMDs, the faster the assumed decay rate
- The faster the assumed decay rate on NMDs, the faster the forecast withdrawals
- The faster the forecast NMD withdrawals, the shorter the forecast average life
- **The shorter the forecast average life of the NMDs, the worse the Net Economic Value results**

## OCC Survey of Bank Decay Rates Fall 2014 Risk Perspectives



Source: OCC Fall 2014 Risk Perspectives:

<http://www.occ.gov/publications/publications-by-type/other-publications-reports/semiannual-risk-perspective/semiannual-risk-perspective-fall-2014.pdf>

## Economic Value – NMD Sensitivity Analysis Summary

<b>NEV Analysis</b>	<b>Decay Rate Methodology</b>	<b>Weighted Avg Life of NMDs</b>
<b>#1</b>	FASB Topic #825: Decay Rates = 12-year Historical Avg	<b>6.12yrs</b>
<b>#2</b>	FASB Topic #825: Decay Rates = Avg Jun'03-Jun'07	<b>5.78yrs</b>
<b>#3</b>	FASB Topic #825: Decay Rates = Historical Worst 12-month Period	<b>5.23yrs</b>
<b>#4</b>	FASB Topic #825: Decay Rates = Avg. of 12-yr Avg & Worst Q (#1 & #6)	<b>4.77yrs</b>
<b>#5</b>	FASB Topic #825: Decay Rates = Avg. of the Four Worst Quarters	<b>3.93yrs</b>
<b>#6</b>	FASB Topic #825: Decay Rates = Historical Worst Quarter	<b>3.41yrs</b>

## Net Economic Value: Example # 1 NMD Share Values Based on Historical Member Decay Rates

Sample Credit Union December 31	Book Value	Value Flat Rate	Value +300bps	Change From Flat	% Change From Flat
Total Investments	\$59,414,736	\$59,909,650	\$53,120,084	-\$6,789,567	-11.33%
Total Loans	\$131,111,207	\$131,881,232	\$118,820,673	-\$13,060,559	-9.90%
Other Assets	\$9,474,056	\$9,474,056	\$9,474,056	\$0	0.00%
<b>Total Assets</b>	<b>\$200,000,000</b>	<b>\$201,264,938</b>	<b>\$181,414,813</b>	<b>-\$19,850,125</b>	<b>-9.86%</b>
Non-maturity Deposits	\$126,030,472	\$121,887,047	\$113,527,246	-\$8,359,801	<b>-6.86%</b>
Time Deposits	\$43,279,518	\$43,782,068	\$42,089,573	-\$1,692,495	-3.87%
Borrowings	\$7,796,738	\$7,987,866	\$7,844,489	-\$143,377	-1.79%
Other Liabilities	\$1,568,977	\$1,568,977	\$1,568,977	\$0	0.00%
<b>Total Deposits+Liabilities</b>	<b>\$178,675,705</b>	<b>\$175,225,958</b>	<b>\$165,030,285</b>	<b>-\$10,195,674</b>	<b>-5.82%</b>
<b>Net Economic Value</b>	<b>\$21,324,295</b>	<b>\$26,038,980</b>	<b>\$16,384,529</b>	<b>-\$9,654,451</b>	<b>-37.08%</b>
<b>NEV Capital Ratio</b>	<b>10.66%</b>	<b>12.94%</b>	<b>9.03%</b>		

NCUA AIREs Questionnaire (Aug 2012 update) Net Economic Value	RISK ASSESSMENT		
	LOW	MODERATE	HIGH
% Change +300bps Rate-shock "Market Value of Capital"	<25%	25--50%	> 50%
After +300bps Rate-shock "NEV Capital Ratio"	>6%	4--6%	< 4%

In calculating the **NEV Supervisory Test**, the NCUA will use each credit union’s internal NEV calculation for investments, loans, time deposits, borrowings, other assets and liabilities.

### **NCUA will substitute a “standardized” valuation for NMDs.**

**In the flat rate scenario:**

- **All NMDs will be valued assuming a 1% premium (expressed as multiplying the book value \* 99.00% price)**

**In the +300bps rate-shock scenario:**

- **All NMDs will be valued at an additional 4% premium (expressed as multiplying the flat rate value of NMDs \* 96.00% price)**

Mathematically, this equates to a 4.94% premium to book value or a price of 95.04% on all NMDs in the +300bps rate-shock scenario.

Source: NCUA Webinar August 18, 2016: <http://event.on24.com/r.htm?e=1224545&s=1&k=5CFC8BEDBE4190F0791D7E549DC9C3E1>

*These standardized valuations equate to an assumed annual decay rate of 71.57% (implying the risk that 71% of all NMDs could be withdrawn on an annual basis) and a forecast average life (or average maturity) for all NMDs of 1.40 years (approximately 16 months 3 weeks).*

## Economic Value – NMD Sensitivity Analysis Summary

NEV Analysis	Decay Rate Methodology	Weighted Avg Life of NMDs
#1	FASB Topic #825: Decay Rates = 12-year Historical Avg	6.12yrs
#2	FASB Topic #825: Decay Rates = Avg Jun'03-Jun'07	5.78yrs
#3	FASB Topic #825: Decay Rates = Historical Worst 12-month Period	5.23yrs
#4	FASB Topic #825: Decay Rates = Avg. of 12-yr Avg & Worst Q (#1 & #6)	4.77yrs
#5	FASB Topic #825: Decay Rates = Avg. of the Four Worst Quarters	3.93yrs
#6	FASB Topic #825: Decay Rates = Historical Worst Quarter	3.41yrs
#7	NERA: Decay Rates = NCUA "Proposed Safe-harbor" Avg Life	2.03yrs
#8	NCUA NEV Supervisory Test. Decay Rates = Implied 71.57%	1.40yrs
#9	NMDs at PAR: Decay Rates = 1200%	0.08yrs

Source for Data: BSMS ALM Analysis Sample Credit Union

## Net Economic Value Supervisory Test

Flat Rate Scenario NMD Share Values: Assumed **1.00% Premium**  
 +300bps Rate-shock NMD Share Values: Assumed **4.96% Premium**

Sample Credit Union	Book Value	Value Flat Rate	Value +300bps	Change From Flat	% Change From Flat
<b>December 31</b>					
Total Investments	\$59,414,736	\$59,909,650	\$53,120,084	-\$6,789,567	-11.33%
Total Loans	\$131,111,207	\$131,881,232	\$118,820,673	-\$13,060,559	-9.90%
Other Assets	\$9,474,056	\$9,474,056	\$9,474,056	\$0	0.00%
<b>Total Assets</b>	<b>\$200,000,000</b>	<b>\$201,264,938</b>	<b>\$181,414,813</b>	<b>-\$19,850,125</b>	<b>-9.86%</b>
Non-maturity Deposits	\$126,030,472	\$124,770,167	\$119,779,361	-\$4,990,807	-4.00%
Time Deposits	\$43,279,518	\$43,782,068	\$42,089,573	-\$1,692,495	-3.87%
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Other Liabilities	\$1,568,977	\$1,568,977	\$1,568,977	\$0	0.00%
<b>Total Deposits+Liabilities</b>	<b>\$178,675,705</b>	<b>\$178,109,079</b>	<b>\$171,282,399</b>	<b>-\$6,826,679</b>	<b>-3.83%</b>
<b>Net Economic Value</b>	<b>\$21,324,295</b>	<b>\$23,155,860</b>	<b>\$10,132,414</b>	<b>-\$13,023,446</b>	<b>-56.24%</b>
<b>NEV Capital Ratio</b>	<b>10.66%</b>	<b>11.51%</b>	<b>5.59%</b>		

## NEV Supervisory Test – Risk Thresholds

Risk Level	Post-shock NEV	NEV Sensitivity (%)
Low	Above 7%	Below 40%
Moderate	4% up to 7%	40% to 65%
High	2% up to 4%	65% to 85%
Extreme	Below 2%	Above 85%

Note: NCUA has made use of a NEV metric in the current Examiner’s Guide since 2000 in Chapter 13



## Key IRR Review Areas

### Market Risk

- **NEV Supervisory Test**
- Analysis of Balance Sheet Valuations

### Earnings at Risk

- Review of Scenarios
- Review of results/assumptions

### Stress Testing

- Review of Scenarios
- Results

### Measurement Systems

- Platform assessments
- Data controls

### Risk Management

- Oversight
- Policies/Reporting/Controls/Staff

## Benefits for Credit Unions

1. Shifting the focus towards IRR outliers
2. Uniform, measurable, consistent and transparent IRR measure
3. Increased clarity of supervisory expectations
4. Increased accuracy of IRR rating
5. Greater consistency by examiners
6. Risk-focused discussions (majoring in majors)
7. Reduced examination burden for most



# Next Steps

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1. Finalize the Examiner Guidance
2. Communicate to Credit Union Industry via “Letter to Credit Unions” which will include the revised Examiner Guide, Procedures Workbook and Frequently Asked Questions
3. Complete the Agency-wide Examiner training on the revised IRR Guidance
4. Implement the revised IRR Supervision





**Questions ?**

1. **NCUA Rules and Regulation Part 741.3 (effective September 30, 2012 – revised Jan 2013):**  
<http://www.ncua.gov/Legal/Documents/Regulations/FIR20120126InterestRateRiskProg.pdf>
2. **NCUA’s AIREs Examination Questionnaire:**  
Worksheets IRR-Part A, Part B, Part C, and Part D have a list of ALM related questions an examiner may ask during the exam. Embedded in many of the cells/questions is guidance from NCUA to the examiner detailing the issue, offering "red flags" to look for as well as best practices to recommend. This can be helpful in preparing for an upcoming examination.  
<http://www.ncua.gov/DataApps/Documents/AIREs/question.zip>
3. **FFIEC Advisory on Interest Rate Risk Management (Jan 2010):**  
<http://www.ncua.gov/News/Press/NW20100106AdvisoryonInterestRate.pdf>
4. **FFIEC (Jan 2012) Frequently Asked Questions about the FFIEC Advisory on Interest Rate Risk Management (Jan 2012):** <http://www.ncua.gov/News/Press/NW20120112FFIEC-Encl1.pdf>
5. **The National Economic Research Associates (“NERA”) "Evaluation of Non-maturity Deposits“:**  
(Commissioned and published by NCUA this study details various methods for the treatment of non-maturity Deposits in the calculation of Net Economic Value  
<http://www.ncua.gov/Resources/Documents/ALM/ALMNMDeposits.pdf>
6. **NCUA’s “Asset Valuation Workbook”:**  
This excel workbook is updated quarterly by NCUA and contains several “Estimated Interest Rate Risk Calculators”, including the “Gross 17-4 Test” based on Call Report data and the more advanced version of the “17-4 Test”, the “Asset Valuation” calculator which uses market prices as a proxy for estimating the market value of the credit union’s mortgage loan portfolio..  
<http://www.ncua.gov/Resources/Documents/ALM/AssetValuationWorkbook.zip>

### **NCUA "Letter to Credit Unions" relating to Asset Liability Management:**

*(Note: In the descriptions below, the first two digits represent the year the letter was issued, the last two digits represent the number of the letter in that year)*

7. **99-CU-12, August 1999, "Real Estate Lending and Balance Sheet Management"**  
<http://www.ncua.gov/Resources/Documents/LCU1999-12.pdf>
8. **00-CU-10, November 2000, "Asset Liability Management Examination Procedures"**  
<http://www.ncua.gov/Resources/Documents/LCU2000-10.pdf>
9. **00-CU-13, December 2000, "Liquidity and Balance Sheet Risk Management"**  
<http://www.ncua.gov/Resources/Documents/LCU2000-13.pdf>
10. **01-CU-08, July 2001, "Liability Management - Highly Rate Sensitive and Volatile Funding Sources"**  
<http://www.ncua.gov/Resources/Documents/LCU2001-08.pdf>
11. **01-CU-19, October 2001 "Managing Share Inflows in Uncertain Times"**  
<http://www.ncua.gov/Resources/Documents/LCU2001-19.pdf>
12. **03-CU-11, July 2003, "Non-Maturity Shares and Balance Sheet Risk"**  
<http://www.ncua.gov/Resources/Documents/LCU2003-11.pdf>
13. **03-CU-15, September 2003, "Real Estate Concentrations and Interest Rate Risk Management"**  
<http://www.ncua.gov/Resources/Documents/LCU2003-15.pdf>

14. **NCUA's Examiner's Guide (Chapter 13 - ALM)**  
<http://www.ncua.gov/Legal/GuidesEtc/ExaminerGuide/chapter13.pdf>
15. **NCUA’s Financial Performance Report ("FPR") User's Guide and FPR Ratios formula guide**  
<http://www.ncua.gov/Legal/GuidesEtc/FPRGuides/UsersGuideFPR.pdf>

**NCUA’s published Guidance on Liquidity Management:**

16. **NCUA” Letter to Credit Unions 10-CU-14 Strengthening Funding and Liquidity Risk Management:** <http://www.ncua.gov/Resources/Pages/LCU2010-14.aspx>
17. **FFIEC Interagency Policy Statement on Funding and Liquidity Risk Management (Mar 2010):**  
<http://www.ncua.gov/Resources/Documents/LCU2010-14Encl.pdf>
18. **Letter to Credit Unions No. 02-CU-05, *Examination Program Liquidity Questionnaire*:**  
<http://www.ncua.gov/Resources/Documents/LCU2002-05.pdf>,

**NCUA’s published Guidance on Concentration Risk Management:**

19. **NCUA Supervisory Letter on Concentration Risk (Mar 2010):**  
<http://www.ncua.gov/Resources/Documents/LCU2010-03Encl.pdf>

## **Risk Disclosures:**

When executing a sell-buy transaction, the sale may result in a capital gain or loss. Once the replacement security has been purchased, the subsequent sale of that security prior to its maturity may cause an additional capital gain or loss, and may influence performance and total return of the transaction. Before executing any transaction, the investor should understand all of the relevant risks associated with the transaction. Investing in securities contains risks, including but not limited to market risk, interest rate risk, prepayment/extension risk, and credit risk. For all types of debt securities, the sale prior to maturity may cause a principal gain or loss.

### **Interest Rate Risk/Market Risk:**

The market price of the securities may move higher or lower depending on the prevailing market conditions and interest rates. The market value of debt securities will be inversely affected by movements in interest rates. When interest rates increase, market prices of existing securities will fall as these securities become less attractive to investors when compared to higher coupon new issues. When interest rates decrease, market prices on existing securities tend to increase because these securities become more attractive when compared to newly issued bonds with lower coupon rates. Sale of the bonds prior to maturity may cause a principal gain or loss.

### **Credit Risk:**

Credit Risk is the ability or perceived ability of the issuer of a debt security to make all principal and interest payments, in full, and on time. In addition, changes in the law or regulations or the upgrade or downgrade of the issuer's credit rating or other financial disclosures may have an impact on the market price of the bonds in the market. Sale of the bonds prior to maturity may cause a principal gain or loss.

### **Prepayment Risk:**

For securities purchased at a premium (e.g. the price paid for the security was higher than the principal value), the risk that the principal will be paid back to the investor faster than expected which will result in a yield to maturity lower than expected. For amortizing investments:

- o If actual prepayment speeds are faster than projected prepayment speeds, there will be a shorter average life and a decrease in the yield to maturity.
- o If actual prepayment speeds are slower than projected prepayment speeds, there will be a longer average life and an increase in the yield to maturity.

Generally, prepayment speeds on amortizing securities tend to accelerate in a declining interest rate environment. The payment of principal before it is expected may cause the reinvestment into a lower interest rate environment.

### **Extension Risk:**

For securities purchased at a discount (e.g. the price paid for the security was lower than the principal value), the risk that the principal will be paid back to the investor slower than expected which will result in a yield to maturity lower than expected. For amortizing investments:

- o If actual prepayment speeds are faster than projected prepayment speeds, there will be a shorter average life and an increase in the yield to maturity.
- o If actual prepayment speeds are slower than projected prepayment speeds, there will be a longer average life and a decrease in the yield to maturity.

Generally, prepayment speeds on amortizing securities tend to decelerate in a rising interest rate environment. The payment of principal later than expected may reduce the opportunity for reinvestment into a higher interest rate environment.

For additional information detailing these risks please go to [www.1empire.com/disclosures.html](http://www.1empire.com/disclosures.html)

A Glossary of financial terms can be found here: <http://www.finra.org/investors/investmentchoices/bonds/smartbondinvesting/glossary/>



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