BOARD ACTION MEMORANDUM

TO: NCUA Board

DATE: June 18, 2015

FROM: Larry Fazio – Director
Office of Examination and Insurance

SUBJECT: Federal Credit Union (FCU)
Loan Interest Rate Ceiling

ACTION REQUESTED: Board approval to maintain the current 18 percent interest rate ceiling for loans made by federal credit unions through March 10, 2017

DATE ACTION REQUESTED: June 18, 2015

NCUA OFFICES CONSULTED: Office of General Counsel, Office of Small Credit Union Initiatives, and Office of Public and Congressional Affairs

EXTERNAL PARTIES CONSULTED: Board of Governors of the Federal Reserve System, Department of the Treasury, House Committee on Financial Services, and Federal Deposit Insurance Corporation and Senate Committee on Banking, Housing and Urban Affairs

VIEWS OF OTHER OFFICES AND PARTIES CONSULTED: Concur

BUDGET IMPACT, IF ANY: None

SUBMITTED TO THE INSPECTOR GENERAL FOR REVIEW: Yes

RESPONSIBLE STAFF MEMBERS: J. Owen Cole, Director, E&I Division of Capital and Credit Markets (DCCM); John G. Nilles, Senior Capital Markets Specialist, E&I Division of Capital and Credit Markets (DCCM)

BACKGROUND: Congress established a 12 percent interest rate ceiling for loans made by federal credit unions in 1934. In March 1980, the Depository Institutions Deregulation and Monetary Control Act raised the interest rate ceiling to 15 percent and authorized further increases at NCUA Board discretion for periods not to exceed 18 months provided: (1) money-market interest rates had risen in the preceding six months; and (2) disintermediation threatened the credit-union industry.

NCUA has since defined the second criteria as general trends in interest rates that threaten the safety and soundness of the credit union industry, as evidenced by adverse trends in growth, capital, liquidity and earnings. In December 1980 the NCUA Board voted to raise the ceiling to 21 percent. In May 1987, the ceiling was reduced to the current level of 18 percent.

The 18 percent interest rate ceiling applies to all federal credit union lending, excepting originations under the Payday Alternative Loans program. The current limit on PALs is 28 percent, which is determined by adding 1,000 basis points to the interest rate ceiling set by the Board. The maximum allowable rate on PALs would fall to 15 percent if the interest rate ceiling reverts to the limit specified by the Federal Credit Union Act.

A reduction in the interest rate ceiling could affect a large number of FCUs and the volume of FCU loans. A significant number of FCUs in all asset-size cohorts do some lending at rates above 15 percent. The percentage of FCUs that make such loans rose from 36.01 percent in the third quarter of 2006 to 64.53 percent in the first quarter of 2015. The average interest rate on such loans was 17.09 percent.

Interest rates on credit cards offer another perspective on potential exposure (see Attachment 1, Figure 2). As of May 2015, the average rate nationwide (across all issuers, not just credit unions) was 14.92 percent, while the average rate on cards for substandard credit was 22.73 percent. Reducing the interest rate ceiling to 15 percent would prevent FCUs from providing credit cards to borrowers with lower-than-average credit scores.

Just as importantly, a reduction in the interest rate ceiling could limit low-income borrowers' access to credit. As of the first quarter of 2015, 47.9 percent of FCUs that make loans with an interest rate higher than 15 percent were formally designated as providers of financial services to low-income communities. Of the low-income FCUs that make loans with an interest rate higher than 15 percent, 44.1 percent charged average rates higher than 17 percent. An adverse shock to loan profitability could result in low-income credit unions reducing lending to preserve safety and soundness.

Moreover, a reduction in the interest rate ceiling would remove an effective alternative to costly payday loan products. The number of federal credit unions offering Payday Alternative Loans (PALs) that meet NCUA regulatory standards increased from 386 (March 2011) to 536 (March 2015). Average PAL balances outstanding at FCUs have grown from $13.5 million (March 2012) to $29.7 million (March 2015). A reduction to the statutory 15 percent interest rate would render PALs no longer feasible for FCUs that could no longer recover the costs of the program. As a result, consumers with the greatest need for credit unions' services would likely fall prey to predatory payday loan programs.

CASE FOR RECOMMENDED ACTION: Trends in money-market rates and the condition of credit unions justify extension of the current 18 percent interest rate ceiling on FCU loans. The recent trend in short-term money market rates is upward (see Attachment 1, Figure 3).[1] The market expectation for the path of short-term rates is also evident in the shape of the Treasury yield curve which remains steeply upward sloping (see Attachment 1, Figure 4)[2].

[1] The term "money market" is traditionally reserved for debt instruments that have a maturity of one year or less.
[2] Along the Treasury yield curve, the rate for a maturity of "n" years has two components: the expected path of short-term rates between now and year "n," and a premium to compensate for the additional interest-rate and liquidity risk of longer-term instruments. Absent "flights to quality," these risk premia do not change much over time. The recent increase in yields for 6+ month maturities reflects market expectations of rising rates.

In a rising-rate environment, any reduction in the interest rate ceiling could impair the earnings of FCUs reliant on loans with interest rates higher than 15 percent. In a competitive market, loan demand and supply determine the interest rate and loan volume. Imposing an interest rate ceiling below the market rate will shrink loan volume. Interest income on loans is the product of rates and volume; a binding ceiling will reduce both.

Net interest income (NII) – a key driver of credit-union earnings – currently benefits from a steep yield curve. The April 2015 term spread is 192 basis points (see Attachment 1, Figure 4); the average term spread between 1982 and 2007 was 168 basis points. When the term spread returns to normal levels, NII will come under pressure. A reduction in the interest rate ceiling could add to this pressure. At the same time, FCUs may be forced to keep share rates low, which could cause disintermediation and lead to liquidity concerns.

A significant number of FCUs depend on loans with interest rates that would be affected by any reduction in the interest rate ceiling. As stated above, the percentage of FCUs that make such loans rose from 36.01 percent in the third quarter of 2006 to 64.53 percent in the first quarter of 2015.

Staff are prepared to advise the Board to reconsider the recommended action at any time interest rates or economic conditions warrant.

RECOMMENDED ACTION: The Board approve an 18 percent maximum loan interest rate for federal credit unions, effective September 10, 2015 through March 10, 2017.

ATTACHMENTS

1. Summary of Credit Union and Interest Rate Statistics
2. Supplemental Information

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