BOARD ACTION MEMORANDUM

TO: NCUA Board

DATE: July 19, 2012

FROM: Larry Fazio – Director, Office of Examination & Insurance

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

ACTION ITEM: Board approval to: 1) continue the current 18 percent ceiling for loans made by federal credit unions, effective September 11, 2012 through March 10, 2014; and 2) issue notice to all federal credit unions of its determination in a Letter to Federal Credit Unions.

ACTION DATE: July 24, 2012

OTHER OFFICES CONSULTED: *NCUA Offices* – Office of General Counsel; Office of Small Credit Union Initiatives; and Office of Public and Congressional Affairs. *External Parties* – Board of Governors of the Federal Reserve System; Department of the Treasury; House Committee on Financial Services; and Senate Committee on Banking, Housing and Urban Affairs

VIEWS OF OTHER OFFICES CONSULTED: Concur

BUDGET IMPACT, IF ANY: None

SUBMITTED TO THE INSPECTOR GENERAL FOR REVIEW: Yes

RESPONSIBLE STAFF MEMBERS: J. Owen Cole, Director, Division of Capital and Credit Markets (DCCM); Jeremy F. Taylor, Senior Capital Markets Specialist, Division of Capital and Credit Markets (DCCM).

BACKGROUND: Congress set a 12 percent interest-rate ceiling for Federal credit-union loans in 1934. In March 1980, the Depository Institutions Deregulation and Monetary Control Act raised that 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. The NCUA has since defined the second criteria as general trends in interest rates that threaten safety-and-soundness – 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 interest-rate ceiling applies to all federal credit union lending, excepting originations under the short-term small loan program. The current limit on short-term small loans is 28 percent. This exceptional limit is any interest rate ceiling set by the Board plus 1,000 basis points. However, if the ceiling reverts to the limit specified by the Federal Credit Union Act, then the maximum allowable rate on short-term small loans will also fall to 15 percent.[1]

A reduction in the loan-interest ceiling could affect a large number of FCUs and volume of FCU loans. A significant number of FCUs in all asset-size cohorts do some lending at rates above 15 percent. In fact, the percentage of FCUs making such loans rose from 52.6 percent in 2006:Q3 to 61.44 percent in 2012:Q1. [See Attachment 1, figure 1.] The average interest rate on such loans was 16.97 percent, and 40.5 percent of those lenders charged rates averaging above 17 percent. Moreover, the ratio of unsecured FCU loans to total assets – a measure of potential exposure to a ceiling reduction – was 6.47 percent.

Interest rates on credit cards offer another perspective on potential exposure. [See Attachment 1, Figure 2.] Average rates nationwide (across all issuers, not just credit unions) were 18.72 percent in March 2012 while rates for borrowers with substandard credit were well above 18 percent.[2]

Even more important, a reduction in the ceiling could limit access of low-income borrowers to credit. As of 2012:Q1, nearly 22 percent of FCUs making 15-to-18 percent loans had formal designation as providers of financial services to low-income communities (compared with 16.6 percent of all federally insured credit unions). Roughly 39 percent of the low-income FCUs making 15-to-18 percent loans charged average rates above 17 percent. An adverse shock to loan profitability could lead low-income credit unions to reduce lending to preserve safety-and-soundness.

CASE FOR RECOMMENDED ACTION: Trends in money-market rates and credit-union condition justify extension of the 18-percent interest-rate ceiling on FCU loans but do not justify an increase.

Some money-market rates are lower than six months ago, but the recent trend in short-term treasury rates and the Fed Funds rate is upward.[3] [See Attachment 1, Figure 3.] The Fed Funds rate – an anchor rate in the money market – rose from 0.08 to 0.16

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1. Short-term small loans represent an effective alternative to costly payday loan products. The number of credit unions offering short-term small loans more than doubled to 386 institutions since March 2011. Average short-term small loan balances outstanding at FCUs between December 2011 and March 2012 reached $13.5 million. The number of short-term small loans outstanding has increased at an annual rate of 40 percent and reached approximately 39,000 short-term small loans outstanding as of March 2012. A reduction to the statutory 15 percent level would make the short-term small loan program 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 more likely fall prey to predatory payday loan programs.

2. Average credit-card rates for all classes of borrowers are also up from levels six months ago.

3. Traditionally, the term "money market" is reserved for debt instruments with maturities of one-year or less. A basis point is 1/100th of a percentage point.

percent between November 2011 and May 2012.[4] From November 2011 to May 2012, the yield on one-month Treasuries increased from 0.00 to 0.07 percent. Three-month Treasuries increased by from 0.01 to 0.09 percent over the same period; six-month Treasuries increased from 0.05 to 0.15 percent; one-year Treasuries increased from 0.11 to 0.19 percent. The likely path of short-term rates is also evident in the slope of the Treasury yield curve which remains steep.[5] [See Attachment 1, Figure 4.]

In a rising-rate environment, any reduction in the ceiling could impair the earnings of FCUs reliant on 15-to-18 percent loans. In a competitive market, loan demand and supply determine the interest rate and loan volume. Imposition of a ceiling below the market rate will shrink loan volume. Interest income on loans is the product of rates and volume; a binding ceiling reduces both.

Net interest income (NII) – a key driver of credit-union earnings – currently benefits from a steep yield curve. The April 2012 term spread of 214 basis points substantially exceeded the average term spread of 168 basis points in the period 1982-2007. When the term spread returns to normal levels, NII will come under pressure. Reduction in the loan-interest ceiling could add to that pressure. At the same time, credit unions may be forced to keep share rates low which could cause disintermediation and lead to liquidity concerns.

Moreover, a significant number of FCUs depend on loans with interest rates that would be affected by any reduction in the ceiling. Indeed, as of 2012:Q1, 98 FCUs had volumes of 15-18 percent loans exceeding 10 percent of assets. These credit unions have less opportunity to replace lost earnings by diversifying across geographic or product lines because of relatively small size. Median asset size was $4.02 million (compared with a median for all federally insured credit unions of $17.33 million).

RECOMMENDED ACTION: The Board approve an 18-percent maximum loan interest rate for federal credit unions, effective September 11, 2012 through March 10, 2014.

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

ATTACHMENTS

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

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4. The Fed Funds rate is the rate of interest on unsecured very short-term (usually overnight) loans of excess reserves to U.S. financial institutions. The Federal Reserve uses the funds rate as a policy target. The target range for the funds rate has been 0-to-25 basis points since December 2008 as part of Federal Reserve policy to stimulate the macro-economy.
5. Along the Treasury yield curve, the rate for a maturity of "n" years has two components: (i) the expected path of short-term rates between now and year "n" and (ii) 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. So the recent increase in yields for 6+ month maturities reflects market expectations of rising rates. Historically, the bulk of movements in nominal rates has been traceable to changes in expected inflation.

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