BOARD ACTION MEMORANDUM

TO: NCUA Board **DATE:** February 10, 2011

FROM: J. Owen Cole, Jr. – Director, Office of Capital Markets (OCM) **SUBJECT:** Federal Credit Union (FCU) Loan Interest-Rate Ceiling

---

ACTION ISSUE: The 18-percent interest-rate ceiling on FCU loans expires March 10, 2011. Absent Board action, the ceiling will revert to 15 percent – the default setting under the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). If the ceiling reverts, the maximum permissible rate for short-term, small-dollar loans (STS) will also fall to 15 percent. Accordingly, the Board must determine whether continuation of a general interest-rate ceiling for FCU loans above 15 percent is warranted and, if so, what specific rate is appropriate.

ACTION DATE: February 17, 2011

OTHER OFFICES/PARTIES CONSULTED: *NCUA Offices* – Office of the Chief Economist; Office of Examination and Insurance; 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

SUBMITTED TO THE INSPECTOR GENERAL FOR REVIEW: Yes

BUDGET IMPACT, IF ANY: None

RESPONSIBLE STAFF MEMBERS: Mark D. Vaughan, Director – Division of Capital Markets (OCM); Dale T. Klein, Senior Capital Markets Specialist (OCM)

***

BACKGROUND: Congress set a 12-percent interest-rate ceiling for Federal credit-union loans in 1934. In March 1980, DIDMCA 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 STS program. The current STS limit is 28 percent (any FCU interest-rate ceiling above 15 percent plus 1,000 basis points) and will so remain if the Board extends the 18-percent general FCU ceiling. As noted, however, if the general ceiling reverts to 15 percent, the maximum allowable STS rate will also fall to 15 percent.

Reconsideration of the FCU ceiling takes place at a challenging time for credit unions. The financial crisis-cum-recession of 2007-09 left the industry in weaker-than-normal condition. Year-over-year loan growth as of September 30, 2010 (2010:Q3) was -1.50 percent, compared with 8.37 percent in September 30, 2006 (2006:Q3). Supervisory ratings tell a similar story. The average CAMEL rating – along with every component rating – was weaker in 2010:Q3 than 2006:Q3.[1]

A reduction in the loan-interest ceiling could affect a large number of FCUs and volume of FCU loans. Average holdings of 15-to-18 percent loans are quite small (0.84 percent of the assets of institutions making such loans, as of 2010:Q3), but a significant number of FCUs in all asset-size cohorts do some lending at rates above 15 percent.[2] [See figure 1 on page 5] The average interest rate on such loans was 16.8 percent, and 31.8 percent of 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 nearly 8 percent. Interest rates on credit cards offer another perspective on potential exposure. [Please see figure 2 on page 5.] Average rates nationwide (across all issuers, not just credit unions) were just under 15 percent in January 2011 while rates for borrowers with substandard credit were well above 18 percent.[3]

Even more important, a reduction in the ceiling could limit access of low-income borrowers to credit. As of 2010:Q3, nearly 20 percent of FCUs making 15-to-18 percent loans had formal designation as providers of financial services to low-income communities (compared with 12.8 percent of all federally insured credit unions). Loans at 15-to-18 percent interest came to roughly 1.6 percent of institution assets – nearly twice the average ratio for FCUs making such loans. Roughly 35 percent of the low-income FCUs making 15-to-18 percent loans charged average rates above 17 percent. Finally, the average CAMEL rating of the low-income FCUs making 15-to-18 percent loans was weaker than that of other FCUs involved in such lending. An adverse shock to loan profitability could lead low-income credit unions to reduce lending to preserve safety-and-soundness.

***

1. The latest available call-report data are as of 2010:Q3. CAMEL ratings as of the same quarter were used for consistency. More recent CAMEL ratings are also weaker than 2006:Q3.
2. These figures exclude loans made through the STS program. The number of FCUs making non-STS 15-to-18 percent loans has not changed appreciably in recent years. The increase in the percentage of FCUs making such loans rose from 52.6 percent in 2006:Q3 to 59.8 percent in 2010:Q3 because of a decline in the overall number of FCUs from mergers and failures.
3. Average credit-card rates for all classes of borrowers are also up from levels six-months ago.

CASE FOR RECOMMENDED ACTION: Trends in money-market rates and credit-union condition do justify extension of the 18-percent interest-rate ceiling on FCU loans but do not justify an increase. A higher ceiling is not justified because money-market rates have not risen from since summer 2010. [See figure 3 on page 6.]

Money-market rates are lower than six months ago, but the recent trend is upward.[4] The Fed funds rate – an anchor rate in the money market – has hovered around 19 basis points for nearly a year, but other short- and intermediate-term rates began to climb in the fourth quarter on market concerns about inflation.[5] These rates are good barometers of the likely path of money-market rates. From November to December 2010, for example, 3-month LIBOR rose from 0.2865 percent to 0.3026 percent.[6] Meanwhile, the average rate on six-month negotiable certificates-of-deposit climbed from 6 basis points to 0.41 percent. From October to December 2010, the yield on one-year Treasuries increased from 0.23 to 0.29 percent. The likely path of short-term rates shows up even more clearly in the Treasury yield curve.[7] [See figure 4 on page 6.] Between September and December 2010, the yield on five-year U.S. Treasuries jumped from 75 basis points to 1.93 percent.

In a rising-rate environment, any reduction in the ceiling could impair the earnings of FCUs reliant on 15-to-18% 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.[8]

---

4. 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.
5. 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.
6. The (L)ondon (I)nter(B)ank (O)ffered (R)ate is the rate on unsecured loans to depository institutions in the U.K.
7. 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.
8. Between December 1982 and November 2007 – the so-called "Great Moderation" – the difference between yields on 3-month and 10-year Treasuries (the term spread) averaged 168 basis points. In March 2005, the term spread last equaled this long-term average. The table below uses income-statement data from 2005:Q1 (a "normal" period) to demonstrate the importance of loan interest to total interest income, total interest income to net interest income, and net interest income to net income (earnings).

NET INCOME COMPONENTS	2005:Q1 AMOUNT
Net Interest Income	$ 5,424,153,732
Net Non-Interest Income	$ (3,321,515,039)
Provision for Loan Losses	$ (553,928,125)
NET INCOME	**$ 1,548,710,568**
NET INTEREST INCOME COMPONENTS	**2005:Q1 AMOUNT**
Total Interest Income	$ 7,912,486,725
Total Interest Expense	$ (2,488,332,993)
NET INTEREST INCOME	**$ 5,424,153,732**
INTEREST INCOME COMPONENTS	**2005:Q1 AMOUNT**
Net Interest from Loans	$ 6,438,351,415
LOAN INTEREST / TOTAL INTEREST INCOME	**81.4%**

Net interest income (NII) – a key driver of credit-union earnings – currently benefits from an unusually steep yield curve.[9] Indeed, the December term spread of 315 basis points exceeded the spread in 85 percent of the months between December 1982 and December 2010. When the term spread returns to normal levels, NII will come under pressure. Reduction in the loan-interest ceiling could add to that pressure.

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 2010:Q3, 122 FCUs had volumes of 15-18 percent loans exceeding 10 percent of assets. Moreover, these institutions were not as safe-and-sound as other credit unions. Indeed, at year-end, they posted an average CAMEL of 2.66 (earnings or "E" rating of 2.57) – compared with 2.19 for all federally insured credit unions ("E" rating of 2.45). Finally, these credit unions have less opportunity to replace lost earnings by diversifying across geographic or product lines because of relatively small size.[10] Indeed, median asset size was $2.99 million (compared with a median for all federally insured credit unions of $17.37 million), and the management supervisory rating was 2.71 (compared with 2.29 for all federally insured credit unions).

***

RECOMMENDED ACTION: OCM recommends the Board approve an 18-percent maximum loan interest rate for federal credit unions, effective March 10, 2011 through September 10, 2012.

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

9. As noted, the average term spread from December 1982 to November 2007 was 168 basis points. In only 15 percent of months since December 1982 has the term spread been higher than its current level.

10. Another potential obstacle to loan diversification is the macroeconomic environment – 33 of the 122 FCUs operate in states with unemployment above the national average (November 2010 figures).

Figure 1 shows the importance of lending at 15-to-18 percent rates across FCUs. The average 15-to-18 percent lender is larger than the average federally insured credit union, but 15-to-18 percent lending is important to all FCU asset cohorts.

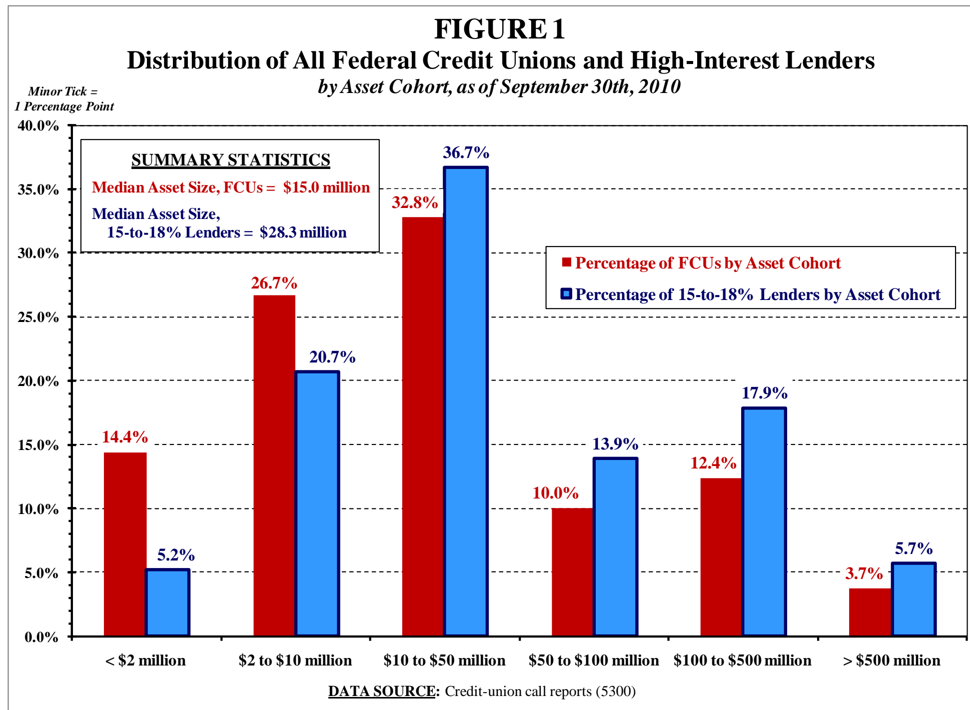

Figure 2 shows another measure of potential credit-union exposure to a reduction in the FCU loan-interest ceiling – credit-card interest rates. Average rates nationwide (across all issuers, not just credit unions) were just under 15 percent in January 2011 while rates for borrowers with substandard credit were well above 18 percent. Moreover, rates across all classes of borrowers have increased over the past six months.

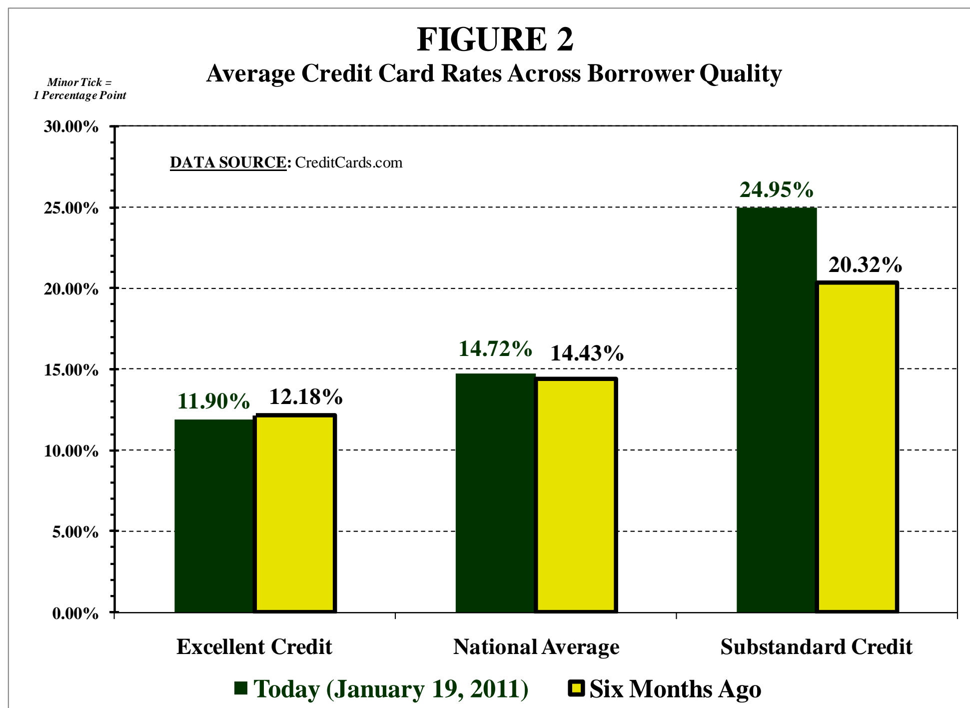

Figure 3 depicts the recent path of money-market interest rates. Although rates are lower than six months ago, the recent trend is upward. The Fed funds rate – a anchor in money market – has hovered around 19 basis points for nearly a year, but other short- and intermediate-term rates began to climb late last year on market concerns about inflation. These rates are good barometers of the likely path of money-market rates.

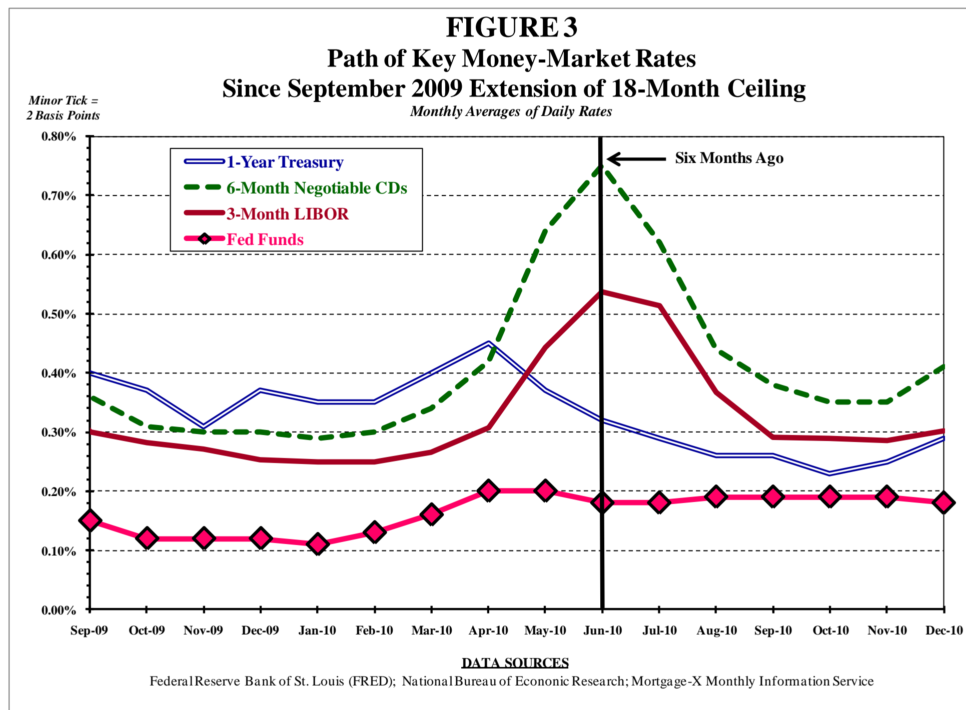

Figure 4 shows recent changes in the shape of the Treasury yield curve. Shifts in the curve could be caused by changes in the expected path of short-term rates or interest-rate/liquidity risk premia on longer-term instruments. These risk premia do not change much over time, so recent increases in yields for 6+ month maturities reflect expectations of rising rates. These expectations, in turn, are traceable to market concerns about inflation.