NCUA
National Credit Union Administration

CDRLF Loan Interest Rate Policy

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Purpose

The purpose of this information is to clarify the policies that govern the interest rate on loans made through the Community Development Revolving Loan Fund (CDRLF) program. Any changes to the CDRLF loan interest rate policy, such as rate changes, shall be distributed to the National Credit Union Administration (NCUA) Board and Office of the Executive Director prior to implementation or announcement.

Authority

According to NCUA Rules and Regulations § 705.5(d), the NCUA Board will announce changes, if any, to the CDRLF loan interest rate policy. The NCUA Board has delegated authority to determine interest rates on CDRLF loans to the Office of Credit Union Resources and Expansion (CURE) Director via NCUA Delegation of Authority, Special Activities 21 (SPE21).

Objectives

The primary objective of the CDRLF program is to support credit unions that serve communities with borrowers that have difficulty obtaining affordable financial products and services. To fulfill this goal, CURE provides low-cost loans to qualified credit unions that support the people in these communities.

CURE aims to maximize the deployment of available loan funds so the CDRLF program can support more qualified credit unions serving millions of members experiencing difficult financial circumstances. CURE also tries to ensure that the program policies and characteristics are appropriate given market conditions, cost considerations, and the strategic goals of the agency.

Internal Controls

This policy institutes internal controls to ensure that the appropriate interest rate is applied to each CDRLF loan issued by CURE. Internal controls include the separation of duties among the following:

- staff that analyze the interest rate (CDRLF loan and grants manager),
- staff that approve the interest rate (CURE Director),
- staff that approve CDRLF loan applications (CURE Deputy Director), and
- staff that control the accounting function (NCUA's Office of the Chief Financial Officer).

At every point of the loan approval process, the interest rate is confirmed by the reviewer.

Interest Rate Factors

The following factors are considered when determining the interest rate on CDRLF loans.

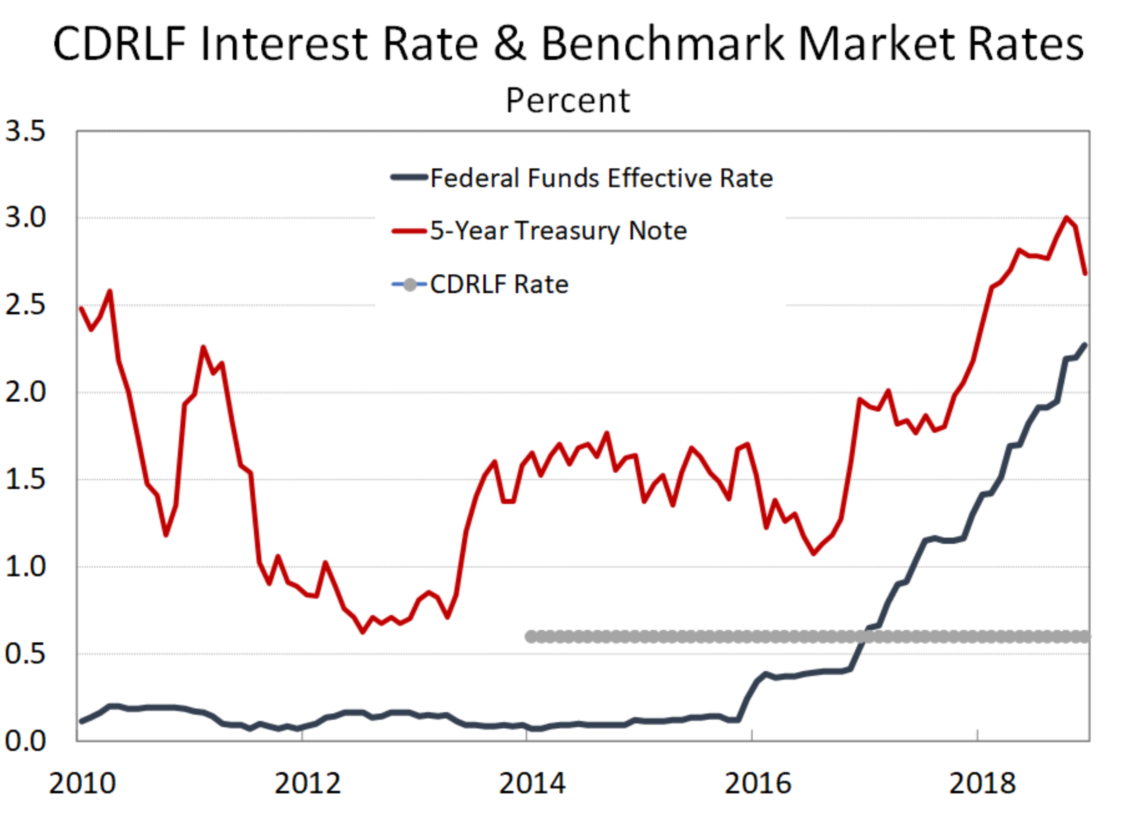
- **Competitive Offerings**
  Alternative funding opportunities for potential CDRLF loan recipients.
- **Demand for Loanable Funds**
  Behavior of previous CDRLF loan recipients and the quantity of loans demanded.
- **Opportunity Costs**
  Credit risk and potential income from alternative investments in relation to the resources available to the CDRLF.
- **Strategic Goals**
  Agency goals, as well the goals of CURE and the CDRLF program.

Analysis of Each Factor

This section seeks to explain CURE's January 2019 analysis of each interest rate factor. On balance, the factors support the need for an increase in the CDRLF interest rate over the rate that was in effect prior to January 2019. The considerations for each factor are described below.

Competitive Offerings
The federal funds rate is the interest rate at which depository institutions lend reserve balances to other depository institutions overnight, on an uncollateralized basis. In a sense, such funds are an alternative source of financing for some types of credit union operations. In evaluating the appropriateness of the CDRLF rate, it is reasonable to take into account the interest rate for this "competing" option.

The chart below shows the time trend in the federal funds rate and compares it to the CDRLF rate. Also shown is the five-year U.S. Treasury Note rate, the relevance of which will be discussed later.



The chart makes it clear that the federal funds rate has risen sharply over the last several years, with no corresponding change in in the CDRLF rate (which has remained constant since 2014).

<u>*Demand for Loanable Funds*</u>
Although demand for CDRLF funds in recent years has been somewhat modest, the program generally has been popular. As of September 30, 2018, the ratio of total CDRLF loans outstanding to total loan appropriations was 73 percent[1]. The availability of remaining funds for disbursement is thus somewhat limited.

Given the recent increases in market interest rates, CDRLF fund demand could be extreme this year barring any changes in the CDRLF rate. Indeed, without a response, there may be a risk that the program could run out of available funds for qualified credit unions. To mitigate that risk somewhat, it would seem reasonable to increase the CDRLF rate.

<u>*Opportunity Costs*</u>[2]

[1] See Appendix: Section 3
[2] The information used to calculate the Opportunity Costs is located in the Appendix: Section 4.

The NCUA is authorized to invest idle CDRLF funds in Treasury securities. Thus, the interest rate on Treasury securities acts as an "opportunity cost" for the NCUA. Given the typical duration of CDRLF loans, the interest rate on the five-year Treasury note is an appropriate rate for evaluating the potential income that the NCUA might earn in *lieu* of lending the CDRLF funds.

The chart above shows the time trend in interest rates paid on five-year treasury notes (the so-called "constant maturity" rate, in particular). The graph plainly displays a dramatic rise in the opportunity cost, with an increase in the five-year Treasury rate of more than one percentage point over the last several years.

As of September 30, 2018, the balance of idle CDRLF funds totaled $3,632,179. If the NCUA were to invest this portion in a Treasury security with a similar maturity to the CDRLF loans being made, the annual interest earned would equal $106,786. In comparison, if the NCUA were to loan out the balance of idle CDRLF funds to credit unions at the current CDRLF interest rate (0.60 percent) then annual interest earned would equal $21,793. As a result, the opportunity cost of keeping the CDRLF interest rate at 0.60 percent is $84,993.

Strategic Goals
The NCUA Strategic Plan 2018 – 2022[3] outlines how the agency will continue creating an environment that allows credit unions to better serve their members while maintaining safety and soundness of the system. The strategies that specifically align with the objectives of CURE and the CDRLF program include the following:

- Support credit unions in their efforts to offer essential products and services.
- Promote the value of diversity and inclusive financial services in credit unions.
- Support the success of small credit unions through grants and loans.

While it is difficult to quantify a specific interest rate that best supports each of these, a modest increase in the CDRLF rate does not in any way hinder the achievement of these goals.

Policy Action

Final Policy Recommendation
CURE's policy is to set the interest rate at a level that helps credit unions subsidize the expenses associated with delivering higher quality financial products and services to low-income members.

[3] The URL link for the NCUA Strategic Plan 2018 – 2022.

After evaluating developments in market interest rates and balancing the factors discussed above, CURE believes increasing the interest rate is a reasonable course of action. Increasing the rate to 1.50 percent will appropriately respond to increases in the federal funds rate and the five-year Treasury rate, while ensuring that the CDRLF continues to be an attractive financing option for qualified credit unions.

Final Policy Decision

In view of each contributing factor addressed in this policy, the CURE Director decided to increase the CDRLF interest rate by 90 basis points, to 1.50 percent. This rate will be effective 30 days from the CDRLF Notice of Funding Opportunity (NOFO) for loans being posted in the Federal Register.

Martha J Ninichuk, CURE Director

Appendix: Pricing Strategy and Other Calculations

This section highlights the data and figures used to determine the appropriate pricing strategy and other calculations referenced in this policy. All of the rates used in this section will be the effective rate as of September 30, 2018, unless specifically classified as an "anticipated rate" at a future date. The areas computed in this section include the *Competitive Offerings, Demand for Loanable Funds, Opportunity Costs, and the Final Policy Recommendation and Decision.*

Section 1. Definitions

1. **Benchmark Treasury Security Rate**: The yield on a Treasury security to its time to maturity. This rate is also commonly referred to as "CMT". The yield is interpolated by the Treasury from the daily yield curve. It is based on the closing market bid yield on actively traded Treasury securities. CURE uses the five-year maturity for this policy because this duration is similar to the length of CDRLF loans.
2. **CDRLF Interest Rate**: The interest rate and subsidy level at which qualified credit unions can borrow Federal funds to accomplish CDRLF program goals and objectives.
3. **Federal Funds Rate**: The interest rate at which depository institutions lend reserve balances to other depository institutions overnight. The FOMC establishes the target range for this rate.
4. **Program Need/Discount Rate**: The rate or discount that CURE may opt to use to adjust the CDRLF interest rate whenever a program need is necessary. This refers to an adjustment being made as a result of the holistic analysis and considerations of each interest rate factor in this policy.

Section 2. Competitive Offerings Calculation

Upward pressure on the Federal Funds rate steadily diminished in late 2018 and into January 2019. While the Fed's target range was originally expected to rise throughout 2019, recent indications from the Fed suggest that the current target range of 2.25-2.50 percent is a reasonable forecast for the indefinite future.

Section 3. Demand for Loanable Funds Calculation

As of September 30, 2018, the figures for the CDRLF's loan portfolio equal the dollar amounts outlined below.

- Total CDRLF Loan Appropriation = $13,387,777
- Total CDRLF Loans Outstanding = $9,755,598
- Available Loan Balance = $3,632,179
- 2018 Loan Maturities (Cash Flow from Future Payoffs) = $0

The calculation used to determine the ratio of total CDRLF loans outstanding to the total CDRLF loan appropriation is spelled out below. Total CDRLF loans outstanding to the total CDRLF loan appropriation equals 73%.

$$73 \text{ percent} = \frac{((\$13{,}387{,}777) - (\$0 + \$3{,}632{,}179))}{\$13{,}387{,}777}$$

Section 4. Opportunity Costs Calculation

The opportunity cost of keeping the CDRLF interest rate at 0.60 percent compared to investing idle CDRLF funds in a Treasury security is outlined below.

- Available Loan Balance (Idle CDRLF funds) = $3,632,179
- Benchmark Treasury Security Rate = 2.94 percent[4]
- Current CDRLF Interest Rate = 0.60 percent

Table 1.

Description	Formula	Result
This is the amount of interest that will be earned on idle CDRLF funds if the NCUA were to invest this amount in a benchmark Treasury security with similar maturity.	$3,632,179 x 2.94% =	$106,786
This is the amount of interest that will be earned on idle CDRLF funds if the NCUA were to loan out the remaining amount at 0.60 percent.	$3,632,179 x 0.60% =	$21,793
This is the difference between the amount of interest NCUA can earn investing in Treasury securities and the amount of interest NCUA would earn loaning out funds at 0.60 percent.	$106,786 - $21,793 =	$84,993

Therefore, the opportunity cost of maintaining the CDRLF interest rate at 0.60 percent was $84,993 as of September 2018.

Section 5. Final Policy Recommendation and Decision Calculation

The formulas and calculations used to determine the new interest rate for CDRLF loans is outlined below in Table 2. This rate was determined by considering all of the factors described in this policy.

[4] This rate was obtained from Treasury.gov: https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2018

Table 2.	
Formula	**Result**
Benchmark Treasury Security – Program Need/Discount Rate =	CDRLF Rate

The program need/discount rate that CURE recommends applying to this policy is 1.50 percent. The adjustment level was selected to help CURE maintain an attractive rate for CDRLF loans while reducing the opportunity costs of preserving a 0.60 percent interest rate. This adjustment aims to account for the market fluctuations that are expected to impact the economy.

The interest rate for CDRLF loans will be increased by 90 basis points, to 1.50 percent.

Table 3.			
Benchmark Treasury Security Rate	**Program Need/Discount Rate**	**Result**	**New CDRLF Interest Rate***
2.94	1.50	1.44	1.50

**Rounded the result up to 1.50% for purposes of efficiency.*