



BOARD ACTION MEMORANDUM

TO: NCUA Board **DATE:** January 17, 2014
FROM: Larry Fazio – Director,
Office of Examination & Insurance **SUBJECT:** Federal Credit Union (FCU)
Loan Interest-Rate Ceiling

ACTION ITEM: Board approval to continue the current 18 percent ceiling for loans made by federal credit unions, effective March 11, 2014 through September 10, 2015.

ACTION DATE: January 23, 2014

OTHER OFFICES CONSULTED: NCUA Offices Consulted – 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; Federal Deposit Insurance Corporation 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); John G. Nilles, 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 Payday Alternative Loan (PAL) program. The current limit on PAL loans is 28 percent, if FCUs comply with NCUA's PAL rule limits on loan amounts, fees, terms, and frequency. 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 Payday Alternatives (PAL) 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 62.92 percent in 2013:Q3. [See Attachment 1, Figure 1.] The average interest rate on such loans was 17.06 percent, and 44.7 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 7.65 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 14.98 percent while rates for borrowers with substandard credit were well above 18 percent.

Even more important, a reduction in the ceiling could limit access to credit for low-income borrowers. As of 2013:Q3, nearly 42.6 percent of FCUs making 15-to-18 percent loans had formal designation as providers of financial services to low-income communities. Roughly 48 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 the condition of credit unions 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 is upward.² [See Attachment 1, Figure 3.] From May 2013 to November 2013, the yield on one-month Treasuries increased from 0.01 to 0.05 percent. Three-month Treasuries increased from 0.04 to 0.09 percent over the same period; six-month Treasuries increased from 0.08 to 0.10 percent; one-year Treasuries increased from 0.12 to 0.13 percent.

1. PAL loans represent an effective alternative to costly payday loan products. The number of federal credit unions offering PAL loans has increased since March 2011 from 386 FCUs to 505 as of September 2013. Average PAL balances outstanding at FCUs since March 2012 has grown from \$13.5 million to \$22.4 million as of September 2013. A reduction to the statutory 15 percent level would make the PAL 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. Traditionally, the term "money market" is reserved for debt instruments with maturities of one year or less.

The likely path of short-term rates is also evident in the slope of the Treasury yield curve which remains steep.³ [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 September 2013 term spread of 279 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 2013:Q3, 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. Their 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 approves an 18-percent maximum loan interest rate for federal credit unions, effective March 11, 2014 through September 10, 2015.

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

ATTACHMENTS

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

3. 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 premiums 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 have been traceable to changes in expected inflation. Currently, the curve has steepened due to expectations of a suspension of the “quantitative ease” program by the Federal Reserve.

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