

**Via Electronic Delivery**

July 26, 2019

Mr. Gerard Poliquin,  
Secretary of the Board  
National Credit Union Administration  
1775 Duke Street  
Alexandria, Virginia 22314-3428

RE: Notice of Proposed Rulemaking – Delay of Effective Date of Risk-Based Capital Rules [RIN 3133-AF01]<sup>1</sup>

Dear Mr. Poliquin:

The American Bankers Association (ABA)<sup>2</sup> appreciates the opportunity to respond to the notice of proposed rulemaking (Proposal) from the National Credit Union Administration (NCUA) to delay implementation of NCUA's risk-based capital rules (RBC). NCUA began considering risk based capital in January of 2014. The Proposal would delay the effective date of NCUA's October 29, 2015 final RBC rule (2015 Final Rule)<sup>3</sup>, and NCUA's November 6, 2018 supplemental final RBC rule (2018 Supplemental Rule)<sup>4</sup>, moving the effective date of both rules to January 1, 2022. The 2015 Final Rule was originally scheduled to take effect on January 1, 2019, and the 2018 Supplemental Rule delayed its effectiveness until January 1, 2020.

Very simply, NCUA has not explained why another delay could be necessary, or why it believes credit unions are so ill prepared to do what other types of financial institutions have done for nearly a decade. It also has presented an administrative record which is currently deficient, failing to consider a number of basic points that it must address under the Administrative Procedure Act before this proposal can proceed to a final rule. This is the latest step by NCUA to make their regulations, already documented to be substandard, even worse. Because robust capital cushions are essential protections for Federal insurance funds and U.S. taxpayers, ABA urges NCUA to establish a robust RBC regime and put it into effect without additional delay.

**RBC Principles and Standards Are Well Understood.**

The fundamental elements of risk-based capital policy for insured financial institutions are well understood. The banking industry's experience with risk-based capital policy extends for over three decades, during which its own RBC rules have been refined to balance improved

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<sup>1</sup> 84 *Federal Register* 30,048, June 26, 2019, posted [here](#).

<sup>2</sup> The American Bankers Association is the voice of the nation's \$18 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard nearly \$14 trillion in deposits and extend more than \$10 trillion in loans.

<sup>3</sup> See 80 FR 66,625 (Oct. 29, 2015).

<sup>4</sup> See 83 FR 55,467 (Nov. 6, 2018).

protections with fostering responsible economic growth. The principles of risk-based capital regimes for financial institutions have been refined over this period in a wide variety of economic conditions. This process has yielded valuable insights into financial institution capital policy and offers a roadmap to a robust, risk-sensitive RBC regime.

The banking industry's RBC rules, originated in the late 1980's, were strengthened considerably following the savings and loan crisis with the introduction of "prompt corrective action" (PCA) authority,<sup>5</sup> with further "early remediation powers" added following the financial crisis.<sup>6</sup> These powers permit banking regulators to respond to stressed institutions that have become capital deficient before losses grow to the point of irreversible insolvency. To implement these powers more effectively, the banking regulators have expanded their RBC rules to take account of operational and other risks.

Though NCUA has somewhat similar statutory powers to deal with distressed credit unions,<sup>7</sup> effective implementation depends critically on a robust measurement of credit unions' capital positions, with particular sensitivity to adjustments reflecting risk. The same statutory authority includes a 1998 Congressional mandate requiring NCUA to impose RBC rules on credit unions similar to those that apply to banks, but to date NCUA has failed to do so. While the banking industry's regulators revised and finalized RBC capital rules expeditiously following the financial crisis, including the most recent revisions to the industry's RBC rules in 2014, NCUA has yet to finalize what Congress has required. To protect the Federal insurance resources for which it is responsible, and to promote stability across types of financial institutions, NCUA should have joined the banking agencies in shoring up capital rules to protect against an economic downturn and ensuing losses. The Proposal would extend this delay, even as economic conditions threaten to expose institutions and ultimately the Share Insurance Fund to losses. This is, already, an exercise that comes many years too late.

***Lack of Credit Union RBC Standards Will Leave the Industry Unprepared for Economic Stress.***

As indicators suggest we may be near the peak of the current economic cycle, the two year delay NCUA is proposing is exceptionally significant over *this* two year period. The challenge in establishing an appropriate capital level always is that no one knows when the next downturn may come; prudence suggests the appropriate measure is to hope for the best but plan for the

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<sup>5</sup> Federal Deposit Insurance Corporation Improvement Act (FDICIA) § 131, Pub. L. No. 102-242, 105 Stat. 2236, 2253 (Dec. 19, 1991), available at <https://www.govinfo.gov/content/pkg/STATUTE-105/pdf/STATUTE-105-Pg2236.pdf>.

<sup>6</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) § 313, Pub. L. No. 111-203, 124 Stat. 1376, 1432 (July 21, 2010), available at <https://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf>.

<sup>7</sup> Credit Union Membership Access Act (CUMAA), Pub. L. No. 105-219, 112 Stat. 913, 923 (Aug. 7, 1998), available at <https://www.congress.gov/105/plaws/publ219/PLAW-105publ219.pdf>.

worst. NCUA's RBC rule should be put in place now before any possibility that the economy may weaken.

There are already signs that economic growth could be faltering, both domestically and around the world.<sup>8</sup> Bond market yields have fallen across the board, a historic warning sign. The spread between three-month and ten-year Treasuries became negative two months ago and has remained inverted since, raising serious concerns, given that such inversions have been reliable predictors of recessions in the past.<sup>9</sup> The Federal Reserve Bank of New York's model for the probability of a recession occurring in the next 12 months registered a reading of 32.9 percent in June, the highest level since 2008.<sup>10</sup> The pace of job growth has slowed from the end of 2018, as the monthly change in nonfarm payrolls has declined on both a three-month moving average and 12-month moving average basis.<sup>11</sup> Similarly, wage growth has also decelerated from a high of 3.4 percent year-over-year in January to 3.1 percent in June.<sup>12</sup> There are also signs that employees are feeling more hesitant about changing jobs, as evidenced by a quits rate that has plateaued and has remained unchanged at 2.3 percent for the past 12 months.<sup>13</sup>

In addition, the manufacturing sector, both in the U.S. and world-wide, has cooled greatly over the last year. Manufacturing indices in Europe and China have fallen into contractionary territory as of late, and the U.S. is not far behind: the ISM Manufacturing Index is at its lowest level in nearly three years, while the new orders component has moved lower and is right on the breakeven mark between expansion and contraction, a worrying sign.<sup>14</sup> Additionally, the services sector has cooled a bit in 2019: the ISM Non-Manufacturing Index declined to its lowest level in two years in June.<sup>15</sup>

There has been growing concern at the Federal Reserve over these signs of weakening economic growth. The Fed's tone on monetary policy turned extremely dovish after its June meeting, as

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<sup>8</sup> Federal Reserve, "Semiannual Monetary Policy Report to the Congress," Chair Jerome H. Powell, Before the Committee on Financial Services, U.S. House of Representatives, Washington, D.C., available at <https://www.federalreserve.gov/newsevents/testimony/powell20190710a.htm>, July 11, 2019.

<sup>9</sup> Federal Reserve Bank of St. Louis, 10-Year Treasury Constant Maturity Minus 3-Month Treasury Constant Maturity [T10Y3M], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/T10Y3M>, July 21, 2019.

<sup>10</sup> Federal Reserve Bank of New York, Economic Research, "The Yield Curve as a Leading Indicator," available at [https://www.newyorkfed.org/research/capital\\_markets/ycfaq.html](https://www.newyorkfed.org/research/capital_markets/ycfaq.html), July 25, 2019.

<sup>11</sup> U.S. Bureau of Labor Statistics, All Employees: Total Nonfarm Payrolls [PAYEMS], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/PAYEMS>, July 25, 2019.

<sup>12</sup> U.S. Bureau of Labor Statistics, Average Hourly Earnings of All Employees: Total Private [CES0500000003], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/CES0500000003>, July 25, 2019.

<sup>13</sup> U.S. Bureau of Labor Statistics, Quits: Total Nonfarm [JTSQR], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/JTSQR>, July 25, 2019.

<sup>14</sup> Institute for Supply Management, "June 2019 Manufacturing ISM Report on Business," available at <https://www.instituteforsupplymanagement.org/ismreport/mfgrob.cfm?SSO=1>, July 25, 2019.

<sup>15</sup> Institute for Supply Management, "June 2019 Non-Manufacturing ISM Report on Business," available at <https://www.instituteforsupplymanagement.org/ISMReport/NonMfgROB.cfm?SSO=1>, July 25, 2019.

Chair Powell and other members of the Federal Open Market Committee have hinted that more accommodative policy could be necessary if economic conditions continue to worsen. The minutes of their June meeting showed many officials believed a rate cut “would be warranted in the near term should these recent developments prove to be sustained.”<sup>16</sup>

The impact on the credit union industry of economic stress is more than hypothetical, as the financial crisis demonstrated. At that time, the Troubled Asset Relief Program (TARP) provided capital support to 67 U.S. credit unions.<sup>17</sup> The U.S. Treasury also provided direct support to the Share Insurance Fund totaling over \$21 billion,<sup>18</sup> as well as substantial contingent financial resources.

Notwithstanding such economic signs, there are no guarantees that a recession is impending. However, a prudent regulatory approach that raises credit union standards to the minimums required by Congress and currently imposed on the banking industry is not just warranted but immediately necessary. To avoid placing public funds at risk to support the credit union industry during the next inevitable economic downturn, the industry’s RBC rule needs to be in effect and credit unions held to its requirements.

**NCUA Has Not Considered Critical Issues in this Proposal; The Current Administrative Record is Deficient.**

By definition, extending current rules at the expense of implementing a modernized approach to capital is an implicit agency stamp that the current rules are superior, or at least adequate. However, the Government Accountability Office, NCUA’s Inspector General, and notable commentators have judged those existing rules as substandard.

Based on the text of the proposal, and NCUA’s prior statements regarding the need for a robust risk based capital system to be applied to credit unions, the administrative record on the adequacy of the current capital rules that will remain in effect over the next two years is incomplete and procedurally deficient. Therefore, to ensure that the NCUA Board has all the facts on which to judge any final rule, NCUA should address the questions below. As you know, under the Administrative Procedure Act, NCUA must answer each of these questions in detail in the preamble of any final rule, or else any agency action would be considered arbitrary and capricious, especially in light of prior agency action emphasizing the urgency for risk based capital.

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<sup>16</sup> Federal Reserve System, “Minutes of the Federal Open Market Committee June 18-19, 2019,” available at <https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20190619.pdf>.

<sup>17</sup> ProPublica, “Bailout Recipients,” ProPublica Bailout Tracker: Tracking Every Dollar of Every Recipient, Updated February 25, 2019, available at <https://projects.propublica.org/bailout/list>.

<sup>18</sup> NCUA, “Corporate System Resolution, Borrowing Cost,” accessed April 12, 2019, available at <https://www.ncua.gov/support-services/corporate-system-resolution/borrowing-cost>; Government Accountability Office, “National Credit Union Administration: Earlier Actions Are Needed to Better Address Troubled Credit Unions,” GAO-12-247 at 21 (January 2012), available at <https://www.gao.gov/assets/590/587409.pdf>.

1. Why does NCUA believe capital is important? How does this proposal fit with that answer?
2. What is the agency's position as to why Congress required Prompt Corrective Action and other capital requirements to be applied to credit unions?
  - a. What does the legislative history reveal about Congressional intent?
  - b. Does this proposal align with that legislative history and the agency's understanding of Congressional intent?
3. What is the agency's position as to why Congress required NCUA to have comparability<sup>19</sup> with Federal banking agencies regarding Prompt Corrective Action and other capital requirements?
  - a. What does the legislative history reveal about Congressional intent?
  - b. How have NCUA's actions over the past decade, including in this proposal, aligned with that legislative history and Congressional intent?
4. Is NCUA's current capital rule (which would be extended under this proposal) comparable to those currently in effect for the Federal banking agencies?
  - a. If so, how so, especially considering the agency's prior statements regarding the need for risk based capital?
  - b. If not:
    - i. What specific differences exist between NCUA's current rule and those currently in effect for other Federal banking agencies?
    - ii. How will this proposal exacerbate those differences over the next two years?
5. Does NCUA believe it is currently meeting the statutory requirement of comparability to the Federal Deposit Insurance Act?
  - a. If so:
    - i. What are the similarities and differences between NCUA rules and those currently in effect for the Federal banking agencies?
    - ii. Why does NCUA believe that the rules are more similar than different, and thus comparable?
  - b. If not:
    - i. When did NCUA stop meeting the comparability requirement?
    - ii. Why does NCUA believe that this statutory requirement is, in effect, optional?
  - c. How does this proposal fit with the answer to (a) or (b)?
6. When was the current capital rule implemented?

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<sup>19</sup> See text accompanying Note 7, *supra*.

7. What specific changes has NCUA made to the current capital rule over the years? When were those changes made, and what issues were addressed at that time?
8. What are the marketplace changes that have occurred since the capital rule currently in effect was originally implemented?
9. How do those marketplace changes impact NCUA thinking as to the timing of implementation of modernization programs?
10. In 2012, the Government Accountability Office found that NCUA rules related to capital were substandard, as indicated by the financial crisis-era performance of NCUA supervision at failed credit unions. Specifically,

*[t]o improve the effectiveness of the PCA framework, we recommend that the Chairman of NCUA consider additional triggers that would require early and forceful regulatory actions, including the indicators identified in this report. In considering these actions, the Chairman should make recommendations to Congress on how to modify PCA for credit unions, and if appropriate, for corporates.<sup>20</sup>*

What specific steps has NCUA taken, or will be taking over the next two years, to respond to the GAO recommendations? Will those steps be implemented during the period of the risk based capital delay?

11. GAO also found that “once an institution falls below PCA’s capital standards, it may not be able to recover regardless of the regulatory action imposed.”<sup>21</sup>
  - a. Since the crisis, what has been NCUA’s experience regarding the ability of an institution to recover if its capital standards fall below the PCA requirements?
  - b. Would NCUA expect those trends to continue over the next two years if an RBC delay is imposed? Why or why not?
12. GAO noted that, “NCUA also described [in written comments made to GAO during their review] its commitment to continued research and analysis to improve the effectiveness of PCA. In particular, NCUA cited its membership on the Federal Financial Institutions Examination Council and the Financial Stability Oversight Council. NCUA also noted that it was following developments related to the federal banking agencies’ consideration of enhancements to PCA triggers.”<sup>22</sup>
  - a. What have the other FFIEC and FSOC agencies done to PCA triggers and capital requirements since the 2012 GAO review?

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<sup>20</sup> Gov’t Accountability Office, “National Credit Union Administration: Early Actions Are Needed to Better Address Troubled Credit Unions,” GAO 12-247.

<sup>21</sup> *Id.* at 37.

<sup>22</sup> *Id.* at 44.

- b. What has NCUA done, in terms of concrete steps that have actually been implemented, to improve the adequacy of PCA and capital standards since the 2012 GAO review?
  - c. Given recent changes that place NCUA far outside the mainstream of financial regulators, such as this proposal as well the weakening of appraisal standards for commercial real estate, is the position of NCUA that the actions of other sister FFIEC agencies still should carry weight in NCUA decision-making?
  - d. If the answer to part (c) above is that the actions of other FFIEC agencies should carry weight in NCUA decision-making, how does this proposal fit into that regulatory philosophy?
  - e. If the answer to part (c) above is that the actions of other FFIEC agencies should carry weight in NCUA decision-making, does this proposal make NCUA regulation substandard? Why or why not?
  - f. Will the answer to part (c) above continue to be the view of the agency during a two-year RBC delay? Why or why not?
13. Does the agency believe the rule currently in effect is sufficient to protect taxpayers and the NCUSIF from losses over the next two years, especially in light of potential macroeconomic changes?
14. What does NCUA believe are important lessons of the financial crisis? Does NCUA believe the rule currently in effect adequately reflects those lessons? Why or why not?
15. Is the rule currently in effect adequate to support vigorous action by NCUA to minimize losses at troubled credit unions through appropriate use of “prompt corrective action, and if so, what specific reasons demonstrate such adequacy?”
16. Does the rule currently in effect focus on the institutions whose assets and operations pose the greatest risks?
- a. Does it adequately cover all parts of the industry?
  - b. If not, what parts of the industry that could be susceptible in a downturn?
17. What would be the effect of this delay on credit union service organizations, especially those CUSOs that engage in significant business lending, commercial real estate, mortgage origination, and deposit brokerage activities?
18. What would be the effect of this delay on credit unions that have stated that they plan to grow significantly over the two-year period, such as PenFed’s public desire to triple in size to \$75 billion by 2025?
19. How would the taxi medallion crisis have been different had risk based capital been in effect?
20. Does NCUA consider asset concentration a risk to both capital adequacy and safe-and-sound operations?
21. Does the rule currently in effect take account the effects of asset concentration?

22. NCUA has publicly stated that it did not have the authority to regulate concentration risk for the taxi medallion credit unions because of the legislative history to 1998 legislation regarding field of membership.
  - a. Why not? Don't ordinary supervisory tools still enable prudent regulation of safety and soundness issues?
  - b. Does NCUA believe that RBC would have provided the agency with additional authority?
  - c. Are there other similar monoline credit unions that pose concentration (and thus capital) risks to the credit union system? Does NCUA believe it has the tools to address those risks?
23. What specific regulatory tools will NCUA rely on to prevent concentration risk over the next two years?
24. If NCUA approves this proposed this delay, will the supervisory process be strengthened over the next two years? If so, what specific plans does NCUA have in place?
25. The NCUA Inspector General has repeatedly found that the lack of a timely and aggressive supervisory approach has led to concentration risks and credit union failures, most recently visible during the taxi medallion crisis.<sup>23</sup> The Inspector General raised nearly identical concerns with the corporate credit union crisis nearly a decade ago.<sup>24</sup>
  - a. Since 2008, what steps has NCUA taken to address supervisory concerns?
  - b. What of those steps have been implemented in final form?
  - c. What steps has NCUA taken to address the findings of the Inspector General regarding the adequacy of NCUA supervision?
26. In the absence of RBC, will NCUA provide supervisors with new tools to prevent concentration risk over the next two years?
27. Given exemptions, what percentage of the credit union industry's assets would be covered by risk based capital?
28. Given exemptions, how many credit unions would be covered by risk based capital?
29. How many banks enjoy an exemption from Basel III? Does RBC achieve the statutorily-required comparability between banks and credit unions, given exemptions?
30. As noted below, the recent paper *The Credit Union Equality Commitment: An Analytical Assessment*, by Federal Financial Analytics and noted financial services commentator Karen Shaw Petrou, raises significant concerns of what Petrou calls "charter arbitrage" and "regulatory capture" that may raise parallels to the 1980s Savings & Loan crisis.

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<sup>23</sup> Material Loss Review of Melrose Credit Union, LOMTO Federal Credit Union, and Bay Ridge Federal Credit Union, OIG 19-06, March 29, 2019, available at <https://www.ncua.gov/files/audit-reports/oig-material-loss-review-march-2019.pdf>.

<sup>24</sup> OIG Capping Report on Material Loss Reviews, OIG 10-20, Nov. 23, 2010, available at <https://www.ncua.gov/files/audit-reports/OIG201020CappRpt.pdf>.



That crisis, of course, ended very badly, and was a driving force behind the development of PCA. Given these historic parallels, recent examples of regulatory problems and potential risks posed by an increasingly suspect approach to regulatory capital requirements, what is the agency's position as to potential parallels between this delay and the history shown with the S&L industry?

31. What is it about the credit union business model that makes credit unions ill-equipped to actually implement capital standards that are consistent with the requirements other types of financial institutions have lived with for nearly a decade?

**Federal Financial Analytics' Analysis Reveals Important Questions NCUA Must Consider.**

Some detailed insights into the current state of credit union capital regulation are contained in a white paper, *The Credit-Union Equality Commitment: An Analytical Assessment*,<sup>25</sup> prepared by Federal Financial Analytics and noted financial commentator Karen Shaw Petrou and attached as an appendix here. The analytical detail of Ms. Petrou's work will inform the administrative record as it is directly responsive to this proposal and the critical need to implement RBC now. The concerns raised by Ms. Petrou in this white paper should be addressed by the NCUA before it moves to finalize this proposal. ABA incorporates the relevant section (pages 25-36) directly into its comment letter, and notes the requirement under the Administrative Procedure Act for NCUA to respond in detail to these concerns in the preamble to any final rule.

**Conclusion**

The importance of an RBC regime is critical to the safety and soundness of the Federally insured credit union industry and the protection of the public resources that support it. The process underway since the end of the financial crisis must be concluded, and the path to an appropriate RBC rule is clear. Accordingly, ABA urges NCUA to finalize its RBC rule without delay, taking into account the issues ABA has raised. Please contact the undersigned if you have any questions regarding ABA's response to the Proposal.

Sincerely,

Kenneth J. Clayton

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<sup>25</sup> Karen Shaw Petrou, *The Credit-Union Equality Commitment: An Analytics Assessment*, June 25, 2019, available at [http://www.fedfin.com/images/stories/client\\_reports/FedFin%20Paper-The%20Credit-Union%20Equality%20Commitment-An%20Analytical%20Assessment.pdf](http://www.fedfin.com/images/stories/client_reports/FedFin%20Paper-The%20Credit-Union%20Equality%20Commitment-An%20Analytical%20Assessment.pdf).

# The Credit-Union Equality Commitment: An Analytical Assessment\*



**Federal Financial Analytics, Inc.**

[www.fedfin.com](http://www.fedfin.com)

**June 25, 2019**

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\* This paper represents the views of Federal Financial Analytics, Inc. Funding for this research was provided by the American Bankers Association, which was not granted editorial authority over the paper's content, methodology, or findings. These are solely the responsibility of Federal Financial Analytics, Inc.

# Table of Contents

<b>Executive Summary</b> .....	1
<b>I. Introduction</b> .....	4
<b>II. The Credit Union Promise</b> .....	7
A. Origins and Mission Focus.....	7
1. Credit-Union Mission.....	7
2. Credit-Union Business Model.....	9
3. Mission Transformation.....	10
B. Sector Analysis.....	12
<b>III. Do Credit Unions Serve Small-Means Households?</b> .....	15
A. Mission Performance.....	16
B. Low-Income Credit Unions.....	18
C. Common-Bond Membership.....	20
D. Provident and Productive Lending.....	22
1. The Provident Mandate.....	22
2. Do Credit Unions Increase Productivity? .....	23
<b>IV. Credit-Union Regulation and Risk</b> .....	25
A. Credit-Unions and the Great Financial Crisis.....	26
B. Hard-Learned Crisis Lessons.....	27
C. Effective Supervision.....	29
D. Capital Regulation.....	31
1. Definition of Capital.....	32
2. The Definition of Risk.....	33
3. Stress Testing.....	34
E. Additional Risks.....	34
<b>V. Conclusion</b> .....	36

## Executive Summary

In 1934, Congress established the initial construct for credit unions, adding it to the mix of Depression-era reforms designed to ensure that American financial institutions operate safely to enhance American values, most importantly those premised on the United States as a “land of opportunity.” Two financial crises since 1934 – the S&L debacle of the late 1980s and the great financial crisis of 2007 through 2009 – demonstrate the critical importance of continuing the mission set for U.S. credit unions in the 1930s. Indeed, given the sharp increase in U.S. economic inequality since the great financial crisis,<sup>1</sup> this mission is still more urgent.

But in 2019, the companies chartered with high hopes of economic equality in 1934 have often strayed far afield. Some have even figured prominently in investigative reports of new forms of predatory lending that immeasurably harm vulnerable borrowers yet provide multi-million dollar salaries and perquisites to credit-union management.<sup>2</sup> Mounting evidence also suggests that the credit-union sector as a whole now largely serves middle- and upper-income households, not those with the “small means” to which the law dedicates their charters or even those with the “modest means” cited by the industry’s regulator when credit-union customers are judged by the actual income and wealth distributions of U.S. households. It is thus still more urgent to assess credit unions in 2019 given this equality challenge due to the special benefits credit unions enjoy premised on adherence to a public mission of service and safety.

Often, the credit-union debate is framed in competitiveness terms – that is, whether credit unions use federal benefits to compete with undue advantage against community banks or other financial institutions. Debate often also focuses on whether or not one or another credit-union activity is permissible under law. This paper addresses another question: regardless of whether credit unions out-compete other financial institutions or do so within the parameters of the law, do institutions with an express mission to serve persons of “small means” through “provident” and “productive” financial services still serve that mission. Looking at this question analytically for the first time in at least a decade, we find that:

- The statutory mission established for credit unions in 1934 to serve persons of “small means” with “provident or productive” financing is unchanged in 2019. However, the federal-regulatory framework governing credit unions rarely mentions this mission in anything other than rhetorical terms. Instead, rules now provide for expansive executive-compensation powers, permissible-product definitions with no equality focus, and idiosyncratic definitions of “low-income” households. The “common bond” of membership on which the credit-union mission was premised in 1934 has also largely dissolved as credit unions serve large communities of borrowers with little affinity to each other and ample alternative financial providers. The lack of a meaningful common

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<sup>1</sup> Board of Governors of the Federal Reserve System (FRB) Governor Lael Brainard, *Speech at “Renewing the Promise of the Middle Class” 2019 Federal Reserve System Community Development Research Conference, Washington, D.C.: Is the Middle Class within Reach for Middle-Income Families* (May 10, 2019), available at <https://www.federalreserve.gov/newsevents/speech/brainard20190510a.htm>.

<sup>2</sup> Brian M. Rosenthal, “As Thousands of Taxi Drivers Were Trapped in Loans, Top Officials Counted the Money,” *New York Times*, May 19, 2019, available at <https://www.nytimes.com/2019/05/19/nyregion/taxi-medallions.html>.

bond undermines the ability of credit unions to focus on provident and productive lending, instead converting business objectives to profit maximization.

- The 2019 credit-union regulatory regime has redesigned the credit-union business model into one often indistinguishable from expressly for-profit financial institutions with no comparable duties to serve low-and-moderate income households.
- Beginning in 1937, the industry was granted significant benefits premised on this mission. By 2019, there is significant evidence of charter arbitrage, with credit unions actively promoting lending for purchases they frequently describe as “toys” (e.g., private aircraft), offering wealth-management services, and offering multi-million dollar commercial real estate loans. All of these activities, which have grown dramatically in recent years, pose not only economic-equality, but also safety-and-soundness risks, especially at the height of the U.S. business and financial cycle.
- Although often seen as an industry of small organizations cemented by a common bond focused on persons of small means, the credit-union sector in aggregate is now a major force in U.S. consumer finance, growing faster since the crisis than either small or large banks. Indeed, credit unions are now buying small banks, suggesting that the prior mission differentiation between banks and credit unions is increasingly immaterial and that credit-union regulation allows for more profitable operation given a comparable or even riskier business model.
- Credit-union assets now exceed \$1.5 trillion and account for 9.2 percent of U.S. insured deposits. Members are disproportionately middle- and upper-income households, with the sector’s regulatory definition of “low-income” reaching into higher-income groups than allowed under the criteria established by other federal-government agencies. As a result, low-income credit unions – a special designation granted additional benefits – serve areas as wealthy as Greenwich, Connecticut.
- Credit unions appear to lend disproportionately also to higher-income households in low-income areas and to deny a greater proportion of African-American borrowers than whites of comparable risk profiles.
- Credit-union regulation is often premised on profit maximization, not mission compliance. For example, a new rule liberalizing executive compensation focuses on ensuring that credit unions compete with companies with no such missions for executive talent. Permissible incentives do not appear to include any related to mission achievement, instead focusing on the ability of credit unions to compete with banks through greater loan growth regardless of whether loans are safe, protect vulnerable borrowers, or promote low-income community development.
- Charter arbitrage at credit unions is powered not only by unique federal benefits, but also by regulatory arbitrage – i.e., less stringent safety-and-soundness regulations. Although Congress has stipulated that federal credit unions must operate under capital rules comparable to those governing banks, this has not been implemented. About half of all credit unions are allowed to use “secondary” capital instruments generally barred for banks. Credit unions that issue this capital fail at a rate that is 362 percent greater than conservative institutions. Proposals to expand the use of these instruments thus may increase overall solvency risk in the credit-union sector, exposing members and the broader economy to risk.

- Capital comparisons between credit unions and banks are often misleading due to significant differences in the definition and resilience of the instruments permitted to count as regulatory capital. Member/shareholder capital is critical to ensure risk-taking incentive alignment, but this critical constraint is less meaningful at federal credit unions which have considerably less capital for like-kind risk when compared to banks. Pending changes to the definition of credit-union capital would further erode capital resilience in comparison to banks and global norms.
- During the 2007-09 great financial crisis, credit unions received direct federal assistance – i.e., the sector was bailed out. Indirect assistance – e.g., regulatory acceptance of insufficient capital – also supported a sector then under acute stress.
- Policy options to ensure that credit unions adhere to their mission and remain an important part of the U.S. financial system include mandating the transparency necessary to assess the extent to which credit unions serve persons of small means with provident and productive financial products. Transparency should then be supplemented with effective enforcement so that credit unions that adhere to their statutory mission are differentiated from those that, while enjoying significant tax and regulatory advantages, nonetheless use these benefits for executive compensation, expansion, or other objectives that – absent mission enforcement – may be incompatible with mission adherence.
- Additional mission-adherence controls may also be warranted, especially for low-income credit unions which enjoy additional benefits intended to ensure service to truly low-income households. Mandatory income targeting is one option, as are tighter product-and-service controls to align credit-union offerings with statutory restrictions.
- However, even these mission-adherence improvements will not enhance economic equality if credit unions fail to operate safely across the entire business and financial cycle. It is thus especially important that credit unions repay their rewards by demonstrable resilience under stress since low-and-moderate income households are likely to be those most urgently in need of financial services during periods of economic stress. NCUA safety-and-soundness rules that are now considerably more relaxed than those applicable to like-kind banks may thus require significant revision.

## I. Introduction

The United States has a long history of financial institutions that are chartered to do good that over time morph into companies focused principally on personal or corporate enrichment, sometimes doing very, very well by themselves no matter the risk to others.<sup>3</sup> The building-and-loan associations of the early 1900s intended to help low-income households that became savings-and-loans by the 1980s and caused what was then the worst U.S. financial crisis since the 1930s are one such case. Another is that of Fannie Mae and Freddie Mac, now well-known examples of public-purpose companies that failed with disastrous effect in what is now known as the great financial crisis of 2007-09. A less well-known, but still apposite, case is that of the National Cooperative Bank, which was chartered by Congress in 1978 to lend to farmers' cooperatives and the student-led ones that were then all the rage. By 1986, the Co-Op Bank had self-privatized to focus on luxury cooperative apartments and fast-food franchises.

All of these cases are in one way or another betrayals of public trust that analysts less emotionally call "charter arbitrage." Granted benefits Congress considers critical to achieving a public purpose, companies sometimes quickly turn these benefits to personal advantage. Once the U.S. might have been able to afford charter arbitrage much as many might nonetheless abhor it. Now, with economic inequality at levels scarcely seen since the Gilded Age and government spending under sharp constraints, the U.S. may not have the luxury of allowing private companies to use public wealth subsidies for personal gain. It is thus timely, if not also urgent, to review the extent to which U.S. credit unions – founded on an economic-equality mission and still granted significant benefits to achieve it – continue to adhere to their initial, lofty goals.

In the midst of the Great Depression, widespread economic suffering led Congress in 1934 to give credit unions a federal charter premised on a mission to serve persons of "small means."<sup>4</sup> In 1937,<sup>5</sup> a federal tax exemption and other benefits were added to the charter to make it still more likely that persons then not served by traditional lenders could obtain equality-essential financial services. Although some closely-held companies are not subject to federal taxation at the company level, corporate profits pass through to owners and thus are ultimately taxed; no such pass throughs apply to credit unions. By 2019, the credit unions' regulators and in some instances Congress have redefined the mission to allow even wealth-management services, vacation-home lending, commercial lending far beyond small businesses, and even financing for private aircraft, jet-skis, and other "toys" as several credit unions describe them.<sup>6</sup> This is

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<sup>3</sup> Mehrsa Baradaran, "How the Poor Got Cut Out of Banking," *Emory Law Journal* 62(3), 483 (2013), available at <http://law.emory.edu/elj/ documents/volumes/62/3/articles/baradaran.pdf>.

<sup>4</sup> An Act To establish a Federal Credit Union System, to establish a further market for securities of the United States, and to make more available to people of small means credit for provident purposes through a national system of cooperative credit, thereby helping to stabilize the credit structure of the United States (The Federal Credit Union Act, or FCU Act), Pub. L. No. 73-467, 48 Stat. 1216 (June 26, 1934), available at <https://www.loc.gov/law/help/statutes-at-large/73rd-congress/session-2/c73s2ch750.pdf>.

<sup>5</sup> Federal Credit Union Act Amendments (FCU Act Amendments), Pub. L. No. 75-416, 51 Stat. 4 (December 6, 1937), available at <https://www.loc.gov/law/help/statutes-at-large/75th-congress/session-2/c75s2ch3.pdf>.

<sup>6</sup> See for examples: Wings Financial Credit Union, "Boat, RV and Toy Loans," accessed April 22, 2019, available at <https://www.wingsfinancial.com/boat-toy-rv-loans>, which offers "toy loans" for products including motorcycles, jet skis, Wave Runners, ATVs, snowmobiles and aircrafts alongside boats and RVs; Altura Credit Union, "Toys (Boats & Motorcycles)," accessed April 23, 2019, available at <https://www.alturacu.com/personal/all-loans/auto/toys-boats--motorcycles>, which includes boats, motorcycles, jet skis, quad-runners, "and more" in its qualifying products for "Toy Loans"; and SkyOne Federal Credit Union, "Toy Loans," accessed April 23, 2019, available at

despite Congress explicitly stating that lending restrictions contained within the Credit Union Membership Access Act<sup>7</sup> “are intended to ensure that credit unions continue to fulfill their specified mission of meeting the credit and savings needs of consumers, especially persons of modest means, through an emphasis on consumer rather than business loans.”<sup>8</sup>

What was once a small, cooperative industry has thus grown to become a major force in U.S. consumer finance. It is with this background in mind that this paper assesses the extent to which U.S. credit unions adhere to the charters granted to them by Congress so that the benefits provided in return indeed remedy U.S. economic inequality to the greatest extent possible.

The question of equality banking is as urgent in 2019 as it was in 1934. In 2019, the United States is by many measures in an even more grave economic-equality crisis. The median net worth of persons in the bottom quintile of the income distribution – all of whom are of “small means,” i.e. earn less than fifty percent of median income – declined by almost forty percent between 2001 and 2016, taking inflation into account. Now, it’s only \$6,500.<sup>9</sup> Although small-means household median income is up 8.6 percent over this same period, the real-dollar value of this increase is only \$1,200, bringing bottom quintile median income in 2016 to a paltry \$15,100.<sup>10</sup> Those of moderate means aren’t fairing much better – over this same period, those in the second quintile, all of whom earn less than eighty percent of median income, saw their median income decline 4.8 percent<sup>11</sup> and their median wealth drop a stunning 36.3 percent.<sup>12</sup>

Given these distressing equality facts, it is surely reasonable to analyze the extent to which companies meet their Congressional mandate to serve those with small means when they are, like credit unions, backed by a \$24 billion federal tax benefit (measured over ten years),<sup>13</sup> a deposit-insurance system and unique liquidity fund backed by the U.S. Treasury, access to the Federal Reserve, and the ability to draw loans from another taxpayer-backed entity, the Federal Home Loan Banks. Although much attention has been paid to credit-union competitiveness related to these taxpayer benefits, it has been a decade since a national community group questioned the extent to which U.S. credit unions adhere to their chartered mission<sup>14</sup> and more than that since the U.S. Government Accountability Office (GAO) assessed the regulatory framework established by the National Credit Union Administration (NCUA) from an economic-

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<https://www.skyone.org/loans/toy-loan.html>, which includes motorcycles, airplanes, boats, RVs, dirt bikes, jet skis, snowmobiles, and ATVs in its qualifying products for “Toy Loans.”

<sup>7</sup> Credit Union Membership Access Act (CUMAA), Pub. L. No. 105-219, 112 Stat. 913 (August 7, 1998), available at <https://www.congress.gov/105/plaws/publ219/PLAW-105publ219.pdf>.

<sup>8</sup> Senate Report 105-193, “Credit Union Membership Access Act Report Together with Additional Views,” 9 (May 21, 1998), available at <https://www.congress.gov/105/crpt/srpt193/CRPT-105srpt193.pdf>.

<sup>9</sup> FRB, *Survey of Consumer Finances 2016 Chartbook*, 43 (October 16, 2017), available at <https://www.federalreserve.gov/econres/files/BulletinCharts.pdf>.

<sup>10</sup> *Ibid.* at 7.

<sup>11</sup> *Ibid.*

<sup>12</sup> *Ibid.*, at 43

<sup>13</sup> Office of Management and Budget (OMB), *A Budget for a Better America: Promises Kept. Taxpayers First. Analytical Perspectives: Fiscal Year 2020 Budget of the U.S. Government*, 175 (March, 2019), available at <https://www.whitehouse.gov/wp-content/uploads/2019/03/spec-fy2020.pdf>.

<sup>14</sup> National Community Reinvestment Coalition (NCRC), *Credit Unions: True to Their Mission? (Part II) A Follow-Up Analysis of Credit Union Compared to Bank Service to Working and Minority Communities*, (September, 2009), available at <https://ncrc.org/wp-content/uploads/2009/09/creditunionreport090309.pdf>.



equality perspective.<sup>15</sup> Academic literature on credit unions is scarce and generally focused on the extent to which the federal tax exemption is warranted.

This paper contributes to this literature and to public discussion by analyzing the history, mission, and structure of the U.S. credit-union industry as of 2019. It assesses current data to evaluate the extent to which the combination of the current credit-union business model and applicable regulation results in a sector that continues to adhere to the public mission on which numerous federal advantages are premised.

We find that credit-union members are disproportionately middle- and upper-income households and that many lending services put vulnerable households at risk of unaffordable indebtedness instead of creating a solid foundation for long-term wealth accumulation. Surprisingly, those credit unions that are premised on service exclusively to low-income households, and thus receive additional charter benefits, not only mostly serve those with higher incomes, but also principally provide subprime automobile lending with disproportionately high default rates.

Chastened by the great financial crisis, the NCUA has added new controls to the federal credit-union prudential framework, but significant differences exist between it and those set by global and U.S. regulators for other financial institutions. To the extent charter arbitrage is powered by regulatory arbitrage – i.e., the ability to gain market share due to less stringent safety-and-soundness rules – a mission-focused financial institution may well stray still farther from its charter and do so at grave risk. When an institution is expressly chartered to serve people of small means and is owned by members, then risks may have particularly destructive impact on the households that can afford them the least.

This paper thus also assesses the structure of current credit-union prudential regulation, differences between established banking precedent, reasons for any such differences, and potential risks. Although credit unions individually and perhaps even in aggregate may be too small to present systemic risk, the U.S. learned during the great financial crisis that stressed markets can take flight when even a very small company falters (e.g., the Reserve Primary Fund<sup>16</sup>). As a result, systemic-risk considerations are also addressed. A financial institution may appear to adhere to its mission, but if it does so at risk of failure, then any short-term gains in credit availability for small-means households will be very costly in terms of longer-term loss to these same households. Equality risks are exacerbated if the products offered to vulnerable households are unduly costly, they belong to a financial institution that fails, or if failures in aggregate lead to macroeconomic shock and thus also to increased unemployment and lost savings. A financial institution's equality impact must thus be judged not only by its ostensible mission, but also by the extent to which it can safely execute on that mission over the business and financial cycle.

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<sup>15</sup> Government Accountability Office (GAO), "Credit Unions: Greater Transparency Needed on Who Credit Unions Serve and on Senior Executive Compensation Arrangements," *GAO-07-29*, (November, 2006), available at <https://www.gao.gov/new.items/d0729.pdf>.

<sup>16</sup> Neil Irwin, "The hidden cost of bailouts: The money market mutual funds and moral hazard," *Washington Post*, September 28, 2012, available at [https://www.washingtonpost.com/business/economy/the-hidden-cost-of-bailouts-the-money-market-mutual-funds-and-moral-hazard/2012/09/28/e178cc1c-0966-11e2-858a-5311df86ab04\\_story.html](https://www.washingtonpost.com/business/economy/the-hidden-cost-of-bailouts-the-money-market-mutual-funds-and-moral-hazard/2012/09/28/e178cc1c-0966-11e2-858a-5311df86ab04_story.html).

## II. The Credit Union Promise

If the U.S. were more equal, then the question of credit-union mission adherence could be deemed as a case of competitive sour grapes reminiscent of many instances in which a struggling sector blames the success of its competitors on seemingly-unfair advantages gained by virtue of charter or regulatory arbitrage. However, the U.S. is of course far from equal and sure to get still more so if well-priced deposit, loan, and advisory services are hard for vulnerable households to obtain close to home over both their own life cycle and that of the U.S. macroeconomy and financial system. Private-sector companies can of course choose with whom they do business, but private-sector companies operating under rules mandating a mission have a higher duty, not to mention a legal obligation,<sup>17</sup> to offer products targeted to those who need them the most on terms that protect these customers to the greatest possible extent. Before turning to whether credit unions meet this mission, it is thus first important to establish that they have one and to define its obligations.

### A. *Origins and Mission Focus*

#### 1. *Credit-Union Mission*

Credit unions began in concert with other non-traditional banking organizations during the Progressive Era at the turn of the 20<sup>th</sup> century, a time of acute financial-stability stress that eventually led to the establishment not only of these non-traditional banks, but also of the Federal Reserve in 1913 to prevent the violent boom-bust cycles that do the most damage then and now to those who can afford it the least. Following informal lending associations that now would be called “microfinance” organized by cooperatives of farmers and workers, the first credit union is generally considered to have been established in 1908 – one year after the 1907 crash.<sup>18</sup>

The concept behind credit unions is comparable to that of another progressive alternative bank, the “Morris Bank,” which posited credit decisions on the support given the applicant by members of his (less usually her) community.<sup>19</sup> However, unlike Morris Banks – which were formal organizations – credit unions were cooperatives founded by members with a “common bond” (e.g., a shared workplace) who took deposits only from members, lent only to members on only members’ advice, were governed only by members on a one-man, one-vote principle, and returned earnings to members in the form of interest on deposits (known as “shares”). By 1932, the average credit union had only 187 members.<sup>20</sup>

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<sup>17</sup> CUMAA §2(4), 12 U.S.C. 1751(4) (2017), available at <https://www.govinfo.gov/content/pkg/USCODE-2017-title12/pdf/USCODE-2017-title12-chap14-sec1751.pdf>.

<sup>18</sup> Liz Marshall and Sabrina Pellerin, “Credit Unions: A Taxing Question,” *Federal Reserve Bank of Richmond Econ Focus* 22(2), 20 (Second Quarter, 2017), available at [https://www.richmondfed.org/-/media/richmondfedorg/publications/research/econ\\_focus/2017/q2/feature2.pdf](https://www.richmondfed.org/-/media/richmondfedorg/publications/research/econ_focus/2017/q2/feature2.pdf).

<sup>19</sup> O. Emre Ergungor and James B. Thomson, “Industrial Loan Companies,” *Federal Reserve Bank of Cleveland Economic Commentary*, (October 1, 2006), available at <https://www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/economic-commentary-archives/2006-economic-commentaries/ec-20061001-industrial-loan-companies.aspx>.

<sup>20</sup> John R. Walter, “Not Your Father’s Credit Union,” *Federal Reserve Bank of Richmond Economic Quarterly* 92(4), 354 (Fall, 2006), available at [https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic\\_quarterly/2006/fall/pdf/walter.pdf](https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic_quarterly/2006/fall/pdf/walter.pdf).

Today, the average number of credit union members is 21,429,<sup>21</sup> with the largest credit union – Navy Federal – serving 8.4 million members.<sup>22</sup>

Although small, credit unions as the Depression began joined with other non-traditional banks founded on collective credit-risk assessment to provide equality-essential credit not available from traditional, collateral-focused banks or traditional lenders. As a result, Congress enacted and Franklin D. Roosevelt in 1934 signed into law the Federal Credit Union Act.<sup>23</sup> To this day, the law echoes many themes of the Progressive Era that not only resonate now, but also have significant impact on our understanding of equality-enhancing finance.

In addition to the mandate that credit unions serve individuals of “small means,” the law also then and now mandates that credit be for “provident or productive purposes.” This term is consistent with the overall focus of cooperative banking in the early 20<sup>th</sup> century which focused on promoting what was then called thrift, but which we now think of as wealth accumulation for people of modest means.

Although it may seem anachronistic to talk about “thrift,” ample evidence exists that the U.S. has become increasingly unequal because households are so mired in debt to finance increasingly unaffordable consumption that it has become impossible for all but the highest-income households to acquire the wealth needed for day-to-day financial resilience, let alone a secure future for themselves and their children.<sup>24</sup> It is increasingly well known that four in ten American adults – about 100 million people – have less than \$400 saved against the unexpected.<sup>25</sup> Less known and even more alarming is that forty percent of the population may be no more than one paycheck away from poverty.<sup>26</sup> No wonder, then, that 24 percent of American adults – and 36 percent of those with family income below \$40,000 – skipped medical treatment that they simply could not afford in 2018.<sup>27</sup> Clearly, secure financial institutions that safeguard the scant savings of persons of small means and then transform these funds into low-cost lending for long-term family security are as essential in 2019 as in 1934.

Some relatively recent research focused on the modern credit-union industry assesses the extent to which it complies with its small-means mission; less studied is the extent to which it also provides equality-essential financial intermediation in compliance with the “provident or productive” mandate. This term is not defined in the 1934 Act, nor does the NCUA define it in its descriptions of the credit-

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<sup>21</sup> Credit Union National Association (CUNA), *Monthly Credit Union Estimates March 2019*, 4 (April 29, 2019), available at [https://www.cuna.org/uploadedFiles/Global/About\\_Credit\\_Unions/CUMonthEst\\_MAR19.pdf](https://www.cuna.org/uploadedFiles/Global/About_Credit_Unions/CUMonthEst_MAR19.pdf).

<sup>22</sup> Navy Federal Credit Union (NFCU), *About Navy Federal Credit Union*, accessed May 21, 2019, available at <https://www.navyfederal.org/about/about.php>.

<sup>23</sup> FCU Act, Pub. L. No. 73-467, 48 Stat. 1216 (June 26, 1934), *op. cit.*

<sup>24</sup> Moritz Kuhn, Moritz Schularick, and Ulrike I. Steins, “Income and Wealth Inequality in America, 1949-2016,” *Federal Reserve Bank of Minneapolis Opportunity and Inclusive Growth Institute Working Paper 9*, (June, 2018), available at <https://www.minneapolisfed.org/institute/working-papers-institute/iwp9.pdf>.

<sup>25</sup> Board of Governors of the Federal Reserve System (FRB), *Report on the Economic Well-Being of U.S. Households in 2018*, 21 (May, 23 2019), available at <https://www.federalreserve.gov/publications/files/2018-report-economic-well-being-us-households-201905.pdf>.

<sup>26</sup> Prosperity Now, “Vulnerability in the Face of Economic Uncertainty: Key Findings from the 2019 Prosperity Now Scorecard,” *2019 Prosperity Now Scorecard*, 1 (January, 2019), available at [https://prosperitynow.org/sites/default/files/resources/2019\\_Scorecard\\_Key\\_Findings.pdf](https://prosperitynow.org/sites/default/files/resources/2019_Scorecard_Key_Findings.pdf).

<sup>27</sup> Board of Governors of the Federal Reserve System (FRB), *Report on the Economic Well-Being of U.S. Households in 2018*, *op. cit.* at 23.

union's mission on its website or in any other substantive way. In the context of regulations governing member business loans (MBLs),<sup>28</sup> the NCUA refers to "productive" activities solely with regard to allowing certain risks that do not clearly comport with the charter on grounds that they make the credit union itself more "productive."<sup>29</sup> This appears to mistake business efficiency with productivity, which is best understood as "the output per unit of input."<sup>30</sup> This definition means that productivity is measured by how much gain is achieved for how much effort; in a credit union's terms, this means how much return a member receives in terms of increased economic wealth in return for his or her savings or the cost of obtaining a loan. Efficiency is not productivity although it contributes to it. Efficiency thus is valued, but all financial institutions seek to operate efficiently; what distinguishes the 1934 charter and thus the credit-union mission is the emphasis also on member protection and long-term reward.

## 2. Credit-Union Business Model

In the absence of sophisticated credit-underwriting techniques and because credit-union founding members knew the benefit of what we now call "character" lending, many cooperative banks carefully screened not only members, but also loan purposes independent of likely repayment capability to ensure that member funds enhance family well-being. This may now seem paternalistic, but the law<sup>31</sup> continues to require it because the cooperative construct puts others at risk for each member's decisions. Intemperate members thus jeopardize the well-being of the group as a whole unless credit-union members recognize low-risk lending that eludes more anonymous underwriting techniques and those distanced from the community and its needs.

Indeed, as credit-underwriting practices evolved and shared interests diminished at increasingly larger banks, Congress stipulated an increasingly demanding federal regulatory framework for insured depositories enjoying either a state or federal banking charter. This essentially substitutes a regulator's judgment for that of the members or shareholders of a financial institution, often considerably less well. However, as we shall see, there are considerable differences between the regulatory structure now governing banks and credit unions, differences which make it even less likely that regulatory judgment in the absence of effective internal controls suffices to protect vulnerable members and households.

Reflecting the demonstrable prudential value of enforceable shared interests, another critical charter-mission provision of the Federal Credit Union Act specifies that the initial members of a new credit union acknowledge that the credit union upon establishment will be "made to enable such persons [i.e., those with small means] to avail themselves of the advantages of this charter."<sup>32</sup> By this reading, all credit unions must be only for persons of small means and established to provide provident and productive financial services, not to engage in higher-risk, higher-cost consumption financing that could lead to the indebtedness borrowers with small means might find difficult to repay, especially under stress. It would also appear to be a fundamental violation of the intent of the charter for credit unions

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<sup>28</sup> NCUA Member Business Loans; Commercial Lending, 12 C.F.R. § 723 (2018), available at <https://www.govinfo.gov/content/pkg/CFR-2018-title12-vol7/pdf/CFR-2018-title12-vol7-part723.pdf>.

<sup>29</sup> NCUA Member Business Loans; Commercial Lending, 12 C.F.R. §§ 701, 723, and 741, 81 Fed. Reg. 13530, 13549 (March 14, 2016), available at <https://www.govinfo.gov/content/pkg/FR-2016-03-14/pdf/2016-03955.pdf>.

<sup>30</sup> Paul A. Samuelson and William D. Nordhaus, *Economics*, 19<sup>th</sup> ed. (New York: McGraw-Hill/Irwin, 2010) 39.

<sup>31</sup> FCU Act § 114, 12 U.S.C. § 1761c (2017), available at <https://www.govinfo.gov/content/pkg/USCODE-2017-title12/pdf/USCODE-2017-title12-chap14-subchapl-sec1761c.pdf>.

<sup>32</sup> FCU Act § 103(7), 12 U.S.C. § 1753(7) (2017), available at <https://www.govinfo.gov/content/pkg/USCODE-2017-title12/pdf/USCODE-2017-title12-chap14-subchapl-sec1753.pdf>.

to provide financing for middle- or upper-class households and the discretionary consumption (e.g., private aircraft) they may choose to purchase.

The law stipulating a small-means, provident and productive purpose is in effect *de jure* today and remained largely intact *de facto* for the first forty years after formalization of the charter in 1934. However, as credit underwriting and financial-service delivery evolved, credit unions were challenged by other lenders reaching into low-and-moderate income (LMI) households. These lenders were able to judge credit risk – or at least they hoped so – without reference to an individual borrower’s character, but instead by quantifying the borrower’s ability to repay based on seemingly objective measures and/or the collateral available to make good on a loan if times got hard. These lenders were powered by innovations such as credit scores and the development of products such as credit cards and the secondary mortgage market, with these tools also permitting cross-subsidization of higher-risk borrowers with small means across pools of other borrowers with more likely repayment capacity at least as measured by these new models of credit-risk underwriting. In concert with these financial-product and technology changes also came a new product – home equity lines of credit (HELOCs) – that reduced the need of households to take out personal loans to finance personal consumption such as the unsecured personal loans for identified, provident purposes that once constituted the bulk of credit-union lending.

### 3. *Mission Transformation*

To meet these profitability challenges, credit unions and their regulatory framework dramatically evolved from a tightly-focused charter premised on a common bond of member affiliation and a limited class of provident, productive offerings. By the late 1960s, credit unions struggled to survive against companies that provided competitive financial services to LMI households, taking on undue risk that put their charters – not to mention their members – at grave risk. As a result, Congress in 1970 implemented a federal insurance backstop for credit unions,<sup>33</sup> also beginning to modernize credit-union federal regulation by transferring what little prudential supervision there had been under the Social Security Administration to a newly-created NCUA.<sup>34</sup>

According to a Federal Reserve Bank of Richmond study,<sup>35</sup> credit unions in the late 1960s opposed creation of the National Credit Union Share Insurance Fund (NCUSIF) because they thought it would add unnecessary cost. It may well have done so given the still-formidable ability of common-bond members in well-managed credit unions to pressure others to repay their loans at the time. However, with the creation of the NCUSIF, this pressure diminished, leading the Richmond Fed study to conclude that federal deposit insurance undermined the incentive of members with funds at stake to continue effective character-lending discipline. Reflecting this transformation, the common-bond constraint began to erode in 1982, when single-bond credit unions were allowed to draw members from other

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<sup>33</sup> An Act to provide insurance for member accounts in State and federally chartered credit unions and for other purposes (October, 1970 FCUA Amendments), Pub. L. No. 91-468, 84 Stat. 994 (October 19, 1970), available at <https://www.govinfo.gov/content/pkg/STATUTE-84/pdf/STATUTE-84-Pg994.pdf>.

<sup>34</sup> An Act to amend the Federal Credit Union Act so as to provide for an independent Federal Agency for the supervision of federally chartered credit unions, and for other purposes (March, 1970 FCUA Amendments), Pub. L. No. 91-206, 84 Stat. 49 (March 10, 1970), available at <http://uscode.house.gov/statutes/pl/91/206.pdf>.

<sup>35</sup> John R. Walter, “Not Your Father’s Credit Union,” *Federal Reserve Bank of Richmond Economic Quarterly* 92(4), *op. cit.* at 367.

groups.<sup>36</sup> By 1998, this decision was invalidated by the Supreme Court.<sup>37</sup> Congress then quickly reversed course, enacting the Credit Union Membership Access Act,<sup>38</sup> which authorized a single credit union to serve multiple groups under certain restrictions.

A “community” charter for credit unions also exists, disposing of the concept of common bond in favor of affiliation by virtue of geographic location. Community credit unions now serve customers without any other bond beyond the fact that they all live in a city as large as Los Angeles or a single state such as California.<sup>39</sup> Several credit unions – e.g., the \$24.5 billion PenFed – now also have nationwide charters that permit operation without any regard to geography as long as nominal common-bond criteria are met. Low-income credit unions (LICUs) are also now allowed to offer some services without regard to common bond or even community location, including to nonmembers.<sup>40</sup> However, as we shall see, these LICUs – which now hold over \$540 billion in assets<sup>41</sup> – raise numerous questions about the extent to which they in fact advance the industry’s express equality mission. Federal Reserve research<sup>42</sup> has found that they mostly make subprime auto loans with higher default probability; as a result, low-income credit unions may not only fail to increase urgently-needed financial services for low-income households, but also violate the “provident or productive” charter requirement.

Diversified product offerings have also combined with relaxed common bonds to fuel the growth evident in the modern credit-union industry described below.<sup>43</sup> The industry won the power to offer residential-mortgage loans in 1977,<sup>44</sup> began to engage in credit-card lending as these products developed, and in recent years has been granted sharply expanded business-lending powers.<sup>45</sup>

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<sup>36</sup> National Credit Union Association (NCUA) Interpretative ruling and policy statement, “Membership in Federal Credit Unions,” 12 C.F.R. §§ 701, 707, 708, and 745, 47 Fed. Reg. 16755 (April 20, 1982), available at <https://cdn.loc.gov/service/ll/fedreg/fr047/fr047076/fr047076.pdf>.

<sup>37</sup> NCUA v. First National Bank & Trust Co., 522 U.S. 479, (1998).

<sup>38</sup> CUMAA, Pub. L. No. 105-219, 112 Stat. 913, *op. cit.*

<sup>39</sup> Golden 1 Credit Union, “Membership: All Californians Can Join,” Accessed April 5, 2019, available at <https://www.golden1.com/Membership/default>.

<sup>40</sup> NCUA Designation of Low-Income Status; Acceptance of Secondary Capital Accounts by Low-Income Designated Credit Unions Rule, 12 C.F.R. § 701.34 (2018), available at <https://www.govinfo.gov/content/pkg/CFR-2018-title12-vol7/xml/CFR-2018-title12-vol7-sec701-34.xml>.

<sup>41</sup> NCUA, *2018 Annual Report*, 16 (March 19, 2019), available at <https://www.ncua.gov/files/annual-reports/annual-report-2018.pdf>.

<sup>42</sup> Stefan Gissler, Rodney Ramcharan, and Edison Yu, “The Effects of Competition in Consumer Credit Markets,” *Federal Reserve Bank of Philadelphia Working Paper 18-24*, (November, 2018), available at <https://www.philadelphiafed.org/-/media/research-and-data/publications/working-papers/2018/wp18-24.pdf>.

<sup>43</sup> Emir Malikov, Shunan Zhao, and Subal C. Kumbhakar, “Economies of Diversification in the US Credit Union Sector,” *Journal of Applied Econometrics* 32(7), (April 21, 2017), available at [https://www.researchgate.net/publication/316314427\\_Economies\\_of\\_diversification\\_in\\_the\\_US\\_credit\\_union\\_sector](https://www.researchgate.net/publication/316314427_Economies_of_diversification_in_the_US_credit_union_sector).

<sup>44</sup> An Act to Extend the authority for the flexible regulation of interest rates on deposits and accounts in depository institutions, Pub. L. No. 95-22, 91 Stat. 49 (April 19, 1977), available at <https://www.govinfo.gov/content/pkg/STATUTE-91/pdf/STATUTE-91-Pg49.pdf>.

<sup>45</sup> NCUA Member Business Loans; Commercial Lending Final Rule, 12 C.F.R. §§ 701, 723, and 741, 81 Fed. Reg. 13530 (March 14, 2016), available at <https://www.govinfo.gov/content/pkg/FR-2016-03-14/pdf/2016-03955.pdf>.

## **B. Sector Analysis**

As demonstrated above, the U.S. credit-union sector has been transformed since its origins in the 1930s and, indeed, even since the NCUA expanded the common bond in 1998. According to the most recent data from the Credit Union National Association (CUNA), the U.S. has 5,572 credit unions with a total membership of 119.4 million members.<sup>46</sup> The average size of a U.S. credit union now is \$275 million in assets,<sup>47</sup> but 308 credit unions had assets over \$1 billion as of year-end 2018.<sup>48</sup> The largest credit union, Navy Federal, now has assets exceeding \$103 billion.<sup>49</sup> The top ten credit unions by asset size had \$250.6 billion in assets at year-end 2018,<sup>50</sup> comprising 17 percent of the \$1.48 trillion in assets then held by U.S. credit unions.<sup>51</sup> U.S. credit-union assets now exceed \$1.53 trillion.<sup>52</sup>

Much of this growth has occurred since 2005 despite the interruption caused by the 2007-09 financial crisis; credit-union deposits have expanded 108 percent since 2005, now comprising 9.2 percent of all federally-insured deposits.<sup>53</sup>

We will turn shortly to the question of the extent to which credit unions make the equality contribution promised by so large a presence in the U.S. consumer-finance sector under so binding a charter. However, it is important to put this analysis in the context of the business model credit unions have developed as they balance the business imperative of profitability with the charter demand for an equality purpose. Credit unions are not publicly-traded entities; instead, they are member-owned. However, just as bank customers have many options among which to select for the best financial offer, so too do credit-union members. Once credit-union members would have selected only the credit union they jointly owned due to the strength of the common bond. Now, with credit unions making it easy to join a credit union with as little as a \$17 contribution to a designated nonprofit<sup>54</sup> or by providing complementary memberships to organizations that allow one to meet common-bond criteria,<sup>55</sup> credit union members are often just as bottom-line focused as those at banks large and small. Credit unions must thus pay members the highest possible amount on deposits/shares in order to provide members with the largest possible return, increasing credit-union funding costs in ways that have demonstrably altered their asset composition in favor of riskier and less-mission focused exposures.

Although the overall business model of U.S. credit unions is best compared to that of community banks (i.e., generally those with assets below \$10 billion), there are significant differences due to variations in the nature of binding constraints such as capital regulation. Thus, while both credit unions and banks focus on

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<sup>46</sup> CUNA, *Monthly Credit Union Estimates March 2019*, *op. cit.*

<sup>47</sup> *Ibid.*

<sup>48</sup> NCUA, *2018 Annual Report*, *op. cit.* at 192.

<sup>49</sup> Navy Federal Credit Union (NFCU), *About Navy Federal Credit Union*, *op. cit.*

<sup>50</sup> NCUA, "Credit Union and Corporate Call Report Data, Custom Query: Total Assets" (December, 2018), accessed April 8, 2019, available at <https://webapps2.ncua.gov/CustomQuery/CUSelect.aspx>.

<sup>51</sup> CUNA, *Monthly Credit Union Estimates March 2019*, *op. cit.*

<sup>52</sup> *Ibid.*

<sup>53</sup> Keef, Bruyette & Woods (KBW), "The Non-Bank Chronicles, A spotlight Report Part 1: The Rise of Credit Unions," *KBW Spotlight*, Stifel Financial Corporation, March 25, 2019.

<sup>54</sup> PenFed Credit Union, "Ways to Become a Member," September 25, 2013, accessed April 8, 2019, available at <https://www.penfed.org/learn/ways-to-become-a-member>.

<sup>55</sup> NASA Federal Credit Union (NASAFCU), "Membership," accessed May 17, 2019, available at <https://www.nasafcu.com/membership/>.

consumer finance when looked at in broad terms, they do so very differently and with sharp variations in the rate of return afforded by the mix of what may be costly regulation and/or what are allowed to be expansive product offerings.

An analysis of credit-union versus community-bank models<sup>56</sup> finds that the majority of credit unions are, like smaller banks, focused on financial intermediation – i.e., gathering deposits and making loans. However, this analysis does not differentiate also by regulatory restrictions, the approach taken by numerous studies of credit unions, including one from the Federal Reserve Bank of Philadelphia directly comparing credit unions to community banks.<sup>57</sup> The impact of regulation on the business model is apparent not only in the detailed discussion below, but also in the accelerating trend in which credit unions are actually acquiring community banks and saving associations.<sup>58</sup> In these transactions, a credit union generally gets a base of new members that were formerly bank customers – clear evidence of the limited constraint now imposed by the common bond – and acquires deposits and loans also compatible with credit-union restrictions – clear indication again that these are not binding in comparison with those of a bank. The currency with which the credit union is able to accomplish the acquisition for greater value beyond simple growth comes from the very different regulatory framework governing credit unions versus banks. Quite simply, the lower-cost regulatory framework (see below) makes it possible to do the same business with the same customers at greater return – if also at greater risk.

The value of the credit-union charter is also evident in the chart below. It shows that credit unions have grown considerably faster than small banks since the 2008 financial crisis. Even more surprising given the different business models and assertions about “Wall Street” bank dominance, credit unions have also surpassed the growth rate of the largest banks, as shown below.

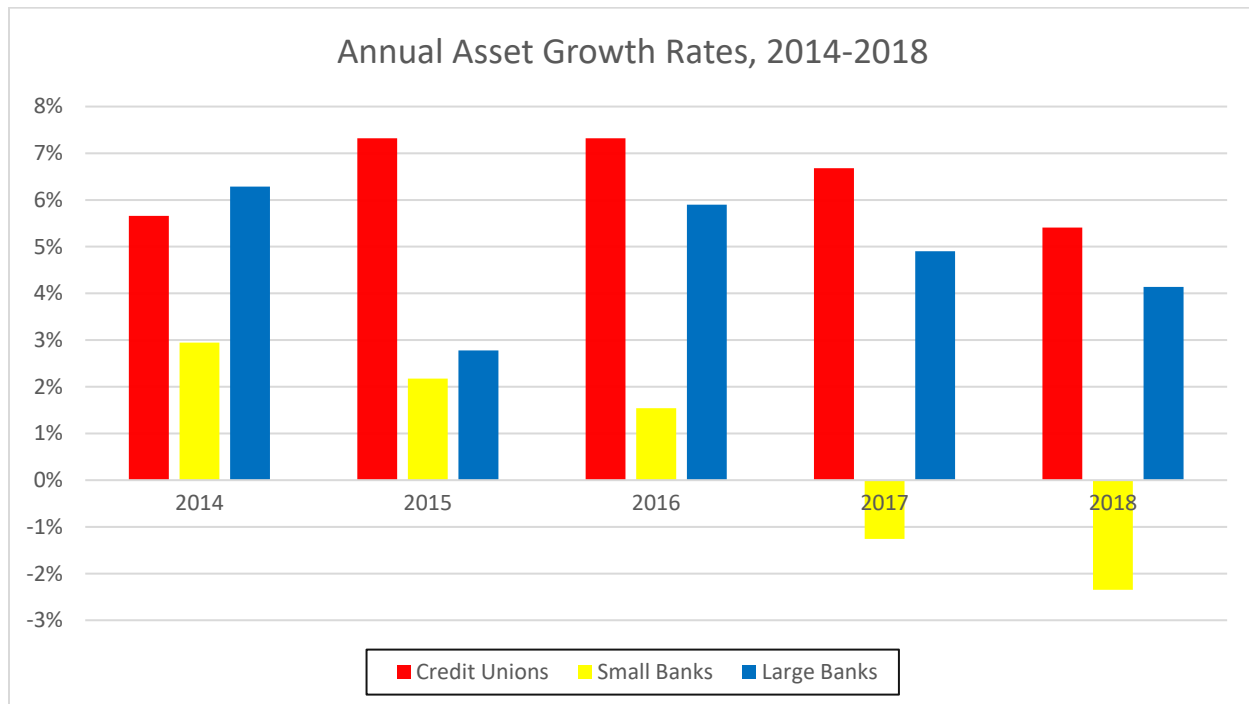
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<sup>56</sup> Rym Ayadi, Michael Keoula, Willem Pieter De Groen, Walid Mathlouthi, and Ibtihel Sassi, *Bank and Credit Union Business Models in the United States*, (January 31, 2018), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3107931](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3107931).

<sup>57</sup> James Disalvo and Ryan Johnston, “Credit Unions’ Expanding Footprint: Is there any evidence new rules could cause small banks to lose market share to credit unions?,” *Banking Trends*, Federal Reserve Bank of Philadelphia Research Department, (First Quarter, 2017), available at [https://www.philadelphiafed.org/-/media/research-and-data/publications/banking-trends/2017/bt-credit\\_unions.pdf?la=en](https://www.philadelphiafed.org/-/media/research-and-data/publications/banking-trends/2017/bt-credit_unions.pdf?la=en).

<sup>58</sup> Andrew P. Meyer, “Why Are More Credit Unions Buying Community Banks?,” *Regional Economist*, Federal Reserve Bank of St. Louis, (First Quarter, 2019), available at <https://www.stlouisfed.org/publications/regional-economist/first-quarter-2019/credit-unions-buying-community-banks>.





Source: Credit Union growth rates are gathered from the NCUA’s *2018 Annual Report*; Bank growth rates are calculated using data from FDIC Quarterly Banking Profiles. “Small Banks” are those with assets totaling less than \$10 billion; “Large Banks” are those with assets totaling \$10 billion or greater.

This sharp growth is surprising given the general view that modern banking requires the economies of scale possible only at large financial-services firms. While credit unions had a unique market edge due to the common bond during the period when banks did not serve LMI customers, credit scoring and other modern underwriting techniques have dramatically reduced the obstacles to measuring the credit risk of most households. Assets such as credit-card loans have also created ways to cross-subsidize risks across a broad range of borrowers in a loan portfolio as long as the portfolio is large enough. One study believes that credit-union growth is due principally to the industry’s ability to diversify into additional services – e.g., automobile loans – not otherwise served by commercial banks likely due to capital and risk constraints under applicable bank regulation.<sup>59</sup> A Federal Reserve Bank of Richmond study<sup>60</sup> also notes that the establishment of the NCUSIF in 1970 eliminated the need for a common-bond tie to permit members to assess the risk of placing funds with a credit union, making the decision to do so the simple business one cited above. Studies such as the one in 2006 from the GAO<sup>61</sup> and a subsequent one by a community-advocacy group<sup>62</sup> find that credit unions generally pay a bit more for savings and checking deposits than community banks, with this is likely due to their exemption from federal taxes and broader efficiencies resulting from exemptions from costly safety-and-soundness rules discussed in more detail below.

<sup>59</sup> Emir Malikov, Shunan Zhao, and Subal C. Kumbhakar, “Economies of Diversification in the US Credit Union Sector,” *op. cit.*

<sup>60</sup> John R. Walter, “Not Your Father’s Credit Union,” *Federal Reserve Bank of Richmond Economic Quarterly* 92(4), *op. cit.* at 369-370.

<sup>61</sup> GAO, “Credit Unions: Greater Transparency Needed on Who Credit Unions Serve and on Senior Executive Compensation Arrangements,” *op. cit.*

<sup>62</sup> NCRC, *Credit Unions: True to Their Mission? (Part II) A Follow-Up Analysis of Credit Union Compared to Bank Service to Working and Minority Communities*, *op. cit.*

### III. Do Credit Unions Serve Small-Means Households?

\$1.53 trillion is a lot of assets that could do a tremendous amount of good for persons of small means. Are these the Americans whom credit unions serve?

The NCUA website provides virtually no information on this critical question, thus affording no actual insight into how the agency evaluates the extent to which credit unions serve small-means households or, as the NCUA prefers to call them, households of “modest means.” After considering a pilot program in the early 2000s, the NCUA abandoned any effort to track these mission-critical data. Although it is unusual for regulators to defer to regulated institutions on statutory matters, the NCUA apparently concurred with a commission comprised of the industry which concluded that:

The Commission is of the strong opinion that supervisory authorities must limit their activities to those related to safety and soundness and compliance with applicable laws and regulations. In particular, it is not the responsibility of regulatory authorities to define, direct, or examine the social mission of credit unions. That is the responsibility of each credit union’s board of directors.<sup>63</sup>

The NCUA does not make it clear why the agency discarded its statutory standard in favor of the “modest-means” criterion or the commonly-accepted definition of low-and-moderate income households that has come into widespread use by policy-makers, economists, and the banking agencies. The NCUA’s definition of modest means is expansive, with the chair of the agency in 2005 telling the House Ways & Means Committee that she thought everyone in the hearing room – Members of Congress and lobbyists included – met the modest-means criterion.<sup>64</sup>

The agency’s definition of “low income” is particularly problematic in comparison to established norms. Under the NCUA’s current rules,<sup>65</sup> a “low-income” member is anyone with a family income below the greater of eighty percent of the relevant area or the national median income. However, most methodologies<sup>66</sup> define low-income households as those with incomes below fifty percent of the applicable median. Low-and-moderate income thresholds may go as high as eighty percent, but then of course these households are no longer all “low-income” – they are also those with modest means and thus the only ones eligible for membership in any credit union were the NCUA’s criteria enforced.

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<sup>63</sup> Reed White, “If It Quacks Like a Duck: In Light of Today’s Financial Environment, Should Credit Unions Continue to Enjoy Tax Exemptions?,” *Georgia State University Law Review* 24(4), 1383 (2012), available at <https://readingroom.law.gsu.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=2712&context=gsulr>.

<sup>64</sup> NCRC, *Credit Unions: True to Their Mission? (Part II) A Follow-Up Analysis of Credit Union Compared to Bank Service to Working and Minority Communities*, *op. cit.* at 7.

<sup>65</sup> NCUA Designation of Low-Income Status; Acceptance of Secondary Capital Accounts by Low-Income Designated Credit Unions Rule, 12 C.F.R. § 701.34(a)(2) (2018), *op. cit.*

<sup>66</sup> See, for example: FRB Community Reinvestment (Regulation BB), 12 C.F.R. § 228.12(m)(1) (2018), available at <https://www.govinfo.gov/content/pkg/CFR-2018-title12-vol3/pdf/CFR-2018-title12-vol3-part228.pdf>.

Further, the “greater-of” approach to calculating “low” income – i.e., the greater of regional or national median income – means that families with incomes well above median in a low-income area nonetheless qualify as low-income for NCUA purposes even though they are affluent under regional norms. Indeed, the definition of “low-income” is so expansive that a community credit union with a low-income designation in an affluent area such as one in Stamford, Connecticut<sup>67</sup> is allowed to serve towns that are among the wealthiest in the nation, if not the world (e.g., Greenwich in the case of this particular credit union). The NCUA’s current definition of “low-income member” also includes students – all students, not just those from lower-income families or those receiving financial aid. Judged by this measure, large swaths of Palo Alto qualify as low-income communities given all the Stanford students.

NCUA standards thus appear designed to maximize credit-union membership, not to ensure adherence to the statutory small-means mission. As shall be shown below, the agency’s idiosyncratic definition of “low income” may undermine the focus of this preferential designation of “low-income credit unions” (LICUs), the number of which exploded after the NCUA decided on its generous definition of “low-income” in 2008.<sup>68</sup>

### **A. Mission Performance**

It is of course possible that credit unions, including large ones, comply with the industry’s statutory mission despite NCUA’s apparent refusal to measure it as other agencies do or to enforce this. However, independent data confirm that the industry falls short of banks in serving LMI households as these are usually defined. Even though banks do not enjoy a tax exemption or regulatory benefits premised on providing banking to small-means households, they were found by the GAO in 2006 and the National Community Reinvestment Coalition (NCRC)<sup>69</sup> in 2009 to do a demonstrably better job at it. This is likely due to the fact that banks come under an equality mission mandate, the Community Reinvestment Act (CRA),<sup>70</sup> to which regulators hold them accountable and for which non-compliance penalties are enforced.

When enacted in 1977 and ever since, the CRA’s rationale rests on the benefits financial institutions receive when they are allowed to accept funds backed by federal deposit insurance. CRA measures LMI lending and investment so that insured deposits gathered from these communities are deployed in them to the greatest extent possible commensurate with safety and soundness.<sup>71</sup> Reflecting the proven importance of the CRA to increasing credit availability and other banking services to LMI communities, the Treasury Department in 2018 recommended that the Act be expanded also to cover nonbank mortgage

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<sup>67</sup> Stamford Federal Credit Union, “Membership: Who Can Join Stamford Federal?,” accessed May 22, 2019, available at <https://www.stamfordcu.org/About-Us/Membership/Who-Can-Join.aspx>.

<sup>68</sup> NCUA Low-Income Definition, 12 C.F.R. §§ 701 and 705, 73 Fed. Reg. 71909, 71912 (November 26, 2008), available at <https://www.govinfo.gov/content/pkg/FR-2008-11-26/pdf/E8-28076.pdf>.

<sup>69</sup> National Community Reinvestment Coalition (NCRC), *Credit Unions: True to Their Mission? (Part II) A Follow-Up Analysis of Credit Union Compared to Bank Service to Working and Minority Communities*, (September, 2009), available at <https://ncrc.org/wp-content/uploads/2009/09/creditunionreport090309.pdf>.

<sup>70</sup> Community Reinvestment Act of 1977 (CRA), Pub. L. No. 95-128, Title VIII, 91 Stat 1147 (October 12, 1977), available at <https://www.govinfo.gov/content/pkg/STATUTE-91/pdf/STATUTE-91-Pg1111.pdf>.

<sup>71</sup> *Ibid.*, at § 802(b)

companies even though these are not eligible to accept insured deposits.<sup>72</sup> This may seem surprising given the Trump Administration’s general aversion to mandatory community-development initiatives, but the Treasury Department recognized the importance of mandates and measurements, as well as the importance of equality-essential financial product offerings.

Although the CRA’s logic clearly applies to credit unions which have enjoyed federal deposit insurance since 1970, the industry has fiercely rejected any measurement of or accountability for its statutory mission. Indeed, when recent legislation was introduced without the CRA mandate for credit unions included in an earlier draft, an industry trade association said that, “Subjecting credit unions to CRA requirements would require them to shift resources away from increasing access to responsible financial products in order to satisfy additional compliance demands. That result would frustrate, rather than benefit, the objectives of increasing access to credit and capital in underserved communities.”<sup>73</sup> While CRA does in fact involve compliance burden – perhaps accounting for the better performance of banks in serving LMI communities – the burden would not appear to outweigh the mission benefits. Indeed, a CRA-like standard would likely be little more than a small reporting burden to credit unions if they served low-and-moderate income families and focused their activities on those advantageous to persons of small means and their communities.

The burden credit unions fear may well arise because NCUA rules allow credit unions to serve higher-income households with a wide array of financial products. As noted, the NCUA does not know if members are indeed of small or even modest means as these are usually measured; its rules authorize membership for a far wider swath of households even when specific benefits are targeted to “low-income” families. Further, credit-union offerings are not consistent with those for which banks usually receive CRA credit. The CRA challenge for credit unions is evident in the most recent analysis of credit-union mission compliance from a 2017 Federal Reserve Bank of Philadelphia paper.<sup>74</sup> Comparing credit unions to community banks shows that credit unions and banks make similar mortgages principally to middle-income borrowers – not those of small or even “modest” means.<sup>75</sup> Credit unions do make a slightly larger portion of their loans in LMI census tracts,<sup>76</sup> but credit unions reject a larger proportion of applicants in LMI census tracts and make safer loans than banks of all sizes. This suggests to the Federal Reserve researchers that credit unions are lending to the often-significant proportion of applicants who, while residing in LMI census tracts, have higher incomes. This is not surprising given that the NCUA has found that middle- and upper-

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<sup>72</sup> Department of the Treasury (Treasury), “Community Reinvestment Act – Findings and Recommendations” Memorandum for the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, April 3, 2018, available at <https://home.treasury.gov/sites/default/files/2018-04/4-3-18%20CRA%20memo.pdf>.

<sup>73</sup> CUNA, “Sen. Warren releases CRA bill reflecting months of CUNA/League engagement,” March 13, 2019, accessed April 15, 2019, available at <https://news.cuna.org/articles/115722-breaking-sen-warren-releases-cra-bill-reflecting-months-of-cunaleague-engagement>.

<sup>74</sup> James Disalvo and Ryan Johnston, “Credit Unions’ Expanding Footprint: Is there any evidence new rules could cause small banks to lose market share to credit unions?,” *op. cit.*

<sup>75</sup> *Ibid.*, at 19.

<sup>76</sup> A low-income census tract is defined as one where the median family income is less than 60 percent of the median family income of the metropolitan statistical area in which it is located. A moderate-income tract has a median family income between 60 and 80 percent of the metropolitan statistical area median.

income households are a far larger share of credit-union members than low- and/or moderate-income ones.<sup>77</sup>

Notably, the NCRC also found that credit unions are more likely to deny mortgage loans to African-American households than to white borrowers with similar credit-risk profiles. Credit unions also generally serve a higher-income customer base than community banks.<sup>78</sup>

In addition to mortgages, credit unions make auto loans, accounting for about 25 percent of the national market as of 2016.<sup>79</sup> Credit-union auto borrowers generally have lower credit scores and receive longer-term, and thus lower-cost loans compared to those who borrow from small and mid-sized banks.<sup>80</sup> However, credit-union delinquencies are lower than those for banks, suggesting to researchers that auto lending may be an area in which the common bond – i.e., the direct relationship with the borrower – permits more equality-advantageous lending.<sup>81</sup> It is not clear how these data will fare as very large credit unions such as PenFed expand into auto lending with campaigns aimed at any and all households facilitated by “membership” terms that are in essence a one-time “charitable” contribution.<sup>82</sup>

Notably, credit unions are found to do better than banks in terms of the rates they pay to members on deposits.<sup>83</sup> It appears that credit unions pass along three-quarters of the cost benefits resulting from their federal income tax exemption, reserving the remaining subsidy for operations and, surprisingly, also to pay for investment losses on riskier holdings than banks may be willing or allowed by their regulators to acquire.<sup>84</sup> Despite the high percentage found to benefit members, it is unclear if this subsidy benefit supports the credit unions’ statutory mission since, as noted, most members are middle- or upper-income households, not those with small means as these are usually measured.

## **B. Low-Income Credit Unions**

It would seem redundant to establish a special-purpose designation for credit unions to serve low-income households given the statutory demand that the NCUA ensure that all credit unions focus on persons of

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<sup>77</sup> NCUA, *Member Service Assessment Pilot Program: A Study of Federal Credit Unions Service*, 28 (November 3, 2006), available via: NCRC, *Credit Unions: True to Their Mission? (Part II) A Follow-Up Analysis of Credit Union Compared to Bank Service to Working and Minority Communities*, *op. cit.* at 11. [Primary source document is no longer available; it was previously available at <https://www.ncua.gov/Legal/Documents/MSAP-Pilot.pdf> and has since removed it from the NCUA website. NCRC reports these NCUA findings.]

<sup>78</sup> James Disalvo and Ryan Johnston, “Credit Unions’ Expanding Footprint: Is there any evidence new rules could cause small banks to lose market share to credit unions?,” *op. cit.* at 20.

<sup>79</sup> *Ibid.*

<sup>80</sup> *Ibid.*, at 21

<sup>81</sup> *Ibid.*, at 23.

<sup>82</sup> Ryan Tracy, “A Military Credit Union Grows With ‘No Speed Limit,’” *Wall Street Journal*, August 1, 2018, available at <https://www.wsj.com/articles/a-military-credit-union-grows-with-no-speed-limit-1533121200>.

<sup>83</sup> James Disalvo and Ryan Johnston, “Credit Unions’ Expanding Footprint: Is there any evidence new rules could cause small banks to lose market share to credit unions?,” *op. cit.* at 23.

<sup>84</sup> Robert DeYoung, John Goddard, Donal G. McKillop, and John O.S. Wilson, “Who Consumes the Credit Union Tax Subsidy?,” December 22, 2016, available at <https://www.aeaweb.org/conference/2017/preliminary/paper/AZTdzAs6>.

small means. However, perhaps due to the increasingly generous definition of low-income and expansion of the credit-union product suite, Congress approved amendments to the Federal Credit Union Act in 1970<sup>85</sup> to authorize a special-purpose designation for “low-income credit unions” (LICUs). LICUs were then allowed to accept non-member deposits from any source, offer secondary capital accounts, and receive an exemption from business lending limits, in addition to obtaining grants and consulting services from the NCUA. NCUA Chairman Hood recently requested that Congress further loosen what remains of these restrictions, asking for statutory authority allowing credit unions to serve underserved areas without requiring them to be local communities as well as explicit authority for “web-based” communities as a basis for a credit union charter.<sup>86</sup> In 1993, the NCUA also made it far easier for a credit union to become an LICU by specifying that only more than a bare majority of members is needed to meet “low-income” eligibility criteria.<sup>87</sup> As noted, NCUA now also provides a very generous definition of who is a “low-income” member.<sup>88</sup>

Unsurprisingly, LICUs have become a popular designation in light of all the benefits added to those already provided to all federal credit unions. In the eight years between the expanded definition of “low-income” in 2008 and 2016, LICUs grew almost 800 percent.<sup>89</sup> As of year-end 2018, LICUs now hold \$542.4 billion<sup>90</sup> or 38 percent of total credit-union assets.

LICUs have thus become a major financial force. Are they a force for the good of low-income members and their communities? Despite increasing U.S. inequality and greater demand for financial services targeted at truly low-income households, the record of LICUs as a charter class is problematic.

According to an analysis from the Federal Reserve Bank of Philadelphia,<sup>91</sup> LICUs do not appear to provide new credit beyond that already available from banks, but instead replace community banks; the study concludes that some LICU activities are the “mirror” image of business lost by community banks over the time period examined.<sup>92</sup> Further, as LICUs grew, they also became formidable competitors in subprime auto lending. This might seem helpful to low-income households given the importance of an automobile to get to work or to address other responsibilities. However, LICUs and the nonbank lenders that competed with them focused their activities largely on the riskiest quartile of the auto-lending market. Perhaps unsurprisingly, non-performing loans also ratcheted up as LICUs grew, leading the Federal Reserve

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<sup>85</sup> October, 1970 FCUA Amendments, Pub. L. No. 91-468, *op. cit.*

<sup>86</sup> NCUA Chairman Rodney E. Hood, *Testimony before the Senate Committee on Banking, Housing, and Urban Affairs: Congressional Testimony: Hearing on Oversight of Financial Regulators* (May 15, 2019), available at <https://www.banking.senate.gov/imo/media/doc/Hood%20Testimony%205-15-191.pdf>.

<sup>87</sup> NCUA Community Development Revolving Loan Program for Credit Unions, 12 C.F.R. § 701.32(d)(3), 58 Fed. Reg. 21642, 21646 (April 23, 1993), available at <https://www.govinfo.gov/content/pkg/FR-1993-04-23/pdf/FR-1993-04-23.pdf>.

<sup>88</sup> NCUA Designation of Low-Income Status; Acceptance of Secondary Capital Accounts by Low-Income Designated Credit Unions Rule, 12 C.F.R. § 701.34(a)(2) (2018), *op. cit.*

<sup>89</sup> Stefan Gissler, Rodney Ramcharan, and Edison Yu, “The Effects of Competition in Consumer Credit Markets,” *op. cit.* at 3.

<sup>90</sup> NCUA, *2018 Annual Report*, *op. cit.* at 16.

<sup>91</sup> Stefan Gissler, Rodney Ramcharan, and Edison Yu, “The Effects of Competition in Consumer Credit Markets,” *op. cit.*

<sup>92</sup> *Ibid.*, at 3.

researchers to conclude that LICU activities may be “socially-inefficient”<sup>93</sup> – i.e., put vulnerable households at risk of unsustainable debt and thus worsen already-grave economic inequality.

Better regulation might, the study concludes, have permitted credit expansion in concert with improved equality. Clearly, LICUs did not step in for affordable-housing finance, start-up small businesses, or first-time mortgages, or for community-development lending to supplement that already offered by banks, which, the Federal Reserve research concludes, failed more often in LICU market areas.

### **C. Common-Bond Membership**

The question of the extent to which credit unions comply with meaningful common bonds is currently before the courts in connection with the most recent NCUA decision in this area.<sup>94</sup> However, leaving aside the question of what Congress may have allowed, numerous aspects of recent NCUA decisions warrant examination in terms of the extent to which credit unions support households of small means and the communities in which they live.

As noted above, credit unions were chartered and are still intended to provide unique equality benefits by virtue of a common bond that creates and then reinforces a cooperative interest in member well-being. The NCUA’s standards are thus meant to define “field of membership” for purposes of satisfying the common-bond objective. Originally, fields of membership had to have a single common bond – i.e., membership in a single organization or employment at a single company. Over time, the NCUA and in some cases, statutory change expanded this traditional construct to permit “multiple” common bonds – i.e., fields of membership with more than one group. Now, “community” credit unions may serve anyone in a “well-defined local community, neighborhood, or rural district,”<sup>95</sup> and the NCUA has also authorized the low-income credit unions with far broader membership fields described above.

The gradual liberalization of common bonds is controversial, with the GAO opining in 2006<sup>96</sup> that community credit unions serving areas as large as all of Los Angeles do not clearly support the small-means mission. Even so, the population limit setting a “local community” continued to be generously interpreted by the NCUA, with the agency even proposing to expand the common bond to areas of up to ten million inhabitants without any other restrictions or focus.<sup>97</sup> At least one credit union now also has acquired a nationwide charter without limitations by acquiring a failing credit union.<sup>98</sup>

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<sup>93</sup> *Ibid.*, at 6.

<sup>94</sup> *American Bankers Association v. National Credit Union Administration*, No. 18-5154 (D.C. Cir. filed May 23, 2018).

<sup>95</sup> CUMAA § 101(b)(3), Pub. L. No. 105-219, 112 Stat. 913, *op. cit.* at 915.

<sup>96</sup> GAO, “Credit Unions: Greater Transparency Needed on Who Credit Unions Serve and on Senior Executive Compensation Arrangements,” *op. cit.* at 11.

<sup>97</sup> NCUA Charter and Field of Membership Manual Proposed Rule, 81 Fed. Reg. 78748 (proposed November 9, 2016) (to be codified at 12 C.F.R. § 701), available at <https://www.govinfo.gov/content/pkg/FR-2016-11-09/pdf/2016-26921.pdf>.

<sup>98</sup> Palash Ghosh and John Reosti, “PenFed deal feeds bankers’ fears of unlimited credit union membership,” *American Banker*, January 4, 2019, available at <https://www.americanbanker.com/news/penfed-deal-feeds-bankers-fears-of-unlimited-credit-union-membership>.

The NCUA's latest definition of the common bond for federally-chartered credit unions<sup>99</sup> also relies on a credit union's "narrative description" of an area in order to deem it a community suitable to establish a single field of membership. It is notable that banks may not provide their regulators with a story about their CRA performance but must instead provide extensive data supporting the extent to which loans and investments are made to LMI households and to community-development activities. Pending revisions to CRA regulation<sup>100</sup> do not contemplate any such relaxation of current bank regulation.

Another contrast between the CRA responsibilities banks must meet and the way common bonds are set is that applicable NCUA regulation<sup>101</sup> permits a community to be defined as a "core" statistical area surrounding – but not including – an urban core. Historically, lending that excluded urban areas has been considered "redlining" – i.e., purposefully setting a business strategy to exclude communities a lender thinks undesirable (e.g., racial or ethnic minorities). This matter is also pending in the courts, but even if it is ultimately found legal, it may still prove adverse to ensuring equal access to credit for persons of small means marooned in an urban area in the midst of wider prosperity.

The NCUA has also defined rural areas so generously that entire states – e.g., Alaska, North Dakota, South Dakota, Vermont, and Wyoming – are deemed single communities that may be subsumed in a common bond.<sup>102</sup> Again, this approach does not constrain a credit union then from serving only the wealthiest households in a state, engaging in business lending for projects such as resorts, or otherwise defining a business model within a permissible common bond with little relation to persons of small means or the "provident" lending also stipulated by law within the credit-union mission.

The NCUA most recently has proposed a new approach to credit-union executive compensation that would appear to create still more incentives within credit unions to maximize profit, not purpose. In its advance notice of proposed rulemaking (ANPR),<sup>103</sup> the NCUA indicates that, "...the Board is seeking comment on how to update the regulations so that credit unions can offer competitive compensation plans without encouraging inappropriate risks, incentivizing bad loans, or negatively effecting safety and soundness." No mention is made of mission compliance, with much in the ANPR instead emphasizing the need for credit unions to compete with other private companies to obtain the best executive talent.

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<sup>99</sup> NCUA, 12 C.F.R. § 701 App. B(V.A.2) (2018), available at <https://www.govinfo.gov/content/pkg/CFR-2018-title12-vol7/pdf/CFR-2018-title12-vol7-part701-appB.pdf>.

<sup>100</sup> Office of the Comptroller of the Currency (OCC) Reforming the Community Reinvestment Act Advanced Notice of Proposed Rulemaking (ANPR), 83 Fed. Reg. 45053 (proposed September 5, 2018) (to be codified at 12 C.F.R. §§ 25 and 195).

<sup>101</sup> NCUA, 12 C.F.R. § 701 App. B(V.A.2) (2018), *op. cit.*

<sup>102</sup> *Ibid.*

<sup>103</sup> NCUA Compensation in Connection With Loans to Members and Lines of Credit to Members ANPR, 84 Fed. Reg. 16796 (proposed April 23, 2019) (to be codified at 12 C.F.R. § 701), available at <https://www.govinfo.gov/content/pkg/FR-2019-04-23/pdf/2019-08166.pdf>.



#### **D. Provident and Productive Lending**

In addition to the small-means mandate, the Federal Credit Union Act of 1934 to this day also states that a credit union is to be organized "...for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes."<sup>104</sup> This purpose is at least as vital now as it was in the Great Depression. Thrift is proving elusive for all too many households, meaning that simple judgments about the extent to which a financial institution makes more loans to vulnerable households tells one little about the extent to which credit enhances long-term wealth accumulation. A compensation standard encouraging lending such as the one contemplated by the NCUA may thus not only distance credit unions from small-means households, but emphasize lending growth at the expense of lending that truly serves long-term wealth accumulation so that family means are small no more.

##### **1. The Provident Mandate**

Pursuant to the charter, it would appear that meeting the credit-union mission cannot be judged solely on how many loans are given to small-means households; it must also be considered in light of whether these loans contribute to wealth equality by improving the ability of small-means households to save for or invest in a family's future well-being. Indeed, more debt may well put households at immediate risk of financial distress after just a small set-back.

A key measure of household financial resilience is the non-mortgage debt of households measured against non-financial assets – i.e., how much credit card, student-loan, auto, and similar debt a household has when measured against non-residential, liquid assets such as savings accounts or investments. Looking at non-mortgage debt to non-financial non-residential assets – i.e., cars, household goods, and other illiquid holdings – shows a jump from 38 percent in 1988 to over 100 percent as of the first quarter of 2018.<sup>105</sup> Given that these households are far more likely to be lower-income than those with financial assets, the magnitude of a debt bubble is instantly apparent. Clearly, credit-union mission-compliance assessments based solely on how much debt is provided to members may well do little but put already-vulnerable households in still greater danger of insolvency.

The nature of the debt bubble has also changed over time. Student debt has more than doubled since 2009,<sup>106</sup> auto debt is up 76 percent since 2010,<sup>107</sup> and many other forms of the short-term, high-cost debt on which lower-income households rely for day-to-day survival are also up dramatically since the financial crisis.

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<sup>104</sup> FCU Act § 101(1), 12 U.S.C. § 1752(1) (2017), available at <https://www.govinfo.gov/content/pkg/USCODE-2017-title12/pdf/USCODE-2017-title12-chap14-subchapl-sec1752.pdf>.

<sup>105</sup> Aaron Brown, "The Next Credit Crisis Will Hit Consumers Hardest," *Bloomberg*, November 21, 2018, available at <https://www.bloomberg.com/opinion/articles/2018-11-21/households-are-not-positioned-well-for-the-next-credit-crisis>.

<sup>106</sup> Alexandre Tanzi, "U.S. Student Loan Debt Sets Record, Doubling Since Recession," *Bloomberg*, December 17, 2018, available at <https://www.bloomberg.com/news/articles/2018-12-17/u-s-student-loan-debt-sets-record-doubling-since-recession>.

<sup>107</sup> Kevin Wack, "Consumer debt is at an all-time high. Should banks be worried?," *American Banker*, July 30, 2018, available at <https://www.americanbanker.com/news/consumer-debt-is-at-an-all-time-high-should-banks-be-worried>.

Given these data, is the credit-union statutory objective of enhancing thrift and lending for provident purposes achieved solely by underwriting new loans based on a borrower's ability to repay yet another obligation on a monthly or interest-only basis? Or, is the objective best met by offering above-market returns on savings accounts, loan-consolidation products that reduce indebtedness over time, or similar, innovative products? Is the "thrift" mission achieved with products such as the 100 percent loan-to-value ratio mortgages now widely on offer from federal credit unions?<sup>108</sup> Extensive research has demonstrated the importance of homeowner equity as a source of wealth accumulation<sup>109</sup> and as a vital safeguard against foreclosure when house prices decline.<sup>110</sup>

As noted above, LICUs have a proven record of making automobile loans to vulnerable households with high default rates. Clearly, this is neither provident nor productive lending, especially in the context of a charter granted unique privileges to enhance low-income household prosperity. As we have also seen, credit-union mortgage lending does not serve those most in need of sustainable financing that ensures long-term home ownership.<sup>111</sup>

## 2. Do Credit Unions Increase Productivity?

What of the "productive" mission also established in the 1934 credit-union charter act? "Productive" lending is not defined in the law nor is it mentioned in NCUA regulation beyond a brief discussion in business-lending regulation that appears to confuse productive activities with those that enhance the business efficiency of a credit union engaged in investment activities.<sup>112</sup> Indeed, the business-lending rule as a whole does not appear to have any mission focus, with the NCUA stating that it is intended to give credit unions "greater flexibility and individual autonomy in safely and soundly providing commercial and business loans...."<sup>113</sup> The member business loan (MBL) rules thus dispense with an array of mission-focused provisions to provide a "principles-based" framework allowing a wide range of commercial-lending activities.<sup>114</sup> At the same time, despite the mention of safety-and-soundness noted above, the final rule eliminated or reduced prior restrictions such as loan limits and collateral requirements. Credit unions may also engage in commercial-lending activities far afield from member-owned businesses – for example, they may purchase participations in loans originated by other institutions regardless of the extent to which such loans support household thrift, productivity, or

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<sup>108</sup> See for examples: NFCU, "HomeBuyers Choice Loan," accessed April 23, 2019, available at <https://www.navyfederal.org/loans-cards/mortgage/mortgage-rates/100-percent-financing.php>; Arlington Community Federal Credit Union (ACFCU), "We Get It. It's Hard to Save. How does Zero-Down Sound?," accessed April 23, 2019, available at <https://www.arlingtoncu.org/personal/home-loans/zero-down>; and NASAFCU, "\$0 Down Fixed-Rate Mortgage\* No PMI Required!," accessed April 23, 2019, available at <https://www.nasafcu.com/zerodown/>.

<sup>109</sup> Matthew Rognlie, "Deciphering the Fall and Rise in Net Capital Share: Accumulation or Scarcity?," *Brookings Papers on Economic Activity: Spring 2015*, (June 7, 2016), available at [https://www.brookings.edu/wp-content/uploads/2016/07/2015a\\_roggnlie.pdf](https://www.brookings.edu/wp-content/uploads/2016/07/2015a_roggnlie.pdf).

<sup>110</sup> See for example: U.S. Department of Housing and Urban Development (HUD) Office of Policy Development and Research, *Report to Congress on the Root Causes of the Foreclosure Crisis*, 16 (January, 2010), available at [https://www.huduser.gov/portal/publications/Foreclosure\\_09.pdf](https://www.huduser.gov/portal/publications/Foreclosure_09.pdf).

<sup>111</sup> James Disalvo and Ryan Johnston, "Credit Unions' Expanding Footprint: Is there any evidence new rules could cause small banks to lose market share to credit unions?," *op. cit.* at 20.

<sup>112</sup> NCUA Member Business Loans; Commercial Lending, 12 C.F.R. §§ 701, 723, and 741, 81 Fed. Reg. 13530, *op. cit.* at 13549.

<sup>113</sup> *Ibid.*, at 13530.

<sup>114</sup> *Ibid.*

economic equality for families of small means.

Examples of equality-problematic lending include commercial real-estate development and housing-finance activities absent any connection to increasing the scant supply of affordable housing. Banks and credit unions have found it sometimes difficult to find qualified appraisers to support non-residential real estate activities, leading to a recommendation in the most recent regulatory review required by the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) to increase the threshold for loans above which such an appraisal is required.<sup>115</sup> In response, bank regulators raised this threshold to \$500,000.<sup>116</sup> Not only has the NCUA proposed to raise its threshold for commercial real estate to \$1 million, but it is also considering raising the appraisal threshold for residential property above the current \$250,000 standard.<sup>117</sup> However, doing so could not only facilitate credit-union mortgage finance for affluent households, but also make it still more likely. The current median U.S. home price is \$226,700,<sup>118</sup> meaning that the current appraisal threshold already applies to higher-priced homes. In fact, the U.S. median price is pushed up by very high-price housing in some major population centers.<sup>119</sup> As a result, \$250,000 is far above the median cost of a home in many of the areas most in need of provident mortgage finance. In many states, the median house price is far lower than \$226,700, with the lowest median price – \$97,300 – found in West Virginia.<sup>120</sup>

Further, the difference between the NCUA and bank-regulatory appraisal standards may lead developers concerned about the rigor of an appraisal to prefer doing business with a credit union – i.e., the higher threshold may exacerbate regulatory arbitrage at long-term risk to financial stability. In concert with liberal appraisal requirements, the more stringent safety-and-soundness standards applied to banks may make it easier not only for credit unions to take on risk barred for banks, but also to do so at greater return due to reduced capital or other prudential costs atop the earnings benefit of the federal tax exemption. Higher-risk loans priced more advantageously due to these benefits could well have equality benefits, especially when credit unions are careful to ensure that such loans are well underwritten to protect themselves and borrowers who otherwise might have difficulty attracting sustainable credit. However, the combination of high-risk lending without clear charter benefit and lenient regulation is the reason that many institutions originally intended to advance equality have over the decades failed at so much cost to themselves, their customers, and the financial system.

For example, the new risk-based capital rules discussed below are not yet in effect, meaning that there are at present few express constraints on the ability of credit unions to stretch for yield or skirt prudent-underwriting constraints. However, even if the 2015 risk-based capital rules come into effect, then

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<sup>115</sup> Federal Financial Institutions Examination Council (FFIEC), *Joint Report To Congress: Economic Growth and Regulatory Paperwork Reduction Act*, 31 (March, 2017), available at [https://www.ffiec.gov/pdf/2017\\_FFIEC\\_EGRPRA\\_Joint-Report\\_to\\_Congress.pdf](https://www.ffiec.gov/pdf/2017_FFIEC_EGRPRA_Joint-Report_to_Congress.pdf).

<sup>116</sup> OCC, FRB, and Federal Deposit Insurance Corporation (FDIC) Real Estate Appraisals, 12 C.F.R. §§ 34, 225, and 323, 83 Fed. Reg. 15019 (April 9, 2018), available at <https://www.govinfo.gov/content/pkg/FR-2018-04-09/pdf/2018-06960.pdf>.

<sup>117</sup> NCUA Real Estate Appraisals NPR, 83 Fed. Reg. 49857 (October 3, 2018) (to be codified at 12 C.F.R. § 722), available at <https://www.govinfo.gov/content/pkg/FR-2018-10-03/pdf/2018-20946.pdf>.

<sup>118</sup> Zillow, “United States Home Prices & Values,” (March 31, 2019), accessed April 25, 2019, available at <https://www.zillow.com/home-values/>.

<sup>119</sup> Joint Center for Housing Studies of Harvard University (JCHS), *The State of the Nation’s Housing 2018*, (June 19, 2018), available at <https://www.jchs.harvard.edu/research-areas/housing-markets-conditions-list>.

<sup>120</sup> Zillow, “United States Home Prices & Values,” *op. cit.*

differences between these rules and the broader supervisory framework applied to credit unions may well give credit unions the “flexibility” and “autonomy” their regulator anticipates from broad business-lending powers. The extent to which this also leads to risk may be evident only after the U.S. economy experiences renewed recession or still worse market stress, but many prior instances in which financial institutions were allowed to self-regulate have ended very badly.

It is also unclear if some of the new activities authorized for credit unions meet the original “productive” criterion even though they may be allowed by law or rule. MBLs may be land-development or construction loans, loans secured by non-farm residential property (regardless of occupancy), commercial real estate, farm loans and those for agriculture production, commercial-and-industrial loans, unsecured business loans, or even unsecured revolving lines of credit for business purposes that may never be repaid.<sup>121</sup>

This is not to say that small-business lending by credit unions, if meaningfully increased, would not be of economic-equality value. Quite the contrary. Small businesses in general and start-up small business in particular are critical to prosperity. As a Federal Reserve Bank of New York study notes,<sup>122</sup> start-ups account for 34 percent of all small businesses with employees – let alone start-ups with a lonely founder working hard to get enough to hire a worker or two – and account for nearly all net new job creation. Small start-ups are often seen as the most effective engine of net new job creation,<sup>123</sup> although for the first time since the 1970s, the number of small businesses fell in the years following the financial crisis and still remains well below trend.<sup>124</sup> Thus, the equality question is not whether MBLs authorized by the NCUA should include small-business lending; the question posed by the rules cited above and the lack of evidence provided by the NCUA is whether the sector’s member business loans in fact make the urgent difference demanded by ever-worse U.S. income inequality.

#### IV. Credit-Union Regulation and Risk

As noted, the extent to which credit unions “earn” their federal tax exemption and related mission benefits depends first on whether the industry meets the statutory demand for provident, productive lending to small-means households. This is a necessary mission-compliance test, but still insufficient. It is also important to assess the extent to which, even if the mission is met, it is then also met prudently so that credit unions serve the most vulnerable households across the full business and financial-market cycle. It is particularly important for institutions that focus on vulnerable households to ensure that sustainable financial services are on offer even in severe-stress situations – i.e., counter-cyclically – as its customers are the ones likely to be most desperate for support when an economy is in recession or worse.

In this section, we thus assess credit-union resilience under stress during the great financial crisis and the

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<sup>121</sup> NCUA Member Business Loans; Commercial Lending, 12. C.F.R. § 723.2 (2018), *op. cit.* at

<sup>122</sup> FRB-NY, *2016 Small Business Credit Survey: Report on Startup Firms*, iii (August 8, 2017), available at <https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-StartupFirms-2016.pdf>.

<sup>123</sup> John Haltiwanger, Ron S. Jarmin, and Javier Miranda, “Who Creates Jobs? Small Versus Large Versus Young,” *The Review of Economics and Statistics* XCV, no. 2 (May, 2013): 347, available at [https://www.mitpressjournals.org/doi/pdf/10.1162/REST\\_a\\_00288](https://www.mitpressjournals.org/doi/pdf/10.1162/REST_a_00288).

<sup>124</sup> Steven H. Strongin, *Testimony before the House Small Business Committee: Job Creation, Competition, and Small Business’ Role in the United States Economy* (February 14, 2018), available at [https://smallbusiness.house.gov/uploadedfiles/2-14-18\\_strongin\\_testimony.pdf](https://smallbusiness.house.gov/uploadedfiles/2-14-18_strongin_testimony.pdf).

industry's prospects in the event of a U.S. recession or even renewed financial crisis. All regulated financial institutions of course should operate in the best interests of safety and soundness not only to prevent the need for more taxpayer bail-outs, but also because of the damage the failure of even a small financial institution may do to its community. When an institution is owned by its members and its members are of only "small means," then an institution's failure does still more grievous damage to economic inequality.

### **A. Credit Unions and the Great Financial Crisis**

The crash of 2007-09 has come to be called the "great financial crisis" or GFC in the literature wrestling with causes, cures, and forecasts of crises to come. Although often seen as a crisis of giant financial companies, the GFC's origins also lie in problematic lending at companies far smaller than giant banks and/or well outside the regulatory perimeter of pre-crisis safety-and-soundness regulation. Liquidity risk – i.e., having short-term funding for long-term obligations – also toppled financial institutions large and small, as did operational risk – internal-control, management, and systems failures that led to insufficient resilience and buried risks.

The bulk of the macroeconomic damage done by the GFC may well have been wrought by giant bank and non-bank companies with what economists call "negative externalities" – i.e., size and/or scope so great as to ensure widespread damage in the wake of a company's weakness or failure. However, there are also negative externalities when small financial companies falter. These are evident in the GFC's wake in the damage done to homeowners who lost their homes and thus their main source of wealth, to small businesses suddenly cut off from credit and thus from survival, to uninsured depositors, and to the small communities that often depend on small financial institutions as critical providers of equality-essential deposit and lending services. The GFC thus matters to public policy and economic inequality not only as it manifested itself at giant financial companies, but also as it was experienced by small financial institutions such as credit unions.

Because the GFC was a national crisis, the taxpayer rescue was provided to many small institutions that, while under the radar, were also bailed out. For example, assistance in the form of Troubled Asset Relief Program (TARP) capital support was provided to 67 U.S. credit unions, amounting to \$91 million.<sup>125</sup> The industry also required an \$11.21 billion direct backstop from the Treasury Department for the Share Insurance Fund<sup>126</sup> and an additional \$10 billion draw from the Treasury at the height of the financial crisis.<sup>127</sup> During the crisis, the NCUA also had a \$41 billion line of credit with the Treasury via the Federal Financing Bank.<sup>128</sup> These various Treasury backstops would have been still greater had the NCUA not created a temporary waiver from capital requirements for corporate credit unions that permitted them to operate in lieu of resolution.

Notably, the Share Insurance Fund is structured differently than the FDIC's Deposit Insurance Fund (DIF). Although insured depository institutions that are not credit unions pay premiums to the FDIC that are then

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<sup>125</sup> ProPublica, "Bailout Recipients," *ProPublica Bailout Tracker: Tracking Every Dollar of Every Recipient*, Updated February 25, 2019, available at <https://projects.propublica.org/bailout/list>.

<sup>126</sup> NCUA, "Corporate System Resolution, Borrowing Cost," accessed April 12, 2019, available at <https://www.ncua.gov/support-services/corporate-system-resolution/borrowing-cost>.

<sup>127</sup> GAO, "National Credit Union Administration: Earlier Actions Are Needed to Better Address Troubled Credit Unions," *GAO-12-247*, 21 (January, 2012), available at <https://www.gao.gov/assets/590/587409.pdf>.

<sup>128</sup> *Ibid.*

solely the assets of the DIF, credit unions place “deposits” at the NCUSIF that are treated under law as equity for the NCUSIF and at the same time as assets of the credit union. This allows credit unions to avoid the balance-sheet cost of contributions to a federally-backed deposit insurance fund which has been a longstanding cost against profitability for all other insured depository institutions, essentially subsidizing the credit-union industry’s line of credit to the Treasury by permitting double-counting of deposit-insurance coverage payments as if they are both ordinary assets (e.g., loans) and as equity in the Share Insurance Fund, a riskless government entity.

## **B. Hard-Learned Crisis Lessons**

The GFC acquired its name since its damage – estimated by some to amount to at least \$22 trillion to the U.S. macro-economy<sup>129</sup> – was the worst since the Great Depression of the 1930s. However, prior to the GFC, the U.S. savings-and-loan (S&L) crisis of the 1980s and early 1990s was more than noteworthy in terms of the damage done to the U.S. economy – \$10.5 trillion (in 2019 dollars) in lost output,<sup>130</sup> \$220.34 billion (2019 dollars) in taxpayer costs,<sup>131</sup> and the end of an industry with charters founded on providing the “American dream of home ownership.” The S&L crisis also led to the collapse of the industry’s own deposit insurance fund (known as FSLIC), the end of a regulatory structure found to have been all too captive to S&Ls, and a \$46.7 billion<sup>132</sup> (2019 dollars) loss at the FDIC that cost insured banks dearly in terms of higher costs for DIF recapitalization until the Fund met statutory requirements in 1996.<sup>133</sup> Much damage thus was done in the name of the “American dream” ideal, making the S&L crisis an instructive case of the risks of seemingly high-minded charters operating in pursuit of maximum profit unconstrained by effective safety-and-soundness standards.

In the case of both the S&L debacle and great financial crisis, several lessons guided Congressional and regulatory reform efforts. The first was to question the mission when vulnerable-household needs are unmet. Although there was much talk about the critical importance of dedicated housing-finance institutions even after the S&L crisis, the GFC sealed their fate as savings associations under a uniquely privileged regulatory framework set by the now-closed Office of Thrift Supervision. The need during the crisis to put Fannie Mae and Freddie Mac into conservatorship reinforced the dangers of ostensible mission goals under lax regulation. Congress now is considering how to reform the GSEs to retain dedicated charters with a housing-finance mission, but the nature of all of the controls evident in proposals now under active consideration<sup>134</sup> shows that Congress is no longer willing to let at least some companies cite their mission as a defense against prudential regulation.

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<sup>129</sup> Regis Barnichon, Christian Matthews, and Alexander Ziegenbein, “The Financial Crisis at 10: Will We Ever Recover?” *FRBSF Economic Letter 2018-19*, August 13, 2018, available at <https://www.frbsf.org/economic-research/publications/economic-letter/2018/august/financial-crisis-at-10-years-will-we-ever-recover/>.

<sup>130</sup> Alexander J. Field, “The Saving & Loan Insolvencies and the Costs of Financial Crisis,” *Research in Economic History* 65, 43 (2017), available at <https://scholarcommons.scu.edu/cgi/viewcontent.cgi?article=1091&context=econ>.

<sup>131</sup> GAO, “Financial Audit: Resolution Trust Corporation’s 1995 and 1994 Financial Statements,” *GAO/AIMD-96-123*, 13 (July, 1996), available at <https://www.gao.gov/assets/230/222902.pdf>

<sup>132</sup> *Ibid.*

<sup>133</sup> Kenneth Jones and Barry Kolatch, “The Federal Safety Net, Banking Subsidies, and Implications for Financial Modernization,” *FDIC Banking Review* 12(1), 7 (1999), available at <https://www.fdic.gov/bank/analytical/banking/9905.pdf>.

<sup>134</sup> Senate Banking Committee Chairman Mike Crapo (R-ID), “Housing Reform Outline,” Senate Banking Committee, February 1, 2019, available at <https://www.banking.senate.gov/imo/media/doc/Housing%20Reform%20Outline.pdf>.

Another lasting lesson with direct relevance to assessing credit unions in 2020s is the need for stringent, independent, and forceful safety-and-soundness regulation and proactive supervision of each institution regardless of size. After the S&L crisis, a Congressionally-chartered commission concluded that “the debacle... was a consequence of the perverse incentives, permissive regulation, and inadequate supervision that had been built into the system.”<sup>135</sup> 18 years later, the Financial Crisis Inquiry Commission Congress created concluded that the GFC’s cause was in large part the result of “dramatic breakdowns in corporate governance, profound lapses in regulatory oversight, and near fatal flaws in our financial system.”<sup>136</sup>

The nature and effectiveness of credit-union regulation and supervision is thus vital not only to ensuring the survival of an industry designed to serve an essential equality function, but also to avoiding the profound damage to vulnerable households and the economy when even a small financial institution falters or fails. While only many small failures at the same time are likely to have negative externalities of systemic scale, credit unions now account for 9.2 percent of all federally-insured deposits.<sup>137</sup> Shock across the credit-union sector could thus have severe and possibly even systemic impact.

We thus turn to the four most important planks of post-GFC safety-and-soundness regulation to assess the extent to which credit unions can withstand stress and prevent yet another case in which taxpayers rescue a sector of the U.S. financial industry or grave equality and macroeconomic damage is done. These planks are first and foremost effective regulation and supervision. As both the S&L and great-financial crisis proved in an all-too-costly way, a captive or even just an indolent supervisor undermines the value of the toughest rules a regulator may cause to be printed in the *Federal Register*. Assuming sound supervision, the three essential regulatory planks then are generally considered to be capital, liquidity, and risk-management regulation, each of which is described below, referenced to the standards governing banks similar to credit unions in size and asset composition, and then analyzed in light of applicable NCUA regulation.

The complexity of all of these rules and subtle differences among them may lead to mistaken conclusions about the resilience and comparability of the credit-union framework. For example, in its 2017 report, the Treasury Department concluded that credit unions are “very well capitalized,” citing an aggregate net worth ratio – which it says is equivalent to the bank leverage ratio – of approximately eleven percent.<sup>138</sup> At the same time (year-end 2016), the actual bank leverage ratio for insured depositories below \$10 billion in assets was 10.7 percent.<sup>139</sup> This may seem about the same but these community banks were in fact far better capitalized than credit unions once the definition of capital is taken into consideration along with the far more stringent risk weightings applied to banks. As of year-end 2018, credit unions have a net

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<sup>135</sup> National Commission on Financial Institution Reform, Recovery, and Enforcement (NCFIRRE), *Origin and Causes of the S&L Debacle: A Blueprint for Reform: A Report to the President and Congress of the United States*, 8 (July, 1993), available at <https://babel.hathitrust.org/cgi/pt?id=pur1.32754063100741;view=1up;seq=3>.

<sup>136</sup> Financial Crisis Inquiry Commission (NCIC), *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, xxviii (January, 2011), available at [http://fcic-static.law.stanford.edu/cdn\\_media/fcic-reports/fcic\\_final\\_report\\_full.pdf](http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf).

<sup>137</sup> Keef, Bruyette & Woods (KBW), “The Non-Bank Chronicles, A spotlight Report Part 1: The Rise of Credit Unions,” *KBW Spotlight*,” *op. cit.*

<sup>138</sup> Treasury, *A Financial System That Creates Economic Opportunities, Banks and Credit Unions*, 23 (June 12, 2017), available at <https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf>.

<sup>139</sup> FDIC, “Fourth Quarter 2016,” *FDIC Quarterly Banking Profile 11(1)*, 9 (February, 2017), available at <https://www.fdic.gov/bank/analytical/qbp/2016dec/qbp.pdf>.

worth ratio of 11.3 percent<sup>140</sup> according to the NCUA; banks under \$10 billion had an 11.2 percent leverage ratio<sup>141</sup> under the more stringent standards described in detail below.

### **C. Effective Supervision**

The National Credit Union Administration is unique as what its former chairman (and current board member) describes as a “one-stop shop” which “insures, regulates, examines, supervises, charters, and provides liquidity to credit unions.”<sup>142</sup> This may seem efficient, but it in fact houses so much power in a single agency that mistaken judgments or undue deference to industry concerns may have little chance of correction short of Congressional intervention. Interestingly, Congress engaged in extensive debate in 2010 in formulating the Dodd-Frank Act as to whether it would be advisable to create a similar one-stop shop for bank regulation, insurance, and even liquidity. Ultimately, the Act<sup>143</sup> eliminated only the aforesaid, disgraced Office of Thrift Supervision, allocating its responsibilities to the Office of the Comptroller of the Currency and otherwise retaining the current, but now-strengthened multi-agency regulatory structure. The reason for retaining the three-agency system and all its resulting duplication was Congress’ aversion to creating one regulator that could fall captive without the conflicts over jurisdiction that often provide transparency uncovering unduly accommodative supervision or lenient regulation.

The NCUA is not only a force unto itself, but also independent with regard to its governance except to the extent that its chairman and board members serve at the pleasure of the President.<sup>144</sup> The NCUA is self-funded and thus immune from the discipline of the Congressional appropriations process, nor does any Cabinet officer – e.g., the Treasury Secretary – have any direct authority. This independence shields the NCUA from political capture, but not from what could become a self-reinforcing relationship with the industry, which funds the NCUA and thus supports the board’s desired initiatives without any other checks and balances.

As shall be seen, the current credit-union framework also differs from post-crisis consensus on the need for and nature of capital, liquidity, and other safety-and-soundness rules. However, no matter how stringent a rule, it is meaningless if a supervisor fails to enforce it. The NCUA may be more sanguine about risk than fellow federal regulators because of its liquidity-support authority and distance from external governance. However, the more the NCUA insulates credit unions from early and effective supervisory intervention, the greater the risk that credit unions, even though often small, will be immune from market discipline. As the

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<sup>140</sup> NCUA, *2018 Annual Report*, *op. cit.* at 7.

<sup>141</sup> FDIC, “Fourth Quarter 2018,” *FDIC Quarterly Banking Profile 13(1)*, 7 (February, 2019), available at <https://www.fdic.gov/bank/analytical/qbp/2018dec/qbp.pdf>.

<sup>142</sup> NCUA Chairman J. Mark McWatters, *Oral Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs: Implementation of the Economic Growth, Regulatory Relief, and Consumer Protection Act* (October 2, 2018), available at <https://www.ncua.gov/newsroom/testimony/2018/chairman-mcwatters-oral-testimony-implementation-economic-growth>.

<sup>143</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) § 313, Pub. L. No. 111-203, 124 Stat. 1376, 1523 (July 21, 2010), available at <https://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf>.

<sup>144</sup> FCU Act §102(b), 12 U.S.C. § 1752a(b) (2017), available at <https://www.govinfo.gov/content/pkg/USCODE-2017-title12/pdf/USCODE-2017-title12-chap14-subchapl-sec1752a.pdf>.



GAO has noted, moral hazard may well apply to credit unions that expect the NCUA to rescue them.<sup>145</sup>

To counter moral hazard, Congress mandated prompt corrective action (PCA) for banks and savings institutions in 1991,<sup>146</sup> toughening PCA up for the biggest banks in Dodd-Frank with additional “early remediation” powers.<sup>147</sup> The NCUA received its own PCA authority in 1998,<sup>148</sup> but has interpreted it at considerable variance to the requirements applicable to banks and has also failed to use even this authority to intervene to prevent failure and heightened costs to itself and the taxpayer.

The current NCUA PCA rules are considerably less stringent. They set a single, seven percent ratio of risk-based net worth as the definition of a well-capitalized credit union. As noted below, the NCUA has finalized a new risk-based framework that revises this approach, but it has delayed implementation until 2020 and may well subject it to additional delays. As a result, we compare current NCUA PCA standards with those applicable to banks.

The closest equivalent to the NCUA’s risk-weighted net worth trigger for prompt corrective action is a bank’s risk-based capital level, although as we shall see the ratios are not at all comparable even if ratios look close because the NCUA’s definition of eligible capital is less stringent than that imposed on banks. Further, the credit-union well-capitalized risk-weighted ratio minimum of seven percent compares to a ten percent ratio for banks and a leverage ratio of five percent, with no such risk-neutral PCA requirement applicable to credit unions that might offset flaws in the current risk-weighted net worth approach or those that may come under the risk-based capital rule.

Had the NCUA’s capital PCA been more robust, then fewer credit unions might have failed during the crisis despite these liberal capital requirements. The GAO’s review<sup>149</sup> of NCUA’s performance during the great financial crisis found that credit unions that were subject to PCA were less likely to fail than those allowed to operate unchecked. Corroborating findings of the NCUA’s own Office of Inspector General (OIG), the GAO also found that the NCUA acted too slowly or sometimes not at all to prevent costly credit union failures.

Has this changed in the decade since the crisis? Not according to the NCUA’s OIG, who is required by law to review each failed credit union’s case to assess the extent to which the NCUA used all of its formidable supervisory and regulatory powers to avert failure. In its 2012 report, GAO urged NCUA to adhere to OIG’s recommendations at that time; by 2019, this has yet to occur.

As noted above, the NCUA has allowed many charters to operate with seemingly scant regard for the “small-means” statutory mission. A clear case in point is the state and federal charters enjoyed by three

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<sup>145</sup> GAO, “National Credit Union Administration: Earlier Actions Are Needed to Better Address Troubled Credit Unions,” *op. cit.* at 2.

<sup>146</sup> Federal Deposit Insurance Corporation Improvement Act (FDICIA) § 131, Pub. L. No. 102-242, 105 Stat. 2236, 2253 (December 19, 1991), available at <https://www.govinfo.gov/content/pkg/STATUTE-105/pdf/STATUTE-105-Pg2236.pdf>.

<sup>147</sup> Dodd-Frank § 166, Pub. L. No. 111-203, 124 Stat. 1376, *op. cit.* at 1432.

<sup>148</sup> CUMAA § 301, Pub. L. No. 105-219, 112 Stat. 913, *op. cit.* at 923.

<sup>149</sup> GAO, “National Credit Union Administration: Earlier Actions Are Needed to Better Address Troubled Credit Unions,” *op. cit.*

now-failed credit unions: Melrose, LOMTO, and Bay Ridge. As detailed in a 2019 report by NCUA's OIG,<sup>150</sup> all of these credit unions specialized in lending for New York City taxi medallions and each had so concentrated a portfolio in these loans that, in concert with poor risk management and governance, each failed at considerable cost to the Share Insurance Fund. As noted above, credit unions are limited by law in the amount of member business loans they may make, but the NCUA nonetheless granted all three now-failed organizations a special-purpose charter solely for taxi-medallion lending. Leaving aside the mission-compliance of this lending – much of which went to fleet owners, not cab drivers – and its considerable risk, the OIG found that the NCUA failed to avert failure by effective supervision and, upon demonstrated lapses at the credit unions, then failed to enforce applicable PCA sanctions. Due largely to the failures of credit unions specializing in taxi-medallion lending, the total assets of failed credit unions in 2018 – \$1.6 billion – were more than eleven times greater than the average for the previous four years – \$134.5 million.<sup>151</sup> Notably, this occurred despite fewer failures in 2018 than in any of those years.

#### **D. Capital Regulation**

Capital is at its root the stake owners put in a company in hopes of profiting thereby. The more capital, the safer the company because owners provide low-cost funding in concert with having “skin in the game” to limit risk in hopes of getting their capital back along with a profit for having invested it. The less capital, the greater the potential return because profits are spread over a smaller ownership base, but the greater the risk because ownership stakes are replaced by higher-cost funding without binding incentives to control risk. When a company's funders stand to lose a lot if the company takes undue risk, their incentives are similar to those of owners and exert at least some market discipline. But, when funding is backed by federal deposit insurance and/or bail-out expectations, low capital ensures high return until the music stops and customers, homeowners, depositors, and taxpayers are forced to pay up.

The capital/risk dynamic was evident in the S&L crisis. Regulators in the early 1980s saw growing danger as deposit interest rates rose but the return on portfolios of long-term mortgage loans remained unchanged at rates increasingly below rising funding costs. Convinced by the “American dream” mission and all too close to the companies it regulated, the Federal Home Loan Bank Board (the S&L industry's regulator at the time) created “net worth certificates” – i.e., paper that the agencies counted as capital but that in fact imposed no cost to shareholders or any discipline on “recapitalized” S&Ls. As noted above, despite these disastrous results, the NCUA deployed a similar strategy during the great financial crisis, granting corporate credit unions capital waivers instead of forcefully implementing prompt corrective action.

Strengthened in the wake of crises since the 1980s, the bank capital regime as of 2019 includes not only PCA requirements but also capital rules that vary with risk (risk-based capital or RBC standards), capital standards that are set without regard to risk (leverage ratios), and stress testing designed to ensure capital resilience under even acute stress. Although current law<sup>152</sup> requires the NCUA to impose risk-based net worth rules akin to those applicable to insured depositories, the agency has followed a haphazard route to promulgating standards that not only remain at considerable variance to those governing banks, but are

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<sup>150</sup> NCUA Office of Inspector General (OIG), “Material Loss Review of Melrose Credit Union, LOMTO Federal Credit Union, and Bay Ridge Federal Credit Union,” *Report #)IG-19-06*, (March 29, 2019), available at <https://www.ncua.gov/files/audit-reports/oig-material-loss-review-march-2019.pdf>.

<sup>151</sup> NCUA, *NCUSIF Financial Statistics for the Quarter Ended March 31, 2019*, 12 (May 23, 2019), available at <https://www.ncua.gov/files/agenda-items/AG20190523Item1a.pdf>.

<sup>152</sup> CUMAA § 301, Pub. L. No. 105-219, 112 Stat. 913, *op. cit.* at 923.

also unimplemented and subject to still more potential delay.

### 1. Definition of Capital

Perhaps the most important reason that credit-union and bank regulatory-capital ratios are at considerable variance is that the definition of capital is strikingly different. Capital for credit-union purposes is called “net worth” because credit unions are member – not shareholder – owned. NCUA regulations define net worth as is done under Generally Accepted Accounting Principles (GAAP), except with notable differences that make net worth an uncertain guide to the extent to which a credit union has more assets than liabilities. Many analyses of credit-union capital describe net worth as akin to retained earnings, but it is in fact different in several significant respects.

Under GAAP,<sup>153</sup> net worth is essentially the difference between assets and liabilities – i.e., retained earnings. But, the NCUA rule nonetheless counts certain loans to other credit unions as net worth even though such loans under GAAP otherwise would be assets against which regulatory capital must be held. The definition pending in the NCUA’s risk-based capital rule similarly counts what for banks are assets as capital for credit-union purposes. Further, current NCUA rules and the pending RBC ones count reserves as if they are retained earnings, a sharp variance from bank regulation,<sup>154</sup> which segregates loan loss reserves from regulatory capital except with a very limited exception for “Tier 2” risk-based capital. It is in fact because loan loss reserves are segregated from capital that banks fear the adverse impact of current expected credit loss (CECL) accounting under a soon-to-be-implemented change to GAAP.<sup>155</sup> Bank regulators have steadfastly refused to count reserves as capital, making CECL a costly change with adverse credit-availability implications for banking organizations.

An additional and significant difference between credit-union and bank capital derives from the decision by NCUA also to count “secondary” capital as net worth for low-income credit unions. LICUs now account for almost half of all credit unions<sup>156</sup> and engage in activities at wide variance with those most would view as mission-critical for persons of small means.

Further, the NCUA is proposing to expand eligible capital instruments far beyond even the current, generous net-worth and secondary standards to include “supplemental” investment instruments restricted for banking organizations, including even the biggest ones with knowledge of the capital markets, counterparties, and structures associated with these alternative “capital” constructs.<sup>157</sup> Key to the proposal is the NCUA’s view that it has the authority to allow alternative, otherwise-impermissible capital instruments to define “risk-based net worth.” This appears unclear. The definition for net worth in relation to capital is defined by law, but the agency asserts in its proposal that it has the authority to adjust risk weightings for net-worth measurement purposes which would then be the levels that drive

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<sup>153</sup> Financial Accounting Standards Board (FASB), *Accounting Standards Codification*, available at <https://asc.fasb.org/>.

<sup>154</sup> FDIC Definition of Capital, 12 C.F.R. § 324.20-324.22 (2018), available at <https://www.govinfo.gov/content/pkg/CFR-2018-title12-vol5/pdf/CFR-2018-title12-vol5-part324-subpartC.pdf>.

<sup>155</sup> FASB, “Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments,” *FASB Accounting Standards Update No. 2016-13*, (June, 2016), available at [https://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1176168232528&acceptedDisclaimer=true](https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176168232528&acceptedDisclaimer=true).

<sup>156</sup> NCUA, *2018 Annual Report*, *op. cit.* at 16.

<sup>157</sup> NCUA Alternative Capital ANPR, 82 Fed. Reg. 9691 (proposed February 8, 2017) (to be codified at 12 C.F.R. §§ 701-703, 709, 741, and 745), available at <https://www.govinfo.gov/content/pkg/FR-2017-02-08/pdf/2017-01713.pdf>.

prompt corrective action,<sup>158</sup> perhaps making Congress' early-intervention mandate still easier to circumvent.

The NCUA compares alternative capital to the subordinated debt community banks may raise for limited capital purposes. However, as the proposal notes, only 0.34 percent of community bank capital consists of subordinated debt. The NCUA leaves this unsaid, but this small share is due to regulatory demands for more robust, resilient instruments. There is also a considerable body of academic and regulatory analytics concluding that subordinated debt is a volatile, uncertain source of primary capital.<sup>159</sup>

The NCUA's experience with secondary capital at LICUs is troubling; LICUs derive a significant percentage of capital from these complex sources, but are 362 percent more likely to fail than LICUs that rely on more traditional capital such as retained earnings.<sup>160</sup> Despite this troubling record, the agency still contemplates allowing all credit unions to rely on subordinated debt as "supplemental" capital for both the net-worth and risk-based ratios. Still more problematic could be the proposal also to allow credit unions to float subordinated debt or similar, still more complex instruments to capital-market entities such as hedge funds. Law<sup>161</sup> and rule<sup>162</sup> appear to bind credit unions to borrowing only from "natural persons," but the NCUA does not believe itself bound by this restriction at least with regard to debt used for capital purposes.<sup>163</sup> It does ask for views on the extent to which supplemental capital instruments might be sold to investors (including even non-member consumers) in ways that transfer ownership rights; if this occurs, then this could directly threaten the member-cooperative structure of credit unions, as the NCUA readily recognizes but does not clearly indicate it would prohibit.

## 2. *The Definition of Risk*

Ultimately, capital resilience is judged not only by how much capital a company has and how resilient its capital instruments are, but then also by whether capital is sufficient compared to assets from both a leverage and risk-based perspective. Although current law requires equivalent risk-based capital for banks and credit unions, the NCUA's still-pending approach differs not only because its definition of capital is so lenient, but also because the NCUA's risk-based rule judges asset risk very differently than is done for banks.

Perhaps most striking is that the NCUA varies the amount of RBC not solely on the riskiness of certain assets, but also on how much of them a credit union may hold. This may indirectly constrain credit risk, but it also ensures that a credit union can hold very risky assets (e.g., subprime auto loans, high-leverage residential mortgages or second liens) at capital ratios often below those applied to banks.<sup>164</sup>

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<sup>158</sup> *Ibid.*, at 9695.

<sup>159</sup> FRB and Treasury, *The Feasibility and Desirability of Mandatory Subordinated Debt*, (December, 2000), available at [https://www.federalreserve.gov/boarddocs/rptcongress/debt/subord\\_debt\\_2000.pdf](https://www.federalreserve.gov/boarddocs/rptcongress/debt/subord_debt_2000.pdf).

<sup>160</sup> NCUA Alternative Capital ANPR, 82 Fed. Reg. 9691, *op. cit.* at 9694.

<sup>161</sup> FCU Act, 12 U.S.C. §1757(9) (2017), available at <https://www.govinfo.gov/content/pkg/USCODE-2017-title12/pdf/USCODE-2017-title12-chap14-subchapl-sec1757.pdf>.

<sup>162</sup> NCUA Borrowed funds from natural persons, 12 C.F.R. § 701.38 (2018), available at <https://www.govinfo.gov/content/pkg/CFR-2018-title12-vol7/pdf/CFR-2018-title12-vol7-sec701-38.pdf>.

<sup>163</sup> NCUA Alternative Capital ANPR, 82 Fed. Reg. 9691, *op. cit.* at 9695.

<sup>164</sup> FDIC Capital Adequacy, 12 C.F.R. § 324 (2018), available at <https://www.govinfo.gov/content/pkg/CFR-2018-title12-vol5/pdf/CFR-2018-title12-vol5-part324.pdf>.

A concentrated-risk approach to setting capital permits high-risk obligations to be a large portion of a credit union's assets (e.g., 35 percent). A risk weighting that might make sense in a diversified portfolio is likely to prove more than insufficient if a credit union succumbs to the incentives in the NCUA's risk-based capital rule instead of abiding by the controls long recognized due to portfolio diversification. Bank regulatory risk weightings vary regardless of concentration (which is covered under other rules<sup>165</sup>), instead varying by factors such as the loan-to-value ratio of a mortgage in order to capture the risk of each loan.

Finally, the credit-union capital framework also differs from the risk-based capital rules governing banks because it has yet to have binding impact. Although mandated in 1998, the risk-based proposal was revised again in 2018 and is now set only to become effective starting in 2020. In contrast, banks have been under increasingly-stringent risk-based rules since 1988.

### 3. *Stress Testing*

Regulatory capital is not only as good as its definition and then as the riskiness of the assets it backs, but must also be sufficient to withstand stress not built into basic capital assumptions. The NCUA liberalized its prior stress-testing and capital-planning standards in a 2018 final rule.<sup>166</sup> This applies both of these standards only to credit unions with assets above \$10 billion and retracts current restrictions. As a result, covered credit unions will conduct what once had been supervisory stress testing undertaken by the NCUA. Few, if any, penalties appear likely for a credit union if its stress test is insufficiently resilient under scenarios such as those mandated by the banking agencies for company-run stress testing.<sup>167</sup>

### **E. Additional Risks**

Capital has become the hallmark of post-crisis regulatory policy, with Congress as noted recognizing this in the Dodd-Frank Act and bank regulators doing so by a combined effort to increase supervisory rigor and toughen capital requirements. However, several other risks are also vital to resilient financial-institution operation, with perhaps the most important of these being liquidity-risk management.

Liquidity risk occurs when an institution funds operations with short-term liabilities, which include not only deposits that can be quickly withdrawn, but also wholesale funding sources such as those readily available in the overnight repurchase-agreement (repo) market. It may seem that liquidity risk is a concern only for the biggest banks, but the GAO has determined that, "Liquidity risk is the risk that the credit union may not be able to meet expenses or cover member withdrawals because of illiquid assets. We found that liquidity risk contributed to 31 of the 85 credit union failures" during the financial crisis.<sup>168</sup>

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<sup>165</sup> Lending Limits, 12 C.F.R. § 32 (2018), available at <https://www.govinfo.gov/content/pkg/CFR-2018-title12-vol1/pdf/CFR-2018-title12-vol1-part32.pdf>.

<sup>166</sup> NCUA Capital Planning and Supervisory Stress Testing, 12 C.F.R. § 702, 83 Fed. Reg. 17901 (April 25, 2018), available at <https://www.govinfo.gov/content/pkg/FR-2018-04-25/pdf/2018-08558.pdf>.

<sup>167</sup> FDIC Annual Stress Test, 12 C.F.R. § 325 Subpt. C (2018), available at <https://www.govinfo.gov/content/pkg/CFR-2018-title12-vol5/pdf/CFR-2018-title12-vol5-part325-subpartC.pdf>.

<sup>168</sup> GAO, "National Credit Union Administration: Earlier Actions Are Needed to Better Address Troubled Credit Unions," *GAO-12-247, op. cit.* at 18.

Bank regulators have taken steps to enhance liquidity-risk management since 2008. These include not only complex rules such as the liquidity coverage ratio now applied to banking organizations with assets over \$50 billion,<sup>169</sup> but also inter-agency guidance in 2010.<sup>170</sup> In all of these bank liquidity standards, “core” deposits are viewed as the most liquid form of funding because deposits such as those backed by federal insurance are unlikely to “run” when a bank or the broader financial system comes under stress. Indeed, federal deposit insurance is likely to lead to core-deposit inflows in concert with an overall market flight to safety. However, these rules carefully segment risky deposits such as “non-operational” ones placed by institutional investors that are subject to run risk. Short-term, wholesale funds such as overnight deposits are also penalized due to these risks.

The NCUA joined the agencies in the 2010 guidance and proceeded in 2013 to finalize its own mandate for liquidity and contingent-funding planning.<sup>171</sup> While it may well be appropriate for the NCUA not to mandate the full panoply of banking-agency liquidity rules due to the smaller size of many credit unions, one credit union (Navy Federal) has over \$103 billion in assets<sup>172</sup> and is thus well above the \$50 billion threshold at which the LCR<sup>173</sup> and other liquidity-risk management requirements<sup>174</sup> currently become applicable. Further, the NCUA has just issued a proposal<sup>175</sup> that would permit credit unions to gather far larger amounts of deposits from non-members. The proposal raises the current twenty percent limit for all federal credit unions on public (i.e., municipal) deposits and deposits from other credit unions to fifty percent; further, it allows LICUs to hold up to fifty percent of deposits from any non-member.

As we have seen, LICUs are not only about half of all credit unions, but also do business with many entities that are not ordinarily understood to be low-income. Thus, the NPR provides not only latitude for all credit unions to increase liquidity risk, but also authority for LICUs to do business with investors or others considered significant run risks under applicable bank regulation.

The NCUA does have a liquidity contingency-planning rule. However it not only allows, but in fact also requires credit unions over \$250 million – i.e., all credit unions but the very smallest – to ensure that they can draw on taxpayer-backed liquidity from the NCUA’s Central Liquidity Facility (CLF) or the Federal Reserve’s discount window.<sup>176</sup> In sharp contrast, bank liquidity planning must include a buffer so that taxpayer facilities such as the Federal Reserve are a last resort.

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<sup>169</sup> OCC, FRB, and FDIC Liquidity Coverage Ratio: Liquidity Risk Management Standards, 12 C.F.R § 50, 249, and 329, 79 Fed. Reg. 61440 (October 10, 2014), available at <https://www.govinfo.gov/content/pkg/FR-2014-10-10/pdf/2014-22520.pdf>.

<sup>170</sup> OCC, FRB, FDIC, Office of Thrift Supervision (OTS), and NCUA, Interagency Policy Statement on Funding and Liquidity Risk Management, 75 Fed. Reg. 13656 (March 22, 2010).

<sup>171</sup> NCUA Liquidity and Contingency Funding Plans, 12 C.F.R. § 741, 78 Fed. Reg. 64879 (October 30, 2013), available at <https://www.govinfo.gov/content/pkg/FR-2013-10-30/pdf/2013-25714.pdf>.

<sup>172</sup> NCUA, “Credit Union and Corporate Call Report Data, Custom Query: Total Assets” (December, 2018), accessed April 8, 2019, available at <https://webapps2.ncua.gov/CustomQuery/CUSelect.aspx>.

<sup>173</sup> OCC, FRB, and FDIC Liquidity Coverage Ratio: Liquidity Risk Management Standards, 12 C.F.R §§ 50, 249, and 329, 79 Fed. Reg. 61440, *op. cit.*

<sup>174</sup> FRB Liquidity Risk-Management Requirements, 12 C.F.R. §252.34 (2018), available at <https://www.govinfo.gov/content/pkg/CFR-2018-title12-vol4/pdf/CFR-2018-title12-vol4-sec252-34.pdf>.

<sup>175</sup> NCUA, “Public Unit and Nonmember Shares Proposed Rule,” May 23, 2019 (yet to be published in Fed. Reg.) (to be codified at 12 C.F.R. § 701), available at <https://www.ncua.gov/files/agenda-items/AG20190523Item3b.pdf>.

<sup>176</sup> NCUA Liquidity and Contingency Funding Plans, 12 C.F.R. § 741, 78 Fed. Reg. 64879, *op. cit.* at 94881.

Another critical risk arises when financial institutions hold large percentages of their loans or other exposures to a single borrower, a single geographic region, or a single economic sector. The S&L crisis is of course the poster child of concentration risk because savings institutions were concentrated in housing-related credit, the same phenomenon that led again to large losses and failures in 2008 in the absence of effective concentration-risk limits. Since then, the Dodd-Frank Act increased the stringency of loan-to-one borrower limits for banking organizations<sup>177</sup> and the banking agencies have adopted single-counterparty credit limits for the largest banks.<sup>178</sup> Small banks are also covered by specific concentration limits in areas such as commercial real estate in which they tend to hold concentrated portfolios.<sup>179</sup>

Concentration risk is also evident in the credit-union sector, as demonstrated by the failures of several credit unions specializing in taxi-medallion lending noted above. The GAO in 2012 found that, “concentration risk contributed to 27 of the 85 credit union failures,” noting for example that one failed credit union had sixty percent of its loans in construction finance.<sup>180</sup> However, the NCUA has no credit-exposure or similar constraints, subsuming these within the still-pending risk-based capital rules. As noted, these may actually create risk-taking incentives within certain capital thresholds instead of directly restricting concentrated exposures.

## V. Conclusion

When the policy debate swirling around credit unions is framed as the extent to which credit unions compete with banks, it is perhaps understandable that policy-makers and politicians stand aside to let private-sector companies battle it out. However, this paper demonstrates that credit unions enjoy ample regulatory-arbitrage advantages that have contributed to charter arbitrage – i.e., credit unions use their lower-cost structure, less stringent regulation, and expansive product powers to transform credit-union charters from mission-driven providers of equality-essential services into for-profit enterprises that are difficult to distinguish from insured depositories without like-kind tax, regulatory, or governance freedom.

This raises public policy questions apart from the competitive-equity debate. It is clear that U.S. economic inequality is an urgent social-welfare problem with far-reaching consequences for individuals, financial institutions, and even the stability of the U.S. financial system. All of the safety-and-soundness standards described above are vital stabilizers and market disciplines when sufficiently stringent and effectively enforced. However, economic inequality on its own is also a proven cause of financial crises and in fact possibly the best predictor of all the possible early warning signs of a great-financial crisis repeat.<sup>181</sup> As a result, credit unions – expressly chartered to enhance equality – may have an even more urgent mission to reach under-served households with provident and productive financial services.

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<sup>177</sup> Dodd-Frank § 622, Pub. L. No. 111-203, 124 Stat. 1376, *op. cit.* at 1632

<sup>178</sup> FRB Single-Counterparty Credit Limits for Bank Holding Companies and Foreign Banking Organizations, 12 C.F.R. §252, 83 Fed. Reg. 38460 (August 6, 2018), available at <https://www.govinfo.gov/content/pkg/FR-2018-08-06/pdf/2018-16133.pdf>.

<sup>179</sup> Real Estate Lending and Appraisals, 12 C.F.R. § 34 Subpt. D, App. A (2018), available at <https://www.govinfo.gov/content/pkg/CFR-2018-title12-vol1/pdf/CFR-2018-title12-vol1-part34-subpartD-appA.pdf>.

<sup>180</sup> GAO, “National Credit Union Administration: Earlier Actions Are Needed to Better Address Troubled Credit Unions,” *GAO-12-247*, *op. cit.* at 18.

<sup>181</sup> Pascal Paul, “Historical Patterns of Inequality and Productivity around Financial Crises,” *Federal Reserve Bank of San Francisco Working Paper 2017-23*, (October, 2018), available at <https://www.frbsf.org/economic-research/files/wp2017-23.pdf>.

The analytics presented here suggest that credit unions are falling short of their statutory mission and operating also under safety-and-soundness standards likely to prove insufficient in the face of even moderate stress. With many believing that the U.S. is at the height of the business and financial-market cycles, these vulnerabilities may pose grave risk not only to credit unions and the taxpayers that continue to back them up, but also to the most vulnerable households for which credit-union profitability advantages are intended.

As demonstrated also in this paper, prior incidents of regulatory and charter arbitrage have not ended well for consumers, customers, investors, the financial system, or the macroeconomy. Policy-makers may thus wish to consider actions that renew credit unions as a truly mission-focused and equality-essential sector of the U.S. financial system. In doing so, it is of course important also to ensure that policy solutions do not undermine business viability – that is, credit unions can only be successful equality-enhancing institutions if they are also viable, profitable, and consumer-responsive financial institutions. Profit need not now obscure mission. Indeed, adherence to mission in ways that ensure a reasonable return to members would power up financial institutions able not only to deserve costly federal benefits such as a tax exemption, but also truly able to advance low-and-moderate income households struggling to enter the middle class or ascend still higher up the economic ladder.

Policy options that may increase mission compliance without undermining charter viability include:

- **Mission Enforcement:** As we have shown, the NCUA’s rulebook is devoid of anything beyond rhetorical nods to the statutory mission clearly demanded by Congress as a condition for credit unions to enjoy numerous benefits and expanded powers. It is in fact impossible even to judge mission compliance by official data since the NCUA has steadfastly rebuffed recommendations from the GAO and others to collect charter-relevant data such as household income or to define “low income” in the generally-accepted way that ensures that the households the NCUA says are those of “modest means” are indeed only low or moderate in comparison to market-relevant income distributions. Banks have long been subject to transparent, standardized data releases relating to their consumer markets as well as to the Community Reinvestment Act’s requirements that LMI households be fully served in concert with safety and soundness. There appear to be no reasons why like-kind requirements could not apply to credit unions, especially those backed by federal deposit insurance and all the other taxpayer backstops detailed in this report.
- **Mission Targeting:** However, like-kind rules for credit unions and banks may not be sufficient to ensure mission compliance given that credit unions enjoy significant benefits not afforded to banks. If credit unions only match banks – which will as noted require an increased commitment – then credit unions still may not adhere to their statutory duty to serve persons of “small means.” An effective way to ensure this would be to income-target credit union customers – that is, to allow credit unions to do retail-banking business only with consumers who fall within geographically-determined income thresholds that accurately measure low-or-moderate income in a timely fashion. Income targeting is a common aspect of many federal programs that provide tax benefits – e.g., the earned-income benefit – and could be considered also for access to taxpayer-advantaged financial services. At the least, low-income credit union charters and resulting benefits could be provided only to credit unions that genuinely serve only low-income persons, households, and communities.
- **Provident/Productive Lending Targets:** While it may be that NCUA permissible-product regulation is within the boundaries specified by law – as courts soon will determine – data provided here



make it clear that many “toy”-oriented lending products and those targeted for commercial firms may put consumers at risk and divert capital from mission-critical lending. It is also clear that, by virtue of the express language of the 1934 Act, the NCUA has authority – not shared by the federal banking agencies – to define product offerings not only by what is safe and sound, but also by what increases household “thrift” through loans that advance long-term prosperity and individual financial security. In the event the NCUA does not stipulate by rule how credit unions are to comply with this additional aspect of their charters, then Congress may wish to do so with an eye not only to traditional deposit and loan products, but also to retirement advice, asset safeguards, and emerging technology product options.

- **Profit Enhancement:** As noted, many credit unions are very small and these tend to be the institutions best suited to adhere to meaningful common-bond constraints and thus to provide credit not otherwise available from more broadly-focused financial institutions. Profit challenges confront these institutions much as they confront community banks due to the difficulties of achieving economies of scale/scope and/or of developing new technology for small customer bases and for small-denomination loans. One way to enhance equality-essential finance is to facilitate economies of scale and scope by providing unique charters to credit unions or other entities that undertake activities such as product development, loan aggregation, warehouse financing, and compliance advice. The corporate credit union charter might be one such viable backstop for small credit unions if more carefully defined and effectively regulated; should this not be viable, then Congress may wish to consider creating the equivalent of regulated “bankers’ banks” for federal credit unions.
- **Safety and Soundness:** All of these progressive, charter-focused improvements may have no long-term benefit and indeed could backfire if the credit unions governed by them are vulnerable to credit, liquidity, concentration, and other market stress. Congress has in critical instances (e.g., the risk-based capital rules) sought to ensure parity for prudential purposes between credit unions and banks. Regulatory-arbitrage opportunities have competitiveness consequences of concern to Congress, but they also have financial-stability impact that may undermine household financial security and slow economic growth. NCUA safety-and-soundness regulation may thus warrant reconsideration to ensure that credit-union management – not members or taxpayers – are responsible and accountable for effective internal controls, disciplined earnings objectives, and mission compliance.