

CUNA's Response to Objections to Raising the Credit Union Member Business Loan Cap

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Banking trade associations object to the expansion of credit union business lending authority. This paper provides a summary of the objections made by those opposed to lifting the business lending cap, and outlines responses to those claims.

By way of background, as of December 2009, credit unions held \$36 billion in loans to small businesses. This represents 4.5% of all small business loans at depository institutions.¹ Were a doubling of the business lending cap at credit unions to eventually lead to a doubling of credit union business lending, that would leave at least 91% of the market to banking institutions. To the extent the additional credit union loans were made to borrowers whose credit demands would not have been met by banking institutions, the reduction in the banks' share would be less.

Most credit unions are currently under a business lending cap of 12.25% of assets, established by law in 1998. Prior to that date, there was no business lending cap at credit unions. Although the majority of credit union lending has always been in loans to consumers, credit unions have engaged in business lending since their inception in the US in 1908. The cap is expressed as 1.75 times net worth, but only net worth up to the level required to be well-capitalized (7%) can be counted. Thus, credit unions with excess capital are not permitted to hold additional business loans. Approximately 100 business lending credit unions were grandfathered because they exceeded the cap at the time of its imposition.

Banker Claim: Raising the cap would undermine credit union safety & soundness.

Facts: Credit unions have a long history of engaging in safe and sound business lending. Business lending at credit unions is much safer than at other institutions. According to data collected by NCUA and FDIC:

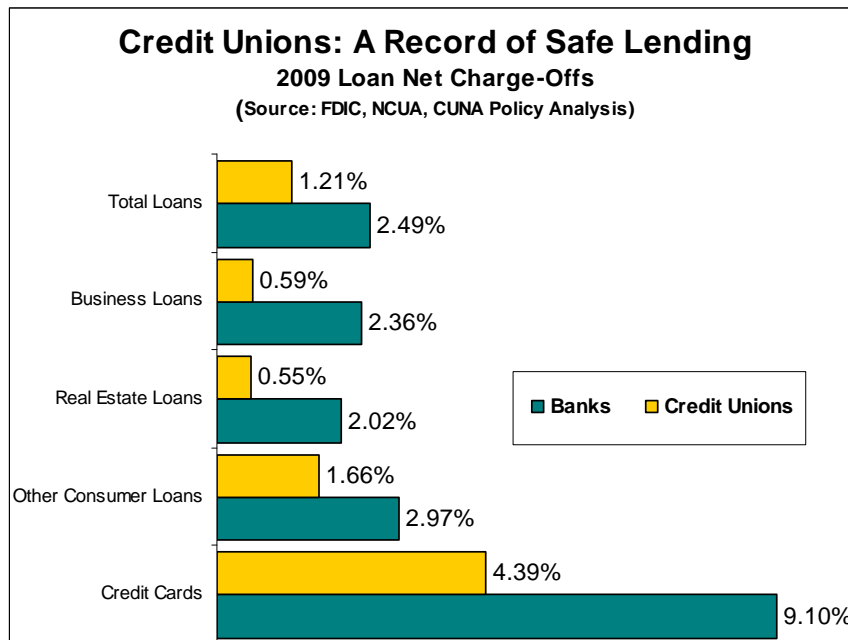
- Credit union member business loan net charge-off rates have been significantly lower than bank rates year-in and year-out for over a decade. Since 1997, credit union member business loan net charge-off rates have averaged 0.15%, a figure that is roughly **one-sixth** the 0.82% bank average over the same period.²

¹ NCUA Call Reports and FDIC Statistics on Depository Institutions.

² Ibid.

- More recently, the financial crisis and recession have increased losses at all lenders. However, the increase in loss rates at credit unions pales in comparison to bank results. During 2009, credit unions charged off business loans at a 0.59% rate – about one-fourth the 2.36% rate reported by banks over the same period.³
- Compared to other loans at credit unions, business loan net charge-off rates are lower than net charge-off rates on credit union consumer loans and essentially identical to the net charge-off rates in credit union real estate loan portfolios.⁴

As shown in the following graph, relatively low charge-offs are NOT confined to credit union business lending portfolios. Credit union net charge-offs are substantially lower than bank net charge-offs in each loan category. This lower loss experience at credit unions is the result of their operation under a cooperative structure, which provides much lower incentives to take on risk than a for-profit structure.⁵



Further, most credit unions have excess liquidity today which is depressing their overall earnings. Moving assets from low-yielding investments into higher-yielding member business loans, even after accounting for credit losses on those loans, will increase credit union earnings, capital contributions, and overall safety and soundness.

³ Ibid.

⁴ NCUA Call Reports.

⁵ Edward J. Kane and Robert J. Hendershott, *The Federal Deposit Insurance Fund that Didn't Put a Bite on U.S. Taxpayers*, *Journal of Banking and Finance*, 20(September, 1996), pp. 1305-1327. Kane and Hendershott describe how the cooperative structure of credit unions presents credit union decision makers with incentives that are strikingly different from those faced by a for-profit financial institution, making it less feasible for credit union managers to benefit from high-risk strategies.

Finally, the credit union regulator, the National Credit Union Association (NCUA), has full authority to supervise credit union business lending. That regulation is no doubt an important reason behind the very low loss rates experienced on credit union business loans over the past decade. Recently, NCUA Chairman Matz emphasized in a February 24, 2010 letter to Treasury Secretary Geithner⁶: “If legislative changes increase or eliminate the aggregate MBL cap, NCUA would promptly revise our regulation to ensure that additional capacity in the credit union system would not result in unintended safety and soundness concerns.”

Banker Claim: Raising the cap would not create jobs or reduce unemployment. However, even if it did do so, the CUNA-produced estimate of job creation is too high.

Facts: Relaxation of artificial statutory lending restrictions will increase the efficiency of capital allocation in the economy. This will promote more lending, more spending, more job creation and higher economic growth. Recent bank business loan contraction suggests that, at least to some degree, credit unions will be making loans that banks are not making.

CUNA estimates that raising the business lending cap would allow credit unions to increase business lending by up to \$10 billion in the first year after the cap is lifted. This estimate is based on three conservative assumptions, and is described below:

1. We assume that “grandfathered” credit unions (i.e., the approximately 100 credit unions that are currently above the 12.25% cap) do not increase their lending when the cap is raised.
2. We assume that credit unions that are not currently engaged in business lending would enter the market in an amount equal to 1% of total assets on average under the new authority. We further assume that only 40% of the increased activity would occur in the first year.
3. We assume that all other business lending credit unions lend in an amount equal to their current “use” rate, i.e., all non-grandfathered current business lending credit unions would eventually just over double their business lending. Our conservative estimate assumes that only 40% of the increased lending would occur in the first year.

Applying these assumptions produces an estimate of a \$10.8 billion first-year increase in lending, which we have rounded down to \$10 billion. That would represent an approximately 30% increase in credit union business lending. This is certainly plausible considering that credit union business loan portfolios increased by 30% or more in four of the past eight years. That growth has slowed recently as an increasing number of credit unions have begun to approach their caps.

⁶ http://www.ncua.gov/news/press_releases/2010/MA10-0225MatzLending.pdf

Because bank business loan portfolios are shrinking we assume that the new loans would largely be loans that would not otherwise be made by banks. We further assume that the \$10 billion increase in lending would be a "new normal" - that the first-year addition would represent a permanent addition to loan volume in credit union portfolios. In this regard, the increase in lending can be viewed as ARRA-like stimulus similar to direct spending. Thus, we assume that the additional lending would produce jobs at a rate that is similar to the estimates published by the Council of Economic Advisors (CEA) in its May 2009 estimates of job creation.⁷

Using these assumptions and rounding, each \$92,000 in additional MBL lending on the part of the nation's credit unions will create one additional job. Therefore expanded credit union MBL authority will result in an estimated first-year increase of 108,000 new jobs nationally.

Banker Claim: There is no evidence to support the contention that credit for small businesses is in short supply, as community banks have been lending to small businesses in their communities throughout the economic crisis.

Facts: There is no doubt that there has been a reduction in the demand for business credit as a result of the recession. However, there is also considerable evidence that a significant contraction in the supply of business credit has contributed to the reduction in credit outstanding.

In a very recent study, the NFIB reported that only . . . “Forty (40) percent of small business owners attempting to borrow in 2009 had all of their credit needs met. . . The current level of borrowing success is significantly lower than in the mid-2000s when up to 90 percent had their most recent credit request approved.”⁸ As the NFIB points out, for many businesses, the recessionary lack of sales is a more basic problem than lack of access to credit, but their findings are strong evidence that low credit availability is exacerbating the effects of the recession.

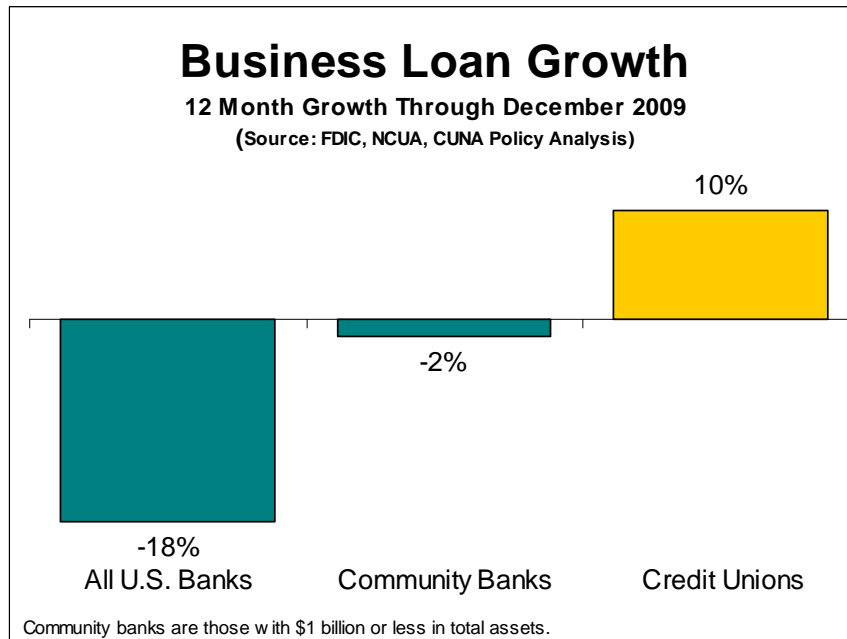
Not surprisingly, a large number of small business owners are telling policy makers that they are being turned away by their banks. That is the primary reason that Congress has held several hearings on this subject (most recently on February 26, 2010).

Moreover, recent data from financial institution regulatory reports supports this view. Call Report data suggests that banks – both large and small – are turning away many business borrowers. As shown in the following graph, bank business loan portfolios are shrinking, while credit union business loan portfolios are growing. If indeed the

⁷ See: <http://www.whitehouse.gov/administration/eop/cea/Estimate-of-Job-Creation/>. Note: Use of Small Business Administration survey data would produce a much larger estimate of job creation. Since CUNA's aim was to produce a conservative estimate we chose not to use the SBA job creation data.

⁸ William J. Dennis, Jr. *Small Business Credit in a Deep Recession*, NFIB Research Foundation, February 2010, p 1. Available at www.nfib.com/Portals/0/PDF/AllUsers/research/studies/Small-Business-Credit-In-a-Deep-Recession-February-2010-NFIB.pdf

contraction in business credit outstanding were due solely to reduced demand, credit union lending would have declined as it did at banks, rather than registering a 10% increase in 2009.



Allowing credit unions to extend loans to businesses that need credit will add fuel to a self-sustaining economic expansion. Increasing competition in the small business loan market will increase the efficiency of capital allocation. Businesses will choose credit union loans over community bank loans only if credit unions provide a product that provides an overall better value. And credit union competition will ensure that banks are treating their small business customers more fairly.

Banker Claim: Raising the cap is unnecessary because relatively few credit unions are now near the 12.25% member business lending cap.

Facts: For the past several years, business loans have been the fastest growing component of credit union lending (the other two sectors being residential mortgage loans and non-residential consumer loans.) From 2000 to 2009, business loans at credit unions grew at an annual rate of 25.1%, over three times faster than the 7.4% annual growth rate of all credit union loans.

However, that growth is now slowing as more and more credit unions approach their caps. The closer a credit union gets to its cap, the less accommodative it can be in granting business loans. As of December, 2009 the following conditions held with respect to credit union proximity to the cap (excluding grandfathered credit unions):

- 174 credit unions, with \$8.8 billion in business loans outstanding, had business loans of more than 10% of assets. These credit unions are essentially capped;

they are either at the cap or will be there within a little more than a year or less. In the three years ending December 2009, their business loans outstanding rose by \$4.5 billion. They will be able to contribute very little to future business loan growth without an increase in the cap.

- Another 163 credit unions hold business loans between 7.5% and 10% of assets. Most of these credit unions will be capped within three years. They held \$5.6 billion in business loans at year-end 2009, and their business loans grew by \$1.9 billion over the preceding three years. Their business lending will have to slow dramatically in the coming few years without an increase in the cap.

Taken together these nearly 350 credit unions account for approximately 60% of all business loans subject to the 12.25% cap. These credit unions have been the major contributors to credit union business loan growth over the past few years. Over the next few years, their business loan growth will dry up without an increase in the cap.

Finally, the cap also has a chilling effect on credit union entry into the business lending arena: For many credit unions even capped portfolios are not large enough to justify the sizeable up-front investment necessary provide this service.

Banker Claim: Raising the cap is undesirable because member business lending is incompatible with credit unions' statutory mission of serving only consumers.

Facts: Credit unions have been making business loans since their inception in the early 1900's. In the first 90 years of their existence, there was no business lending cap at credit unions. The current 12.25% of assets cap was an arbitrary limit imposed by Congress in the Credit Union Membership Access Act in 1998 (CUMAA).

The credit union tax exemption arises from their unique structure as not-for-profit, democratically-controlled cooperatives – and that structure is unchanged over the past 100 years. The tax exemption has absolutely nothing to do with the breadth or volume of credit union product and service offerings – a fact clearly spelled-out by Congress in CUMAA.

Banker Claim: Raising the cap is undesirable because increased member business lending will force credit unions to reduce their lending to consumers.

Facts: The average loan-to-asset ratio at credit unions that offer business loans is 69%. Accounting for the roughly 5% of assets in fixed and other assets, that leaves about 26% of assets in cash and investments. If an additional 12% of assets were eventually devoted to business lending as a result of lifting the cap, credit unions could fund the increase almost exclusively out of investment holdings.

Banker Claim: Tax-subsidized institutions like credit unions should not be granted expansion of powers – this is especially true now because the credit union tax subsidy is contributing to the national debt during a time of extreme budgetary pressure.

Facts: Having credit unions pay federal income taxes will have no discernable effect on the federal budget deficit. The Administration's current estimate of the value of the credit union tax exemption was \$650 million in 2009, whereas the federal budget deficit was over \$1.4 trillion in 2009.

Because credit union taxation would have an indiscernible effect on the deficit it would have no impact on interest rates in the economy. With no effect on interest rates, borrowing, spending, job creation and economic activity would be unaffected. However, credit union small business lending does in fact produce greater capital expenditures, greater economic activity and ultimately more job creation. The multiplier effect means that these new jobs lead to new spending which then sets in motion support to a self-sustaining economic recovery.

Banker Claim: Raising the cap will harm community banks.

Facts: As of December 2009, credit unions held a total of \$36 billion in loans to small businesses. This represents 4.5% of all small business loans at depository institutions. It took credit unions 100 years to reach this share of market. Even if credit unions were to double their market share in the future that would still leave banks with an overwhelming 91% share.

The Treasury Department has found that credit unions do not have a competitive advantage over banks, and that credit union business lending does not harm community banks. In a 2001 report on credit union business lending, the Treasury Department concludes:

Credit unions have advantages over other depository institutions in that some receive sponsor subsidies, while all are exempt from the federal corporate income tax. However, credit unions do face certain constraints, in the form of limitations on the eligibility to receive such loans and on the loans themselves, that banks and thrifts do not have. Overall, we cannot discern whether credit unions have a competitive advantage.⁹

and,

Overall, credit unions are not a threat to the viability and profitability of other insured depository institutions.¹⁰

These Treasury conclusions were admittedly based on the existence of a 12.25% cap and a lower level of credit union business lending than pertains today. However, as mentioned above, doubling current credit union business lending would still leave over 90% of the market to banks. Under those circumstances, it is unlikely that Treasury would need to dramatically alter its conclusions.

⁹ United States Department of the Treasury, *Credit Union Member Business Lending*, January 2001. p 5.

¹⁰ Ibid. p.5.

Banker Claim: Pursuit of expanded commercial lending powers calls into question the credit union industry's commitment and ability to serve the needs of lower-income and un-banked populations.

Facts: It is true that part of the credit union mission is to serve those of modest means. It also is true that many modest means individuals run small businesses and need credit. This is especially true in economic downturns because unemployed and discouraged job seekers are more likely to form businesses during these events. Treasury's 2001 comprehensive analysis of credit union business lending showed that credit unions do a very good job of serving the business credit needs of low and moderate income business owners. Treasury found that 25 percent of member business loans were made to members with household income of less than \$30,000 -- and that these loans totaled 13 percent of the outstanding member business lending balances. Another 20 percent of the loans (with 15 percent of the outstanding loan balance) went to households with incomes reported to be between \$30,000 and \$50,000.¹¹

Beyond business lending, credit unions do an outstanding job of serving those of modest means. For instance, Home Mortgage Disclosure Act (HMDA) data – the primary data source in CRA examinations - clearly and consistently show that compared to banks, credit unions make a greater percentage of their loans to lower income individuals. HMDA data also reveal that lower income households are substantially more likely to be approved for loans at credit unions and substantially less likely to be denied a loan at credit unions.

For example, analysis of HMDA data shows that, since 2005, credit unions have approved an average of 68% of applications from low/mod income borrowers, whereas other lenders approved an average of only 51% of these applications. Moreover, since 2005, an average of 26% of total credit union mortgage originations were to low/mod income borrowers while low/mod income originations represented only 23% of total originations at other lenders.

It is worth noting that credit unions have repeatedly attempted to reach out to serve more individuals in lower-income households. However, bankers have used the courts to bar those efforts. This tactic of claiming that credit unions are not “doing enough” on the one hand while simultaneously erecting obstacles to the provision of credit union service does nothing to help these communities.

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¹¹ Ibid. p. 3.